



LATVIJAS BANKA
EIROSISTĒMA

LATVIJAS BANKA: ANNUAL REPORT 2017



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ABBREVIATIONS

ABSPP	asset-backed securities purchase programme
BIS	Bank for International Settlements
CBPP3	third covered bond purchase programme
CSB	Central Statistical Bureau of Latvia
CSPP	corporate sector purchase programme
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EEA	European Economic Area
EFC	Economic and Financial Committee
EKS	Electronic Clearing System of Latvijas Banka
ESCB	European System of Central Banks
ESRB	European Systemic Risk Board
EU	European Union
EURIBOR	Euro Interbank Offered Rate
Eurostat	Statistical Bureau of the EU
expanded APP	expanded asset purchase programme
FCMC	Financial and Capital Market Commission
FRS	US Federal Reserve System
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
JSC	joint stock company
Ltd.	limited liability company
LTRO	longer-term refinancing operations
M1	narrow monetary aggregate
M2	intermediate monetary aggregate
M3	broad monetary aggregate
MFI	monetary financial institution
NCB	national central bank
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
PIT	personal income tax
PSPP	public sector purchase programme
SDR	Special Drawing Rights
SEPA	Single Euro Payments Area
SSM	Single Supervisory Mechanism
TLTRO	targeted longer-term refinancing operations
UK	United Kingdom
US	United States of America
VAT	Value Added Tax



Global economic growth accelerated in 2017; moreover, higher rates were reported by most global economies. Growth was supported by the availability of financing ensured by the accommodative monetary policies pursued by the central banks as well as the recovery in global trade.

This was a particularly successful year for the euro area: its GDP growth exceeded the forecasts, reaching the highest peak of the last decade at 2.5%. With consumer and business confidence indicators climbing to a record-high, consumption and investment increased. Against the backdrop of the strong growth, labour market conditions also continued to improve, with unemployment shrinking further in all euro area countries. Labour demand continued to grow and the number of employed reached an all-time high. The accommodative monetary policy implemented by the Eurosystem played a significant role in supporting growth and contributed positively to lending development. There is more confidence that inflation is approaching its target, i.e. the price rise that is below but close to 2% in the medium term, but uncertainty still remains.

In 2017, Latvia reported the strongest economic growth of the last six years, with its GDP increasing by 5.0%. This was achieved on account of the strengthening of external demand and the recovery of investment activity, with both private and EU funds related investment on the rise. Favourable labour market conditions for employees stimulated private consumption; at the same time, the labour market developments also signalled potential future problems. The progressive tightening of the labour market and the associated acceleration of wage growth reduced the potential for cost competitiveness. The gap between productivity and wage growth widened slightly in 2017, yet Latvia's global export market shares remained stable. In order to sustain Latvia's competitiveness, further investment in both physical and human capital will be required.

In an environment of robust growth and low interest rates, both Latvia and the entire euro area should pursue economic policies aimed at improving their economic potential for ensuring sustainable long-term development. Building up reserves and savings during the above period is essential, particularly considering that interest rates will not stay low forever. Moreover, structural reforms to increase economic flexibility and maintain competitiveness must continue.

Globally competitive education is the cornerstone of long-term growth and stability. With that in mind, Latvijas Banka came up with its vision of the factors affecting the quality of education and its opportunities. Rising labour costs could serve as an incentive to

increase investment in technologies allowing to achieve higher labour productivity. At the same time, an investment-friendly environment, including a stable tax policy aimed at promoting economic growth, business competitiveness and household well-being, is essential. These were the key principles incorporated by Latvijas Banka in its tax strategy proposal and used in discussions about the required changes in the national tax policy framework.

Latvia's economic growth can be expected to remain solid also in 2018 against the background of positive global economic developments and continued investment inflows.

Latvijas Banka implemented several major projects in 2017. Instant interbank payments, the completion of significant securities market projects, the establishment of a Baltic regional cash processing centre – these are but a few of the initiatives with a significant effect on the financial sector and overall economy.

Innovative financial market products are bound to become a part of the daily lives of every resident of Latvia in the coming years, and the state-of-the-art interbank payment infrastructure maintained by the national central bank has a major role to play in this respect. Latvia was the first euro area country to introduce instant payments, i.e. interbank payments executed within a matter of seconds 24/7/365. Cash transfers between credit institutions taking days, hours, even minutes on business days and within business hours only will soon become a chapter of history closed for good.

Two significant projects were implemented on the securities market in cooperation with other financial market participants. Latvia joined the TARGET2-Securities (T2S) platform created by the Eurosystem. It enables the provision of harmonised and standardised securities and cash settlement services to the European central securities depositories and their customers in an integrated technical environment in the delivery versus payment mode. Latvijas Banka invested considerable effort in order to ensure that Latvia became to country where Nasdaq CSD SE, the central securities depository of all three Baltic States, was successfully launched. Nasdaq CSD SE has been assessed as fully eligible for use in the Eurosystem's monetary policy operations.

Considerable work has been accomplished in the field of cash processing. A Baltic regional cash processing centre started operating at Latvijas Banka and handled approximately 140 million banknotes and 40 million coins in 2017.

Taking account of the interests of households and businesses, work continued towards reducing the duration of the currency authentication process at the national currency authentication centre established by Latvijas Banka and operating since 1 July 2016. Earlier, the testing of suspicious banknotes and coins could take up to one and a half months, whereas now the experts of Latvijas Banka are able to complete it in one week.

One of the most significant initiatives in 2017 was Latvijas Banka's participation in drafting proposals for improving the state-funded pension scheme. Changes to the pension funds' legal framework were made in order to balance the interests of managers and investors, and the reduction of the pension funds' management fees allowed saving at least 20 million euro a year, with each participant of the second pillar of the pension scheme saving approximately 16 euro.

In the time period between the end of 2017 and the approval of Latvijas Banka's Annual Report 2017, significant changes affected the work of Latvijas Banka's senior management. As of 19 February 2018, a prohibition to engage in any activities relating to the functions of decision-making, control and supervision at Latvijas Banka was imposed on Ilmārs Rimšēvičs, Governor of Latvijas Banka. The management of Latvijas Banka is confident that the above factor affects neither the financial position and financial performance results of Latvijas Banka nor Latvijas Banka's professional capability to perform its tasks.

This development had no effect on the everyday work of Latvijas Banka and individuals and businesses continue to enjoy the traditional services provided by the national central bank. Its infrastructure ensures smooth and safe interbank payments (including instant payments), clean and high quality cash currency is in circulation, the Credit Register provides timely information on existing and past liabilities of individuals.

A maximum fast investigation and resolution of the situation is certainly required. At the same time, it is important to stress that Latvijas Banka maintains its legal capacity even in the absence of its Governor, the decision-making is ensured by the Council of Latvijas Banka, whereas its operation is managed by the Board of Latvijas Banka. Each and every employee of Latvijas Banka is highly professional in the discharge of his or her duties.

I would like to express my gratitude to all employees of Latvijas Banka for their professional accomplishments in 2017 and would like to encourage them to continue with initiatives that are important for the financial market at large as well as for all individuals and businesses.

A handwritten signature in blue ink, appearing to read 'Z. Razmusa', with a long horizontal flourish extending to the right.

Z. Razmusa
Deputy Governor of Latvijas Banka
Riga, 9 April 2018

STATEMENT OF VISION, MISSION AND VALUES OF LATVIJAS BANKA

VISION OF LATVIJAS BANKA

Latvijas Banka is a participant of the Eurosystem and a full-fledged member of the European System of Central Banks. It makes a significant contribution to stable and sustainable economic development of Latvia and the euro area. Latvijas Banka is an independent entity that carries out its tasks for public benefit and with a high sense of professional responsibility. Latvijas Banka is a reliable cooperation partner and the economic competence centre in Latvia.

MISSION OF LATVIJAS BANKA

The primary operational objective of Latvijas Banka as the central bank and a participant of the Eurosystem is the maintenance of price stability to promote long-term economic growth.

Latvijas Banka performs the tasks entrusted to it in a professional and continuous manner, ensuring high-quality work and efficiency.

Latvijas Banka contributes to the general public's knowledge of economics and is an active participant of the Eurosystem.

VALUES

Our values reflect our attitude towards work, colleagues and society.

Competence:

- we have in-depth knowledge and excellent skills;
- we learn from best practices of others and serve as a model to others;
- we are committed to finding quality and effective solutions.

Credibility:

- we work for public benefit, and we are interested in public opinion;
- we act in a responsible and predictable manner;
- our operations and activities are transparent – we act openly and explain our action.

Cooperation:

- we work as a team;
- we are responsive and open to new ideas;
- we listen to recommendations and maintain good long-term partnerships;
- we are result-oriented.



GLOBAL ECONOMIC DEVELOPMENTS

In 2017, the global economic activity was notably gathering speed; moreover, a pickup in the economic growth momentum was observed in advanced economies and developing countries alike. Particularly strong growth rates were observed in the second half of the year when the earlier forecasts were beaten in the majority of European countries, the US, Japan, a number of other developed countries as well as in China, Brazil and elsewhere.

Given the increasing economic activity and essentially improving outlook for global growth, the oil prices elevated and pushed up inflation in the second half of 2017. However, despite the rising level of headline inflation, excluding its more volatile components, oil and food among them, the price rise pressure remained weak, particularly in the developed countries.

The world leading central banks continued their favourable financing strategies notwithstanding the recent domination of divergent monetary policies. With the central banks of the EU countries and the Bank of Japan keeping to their accommodative monetary policies, the Bank of England and the FRS implemented a gradual monetary policy normalisation process.

Global growth continued to strengthen in 2017

Global economic growth continued to strengthen in 2017. An ever growing number of countries experienced higher growth rates. The development of advanced countries had become more robust. While investment growth accelerated, private consumption still acted as the main driver of progress. Investment grew on account of the recovering global trade and improving business and consumer sentiments. Labour market conditions were likewise on an upswing, with jobs increasing and unemployment receding. Though labour market slack (spare capacity) was rebounding, it had not translated into a broad-based wage growth. Accommodative monetary policies underpinned the growth in advanced economies and ensured access to financial resources for businesses and households.

Overall US economic growth data in 2017 were positive, yet the damages and industrial disruptions resulting from hurricanes in the third quarter caused some slight revisions, which albeit were unlikely to have a long-lasting economic effect. Given the optimistic economic indicators, the FRS raised the benchmark interest rate three times within 2017 (to 1.25%–1.5%). A programme of gradually reducing the central bank's balance sheet was discussed at September meeting and launched in October 2017; under it reinvestment of principal payments in government debt securities and mortgage backed securities was decreased.

The pace of economic growth was more sluggish in the UK than in other advanced countries in 2017. Uncertainty related to the UK's exit from the EU weighed down on the country's economy. The incurred circumstances point to the need of a transition period for the UK to shape a new partnership with the EU and other external partners. As over the year inflation kept on climbing and exceeded the target set by the Bank of England, the latter raised interest rates to 0.5%, at the same time leaving the quantitative easing (asset purchase) programme unchanged (435 billion and 10 billion British pound sterling). Inflation rose, driven by the prices of imported goods which hiked faster due to the weakening of the British pound sterling after the UK's referendum on the EU membership.

Japan's GDP had been on an upswing for the last eight quarters in the run, a unique phenomenon of the last ten years. Despite the favourable developments in export related sectors, private consumption remained weak in Japan. And even though the country's economic situation improved, the Bank of Japan held to its accommodative monetary policy stance. In 2017, it retained the existing short-term policy interest rate, the target level of 10-year government bond yields and the annual pace of increase of the monetary

base unchanged, at -0.1%, 0%, and 80 trillion Japanese yen or around 608 billion euro respectively.

In developing countries, the economic growth was facilitated by accelerating progress in advanced economies and the recovery of global trade. Commodity (oil in particular) price hikes gave an additional impetus to commodity exporting countries. Growth was also boosted by stronger consumption and investment as well as ever rising business confidence. Oil price hikes delivered recovery opportunities in Russia and Brazil where growth rates were negative in 2016. Due to stronger global trade buoyancy and significant capital inflows, growth revived also in other developing countries, specifically in China and India.

Commodity price hikes underpinned global inflation hikes

Inflation remained at a low level in most advanced countries in 2017, yet hikes in energy prices supported a general price rise. Oil price trends remained the same as in 2016; characterised by certain volatility, prices kept going up. As in the first half of the year, the US oil production continued to expand, oil prices decreased and were bottoming out in mid-summer to demonstrate a sharp upswing afterwards when at the end of the year Brent crude oil quotes were 17.7% higher than at the beginning of the year (66.87 US dollars per barrel). Oil prices began to augment in the second half of the year due to a more dynamic global economic advance than expected and also stronger demand. A positive impact on oil prices came also from other factors, among them weaker US dollar, aggravation in the Middle East, and the OPEC agreement with Russia on oil production cuts also in 2018 reached towards end-November.

The price of gold picked up 12% at the end of 2017, standing at 1 314 US dollars per troy ounce. A change in the price of gold was primarily caused by depreciation of the US dollar and rising inflation expectations.

Consolidation of economic growth and divergence of monetary policy affected financial market volatility

Appreciation of the euro against the US dollar was spurred by economic improvements along with easing political uncertainty in the euro area. Interest rates in the US were above those in the euro area; the FRS raised the benchmark interest rate interval on three occasions within one year; meanwhile, financial markets anticipated an even more accelerated economic advance in the US. In 2017 overall, the euro appreciated against the US dollar by 14.1% (from 1.0517 at the end of 2016 to 1.2005 at the end of 2017).

Fluctuations in the value of the British pound sterling in 2017 were primarily determined by the UK-EU negotiations about the former's exit from the EU. Over the year, the euro appreciated against the British pound sterling by 4.1% (from 0.8535 at the end of 2016 to 0.8880 at the end of 2017). As against the Japanese yen, the euro appreciated by 10.0% (from 122.97 at the end of 2016 to 135.28 at the end of 2017). The nominal effective euro rate increased by 5.43% in 2017.

Even though the FRS and the Bank of England raised their base rates, the average weighted yields on the respective 10-year government bonds declined by 4 basis points and 5 basis points, at the end of the year standing at 2.41% and 1.19% respectively. The factors supporting decreased yields in the US are related to lower expectations of long-term inflation, expectations of the FRS changing the base rates, and the strong demand for investors. In the UK, on the other hand, they remained at a low level due to the terms-of-the-exit-related uncertainty, which might have an essential impact on the UK growth prospects and opportunities. The euro area bond markets showed a mixed picture: some countries managed to lift their credit ratings up, hence the yields dropped, while in the majority of states, Germany including, yields on debt securities increased on the back of the ECB announcement in autumn 2017 on reduced asset purchases in 2018 and

generally better-than-expected economic performance in the euro area. Over the year, the weighted average yield on the German 10-year government bonds picked up 22 basis points, to stand at 0.42% at the end of the year. At the same time, the respective yields on their French counterparts increased by 10 basis points, to stand at 0.78% at the end of the year. The more sluggish rise of the latter was determined by the waning uncertainty after Emmanuel Macron's victory in the presidential election in France. Similar to Germany, the growth in yields on 10-year government bonds in Italy and Spain was more dynamic in 2017 (19 basis point and 18 basis point increase respectively). The politically insecure situation in these two countries (Catalonian events in Spain and the upcoming (in 2018) general election in Italy) exerted additional upward pressures on government bond yields.

In 2017, the US stock market reached record high levels. Amidst further economic growth and ever improving US macroeconomic indicators, the stock market also developed dynamically, with investors anticipating higher stock company yields. S&P 500 and Dow Jones indices went up by 19.4% and 25.1% respectively. The pace at which the US bank stock price index increased (by 20.0%) was slightly faster than that of S&P 500. Due to better macroeconomic indicators, financial market trends in the euro area were also positive. Thus, for instance, EURO STOXX 600 picked up 7.7%, and EURO STOXX bank index, increasing by 10.9%, managed to outpace all other market indices. Although the UK's FTSE 100 increased by 7.6%, and the bank index gained 11.6%; the attainment of higher indicators was hindered by still impressive uncertainty ruling negotiations on the UK leaving the EU. Such indices as Japan's Nikkei 225, China's stock market index and MSCI EM of developing countries grew by 19.1%, 6.6% and 34.5% respectively. The developing countries' MSCI EM rose so dynamically on account of the falling US dollar and stronger external demand (i.e. economic advance of industrial countries).

EURO AREA ECONOMY AND EUROSISTEM'S MONETARY POLICY

Euro area economy was supported by favourable financial conditions and global growth

In 2017, the euro area economy grew at the fastest pace in the last 10 years. Growth accelerated notably across all euro area member states and was driven by Eurosystem's accommodative monetary policy, global progress and boosting international trade. Given the record high level of business and consumer sentiment indicators, consumption and investment swelled. Due to euro area export expansion amidst the rising global trade activity, the contribution of net exports to GDP growth was positive. The euro area GDP growth amounted to 2.3% (working day unadjusted data), which is not only a substantial improvement vis-à-vis 2016 (an increase of 1.8%) but also an excess over average growth¹ in the pre-crisis period.

Private consumption, which over the year expanded by 1.6%, made a marked contribution of 0.9 percentage point to GDP annual growth also in 2017. Private consumption was spurred by low interest rates and incomes rising on account of cardinally improved labour market situation. The improving employment rather than higher wages was the main driver of higher incomes, since the wage growth, though gaining some momentum, was not broadly based. In the euro area overall, consumer sentiment indicators continued to improve and, towards the close of the year, stabilised at the highest level by historical standards.

Investing in the euro area accelerated

A surge in investment was backed by the favourable financing conditions, robust domestic and external demand, higher corporate profits and better, in historical terms,

¹ The average growth rate in the euro area in 1999–2007 was 2.2%.

business confidence indicators. Investment in machinery and equipment, responsible for a half of the overall investment growth in 2017, was the primary driver of this surge; investment in buildings and structures also expanded, while investment in intellectual property contracted. Despite cardinal investment growth divergences across different countries¹, in the largest euro area participants investment grew, thus allowing to expect robust economic development also in the future. With a new EU Structural and Cohesion Fund programming period setting in, the accelerated acquisition of funding substantially increased investment flows in the new EU Member States.

Together with the healthy domestic demand the external demand supported growth in the euro area. The recovery of global economy boosted the dynamic growth of exports. Exports from euro area countries to non-euro area countries posted a 4.9% pickup, while imports from latter countries increased by 4.4%.

According to the EC estimates, such more dynamic economic development has enabled governments of the euro area countries to cut their budget deficits to an overall 1.1% of GDP. Despite the fact that fiscal policy stances are not always assessed as countercyclical, the reduction of budget deficit is an instrument to constrain the risk associated with sovereign debt. However, the fiscal situation varies notably among countries. Thus, for instance, over the period of three previous years the German government had already ensured a budget surplus, while France was only projecting to cut its budget deficit to 2.9% of GDP in 2017.

Unemployment continued to decline

The labour market continued on an upward trend in 2017. Employment kept on expanding (by 1.6% over the year). In the fourth quarter, the number of employed reached 156.7 million and a historical high, by 2.3 million employed exceeding the figure in early 2008.

Given the increase in the number of jobs, the unemployment rate declined to the level recorded at the end of 2008, standing at 8.6% in December of 2017. Similarly, unemployment decreases were characteristic across the entire euro area, yet their level divergences across countries remained significant. In December 2017, Germany recorded the lowest unemployment rate (3.6%), while Greece excelled at having the highest one (20.8%). Spain was another country with a diminishing yet still elevated unemployment rate (16.4%).

As the number of job seekers was shrinking progressively, the end of 2017 saw a steep rise in the number of businesses hit by work force shortages; however, this labour market tightness had not yet translated into more pronounced wage dynamics. In the fourth quarter of 2017, remuneration in the euro area increased by 1.9% year-on-year.

The still slow wage rise did not deliver sufficiently strong upward pressure on inflation

Despite the vigorous economic development, inflation lacked a sustainable growth trend. Against 2016, inflation surged, yet the move was mainly observed at the beginning of 2017 and in the second half of the year it became stable.

The average annual inflation of 2017 amounted to 1.5% vis-à-vis 0.2% in 2016. In comparison with 2016, its elevation was significantly driven by rising energy and food prices. Energy price hikes accounted for 0.5 percentage point and those of food prices for 0.4 percentage point of the average annual inflation.

Core inflation (calculated excluding the influence from volatile food and energy prices on inflation) posted a year-on-year pickup of only 0.1 percentage point (from 0.9% to 1.0%) in 2017. Amidst steeply accelerating overall economic activity, this marginal

¹ Germany, France, Italy, Spain, the Netherlands, Belgium and Austria.

rise was a reflection of insufficient pressure of domestic factors upon price dynamics, also affected by the sluggish wage growth. Price changes of core inflation components, services and other products (food and energy excluding) in 2017 were relatively small. Non-energy and non-food product prices increased by 0.4% on average in 2017 (at the same pace as in 2016). Price hikes did not gain momentum, although energy and import prices grew faster in 2017 than in 2016, pointing to the weakness of the pass-through of effects at the moment. In 2017, the rise in service prices (1.4%) was slightly more pronounced than in 2016.

Despite robust economic growth, slowly rising inflation determined continuation of accommodative monetary policy stance

The key ECB interest rates remained unchanged (see Table 1), but the value of the Eurosystem's asset balance continued to grow, reflecting the ongoing pursuit of accommodative monetary policy.

Table 1

KEY ECB INTEREST RATES
(%)

Types of key ECB interest rates	31.12.2016	31.12.2017
Deposit facility	-0.40	-0.40
Main refinancing operations	0.00	0.00
Marginal lending facility	0.25	0.25

Source: ECB.

Accommodative monetary policy continued to influence positively the availability of funding and conditions of lending for households and non-financial corporations. Strengthening of the growth notwithstanding, the inflation dynamics, nevertheless, was not consistent with sustained adjustment of inflation path that would corroborate confidence in the attainment of the Eurosystem's inflation target.

The Governing Council of the ECB resolved to continue the pursuit of accommodative monetary policy in the given circumstances and, until March 2017, made net purchases of securities at the pace of around 80 billion euro monthly. Then the Governing Council decided to make monthly net purchases of securities at the pace of 60.0 billion euro from April 2017. By the decision of October 2017, the term of expanded APP was extended until September 2018, and security purchases would continue at a new pace of 30.0 billion euro monthly from January 2018.

As over the year the economic performance indicators and financial market data had improved notably, the ECB Governing Council modified the assessment of risks at its June 2017 meeting, concluding that risks to the euro area growth outlook had become broadly balanced. The ECB Governing Council aligned its forward guidance concerning interest rates consistently with the changed assessment, by removing the reference to further key rate cuts from it. The Governing Council expected the key ECB interest rates to remain at their present levels for an extended period of time and well past the horizon of the net asset purchases.

In order to alleviate the implementation of the expanded APP, the ECB Governing Council used the opportunity of ad hoc deviation from the specialisation scheme envisaged by the programme. Thus in January 2017, the maturity spectrum of securities purchased under the CSPP was modified by reducing the minimum remaining term to maturity from two years to one year. The purchase of assets with the yield to maturity below the interest rate on ECB's deposit facility was also allowed, provided that it was necessary for the implementation of the expanded APP.

With the aim to proceed with delivering favourable euro area money market conditions,

the ECB extended the fixed rate tender procedures with full allotment at least until the end of the last reserve maintenance period of 2019.

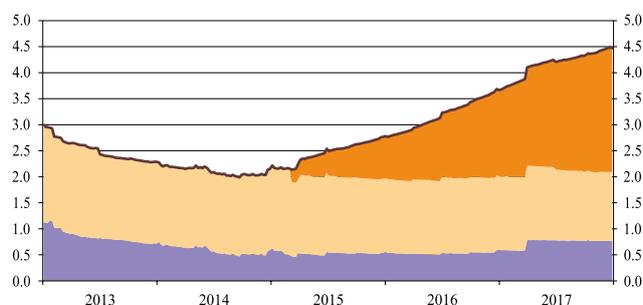
In addition, the final tender under TLTRO II was conducted in March. The volume allotted at it reached 233.5 billion euro. Some banks used the repayment possibility of their borrowings made under TLTRO I. Over the year, residual TLTROs and LTROs increased from 556.6 billion euro to 760.6 billion euro. Meanwhile, with excess liquidity swelling, the use of the main refinancing operations decreased to 3.4 billion euro (39.1 billion euro in 2016).

Overall, the book value of Eurosystem's assets increased by 808.8 billion euro in 2017, amounting to 4.5 trillion euro at the end of the year. Most important changes were on account of growing asset purchases under the expanded APP. The book value of the asset portfolio formed via purchases under the expanded APP was 2.4 trillion euro in December 2017 (see Chart 1), of which CSPP accounted for 82.6%. Excess liquidity elevated from 1.2 trillion euro to 1.8 trillion euro.

Chart 1

EUROSYSTEM'S ASSETS (trillions of euro)

- Securities of euro area residents purchased under the expanded APP
- Other assets
- Loans granted to euro area credit institutions as a result of monetary policy operations
- Total assets



Source: ECB.

ECONOMIC DEVELOPMENT OF LATVIA

FINANCIAL CONDITIONS AND MONEY SUPPLY

With low interest rates as well as stock prices rising slowly, the financial market conditions in Latvia were favourable for the government, non-financial corporations and households in 2017. The supportive financial conditions promoted a faster growth of the Latvian economy, boosting the value of investors' assets and reducing borrowers' loan repayments as well as strengthening both non-financial corporations' demand for loans and new investments and household consumption. The stability and predictability of the domestic business environment are simultaneously important preconditions for creating even more favourable financial conditions, while, for instance, the amended legal acts, judiciary weaknesses, uncertainty in some business partner countries, and tight lending standards constrained the dynamics of credit flows. Even though the low deposit rates notably diminished the net interest income, the volume of domestic deposits did not change markedly, and the ratio of more liquid deposits even expanded. In general, key financial indicators testified to the stability of Latvian credit institutions.

Accommodative monetary policy facilitated decline in euro money market rates

The accommodative monetary policy of the Eurosystem, still including also non-standard policy instruments, supported a further decline of euro money market interest rates and transaction volumes. It affected credit institutions' free reserves (bank holding in excess of required reserves), which retained their high level also in 2017. Free reserves of the Eurosystem's credit institutions had amounted to 1.8 trillion euro by the end of 2017, while those of Latvijas Banka stood at 5.5 billion euro. It was due to the weak demand in the interbank market for loans in euro, dominating in 2017 and underpinning a decrease in euro money market rates and transaction volumes.

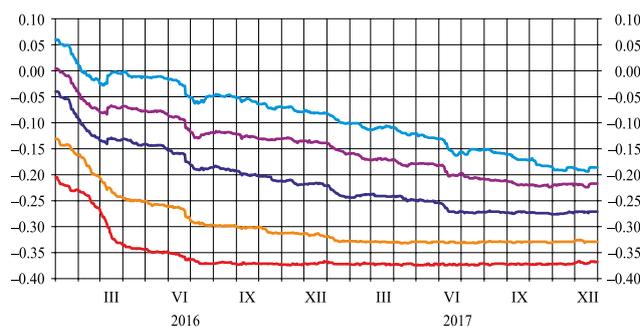
Euro money market rates went on declining in 2017. 3-month and 6-month EURIBOR, i.e. the rate to which interest rates on loans to non-financial corporations and households are as a rule pegged, in the second half of 2017 hit an all-time low since the introduction of the said money market interest rate index, to stand at -0.33% and -0.27% respectively (see Chart 2). Likewise, the difference between 1 year and 1 month money market interest rates narrowed.

Chart 2

EURIBOR (%)

- 1 month
- 3 months
- 6 months
- 9 months
- 12 months

Source: Bloomberg.



The relatively sluggish demand of credit institutions for loans in the euro interbank market in 2017 was the driver of transaction volume shrinkages in this market. Thus, for instance, EONIA (the rate at which major European banks provide overnight loans in euro to other credit institutions) transactions in the euro area dropped to a historical low in 2017 and at the close of the year (in November and December) stood at around 5.3 trillion euro. The volume of euro overnight transactions of Latvian credit institutions with their domestic counterparts contracted by 38.5% in comparison with the previous year and in 2017 constituted 8.2 million euro monthly on average (13.2 million euro in 2016). Sufficient liquidity determined smaller volumes of not only Latvian credit institutions' overnight transactions but also of those with up to 1-month maturity (monthly average of 1.4 million euro in 2017 and of 15.1 million euro in 2016).

Though at a slower pace, the transaction volume of Latvian credit institutions with their domestic counterparts narrowed also in the segment of foreign currencies (by 16.9%), which in 2017 was 303.8 million euro monthly (365.5 million euro in 2016).

By convention, the Latvian credit institutions involve in interbank money market transactions with foreign monetary and financial institutions operating in a vast geographical space. Similar to previous years, such transactions accounted for a major part of interbank market transactions of the Latvian credit institutions. The monthly average of the said transactions amounted to 14.9 billion euro in 2017 (21.0 billion euro in 2016).

Implemented monetary policy and decreasing country risk premium created positive environment for public debt financing

Interest rate development trends in the euro area money market and the expanded APP carried out in the euro area countries, Latvia including, created preconditions for low rates on government bonds. Latvia's economic growth, ongoing reforms and stable domestic political environment consolidated financial market participants' confidence in country's creditworthiness, hence the country risk premium decreased. Moreover, a relatively higher yield on Latvian bonds amidst low interest rates delivered opportunities to attract investors willing to invest. With the risk premium vis-à-vis euro area core countries diminishing, the yield on 10-year bonds of the Latvian government used in the ECB assessment of convergence from 0.9% in December 2016 went down to 0.6% in December 2017. The mark-up above German government bond yields of the same maturity declined from 65 basis points to 29 basis points.

Overall successful economic growth and previous reform processes supported the investors' demand also in 2017 when bonds were issued into the international market.

A stronger demand for government debt securities triggered some improvement in the borrowing terms for Latvia. For the first time, the country issued 30-year-to-maturity bonds in the international market. In the primary market, the yield on bonds was quite low vis-à-vis other countries with a similar credit rating (2.3%). The tender yield by 98 basis points exceeded that of mid swap and was 127 basis points above the yield on the German government bonds of the same maturity.

Stock markets showed very buoyant growth

Improved performance indicators and more dynamic activity of non-financial corporations spurred the price hikes in the Latvian stock market, while tighter requirements for credit institution identification and verification of the origins of their customer funds reduced the amounts foreign customers deposited in Latvia.

The stock of securities issued by the Latvian MFIs and non-financial corporations shrank by 219.5 million euro in 2017 (to 1.1 billion euro). It was due to diminishing interest of foreign investors to invest in the Latvian credit institutions. Nevertheless, the favourable financing conditions facilitated entrance of new issuers into the bond market.

In 2017 vis-à-vis 2016, the turnover of Nasdaq Riga Main List and Secondary List shares increased 3.6 times (to 49.6 billion euro). Along with the improving profits of stock companies, the Nasdaq Riga stock market index went up by 35.8% in 2017.

A more dynamic economic development facilitated increase in the number of foreign exchange transactions

A more dynamic economic development was a driver of increased foreign currency flows, and the need to use foreign exchange services strengthened. Following a decline in the previous two years, the activity of Latvian credit institutions in foreign exchange markets became slightly more pronounced in 2017. The average monthly volume of currency trade in 2017 was 36.1 billion euro or by 0.4% more than the respective average volume in 2016.

The monthly average of foreign exchange transactions with domestic partners vis-à-vis the previous year increased by 88.2% with domestic non-bank financial institutions and by 4.9% with domestic non-financial corporations. While the Latvian foreign exchange market continued to be dominated by the euro conversion to the US dollar, the turnover of transactions with the domestic non-financial sector of euro conversion to the British pound sterling and other currencies in 2017 increased (by 10.0% and 23.0% respectively).

Low market interest rates reduced borrowing costs, eased loan repayment and improved credit quality

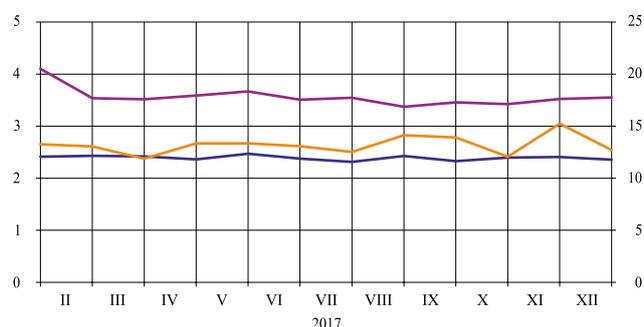
Interest rates on new credits in euro to households and non-financial corporations continued on a downward trend, reaching the lowest level in Latvia since the restoration of independence. Low interest rates on new credits had an ever growing impact on interest rates of already issued loans. In general, low interest rates enabled non-financial corporations and households to save on account of borrowing costs, eased the repayment of loans, improved the quality of loans, and boosted consumption. The positive impact of low interest rates on non-financial corporation and household demand for new credits, on the other hand, was offset by flaws in business environment stability and transparency as well as ineligibility of borrowers for credit institution loans.

Lending rates for households continued on a downward trend in 2017, though at a much slower pace. The weighted average interest rate on euro loans already issued for house purchase was within the range of 2.2%–2.3% in 2017 (see Chart 3), while that on consumer credit and other household loans fluctuated between 11.5% and 11.8%. Interest rates on loans to non-financial corporations elevated marginally, mainly due to one-off structural changes in the credit institution market. However, the weighted average interest rate on loans in euro to non-financial institutions remained at a rather low level in 2017 (2.5%).

Chart 3

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

— Loans to non-financial corporations
— Household loans for house purchase
— Consumer credit to households (right-hand scale)



Source: Latvijas Banka.

The terms and conditions for new euro loans to households tended to improve in 2017: the loan to value (debt to collateral) ratio increased, and consumer loan amounts expanded. Thus, the weighted average interest rate on new euro loans for house purchase in 2017 lost 0.3 percentage point (to 2.7%), whereas that on consumer credit and other household borrowing decreased by 0.8 percentage point (to 12.1%). The volume of new loans to households augmented and exceeded the level of the previous year; it was on account of both the ongoing house purchase support programme for new families and economic progress, translating into higher wages, falling unemployment and expanding household savings.

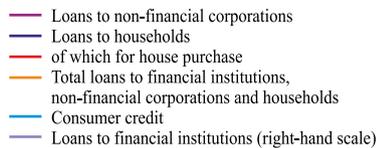
Interest rates on new loans to non-financial corporations in 2017 were affected not only by the money market interest rate developments but also by the credit risk premium which, driven by the economic growth and strengthening of individual sectors, was falling. In addition in 2017, growth in the demand from small and medium-sized non-financial corporations in comparison with large ones was steeper. The former surge was driven by the low interest rates and the need to invest in fixed capital. The growth in the demand of large non-financial corporations stagnated as they relied more on their internal resources. In such a way, the share of relatively more expensive small and medium loans in the overall portfolio of new euro loans to non-financial corporations grew and had a somewhat upward pressure on the respective weighted average interest rate. In 2017, the latter posted a year-on-year 0.1 percentage point decline (to 2.6%), with the respective interest rate on small and medium loans (up to 1 million euro) decreasing by 0.4 percentage point (to 3.6%), and on large loans (over 1 million euro) remaining unchanged (2.5%).

Despite low interest rates, lending growth remained sluggish

Rather buoyant development of the Latvian economy in 2017 notwithstanding, the lending growth remained quite sluggish. Whereas the ECB accommodative monetary policy provided credit institutions with the opportunity to ensure more favourable lending term offers and lower interest rates, the lending potential was not used to the full.

Particularly volatile was the portfolio of loans to non-financial corporations. In the initial months of the year, the portfolio grew, since April its expansion had practically stopped, and in September its volume notably contracted due to some financial market participant transferring a part of credit portfolio to a foreign parent bank. It, however, did not affect the Latvian economy, since non-financial corporations continued to use the already issued loans; nevertheless, the total domestic portfolio contracted, with the pace of its annual growth returning to negative territory, and, in the year as a whole, loans issued to domestic financial institutions (investment funds excluding money market funds, alternative investment funds, other financial intermediaries, financial vehicle corporations, captive financial institutions and money lenders, insurance corporations, and pension funds), non-financial corporations and households decreased by 2.5% (see Chart 4). By contrast, if the said structural changes were excluded, a marginal lending boom would go on. As to the non-bank financial sector, lending was on an upward trend throughout the year on account of the positive leasing sector growth, yet at a slower pace than in

Chart 4

ANNUAL CHANGES IN LOANS TO DOMESTIC FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS (%)


Source: Latvijas Banka.

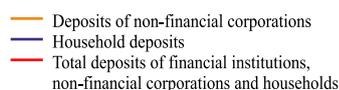
2016. Lending to households was not affected by significant modifications. The house purchase support programme for new families continued, yet total loans to households contracted by 1.0% over the year.

Low deposit rates caused depositors' interest income decline, yet domestic deposits remained a stable source of credit institutions' funding

The low deposit rates reduced depositors' income from interest. As demand deposits dominated in the overall household and non-financial corporation deposits, the interest rate on the respective deposits was close to zero in 2017. Though low interest rates encouraged depositors to take on higher risk, the share of such transactions was not excessive. At the end of 2017, the household term deposits accounted for 7.2% in the overall volume of household and non-financial corporation deposits (8.4% at the end of 2016). The weighted average interest rate on household term deposits was retained at 1.3% in 2017, while the respective rate on new term deposits increased by 0.1 percentage point (to 0.7%).

Amidst low deposit interest rates, the volume of domestic deposits picked up 2.5% in 2017 (see Chart 5), primarily on account of expanding household deposits, which had been rising quite impressively for the fourth consecutive year (by 8.2% in 2017). The overall annual pace of growth in deposits, however, was slower than in 2016. Its stronger momentum was held back by the developments in the sectors of financial institutions and non-financial corporations, where changes in savings testified to a faster growth of non-financial corporations' current expenditure and investment. Deposits of non-financial corporations did not change much over the year, with businesses using extra incomes for imports and investment. In the meantime, financial institutions, primarily pension funds, reduced their deposits with credit institutions, opting for more profitable placement opportunities for their funds.

Chart 5

ANNUAL CHANGES IN DEPOSITS OF DOMESTIC FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS (%)


Source: Latvijas Banka.

Successful economic growth of Latvia was reflected by monetary developments

Primarily, strengthening of more liquid components determined the growth of broad money. Overnight deposits (Latvia's contribution to the euro area M1) expanded by 5.9% in 2017. Latvia's contribution to the euro area money supply aggregate M2 rose slower (by 3.4%), because in 2017 an increase was recorded only in deposits redeemable at notice of up to 3 months (10.1%), while deposits with an agreed maturity of up to 2 years

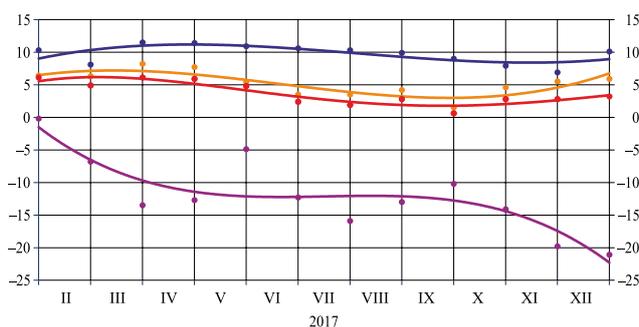
decreased by 21.1% (see Chart 6). Likewise, the number of additional components in Latvia's contribution to the euro area broad monetary aggregate M3 decreased and was insignificant. The overall 2017 contribution of Latvia to the euro area monetary aggregate M3 increased by 3.2% (see Appendix 1). Latvia's contribution to the euro area monetary base in 2017 expanded by 20.0%, reaching 10.1 billion euro at the end of the year. It was made up of demand deposit accounts of credit institutions (including the mandatory reserve system; 5.7 billion euro) and Latvijas Banka's proportionate share of the total amount of banknotes issued by the Eurosystem (4.4 billion euro). Latvijas Banka's net foreign assets (non-euro area assets) expanded by 0.5 billion euro or 14.0%, to stand at 3.9 billion euro at the end of 2017.

Chart 6

LATVIA'S CONTRIBUTION TO EURO AREA MONEY SUPPLY AND ITS COMPONENTS

(year-on-year changes; %)

- Overnight deposits
- Deposits with an agreed maturity of up to 2 years
- Deposits redeemable at a period of notice of up to 3 months
- M3



Source: Latvijas Banka.

Significance of domestic financing for Latvian credit institutions grew

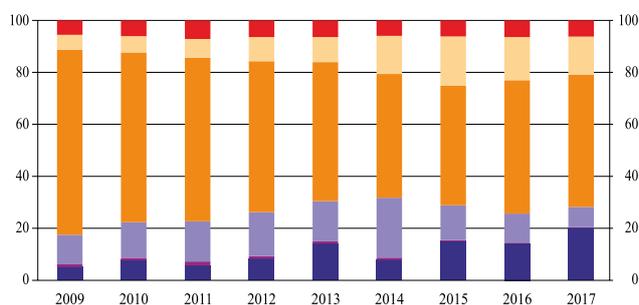
Despite lending and depositing rates continuing on a downward trend in 2017, the robust ongoing growth of domestic deposits resulted in the stabilisation of assets and liabilities composition of Latvian credit institutions at a sustainable level. In 2017, domestic loans granted by Latvian credit institutions were fully covered by attracted domestic deposits, with the loan to deposit ratio standing at 101.9% at the end of 2017 (104.9% at the end of 2016).

Assets of Latvian credit institutions¹ (see Chart 7 for structure) decreased by 3.7% on account of the requirements for MFIs falling by 32.4% and credit portfolio of credit institutions contracting by 4.6%. The latter was primarily caused by changes in the foreign customers' credit portfolio. The decline of 2.5% in loans to domestic entities, the government excluding, on the other hand, can be explained by a one-off activity related to structural changes in the sector of credit institutions.

Chart 7

COMPOSITION OF CREDIT INSTITUTION ASSETS (%)

- Other assets
- Debt securities and other fixed income securities
- Loans
- Claims on foreign MFIs
- Claims on domestic MFIs, except Latvijas Banka
- Claims on Latvijas Banka



Source: Latvijas Banka.

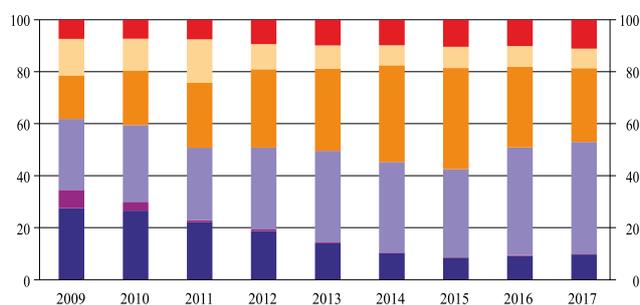
As to the composition of liabilities of Latvian credit institutions, the share of domestic financing continued to expand in 2017 (see Chart 8). Liabilities of Latvian credit institutions diminished due to a decrease of foreign deposits by 12.0%, generally associated with tighter servicing standards of foreign clients. As has been already stated, domestic deposits grew only marginally in 2017. MFI financing attracted from abroad, its major part coming from parent banks, did not change substantially either (10.0% of total liabilities of credit institutions).

¹ At the end of 2017, there were 21 registered credit institutions (including five foreign bank branches) in the Republic of Latvia. As a result of the merger of AS DNB banka and Nordea Bank AB Latvian branch, a new credit institution Luminor Bank AS was created.

Chart 8

COMPOSITION OF CREDIT INSTITUTION LIABILITIES (%)

- Capital and reserves
- Other liabilities
- Non-resident deposits
- Domestic deposits
- Liabilities to other foreign MFIs
- Liabilities to related foreign MFIs



Source: Latvijas Banka.

Despite low interest rates causing a drop in interest incomes and profits of Latvian credit institutions, key financial performance indicators confirm their financial stability

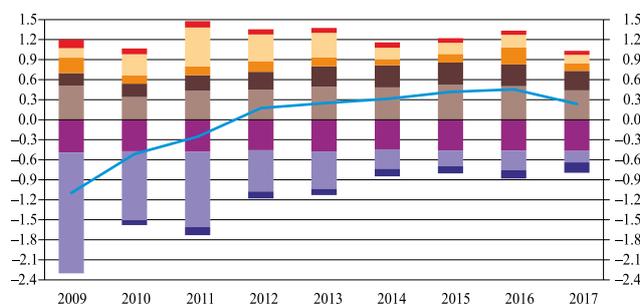
The share of liquid assets of Latvian credit institutions remained at a high level and accounted for more than one third of total assets or 37.4% at the end of 2017. Driven by fast economic growth, the quality of credit portfolio was gradually improving, and at the end of 2017 the share of payments on loans past due by over 90 days went down to 4.1% in the aggregate credit portfolio of credit institutions (4.4% at the end of 2016). The stability of financial system was also attested by the credit institutions' total capital ratio, which retained its high level of 21.4% at the end of the year (minimum requirement of 8%), while the common equity Tier I capital ratio was 19.0%. Over the year, five credit institutions increased their common equity Tier I capital by a total of 343.4 million euro. Profits of Latvian credit institutions (see Chart 9) were substantially lower in 2017 (236.1 million euro) than in 2016 (453.8 million euro). In the course of the last two years, these developments were driven by both one-off transactions and structural changes in the sector of credit institutions.

Chart 9

DYNAMICS OF CREDIT INSTITUTION INCOME, EXPENSE AND PERFORMANCE RESULTS

(billions of euro)

- Net interest income
- Net income from commissions and fees
- Income from trading in financial instruments and revaluation
- Income from reversal of provisions
- Other income
- Administrative expenses
- Expenditure on provisions
- Other expense
- Retained earnings or losses of the reporting year



Source: Latvijas Banka.

The composition of components responsible for operating income remained broadly unchanged. Net interest income continued to account for over a half of the financial operating income, while net income from commissions and fees represented one third of the operating income. Consequently, the protracted period of low interest rates did not substantially affect the composition of financial operating income of credit institutions.

EXTERNAL DEMAND AND COMPETITIVENESS

Strengthening of external demand was also reflected by the expansion of Latvian exports. Uncertainty about Brexit and further trade terms and conditions was still in place

The growth of global economy coupled with economic development in the euro area and Latvia's major trade partner countries triggered an upswing of Latvia's external demand in 2017 which strengthened notably in comparison with 2016. Its improvements were reflected by an expansion in real volumes of goods and service exports by 4.7%. The largest contribution to stronger external demand came from Lithuania and Russia, the two countries with significant import growth since 2016. Russia's imports had fallen behind

year-on-year figures as late as the end of 2016, but already in 2017, its annual import growth exceeded 10%. This fast advance was on account of both higher prices of oil and other natural resources in 2017 and also the accompanying rise of exports and domestic consumption in Russia. The reviving demand in Russia had an upside pressure on Latvia's exports to this country. Lithuanian imports, on the other hand, grew on account of larger investment due to the recovery of inflows of the EU funding. Uncertainty related to the UK leaving the EU is still in place; nevertheless, Latvia's exports to the UK continued to expand also in 2017.

In 2017 year-on-year, income from exports of goods picked up 10.1%. The rise was driven by expanding volumes of real exports (5.7%) and also by export price hikes (4.3%). In the course of the year, prices elevated not only for oil products but also for a part of Latvia's export goods, like milk and dairy products, meat products, grain, wood products, base metals and electrical appliances.

In the breakdown by commodity group, exports of food industry accounted for the largest positive contribution to the income from exports. In comparison with the modest progress in 2016 and negative pace in 2015, it is clear that since the sanctions against Russia the domestic producers managed to redirect their exports to new markets and proceed with stepping up production as well. Such industries as base metals and articles of base metals, mechanical appliances and electrical equipment, live animals and their products as well as wood and articles of wood also made significant contributions. Notably, the overall export expansion was primarily ensured by exports of domestic goods rather than re-exporting. All in all, however, the capacity utilisation in manufacturing is close to its maximum and historically at the highest point, and, in order to maintain such a pace of growth also in the future, investment is vitally needed.

The year-on-year increase in income from service exports accelerated somewhat (6.9%), with the service groups driving the growth changing. The transport service sector with previously negative effects made the largest positive contribution in 2017, determined by good performance of transportation by sea, road and air. Earlier made investment would foster growth. Thus, for instance, truck fleets were upgraded, aircraft replaced and investment in the infrastructure of SJSC RIGA INTERNATIONAL AIRPORT made. As freight volumes went on contracting, on the other hand, transportation services by rail declined also in 2017. Growth stability was retained in such sectors as construction and computer and information technology services. The demand for construction services was still supported by newly acquired markets, while the future of construction service exports might be dependent on a notable extension of export geography, because implications from the UK Brexit and potential adjustments in the Scandinavian housing market may possibly weaken the current market demand for construction services. In the year overall, income from foreign travellers visiting Latvia remained at the previous year's level. Meanwhile, the number of foreign visitors and the length of stay in Latvia kept on rising. Tourists from Russia, Lithuania and Germany contributed most to the increase in the number of visitors to Latvia.

In the breakdown by country, Latvia's exports of goods vis-à-vis 2016 grew to almost all major trade partner countries. The largest positive contribution to goods export growth in 2017 came from exports to Russia, the US, Germany, Estonia and Sweden. Of major partner countries, exports of goods to Poland declined, albeit primarily on account of falling re-exports, because exports of domestically produced goods expanded markedly. In comparison with 2016, exporting to the Baltic counterparties proceeded successfully in 2017. The pace of exporting goods to Estonia accelerated to 6.8%, while exports to Lithuania, in contrast to the decline of the previous year, posted a 2.5% pickup. As previously, the two countries received smaller volumes of re-exported electrical equipment and mineral products (Lithuania), while exports of products usually sold in large quantities increased (e.g. dairy products, wood and articles of wood). Almost all commodity groups

of exports to Russia demonstrated a steep rise in 2017, thus, in exports overall, the share of this country swelled to 9.1%.

Latvian exporters of goods managed to increase their world market share, yet cost competitiveness continued to deteriorate and investment is needed to sustain it

Cost competitiveness indicators in 2017 retained dynamics similar to the previous year, with the real effective rate somewhat on the upward trend. In contrast to Latvia's goods export share in the EU market slightly falling under the impact of diminishing competitiveness, the respective global market share expanded. In addition, average profitability of manufacturing businesses went up. Latvia's market share of service exports in EU imports in 2017 exceeded that of 2016, driven by its particularly steep enlargement in the early part of the year. Especially strong was the expansion in export shares of construction, information technology and transport services. The EC survey confirms that the business assessment of competitiveness of manufacturing in external markets improved further in 2017.

The projections for external demand in 2018 suggest that it will be sustainable, with an ongoing upside effect on exports. However, on the back of wage hikes, high level of capacity utilisation and previously low-level investment, only a moderate export growth vis-à-vis 2017 can be projected. Diversification across commodity groups and countries will continue to play a crucial role for exporters. In order to maintain competitiveness and increase incomes, investment will be required, and new innovative products as well as products with higher value added are to be produced.

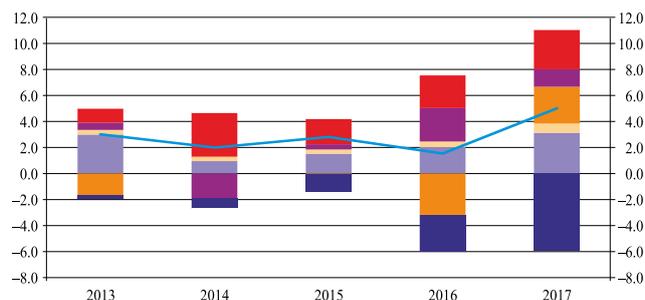
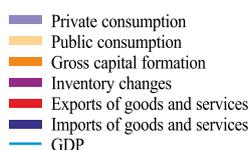
DOMESTIC ECONOMIC ACTIVITY

In 2017, the economic growth rate accelerated to the highest point in the last six years, with GDP increasing by 4.5% according to seasonally and calendar non-adjusted data, and by 5.0% in seasonally and calendar adjusted terms. Substantial growth changes in comparison with 2016 were triggered by the recovering investment activity, private consumption which went on strengthening due to higher incomes, and improving export opportunities. Consequently, savings grew at a slower pace than in 2016

In contrast to the 2016 performance, investment activity not only contributed positively to the GDP growth in 2017 but also was approaching the contribution of private consumption (see Chart 10). In 2016, sluggishness in investing was associated with the disruption of the EU financing flows; in 2017, the steep rise in investment was supported both by the previous low base of these flows and also wide-spectrum investment projects financed from various sources. Investment in civil engineering works, construction of warehouses and trade facilities as well as transport vehicles increased substantially. Albeit investment in machinery and equipment remained weak.

Chart 10

GDP COMPONENT CONTRIBUTION TO GDP ANNUAL GROWTH AND GDP ANNUAL GROWTH
(seasonally and calendar adjusted data; %)



Source: CSB.

Inflation exerted a slight downward pressure on the growth of real purchasing power in 2017: despite gross nominal wages rising faster (by 7.9%) – supported by some rise in minimum wage and labour market tightness –, the net real wage rose slightly slower than

in 2016 (by 4.0%). Nevertheless, private consumption recovered resiliently and went on supporting GDP growth. The pace of saving, on the other hand, fell behind the 2016 level.

The demand for imports was significantly affected by stronger investment activity and better export opportunities in 2017, and imports of both capital and intermediate goods expanded. The strength of external demand found its reflection in more voluminous exports of goods and services (4.7% in real terms; seasonally and calendar adjusted data). However, the rising remuneration is still expected to affect cost competitiveness.

The economic growth is expected to remain robust in 2018. A large number of significant ongoing investment projects launched in 2017 will be completed in 2018; however, the upswing in investment is likely to continue against a higher base than in the previous year, hence the growth will decelerate marginally. Consumption will be still supported by remuneration rising robustly, with the raised minimum wage being one of its drivers in 2018. The outlook for the global economic growth in 2018 points to a relatively stable strengthening of external demand; however, in order for exporting industries to maintain their competitiveness, more investment in machinery and equipment to boost productivity is required.

In 2017, GDP growth was supported by both the recovery of construction after its steep recession in 2016 and expansion of industry

The situation in construction was opposite to that in 2016: notably stronger inflows of financing earmarked for the construction sector under the EU 2014–2020 budget programming period resulted in a significant boost, with the sector value added growing by 16.2%. The EU funding ensured a larger contribution to growth from construction of civil engineering objects, including roads, highways, pipelines. In addition to the effects from accessibility to the EU funding, the development was substantial also in the segments more dependent on private investment and contributing to the construction of administrative, industrial and wholesale and retail buildings. The expanding construction activities abroad enhanced the sectoral growth as well: over the year, the volume of construction works outside Latvia doubled and accounted for more than 10% of the sectoral output.

The recovering construction sector boosted the performance of other sectors as well: in 2017, the mining industry, domestic transportation and construction-related manufacturing subsectors also prospered. The dynamic upswing in manufacturing was determined not only by the domestic activity (including construction) but also by the resilient external demand. Robust growth persisted throughout 2017, even towards the close of the year when deceleration of growth was more likely due to the already high annual base. Value added in the sector increased by 8.1%. In 2017, almost all subsectors exhibited some kind of production growth, either more dynamic or modest; it was especially pronounced in the production of input materials for the powerfully developing construction sector (manufacture of non-metallic mineral products, metal constructions, and miscellaneous building materials produced by sub-industries of chemical substances, rubber and plastic products). Foreign markets, in turn, focused more on food and beverages, chemical products, electrical equipment, fabricated metal products, automobiles and their spare parts, and, according to business surveys, also pharmaceutical products originating in Latvia. The season of heavy autumn rains in 2017 brought about problems with input supplies, harvesting and logistics, which impeded progress in wood and food processing industries. Input supplies were adversely affected also by the ban on sawn log exports from Belorussia.

Business surveys implied that producer sentiments had improved over the year, reaching the highest level since 2007. The assessment was better overall and improved for export orders as well. Producers were optimistic about the outlook for output and sales prices of their products; a major part of the interviewed believed in the absence of obstacles

to their activities. Consequently, the growth of manufacturing is expected to continue. Meanwhile, the high overall growth rate of 2017 is most likely unsustainable and will gradually decline. Labour shortages are likely to constrain further growth acceleration. Capacity utilisation reached a record high in the first quarter of 2018. The high capacity utilisation indicators point to the need of additional investment, which would be essential in determining the future growth potential.

In 2017, the trade activity also outpaced its growth in 2016, and retail trade posted a pickup of 4.3%, most of which was on account of food and housing-related goods. The increment of the latter partly reflected population's better purchasing power, even though the pace of growth lagged slightly behind the previous year. Trade activities were rather dynamic and forward-looking in 2017 also with regard to the future outlook: trade logistics were evolving, construction of several new or expansion of the existing trade facilities was launched, some new participants entered the Latvian market or showed interest in it, etc. At the same time, retail trade was characterised by certain restructuring. Sector representatives point to tough competition and the need to make effort to win over both clients and labour. Migration of the existing commercial enterprises in search for more profitable operation modes is going on.

Among the sectors that developed faster in 2017 than in 2016, mention should be made of energy, mining and water supply (with value added growth of 7.6%); however, the growth in the energy sector as an example was supported basically by short-term factors. Thus, for instance, weather conditions unfavourable for agriculture and forestry promoted generation of electric power at hydroelectric plants, while, on the other hand, energy consumption was partly constrained by warmer weather during the heating season. Consequently, the need for heating and electricity generation through cogeneration both decreased. For the year overall, periodical outages of the Lithuanian power interconnection with the fourth Swedish district (with repair works planned for 2018) figured as a factor fostering electricity generation and exports. A limited domestic market is likely to become a pressing medium or longer term growth problem for the energy sector: the demand and its further developments can potentially be inconsistent with the historically formed capacity.

Even though value added in the transport sector picked up 6.5% in 2017 overall, freights loaded and unloaded at ports and freight transportation by rail, formerly pillars of the sector, proceeded with their three-year-long decline in 2017, with the drop accelerating towards the close of the year. Driven by a more severe winter weather, the performance of ports and transportation by rail may somewhat improve in the short term, but the general tendency to redirect Russian export freights to the ports in Russia is likely to persist. The dynamic regional development along with the domestic growth gave momentum to freight transport flows by road, while investment in SJSC RIGA INTERNATIONAL AIRPORT and buoyant airline activities helped increase the number of passengers and the volume of freight transported by air.

Financial services figure as the sole sector with pronounced negative growth (–16.6%). The observed decline of the sector can be explained by continuously shrinking non-resident business due to tighter requirements and also by falling income earned from the securities trading business. Income credit institutions earned in 2017 overall contracted by around 50%, this being partly reflected by diminishing value added.

Downside risks to the global growth, including concerns arising in connection with the US policy about the possibility of a trade war and tensions emerging in relations of many countries with Russia aggravated in early 2018. Nevertheless, overall successful growth which would foster the development of exporting sectors is still projected in Latvia's trade partner countries. Domestic-demand-oriented sectors will continue to prosper, among them the construction sector due to stronger investment activity, and

retail trade and private services due to recovering private consumption. However, the financial sector is likely to go on a downward trend due to the hardships experienced in early 2018. Hence the development in 2018 overall is expected to slow down vis-à-vis 2017 when momentum was gained from the low base of 2016. Latvijas Banka's forecast for GDP growth in 2018 is 4.1%.

LABOUR MARKET

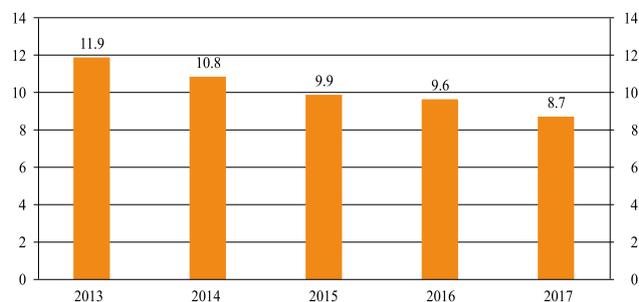
Unemployment is dropping, yet there is still some slack in the labour market

Acceleration of the economic activity caused a steady increase in labour demand, with participation and employment rates reaching their historical highs. At the same time, there were still several factors that had a limiting effect on labour supply. As a result, the number of employed remained broadly unchanged. Labour market conditions became increasingly favourable for workers in 2017. With unemployment shrinking below the natural rate, a larger number of businesses pointed out shortage of labour as a factor causing a higher increase in wages and salaries.

Unemployment continued to decrease gradually, reaching the lowest level of the last nine years. This was mainly supported by the strengthening of the economic growth. In 2017, job seekers accounted for 8.7% of the economically active population, representing an annual decrease of 0.9 percentage point (see Chart 11). The number of employed remained broadly unchanged over the year as the increase in the rate of employment was offset by a decline in the working-age population. Slow employment growth and increasing number of vacancies, however, does not signal that the domestic workforce has been exhausted as broadly-defined unemployment remains high. Including economically inactive population not seeking work but ready to work, as well as part-time employed unable to find a full-time job it is almost twice as high as the rate of job seekers. High unemployment suggests that there is still available workforce underutilised in Latvia that should be used to reduce the mismatch between the supply and demand of labour. Moreover, Latvia also has certain remigration potential. Without addressing the problem of labour shortage, the rising number of vacancies and the business' plans to increase the number of their employees will progressively tighten the competition over hiring staff among those businesses and cause wages to grow faster than productivity. This will deteriorate business competitiveness and significantly reduce Latvia's future economic growth prospects.

Chart 11

RATE OF JOB SEEKERS
(% of the economically active population)



Source: CSB.

Wage acceleration erodes competitiveness, yet at the same time provides new development opportunities

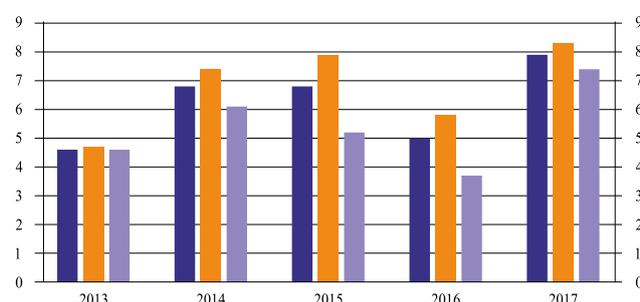
Acceleration of the average wage (to 7.9%; see Chart 12) was broad-based across all main economic sectors and both the private and public sector. Nevertheless, productivity gains were also observed. As a result, the labour income share in total value added remained unchanged in 2017, stabilising close to the EU average. A significant raise of the minimum wage is expected to have an upward effect on wages in 2018. With regional unemployment and wage disparities persisting, an overly substantial increase (one which

Chart 12

CHANGES IN GROSS AVERAGE NOMINAL MONTHLY WAGES (annual growth rate; %)

■ Total
■ Private sector
■ Public sector

Source: CSB.



is not supported by productivity and average wage developments) of the minimum wage could deteriorate the labour market conditions in regions where the average wage is low.

On the one hand, the signs of labour market tightening and wage acceleration erode competitiveness, while, on the other hand, this also gives the long-term unemployed a chance to return to the labour market and serves as an incentive for businesses to boost their investment in technologies and equipment. It is also an important prerequisite for remigration. For further decline in unemployment to be sustainable, it should be based on a decrease in the structural component of unemployment. This can be achieved through improving the effectiveness of labour market measures and also through structural reforms in education and health care in the long term.

INFLATION

The path of inflation primarily reflected the movements of global food prices

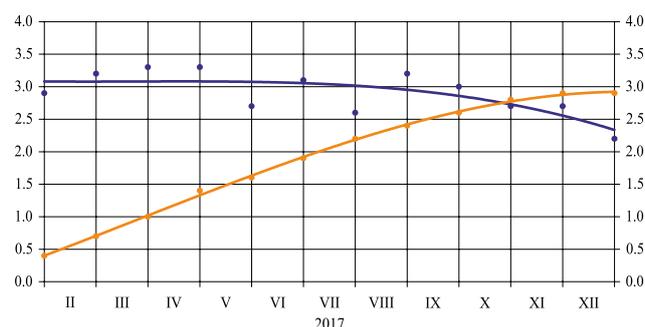
Following a four-year period of exceptionally low inflation, average inflation (HICP) rose to 2.9% in 2017 (see Chart 13). The path of inflation over the year primarily reflected the global trends observed for the supply-side factors, i.e. the development of food and oil prices. A more substantial rise was recorded at the beginning of the year, with the primary contributor being the food prices, whereas at the end of the year inflation was lower due to the base effect. Against the background of accelerating economic growth, the effect of demand-side factors on inflation slightly increased.

Chart 13

HICP DYNAMICS (%)

— HICP (year-on-year)
— Last 12 month annual average HICP

Source: CSB.



Despite being, on average, higher than in 2016, the global food prices ended the year 2017 on a lower level than at the beginning of the year. A pick-up in the global dairy product prices at the beginning of the year was followed by an equally steep fall at the end of the year, which was not yet reflected in Latvia's retail prices. Grain prices, by contrast, increased only marginally over the year due to the record-high harvests and ever-growing global stocks; therefore, the retail prices on bread remained stable.

The effect of oil prices and domestic demand on inflation is growing

Oil prices followed a downward trend in the first half of 2017, reflecting market expectations of a step-up in US oil production. In the second half of the year, however, with the stocks of oil products running low and OPEC extending the agreement on oil

output curbs, oil prices rebounded significantly. This was partly offset by the strengthening of the euro against the US dollar. The global oil-price increases have already passed through to fuel prices, but not yet to the prices of natural gas and heating.

Against the background of wages continuing to grow, the effect of demand-side factors on inflation slightly increased. Prices on non-administered services, an inflation component significantly affected by the households' purchasing power, increased two times more than in 2016 (by 3.1%).

The upward pressure of demand-side factors on inflation is expected to strengthen further in the coming months, while the contribution of the food price component will be smaller than in 2017. At the same time, several introduced amendments to legislation, i.e. raising the excise duty on fuel, alcohol and tobacco, introducing a reduced VAT rate on fruit and vegetables typical to Latvia as well as a significant rise in the minimum wage will have a substantial effect on inflation in 2018.

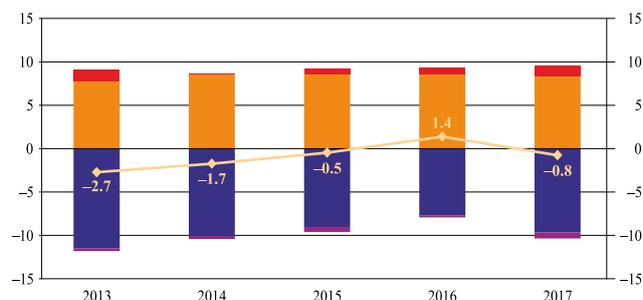
BALANCE OF PAYMENTS AND EXTERNAL DEBT

Although Latvian exporters benefited considerably from the strengthening of the global economy, the current account ran a deficit in 2017 due to the rising global prices and the recovery of the domestic economic activity

Export growth was supported by robust global demand and that of Latvia's main trade partners. At the same time, the growth in imports was determined by the recovery of the domestic economic activity, mostly on account of investment and imported manufacturing inputs. With imports growing faster than exports, the balance of goods and services was negative (a modest surplus in 2016), and the deficit was only partly offset by inflows of EU funds. Therefore, the current account ran a 204.0 million euro (0.8% of GDP) deficit in 2017 overall (see Chart 14).

Chart 14

CURRENT ACCOUNT BALANCE (% of GDP)



Source: Latvijas Banka.

In 2017, Latvia's exports of goods were supported by the strengthening of external demand, which, in turn, contributed also to global price increases. On the one hand, this boosted the income from Latvia's exports of goods, yet, on the other hand, also the costs of imported goods. At the same time, the volume of imports increased on account of a significant improvement in the domestic economic activity. Although the recovery of domestic investment was one of the reasons behind a higher trade deficit of goods (an increase of 9.7% of GDP), it provides an opportunity to improve the future competitiveness of exports.

Stronger external demand and higher activity in international trade also had a positive effect on the services sectors. With exports of services growing at a somewhat higher rate than in 2016 and still significantly outpacing imports, the services account retained a surplus of 8.4% of GDP. Exports of services were mainly underpinned by transportation services, construction services and computer services. Imports of services also continued on an upward path in 2017, albeit at a slower pace than in the previous years.

Inflows from EU structural funds totalled 734 million euro, which is less than the average received by Latvia in the previous five years; absorption of EU structural funds was still subdued at the beginning of the year.

Due to the gradually improving external demand, the outlook for Latvia's export income growth in 2018 is positive. At the same time, however, the observed rise in global oil prices as well as strong domestic consumption, better absorption of EU funding, high degree of capacity utilisation in businesses and anticipated domestic investment activity are likely to boost the demand for imports. Therefore, with Latvia's economic growth rates remaining solid, a moderate increase in the current account deficit can also be expected.

A net outflow of financing from Latvia was recorded, while net external debt decreased in 2017

Cross-border financial flows recorded in the financial account of the balance of payments in 2017 reveal that foreign assets increased more than Latvia's foreign liabilities (by 2.7 billion euro and 2.5 billion euro respectively). This resulted in a net outflow of financing from Latvia. The increase in foreign financial assets was primarily driven by the public sector. Latvijas Banka continued to participate in the expanded asset purchase programme within the Eurosystem's monetary policy framework. Foreign reserve assets in the form of securities also grew. Recovering from the low levels reported in 2016, the overall foreign direct investment inflows in Latvia were again close to their historical average in 2017, reaching 2.4% from GDP. The largest foreign direct investment inflows in 2017 overall were recorded in the financial sector, trade, transport and agriculture, mostly from Sweden, Lithuania and Luxembourg.

Both Latvia's gross external debt and net external debt to GDP decreased in 2017, to 140.9% of GDP and 24.4% of GDP respectively. Eurobonds issued in 2012 matured at the beginning of 2017, thereby supporting the reduction of the government's external debt. Liabilities of MFIs remained broadly unchanged, while the external liabilities of non-financial corporations increased. This was mainly a result of a merger of two credit institutions, whereby a part of the previously granted loans to residents was transferred to the foreign parent bank, with liabilities to a domestic credit institution becoming liabilities to a foreign credit institution. At the same time, foreign assets increased, supporting a decline in Latvia's net external debt.

FISCAL POLICY

As confirmed by the budget outcomes, an expansionary fiscal policy was implemented in 2017, with the ratio of the structural balance to GDP deteriorating. Unlike in 2016 when the fiscal position showed a temporary improvement due to external factors, both the outcomes of 2017 and the approved government budget plans¹ for the subsequent years suggest that the fiscal policy will continue to be expansionary.

A deterioration of the general government balance was observed in nominal terms as well in 2017, and Latvia ended the year with a deficit of 0.5% of GDP as opposed to a minor surplus of 0.1% of GDP in 2016. Despite the revenue rising substantially (by 8.9%) over the year, primarily on account of the tax revenue growing by 8.0% as a result of a progressive pick up in economic activity, the increase of expenditure was even more notable at 10.3%.

The increase of the consolidated general government budget expenditure in 2017 was primarily on account of higher government spending on remuneration as well as goods and services in combination with an increase in capital investment of the public sector.

¹ Article 5 of the Law on Medium-Term Budget Framework for 2018, 2019 and 2020 [reviewed on 3 April 2017]. Available at: <https://likumi.lv/ta/id/295595-par-videja-termina-budzeta-ietvaru-2018-2019-un-2020-gadam>.

The latter reflects a recovery in comparison with the low base of 2016 mainly caused by slow progress in projects co-financed by EU structural funds. More than a half of the increase in capital spending is attributable to specifically projects implemented by local governments (roads, infrastructure, etc.). Government investment inflows can be expected to remain equally strong also over the next three years. With average social security contributions growing along with the rising wages, spending on social benefits has also increased.

Tax revenue grew supported by both the rising household income and robust private consumption as well as improved tax collection. Although Latvia's tax revenue inflows into the government budget relative to GDP are still among the lowest in the EU where the average figure for 2016 was 40%, the sizeable increase in tax revenue amounting to nearly 600 million euro achieved in 2017 was enough for Latvia to retain the ratio of its tax revenue to GDP above 30% for the second consecutive year. This is the highest level of the last 15 years. Like in 2016, the overall budget revenue growth was more moderate: because of the slow transition to the new EU structural funds programming period, at the beginning of the year funding of the new period was not yet available and revenue from foreign financial assistance contracted slightly in comparison with the previous year. At the same time, non-tax revenue also somewhat decreased.

An increase in revenue was reported for all major types of taxes (PIT, corporate income tax, VAT, mandatory state social insurance contributions and excise tax) in 2017, yet almost 80% of the rise in roughly equal shares was attributable to VAT, PIT and mandatory social insurance contributions, each contributing over 150 million euro the government revenue. VAT revenue grew by 8.4%, reflecting the strengthening of private consumption. Higher economic activity boosted household income, resulting in a steep rise in taxes on labour (PIT, mandatory state social insurance contributions and solidarity tax), with the respective revenue growing by 9.6%.

At the turn of 2017, the Parliament of the Republic of Latvia adopted the Law on State Budget 2018 and the Law on Medium-Term Budget Framework for 2018, 2019 and 2020, taking into account the changes in tax regulation adopted by the Parliament of the Republic of Latvia in summer 2017 and providing for a government deficit of 1.0% of GDP in 2018, 0.9% of GDP in 2019 and 0.4% of GDP in 2020. Improving access to health care, strengthening the national security, demographic measures, improving the public infrastructure of roads and railways as well as raising the wages of higher education teaching professionals were named as medium-term budgetary policy priorities.

In preparation for the upcoming redemption of 5-year eurobonds in the amount of 1.0 million euro on 22 February 2017, the Treasury issued eurobonds in the amount of 650 million euro in February 2017 on top of the funding already raised in 2016. This included 500 million euro received on long-term bonds issued with the currently historically longest maturity of 30 years. In addition to that, eurobonds in the amount of 350 million euro were issued in June. As maturing eurobond amounts were offset by the new issues, the government debt remained broadly unchanged in 2017, contracting from 40.5% of GDP in 2016 to 40.1% of GDP in 2017 exclusively on account of GDP growth.

The Fiscal Discipline Council published its regular opinion¹ on compliance with the fiscal discipline rules in December. It confirmed that no structural balance adjustments were required, but recommended to continue with the implementation of a conservative fiscal policy and restricting of expenditure increases, considering the potential risks associated with the significant impact of the structural component when assessing compliance with the structural balance rule and the impact of the GDP deflator estimates in calculations of the expenditure growth rule.

¹ Fiscal Discipline Council's Opinion on compliance with Article 11 of the Fiscal Discipline Law [reviewed on 3 April 2018]. Available at: http://fdp.gov.lv/files/uploaded/FDP_1_08_1757_20171206_FDL_11pant.pdf.

Considering that Latvia's economic growth rate currently exceeds its potential, the government should reduce the structural deficit aiming at a balanced budget in structural terms, following an approach already adopted by the governments of Lithuania¹ and Estonia². To this end, Latvia's government should formulate the nominal general government balance with a surplus.

¹ Lithuania's Draft Budgetary Plan 2018, p. 9 [reviewed on 3 April 2018]. Available at: https://ec.europa.eu/info/sites/info/files/economy-finance/li_dbp_2018_en.pdf.

² Estonia's Draft Budgetary Plan 2018, p. 15 [reviewed on 3 April 2018]. Available at: https://ec.europa.eu/info/sites/info/files/economy-finance/2018_dbp_ee_en.pdf.

OPERATIONS AND ACTIVITIES OF LATVIJAS BANKA



LEGAL FRAMEWORK AND FUNCTIONS. LATVIJAS BANKA IN THE EUROSISTEM AND INSTITUTIONS OF THE EUROPEAN UNION

Latvijas Banka is the central bank of the Republic of Latvia and a member of the ESCB and the Eurosystem.

In its activities, Latvijas Banka complies with the Republic of Latvia and EU legislation, including ECB legal acts in accordance with the Treaty on the Functioning of the European Union and the Statute of the European System of Central Banks and the European Central Bank (hereinafter, the Statute of the ESCB and ECB).

Pursuant to the Law on Latvijas Banka, the primary goal of Latvijas Banka is to maintain price stability. Latvijas Banka has the following primary tasks:

- participate in defining and implementing the Eurosystem's monetary policy;
- manage the foreign reserves and other financial investments;
- ensure currency circulation in Latvia and participate in ensuring the currency circulation in the euro area;
- participate in promoting smooth functioning of payment systems;
- compile and publish statistical information in order to ensure the performance of the tasks of Latvijas Banka;
- cooperate with the ECB, the central banks of other EU Member States and other countries, as well as other financial institutions;
- act as the financial agent of Latvia's government and provide financial services to other market participants;
- act as an advisor to the Saeima and the Cabinet of Ministers of the Republic of Latvia on monetary policy issues and other issues related to the performance of the tasks of Latvijas Banka;
- maintain the Credit Register;
- issuing licences to legal persons listed in the Register of Enterprises of the Republic of Latvia, except credit institutions, for the purchase and sale of foreign currency as a commercial activity;
- implement the functions of the National Analysis Centre and the Coin National Analysis Centre, ensuring efficient analysis of currency counterfeits.

Latvijas Banka neither seeks nor takes instructions from the government of Latvia and other EU Member States, EU institutions and other national, foreign or international institutions and their entities. Latvijas Banka is independent in setting and implementing policy under its legal mandate. Latvijas Banka is supervised by the Saeima of the Republic of Latvia.

In 2017, the Governor of Latvijas Banka participated in the work of the Governing Council and the General Council of the ECB, namely, in the formulation of the Eurosystem's monetary policy and decision-making related to the tasks of the Eurosystem and the ESCB.

The Deputy Governor of Latvijas Banka, in cooperation with the FCMC, participated in the work of the Supervisory Board of the ECB, ensuring the fulfilment of the ECB tasks relating to the supervision of credit institutions and preparing the respective draft decisions to be submitted to the Governing Council of the ECB according to the non-objection procedure.

Representatives of Latvijas Banka participated in the Eurosystem/ESCB committees (see Appendix 4) and working groups, dealing with issues related to monetary policy, market operations, financial stability, payment systems, euro banknotes, statistics, international relations, communication, accounting etc.

Experts of Latvijas Banka also participated in committees and working groups of the Council of the EU and the EC. Sitting on the EFC and its subcommittees, representatives of Latvijas Banka regularly participated in the preparation of decisions concerning the economic development and financial stability of the EU and the development of the EU economic policy strategy, focusing in particular on the implementation of structural reforms in the EU and risk reduction measures in the banking union as well as in the formulation of policies of international financial institutions.

Representatives of Latvijas Banka participated in the EC and Eurostat working groups addressing issues related to euro coins, payment systems, economic forecasting and statistics.

In 2017, the Governor of Latvijas Banka participated in the work of the ESRB which made decisions on the issues related to the EU macroprudential policy. Representatives of Latvijas Banka engaged in the work of the Advisory Technical Committee of the ESRB and its working groups.

With the FCMC's consent, a representative of Latvijas Banka also participated in the work of the Board of Supervisors of the EBA whose general objective is to maintain financial stability and to safeguard the integrity, efficiency and orderly functioning of the banking sector.

MONETARY POLICY IMPLEMENTATION IN LATVIA

Implementing the Eurosystem's monetary policy, Latvijas Banka participated in the PSPP by purchasing debt securities of the Latvian government or in case their purchase was limited by the volume of the issue of such securities or the market situation, Latvijas Banka purchased securities issued by international institutions. With a large amount of free liquidity accumulating on Latvian credit institutions' settlement accounts, their interest in borrowing financial resources via Eurosystem monetary policy operations at Latvijas Banka was low.

As purchases of securities within the PSPP in the secondary market continued, Latvijas Banka's balance sheet item "Securities held for monetary policy purposes" grew from 4.4 billion euro to 6.7 billion euro in 2017¹ (the average monthly purchase value of securities stood at 192 billion euro; 212 billion euro in 2016). Overall, the Eurosystem's holding of the Latvian government securities totalled 1.7 billion euro² (1.3 billion euro at the end of 2016). The amount of securities purchased by Latvijas Banka decreased since, due to a drop in the average monthly purchase value under the PSPP, demand for securities issued by international institutions went down.

The continued accommodative monetary policy contributed to an increase in excess liquidity in Latvian credit institutions, averaging 5.0 billion euro in December 2017 (an average of 4.1 billion euro in December 2016). However, liquidity of Latvian credit institutions recorded a more moderate rise compared to the outstanding value of securities held by Latvijas Banka for monetary policy purposes. It was foreign not Latvian credit institutions that sold most of their securities to Latvijas Banka.

The minimum reserve requirements for credit institutions shrank from 229 million euro at the end of 2016 to 212 million euro at the end of 2017. The ratio of balance on credit institutions' settlement accounts to the minimum reserve requirements was 27 at the end of 2017, i.e. still the highest ratio among the euro area countries (10 in the euro area on average), implying a significant excess of liquidity.

¹ <https://www.bank.lv/en/about-us/reports/lb-monthly-balance-sheet>.

² <https://www.ecb.europa.eu/mopo/implementation/omt/html/index.en.html>.

Amidst ample liquidity, Latvian credit institutions showed little interest in the central bank's credit operations. The average balance of the main refinancing operations stood at 0.5 million euro, but the average outstanding amount of LTROs was 246.5 million euro (close to the average indicators of 2016). Moreover, LTROs mostly consisted of TLTROs whose average outstanding amount accounted for 244.7 million euro, while the average balance of LTROs with a 3-month maturity was 1.8 million euro.

ECONOMIC RESEARCH, ANALYSIS AND FORECASTING

Economic research and economic analysis are important functions of Latvijas Banka's operation; the objective is to provide sound explanation for current and projected future economic processes as well as for alternative economic growth scenarios in a changing economic policy environment by employing scientific methods. This enhances the adoption of quality economic policy decisions at the level of both Latvia and the euro area.

The macroeconomic projections prepared by Eurosystem staff, including Latvijas Banka's experts, are published twice a year in June and December. The forecasting process at Latvijas Banka is adapted for successful participation in forecasting procedures of the Eurosystem both by developing macroeconomic forecasts for the Latvian economy and taking part in the discussions of forecasting outcomes of other euro area countries in the Eurosystem/ESCB Monetary Policy Committee and its Working Group on Forecasting.

Daily analytical work is no less important than forecasting, and in cooperation with other central banks of euro area countries it is conducted within the Eurosystem/ESCB Monetary Policy Committee and its three Working Groups on Econometric Modelling, on Forecasting, and on Public Finance, wherein substantiated discussions form the basis for the Eurosystem's monetary policy decisions by the Governing Council of the ECB. Employees of Latvijas Banka are active participants of the Monetary Policy Committee as well as research networks and task forces established within the above Committee's working groups. In 2017, Latvijas Banka's staff presented the results of their research to three expert groups, i.e. the Household Finance and Consumption Network; Structural Reforms; and Natural Interest Rate.

In 2017, Latvijas Banka proceeded with research activities in three priority directions: 1) monetary policy transmission, 2) fiscal policy and public debt sustainability and 3) long-term growth and competitiveness. In 2017, Latvijas Banka published four working papers on its website, and one more working paper was completed at the year-end.

Working Paper No. 1/2017 aimed at improving the operation of the New Keynesian open economy model, available to Latvijas Banka, by introducing the alternating-offer wage bargaining mechanism. When assessing the model by using data on Latvia, the author concluded that the wage bargaining mechanism provided a good picture of the architecture of Latvia's labour market and improved the model performance.

The authors of Working Paper No. 2/2017 continued to study the factors influencing the export market share and analysed export market shares of 25 EU countries by employing Bayesian Model Averaging in a panel setting. The authors found that the factors contributing to export market share growth in the old and new EU Member States¹ differ. For the new EU Member States, labour and total factor productivity are particularly important, while foreign direct investment matters more than domestic investment. There is one common factor affecting the market share of the old and new EU Member States, i.e. competitive pressures from China that have strongly affected export performance in

¹ The group of old EU Member States includes the UK, Austria, Belgium, Denmark, France, Greece, Ireland, Italy, the Netherlands, Portugal, Finland, Spain, Germany and Sweden. The group of new EU Member States includes Bulgaria, the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and Hungary (Croatia, Luxembourg and Malta are not included in the assessment due to restricted access to data).

both country groups since the early 2000s. The results of the working paper also show that price competitiveness does not play a very important role in any of the above country groups, i.e. relative export prices do show correlation with export performance in the new EU Member States, but only when they are adjusted for quality. The study was carried out in cooperation with researchers from Goethe University, the ECB and EC.

When examining factors affecting Latvia's economy, the author of Working Paper No. 3/2017 analysed the features of the education system in more detail. The working paper was aimed at identifying the school characteristics enabling pupils to better perform on state exams. The author concluded that exam results had a positive correlation between the school size (the number of pupils at the respective school) and teachers' salaries. Meanwhile, the quantitative indicators, e.g. the number of teachers and computers per pupil, were not robust factors affecting learning achievements. The results also show that pupils' performance at urban and rural schools would be similar if characteristics of the above schools were the same.

Working Paper No. 4/2017 was produced in cooperation with researchers from other EU national central banks. The authors analysed responses of businesses to a rise in the minimum wage by using the Wage Dynamic Network. Currently the minimum wage in Latvia vis-à-vis other Baltic States is already quite high, and the results of the working paper suggest that businesses are also more responsive to its increase.

The objective of another working paper drawn up in 2017 was to investigate the effects of EU regional support on productivity of businesses. The results of the working paper show that the implementation of projects co-funded by the European Reconstruction and Development Fund provides an opportunity for businesses to increase their turnover, the number of employees and capital almost immediately; however, positive effect on productivity can be observed with a lag of approximately two years. The study was conducted in cooperation with an OECD researcher.

Quality research activities are impossible without continuous improvement of staff qualifications and thorough assessment of the results achieved. External reviewers from national central banks and academia of other countries are involved in assessing working papers to ensure their high quality.

Latvijas Banka also supports the publication of its employees' working papers in internationally refereed journals. For instance, *Macroeconomic Dynamics*, Cambridge University Press, has published an article dealing with an alternative method to the commonly employed perturbation methods for solving neoclassical growth models. Meanwhile, an article proposing a theoretical framework for explaining gains and losses in export market shares has been published in *Structural Change and Economic Dynamics Articles*, Elsevier.

With the aim of raising the qualifications of Latvijas Banka's researchers and strengthening their deeper integration into the international research environment, Latvijas Banka organises regular seminars to which highly qualified experts are invited to present their research results. In 2017, interested parties from other institutions had an opportunity to participate in eight out of nine such seminars.

Latvijas Banka also disseminates research findings to the public at large by explaining conclusions of working and discussion papers via articles and blogs published on www.macroeconomics.lv and other popular websites.

INVESTMENT MANAGEMENT

Foreign reserves of gold and foreign currencies as well as other financial investments of Latvijas Banka amounted to 5.7 billion euro at the end of 2017 (5.8 billion euro at the end of 2016).

Latvijas Banka manages its investments in compliance with the guidelines adopted by the Council of Latvijas Banka. The major share of Latvijas Banka's financial assets was managed relative to the weighted index of 1–10 year government securities of the US, euro area countries, Canada and the UK. The benchmark currency is the euro, and the benchmark assets are composed of 55% US dollar-denominated, 21% euro-denominated, 14% British pound sterling-denominated and 10% Canadian dollar-denominated assets. In 2017, the structure of Latvijas Banka's financial assets was slightly modified by abolishing the 10-year government fixed income securities portfolio and establishing a long-term securities portfolio by replacing the securities of the euro area countries contained in the 10-year government fixed income securities portfolio by higher yield securities of the euro area countries as well as by expanding the 1–10 year fixed income securities portfolio. Latvijas Banka invests its financial assets in safe and liquid financial instruments, basically in debt securities issued by the governments of EU countries and the US, their agencies and international organisations as well as in highly rated bank and corporate debt securities, asset-backed debt securities and callable bonds. Interest rate futures are used to regulate the duration and to implement yield curve strategies on the interest rate market, whereas both currency futures and forward exchange rate contracts ensure the optimal currency composition of financial assets.

Dynamics of 2, 5 and 10-year government bond interest rates play an important role in investment management. The year 2017 saw an increase in the weighted average interest rate on the German and Canadian 2-year, 5-year and 10-year government bonds (see Table 2) and a rise in the weighted average interest rate on the UK and US 2-year and 5-year government bonds as well as a decline in the weighted average interest rate on 10-year government bonds of the latter two countries. With historically very low interest rates persisting, it is complicated for a national central bank as conservative investor with modest risk appetite to generate positive yields.

Table 2

GOVERNMENT BOND INTEREST RATES (end of year; %)

Government bond maturity	Germany		UK		US		Canada	
	2017	2016	2017	2016	2017	2016	2017	2016
2 years	-0.63	-0.77	0.44	0.08	1.88	1.19	1.69	0.75
5 years	-0.20	-0.53	0.72	0.49	2.21	1.93	1.87	1.11
10 years	0.43	0.21	1.19	1.24	2.41	2.44	2.05	1.72

Source: Bloomberg.

The gold reserves of Latvijas Banka are stored in the Bank of England. To hedge the risk related to market value fluctuations of the gold reserve, Latvijas Banka used currency futures and foreign exchange forward contracts as well as foreign exchange swaps. At the end of 2017, Latvijas Banka discontinued the hedging of the gold price risk.

Latvijas Banka uses the services provided by seven external managers. They manage a portion of Latvijas Banka's financial assets in compliance with the guidelines adopted by the Council of Latvijas Banka to further diversify financial assets and boost income in proportion to the undertaken risk.

In investment management, much attention is paid to risk management and control. The compliance of financial asset and gold portfolios with the guidelines is monitored, and the risk allocation in accordance with various investment decisions is controlled on a daily basis.

Latvijas Banka manages its share of foreign reserve assets denominated in Japanese yen and transferred to the ECB together with the Oesterreichische Nationalbank.

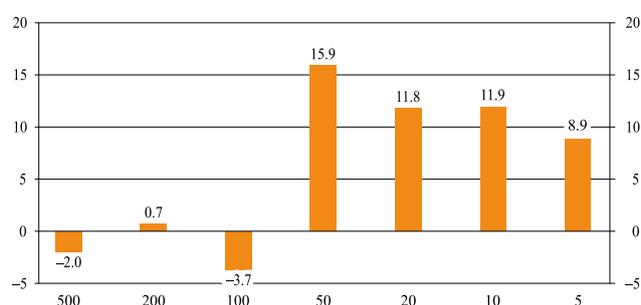
CURRENCY IN CIRCULATION

At the end of 2017, the value of euro banknotes and coins in circulation issued by Latvijas Banka was 63.2 million euro.

The number of euro banknotes issued by Latvijas Banka during 2017 grew by 4.1%, amounting to 43.6 million banknotes at the end of the year. Of net euro banknotes issued by Latvijas Banka, 50 euro and 10 euro banknotes predominated in circulation at the end of 2017 (15.9 million and 11.9 million respectively; see Chart 15).

Chart 15

EURO BANKNOTES ISSUED BY LATVIJAS BANKA IN NET TERMS
(at the end of 2017; face value; number in millions)

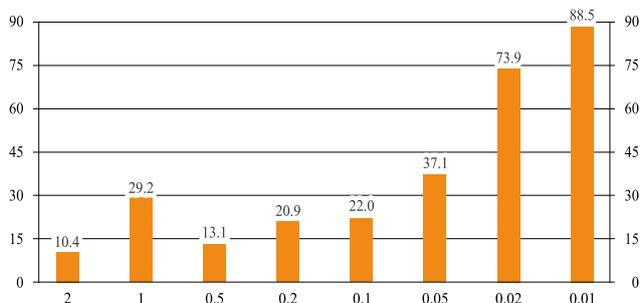


Source: Latvijas Banka.

Meanwhile, the number of coins issued by Latvijas Banka in 2017 increased by 15.8%, amounting to 295.1 million euro coins at the end of December. Of net euro coins issued by Latvijas Banka, 1 cent and 2 cent coins made up the largest part of euro coins in circulation at the end of 2017 (88.5 million and 73.9 million coins respectively; see Chart 16).

Chart 16

EURO COINS ISSUED BY LATVIJAS BANKA IN NET TERMS
(at the end of 2017; face value; number in millions)



Source: Latvijas Banka.

The cash received from credit institutions was checked for fitness and authenticity by automated cash processing systems of Latvijas Banka. They processed 139.1 million banknotes in 2017. 8.5% (11.8 million) of the processed banknotes were sorted as unfit for circulation and destroyed (20.5% and 28.5 million respectively in 2016).

In 2017, Latvijas Banka continued to register merchants, engaged in handling and recirculating of euro banknotes and coins, and to monitor their operation. A merchant is entitled to carry out the processing and recirculation of euro banknotes and coins in the Republic of Latvia upon registering as a cash processing institution with Latvijas Banka. At the end of 2017, 62 cash processing institutions were registered in Latvia.

To allow the merchants involved in cash handling to prepare for putting into circulation the 50 euro banknote of the Europa series in a timely manner, Latvijas Banka provided the opportunity to borrow the new 50 euro banknotes for testing equipment before these banknotes officially entered into circulation on 4 April 2017. Upon receiving requests from such enterprises, Latvijas Banka organised seminars on the security features of the new 50 euro banknote. Studies suggest that Latvia keeps ranking among the euro

area leaders in terms of awareness of the design and security features of the euro cash. The 50 euro banknote of a second series (Europa series) entered into circulation without any problems.

In 2017, Latvijas Banka became the Baltic Regional Cash Logistics Centre and provides services related to cash logistics to other EU central banks.

The National Analysis Centre and the Coin National Analysis Centre located at Latvijas Banka identified 1 749 counterfeits (1 462 banknotes and 287 coins; in 2016, 1 577 banknotes and coins were found to be counterfeits, including 1 277 banknotes and 300 coins). The total nominal value of counterfeits (75.4 thousand euro) detected in 2017 decreased year-on-year, but the number of identified counterfeits went up by 172. The 50 euro and 20 euro banknotes were the most counterfeited denominations.

Withdrawal of lats banknotes and coins from circulation continued throughout 2017 by exchanging lats banknotes and coins (worth 2.1 million lats) to euro banknotes and coins; of the exchanged amount, 1.9 million lats were in banknotes and 0.2 million lats in coins. At the end of 2017, lats banknotes and coins worth 44.9 million lats and 44.4 million lats respectively were not yet exchanged. At the end of December 2017, the 5 lats and 20 lats banknotes (1.7 million and 0.9 million respectively) and the 1 santim and 2 santim coins (150.2 million and 90.2 million respectively) were among the least exchanged.

In 2017, to mark anniversaries significant to Latvian history and culture as well as to highlight Latvia's cultural and historical values, Latvijas Banka issued collector coins "Fairy Tale Coin III. The Old Man's Mitten" (in circulation as of 28 March 2017), "Latgale Congress" (in circulation as of 4 May 2017), "Gold Brooches. The Horseshoe Fibula" (in circulation as of 31 August 2017), "Eduards Veidenbaums" (in circulation as of 5 October 2017), "Smith Forges in the Sky" (in circulation as of 4 November 2017 and "First Session of the LPNC" (in circulation as of 2 December 2017).

In 2017, Latvijas Banka put two 2 euro commemorative coins into circulation. They are "Kurzeme" (in circulation as of 14 November 2017) and "Latgale" (in circulation as of 14 November 2017).

2 EURO COMMEMORATIVE COINS



LATGALE

Struck in 2017 by *Staatliche Münzen Baden-Württemberg* (Germany)

The national side artists: Laimonis Šēnbergs (graphic design) and Jānis Strupulis (plaster model)

The national side features the coat of arms of Latgale.



KURZEME

Struck in 2017 by *Staatliche Münzen Baden-Württemberg* (Germany)

The national side artists: Laimonis Šēnbergs (graphic design) and Jānis Strupulis (plaster model)

The national side features the coat of arms of Kurzeme.

Weight: 8.50 g; diameter: 25.75 mm; thickness: 2.20 mm

Shape: round; colour: outer part – silver, inner part – gold

Composition: outer part – copper-nickel (Cu, Ni), inner part – three layers: nickel brass, nickel, nickel brass (Ni, Cu, Zn; Ni; Ni, Cu, Zn)

The edge of the coin bears the inscription * DIEVS * SVĒTĪ * LATVIJU (God, Bless Latvia).

The common side artist Luc Luyex

COLLECTOR COINS

FAIRY TALE COIN III. THE OLD MAN'S MITTEN

Face value: 5 euro
 Weight: 31.47 g; diameter: 38.61 mm
 Metal: silver of .925 fineness; quality: proof, with three-colour print on the obverse
 Struck in 2017 by *UAB Lietuvos monetų kalykla* (Lithuania)
 Artists: Arvids Priedīte (graphic design) and Jānis Strupulis (plaster model)



LATGALE CONGRESS

Face value: 5 euro
 Weight: 26.00 g; shape: square; measurements: 32 mm × 32 mm
 Metal: silver of .925 fineness; quality: proof, with three-colour print on the obverse
 Struck in 2017 by *Faude & Huguenin SA* (Switzerland)
 Artist: Ivars Drulle

GOLD BROOCHES. THE HORSESHOE FIBULA

Face value: 20 euro
 Weight: 6.00 g; diameter: 21.00 mm
 Metal: 999.9° gold; quality: proof
 Struck in 2017 by *Münze Österreich Aktiengesellschaft* (Austria)
 Artists: Ingūna Elere (graphic design) and Solvita Rulle (plaster model)



EDUARDS VEIDENBAUMS

Face value of each coin of the two-coin set: 2.5 euro
 Weight: 20.00 g; diameter: 35.00 mm
 Metal: silver of .925 fineness; quality: proof
 Struck in 2017 by *Koninklijke Nederlandse Munt* (The Netherlands)
 Artists: Arvids Priedīte (graphic design) and Ligita Franckeviča (plaster model)

SMITH FORGES IN THE SKY

Face value: 5 euro
 Weight: 31.47 g; diameter: 38.61 mm
 Metal: silver of .925 fineness; quality: proof
 Struck in 2017 by *Koninklijke Nederlandse Munt* (The Netherlands)
 Artists: Edgars Folks (graphic design) and Ligita Franckeviča (plaster model)





THE FIRST SESSION OF LPNC

Face value: 5 euro
 Weight: 31.47 g; diameter: 38.61 mm
 Metal: silver of .925 fineness; quality: proof
 Struck in 2017 by *Koninklijke Nederlandse Munt* (The Netherlands)
 Artist: Ivars Drulle (graphic design)

In 2017, collector coins of Latvijas Banka received recognition at the international Coin Constellation Contest organised by *Watermark*, Russian Numismatic Publishing House. The coins issued in 2016 were assessed at the above contest. The coin "The Earth" made of perlucor with a silver outer ring was the winner in the category "Original Technology", but the silver collector coin "Christmas Battles" was awarded the second place in the category "Successful Artistic Solution". Following the assessment of coins issued in 2016, the Spanish magazine *EL ECO Filatélico y Numismático* announced the silver collector coin "National Entrepreneur" the third best coin in the world.

On 1 July 2017, Latvijas Banka launched its collector coin online sales platform, thereby making it possible to pay for the purchase of collector coins and other numismatic products and receive them at the preferred time and place.

PAYMENT AND SETTLEMENT SYSTEMS

OPERATION OF TARGET2-LATVIJA AND TARGET2-SECURITIES

TARGET2, operated by the Eurosystem, was one of the world's largest payment systems in 2017. It provides real-time gross settlement in euro to support the implementation of the Eurosystem's monetary policy operations and interbank market transactions, the enforcement of customers' urgent payments and interbank settlement of other payments, securities settlement and financial instrument clearing systems. Latvijas Banka continued to maintain TARGET2-Latvija – one of the 25 TARGET2 component systems.

On 18 September 2017, Latvijas Banka and Nasdaq CSD SE, the single central securities depository of the Baltic States, successfully completed migration of Latvia's securities market to the TARGET2-Securities platform. Latvijas Banka started to provide securities cash settlement to 13 participants of Latvia's securities market. Migration of Latvia's, Estonia's and Lithuania's securities markets to the TARGET2-Securities platform marked a successful completion of the TARGET2-Securities project implemented by the Eurosystem. The above project was a joint international and unique securities settlement development project involving 21 central banks, 21 central depositories and securities markets of 20 countries. The project aimed at ensuring harmonised settlement of cash and securities transactions on the single TARGET2-Securities platform. The TARGET2-Securities project is the Eurosystem's largest project ever implemented in the area of financial market infrastructures.

Following the conclusion of the TARGET2-Securities project in 2017, Latvijas Banka together with other participants of the Eurosystem launched a new strategic project, i.e. consolidation of TARGET2 and TARGET2-Securities. The TARGET2 real-time settlement services will be modernised within the project by employing the modern technologies of the TARGET2-Securities platform. The upgraded TARGET2 services will provide an opportunity to optimise credit institutions' liquidity management as well as to execute real-time cash and securities settlement in all market infrastructure services of the Eurosystem in a modern and secure environment. 2021 is the year when participants of the Latvian market will start to use the upgraded TARGET2.

Within the framework of the Eurosystem, Latvijas Banka participated in the introduction of instant payments at European level. In November 2017, a new settlement procedure for the European payment systems, including the EKS of Latvijas Banka, which make instant payments on a European scale in a continuous manner within a few seconds on a daily basis (the so-called 24/7/365 regime), was introduced.

The availability of TARGET2, including TARGET2-Latvija, accounted for 100% in 2017. TARGET2-Latvija processed 479.8 thousand payments totalling 240.4 billion euro in 2017 (see Table 3), i.e. on average 1.9 thousand payments a day totalling 942.7 million euro.

Table 3

PAYMENTS PROCESSED IN TARGET2-LATVIJA

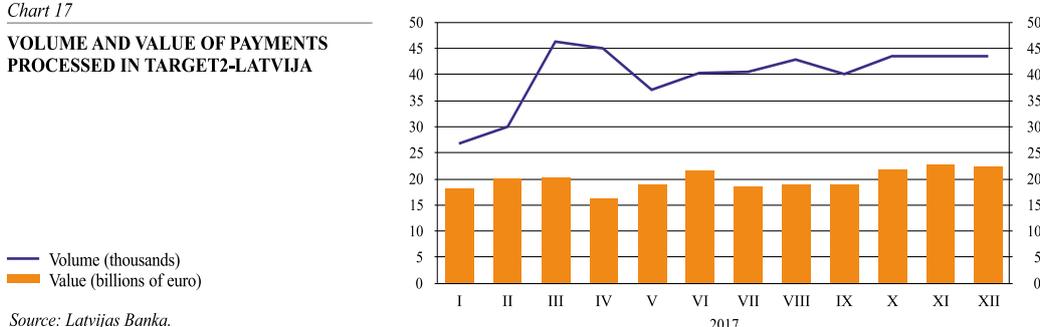
	Volume (thousands)			Value (billions of euro)		
	Interbank payments	Customer payments		Interbank payments	Customer payments	
2017	115.2	364.6	479.8	216.8	23.6	240.4
2016	89.8	339.4	429.2	209.7	25.4	235.1
2015	68.3	290.8	359.1	243.6	21.1	264.7
2014	75.1	281.2	356.3	326.9	16.1	343.0
2013	38.3	311.5	349.8	116.4	15.6	132.0

Source: Latvijas Banka.

The total volume of payments increased by 11.8%, but the total value decreased by 2.3% year-on-year. As in the previous year, the last months of the year saw the highest payment volume executed in TARGET2-Latvija (see Chart 17).

Chart 17

VOLUME AND VALUE OF PAYMENTS PROCESSED IN TARGET2-LATVIJA



Source: Latvijas Banka.

At the end of 2017, 19 credit institutions, the Treasury and Latvijas Banka were the participants of TARGET2-Latvija. TARGET2-Latvija also ensured final settlement in euro for the EKS and the payment card processing system of Worldline Latvia Ltd.

OPERATION OF THE EKS, A SYSTEM MAINTAINED BY LATVIJAS BANKA, INSTANT PAYMENTS AND OTHER PAYMENT SERVICES

In order to ensure fast and innovative payment services to Latvia's population and entrepreneurs, Latvijas Banka introduced an instant payment service of the EKS on 28 August 2017. It was developed by Latvijas Banka's employees by making use of the latest information technologies. The above service enables customers of credit institutions to make cash transfers from an account in one credit institution to an account held by another credit institution within a few seconds at any time of day or night, seven days a week, including weekends and holidays.

On 21 November 2017, Latvijas Banka and 16 other European banks connected to the European instant payment solution RT1 operated by EBA Clearing. Thus, Latvijas Banka provided an opportunity to Latvian credit institutions and their customers to send and receive instant payments within SEPA across Europe. It was a strategically coherent and



ZIBMAKSĀJUMS

NODROŠINA: | LATVIJAS BANKA
EIROSISTĒMA

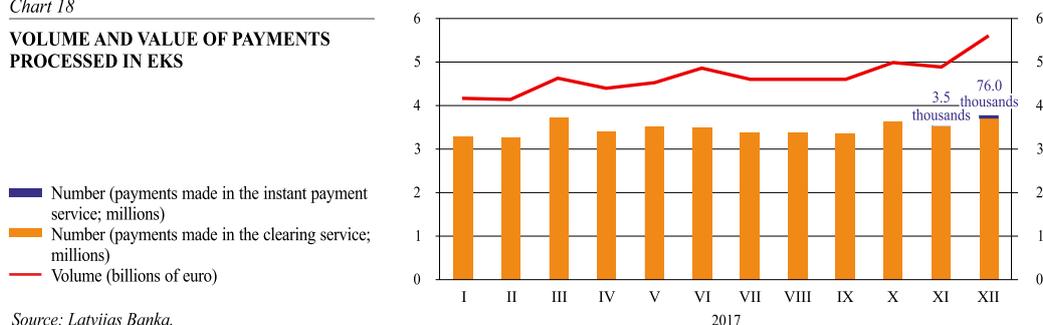
timely action that allowed Latvia rank first in Europe at the close of 2017 with regard to the number of instant payments made, handling over 5 000 instant payments a day, including a large number of payments also outside the traditional banking hours, previously closed for interbank payments. By the end of 2017, the instant payment service ensured by Latvijas Banka processed 79.5 thousand instant payments totalling 18.5 million euro.

The EKS clearing service, maintained by Latvijas Banka, continued to ensure customer payments in euro within SEPA for Latvian credit institutions and the Treasury. Latvijas Banka carried out fully automated processing of SEPA credit transfers in the EKS clearing service, providing settlement seven times a day within TARGET2-Latvija in participants' settlement accounts opened with Latvijas Banka. The EKS clearing service ensured cash transfers from one customer account held with a credit institution to a customer account of another credit institution within a few hours on business days.

In 2017, 42.1 million SEPA credit transfers totalling 56.0 billion euro were executed in the EKS system whose availability accounted for 100%. This means that the average volume and value of customer SEPA credit transfers executed on a daily basis was 164.0 thousand and 218.8 million euro respectively. The volume and value of payments processed in the EKS increased by 4.1% and 3.7% respectively year-on-year. The trend observed in 2016 continued, i.e. the year-end saw the highest volume and value of payments processed in the EKS but the beginning of the year – the lowest (see Chart 18).

Chart 18

VOLUME AND VALUE OF PAYMENTS PROCESSED IN EKS



Source: Latvijas Banka.

At the end of 2017, the EKS comprised the following direct participants: 14 credit institutions, the Treasury and Latvijas Banka, as well as two indirect participants. Two credit institutions in their capacity as direct participants took part in the EKS instant payment service.

Latvijas Banka also ensured the execution of SEPA credit transfers to its customers, i.e. the financial institutions whose settlement accounts were opened with Latvijas Banka, but which were not direct participants of Latvijas Banka's payment systems, including credit unions, via their indirect participation in the EKS. Thus, a possibility to make and receive payments in euro throughout the SEPA area was ensured. For other Latvijas Banka's customers, which had not migrated to the SEPA Credit Transfer Scheme, Latvijas Banka ensured access to SEPA by submitting credit transfers on their behalf. To support competitiveness of the sector of Latvian financial technologies (FinTech) in the field of payments, Latvijas Banka, in early 2017, started offering payment institutions and e-money institutions licensed in the EEA to open an account with the central bank for storage of customers' funds for settlement purposes and to make instant payments and SEPA credit transfers in the EKS by using services provided by Latvijas Banka. In 2017,

Latvijas Banka provided payment services in euro to the FCMC and other Latvian, foreign and international financial institutions, processing payments in the amount of 1.2 billion euro (1.3 billion euro in 2016).

OVERSIGHT OF PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

In 2017, Latvijas Banka participated in the joint Eurosystem oversight of payments and securities settlements organised by the Eurosystem, thus enhancing development of efficient and secure payment systems in the EU. One of the most significant activities with regard to Latvia's payment systems was the oversight of the establishment of the EKS innovative instant payment service carried out by Latvijas Banka. The EKS instant payment service was assessed by Latvijas Banka and found to be fully compliant with all applicable international Principles for Financial Market Infrastructures (hereinafter, the PFMI).

In 2017, Latvijas Banka together with other Eurosystem central banks assessed the compliance of the Eurosystem's 24 retail customer payment systems operating in the euro area with the PFMI. Within the framework of this comprehensive oversight assessment, Latvijas Banka performed a peer review of assessments with regard to individual payment systems of other euro area countries to ensure equal approach to an oversight assessment of retail payment systems operating in the euro area. The comprehensive oversight assessment showed that operation of the retail customer payment systems operational in the euro area, at a general level, is secure and efficient and complies with the PFMI. In addition, Latvijas Banka together with other Eurosystem central banks continued to produce the first comprehensive assessment of the Eurosystem's systemically important payment systems pursuant to the Regulation on oversight requirements for systemically important payment systems¹. Latvijas Banka together with other Eurosystem's central banks and in cooperation with other institutions carried out the oversight of TARGET2-Securities and monitored a gradual migration of central securities depositaries to the TARGET2-Securities platform.

In 2017, Latvijas Banka's experts participated in drafting appropriate amendments to the Law on Payment Services and Electronic Money in relation to the introduction of the revised Payments Services Directive² (hereinafter, the Payments Services Directive) in Latvia. Latvijas Banka, with the support of the FCMC, organised workshops on the tasks and opportunities specified by the Payments Services Directive with regard to providers of non-bank payment services. In 2017, Latvijas Banka took part in ECB consultations and discussions by participating in the creation of a secure and harmonised payment market in Europe by representing interests of Latvia's payment market. Latvijas Banka, in collaboration with the FCMC, continued to take an active part in the European Forum on the Security of Retail Payments established by the ECB. In the framework of the Forum, Latvijas Banka, in cooperation with the EBA, developed guidelines and technical standards on secure communication of market participants and strong user authentication stipulated by the Payments Services Directive. Such technical standards are necessary to improve customer protection, enhance innovation and strengthen payment services security.

In 2017, Europe and other parts of the world saw an increased interest in the rise in popularity of the blockchain and distributed ledger technology. This technology has the potential for boosting efficiency of specific business processes and also reducing the costs related to record keeping of information and transactions of the financial sector. Latvijas

¹ Regulation of the European Central Bank (EU) No. 795/2014 of 3 July 2014 on oversight requirements for systemically important payment systems (ECB/2014/28).

² Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No. 1093/2010, and repealing Directive 2007/64/EC (Payments Services Directive).

Banka continued to examine the distributed ledger technology and the opportunities this technology offers by organising a workshop to raise market participants' awareness of the opportunities provided by this technology and the potential to improve certain financial processes and business models. At the same time, Latvijas Banka together with other European central banks launched a project to create a prototype of the payment system by employing the blockchain and distributed ledger technology. Within the above project, Latvijas Banka will fully provide one of the nodes of dispersed accounting. The project results, advantages and drawbacks of the new technology will be compiled in 2018 based on the practical experience acquired.

On 20 December 2017, the FCMC introduced the Innovation Sandbox in Latvia to support innovative solutions which would enhance the variety of possibilities and efficiency of services of the Latvian financial sector. Within the framework of the Innovation Sandbox created by the FCMC, Latvijas Banka delivers advice to payment service providers in relation to development of the Latvian payment market, the operating principles of Latvijas Banka's payment systems, the services offered by Latvijas Banka to providers of payment services as well as the principles of best practice by developing innovative payment services.

During 2017, in the area of oversight of securities settlement systems, Latvijas Banka in cooperation with Eesti Pank and Lietuvos bankas monitored a project of merging the central securities depositories of the Baltic States in one depository, i.e. Nasdaq CSD SE, to facilitate project development in accordance with the PFMI, compliance with the best practice of operation of securities settlement systems and with Latvian and EU legislation as well as to ensure successful joining of Latvia's securities market to the TARGET2-Securities platform. Latvijas Banka carried out all assessments necessary for the implementation of the project. On 24 August 2017, the Governing Council of the ECB deemed the Estonian, Latvian and Lithuanian securities settlement systems appropriate for use in Eurosystem credit operations. The above systems, following their planned merger, will operate under the new management of Nasdaq CSD SE. On the same date, the Governing Council of the ECB also acknowledged Nasdaq CSD SE to be eligible for accessing TARGET2-Securities services. On 15 September 2017, the merger of the central securities depositories of the three Baltic States led to the establishment of one central securities depository, i.e. Nasdaq CSD SE, headquartered in Latvia and having branches in Estonia and Lithuania. Nasdaq CSD SE launched its operation on 18 September 2017, following the receipt of a licence of a central securities depository and by joining the Eurosystem's TARGET2-Securities platform. Thus, the merger project of the central securities depositories of the Baltic States was successfully completed.

Latvijas Banka compiled and analysed data on the development of customer payment market in Latvia (see Table 4). In 2017, a total of 441.2 million non-cash payments in

Table 4

**NON-CASH PAYMENT INSTRUMENTS
USED IN LATVIA**

	Volume (millions)				Value (billions of euro)			
	Customer credit transfers	Card payments	Direct debit, cheques, e-money payments and other payment instruments		Customer credit transfers	Card payments	Direct debit, cheques, e-money payments and other payment instruments	
2017	167.3	271.9	2.0	441.2	242.6	5.0	0.4	248.1
2016	156.0	242.8	5.0	399.3	284.8	4.6	0.2	289.6
2015	145.9	215.2	0.1	361.2	361.9	4.2	0.0	366.1
2014	138.3	191.0	5.0	334.3	437.9	3.8	0.3	442.0
2013	139.7	151.6	6.4	297.7	575.7	3.2	0.3	579.2

Source: Latvijas Banka.

the amount of 248.1 billion euro were made in Latvia. In comparison with 2016, the total volume of non-cash payments recorded an increase of 10.5% primarily on account of card payments, which were the most frequently used non-cash settlement. Overall, 271.9 million card payments in the amount of 5.0 billion euro were made in 2017. The volume and value of card payments picked up by 12.% and 9.1% respectively in comparison with 2016. Another widely used non-cash payment instrument was customers' credit transfers whose volume reached 167.3 million (annual growth of 7.3%), but their value stood at 242.6 billion euro (a decrease of 14.8%) in 2017. Other payment instruments, i.e. cheques, e-money payments and other payment instruments, were relatively seldom used.

FINANCIAL STABILITY

In 2017, Latvijas Banka continued its close cooperation with the FCMC by participating in drafting the legal acts governing the prevention of money laundering and terrorism financing, and was active in providing advice to the Latvian government with regard to the development of various draft laws and draft initiations and draft amendments to EU legislation.

Latvijas Banka was a participant of a working group established by the Ministry of Welfare of the Republic of Latvia focusing on changes in the way the state-funded pension scheme (the second pillar) works. Latvijas Banka made proposals concerning the reduction of total management costs and the procedure for calculating the variable part of the fee. At the end of 2017, the Saeima of the Republic of Latvia supported amendments to the Law on State-funded Pensions, and the associated regulations of the Cabinet of Ministers were adopted. As estimated by Latvijas Banka, the implementation of these regulatory requirements will save Latvian households at least 20 million euro in 2018.

With active cooperation among the Nordic and Baltic countries in the field of financial stability, a Memorandum of Understanding between the Nordic and Baltic Countries was approved within the Nordic-Baltic Stability Group in 2017. In January 2018, the above Memorandum was signed by the respective ministers, governors of the central banks and heads of supervision and resolution authorities of the involved countries. The Memorandum intends to maintain close cooperation between the Nordic and Baltic countries with regard to financial stability issues, including exchange of information significant for financial stability as well as to propose and decide on joint activities concerning regional cooperation to contribute to financial stability. Working groups focusing on examination of specific topics related to financial stability may be established within the Memorandum.

Latvijas Banka participated in the workstream of the Macroprudential Policy Working Group of the ECB Financial Stability Committee by forging a shared approach to the analysis of cross-border effects on macroprudential instruments. Theoretical influence channels of macroprudential instruments and the existing practice used by the Member States for impact assessment of the above instruments are dealt with at workstream meetings. On the basis of the information obtained, a uniform methodology to be used by Member States in their analysis will be developed.

Latvijas Banka participated in an international ECB-led study on the impact of borrower-based macroprudential instruments on real estate price dynamics and lending by using the granular data obtained from the Household Finance and Consumption Survey conducted by Latvijas Banka.

Latvijas Banka further developed the framework for the analysis of systemic risks to financial stability and added a risk panel to the range of quantitative instruments for the analysis of financial stability risks. This is a risk assessment and visualisation tool supplementing the assessment of financial system stability with a substantial number of

macroprudential indicators. Changes in these indicators provide early warnings of an increase in systemic risks.

In 2017, Latvijas Banka conducted its regular survey of household borrowers. The obtained data were used to assess the financial position of household borrowers and resilience of household creditworthiness to potential macrofinancial shocks.

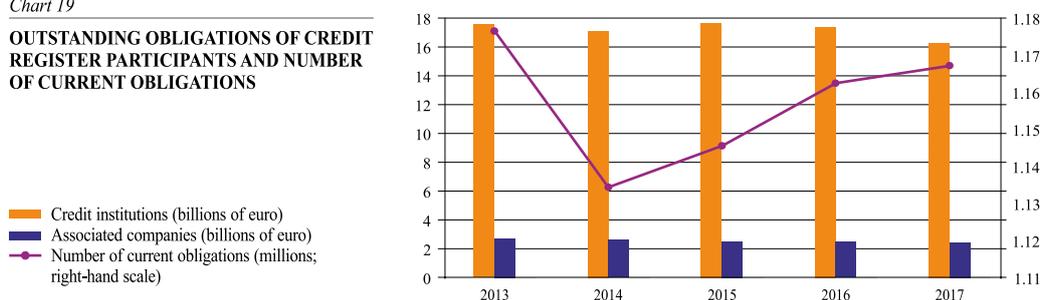
OPERATION OF THE CREDIT REGISTER

Latvijas Banka continued to accumulate data on credit liabilities of and guarantees provided by natural and legal persons by collecting and storing in the Credit Register data on its participants' (credit institutions, credit institutions' subsidiaries (leasing companies), other companies having close links with credit institutions, credit unions, insurers and JSC "Attīstības finanšu institūcija Altum") borrowers and borrowers' guarantors, their credits and delayed payments. When using the Credit Register data, its participants have an opportunity to assess the creditworthiness of the person which applies for credit or wants to provide a guarantee for other person's liabilities. Thus, the use of the Credit Register data enhances honest and responsible lending and borrowing, thereby strengthening the stability of Latvia's financial system. At the same time, the Credit Register provides information necessary for the fulfilment of Latvijas Banka's and the FCMC's tasks, contributes to the execution of the ESCB's tasks as well as presents additional opportunities for public institutions to receive data for the purpose of performing the tasks stipulated by laws and regulations.

In 2017, Latvijas Banka continued a comprehensive improvement of the Credit Register to implement the requirements of Regulation (EU) No. 2016/867 of the European Central Bank of 18 May 2016 on the collection of granular credit and credit risk data (ECB/2016/13) (hereinafter, the Regulation). In implementing the requirements of the Regulation, the national central banks of the euro area will include detailed data on loans granted to legal persons by credit institutions in the Analytical Credit Datasets. The Eurosystem, ESCB and ESRB need such detailed information for successful execution of their tasks. In 2017, Latvijas Banka drew up the necessary amendments to the Law on Credit Register (Amendments to the Law on Credit Register were approved by the Saeima of the Republic of Latvia on 21 December 2017; with effect from 1 April 2018) as well as the new versions of Latvijas Banka's regulations to improve the legal acts regulating operation of the Credit Register in compliance with the requirements of the Regulation. At the same time, the Credit Register requirements with regard to the collection of information necessary for the execution of the tasks assigned to the FCMC for supervision of financial market participants were extended. Thus, the Credit Register participants will report data once, to the Credit Register, instead of reporting them to two individual institutions. The above amendments to the Law on Credit Register provide for the Treasury's participation in the Credit Register as of 1 October 2018. As from that date, data on the loans and warranties (guarantees) granted by the Treasury will be included in the Credit Register, thus enabling other participants of the Credit Register to access extended information on credit liabilities of borrowers. At the same time, the Treasury's opportunities to assess borrowers' creditworthiness on a regular basis will be ensured.

At the end of 2017, the Credit Register comprised 104 participants which authorised 825 users to work with the Credit Register (105 participants and 788 users respectively in 2016). The Credit Register contained data on 4.6 million obligations, of which 1.2 million obligations were outstanding ones, pertaining to 1.2 million persons (at the end of 2016, on 4.2 million obligations pertaining to 1.1 million persons). The total outstanding obligations of the Credit Register participants amounted to 18.8 billion euro (19.9 billion euro at the end of 2016; see Chart 19).

Chart 19

OUTSTANDING OBLIGATIONS OF CREDIT REGISTER PARTICIPANTS AND NUMBER OF CURRENT OBLIGATIONS


Source: Latvijas Banka.

Note. Over a five-year period, the average outstanding obligations of insurers constituted 0.012 billion euro and those of cooperative credit unions – 0.019 billion euro.

Latvijas Banka made it possible for any person to receive Credit Register data pertaining to him/her/it free of charge. In 2017, 4.6 thousand persons (4.8 thousand persons in 2016) used this opportunity by arriving at Latvijas Banka in person. A natural person can immediately receive the Credit Register data pertaining to him/her electronically on the website <https://mandati.kreg.lv>. Over the year, natural persons requested information about themselves in electronic form 1 066 times (949 times in 2016). Credit Register participants submitted 13.2 million requests (12.4 million requests in 2016) to the Credit Register for the purpose of the assessment of the creditworthiness of their current or potential borrowers and borrowers' guarantors.

In 2017, Latvijas Banka continued to take care of the quality of the data contained in the Credit Register and the rationale behind the requests by checking activities undertaken by Credit Register participants on a regular basis.

STATISTICS

Latvijas Banka collects and compiles financial and monetary statistics and balance of payments statistics as well as prepares quarterly financial account statistics and government finance statistics. Following the ECB's request, Latvijas Banka has also been involved in addressing the methodology-related issues of some fields of economic statistics and compiling specific aggregates.

Latvijas Banka employs statistical data to perform financial and macroeconomic analyses as well as raise public awareness of the developments in the financial sector and the economy. The ECB uses statistical data produced by Latvijas Banka to compile the Eurosystem's monetary statistics and the relevant statistics of the euro area as well as to discharge its other tasks.

Latvijas Banka continued regular transmission of statistical data to the ECB, BIS, Eurostat, OECD, the World Bank and IMF as well as provided statistical information to other data users in Latvia and abroad. To furnish a wide range of data users with timely information, Latvijas Banka disseminated financial and monetary statistics, balance of payments statistics and quarterly financial account statistics of Latvia via its regular publications and the website of Latvijas Banka and compiled data for publishing in the ECB publications and the ECB Statistical Data Warehouse, as well as in IMF publications and on its website and within the framework of the IMF Special Data Dissemination Standard. Latvijas Banka complemented the range of financial soundness indicators with new indicators for transmission to the IMF as well as participated in the IMF's Financial Access Survey, reporting data on the access to and the scope of the services provided to households by Latvia's credit institutions and other financial institutions. Latvijas Banka participated in promoting the new visualisation tool of the section "Financing and Investment Dynamics" of the ESCB statistics site "Our Statistics" by publishing information on Latvijas Banka's website. In 2017, the section "Statistics" of Latvijas Banka's website was extended by adding a new theme "Current Indicator".

On 5 July 2017, the IMF Statistical Department was informed of Latvia's intention to adhere to the IMF's Special Data Dissemination Standard Plus as well as of the fact that Latvijas Banka takes over the coordination role of the IMF's Special Data Dissemination Standards. To ensure the 15 data categories of the IMF's Special Data Dissemination Standard Plus Latvijas Banka is responsible for, the section of financial account statistics of Latvijas Banka's internet statistical database INTS was supplemented with two new data categories, i.e. data of other financial corporations and debt securities data.

FINANCIAL AND MONETARY STATISTICS

In 2017, the compilation of statistical data in accordance with the requirements of the ECB and other data users was successfully ensured in the field of financial and monetary statistics. It was the first time that Latvijas Banka compiled and submitted to the ECB data on insurance corporations' premiums, claims and commissions, thus meeting the requirements of Regulation (EU) No. 1374/2014 of the European Central Bank of 28 November 2014 on statistical reporting requirements for insurance corporations (ECB/2014/50) and Guideline ECB/2014/15 of the European Central Bank of 4 April 2014 on monetary and financial statistics (2014/810/EU). Moreover, fact-finding and costs exercises were conducted in relation to the envisaged ECB regulation in the field of pension fund statistics as well as certain methodological issues were examined. Latvijas Banka's experts participated successfully in the work of ECB-organised task forces aimed at making proposals for the establishment of the European Reporting System as well as at improving the ECB Register of Institutions and Affiliates Database (RIAD).

In 2017, Latvijas Banka studied experience of credit institutions concerning the provision of notional cash pooling services. The ECB will use the results obtained to amend Guideline ECB/2014/15 of the European Central Bank of 4 April 2014 on monetary and financial statistics (2014/810/EU).

In accordance with the ESCB work plans and the Statistical Programme of Latvijas Banka for 2017, it was intended to conduct the investigative and costs survey on the establishment of the European Reporting System. However, taking account of the scope of methodological work which also involved the conduction of a survey on the national statistical data collection practice, data compilation and analysis as well as the necessity to coordinate the survey content at the EU level, only the fact-finding survey has been drawn up, and it is planned to send the above survey to credit institutions in 2018.

In 2017, Latvijas Banka upgraded information systems to introduce the new RIAD-related ECB requirements whereby indicators of non-financial corporations are set. These indicators make it possible to identify resident non-financial corporations and are necessary for the ESCB to compile credit registers statistics. Latvijas Banka also participated in the ECB-organised testing of the information systems involved in the transmission process of the above indicators. In accordance with the ESCB work plans and the Statistical Programme of Latvijas Banka for 2017, transmission of such data to the ECB had to be commenced. However, due to the postponement of deadlines for the introduction of ECB technical solutions, data transmission will be started in 2018. In compliance with the ESCB work plan, the time-frame for the conduction of the planned fact-finding and costs exercises in the field of payment statistics has also been changed. Consequently, the above exercises have been included in the Statistical Programme of Latvijas Banka for 2018.

BALANCE OF PAYMENTS STATISTICS

In order to enable credit institutions to submit information on their ownership of negotiable and non-negotiable debt securities pursuant to International Financial Reporting Standard 9 "Financial Instruments", Regulation No. 136 "Regulation for Compiling Reports on Securities" of Latvijas Banka of 16 May 2014 (with effect from 1 January 2018) was amended.

The Council of Latvijas Banka approved Regulation No. 154 "Regulation for Compiling the 'Quarterly Financial Reports (1-FP)'" of Latvijas Banka of 14 September 2017 (with effect from 1 January 2018) to ensure the takeover from the CSB of the survey on other financial institutions' financial assets and liabilities (3-FAP). The takeover of the survey provides coherent use of data for the preparation of financial account statistics, balance of payments statistics and statistics of other financial intermediaries, for the needs of financial stability analysis as well as prevents the situation where other financial institutions provide similar data on non-resident financial assets and liabilities both to the CSB and Latvijas Banka. With the Regulation coming into force, the range of the respondents to which Latvijas Banka's Regulation No. 110 "Regulation for Compiling the 'Quarterly Report on Foreign Assets and Liabilities (1-MB)'" applies will be narrowed down since the respondents of the "Quarterly Financial Report (1-FP)" will not have to compile the "Quarterly Report on Foreign Assets and Liabilities (1-MB)".

GENERAL ECONOMIC AND GOVERNMENT FINANCE STATISTICS

In 2017, it was agreed between Latvijas Banka and the CSB that the compilation of annual financial accounts would be the responsibility of Latvijas Banka as of 2018. Thus, Latvijas Banka will compile both the quarterly and annual financial account statistics, ensuring quality and harmonised time series of annual and quarterly financial accounts.

Latvijas Banka launched the 2017–2019 Household Finance and Consumption Survey. This is already the second survey of its kind in Latvia, and in accordance with the ECB requirements, it is conducted every three years to obtain data on the real and financial assets, credit liabilities, income and consumption of households. In 2017, the household sample used in the previous 2014–2016 survey was updated in cooperation with the CSB. The panel approach allowing to obtain more complete information on changes in the financial situation and consumption of households in the longer term was employed to select the sample. In accordance with the panel approach, the sample includes the households that participated in the previous surveys. However, for the purpose of data quality, a household is usually interviewed in up to three consecutive surveys only. In autumn 2017, the sampled households were interviewed. In 2017, it was the first time that Latvijas Banka published the household financial and consumption statistical indicators obtained during the 2014–2016 survey on its website in the section "Statistics". Moreover, anonymised files containing the 2014–2016 Household Finance and Consumption Survey data are available upon request for research purposes.

PROVIDING FINANCIAL SERVICES TO THE GOVERNMENT

In order to facilitate efficient and safe budgetary payments of Latvia, in 2017 Latvijas Banka ensured the management of the Treasury's settlement accounts opened with Latvijas Banka. The Treasury used payment services provided by Latvijas Banka for effecting settlement and also participated in the payment systems of Latvijas Banka in the capacity of a direct participant. In 2017, the Treasury had settlement accounts in euro and foreign currencies with Latvijas Banka. Over the year, Latvijas Banka settled 1.3 thousand payments of the Treasury in euro and foreign currencies totalling 14.8 billion euro (year-on-year increases of 35.9% and 2.5 times respectively).

ADVISORY SERVICES TO THE GOVERNMENT AND OTHER INSTITUTIONS

One of the tasks of Latvijas Banka is to advise the Saeima and the Cabinet of Ministers of the Republic of Latvia on monetary policy and other issues related to the performance of the tasks of Latvijas Banka.

In 2017, the Governor of Latvijas Banka, other officials of Latvijas Banka and its

employees held regular meetings with the representatives of the Saeima and the government of the Republic of Latvia, including participation in the meetings of the commission of the Saeima and the Cabinet of Ministers of the Republic of Latvia and in the work of several committees established by the government, providing an opinion on the financial and economic development issues, as well as recommendations on structural reforms. In 2017, when analysing Latvia's economic growth prospects, Latvijas Banka paid particular attention to issues related to the tax system and educational reforms. Latvijas Banka published its "Tax Strategy 20/20" aimed at promoting Latvia's economic growth, businesses competitiveness and household wealth and contributed to discussions on the Tax Policy Guidelines. When examining factors affecting Latvia's economy, Latvijas Banka analysed the features of Latvia's educational system, including the school characteristics and the opportunities for improving the global competitiveness of higher education.

Employees of Latvijas Banka contributed to the promotion of Latvia's economic development by participating in different working groups and professional organisations, sharing experience and providing advice to them, including in the field of securities settlements and payments, as well as in the process of drafting legal acts and their amendments regulating the financial sector, financial services, anti-money laundering and combating the financing of terrorism and other areas.

Experts of Latvijas Banka provided support for the government enabling Latvia to take an active part in the EU and the OECD, as well as ensured the provision of information to and its exchange with the international rating agencies.

Employees of Latvijas Banka participated in the work of the Supervisory Committees and sub-committees of the EU structural funds and the Cohesion Fund; they provided advice on the drafting of the planning documents of the EU budget programming period 2014–2020 and were involved in the assessment supervision with regard to the use of financing from the EU structural funds and the assessment of project applications in selected fields.

With regard to the government expenditure, experts of Latvijas Banka engaged in the work of several working groups and provided recommendations on more effective use of state budgetary funds, while in the area of budget revenue, they provided their recommendations and assessment as part of the process of drawing up the Tax Policy Guidelines for 2018–2021.

Employees of Latvijas Banka in their capacity as experts continued to participate in the Working Group for the Preparation of the Notification of the General Government Budget Deficit and Debt for 2016, compiling the notification data of the general government budget deficit and debt for 2016 and dealing with the methodological issues related to accounting of the European System of National and Regional Accounts.

Representatives of Latvijas Banka were engaged in the evaluation of the enterprises participating in a competition "Trademark of the Year" organised by the Patent Office of the Republic of Latvia and the Latvian Chamber of Commerce and Industry and a competition "Export and Innovation Award" organised by the Investment and Development Agency of Latvia in cooperation with the Ministry of Economics of the Republic of Latvia.

INFORMATION AND EDUCATIONAL FACILITIES PROVIDED TO THE PUBLIC

THE MOST IMPORTANT ASPECTS OF COMMUNICATION

Information and educational facilities provided to the public is an important activity of Latvijas Banka as it improves the economic literacy, helps people and entrepreneurs

understand the regularities of the macroeconomic development, the impact monetary and other policies supporting advance in various areas exert on economic growth, competitiveness of Latvia's economy and higher public well-being.

In 2017, Latvijas Banka continued to inform the public about significant monetary policy decisions of the Eurosystem and Latvijas Banka's participation in their implementation. Based on economic expert analysis, Latvijas Banka actively voiced its stance on the economic development in Latvia and euro area, inter alia, published recommendations on structural reforms in the area of health care financing and education policy, as well as on the most essential elements of a competitiveness-enhancing tax system.

At press conferences, the Governor of Latvijas Banka regularly provided information about the economic growth and challenges in both the euro area and Latvia, necessary structural reforms, fiscal discipline, and decisions taken by the ECB's Governing Council.

In 2017, Latvijas Banka focused on several issues crucial for the public and economic development, while continuing the analytical work which started in the previous years to identify obstacles to competitiveness and to prepare proposals to address them. The issues related to employing labour force hinder the development and production of higher value products.

As previously, the public was informed about money design and safety issues, including the security features of euro banknotes and coins and opportunities to examine suspicious banknotes and coins at the national counterfeit centre established by the national central bank.

The public was informed about the main advantages of the implementation of the instant payment infrastructure and the progress of the project implementation. Latvijas Banka continues to upgrade this service; moreover, it is possible to make instant and safe payments in the entire euro area since November 2017, and Latvia holds the leading position with respect to the implementation of the instant payment infrastructure.

PUBLICATIONS

In 2017, Latvijas Banka continued to prepare a wide range of regular publications. Incorporating the data provided by Latvijas Banka, the CSB, the Ministry of Finance of the Republic of Latvia, the FCMC and other institutions, the Macroeconomic Developments Report, issued in June and December, assessed developments of the external sector, financial market, domestic demand and supply, costs and prices, and balance of payments, as well as presented GDP and inflation forecasts. The balance of payments statistics compiled by Latvijas Banka are published in *Latvijas Maksājumu Bilance*. Latvia's Balance of Payments (2016), while the publication Financial Stability Report assessed major financial stability risks. In 2017, four working papers by Latvijas Banka's specialists were published on the websites of Latvijas Banka.

In compliance with the requirements of the Statute of the ESCB and ECB, Latvijas Banka ensured translation of the ECB Annual Report 2016 and the ECB's Economic Bulletin issues published after the monetary policy meetings of the Governing Council of the ECB held in March, June, September and December (published on the Internet).

Economists of Latvijas Banka published their working papers on the websites of Latvijas Banka and respectable international peer-reviewed journals, series and magazines (*Macroeconomic Dynamics* (Cambridge University Press), *Structural Change and Economic Dynamics Articles* (Elsevier), *Comparative Economic Research*, *Economics and Business*, the ECB Working Papers Series and the OECD Economics Department Working Papers Series).

Throughout the year overall, more than 17 000 publications on issues concerning the activities of Latvijas Banka and the macroeconomic and financial analysis appeared in different mass media in Latvia, more than 500 journalists' questions were answered, and over 130 interviews with Latvijas Banka's management, economists and other specialists were published.

LATVIJAS BANKA'S WEBSITES

To inform the public at large about the operation of the Eurosystem and goals and instruments of the monetary policy, Latvijas Banka publishes, on a regular basis, its expert commentaries on the decisions taken by the ECB's Governing Council and the development of economy and financial markets in the euro area on its website www.bank.lv. Information about the use and performance of monetary policy instruments was published.

The population could obtain information on the services provided by Latvijas Banka and its tasks as well as receive extensive explanatory information on topics concerning the activities of Latvijas Banka on the website.

In preparation for the 100th anniversary of Latvia and Latvijas Banka, a microwebsite (www.lb100.lv) where articles, photos and documents regarding the activities of Latvijas Banka, its employees and buildings in these 100 years are published has been developed.

Macroeconomics.lv – an economic analysis website maintained by Latvijas Banka – is a useful source of information and data for persons interested in economics and economic experts, namely, lecturers, students, experts of public institutions, corporate managers, researchers and other observers of economic processes. At www.macroeconomics.lv, one can find in one place the most important macroeconomic data, their analysis and research, as well as commentaries on developments in Latvia's, euro area's and global economy by economic experts of Latvijas Banka.

In 2017, among the most popular topics were economic forecasts provided by Latvijas Banka and materials of its annual conference including the series of articles about the problems related to education development as well as various economic sector reviews, economic updates and explanations of the monetary policy developments. Overall, 63 analytical articles and 63 commentaries on the most recent data and development trends by economists were published on www.macroeconomics.lv in 2017.

In 2017, the improvement of the website (www.macroeconomics.lv) started in 2016 continued to ensure a better comprehensibility of the content.

Latvijas Banka actively communicated with the public also by means of social networks (*Twitter.com*, *Facebook.com*, *draugiem.lv*, *Slideshare.com*, *Youtube.com* and *Flickr.com*) as well as used an online tool for creating infographics *Infogr.am*.

ANNUAL CONFERENCE AND EXPERT ROUNDTABLE DISCUSSIONS

On 27 September 2017, Latvijas Banka organised its economic conference "Education: From Mediocrity to Excellence" which was dedicated to the public's long-awaited reforms in the area of education.

One of the tasks of Latvijas Banka is to ensure long-term stability, thereby laying the foundations for Latvia's future prosperity. This is not possible without a well-educated and globally competitive new generation. Latvijas Banka's conference brought together industry leaders, teachers, university lecturers and experts to think together how to move from the current mediocrity in Latvia's general and higher education towards excellence in the future.

The conference raised widespread interest. It was also webcast, and almost 1 200 viewers followed it.

To enhance the adoption of macroeconomic development-oriented decisions in the country and to encourage a professional discussion on issues relevant for the Latvia's economy, as well as to share expertise regarding the latest developments in the euro area and globally, Latvijas Banka organised the traditional expert roundtable discussions. In 2017, high level experts from public administration institutions, financial and economic circles, businesses and academic community were brought together to address issues regarding instant payments (Latvijas Banka was among the first central banks in Europe introducing the instant payment infrastructure) and to discuss at great length global trends on the payment market. In 2017, the discussion focused on the presidency of the newly-elected US President Donald Trump and its impact on the economy of Europe including Latvia.

IMPROVEMENT OF ECONOMIC LITERACY

In 2017, several activities that had attracted much interest in the previous years continued to educate the general public and the development of new educational programmes on macroeconomic and financial issues was launched.

Latvijas Banka's Knowledge Centre "Money World" which is the basic element of Latvijas Banka's economic educational programme was renovated in 2017. In view of the introduction of the euro and changes in the tasks of the national central bank, it was necessary to gradually modernise and expand the "Money World", offering an enhanced content relevant to the new situation and an upgraded technical solution.

The alteration of the Knowledge Centre was carried out by both the specialists of Latvijas Banka, especially with regard to the content development, and by experts and partners from other institutions specialising in exposition and multimedia, i.e. the FCMC, the Association of Commercial Banks of Latvia, First Data Latvia Ltd. and JSC "Nasdaq Riga".

A seminar "Topical Economic Issues" was organised already for the fourth year to provide the teachers of economics with the most recent information and discuss Latvia's economic development trends, movements in the labour market, the impact the development of technologies has on day-to-day settlements and financial services and what students should know about it. In cooperation with the National Centre for Education, the FCMC, the Consumer Rights Protection Centre, the Fiscal Discipline Council and Jelgava Spīdola Gymnasium, educational lectures for students and seminars for teachers on different financial issues were organised in Dobeles municipality, Preiļi municipality, Kuldīga as well as in the Grammar School of Nordic Languages and Zvejniekiems Secondary School.

To arouse interest of young people in financial, money and economic issues, Latvijas Banka together with the FCMC, within the framework of the Financial Education Week 2017, participated in organising the financial competition for pupils "Financial ABC 2017" offered by the University of Economics and Culture. In early 2017, Latvijas Banka together with several partners involved in the implementation of the financial literacy strategy for Latvian population completed the development of the Core Competencies Standard for Adult Financial Literacy.

The educational work with teachers and pupils carried out for several years by Latvijas Banka earned also international esteem in 2017. The project jointly submitted by the FCMC and Latvijas Banka "National Strategy for Financial Literacy in Latvia (2014–2020)" and "Diversity of Teaching and Learning Methodologies for Training Financial Literacy" was nominated for the final of the CYFI Country Award 2017 of the international non-profit organisation promoting financial literacy *Child & Youth Finance International* (CYFI) as one of the five best in the group of the European and Central Asian countries.

Latvijas Banka supported *Junior Achievement – Young Enterprise Latvija* in organising the competition "My Dictionary" for primary school students and declaring the winners, thus improving the economic and financial literacy of children.

From 14 November 2016 to 10 January 2017, Latvijas Banka organised a competition of children's drawings for the design of the euro collector coin "My Latvia". This was already the third competition of children's drawings organised by Latvijas Banka in which participation was open to children who had not yet reached the age of 13. 6 742 children with more than 10 000 drawings covering a wide range of themes took part in the competition. The drawing by the first prize winner Elizabete Kandere (a 10 years old schoolgirl from the Grobiņa municipality will be redesigned into a collector coin in the year of Latvia's centenary.

In the traditional public survey clarifying the public and art experts' opinions about accomplishments in coin art, the "Fairy Tale Coin II. Hedgehog's Coat" was named "Latvia's Coin of the Year 2016". 16 581 people cast their vote, and 7 601 votes were cast for the "Fairy Tale Coin II. Hedgehog's Coat". The collector coin "National Entrepreneur" won the award of the expert commission of the Latvian National Museum of Art.

COOPERATION WITH INTERNATIONAL ORGANISATIONS AND FOREIGN CENTRAL BANKS

Latvijas Banka is the representative of the Republic of Latvia in foreign central banks and international financial institutions. Latvijas Banka may participate in operations of other international financial and credit organisations consistent with its objectives and tasks.

In 2017, Latvijas Banka continued to represent Latvia's interests at meetings of the IMF Board of Governors and in the coordination of operational issues. Priorities of the IMF policy were mainly related to the developments in the global economy and the financial system. The IMF continued to indicate that the current recovery of the global economic growth was an appropriate moment to implement reforms. This would reduce medium-term risks and boost the economic growth potential of the countries. At the same time, it is necessary to increasingly focus on the development of globalisation and technologies and to promote the positive benefits to the public. The IMF analysed developments in the international monetary system and the possible need to strengthen the global financial safety net, reviewing the IMF's lending instruments and assessing the principles of cooperation with regional financing arrangements. The adequacy of the IMF resources was reviewed, and the 15th review of quotas and the review of the quota formula used for calculation of the quota share are still underway.

Latvia's interests in the IMF were represented in the Nordic-Baltic Constituency that includes Denmark, Estonia, Iceland, Latvia, Lithuania, Norway, Finland and Sweden. One Executive Director represented this constituency on the IMF Executive Board, with a total of 3.3% votes.

Representatives of Latvijas Banka continued to participate in the work of the Nordic-Baltic Monetary and Financial Committee established for setting strategic directions and laying down guidelines and developing a joint opinion on operational issues of the IMF. Meetings of the Nordic-Baltic Monetary and Financial Committee and of its Alternates took place in Riga in 2017.

In 2017, cooperation with the IMF, based on consultations under Article IV of the IMF Articles of Agreement, continued.

In 2017, Latvijas Banka continued its membership in the BIS.

Several external meetings of the Eurosystem/ESCB Committees and their Working Groups as well as other events were organised in Riga in 2017. In May, Latvijas Banka

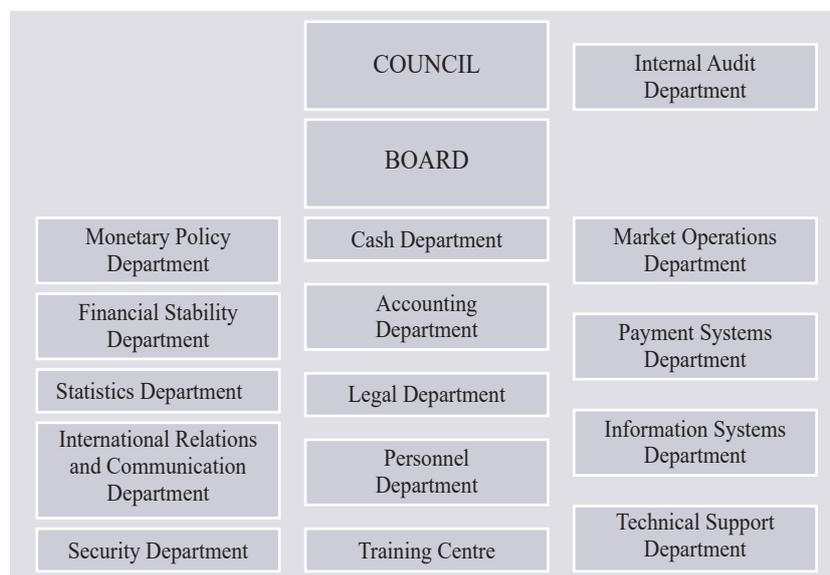
organised external meetings of the Eurosystem/ESCB Communications Committee and the Working Group on Cash Communication of the Eurosystem, whereas an external meeting of the Eurosystem Working Group dealing with foreign reserve management issues was held in summer. In 2017, Latvijas Banka held several ESCB and SSM training workshops for improving different professional skills and research workshops with the participation of the experts of the national central banks of different countries and the ECB. Cooperation among the national central banks of the Baltic States also continued, with a seminar on cash issues being organised in Riga.

In 2017, cooperation with the National Bank of Belarus continued as part of experience exchange visits. Employees of Latvijas Banka shared their know-how in information technology system issues with their counterparts from the National Bank of Kazakhstan and in issues of operation and development of an educational visitors centre with the experts of the Central Bank of the Russian Federation.

In 2017, international financial organisations and foreign central banks extended support to Latvijas Banka, providing an opportunity to participate in the workshops and courses hosted by these institutions. Employees of Latvijas Banka participated in courses, seminars and conferences organised by the EC, ECB, IMF, Joint Vienna Institute, *Study Center Gerzensee*, Federal Reserve Bank of New York, as well as by the central banks of the UK, France, Ireland, Italy, Lithuania, the Netherlands, Portugal, and Finland.

MANAGEMENT AND ORGANISATION OF LATVIJAS BANKA





THE COUNCIL OF LATVIJAS BANKA

The Council of Latvijas Banka takes decisions on behalf of Latvijas Banka. The term of office of the Governor, Deputy Governor and Members of the Council of Latvijas Banka is six years. At the end of 2017, the composition of the Council of Latvijas Banka was as follows:

- Governor **Ilmārs Rimševičs;**
- Deputy Governor **Zoja Razmusa;**
- Members of the Council: **Edvards Kušners,**
Vita Pilsuma,
Arvils Sautiņš,
Aivars Skopiņš.

Meetings of the Council of Latvijas Banka are held as appropriate, but at least once a quarter. The Council of Latvijas Banka held 12 meetings in 2017. Upon performing the tasks stipulated in the Law on Latvijas Banka, the Council of Latvijas Banka overall adopted 109 legal acts in 2017 concerning the use of monetary policy instruments, investment management, provision of currency in circulation, compiling statistical data, operation and oversight of the payment and securities settlement systems, operation of the Credit Register, licensing and supervising of purchase and sale of foreign currency, and other issues pertaining to the operation, management and organisation of Latvijas Banka.

THE BOARD OF LATVIJAS BANKA

To carry out and efficiently manage day-to-day activities of Latvijas Banka, the Council of Latvijas Banka has established the Board of Latvijas Banka that performs activities on a continuous basis. At the end of 2017, its composition was as follows:

- Chairman of the Board **Māris Kālis;**
- Deputy Chairperson of the Board **Ilze Posuma;**
- Members of the Board: **Jānis Blūms,**
Jānis Caune,
Harijs Ozols,
Raivo Vanags.

The Board of Latvijas Banka conducted daily activities of Latvijas Banka in compliance with the requirements of the Law on Latvijas Banka and other legal acts and by implementing decisions of the Council of Latvijas Banka.

EMPLOYEES OF LATVIJAS BANKA

At the end of 2017, Latvijas Banka employed 528 people, of whom 19 had fixed-term employment contracts (compared with 539 and 22 employees at the end of 2016 respectively). At the end of 2017, 57% of Latvijas Banka's staff were male and 43% were female. The Counsellor of Latvijas Banka worked at the Permanent Representation of Latvia to the EU in 2017.

COMMISSIONS, COMMITTEES AND WORKING GROUPS OF LATVIJAS BANKA

In order to ensure quality performance of Latvijas Banka's tasks, several committees, commissions and working groups approved by the Council of Latvijas Banka, the Governor of Latvijas Banka or the Board of Latvijas Banka continued their work in 2017.

The Commission for Management of Banknotes and Coins of Latvijas Banka made decisions on the replacement of damaged euro and lats banknotes and circulation coins, exercised control of identification, accounting, storage and destruction of banknotes and coins with signs of counterfeiting and counterfeits, registered cash processing institutions and cancelled their registration, and controlled the operation of cash processing institutions. To ensure the fulfilment of the requirements specified for purchasing and selling foreign currency as a financial service, the Licensing Committee of Latvijas Banka issued, re-registered and rewrote licences of capital companies for purchasing and selling foreign currency as a commercial activity and controlled the operation of licensed capital companies.

The Operational Risk Management Committee of Latvijas Banka monitored the operational risk management at Latvijas Banka. A range of diverse issues related to security were addressed by the Security Oversight Commission of Latvijas Banka. The Information Systems Management Committee of Latvijas Banka monitored and coordinated issues related to the operation and development of Latvijas Banka's information systems and personal data processing.

The Ethics Committee of Latvijas Banka monitored the implementation of "The Code of Conduct of Latvijas Banka".

COMMISSIONS AND COMMITTEES OF LATVIJAS BANKA AT THE END OF 2017

Audit Committee of Latvijas Banka	Information Systems Management Committee of Latvijas Banka
Budget Commission of Latvijas Banka	
Coin Design Commission of Latvijas Banka	Investment Committee of Latvijas Banka
Commission for Management of Banknotes and Coins of Latvijas Banka	Licensing Committee of Latvijas Banka
Commission for Evaluation of Gifts and Disposal and Write-off of Movable Assets of Latvijas Banka	Operational Risk Management Committee of Latvijas Banka
Document and Archives Management Expert Commission of Latvijas Banka	Security Oversight Commission of Latvijas Banka
Ethics Committee of Latvijas Banka	Standing Commission for Procurement of Latvijas Banka

The Budget Commission of Latvijas Banka, whose aim is to facilitate proper utilisation of financial resources of Latvijas Banka, contributed to the operational management of Latvijas Banka. The Standing Commission for Procurement of Latvijas Banka implemented this objective in the area of procurements organised by Latvijas Banka. The Investment Committee of Latvijas Banka developed and defined strategy for and made tactical decisions on managing financial assets and gold.

The Audit Committee of Latvijas Banka, authorised by the Council of Latvijas Banka, carried out the oversight of the internal audit function, activities of the external auditors of Latvijas Banka and preparation of financial statements; it also enhanced the functioning of the internal control system of Latvijas Banka.

MANAGEMENT PRINCIPLES AND DEVELOPMENT

The management of Latvijas Banka ensures quality performance of the tasks stipulated in the Law on Latvijas Banka and other legal acts. The management model of Latvijas Banka provides an opportunity to detect gaps in the areas of management and leadership of strategies, resources, staff and processes as well as to measure the results achieved vis-à-vis customers, employees and general public.

"Statement of Vision, Mission and Values of Latvijas Banka" and strategic goals of Latvijas Banka formed the basis for the operation and development planning. Every year progress towards achieving the set objectives is measured. At the same time, the execution of functions and processes is monitored daily and implementation of work plans is reviewed on a regular basis. Customer surveys are conducted biennially, asking customers to assess the quality of Latvijas Banka's services, their accessibility and convenience, and cooperation with the staff.

The customer survey of 2016 shows a high performance rating of the core functions (4.73 points out of 5), while the annual staff survey of 2017 assigns a high score to the quality of implementation of support functions (4.65 points out of 5).

RESOURCES MANAGEMENT

HUMAN RESOURCES

In 2017, Latvijas Banka continued to pursue its key principles of human resources policy of hiring qualified and professional employees by way of an effective staff recruitment process and establishing long-term employment relationships, creating a motivating working environment and enhancing professional development opportunities.

Like in previous years, Latvijas Banka used staff rotation and promotion to foster personnel development and career. One employee of Latvijas Banka, appointed as the Adviser to the Executive Director of the Nordic-Baltic Constituency of the IMF in 2015, continued her work.

Staff of Latvijas Banka continued to broaden their professional expertise in the fields of monetary policy, financial stability, macroeconomics, econometrics, financial market, financial institution supervision, statistics, financial accounting, internal audit, personnel management, law, risk management, securities operations, cash processing supervision and information technologies. Several employees of Latvijas Banka further developed their professional knowledge by participating in international professional certification programmes.

Latvijas Banka's staff training costs amounted to 1.4% (the same as in 2016) of the total expenses on remuneration.

FINANCIAL RESOURCES

The financial management system of Latvijas Banka has been developed to ensure support to decision making, financial risk management and efficient use of financial resources.

Latvijas Banka finances its operation primarily from the income generated from managing financial assets. Latvijas Banka does not receive financing from the state budget. Instead, it transfers 65% of the profit made during the reporting year to the state budget. In 2017, Latvijas Banka recorded a profit of 23.9 million euro, of which 15.5 million euro are to be transferred to the state budget. Over the period between 2012 and 2016, Latvijas Banka's profit totalled 161.5 million euro; of that, 104.9 million euro were transferred to the state budget.

Major financial transactions of Latvijas Banka are related to the management of financial assets and implementation of monetary policy. Financial assets are managed in compliance with the basic principles set out in the "Guidelines for Managing Financial Assets and Gold of Latvijas Banka" adopted by the Council of Latvijas Banka. They include preserving the value of investments, ensuring their liquidity, and earning income within the framework of acceptable risk standards without contradicting the monetary policy implemented by the Eurosystem. Meanwhile, operations related to the implementation of monetary policy are performed by Latvijas Banka in line with the "Procedure for Participation in the Eurosystem Monetary Policy Operations Organised by Latvijas Banka" adopted by the Council of Latvijas Banka.

In order to ensure comprehensive and transparent information about financial transactions, financial risks and their management as well as performance results, Latvijas Banka prepares and publishes annual financial statements. They are drafted in accordance with the mandatory requirements of the ECB legal framework for accounting and financial reporting binding on the ESCB, and in line with the "Financial Accounting Policy of Latvijas Banka", adopted by the Council of Latvijas Banka, by organising accounting in compliance with the "Financial Accounting Regulation of Latvijas Banka", adopted by the Board of Latvijas Banka, and other regulations of Latvijas Banka pursuant to the Law on Latvijas Banka and requirements of other laws and regulations of the Republic of Latvia binding on Latvijas Banka.

Latvijas Banka publishes a monthly closing balance sheet and notes to it as well as other financial information, which are also available on the website of Latvijas Banka. Latvijas Banka's integrated information system ensures a standardised, automated, secure and efficient execution of financial transactions of Latvijas Banka, their uniform accounting and drawing up of financial statements. Within the framework of the internal financial control system, the management of Latvijas Banka regularly assesses changes in assets and liabilities as well as in income and expenses of Latvijas Banka, paying particular attention to both the results of investment management and compliance of operating costs and long-term investments with the approved budget of Latvijas Banka. The Council of Latvijas Banka approves the annual budget of Latvijas Banka; the management of the budget is carried out according to the "Regulation for Managing the Budget of Latvijas Banka", adopted by the Council of Latvijas Banka and aimed at ensuring efficient use of Latvijas Banka's financial resources. The Regulation provides for the procedure of drafting, approving and monitoring the execution of Latvijas Banka's budget. Within the budget management framework, Latvijas Banka assesses the effectiveness, costs and human resources of each project on a continuous basis in order to ensure efficient use of funds. To assure the independence of internal audit function, the Council of Latvijas Banka also approves an expenditure plan for the Internal Audit Department.

The Budget Commission of Latvijas Banka evaluates the draft budget prepared by the Board of Latvijas Banka and oversees the budget execution. The Board of Latvijas Banka,

together with the heads of the relevant structural units of Latvijas Banka, draws up the draft budget and submits it to the Budget Commission and the Council of Latvijas Banka as well as controls the budget execution and reports on it on a regular basis.

INFRASTRUCTURE RESOURCES

Engineering and technical infrastructure resources

Latvijas Banka provides and maintains infrastructure necessary for its operation. Construction works critical for the maintenance of buildings were carried out in the buildings of Latvijas Banka in Riga, in the Liepāja Branch building and the building of the Training Centre.

At the competition for the "Building of the Year 2017 in Latvia", organised by the Latvian Association of Civil Engineers and Latvian Builders Association, the renovation of a part of Latvijas Banka building at K. Valdemāra iela 2A, Riga (reconstruction of the Knowledge Centre "Money World" of Latvijas Banka and its adjoining premises in an architectural monument of national significance, incl. reconstruction and restoration) was awarded the 1st prize in the nomination "Renovation".

In 2017, reconstruction of a part of the ventilation system in Latvijas Banka's building at K. Valdemāra iela 2A, Riga was carried out, enabling maintenance of a microclimate as per the legislative requirements in the respective office premises all the year round. The building video surveillance system of the Riga Branch of Latvijas Banka has been upgraded, achieving improved video quality and surveillance ergonomics.

Resources of information technologies

In 2017, changes in the infrastructure of Latvijas Banka's information systems were introduced to ensure its uninterrupted availability and operation 24/7/365 due to the instant payment solution introduced by Latvijas Banka, simultaneously providing continuous access to the non-bank statistical system as well.

The Banking Information System T24 (Globus) was upgraded to a new release, thus obtaining a more advanced banking information system, with improved functionality and with full support from the vendor.

Switching to a new version of the centralised database management system and server operating system has been accomplished; upgrading of several other important components of Latvijas Banka's information systems infrastructure has been carried out (e.g. unified telecommunications solution, e-mail system, firewall system), thereby switching to technologically more advanced solutions, enhanced levels of security and availability, and extra functionality.

Security testing of Latvijas Banka's information systems infrastructure has been conducted; security solutions and procedures were improved to mitigate risks associated with cyber security and most actual technological threats.

More efficient use of environmental resources

Latvijas Banka is an environmentally friendly institution striving to ensure more efficient use of environmental resources.

Over time, several measures have been taken to reduce the usage of paper and, consequently, also resources required for its production. Document circulation in electronic format has also been ensured, thus substantially reducing the need for document printing. Meanwhile, waste paper is recycled.

Efficient printer mode is used to ensure lower consumption of raw materials (toner, ink and paper) and smaller amount of required paper (by applying duplex printing). The

employees are encouraged to choose a more efficient printing mode by assessing the necessity of printing (colour material printing in particular).

As regards energy efficiency, Latvijas Banka also takes into account energy consumption of new devices when implementing projects related to technical modernisation of equipment. Energy efficiency ratio is considered when upgrading hardware and other technical equipment as well as when improving lighting solutions.

In 2017, technical specifications for the installation of a solar power plant on the roof of Latvijas Banka's Riga Branch building were developed. Launching of the technical project is planned for 2018.

RISK MANAGEMENT

Latvijas Banka manages strategic, financial and operational risks. Latvijas Banka's risk management goal and basic principles are set in the "Risk Management Policy of Latvijas Banka", "Business Continuity Management Policy of Latvijas Banka", "Information and Information Systems Security Policy of Latvijas Banka", and "Physical Security Policy of Latvijas Banka" adopted by the Council of Latvijas Banka. A comprehensive and uniform supervision of the implementation of these policies is carried out by the Security Oversight Commission of Latvijas Banka.

Risk management at Latvijas Banka is carried out as part of a systematic process identifying, analysing and assessing risks, developing and implementing relevant risk mitigation measures, overseeing and reviewing risks on a regular basis in order to timely identify, assess and efficiently manage risks that are likely to have a negative effect on:

- the financial position and financial performance of Latvijas Banka;
- Latvijas Banka's capability to perform the tasks provided for in the legislative acts in a quality and efficient manner, inter alia to participate in the implementation of the ESCB functions.

Financial risks are managed with the aim of minimising their potential negative impact on Latvijas Banka's finances and financial performance that might arise from adverse changes in financial market factors or a counterparty default. When managing financial risks, including market risk (price, interest rate and currency risks), credit risk and liquidity risk, acceptable types of risks and their parameters are taken into consideration to preserve the value of investments ensuring the required liquidity and income earning in the long term.

Financial risks related to Latvijas Banka's investment are managed in accordance with the "Procedure for Managing Financial Assets and Gold of Latvijas Banka" adopted by the Council of Latvijas Banka.

Investments are managed by classifying them into different investment portfolios. Parameters for a benchmark reflecting the acceptable level of financial risks and return target are set out for each financial instrument portfolio and the Risk Management Division of the Market Operations Department monitors compliance with them. For the purpose of managing investment, including the related financial risks, the Investment Committee of Latvijas Banka develops an investment management strategy, approves investment tactics, sets detailed limits for financial risks, and oversees the operation of external investment managers. The Investment Committee of Latvijas Banka reviews the investment strategy on a quarterly basis, but on a weekly basis receives and reviews reports on and forecasts for developments in financial markets prepared by financial investment portfolio managers, reports by financial risk managers and approves investment management tactics for the forthcoming week. The Market Operations Department informs the Council of Latvijas Banka about the investment management results on a regular basis.

Operational risks of Latvijas Banka are managed to mitigate a potential negative impact on Latvijas Banka's operation, reputation or financial position and financial performance, resulting from inadequate or erroneous execution of processes, acts or omissions on the part of an employee, inadequate operation or unavailability of either the infrastructure of information systems, the information systems or other infrastructure of Latvijas Banka, or external events.

Latvijas Banka's operational risks are managed under a single framework of operational risk management, with compliance risks (including risks in such areas as conflict of interests, anti-corruption control, personal data protection, prevention of money laundering and terrorism financing, and working environment protection) and those of business continuity, physical security, information security and information systems security (including cyber security risk) ranking among the main operational risks.

At Latvijas Banka, operational risks are managed through processes and projects by identifying and assessing risks and, depending on the risk assessment, defining and implementing the most appropriate measures. Management of operational risks is organised by the Operational Risk Manager of Latvijas Banka and conducted, on a daily basis, by the structural units, project managers and other employees of Latvijas Banka responsible for the execution of Latvijas Banka's processes. Operational risk management is supervised by the Operational Risk Management Committee of Latvijas Banka, appointed by the Board of Latvijas Banka, which effects the coordination of measures to be carried out under the operational risk management process and provides support to the Board of Latvijas Banka in the area of risk management.

Compliance risks are managed with the aim of ensuring compliance of Latvijas Banka's operation with legislative provisions.

Business continuity risk management of Latvijas Banka is aimed at reducing potential negative effects on the performance of critical processes, where their discontinuity may cause negative consequences for Latvia's financial system or adversely affect the implementation of Latvijas Banka's tasks, inter alia by ensuring continuity of the critical processes or their recovery as soon as possible and to a full extent in the event of their disruption or failure, as well as efficient incident management.

Physical security risks, including risks associated with fire safety and civil protection, are managed to reduce potential negative effects on the physical security of persons present on the premises of Latvijas Banka, Latvijas Banka's premises, transportation of valuables, and the events organised by Latvijas Banka.

Information security risks are managed to prevent unauthorised disclosure or use of confidential information, classifying it by its degree of confidentiality and ensuring appropriate protection, at the same time taking care that the protective measures do not prevent Latvijas Banka from providing non-classified information to its cooperation partners and general public in a timely manner.

Information systems risks, including cyber security risks, are managed to prevent a potential negative impact on availability, security and integrity of the information systems and infrastructure of Latvijas Banka. Information systems at Latvijas Banka are classified on the basis of their importance for implementing Latvijas Banka's tasks and the confidentiality, integrity and availability requirements regarding the data to be processed, establishing appropriate physical and logical protection for each level of classification.

In view of the growing cyber security risks, extra security testing was carried out and measures to enhance the protection of Latvijas Banka's information systems and their infrastructure were implemented in 2017.

The staff of Latvijas Banka are trained in the areas of risk management, and routine exercises and tests are organised to maintain their knowledge and skills at an adequate level. Latvijas Banka ensures risk management training for its employees, inter alia to maintain appropriate level of their know-how and skills, and conducts, on a regular basis, training sessions and tests in risk management for employees

INTERNAL AND EXTERNAL AUDIT

By applying a systemic and planned approach, the internal audit provides the management of Latvijas Banka with an objective and independent evaluation of the effectiveness of Latvijas Banka's governance, risk management, control system and processes and advises on improvements in Latvijas Banka's operation.

The internal audit at Latvijas Banka is conducted by the Internal Audit Department. The internal audit is organised and conducted in accordance with "The Internal Audit Policy of Latvijas Banka", adopted by the Council of Latvijas Banka, and the Regulation of the Internal Audit Department. It is carried out in line with the "Core Principles for the Professional Practice of Internal Auditing", "International Standards for the Professional Practice of Internal Auditing" and the "Code of Ethics" of the Institute of Internal Auditors.

The compliance of internal audit activities with the "International Standards for the Professional Practice of Internal Auditing" and the "Code of Ethics" of the Institute of Internal Auditors is also assessed by an external assessor every five years. In 2015, the external assessment was carried out by PricewaterhouseCoopers SIA. The assessment confirmed compliance of the internal audit activities with the above standards and the "Code of Ethics".

The internal audit covers all business areas of Latvijas Banka. Internal audits are planned and conducted using a risk-based approach. The Head of the Internal Audit Department reports the outcomes of each internal audit to the Governor and the Audit Committee of Latvijas Banka. The Audit Committee of Latvijas Banka, jointly with the Head of the Internal Audit Department, reviews the internal audit findings, recommendations and their implementation on a quarterly basis. The results of internal audit activities are reported to the Council of Latvijas Banka on an annual basis.

The Internal Audit Department also carries out internal audits based on the audit plan agreed with the Eurosystem/ESCB Internal Auditors Committee. In 2017, the Internal Audit Department performed two such internal audits at Latvijas Banka.

The staff of the Internal Audit Department engage also in the fulfilment of other Eurosystem/ESCB internal audit tasks. In 2017, Latvijas Banka's auditors participated in three working groups responsible for Eurosystem/ESCB internal audit planning and implementation; during one of such internal audits they carried out internal audit inspections in other central banks of the Eurosystem. Moreover, to support the mobility of auditors and to expand their knowledge, a short-term exchange of internal auditors with Národná banka Slovenska was arranged.

Pursuant to the Law on Latvijas Banka, Latvijas Banka's financial statements are audited by independent external auditors recommended by the Governing Council of the ECB and approved by the Council of the EU. KPMG Baltics SIA, a commercial company of certified auditors, has been approved as the auditors of Latvijas Banka's financial statements for 2015–2019.

Activities of the Internal Audit Department of Latvijas Banka and the external auditor auditing Latvijas Banka's financial statements are overseen by the Audit Committee of Latvijas Banka.

**FINANCIAL STATEMENTS OF LATVIJAS BANKA
FOR THE YEAR ENDED 31 DECEMBER 2017**



BALANCE SHEET

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

	Note ¹	2017	2016
ASSETS			
Gold and gold receivables	6	230 856	234 305
Claims on non-euro area residents denominated in foreign currency	7	3 608 692	3 092 076
Receivables from the International Monetary Fund		143 477	153 992
Balances with banks and security investments, external loans and other external assets		3 465 215	2 938 084
Claims on euro area residents denominated in foreign currency	8	355 065	358 839
Claims on non-euro area residents denominated in euro	9	101 333	144 564
Lending to euro area credit institutions related to monetary policy operations denominated in euro	10	244 660	257 160
Longer-term refinancing operations		244 660	257 160
Other claims on euro area credit institutions denominated in euro	11	438	9 071
Securities of euro area residents denominated in euro	12	8 131 197	6 319 754
Securities held for monetary policy purposes		6 719 984	4 357 306
Other securities		1 411 213	1 962 448
Intra-Eurosystem claims	13	4 604 114	4 195 918
Participating interest in the European Central Bank		115 082	115 082
Claims equivalent to the transfer of foreign reserves		163 480	163 480
Other claims within the Eurosystem		4 325 552	3 917 356
Other assets	14	222 287	160 618
TOTAL ASSETS		17 498 642	14 772 305

¹ The accompanying Notes set out on pages 71 to 114 are an integral part of these financial statements.

<i>(cont.)</i>	(at the end of the year; in thousands of euro)		
	Note	2017	2016
LIABILITIES			
Banknotes in circulation	15	4 314 088	4 150 106
Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	16	5 712 980	4 191 147
Current accounts (covering the minimum reserve system)		5 712 980	4 191 147
Other liabilities to euro area credit institutions denominated in euro	17	22 610	720
Liabilities to other euro area residents denominated in euro	18	215 712	212 239
General government		29 516	46 710
Other liabilities		186 196	165 529
Liabilities to non-euro area residents denominated in euro	19	2 535	17 888
Liabilities to euro area residents denominated in foreign currency	20	144 324	159 844
Liabilities to non-euro area residents denominated in foreign currency	21	634	–
Intra-Eurosystem liabilities	13	6 339 683	5 292 395
Liabilities related to TARGET2 and correspondent accounts (net)		6 339 683	5 292 395
Other liabilities	22	305 552	294 614
Capital and reserves	23	440 524	453 352
TOTAL LIABILITIES		17 498 642	14 772 305

PROFIT AND LOSS STATEMENT

		(in thousands of euro)	
	Note	2017	2016
Net interest income	33	71 498	56 801
Interest income		138 189	102 982
Interest expense		-66 691	-46 181
Net result of financial operations, recognition of revaluation result in profit and loss statement and financial risk provisions		-28 175	-100 590
Realised gains arising from financial operations	34	33 292	38 539
Recognition of revaluation result on financial assets and positions in profit and loss statement	23, 35	-18 791	-52 729
Provisions for market risk and credit risk	36	-42 676	-86 400
Net expense from fees and commissions		-3 087	-2 200
Fees and commissions income		397	396
Fees and commissions expense		-3 484	-2 596
Income from participating interest	37	5 258	5 242
Net result of pooling of monetary income	38	3 651	10 834
Other operating income	39	12 382	81 051
NET INCOME		61 527	51 138
Remuneration	40	-17 616	-17 184
Social security costs and solidarity tax	40	-3 962	-3 852
Banknote and coin acquisition costs	41	-4 542	-7 283
Depreciation of fixed assets and amortisation of intangible assets	14	-3 750	-3 755
Other operating expenses	42	-7 773	-7 291
PROFIT OF THE REPORTING YEAR		23 884	11 773

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

		(in thousands of euro)	
	Note	2017	2016
Profit of the reporting year		23 884	11 773
Revaluation	23	-18 274	-16 416
Realisation of the accumulated revaluation result	23	-29 576	-26 565
Recognition of revaluation result on financial assets and positions in profit and loss statement	23, 35	18 791	52 729
Total changes in the valuation account	23	-29 059	9 748
TOTAL		-5 175	21 521

The financial statements, which are set out on pages 67 to 114, were authorised by the Board of Latvijas Banka on 13 March 2018.

BOARD OF LATVIJAS BANKA

M. Kālis

I. Posuma

J. Blūms

J. Caune

H. Ozols

R. Vanags

NOTES TO THE FINANCIAL STATEMENTS

1. PRINCIPAL ACTIVITIES

Latvijas Banka is the central bank of the Republic of Latvia and a member of the ESCB and the Eurosystem. It was established on 19 September 1922 (re-established in 1990). In its activities, Latvijas Banka complies with the Republic of Latvia and EU legislation, inter alia ECB legal acts, in compliance with the Treaty on the Functioning of the European Union and the Statute of the ESCB and of the ECB.

Pursuant to the Law on Latvijas Banka, the primary goal of Latvijas Banka is to maintain price stability. Latvijas Banka has the following primary tasks:

- participate in the formulation and implementation of the Eurosystem's monetary policy;
- manage the foreign reserves and other financial investments;
- ensure cash currency circulation in Latvia and participate in ensuring the cash currency circulation in the euro area;
- participate in promoting smooth functioning of payment systems;
- compile and publish statistical information in order to ensure the performance of the tasks of Latvijas Banka;
- cooperate with the ECB, the central banks of other EU Member States and other countries, as well as other financial institutions;
- operate as the financial agent of Latvia's government and provide financial services to other market participants;
- act as an advisor to the Saeima (Parliament) and Cabinet of Ministers of the Republic of Latvia on monetary policy issues and other issues related to the implementation of the tasks of Latvijas Banka;
- maintain the Credit Register;
- issue licences to legal persons listed in the Register of Enterprises of the Republic of Latvia, except credit institutions, for the purchase and sale of foreign currency as a commercial activity;
- perform the function of the National Analysis Centre and the Coin National Analysis Centre ensuring efficient analysis of currency counterfeits.

Latvijas Banka neither seeks nor takes instructions from the government of Latvia and other EU Member States, EU institutions and other national, foreign or international institutions and their entities. Latvijas Banka is independent in setting and implementing policy under its legal mandate. Latvijas Banka is supervised by the Saeima of the Republic of Latvia.

Latvijas Banka's execution of operating activities is mainly financed from income received from its investment management.

The Head Office of Latvijas Banka is situated at K. Valdemāra iela 2A, Riga. Latvijas Banka manages the storage, processing and circulation of cash through its branches in Riga and Liepāja.

2. PRINCIPAL ACCOUNTING POLICIES

A summary of the principal accounting policies adopted by Latvijas Banka and applied in the preparation of these financial statements is set out below.

2.1 BASIS OF PREPARATION

These financial statements have been prepared in accordance with the Guideline of the ECB of 3 November 2016 on the legal framework for accounting and financial reporting in the European System of Central Banks (recast) (ECB/2016/34), Financial Accounting Policy of Latvijas Banka approved by Latvijas Banka's Council, and the requirements of the Law on Latvijas Banka governing financial reporting.

2.2 BASIS OF MEASUREMENT

These financial statements have been prepared in accordance with the historical cost basis of accounting. Gold, debt securities (except held-to-maturity debt securities and securities held for monetary policy purposes that are measured at amortised cost), participating interest (except the participating interest in the ECB), currency future contracts and interest rate derivatives are accounted for at fair value. Forward exchange rate contracts and currency swap arrangements are valued according to the principles described in Note 2.15. The comparison of the book value and fair value of these instruments is provided in Note 5.

2.3 FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Fair value is the price at which a financial asset could be sold or financial liability could be transferred in an orderly transaction between market participants at the measurement date.

Fair value of financial instruments is determined by Latvijas Banka using quoted prices in active markets, other financial market information sources or discounted cash flows. The discounted cash flows are modelled using quoted market prices of financial instruments and money market interest rates. The breakdown of assets measured at fair value as well as of financial instruments that have not been measured at their fair value but whose estimated fair value is different from their book value, taking into account the hierarchy of fair value determination, is provided in Note 5.

2.4 FOREIGN CURRENCY AND GOLD TRANSLATION

For foreign currency translation Latvijas Banka applies foreign exchange rates published by the ECB. The price of gold is set on the basis of the quoted gold market price in US dollars and the exchange rate of the US dollar against the euro published by the ECB. The exchange rate of the SDR is set on the basis of the weights of the SDR basket of currencies published by the IMF and the exchange rates of the respective currencies published by the ECB.

Transactions denominated in foreign currencies are recorded in euro at the respective exchange rates on the day of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into euro at the exchange rates at the end of the reporting period. Non-monetary assets and liabilities, measured at cost or amortised cost, are translated into euro at the exchange rate for the respective foreign currency on the day of the transaction.

Transactions in foreign currencies are included in the calculation of net foreign currency position of the respective currency. The transactions in foreign currencies reducing the respective currency position result in realised gains or losses. Any gain or loss arising from revaluation of transactions in foreign currencies and foreign currency positions are credited or charged to the profit and loss statement or the balance sheet item "Capital and reserves" as the foreign currency revaluation reserve ("Valuation account") in accordance with the principles referred to in Note 2.23. The principles referred to herein and in Note 2.23 for valuation and recording of transactions denominated in foreign currencies are also applied to gold.

The exchange rates of major foreign currencies (currency units per euro) and gold price (euro per troy ounce) in euro used in the preparation of the balance sheet for the year ended 31 December 2017 and the year ended 31 December 2016 are as follows:

	(at the end of the year)		
	2017	2016	Changes (%)
US dollar (USD)	1.1993	1.0541	13.8
Japanese yen (JPY)	135.01	123.40	9.4
Canadian dollar (CAD)	1.5039	1.4188	6.0
British pound sterling (GBP)	0.88723	0.85618	3.6
Gold (XAU)	1081.881	1098.046	-1.5

2.5 RECOGNITION AND DERECOGNITION OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Financial assets and financial liabilities are recognised in the balance sheet when Latvijas Banka becomes a contractual party in the respective financial transaction.

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

A regular way purchase or sale of financial assets is recognised and derecognised on the settlement day.

2.6 OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Financial assets and financial liabilities are offset and the net amount in the financial statements is reported only in cases when there is a legally enforceable right to set off the recognised amounts, and there is an intention to dispose of the respective assets and settle the liability simultaneously.

2.7 USE OF ESTIMATES AND ASSUMPTIONS

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 for the reporting year and each year in the future to which it refers.

The major estimates and assumptions in the preparation of the financial statements have been made with respect to the following: impairment of assets (see Note 2.19), the method for establishing the fair value of the BIS shares (see Note 14.2), the exchange probability of those lats banknotes and coins that have not been yet exchanged for the euro banknotes and coins (see Note 2.20), the useful life of fixed assets and intangible assets (see Notes 2.17 and 2.18), the repurchasing probability of collector coins (see Note 2.21), provisions for market risk and credit risk (see Notes 2.22 and 36), the breakdown of fair value determination (see Note 5), and the method of recognising a part of the initial valuation account balance in profit and loss statement (see Note 23).

2.8 GOLD AND GOLD RECEIVABLES

Gold is stated at market value in the balance sheet in accordance with the principles described in Note 2.4.

Any gain or loss arising from revaluation of gold reserves is credited or charged to the profit and loss statement or the balance sheet item "Capital and reserves" as the foreign currency revaluation reserve in accordance with the principles described in Note 2.23.

2.9 DEBT SECURITIES

Debt securities are stated at fair value in the balance sheet, except those held to maturity and securities held for monetary policy purposes, measured at amortised cost. Securities held to maturity are securities with fixed or determinable payments and fixed maturity which Latvijas Banka intends to hold to maturity.

Interest on securities, including premium and discount, is recognised in the profit and loss statement as interest income (see also Note 2.24).

Gain or loss arising from transactions in debt securities and revaluation of the debt securities stated at fair value are credited or charged to the profit and loss statement or the balance sheet item "Capital and reserves" as the securities revaluation reserve in accordance with the principles referred to in Note 2.23.

2.10 REVERSE REPURCHASE AGREEMENTS

Reverse repurchase agreements are accounted for as financing transactions. Securities purchased under reverse repurchase agreements are not reported on Latvijas Banka's balance sheet. The related funding provided to the counterparty is reported on Latvijas Banka's balance sheet at nominal value as claims on the seller of the securities.

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

2.11 REPURCHASE AGREEMENTS

Repurchase agreements are accounted for as financing transactions. Securities sold under repurchase agreements are reported on Latvijas Banka's balance sheet along with other securities that are not involved in these transactions. Funding received from such sales is reported on the balance sheet at nominal value as a liability to the purchaser of the securities.

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

2.12 SECURITIES LENDING

Securities lent under automated security lending programme agreements are reported on Latvijas Banka's balance sheet along with other securities that are not involved in these transactions. Only cash collateral placed on the account of Latvijas Banka is recognised in the balance sheet.

Income from securities lending transactions is recognised as interest income in the profit and loss statement.

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

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

2.14 PARTICIPATING INTEREST

Participating interest includes long-term investments of Latvijas Banka in equity instruments. Latvijas Banka 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. Equity instruments are reported at fair value in the balance sheet, except participating interest in the ECB, which is reported at cost in the balance sheet in accordance with the ECB's legal framework for accounting and financial reporting.

The change in fair value of participating interest is reported under the balance sheet item "Capital and reserves" as the revaluation reserve for equity instruments.

2.15 DERIVATIVE FINANCIAL INSTRUMENTS

Latvijas Banka enters into commitments involving forward exchange rate contracts, currency and interest rate swap arrangements, and interest rate and currency future contracts, which are reported in off-balance sheet accounts at their contract or notional amount. Forward exchange rate contracts and currency swap arrangements are included in the net position of the respective currency on the transaction day at the spot rate of the transaction and are recorded in the balance sheet in euro at the exchange rate of the respective currency at the end of the reporting period. Other derivative financial instruments are reported in the balance sheet at fair value.

Interest on derivative financial instruments, including the spot and forward interest rate spread of forward exchange rate contracts and currency swap arrangements, is recognised in the profit and loss statement as interest income or interest expense over the term of the agreement. Any gain or loss arising from a change in fair value of interest rate and currency future contracts, as well as OTC interest rate swap arrangements is included in the profit and loss statement taking into account settlement. Any gain or loss arising from a change in fair value of other derivative financial instruments is credited or charged to the profit and loss statement or the balance sheet item "Capital and reserves" as the revaluation reserve in accordance with the principles referred to in Note 2.23.

2.16 ACCRUED INTEREST INCOME AND EXPENSE

Accrued interest income and expense are reported under balance sheet items of other assets or other liabilities.

2.17 FIXED ASSETS

Fixed assets are tangible long-term investments with the useful life of over one year. Capitalisation limit of fixed assets is 150 euro, except the costs related to real estate improvements and replacement of fixed asset parts for which the Board of Latvijas Banka has set a higher capitalisation limit depending on their significance. Fixed assets are used in the provision of services as well as in the maintenance of other fixed assets and to ensure operation of Latvijas Banka.

Fixed assets are recorded at cost less accumulated depreciation and impairment, if any.

Depreciation is recognised using the straight-line method over the estimated useful life of the asset. Assets under construction or development, land and works of art are not depreciated. Buildings and structures are accounted for by separate components, with individual useful life set for each such component.

In 2017, the useful lives set for fixed assets were not changed. In 2017 and 2016, the useful lives set for fixed assets were as follows:

	(years)	
	2017	2016
Buildings and their components, improvements to the territory, incl.	5–100	5–100
structures	100	100
finishing, equipment and engineering communications	5–20	5–20
Transport vehicles	10–15	10–15
Office equipment and tools	5–25	5–25
Cash processing, verifying and storage equipment	5–15	5–15
Computer and telecommunication equipment	2–5	2–5
Other fixed assets	5–15	5–15

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.

2.18 INTANGIBLE ASSETS

Intangible assets are long-term investments without physical substance with a useful life of over one year. Capitalisation limit of intangible assets is 150 euro. Intangible assets include software application rights and other rights.

Intangible assets are reported in the balance sheet at cost less accumulated amortisation and impairment, if any.

Acquisition costs of intangible assets are amortised over the useful life of the respective assets using the straight-line method; however, this period may not exceed 10 years.

Costs related to software development by Latvijas Banka are recognised in the profit and loss statement when incurred.

2.19 IMPAIRMENT OF ASSETS

An asset is impaired when its carrying amount exceeds its recoverable amount. Upon detecting any indications of impairment of an asset, the recoverable amount of the respective asset is estimated. If the recoverable amount is less than the carrying amount of the respective asset, adequate impairment allowances for the respective asset are made. Such impairment allowances are recognised in the profit and loss statement with a respective reduction in the asset's carrying amount.

The ECB carries out impairment assessment of securities held for monetary policy purposes, identifying any potential changes in future cash flows and any other factors encumbering the fulfilment of the liabilities by the securities issuer. Assets are impaired when the carrying amount of securities held for monetary policy purposes exceed their recoverable amount. The latter in its turn is defined as the present value of a future cash flow estimate. The ECB Governing Council approves the results of the asset impairment assessment carried out by the ECB.

2.20 CURRENCY IN CIRCULATION

In view of the fact that euro banknotes are issued by all euro area NCBs and the ECB, they report a certain share of the total amount of euro banknotes issued by the Eurosystem on their balance sheets. The share allocated to the ECB is 8% of the total amount of euro banknotes issued by the Eurosystem; the remaining 92% are allocated to the NCBs in proportion to their share in the ECB's capital and reported under the balance sheet item "Banknotes in circulation". Of the total amount of euro banknotes issued by the Eurosystem, the share allocated to Latvijas Banka is larger than the actual net amount of euro banknotes it has issued (see Note 15); consequently, claims on the ECB for the allocation of banknotes are reported under the balance sheet item "Intra-Eurosystem claims".

Pursuant to the Law on the Procedure for Introducing the Euro, the period for exchanging the lats cash to the euro at Latvijas Banka is unlimited.

The lats banknotes and coins issued by Latvijas Banka which have not been yet exchanged for the euro banknotes and coins are recognised in the balance sheet considering the exchange probability of such lats banknotes and coins within 20 years from the euro changeover.

Euro coins and the lats banknotes and coins in circulation issued by Latvijas Banka that have been recognised as liabilities by Latvijas Banka, except collector coins, are reported under the balance sheet item "Other liabilities" at nominal value.

2.21 COLLECTOR COINS

Collector coins sold are not included in the balance sheet liabilities, as the repurchasing probability of those coins is low or the value of precious metals of which the coins are made exceeds the nominal value. Proceeds from sales of collector coins are recognised in the profit and loss statement when incurred. The accounting principles established with respect to collector coins are applied to the Latvian gold circulation coins and collector coins.

2.22 PROVISIONS

Provisions are recognised in the financial statements when Latvijas Banka has incurred a present legal or constructive obligation arising from a past event or transaction and a reliable estimate can be made of the obligation and it can be expected to result in a cash outflow from Latvijas Banka.

In addition, on the basis of reasonable risk estimates, Latvijas Banka's Council decides on making provisions for market risk (price, interest rate and currency risks) and credit risk associated with Latvijas Banka's investment management and other financial transactions (see also Note 36).

2.23 RECOGNITION OF GAINS OR LOSSES ON FINANCIAL INSTRUMENTS, FOREIGN CURRENCY AND GOLD POSITION

Gains or losses on financial instruments, foreign currency and gold position are recognised in accordance with the following principles provided by the ECB's legal framework for accounting and financial reporting:

- (a) realised gains and losses shall be recognised in the profit and loss statement;
- (b) unrealised gains shall be recognised in the balance sheet item "Capital and reserves" as the revaluation reserve;
- (c) unrealised losses recognised in the balance sheet item "Capital and reserves" as the revaluation reserve at the end of the reporting year shall be transferred to the profit and loss statement if they exceed the previous revaluation gain on the respective financial instrument, foreign currency or gold position;
- (d) unrealised losses recognised in the profit and loss statement at the end of the reporting year shall not be reversed and offset by unrealised gains of the respective financial instrument, foreign currency or gold position in the subsequent years;
- (e) there shall be no netting of unrealised losses in a financial instrument, foreign currency or gold position against unrealised gains in other financial instrument, foreign currency or gold position.

The average cost method shall be used to calculate realised and unrealised gains and losses of financial instrument, foreign currency and gold position. The average cost of financial instrument, foreign currency or gold position shall be increased or reduced by unrealised losses that are recognised in the profit and loss statement at year-end.

2.24 INTEREST INCOME AND EXPENSE

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

Interest income includes interest on securities, securities lending, deposits placed, loans granted, forward exchange rate contracts, currency and interest rate swap arrangements, intra-Eurosystem claims, as well as negative interest on deposits received. Interest on securities also includes premium and discount, which is amortised over the remaining life of the respective securities using the straight-line method.

Interest expense includes interest on deposits received from the Latvian government, credit institutions and other financial institutions, as well as interest on forward exchange rate contracts and currency and interest rate swap arrangements, intra-Eurosystem liabilities, as well as negative interest on deposits placed.

In the profit and loss statement received negative interest is reported as interest income; paid negative interest is reported as interest expense. Accrued negative interest on balance sheet liabilities is reported under the balance sheet item "Other assets"; accrued negative interest on balance sheet assets is reported under the balance sheet item "Other liabilities".

2.25 REALISED GAINS OR LOSSES FROM FINANCIAL OPERATIONS

Realised gains or losses from financial operations are recognised in the profit and loss statement at the time of disposal of financial instrument or at the time of settlement.

Realised gains or losses from financial operations include realised gains or losses of derivative financial instruments, disposal of debt securities, and foreign exchange transactions.

2.26 INCOME FROM PARTICIPATING INTEREST

The change in fair value of participating interest is reported under the balance sheet item "Capital and reserves" as the revaluation reserve for equity instruments.

Dividends on participating interest are recognised in the profit and loss statement when the right to receive payment is established.

Pursuant to the decision of the Governing Council of the ECB, the income gained by the ECB on the claims for the allocation of banknotes within the Eurosystem, and from the Securities Markets Programme, the asset-backed securities purchase programme, the third covered bond purchase programme, as well as from the PSPP shall be distributed as interim profit for the reporting year in which it accrues. The Governing Council of the ECB decides on the interim profit distribution in January of the following year; however, it may resolve not to do so in cases when the ECB's net profit for the reporting year is less than its income included in the ECB's interim profit distribution, as well as in the event the Governing Council decides to establish provisions for foreign exchange rate, interest rate, credit and gold price risks. In addition, the Governing Council of the ECB may resolve to make deductions from the interim profit distribution result in respect of expenses incurred by the ECB in connection with the issue and handling of euro banknotes; the deductions may not exceed income on the claims for the allocation of banknotes within the Eurosystem.

Moreover, after the approval of the ECB's Annual Accounts, the Governing Council distributes the remainder of the ECB's annual profit of the reporting year to euro area NCBs in proportion to their shares in the ECB's capital (see Note 13.1).

Income from participating interest in the ECB is reported under the profit and loss statement item "Income from participating interest".

2.27 NET RESULT OF POOLING OF MONETARY INCOME

Pursuant to the Statute of the ESCB and of the ECB, euro area NCBs gain income from the implementation of the single monetary policy of the Eurosystem. Total monetary income of the Eurosystem equals the income on assets arising from the issue of euro banknotes and receiving deposits from credit institutions. The income is allocated to euro area NCBs in proportion to their shares in the capital of the ECB. For the first six years following the joining of the Eurosystem an NCB's monetary income is adjusted in compliance with a definite coefficient to avoid significant euro area NCB income fluctuations (see also Note 33).

The net monetary income pooled by Latvijas Banka includes the income derived from earmarkable assets of Latvijas Banka, reduced by expenses for the monetary liabilities of Latvijas Banka. The earmarkable assets of Latvijas Banka for the allocation of monetary income include gold, assets acquired as a result of monetary policy operations, intra-Eurosystem claims as well as other assets in the amount necessary to fully cover

the monetary liabilities. Monetary liabilities of Latvijas Banka include banknotes in circulation, deposits of credit institutions resulting from monetary policy operations and intra-Eurosystem liabilities.

Latvijas Banka's monetary income received comprises Latvijas Banka's share in the Eurosystem's total monetary income set on the basis of Latvijas Banka's share in the ECB's capital.

2.28 BANKNOTE AND COIN ACQUISITION COSTS

Banknote and coin acquisition costs are charged to the profit and loss statement at the time of banknote and coin acquisition.

2.29 OTHER EXPENSE AND INCOME

Bank's other operating expense and income are recognised in the profit and loss statement on an accrual basis. The amount of accrued expense and income for the reporting period is calculated in accordance with the volume of services received or rendered in the reporting period. Lease payments are recognised in the profit and loss statement proportionally over the term of the respective agreement.

3. SUMMARY OF THE FINANCIAL POSITION AND FINANCIAL PERFORMANCE OF LATVIJAS BANKA

3.1 FINANCIAL POSITION

In 2017, Latvijas Banka's assets grew by 2 726.3 million euro, mostly on account of securities purchases for monetary policy purposes.

In 2017, following the decisions of the Governing Council of the ECB on the PSPP, Latvijas Banka made purchases of securities issued by the Latvian government and international institutions; mostly as a result of the above purchases, the balance of the balance sheet item "Securities held for monetary policy purposes" increased by 2 362.7 million euro. Euro area NCBs purchased PSPP securities in proportion to their shares in the ECB's capital.

An increase in the assets under the balance sheet item "Balances with credit institutions and security investments, external loans and other external assets" and a decrease in the balance of the balance sheet items "Claims on non-euro area residents denominated in foreign currency" and "Other securities" basically resulted from investment activities in line with the liquidity management principles set by the ECB's Governing Council (see also Note 4).

In 2017, the amount of loans granted to credit institutions by Latvijas Banka as a result of monetary policy operations (longer-term refinancing operations) decreased by 12.5 million euro.

Other claims related to other operational requirements within the Eurosystem grew by 408.2 million euro, mostly on account of a rise in claims on banknote allocation in the Eurosystem (see also Note 13.4).

In 2017, banknotes in circulation increased by 164.0 million euro, in line with the pickup in the overall amount of banknotes in circulation of the euro area NCBs.

At the end of 2017, credit institution deposits, reported under the balance sheet item "Liabilities to euro area credit institutions related to monetary policy operations denominated in euro", increased by 1 521.8 million euro.

As a result of cross-border payments, liabilities to the ECB for the settlement result in TARGET2, reported under the balance sheet item "Intra-Eurosystem liabilities", increased to 6 339.7 million euro (5 292.4 million euro at the end of 2016). The above increase

mostly resulted from Latvijas Banka's payments related to purchases of securities issued by the Latvian government and international institutions, as well as an increase in credit institution deposits.

Capital and reserves of Latvijas Banka decreased by 12.8 million euro on account of net changes in valuation of financial instruments (29.1 million euro) and the share of profits earned in 2016 and remitted to the state budget revenue (7.7 million), while profits earned in 2017 (23.9 million euro) had an increasing effect.

3.2 FINANCIAL PERFORMANCE

In 2017, Latvijas Banka's profit amounted to 23.9 million euro (11.8 million euro in 2016). Net interest income in 2017 grew by 14.7 million euro as compared to 2016.

35.2 million euro growth in interest income resulted from a 20.0 million euro rise in interest income on investment on account of increasing yields. Interest income on monetary operations grew by 15.1 million euro, basically as a result of PSPP securities purchases in 2017 and an increase in negative interest received on credit institution demand deposits.

An 20.5 million euro increase in interest expense was mostly a result of a rise in interest expense on investment in relation to the transactions carried out by Latvijas Banka for the purpose of hedging currency risk.

The recognition of the revaluation result on financial assets and positions in profit and loss statement amounted to 18.8 million euro and it was affected by the negative result on revaluation of debt securities due to a rise in yields at the end of 2017.

In 2017, additional provisions in the amount of 42.7 million euro were established for market risk and credit risk, posting a 43.7 million euro decrease in comparison with 2016.

Pursuant to the Statute of the ESCB and of the ECB, the income generated by euro area NCBs through the implementation of the single monetary policy of the Eurosystem is allocated to euro area NCBs in proportion to their shares in the ECB's capital. In 2017, Latvijas Banka's net result of pooling of monetary income was 3.7 million euro (10.8 million euro in 2016).

Other operating income decreased primarily on account of a smaller result of remeasurement of liabilities for the issued lats banknotes and coins.

Total recognised financial result, including changes in the "Valuation account" balance, decreased by 26.7 million euro, primarily on account of a smaller negative result (reduction of 33.9 million euro) on revaluation of financial instruments recognised in the profit and loss statement, a larger decrease in the "Valuation account" (38.8 million euro), and a 12.1 million euro increase in the profits of the reporting year as compared to 2016.

Latvijas Banka's future financial performance will be mostly affected by the monetary policy pursued by the Eurosystem and by interest rate developments in the financial markets of the euro area and US since Latvijas Banka is exposed to interest rate risk.

4. FINANCIAL INVESTMENT POLICY

Investments are managed in compliance with the basic principles set by the Council of Latvijas Banka, inter alia preserving the value of investments, ensuring their liquidity and earning income within the framework of acceptable risk without contradicting the monetary policy implemented by the Eurosystem.

Investments include assets reported under the balance sheet items "Gold and gold receivables", "Claims on non-euro area residents denominated in foreign currency",

"Claims on euro area residents denominated in foreign currency", "Claims on non-euro area residents denominated in euro", "Other claims on euro area credit institutions denominated in euro" and "Other securities", as well as derivative financial instruments and spot exchange rate contracts whose book value is reported under relevant balance sheet items of other assets or other liabilities.

Investments are managed by classifying them into different investment portfolios by investment strategy and source of funding. Portfolios of borrowed funds include investments which correspond to Latvijas Banka's liabilities in foreign currencies to government or government deposits. Investments that are not included in the portfolios of borrowed funds (net investments) are included in the portfolios of 1–10 year fixed income securities, mortgage-backed securities, long-term fixed income securities, Latvian government securities and other portfolios. A part of investments included in the 1–10 year fixed income securities portfolios and mortgage-backed securities portfolios are managed by external investment managers.

The parameters for a benchmark reflecting the acceptable level of financial risks and return target are set out for the 1–10 year fixed income securities portfolios, mortgage-backed securities portfolios, and portfolios of borrowed funds.

The breakdown of investments by type of investment portfolio at the end of 2017 and 2016 was as follows:

	Portfolio value (in thousands of euro)		Proportion (%)	
	2017	2016	2017	2016
1–10 year fixed income securities portfolios	3 708 630	3 043 063	63.9	52.5
10 year government fixed income securities portfolio	–	1 156 619	–	19.9
Mortgage-backed securities portfolios	1 158 211	1 156 594	20.0	19.9
Long-term fixed income securities portfolio	502 820	–	8.7	–
Gold portfolio	230 856	234 505	4.0	4.0
Portfolios of borrowed funds	144 324	159 844	2.5	2.8
Latvian government securities portfolio	49 481	49 606	0.9	0.9
Total	5 794 322	5 800 231	100.0	100.0

The 1–10 year fixed income securities portfolio benchmark at the end of 2017 was the weighted 1–10 year government securities index of the UK, the US, euro area countries and Canada.

The mortgage-backed securities portfolio benchmark was the US mortgage-backed securities index.

In the middle of 2017, Latvijas Banka established a long-term fixed income securities portfolio comprising euro area government securities denominated in euro, with the original maturity of 10 years.

The gold portfolio comprises the gold of Latvijas Banka.

The benchmark for borrowed fund portfolios is formed in compliance with the parameters of respective liabilities.

Latvian government securities portfolio comprises euro denominated Latvian government bonds with term to maturity of 5–10 years at the time of acquisition.

Latvijas Banka's investment benchmark currency is the euro, except for portfolios of

borrowed funds and the gold portfolio, thus limiting the currency risk. For portfolios of borrowed funds, the benchmark currency structure is formed considering the currency of the respective liabilities.

The description of the main methods used in financial risk management is provided in Note 25.1.

BALANCE SHEET NOTES

5. FAIR VALUE MEASUREMENT

Fair value of Latvijas Banka's assets is determined using the following hierarchy (see also Note 2.3):

- quoted market price. Fair value is determined using quoted prices for identical financial instruments in active markets;
- observable data. Fair value is determined using quoted prices for similar financial instruments in active markets, quoted prices for similar or identical financial instruments in inactive markets or using models where all significant inputs are observable;
- non-observable data. Fair value is determined using a model where significant inputs are non-observable.

At the end of 2017 and 2016, Latvijas Banka's assets carried at fair value were generally valued on the basis of a quoted market price.

At the end of 2017 and 2016, participating interest in the BIS was assessed using non-observable data. The assessment was conducted using the 70% net asset value method (see also Note 14.2).

At the end of 2017 and 2016, the breakdown of financial instruments and gold carried at fair value and of the financial instruments whose fair value is different from their book value, according to the fair value hierarchy was as follows:

	Book value	Fair value			Total fair value	Difference between fair value and book value
		Quoted market price	Observable data	Non-observable data		
(in thousands of euro)						
As at 31 December 2017						
Gold	230 856	230 856	–	–	230 856	–
Securities in investment portfolios	5 280 437	4 766 081	517 419	–	5 283 500	3 063
Forward exchange rate contracts	30 907	–	27 971	–	27 971	–2 936
Securities held for monetary policy purposes	6 781 748	6 811 835	–	–	6 811 835	30 087
Participating interest in the Bank for International Settlements	30 414	–	–	30 414	30 414	–
Total	12 354 362	11 808 772	545 390	30 414	12 384 576	30 214
As at 31 December 2016						
Gold	234 305	234 305	–	–	234 305	–
Securities in investment portfolios	5 268 697	4 743 742	524 955	–	5 268 697	–
Forward exchange rate contracts	–13 237	–	–19 110	–	–19 110	–5 873
Interest rate swaps	–1	–	–1	–	–1	–
Securities held for monetary policy purposes	4 401 629	4 423 185	–	–	4 423 185	21 556
Participating interest in the Bank for International Settlements	32 235	–	–	32 235	32 235	–
Total	9 923 628	9 401 232	505 844	32 235	9 939 311	15 683

The debt securities, including accrued interest income on the above securities are reported under the balance sheet items "Claims on non-euro area residents denominated in foreign currency", "Claims on euro area residents denominated in foreign currency", "Claims on non-euro area residents denominated in euro", "Securities of euro area residents denominated in euro", "Other assets" and "Other liabilities".

The book value of forward exchange rate contracts is reported under the balance sheet items "Other assets" or "Other liabilities", while the present Note discloses the total net book value.

The average market prices on the last trading day of the reporting year are obtained from the electronic information systems Bloomberg and Interactive Data (quoted market price if the market of the respective financial instrument is active; observable data if the market is inactive). Where the above quoted price for a financial instrument is absent in the electronic information systems and the market for the financial instrument is inactive, the price provided by a market participant or the discounted cash flow is used for evaluating the financial instrument (observable data).

6. GOLD AND GOLD RECEIVABLES

	Troy ounces	In thousands of euro
As at 31 December 2015	213 384	207 670
During 2016		
Increase in gold market value	x	26 635
As at 31 December 2016	213 384	234 305
During 2017		
Decrease in gold market value	x	-3 449
As at 31 December 2017	213 384	230 856

In 2017, Latvijas Banka discontinued to hedge the risk related to gold price fluctuations (see Note 26). The revaluation result of forward exchange rate contracts and currency swap arrangements, concluded for the purpose of hedging the risk related to gold price fluctuations, as well as the revaluation result of gold is recognised under the balance sheet item "Capital and reserves" as the revaluation reserve, whereas revaluation result of currency future contracts, taking into account that they are settled, is recognised under the profit and loss statement item "Realised gains arising from financial operations".

At the end of 2017 and 2016, Latvijas Banka had no gold receivables.

7. CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

7.1 RECEIVABLES FROM THE INTERNATIONAL MONETARY FUND

Pursuant to the Law on the Republic of Latvia Joining the International Monetary Fund, Latvijas Banka serves as a depository for the IMF and services the IMF accounts in the member state currency without compensation. The IMF holdings in euro comprise promissory notes issued by the Latvian government, Account No. 1 used for financial transactions with the IMF, and Account No. 2 used for the IMF administrative expenditure and receipts.

Latvia's 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. Latvia's quota in the IMF is secured by the Latvian government promissory note issued to the IMF and denominated in SDR.

Latvia's liabilities to the IMF are made up of the IMF holdings in euro and IMF allocations. At the end of 2017, the receivables from the IMF in SDR as recorded on Latvijas Banka's balance sheet were equivalent to 143 477 thousand euro (153 992 thousand euro at the end of 2016), whereas the liabilities to the IMF are made up of funds at the disposal of the IMF in the amount of 1 007 thousand euro (1 081 thousand euro at the end of 2016) held on its Accounts No. 1 and No. 2 (see also Note 19).

At the end of 2017 and 2016, Latvia's net receivables from the IMF were as follows:

	(in thousands of euro)		(in thousands of SDR)	
	2017	2016	2017	2016
Latvia's quota in the International Monetary Fund	394 640	423 550	332 300	332 300
International Monetary Fund holdings in euro	-394 595	-423 501	-332 262	-332 262
Promissory note of the Latvian government	-393 587	-422 420	-331 414	-331 414
Account No. 1	-987	-1 059	-831	-831
Account No. 2	-21	-22	-17	-17
Reserve position in the International Monetary Fund	66	71	55	55
SDR	143 477	153 992	120 813	120 817
General allocation	-111 632	-119 810	-93 998	-93 998
Special allocation	-31 856	-34 190	-26 824	-26 824
Latvia's net receivables from the International Monetary Fund	55	63	46	50

The reserve position in the IMF is the difference between Latvia's quota in the IMF and the IMF holdings in euro, excluding the balance on Account No. 2.

7.2 BALANCES WITH CREDIT INSTITUTIONS AND SECURITY INVESTMENTS, EXTERNAL LOANS AND OTHER EXTERNAL ASSETS

	(in thousands of euro)	
	2017	2016
Debt securities	3 395 413	2 798 318
Demand deposits	51 436	61 190
Reverse repurchase agreements	18 344	78 550
Foreign currency in cash	22	26
Total	3 465 215	2 938 084

8. CLAIMS ON EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

	(in thousands of euro)	
	2017	2016
Debt securities	354 947	356 993
Demand deposits	118	1 846
Total	355 065	358 839

9. CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN EURO

	(in thousands of euro)	
	2017	2016
Debt securities	96 414	133 942
Demand deposits	4 919	10 622
Total	101 333	144 564

10. LENDING TO EURO AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS DENOMINATED IN EURO

At the end of 2017, the total amount of Eurosystem loans in monetary policy operations reached 764 310 million euro (595 874 million euro at the end of 2016), including 244.7 million euro (257.2 million euro at the end of 2016) of loans granted by Latvijas Banka. Pursuant to the Statute of the ESCB and of the ECB, risks associated with the implementation of monetary policy (if any materialise) are allocated among euro area NCBS in proportion to their share in the ECB's capital (see Note 2.27). Losses from Eurosystem lending related to monetary policy operations might only be incurred where the counterparty defaults on its obligations and the funds recovered as a result of the disposal of the collateral provided by the counterparty are not sufficient (see also Note 25.1.2).

10.1 MAIN REFINANCING OPERATIONS

Main refinancing operations are open market operations executed through liquidity providing reverse transactions, conducted through weekly standard tenders with a maturity of one week. These operations play a key role in steering interest rates, managing market liquidity and signalling the monetary policy stance. At the end of 2017 and 2016, Latvijas Banka had granted no loans in main refinancing operations.

10.2 LONGER-TERM REFINANCING OPERATIONS

Longer-term refinancing operations are open market operations with a maturity of over 1 week, executed through reverse transactions with the aim to provide credit institutions with additional longer-term refinancing. At the end of 2017, the balance of longer-term refinancing operations conducted by Latvijas Banka stood at 0 (12 500 thousand euro at the end of 2016). Following the decision of the Governing Council of the ECB, targeted longer-term refinancing operations were launched in 2014. These liquidity providing reverse operations are conducted by way of a fixed-rate tender procedure aiming to promote lending to households and non-financial corporations by credit institutions in euro area countries. At the end of 2017, the balance of the targeted longer-term refinancing operations conducted by Latvijas Banka stood at 244 660 thousand euro; these operations will mature in 2020 (at the end of 2016 the balance was 244 660 thousand euro).

11. OTHER CLAIMS ON EURO AREA CREDIT INSTITUTIONS DENOMINATED IN EURO

Other claims on euro area credit institutions denominated in euro mostly include Latvijas Banka's pledged assets for providing collateral for transactions in financial derivatives (see also Note 44). At the end of 2017, the book value and market value of the pledged assets amounted to 270 thousand euro (8 780 thousand euro at the end of 2016). Latvijas Banka's demand deposits in euro with euro area credit institutions are also reported under this item (168 thousand euro at the end of 2017; 291 thousand euro at the end of 2016).

12. SECURITIES OF EURO AREA RESIDENTS DENOMINATED IN EURO

In 2017, Latvijas Banka purchased securities issued by the Latvian government and international institutions under the PSPP; and the balance sheet item "Securities held for monetary policy purposes" grew by 2 362.7 million euro.

At the end of 2017, the amount of securities held by the Eurosystem for monetary policy purposes totalled 2 386 012 million euro (1 654 026 million euro at the end of 2016). Of them, Latvijas Banka held 6 719 984 thousand euro (4 357 306 thousand euro at the end of 2016). Pursuant to the Statute of the ESCB and of the ECB, any income and losses, if any materialise, are allocated among euro area NCBs in proportion to their share in the ECB's capital, except any risks associated with the purchases of government securities carried out by Latvijas Banka and other euro area NCBs under the PSPP. Of the total amount of securities held by the Eurosystem for monetary policy purposes, at the end of 2017 the amount of government securities purchased by the euro area NCBs under the PSPP totalled 1 508 842 million euro (1 002 725 million euro at the end of 2016); of them, Latvijas Banka held securities in the amount of 982 537 thousand euro (706 919 thousand euro at the end of 2016).

The ECB's Governing Council made a decision to increase the monthly amount of security purchases under the expanded APP from 60 000 million euro to 80 000 million euro from April 2016, and after March 2017 to continue monthly purchases of securities in the amount of 60 000 million euro up to December 2017, while from January 2018 to September 2018 or beyond, if necessary, to set the monthly amount of security purchases to 30 000 million euro.

Securities held for monetary policy purposes and securities held to maturity are measured at amortised cost. The comparison of the book value and fair value of the above securities is represented in Note 5. Other securities are accounted for at fair value.

(in thousands of euro)

	Book value	
	2017	2016
Securities held for monetary policy purposes	6 719 984	4 357 306
Latvian government securities	982 537	706 919
Securities issued by international institutions	5 737 447	3 650 387
Other securities	1 411 213	1 962 448
Securities not held to maturity	908 393	1 962 448
Securities held to maturity	502 820	–
Total	8 131 197	6 319 754

13. INTRA-EUROSISTEM CLAIMS/LIABILITIES (–)

(in thousands of euro)

	Note	2017	2016
Participating interest in the European Central Bank	13.1	115 082	115 082
Claims in respect of foreign reserves transferred to the European Central Bank	13.2	163 480	163 480
Claims for the allocation of banknotes in the Eurosystem	13.4	4 317 942	3 902 650
Claims related to other operational requirements within the Eurosystem	13.5	7 610	14 706
Total intra-Eurosystem claims		4 604 114	4 195 918
Liabilities related to TARGET2 and national central bank correspondent accounts (net)	13.3	–6 339 683	–5 292 395
Total intra-Eurosystem liabilities		–6 339 683	–5 292 395
Intra-Eurosystem liabilities (net)		–1 735 569	–1 096 477

13.1 PARTICIPATING INTEREST IN THE EUROPEAN CENTRAL BANK

With Latvia's accession to the EU, Latvijas Banka became a subscriber of the capital of the ECB. In accordance with the Statute of the ESCB and of the ECB, Latvijas Banka's ECB capital key is calculated on the basis of Latvia's population and gross domestic product data. The NCB capital keys are adjusted every five years or at shorter intervals depending on changes in the number of the EU Member States. Since 1 January 2014 Latvijas Banka's ECB capital key is 0.2821%, equivalent to 30 537 thousand euro.

The Statute of the ESCB and of the ECB stipulates that a euro area NCB shall pay up its subscribed share in the ECB's capital in full, as well as in the ECB's reserve capital, provisions equivalent to reserves and the valuation account for financial instruments, in proportion to its share in the ECB's capital. As of 1 January 2014, participating interest in the ECB consists of the paid up shares in the amount of 30 537 thousand euro in the ECB's capital, transfers to the financial instrument revaluation account amounting to 42 752 thousand euro and the difference between the market value of the foreign reserves transferred to the ECB and the value of the corresponding euro-denominated claim in the amount of 41 793 thousand euro (see also Note 13.2).

ECB's capital shares are not traded in the public securities market, and Latvijas Banka's participating interest in the ECB can be increased or decreased only in the cases referred to in this Note.

	2017	2016
Total amount of the European Central Bank's subscribed capital (in thousands of euro)	10 825 007	10 825 007
The subscribed and paid-up share of Latvijas Banka in the European Central Bank's capital (in thousands of euro)	30 537	30 537
The percentage share of Latvijas Banka in the European Central Bank's capital (%)	0.2821	0.2821

At the end of 2017 and 2016, the percentage shares of NCBs in the ECB's capital (capital key) were as follows:

	(%)	
	2017	2016
Nationale Bank van België/Banque Nationale de Belgique	2.4778	2.4778
Deutsche Bundesbank	17.9973	17.9973
Eesti Pank	0.1928	0.1928
Banc Ceannais na hÉireann/Central Bank of Ireland	1.1607	1.1607
Bank of Greece	2.0332	2.0332
Banco de España	8.8409	8.8409
Banque de France	14.1792	14.1792
Banca d'Italia	12.3108	12.3108
Central Bank of Cyprus	0.1513	0.1513
Latvijas Banka	0.2821	0.2821
Lietuvos bankas	0.4132	0.4132
Banque centrale du Luxembourg	0.2030	0.2030
Bank Ċentrali ta' Malta/Central Bank of Malta	0.0648	0.0648
De Nederlandsche Bank	4.0035	4.0035
Oesterreichische Nationalbank	1.9631	1.9631
Banco de Portugal	1.7434	1.7434
Banka Slovenije	0.3455	0.3455
Národná banka Slovenska	0.7725	0.7725
Suomen Pankki – Finlands Bank	1.2564	1.2564
Subtotal for euro area NCBs	70.3915	70.3915
Българска народна банка (Bulgarian National Bank)	0.8590	0.8590
Česká národní banka	1.6075	1.6075
Danmarks Nationalbank	1.4873	1.4873
Hrvatska narodna banka	0.6023	0.6023
Magyar Nemzeti Bank	1.3798	1.3798
Narodowy Bank Polski	5.1230	5.1230
Banca Națională a României	2.6024	2.6024
Sveriges Riksbank	2.2729	2.2729
Bank of England	13.6743	13.6743
Subtotal for non-euro area NCBs	29.6085	29.6085
Total	100.0000	100.0000

In 2017, the subscribed and paid-up capital of the ECB remained unchanged.

The subscribed and paid-up NCB shares in the ECB's capital at the end of 2017 and 2016 were as follows:

	(in thousands of euro)			
	Subscribed capital		Paid-up capital	
	2017	2016	2017	2016
Nationale Bank van België/ Banque Nationale de Belgique	268 222	268 222	268 222	268 222
Deutsche Bundesbank	1 948 209	1 948 209	1 948 209	1 948 209
Eesti Pank	20 871	20 871	20 871	20 871
Banc Ceannais na hÉireann/Central Bank of Ireland	125 646	125 646	125 646	125 646
Bank of Greece	220 094	220 094	220 094	220 094
Banco de España	957 028	957 028	957 028	957 028
Banque de France	1 534 899	1 534 899	1 534 899	1 534 899
Banca d'Italia	1 332 645	1 332 645	1 332 645	1 332 645
Central Bank of Cyprus	16 378	16 378	16 378	16 378
Latvijas Banka	30 537	30 537	30 537	30 537
Lietuvos bankas	44 729	44 729	44 729	44 729
Banque centrale du Luxembourg	21 975	21 975	21 975	21 975
Bank Ċentrali ta' Malta/Central Bank of Malta	7 015	7 015	7 015	7 015
De Nederlandsche Bank	433 379	433 379	433 379	433 379
Oesterreichische Nationalbank	212 506	212 506	212 506	212 506
Banco de Portugal	188 723	188 723	188 723	188 723
Banka Slovenije	37 400	37 400	37 400	37 400
Národná banka Slovenska	83 623	83 623	83 623	83 623
Suomen Pankki – Finlands Bank	136 005	136 005	136 005	136 005
Subtotal for euro area NCBs	7 619 885	7 619 885	7 619 885	7 619 885
Българска народна банка (Bulgarian National Bank)	92 987	92 987	3 487	3 487
Česká národní banka	174 012	174 012	6 525	6 525
Danmarks Nationalbank	161 000	161 000	6 038	6 038
Hrvatska narodna banka	65 199	65 199	2 445	2 445
Magyar Nemzeti Bank	149 363	149 363	5 601	5 601
Narodowy Bank Polski	554 565	554 565	20 796	20 796
Banca Națională a României	281 710	281 710	10 564	10 564
Sveriges Riksbank	246 042	246 042	9 227	9 227
Bank of England	1 480 244	1 480 244	55 509	55 509
Subtotal for non-euro area NCBs	3 205 122	3 205 122	120 192	120 192
Total ¹	10 825 007	10 825 007	7 740 077	7 740 077

13.2 CLAIMS EQUIVALENT TO THE TRANSFER OF FOREIGN RESERVES TO THE EUROPEAN CENTRAL BANK

Pursuant to the Statute of the ESCB and of the ECB, euro area NCBs shall transfer a definite amount of their foreign reserves to the ECB. The amount of foreign reserves to be transferred shall be fixed in proportion to the percentage share of each euro area NCB in the ECB's capital. For the foreign reserves transferred to the ECB Latvijas Banka received

¹ The total amount and the sum of the components may differ due to rounding.

a euro-denominated claim on the ECB in the amount of 163 480 thousand euro, i.e. in proportion to the value of the respective claims of other euro area NCBs. The difference between the market value of the foreign reserves transferred to the ECB and the value of the corresponding euro-denominated claim in the amount of 41 793 thousand euro is reported as participating interest in the ECB (see also Note 13.1). The interest rate on the main refinancing operations set by the ECB is applied to the claims equivalent to the transfer of foreign reserves to the ECB (see also Note 33).

13.3 CLAIMS/LIABILITIES RELATED TO TARGET2 AND NATIONAL CENTRAL BANK CORRESPONDENT ACCOUNTS (NET)

TARGET2 system is a real-time gross settlement system for large value payments in euro. Claims and liabilities related to TARGET2 settlements originate as a result of cross-border payments settled in the central bank money. The above settlements result in bilateral claims and liabilities in the TARGET2 accounts held by NCBs. The net positions for the bilateral balances are attributed to the ECB and calculated on a daily basis, leaving each NCB with a single net position vis-à-vis the ECB. This is reported on the NCB's balance sheet as net claims or liabilities related to TARGET2 settlements.

In 2017, liabilities related to TARGET2 and national central bank correspondent accounts (net) increased as a result of the cross-border payments effected by credit institutions and Latvijas Banka. The above increase mostly resulted from Latvijas Banka's payments related to purchases of securities issued by the Latvian government and international institutions.

The interest rate on the main refinancing operations set by the ECB is applied to the above claims and liabilities.

13.4 CLAIMS FOR THE ALLOCATION OF BANKNOTES IN THE EUROSISTEM

In view of the fact that euro banknotes are issued by all euro area NCBs and the ECB, they report a definite share of the total amount of euro banknotes issued by the Eurosystem on their balance sheets. Of the total amount of euro banknotes issued, the share allocated to Latvijas Banka is larger than the net amount of euro banknotes it has actually issued (see Note 15); in view of the above, the adjustment related to banknotes in circulation results in corresponding claims on the ECB for the allocation of banknotes, reported under the balance sheet item "Claims related to other operational requirements within the Eurosystem" (see Note 13).

13.5 CLAIMS RELATED TO OTHER OPERATIONAL REQUIREMENTS WITHIN THE EUROSISTEM

Claims related to other operational requirements within the Eurosystem comprise claims on the ECB associated with the net result of pooling of monetary income and the ECB's interim profit distribution.

Monetary income to be received by Latvijas Banka in 2017 was higher than its monetary income to be pooled. This resulted in a claim on the ECB associated with the net result of pooling of monetary income, standing at 3 651 thousand euro at the end of 2017 (see also Notes 2.27 and 38).

Claims for the ECB's interim profit distribution in the amount of 3 959 thousand euro are set as per Latvijas Banka's percentage share in the ECB's capital (see also Notes 2.26 and 37).

14. OTHER ASSETS

(in thousands of euro)

	Note	2017	2016
Accrued income on debt securities		83 973	63 744
OTC financial derivative contracts and spot exchange rate contracts	24	42 551	21 961
Fixed assets	14.1	39 665	37 611
Participating interest in the Bank for International Settlements	14.2	30 414	32 235
Claims on collateral for the use of the instant payment system	17	20 960	–
Intangible assets	14.3	2 363	1 973
Prepaid expenses		867	1 024
Other accrued income		791	886
Other		703	1 184
Total		222 287	160 618

14.1 FIXED ASSETS

(in thousands of euro)

	Buildings, improvement of territory, and land	Furniture and office equipment	Computer and telecommunication equipment	Cash processing and storage equipment	Transport vehicles	Other fixed assets	Total
As at 31 December 2015							
Cost	57 957	4 961	5 271	6 920	1 758	7 816	84 683
Accumulated depreciation	–25 836	–3 940	–3 601	–4 731	–1 227	–6 504	–45 839
Net book value	32 121	1 021	1 670	2 189	531	1 312	38 844
During 2016							
Additions	1 349	93	536	127	47	155	2 307
Disposals and write-offs	–	–293	–380	–14	–78	–48	–813
Net change in cost	1 349	–200	156	113	–31	107	1 494
Depreciation charge	–1 846	–132	–758	–408	–82	–300	–3 526
Accumulated depreciation on disposals and write-offs	–	280	380	14	78	47	799
Net change in accumulated depreciation	–1 846	148	–378	–394	–4	–253	–2 727
As at 31 December 2016							
Cost	59 306	4 761	5 427	7 033	1 727	7 923	86 177
Accumulated depreciation	–27 682	–3 792	–3 979	–5 125	–1 231	–6 757	–48 566
Net book value	31 624	969	1 448	1 908	496	1 166	37 611
During 2017							
Additions	2 154	1 597	679	175	110	787	5 502
Change in classification	–5	66	–	12	–	–73	–
Disposals and write-offs	–	–66	–171	–134	–85	–234	–690
Net change in cost	2 149	1 597	508	53	25	480	4 812
Depreciation charge	–1 884	–148	–617	–388	–88	–301	–3 426
Change in classification	–	–61	–	–12	–	73	–
Accumulated depreciation on disposals and write-offs	–	51	170	132	82	233	668
Net change in accumulated depreciation	–1 884	–158	–447	–268	–6	5	–2 758
As at 31 December 2017							
Cost	61 455	6 358	5 935	7 086	1 752	8 403	90 989
Accumulated depreciation	–29 566	–3 950	–4 426	–5 393	–1 237	–6 752	–51 324
Net book value	31 889	2 408	1 509	1 693	515	1 651	39 665

At the end of 2017, Latvijas Banka's contractual commitments related to acquisition of fixed assets were 306 thousand euro (2 222 thousand euro at the end of 2016).

14.2 PARTICIPATING INTEREST IN THE BANK FOR INTERNATIONAL SETTLEMENTS

At the end of 2017 and 2016, Latvijas Banka owned 1 070 shares in the BIS, which corresponded to 0.19% of the total subscribed and paid-up BIS capital.

The total nominal value of Latvijas Banka'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 1 338 thousand SDR or 25% (see also Note 46). At the end of 2017 and 2016, the BIS shareholding is reported in Latvijas Banka's balance sheet at fair value. The shares in the BIS are not traded in the public securities market. In the opinion of Latvijas Banka's management, the most appropriate method for establishing the fair value of the BIS shares is the use of 70% of the BIS net asset value based on the latest published financial statements of the BIS. The BIS applied this valuation method for calculating the issue price of its shares; the International Court at The Hague has also recognised it as appropriate for the valuation of shares when repurchasing them from former private shareholders of the BIS. Pursuant to the Statutes of the BIS, only central banks can be shareholders in the BIS. At the end of 2017, the estimated fair value of BIS shares was 30 414 thousand euro (32 235 thousand euro at the end of 2016).

14.3 INTANGIBLE ASSETS

(in thousands of euro)

As at 31 December 2015	
Cost	6 508
Accumulated amortisation	-4 600
Net book value	1 908
During 2016	
Additions	298
Derecognised intangible assets	-189
Net change in cost	109
Amortisation charge	-229
Accumulated amortisation on derecognised intangible assets	185
Net change in accumulated amortisation	-44
As at 31 December 2016	
Cost	6 617
Accumulated amortisation	-4 644
Net book value	1 973
During 2017	
Additions	718
Derecognised intangible assets	-77
Net change in cost	641
Amortisation charge	-324
Accumulated amortisation on derecognised intangible assets	73
Net change in accumulated amortisation	-251
As at 31 December 2017	
Cost	7 258
Accumulated amortisation	-4 895
Net book value	2 363

15. BANKNOTES IN CIRCULATION

(in thousands of euro)

	2017	2016
Euro banknotes	4 314 088	4 150 106
Net issuance of euro banknotes by Latvijas Banka	-3 854	247 456
Adjustment for banknote allocation in the Eurosystem	4 317 942	3 902 650
Total	4 314 088	4 150 106

The euro coins issued by Latvijas Banka are reported under the balance sheet item "Other liabilities" (see also Note 22).

As a result of cross-border flows of euro banknotes, at the end of 2017 the amount of banknotes deposited with Latvijas Banka exceeded that of banknotes withdrawn from Latvijas Banka; consequently, the net issuance of euro banknotes by Latvijas Banka was negative.

16. LIABILITIES TO EURO AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS DENOMINATED IN EURO**16.1 CURRENT ACCOUNTS (COVERING THE MINIMUM RESERVE SYSTEM)**

Current accounts contain the credit balances on the transaction accounts of credit institutions that are required to hold minimum reserves. The latest available interest rate used by the Eurosystem in its tenders for main refinancing operations is applied to the balances held on those accounts within the framework of the reserve requirements. Since June 2014, the lower rate of either zero per cent or the ECB's deposit facility rate has been applied to the reserves held in excess of the required minimum reserves. At the end of 2017, balance on the current accounts placed with Latvijas Banka was 5 712 980 thousand euro (4 191 147 thousand euro at the end of 2016), including the minimum reserves in the amount of 211.7 million euro (228.9 million euro at the end of 2016).

16.2 DEPOSIT FACILITY

Deposit facility is a standing facility of the Eurosystem used by credit institutions to place their overnight deposits at a pre-specified rate. No such deposits were placed with Latvijas Banka at the end of 2017 and 2016.

17. OTHER LIABILITIES TO EURO AREA CREDIT INSTITUTIONS DENOMINATED IN EURO

Other liabilities to euro area credit institutions denominated in euro resulted from funds received as collateral for the use of the instant payment system and forward exchange rate contracts accounting for 22 610 thousand euro at the end of 2017 (720 thousand euro at the end of 2016). Collateral received from credit institutions for the use of the instant payment system has been transferred to the respective service provider (see also Note 14).

18. LIABILITIES TO OTHER EURO AREA RESIDENTS DENOMINATED IN EURO

Liabilities to other euro area residents denominated in euro comprise demand deposits by the Latvian government and other financial institutions. Government deposits comprise the Treasury demand deposits received by Latvijas Banka acting as the financial agent of the Latvian government (see also Note 43).

Deposits of other financial institutions mostly include the funds of the FCMC and the Deposit Guarantee Fund and Fund for the Protection of the Insured, both managed by the FCMC, in the amount of 163 446 thousand euro (137 125 thousand euro at the end of 2016).

19. LIABILITIES TO NON-EURO AREA RESIDENTS DENOMINATED IN EURO

	(in thousands of euro)	
	2017	2016
Other financial institutions	1 342	2 260
International Monetary Fund	1 007	1 081
European Commission	186	14 547
Total	2 535	17 888

20. LIABILITIES TO EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

Liabilities to euro area residents denominated in foreign currency comprise demand deposits of the Latvian government in foreign currency standing at 144 324 thousand euro at the end of 2017 (159 844 thousand euro at the end of 2016; see also Note 43).

21. LIABILITIES TO NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

Liabilities to non-euro area residents denominated in foreign currency comprised funds received as collateral for forward exchange rate contracts (634 thousand euro at the end of 2017; 0 at the end of 2016).

22. OTHER LIABILITIES

		(in thousands of euro)	
	Note	2017	2016
Provisions for market risk and credit risk	36	179 176	136 500
Euro coins in circulation	22.1	67 099	60 728
Lats banknotes in circulation	22.1	34 091	45 226
OTC financial derivative contracts	24	11 404	37 624
Accrued expense and similar liabilities		7 408	6 278
Lats coins in circulation	22.1	4 440	6 580
Tax liabilities	22.2	75	159
Other		1 859	1 519
Total		305 552	294 614

22.1 BANKNOTES AND COINS IN CIRCULATION

Apart from the lats and euro circulation coins issued by Latvijas Banka and recognised as a liability on the balance sheet, euro collector coins, lats collector coins and precious metal circulation coins were also in circulation with the total nominal value of 6 703 thousand euro at the end of 2017 (6 529 thousand euro at the end of 2016). The above coins in circulation have not been reported under the balance sheet item "Other liabilities" (see also Note 2.21 and 46).

Lats banknotes and coins with low probability of exchange, in the amount of 88 400 thousand euro (lats banknotes in the amount of 29 731 thousand euro and lats coins in the amount of 58 669 thousand euro; 78 100 thousand euro, including lats banknotes in the amount of 21 325 thousand euro and lats coins in the amount of 56 775 thousand euro at the end of 2016) have not been reported under the balance sheet liabilities (see also Note 46).

22.2 TAX LIABILITIES

At the end of 2017 and 2016, tax liabilities of Latvijas Banka were as follows:

	(in thousands of euro)						
	Personal income tax	State compul- sory social security contributions and ST (by employer)	State compul- sory social security contributions and ST (by employee)	Tax on real estate	Value added tax	Other taxes and duties	Total
Liabilities as at 31 December 2015	–	6	2	–	189	–	197
During 2016							
Calculated	3 085	3 852	1 689	160	1 155	2	9 943
Increase in deferred liabilities	–	–64	–	–	–	–	–64
Paid	–3 085	–3 794	–1 691	–160	–1 185	–2	–9 917
Liabilities as at 31 December 2016	–	–	–	–	159	–	159
During 2017							
Calculated	3 254	3 962	1 764	228	1 379	2	10 589
Increase in deferred liabilities	–	2	–	–	–	–	2
Paid	–3 254	–3 964	–1 760	–228	–1 467	–2	–10 675
Liabilities as at 31 December 2017	–	–	4	–	71	–	75

In addition to the tax payments indicated herein, Latvijas Banka transfers to the state budget 65% of the profit for the reporting year (7 653 thousand euro in 2017; 19 524 thousand euro in 2016; see also Notes 23 and 43). The transfer includes the payment for the usage of state capital. Latvijas Banka is not subject to corporate income tax.

23. CAPITAL AND RESERVES

	(in thousands of euro)				
	Nominal capital	Reserve capital	Valuation account	Profit of the reporting year	Capital and reserves
As at 31 December 2015	100 000	213 370	107 948	30 037	451 355
During 2016					
Net result of revaluation, realisation, and revaluation result recognition in profit and loss statement	x	x	9 748	x	9 748
Profit appropriated to the state budget	x	x	x	–19 524	–19 524
Profit transferred to the reserve capital	x	10 513	x	–10 513	–
Profit of the reporting year	x	x	x	11 773	11 773
As at 31 December 2016	100 000	223 883	117 696	11 773	453 352
During 2017					
Net result of revaluation, realisation, and revaluation result recognition in profit and loss statement	x	x	–29 059	x	–29 059
Profit appropriated to the state budget	x	x	x	–7 653	–7 653
Profit transferred to the reserve capital	x	4 120	x	–4 120	–
Profit of the reporting year	x	x	x	23 884	23 884
As at 31 December 2017	100 000	228 003	88 637	23 884	440 524

The capital and reserves of Latvijas Banka is comprised of the nominal capital, reserve capital and the valuation account, as well as the undistributed profit of the reporting year.

The legal framework does not provide for any capital adequacy requirements for Latvijas Banka; nevertheless, the amount of its capital should be adequate to promote credibility of the monetary policy implemented by Latvijas Banka, and to ensure implementation of its operations and financial independence when performing the tasks set forth by the Statute of the ESCB and of the ECB and the Law on Latvijas Banka. The implementation of the monetary policy as well as exposure to other financial and operational risks may adversely affect Latvijas Banka's income or result in losses to be covered from the capital and reserves of Latvijas Banka.

The nominal capital of Latvijas Banka is comprised of the state-allotted resources, transfers from the reserve capital and Latvijas Banka's profit allocations.

The Law on Latvijas Banka establishes that a part of Latvijas Banka's profit of the reporting year, calculated by applying the same percentage as the tax rate set for resident corporate entities of Latvia by the Law on Corporate Income Tax, together with a payment in the amount of 50% of the profit of the reporting year for the usage of state capital shall be transferred to the state budget, as well as that the Council of Latvijas Banka, upon approving the annual report, may make a decision on reducing the percentage share of the payment for the usage of state capital where it is necessary for increasing the reserve capital of Latvijas Banka in relation to the financial risks Latvijas Banka is exposed to when executing its tasks. At the end of 2017 and 2016, the corporate income tax rate applicable to residents of Latvia was 15%. Therefore, unless the Council of Latvijas Banka decides otherwise, 65% of Latvijas Banka's profit of the reporting year or 15 525 thousand euro shall be transferred to the state budget within 15 days following the approval of the Annual Report of 2017 by the Council of Latvijas Banka.

Latvijas Banka's profit remaining after making the above deductions shall be transferred to the reserve capital as prescribed by the Law on Latvijas Banka. The reserve capital shall be formed to cover potential losses.

The valuation account comprises the positive result on revaluation of the financial instruments and gold. The accounting policy, harmonised with the principal accounting policies established by the ECB's legal framework for accounting and financial reporting and described in Note 2 stipulates that the realised gains are recognised in the profit and loss statement only after the disposal of a financial instrument or settlement while unrealised gains are recorded under the balance sheet item "Capital and reserves" as the revaluation reserve, thus facilitating the preservation of the capital under the impact of financial instrument price, interest rate and exchange rate fluctuations.

In 2017 and 2016, changes in the valuation account were as follows:

(in thousands of euro)

	2017	Recognition in profit and loss statement	Revaluation	Realisation	2016
Initial valuation account	8 521	x	x	-8 395	16 916
Revaluation reserve for equity instruments	27 905	-	-1 821	-	29 726
Result on revaluation of foreign currencies and gold	32 446	2 862	-5 626	-239	35 449
Result on revaluation of securities	19 765	15 929	-10 827	-20 942	35 605
Total	88 637	18 791	-18 274	-29 576	117 696

	2016	Recognition in profit and loss statement	Revaluation	Realisation	2015
Initial valuation account	16 916	x	x	-11 036	27 952
Revaluation reserve for equity instruments	29 726	-	1 536	-	28 190
Result on revaluation of foreign currencies and gold	35 449	72	10 343	-26	25 060
Result on revaluation of interest rate swap arrangements	-	-	-	-185	185
Result on revaluation of securities	35 605	52 657	-28 295	-15 318	26 561
Total	117 696	52 729	-16 416	-26 565	107 948

In accordance with the ECB's legal framework for accounting and financial reporting, on 1 January 2014 Latvijas Banka reclassified the accumulated result on revaluation of foreign currencies to the initial valuation account. The initial valuation account also comprises the accumulated result on revaluation of financial instruments and gold prior to the change in the accounting policy on 1 January 2007.

The balance on the initial valuation account is recognised in the profit and loss statement to compensate lower remuneration for claims related to the banknote allocation within the Eurosystem as per the coefficients applied in accordance with the decisions of the Governing Council of the ECB for the calculation of the remuneration adjustment for claims related to the banknote allocation within the Eurosystem in the first six years after an NCB joins the Eurosystem (see Note 33). The amount to be recognised in the profit and loss statement for the respective year is calculated by multiplying the balance on the initial valuation account as at 1 January 2014 with the share of the coefficient for calculating the compensation amount for the respective year in the total coefficients (indicated in Note 33) during the transition period when the adjustment amounts for the claims on banknote allocation in the Eurosystem are calculated.

The revaluation reserve for equity instruments has been established to account for the result on revaluation of the BIS shares. The result on revaluation of the BIS shares is not recognised in the profit and loss statement.

24. DERIVATIVE FINANCIAL INSTRUMENTS AND SPOT EXCHANGE RATE CONTRACTS

Latvijas Banka enters into forward and spot exchange rate contracts, currency and interest rate swap arrangements, forward transactions in securities, and interest rate and currency future contracts in order to manage interest rate and currency risks associated with Latvijas Banka's investments. At the end of 2017 and 2016, the contract or notional amounts and book value of the above transactions were as follows:

(in thousands of euro)

	Contract or notional amount		Book value			
	2017	2016	Assets		Liabilities	
	2017	2016	2017	2016	2017	2016
OTC financial derivative and spot exchange rate contracts						
Forward exchange rate contracts and currency swap arrangements	4 230 740	4 864 061	41 165	19 451	10 709	33 068
Spot exchange rate contracts	391 716	399 382	451	396	–	16
Forward transactions in securities	1 223 116	1 453 643	935	2 114	695	4 539
Interest rate swap arrangements	11 257	17 380	–	–	–	1
Total	x	x	42 551	21 961	11 404	37 624
Traded financial derivative contracts						
Interest rate future contracts	1 030 055	1 102 247	x	x	x	x
Currency future contracts	100 000	189 710	x	x	x	x

The book value of the OTC financial derivative contracts and spot exchange rate contracts is reported under the balance sheet items "Other assets" or "Other liabilities" (see also Notes 14 and 22). Since settlement has been made for the change in the fair value of future contracts, the change is reported as demand deposits under the respective balance sheet asset item.

MAJOR RISKS AND PRINCIPLES FOR THEIR MANAGEMENT

25. RISK MANAGEMENT

Financial and operational risks are the main risks associated with the activities of Latvijas Banka. Management of Latvijas Banka's risks is organised and implemented according to the Risk Management Policy of Latvijas Banka approved by the Council of Latvijas Banka.

Risk management at Latvijas Banka is carried out as part of a systematic process identifying, analysing and assessing risks, developing and implementing relevant risk mitigating measures, overseeing and reviewing risks on a regular basis in order to timely identify, assess and efficiently manage risks that are likely to have a negative effect on the financial position and financial performance of Latvijas Banka as well as Latvijas Banka's capability to perform the tasks provided for in the legislative acts in a quality and efficient manner, inter alia to participate in the implementation of the ESCB functions.

The risk management process is organised in compliance with the international principles of best practice in risk management, in view of the aims and tasks of Latvijas Banka and the external environment developments, as well as complying with the requirements of the ECB in relation to risk management. Management of Latvijas Banka's financial and operational risks is reviewed by the Internal Audit Department and is monitored by the Budget Commission of Latvijas Banka, Security Oversight Commission, and Audit Committee, each of which is comprised of Members of the Council of Latvijas Banka.

25.1 FINANCIAL RISKS

Market risk (price, interest rate and currency risks), credit and liquidity risks are the most significant financial risks Latvijas Banka is exposed to in its daily activities.

Latvijas Banka manages financial risks related to its investments in line with the Procedure, adopted by the Council of Latvijas Banka; the basic principles of its investment policy are described in Note 4. Investments are managed by classifying them into different investment portfolios. Parameters for a benchmark reflecting the acceptable level of financial risks and return target are set out for each financial instrument portfolio. The Risk Management Division of the Market Operations Department monitors the investment compliance with the established requirements.

For the purpose of investment management, including management of the related financial risks, the Investment Committee of Latvijas Banka develops an investment management strategy, approves tactical decisions and sets detailed limits for financial risks, as well as oversees the operation of the external managers. The Investment Committee of Latvijas Banka reviews the investment strategy at least once a quarter, and on a weekly basis receives and reviews reports on and forecasts for developments in financial markets, prepared by financial investment portfolio managers, reports by financial risk managers, and approves the investment management tactical decisions for the forthcoming week. The Market Operations Department informs the Council and the Board of Latvijas Banka about the results of investment management on a regular basis.

Latvijas Banka purchases assets under the PSPP in accordance with the decisions of the ECB's Governing Council. Latvijas Banka makes the purchases and manages financial risks in line with the guidelines of the ECB's Governing Council and the procedure adopted by the Board of Latvijas Banka. Financial risks arising as a result of implementing monetary policy are shared among the euro area NCBs in proportion to their shares in the ECB's capital, except risks associated with the purchases of Latvian government securities carried out by Latvijas Banka under the PSPP.

25.1.1 MARKET RISK

Market risk is exposure to losses due to adverse changes in financial markets (for example, movements in interest rates or exchange rates).

Latvijas Banka is exposed to interest rate risk due to investing in foreign debt securities and interest rate derivatives that are subject to interest rate fluctuations and have been purchased within the course of investment management. Latvijas Banka manages interest rate risk by using a modified duration and deviation limits set individually for each investment portfolio.

Latvijas Banka's exposure to currency risk is determined by its investment structure. Latvijas Banka manages currency risk by establishing that the benchmark currency is the euro, thus hedging the currency risk (except for the gold portfolio as Latvijas Banka discontinued the hedging of the gold price risk in 2017), and using tracking error limits in relation to the respective benchmark. Tracking error is calculated as the expected annualised standard deviation of the difference in return between the investment portfolio and the respective benchmark. The aggregate market and credit risk of 1–10 year fixed income securities portfolios, and mortgage-backed securities portfolios (see Note 4) is managed by determining the tracking error limit. Tracking error in 2017 and 2016 is disclosed in Note 28.

For investment portfolios, except for portfolios of borrowed funds and the gold portfolio, the benchmark currency is the euro. For portfolios of borrowed funds, the benchmark currency structure is formed in compliance with the respective currency. Deviations from the benchmark currency structure give rise to the open currency position. In order

to achieve the compliance of open foreign currency positions with the limits, Latvijas Banka hedges the currency risk by using forward exchange rate contracts, currency swap arrangements, and currency future contracts.

The Risk Management Division of the Market Operations Department monitors the compliance of the modified duration, tracking error, and open currency positions with the Procedure adopted by the Council of Latvijas Banka and the related resolutions passed by the Investment Committee of Latvijas Banka.

Latvijas Banka's exposure to market risk (as at the end of 2017 and 2016) is disclosed in Notes 26–28.

25.1.2 CREDIT RISK

Credit risk is exposure to losses resulting from counterparty default. Latvijas Banka's exposure to credit risk results mainly from investments in foreign financial instruments, and as a result of monetary policy operations. Pursuant to the Statute of the ESCB and of the ECB, risks associated with the implementation of monetary policy (if any materialise) are shared among euro area NCBs in proportion to their share in the ECB's capital, except risks associated with the purchases of Latvian government securities carried out by Latvijas Banka under the PSPP.

Latvijas Banka manages exposure to credit risk related to investments made in foreign financial instruments by establishing limits on investments of different credit quality. Credit quality is evaluated on the basis of ratings assigned by the international credit rating agencies Fitch Ratings, Moody's Investors Service, Standard & Poor's, and DBRS. Latvijas Banka is allowed to invest in financial instruments of certain credit quality of the OECD countries. Limits are also set on the maximum investment in financial instruments of the same class and counterparty, as well as in financial instruments of one issuer. Forward transactions in mortgage-backed securities are partly secured with short-term financial instruments. To hedge the credit risk associated with OTC derivative counterparties, Latvijas Banka and the respective counterparties enter into Master Agreements of International Swaps and Derivatives Association, Inc. (ISDA Master Agreement) with Credit Support Annex, and the external managers of mortgage-backed securities portfolios enter with their counterparties into Treasury Market Practices Group (TMPG) Master Securities Forward Transaction Agreements. In order to monitor Latvijas Banka's credit risk exposure associated with its investments, the Risk Management Division of the Market Operations Department monitors compliance with the Procedure, adopted by the Council of Latvijas Banka.

In 2017 and 2016, loans granted to credit institutions in monetary policy operations were secured by securities collateral in compliance with the ECB requirements. The Market Operations Department monitors the adequacy of collateral of the respective loans and its eligibility and compliance with the ECB's requirements on a regular basis, as well as maintains a list of securities issued and held in the Republic of Latvia and eligible for monetary policy operations.

Latvijas Banka's exposure to market risk (as at the end of 2017 and 2016) is disclosed in Notes 30–32.

25.1.3 LIQUIDITY RISK

Liquidity risk is associated with a failure to dispose investment in a short time and at a competitive market price. Along with Latvia's participation in the euro area, the need for liquidity as well as the risk associated with a failure to meet liabilities in a timely manner has moderated. Following its investment strategy, Latvijas Banka manages liquidity risk by investing a certain amount of its investments in liquid debt securities issued by international institutions, foreign governments and the corporate sector, short-

term deposits with foreign financial institutions and other financial instruments. The liquidity structure of Latvijas Banka's assets and liabilities as at the end of 2017 and 2016 is disclosed in Note 29.

Liquidity risk can be limited by investment diversification. Latvijas Banka 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.

25.2 OPERATIONAL RISKS

The risk management goal and basic principles are set in "The Risk Management Policy of Latvijas Banka", "The Business Continuity Management Policy of Latvijas Banka", "The Information and Information Systems Security Policy of Latvijas Banka", and "The Physical Security Policy of Latvijas Banka" adopted by the Council of Latvijas Banka. A comprehensive and uniform oversight of the implementation of these policies is carried out by the Security Oversight Commission of Latvijas Banka.

Latvijas Banka's operational risk management is implemented by the Board of Latvijas Banka according to the basic principles defined by the Council of Latvijas Banka.

Operational risks are managed to mitigate a potential negative impact on Latvijas Banka's operation, reputation or financial position or financial performance resulting from inadequate or erroneous execution of processes, actions on the part of an official or employee of Latvijas Banka, inadequate operation or unavailability of the infrastructure of information systems or an information system or the infrastructure, or external events.

Latvijas Banka's operational risks are managed subject to a uniform operational risk management framework, with the major operational risks being compliance risks (inter alia in preventing conflict of interests, anti-corruption control, personal data protection, prevention of money laundering and terrorism financing, and ensuring workplace environment protection), risks related to business continuity, physical security, information security and information systems (including cyber security).

Latvijas Banka's operational risks are managed through processes and projects by identifying and assessing risks and, depending on the risk assessment, defining and implementing the most appropriate actions. The management of operational risks is organised by the Operational Risk Manager of Latvijas Banka and conducted, on a daily basis, by the structural units of Latvijas Banka, project managers and other employees of Latvijas Banka responsible for the execution of Latvijas Banka's processes. Operational risk management is overseen by the Operational Risk Management Committee of Latvijas Banka, appointed by the Board of Latvijas Banka, which ensures coordination of the measures to be carried out under the operational risk management process and provides support to the Board of Latvijas Banka in the area of risk management.

Compliance risks are managed to ensure compliance of Latvijas Banka's operation with the legislative acts.

Risks related to the business continuity of Latvijas Banka are managed to mitigate a potential negative impact on the execution of critical processes where their discontinuity may cause negative consequences for Latvia's financial system or adversely affect the implementation of Latvijas Banka's tasks, inter alia by ensuring continuity of the critical processes or their recovery as soon as possible and to a full extent in the event of their disruption or failure, as well as efficient incident management.

Risks related to physical security, inter alia risks associated with fire safety and civil protection are managed to mitigate a potential negative impact on the physical security of persons present on the premises of Latvijas Banka, the premises of Latvijas Banka, transportation of its valuables and the events organised by Latvijas Banka.

Risks related to information security are managed to prevent unauthorised disclosure or use of confidential information, classifying it by its degree of confidentiality and ensuring appropriate protection, at the same time taking care that the protective measures do not prevent Latvijas Banka from providing non-classified information to its cooperation partners and general public.

Risks related to information systems, including cyber security risks are managed to prevent a potential negative impact on availability, security and integrity of the information systems and infrastructure of Latvijas Banka. The level of classification of the information systems of Latvijas Banka is defined by the Board of Latvijas Banka on the basis of their importance for implementing Latvijas Banka's tasks and the confidentiality, integrity and availability requirements regarding the data to be processed, establishing appropriate physical and logical protection for each level of classification.

Latvijas Banka ensures risk management training for its employees, inter alia to maintain appropriate level of their know-how and skills, and conducts, on a regular basis, training sessions and tests in risk management for employees.

As part of the framework of operational risk mitigation measures, Latvijas Banka is insured against a possible impact of certain types of operational risks.

In 2017, operational risks, inter alia risks related to ensuring Latvijas Banka's business continuity, information and information systems security, as well as physical security were appropriately managed and did not substantially hamper Latvijas Banka's operation.

In view of the persistently growing cyber security risks, additional security tests were carried out and measures were taken to improve the information system infrastructure and their protection in 2017.

26. CURRENCY STRUCTURE

(in thousands of euro)

	EUR	USD	CAD	GBP	Gold	Other	Total
As at 31 December 2017							
Total assets	13 337 282	3 207 840	365 280	320 727	230 856	36 657	17 498 642
Total liabilities	17 393 027	66 822	246	11 879	–	26 668	17 498 642
Net position on balance sheet	–4 055 745	3 141 018	365 034	308 848	230 856	9 989	0
Net position on financial instruments' off-balance sheet accounts	3 851 322	–3 131 099	–364 533	–306 232	–	–18 311	31 147
Net position on balance sheet and off-balance sheet accounts	–204 423	9 919	501	2 616	230 856	–8 322	31 147
Net position on balance sheet and off-balance sheet accounts to total assets (%)	–1.2	0.1	0.0	0.0	1.3	0.0	0.2
As at 31 December 2016							
Total assets	11 123 287	2 934 068	162 661	277 936	234 305	40 048	14 772 305
Total liabilities	14 653 109	78 069	141	12 299	–	28 687	14 772 305
Net position on balance sheet	–3 529 822	2 855 999	162 520	265 637	234 305	11 361	–
Net position on financial instruments' off-balance sheet accounts	3 506 985	–2 842 977	–165 874	–265 516	–234 323	–13 958	–15 663
Net position on balance sheet and off-balance sheet accounts	–22 837	13 022	–3 354	121	–18	–2 597	–15 663
Net position on balance sheet and off-balance sheet accounts to total assets (%)	–0.2	0.1	0.0	0.0	0.0	0.0	–0.1

27. REPRICING MATURITY

The table below reflects the sensitivity of Latvijas Banka's assets, liabilities and off-balance sheet accounts to a change in interest rates. Items reported in this table are stated at carrying amounts, except for interest rate and currency future contracts and forward transactions in securities that are stated at notional amounts and included in off-balance sheet accounts. A nearest contractual interest repricing or residual maturity date to 31 December of the reporting year is used for categorising the items sensitive to a change in interest rates reported in this table.

	(in thousands of euro)						
	Up to 3 months	3–12 months	1–3 years	3–5 years	Over 5 years	Non-inter- est bearing items	Total
As at 31 December 2017							
Gold and gold receivables	–	–	–	–	–	230 856	230 856
Claims on non-euro area residents denominated in foreign currency	67 100	121 206	68 878	831 120	2 325 453	194 935	3 608 692
Claims on euro area residents denominated in foreign currency	3 326	–	44 883	178 647	128 091	118	355 065
Claims on non-euro area residents denominated in euro	–	–	–	6 011	90 403	4 919	101 333
Lending to euro area credit institutions related to monetary policy operations denominated in euro	–	–	–	244 660	–	–	244 660
Other claims on euro area credit institutions denominated in euro	–	–	–	–	–	438	438
Securities of euro area residents denominated in euro	–	–	47 224	300 226	7 783 747	–	8 131 197
Intra-Eurosystem claims	–	–	–	–	–	4 604 114	4 604 114
Other assets	3	–	424	5 286	78 056	138 518	222 287
Total assets	70 429	121 206	161 409	1 565 950	10 405 750	5 173 898	17 498 642
Banknotes in circulation	–	–	–	–	–	4 314 088	4 314 088
Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	5 712 980	–	–	–	–	–	5 712 980
Other liabilities to euro area credit institutions denominated in euro	22 610	–	–	–	–	–	22 610
Liabilities to other euro area residents denominated in euro	213 147	–	–	–	–	2 565	215 712
Liabilities to non-euro area residents denominated in euro	1 528	–	–	–	–	1 007	2 535
Liabilities to euro area residents denominated in foreign currency	144 324	–	–	–	–	–	144 324
Liabilities to non-euro area residents denominated in foreign currency	634	–	–	–	–	–	634
Intra-Eurosystem liabilities	6 339 683	–	–	–	–	–	6 339 683
Other liabilities	–	–	–	–	–	305 552	305 552
Capital and reserves	–	–	–	–	–	440 524	440 524
Total liabilities	12 434 906	–	–	–	–	5 063 736	17 498 642
Net position on balance sheet	–12 364 477	121 206	161 409	1 565 950	10 405 750	110 162	–
Assets on financial instruments' off-balance sheet accounts	5 438 300	3 335	168 598	165 842	1 184 268	–	6 960 343
Liabilities on financial instruments' off-balance sheet accounts	6 352 409	2 501	182 468	30 850	360 968	–	6 929 196
Net position on balance sheet and off-balance sheet accounts	–13 278 586	122 040	147 539	1 700 942	11 229 050	110 162	31 147

<i>(cont.)</i>	(in thousands of euro)						
	Up to 3 months	3–12 months	1–3 years	3–5 years	Over 5 years	Non-inter- est bearing items	Total
As at 31 December 2016							
Gold and gold receivables	–	–	–	–	–	234 305	234 305
Claims on non-euro area residents denominated in foreign currency	131 505	116 403	88 249	584 899	1 934 402	236 618	3 092 076
Claims on euro area residents denominated in foreign currency	30 486	3 349	123 019	–	200 139	1 846	358 839
Claims on non-euro area residents denominated in euro	26 570	1 412	26 276	–	79 684	10 622	144 564
Lending to euro area credit institutions related to monetary policy operations denominated in euro	12 500	–	–	244 660	–	–	257 160
Other claims on euro area credit institutions denominated in euro	–	–	–	–	–	9 071	9 071
Securities of euro area residents denominated in euro	–	–	249 983	128 884	5 940 887	–	6 319 754
Intra-Eurosystem claims	–	–	–	–	–	4 195 918	4 195 918
Other assets	10	18	165	828	51 160	108 437	160 618
Total assets	201 071	121 182	487 692	959 271	8 206 272	4 796 817	14 772 305
Banknotes in circulation	–	–	–	–	–	4 150 106	4 150 106
Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	4 191 147	–	–	–	–	–	4 191 147
Other liabilities to euro area credit institutions denominated in euro	720	–	–	–	–	–	720
Liabilities to other euro area residents denominated in euro	209 835	–	–	–	–	2 404	212 239
Liabilities to non-euro area residents denominated in euro	16 767	–	–	–	–	1 121	17 888
Liabilities to euro area residents denominated in foreign currency	159 844	–	–	–	–	–	159 844
Intra-Eurosystem liabilities	5 292 395	–	–	–	–	–	5 292 395
Other liabilities	–	–	–	–	–	294 614	294 614
Capital and reserves	–	–	–	–	–	453 352	453 352
Total liabilities	9 870 708	–	–	–	–	4 901 597	14 772 305
Net position on balance sheet	–9 669 637	121 182	487 692	959 271	8 206 272	–104 780	–
Assets on financial instruments' off-balance sheet accounts	6 217 398	99 611	170 382	211 626	1 296 391	–	7 995 408
Liabilities on financial instruments' off-balance sheet accounts	7 234 395	167 502	122 770	19 494	466 910	–	8 011 071
Net position on balance sheet and off-balance sheet accounts	10 686 634	53 291	535 304	1 151 403	9 035 753	–104 780	–15 663

28. TRACKING ERROR

The exposure to aggregate market risk and credit risk of investments, included in 1–3 year fixed income securities and 1–10 year government fixed income securities portfolios and mortgage-backed securities portfolios is characterised by the tracking error, which is measured as the expected annualised standard deviation of the difference in return between the investment portfolio and the respective benchmark (see also Note 25.1). At the end of 2017 and 2016, the actual (ex-post) tracking error of the 1–10 year fixed income securities portfolios was 16 and 25 basis points respectively. At the end of 2017

and 2016, the actual (ex-post) tracking errors of the mortgage-backed securities portfolios were 53 basis points and 79 basis points respectively.

The expected (ex-ante) tracking error lay within the following basis point intervals during the year:

	Book value (at the end of the year; in thousands of euro)	Expected tracking error (number of business days)		
		10–39	40–69	70–99
During 2017				
1–10 year fixed income securities portfolios	3 708 630	253	–	–
Mortgage-backed securities portfolios	1 158 211	13	240	–
During 2016				
1–10 year fixed income securities portfolios	3 043 063	86	–	–
1–3 year fixed income securities portfolios	–	167	–	–
Mortgage-backed securities portfolios	1 156 594	3	207	43
1–10 year government fixed income securities portfolio	–	167	–	–

29. LIQUIDITY STRUCTURE

In the liquidity structure, asset items are reported on the basis of Latvijas Banka's capability to convert them into cash. Liabilities items are reported by their expected settlement date.

	(in thousands of euro)			
	Up to 3 months	Over 3 months	No fixed maturity	Total
As at 31 December 2017				
Assets				
Gold and gold receivables	230 856	–	–	230 856
Claims on non-euro area residents denominated in foreign currency	3 608 692	–	–	3 608 692
Claims on euro area residents denominated in foreign currency	355 065	–	–	355 065
Claims on non-euro area residents denominated in euro	101 333	–	–	101 333
Lending to euro area credit institutions related to monetary policy operations denominated in euro	–	244 660	–	244 660
Other claims on euro area credit institutions denominated in euro	438	–	–	438
Securities of euro area residents denominated in euro	7 628 377	502 820	–	8 131 197
Intra-Eurosystem claims	7 610	–	4 596 504	4 604 114
Other assets	148 275	–	74 012	222 287
Total assets	12 080 646	747 480	4 670 516	17 498 642
Liabilities				
Banknotes in circulation	–	–	4 314 088	4 314 088
Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	5 712 980	–	–	5 712 980
Other liabilities to euro area credit institutions denominated in euro	22 610	–	–	22 610
Liabilities to other euro area residents denominated in euro	215 712	–	–	215 712
Liabilities to non-euro area residents denominated in euro	2 535	–	–	2 535
Liabilities to euro area residents denominated in foreign currency	144 324	–	–	144 324
Liabilities to non-euro area residents denominated in foreign currency	634	–	–	634
Intra-Eurosystem liabilities	6 339 683	–	–	6 339 683
Other liabilities	199 894	–	105 658	305 552
Total liabilities	12 638 372	–	4 419 746	17 058 118
Net position on balance sheet	–557 726	747 480	250 770	x

(cont.)

(in thousands of euro)

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	Up to 3 months	Over 3 months	No fixed maturity	Total
As at 31 December 2016				
Assets				
Gold and gold receivables	234 305	–	–	234 305
Claims on non-euro area residents denominated in foreign currency	3 092 076	–	–	3 092 076
Claims on euro area residents denominated in foreign currency	358 839	–	–	358 839
Claims on non-euro area residents denominated in euro	144 564	–	–	144 564
Lending to euro area credit institutions related to monetary policy operations denominated in euro	12 500	244 660	–	257 160
Other claims on euro area credit institutions denominated in euro	9 071	–	–	9 071
Securities of euro area residents denominated in euro	6 319 754	–	–	6 319 754
Intra-Eurosystem claims	14 706	–	4 181 212	4 195 918
Other assets	86 591	–	74 027	160 618
Total assets	10 272 406	244 660	4 255 239	14 772 305
Liabilities				
Banknotes in circulation	–	–	4 150 106	4 150 106
Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	4 191 147	–	–	4 191 147
Other liabilities to euro area credit institutions denominated in euro	720	–	–	720
Liabilities to other euro area residents denominated in euro	212 239	–	–	212 239
Liabilities to non-euro area residents denominated in euro	17 888	–	–	17 888
Liabilities to euro area residents denominated in foreign currency	159 844	–	–	159 844
Intra-Eurosystem liabilities	5 292 395	–	–	5 292 395
Other liabilities	182 050	–	112 564	294 614
Total liabilities	10 056 283	–	4 262 670	14 318 953
Net position on balance sheet	216 123	244 660	–7 431	x

30. SECTORAL STRUCTURE OF ASSETS

	Amount (in thousands of euro)		Proportion (%)	
	2017	2016	2017	2016
International institutions	4 661 390	2 492 350	26.6	16.9
European Central Bank	4 604 114	4 195 932	26.3	28.4
Central governments and other governmental institutions	3 872 539	3 830 747	22.1	25.9
Other financial institutions	3 100 377	3 014 455	17.7	20.4
Central banks and credit institutions	985 722	1 077 208	5.6	7.3
Local governments	165 704	84 388	0.9	0.6
Non-financial corporations	42 895	37 419	0.2	0.3
Unclassified assets	65 901	39 806	0.6	0.2
Total	17 498 642	14 772 305	100.0	100.0

31. ASSETS BY THEIR LOCATION OR THE COUNTERPARTY'S DOMICILE

	Amount (in thousands of euro)		Proportion (%)	
	2017	2016	2017	2016
International institutions	4 661 390	2 492 350	26.6	16.9
European Central Bank	4 604 114	4 195 932	26.3	28.4
Euro area countries	4 506 818	4 843 351	25.8	32.8
US	2 005 183	1 788 884	11.5	12.1
UK	625 523	618 873	3.6	4.2
Canada	585 857	310 337	3.3	2.1
Other European Union countries	160 235	188 658	0.9	1.3
Japan	73 199	65 581	0.4	0.4
Other countries	276 323	268 339	1.6	1.8
Total	17 498 642	14 772 305	100.0	100.0

32. ASSETS BY CREDIT RATING ASSIGNED TO THE COUNTERPARTY

	Amount (in thousands of euro)		Proportion (%)	
	2017	2016	2017	2016
European Central Bank	4 604 114	4 195 932	26.3	28.4
AAA	6 261 804	4 090 375	35.8	27.7
AA	4 171 968	4 455 291	23.8	30.2
A	1 446 160	1 201 468	8.3	8.1
BBB	704 458	529 726	4.0	3.6
Assets not exposed to credit risk and assets without counterparty credit rating	310 138	299 513	1.8	2.0
Total	17 498 642	14 772 305	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 table show the breakdown of Latvijas Banka's assets as at the end of the reporting period. 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. "BBB" is a medium grade considered to be the lowest level of investment-grade rating.

Assets not exposed to credit risk and assets without counterparty credit rating mostly comprise securities purchased in longer-term refinancing operations with Latvian credit institutions (244 660 thousand euro; 257 160 thousand euro at the end of 2016) and fixed assets (39 665 thousand euro; 37 611 thousand euro at the end of 2016).

PROFIT AND LOSS STATEMENT NOTES

33. NET INTEREST INCOME

	(in thousands of euro)	
	2017	2016
Interest income	138 189	102 982
Interest on investments	91 353	71 342
Interest on customer deposits	881	531
Interest on monetary policy operations	45 955	30 879
Interest on intra-Eurosystem claims	–	230
Interest expense	–66 691	–46 181
Interest on investments	–64 404	–45 102
Interest on monetary policy operations	–2 287	–776
Interest on intra-Eurosystem liabilities	–	–303
Net interest income	71 498	56 801

Net interest income was mainly derived from debt securities. In 2017, net interest income increased by 14 697 thousand euro in comparison with 2016. Positive contribution mostly resulted from higher yields on investment and an increase in the amount of monetary policy operations, while a negative impact resulted from higher interest expense on investment, mainly on account of a rise in the costs for hedging currency risks resulting from the widening of the spread between the interest rates of the euro and other investment currencies of Latvijas Banka.

Interest income from and interest expense on the intra-Eurosystem claims and liabilities are remunerated by applying the ECB's interest rate on the main refinancing operations and include income from foreign reserves transferred to the ECB and claims on allocation of banknotes in the Eurosystem, as well as expense on liabilities related to TARGET2 settlements.

According to the ECB Governing Council's decision on the allocation of monetary income for first six years following the euro changeover the remunerable part of the claims on banknote allocation in the Eurosystem is reduced in compliance with a definite coefficient to avoid significant NCB income fluctuations. The adjustment of the reduction of the remunerable part of Latvijas Banka's claims on banknote allocation in the Eurosystem in the course of the six years is as follows:

Reporting year	Coefficient (%)
2014	100.00000
2015	86.06735
2016	70.13472
2017	53.34835
2018	35.98237
2019	18.17225

In 2017, interest income on monetary policy operations increased on account of a higher average daily balance of credit institutions' demand deposits (see Note 16) and the implementation of the PSPP.

The application of the interest on deposits is stipulated in the Guideline of the ECB of 20 February 2014 on domestic asset and liability management operations by the national central banks (ECB/2014/9) (2014/304/EU).

34. REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

	(in thousands of euro)	
	2017	2016
Debt securities	15 073	63 540
Foreign exchange transactions	9 466	12 439
Derivative financial instruments	8 753	-37 440
Total	33 292	38 539

Gains from the disposal of debt securities decreased by 48 467 thousand euro in comparison with 2016, mostly on account of higher yields.

The realised result from financial operations was positively affected by the result on derivative financial instruments posting an increase of 46 193 thousand euro in comparison with 2016, mostly on account of the result of interest rate future contracts as well as the result of currency future contracts concluded for the purpose of hedging currency risks. The positive result of the currency future contracts concluded for the purpose of hedging currency risk exposure is offset in equal value by the negative revaluation result of the balance sheet items hedged for foreign currency risk.

In 2017 and 2016, the realised gains on foreign exchange transactions mostly resulted from the recognition of a part of the initial valuation account balance in profit and loss statement (see also Note 23).

35. RECOGNITION OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS IN PROFIT AND LOSS STATEMENT

	(in thousands of euro)	
	2017	2016
Debt securities	-15 929	-52 657
Foreign currency positions	-2 862	-72
Total	-18 791	-52 729

The revaluation result of several debt securities, foreign currency positions, and interest rate swap arrangements at the end of 2017 and 2016 was negative, and it has been recognised in the profit and loss statement while the positive result on the revaluation of debt securities, foreign currency positions, and interest rate swap arrangements has been reported under the balance sheet item "Capital and reserves" as the revaluation reserve of securities, foreign currency, and interest rate swap arrangements (see also Note 23).

The decrease in the negative result on revaluation of debt securities is related to a more moderate rise in yields at the end of 2017.

36. PROVISIONS FOR MARKET RISK AND CREDIT RISK

Financial risks of Latvijas Banka relate primarily to its investments in financial instruments, as well as the implementation of the single monetary policy operations associated with Latvijas Banka's participation in the Eurosystem and sharing of the related risks and financial results. Latvijas Banka's financial assets are mostly exposed to market risk (interest rate and currency risks) and credit risk (credit rating downgrade and default risks). Furthermore, in 2017, discontinuing the hedging of the gold price fluctuation risk, Latvijas Banka was exposed to another component of market risk, i.e. the gold price risk. Latvijas Banka carries out assessment of its financial risks and financial buffers in compliance with the ECB's common methodology for Eurosystem financial risk assessment. According to the methodology for Eurosystem financial risk assessment, the

Expected Shortfall measure with confidence level of 99% (ES99%) for a risk horizon of one year is used. ES99% describes the losses determined by the average value of 1% of the most unfavourable simulated profitability scenarios. The above methodology takes account of various market risk and credit risk factors as well as uses historical data and assumptions of the Eurosystem/ESCB's Risk Management Committee. ES99% includes assumptions concerning development of adverse financial market factors, e.g. interest rate rise, widening of the interest rate spreads, euro appreciation, and credit rating downgrades. Considering the limitations applied in calculating ES99% and the conservative approach to risk estimates, the management of Latvijas Banka has made an assumption that the targeted amount of provisions for interest rate risk and credit risk should be smaller than the estimated ES99%. The targeted amount of provisions for market risk and credit risk is 220 000 thousand euro (250 000 thousand euro in 2016). In 2017, the decrease in the targeted amount of provisions for interest rate risk and credit risk resulted from changes in the investment portfolios of Latvijas Banka on account of a decrease in the investment portfolio values exposed to interest rate risk and a decrease in the modified duration. As to the targeted amount of provisions for gold price risk, it corresponds to the potential loss in the event the scenario of the gold price decline materialised. Review of the targeted amount of provisions takes place on an annual basis taking into account the level of financial risks, the available financial reserves and long-term prospects of the financial market development.

Based on the above risk estimates, in 2017 the Council of Latvijas Banka decided to establish additional provisions in the amount of 42 400 thousand euro (86 400 thousand euro in 2016) for market risk and credit risk with regard to investment management transactions of Latvijas Banka. In addition to the above, provisions for credit risk, associated with the Eurosystem monetary policy operations, in the amount of 276 thousand euro were established; as a result, the total outstanding amount of provisions reached 179 176 thousand euro at the end of 2017.

It has been planned to continue accumulating provisions for market risk and credit risk for a longer time period, reaching the targeted amount in the next few years. Provisions for the market risk and credit risk may be reduced when financial risks materialise provided they are not offset against the accumulated revaluation result on financial instruments and other income, as well as when financial risks moderate.

37. INCOME FROM PARTICIPATING INTEREST

Income from participating interest comprises dividends received from the participating interest in the BIS in the amount of 390 thousand euro (289 thousand euro in 2016; see also Note 14.2) and income from the ECB's interim profit distribution for the reporting year and the remainder of the ECB's annual profit of the previous year in the amount of 4 868 thousand euro (4 953 thousand euro in 2016, see also Note 2.26).

38. NET RESULT OF POOLING OF MONETARY INCOME

	(in thousands of euro)	
	2017	2016
Monetary income pooled	-39 575	-28 871
Monetary income received	43 226	39 705
Net result of pooling of monetary income	3 651	10 834

The monetary income received grew on account of an increase in the amount of securities purchased under the PSPP. The increase in monetary income pooled was compensated by a respective increase in interest on monetary policy operations.

39. OTHER OPERATING INCOME

	(in thousands of euro)	
	2017	2016
Revaluation of liabilities for the issued lats banknotes and coins	10 300	78 100
Income from sale of collector coins	1 536	1 686
Other	546	1 265
Total	12 382	81 051

As a result of revaluation of liabilities for the issued lats banknotes and coins, income increased as the lats banknotes and coins, whose exchange probability is low, are not reported on the balance sheet pursuant to the "Financial Accounting Policy of Latvijas Banka" (see also Note 2.20). Revaluation of liabilities for the issued lats banknotes and coins is performed on an annual basis, taking into account the latest data on the exchange of lats banknotes and coins to euro banknotes and coins. In 2017, with the pace of exchange of the lats banknotes and coins moderating, the valuation of liabilities for the issued lats banknotes and coins decreased considerably (see also Note 22.1).

40. REMUNERATION, SOCIAL SECURITY COSTS, AND SOLIDARITY TAX

	(in thousands of euro)	
	2017	2016
Remuneration		
Remuneration of Members of the Council and the Board	-1 561	-1 581
Remuneration of other personnel	-16 055	-15 603
Total remuneration	-17 616	-17 184
Social security costs and solidarity tax	-3 962	-3 852
Total remuneration, social security costs, and solidarity tax	-21 578	-21 036

Remuneration of those Members of the Board of Latvijas Banka who are also Heads of Departments of Latvijas Banka includes remuneration for performance of these duties.

At the end of 2017, the number of employees was 528 (539 at the end of 2016), representing 511 full-time equivalents in 2017 (517 in 2016).

41. BANKNOTE AND COIN ACQUISITION COSTS

	(in thousands of euro)	
	2017	2016
Acquisition of banknotes	-3 148	-5 741
Acquisition of collector coins	-1 159	-1 276
Acquisition of circulation coins	-235	-266
Total	-4 542	-7 283

42. OTHER OPERATING EXPENSES

	(in thousands of euro)	
	2017	2016
Maintenance and operation of information systems	-3 404	-3 577
Municipal services	-837	-809
Maintenance of buildings, territory and equipment	-614	-520
Business travel	-516	-576
Information and public relations	-410	-267
Acquisition of low value office supplies	-322	-163
Telecommunication services and system maintenance	-288	-254
Personnel training	-285	-233
Tax on real estate	-228	-160
Risk insurance	-189	-221
Transport provision	-106	-71
Event services	-102	-69
Other	-472	-371
Total	-7 773	-7 291

Other expenses also comprise the remuneration in the amount of 29 thousand euro paid to KPMG Baltics SIA for the audit of 2017 financial statements of Latvijas Banka (29 thousand euro in 2016).

OTHER NOTES**43. TRANSACTIONS WITH THE LATVIAN GOVERNMENT**

Latvijas Banka, whose capital is wholly owned by the Republic of Latvia, carries out transactions with the Treasury, acting as the financial agent of the Latvian government. Performing this function, Latvijas Banka services the Treasury's accounts in euro and foreign currencies. Latvijas Banka is independent in making its own decisions on entering into the above transactions. The Treasury demand deposits are recorded under the balance sheet items "Liabilities to other euro area residents denominated in euro" and "Liabilities to euro area residents denominated in foreign currency".

The interest rates and foreign exchange rates used in the transactions with the Latvian government are market-based according to the ECB's decisions. No commission fees are applied to transactions with the Latvian government.

Pursuant to Guideline of the ECB of 20 February 2014 on domestic asset and liability management operations by the national central banks (ECB/2014/9) (2014/304/EU), Latvijas Banka applies the euro overnight index average (EONIA) rate (it was negative at the end of both 2017 and 2016 (-0.346% and -0.329% respectively) to the amount of the Treasury's deposits in euro up to 200 million euro. As regards the total outstanding amount of the Treasury's settlement accounts in euro and foreign currencies exceeding 200 million euro, Latvijas Banka applies the deposit facility rate set by the ECB (it was negative at the end of both 2017 and 2016 - -0.40%).

At the end of 2017 and 2016, the breakdown of Latvijas Banka's claims and liabilities to the Latvian government were as follows:

	(in thousands of euro)	
	2017	2016
Claims		
Securities held for monetary policy purposes	982 537	706 919
Other securities	48 629	48 754
Accrued interest on debt securities	13 984	12 145
Total claims	1 045 150	767 818
Liabilities		
Demand deposits in euro	29 516	46 710
Demand deposits in foreign currencies	144 324	159 844
Tax liabilities	75	159
Total liabilities	173 915	206 713

In 2017 and 2016, the breakdown of Latvijas Banka's income and expense related to the Latvian government, as well as Latvijas Banka's profit of the previous reporting year appropriated to the state budget was as follows (see also Notes 22.2 and 23):

	(in thousands of euro)	
	2017	2016
Income (-)/expense and Latvijas Banka's profit appropriated to the state budget		
Interest on debt securities	-4 459	-2 272
Negative interest on government deposits	-263	-85
Recognition of revaluation result on debt securities in profit and loss statement	-	1 188
Taxes	10 589	9 943
Profit appropriated to the state budget	7 653	19 524
Total net expense and Latvijas Banka's profit appropriated to the state budget	13 520	28 298

44. PLEDGED ASSETS

Securities and other financial instruments purchased by Latvijas Banka with the market value of 28 671 thousand euro, as at the end of 2017 (33 038 thousand euro at the end of 2016), have been pledged to provide collateral for forward exchange rate contracts, interest rate, currency future contracts and payment system operation.

45. SECURITIES LENDING

On behalf of Latvijas Banka its agents conclude securities lending transactions, as part of an automated security lending programme, where securities held by Latvijas Banka are lent against cash or other securities collateral. Securities lending transactions provide additional income without any material impact on investment liquidity as the securities lent are readily available to Latvijas Banka. The above agents administer the securities lending transactions and monitor the eligibility of the securities lending transactions and related collateral. The fair value of collateral provided in securities lending transactions is higher than that of the securities lent.

To improve securities market liquidity, Latvijas Banka, simultaneously with other euro area NCBS, lends securities purchased under the PSPP; Latvijas Banka conducts the above lending under the automated security lending programme.

At the end of 2017, the fair value of the securities lent, determined using quoted prices

in an active market, was 7 427 thousand euro (118 129 thousand euro at the end of 2016); inter alia, the fair value of securities purchased and lent under the PSPP stood at 2 073 thousand euro at the end of 2017 (11 101 thousand euro at the end of 2016).

Foreign currency cash or securities received in the agent account of Latvijas Banka's automated security lending programme as collateral for securities lending transactions is not recognised in Latvijas Banka's balance sheet (see also Note 2.12).

46. CONTINGENT LIABILITIES AND COMMITMENTS

The uncalled portion of the BIS shares held by Latvijas Banka is 75% of their nominal value; these shares are callable following a respective decision of the BIS Board. At the end of 2017, the uncalled portion of the BIS shareholding was 4 013 thousand SDR (4 766 thousand euro; 4 013 thousand SDR (5 115 thousand euro) at the end of 2016; see also Note 14.2).

At the end of 2017, Latvijas Banka had issued euro collector coins, lats collector coins and precious metal circulation coins in the nominal value of 6 703 thousand euro (6 529 thousand euro at the end of 2016). These coins may be represented to Latvijas Banka at a nominal value. In the opinion of management of Latvijas Banka, the probability that Latvijas Banka will be required to repurchase these coins from their holders is considered low and no provisions have been made.

At the end of 2017, Latvijas Banka had issued lats banknotes and coins with the face value of 126 931 thousand euro (129 906 thousand euro at the end of 2016), reported on the balance sheet in the amount of 38 531 thousand euro (51 806 thousand euro at the end of 2016). Pursuant to the Law on the Procedure for Introducing the Euro, the period for exchanging the lats cash to the euro at Latvijas Banka is unlimited. In the opinion of the management of Latvijas Banka, the probability that Latvijas Banka would be required to exchange lats banknotes and coins in the amount of 88 400 thousand euro (78 100 thousand euro at the end of 2016) at face value, is low.

47. EVENTS AFTER THE REPORTING PERIOD

In February 2018 Latvijas Banka provided emergency liquidity assistance to ABLV Bank, AS by granting short-term loans totalling 297 200 thousand euro in exchange for collateral consisting of high credit quality securities at the market value of 557 936 thousand euro at the time of granting the loans. Subsequently, on 23 February 2018 the European Central Bank determined that ABLV Bank, AS was failing or likely to fail. On 26 February 2018, ABLV Bank, AS announced about the decision on voluntary liquidation of ABLV Bank, AS, taken by its shareholders' meeting. On 2 March 2018, ABLV Bank, AS fully repaid the above loans.

As of 19 February 2018, a prohibition to execute the functions of decision-making, control and supervision in Latvijas Banka was imposed on Ilmārs Rimšēvičs, Governor of Latvijas Banka. According to Latvijas Banka's management, the above factor has no effect on the financial position of Latvijas Banka and its financial performance results or Latvijas Banka's capability to perform its tasks.

TO THE COUNCIL OF LATVIJAS BANKA

Our Opinion on the Financial Statements

We have audited the accompanying financial statements of Latvijas Banka ("the Bank") set out on pages 67 to 114, which comprise:

- the balance sheet as at 31 December 2017,
- the profit and loss statement for the year then ended,
- the statement of total recognised gains and losses for the year then ended,
- the notes to the financial statements, which include a summary of principal accounting policies and other explanatory notes.

In our opinion, the accompanying financial statements give a true and fair view of the financial position of Latvijas Banka as at 31 December 2017, and of its financial performance for the year then ended in accordance with the Guideline (EU) 2016/2249 of the European Central Bank of 3 November 2016 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34), "Financial Accounting Policy of Latvijas Banka" approved by the Council of the Bank, and the requirements of the Law on Latvijas Banka governing financial reporting.

Basis for Opinion

In accordance with the Law on Audit Services of the Republic of Latvia we conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditors' Responsibility for the Audit of the Financial Statements* section of our report.

We are independent of the Bank in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) and independence requirements included in the Law on Audit Services of the Republic of Latvia that are relevant to our audit of the financial statements. We have also fulfilled our other professional ethics responsibilities and objectivity requirements in accordance with the IESBA Code and the Law on Audit Services of the Republic of Latvia.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Board and Those Charged with Governance for the Financial Statements

The Board of the Bank is responsible for the preparation of the financial statements that give a true and fair view in accordance with the Guideline (EU) 2016/2249 of the European Central Bank of 3 November 2016 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34), "Financial Accounting Policy of Latvijas Banka" approved by the Council of the Bank, and the requirements of the Law on Latvijas Banka governing financial reporting. The Board of the Bank is also responsible for such internal control as the Board of the Bank determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Based on the Law on Latvijas Banka, the Board of the Bank is responsible for the preparation of the financial statements using the going concern basis of accounting.

Those charged with the Bank's governance are responsible for overseeing the Bank's financial reporting process.

Auditors' Responsibility for the Audit of the Financial Statements

Our audit objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the entity to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves a fair presentation.

We communicate with those charged with the Bank's governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

KPMG Baltics SIA
Licence No. 55

Armine Movsisjana
Chairperson of the Board
Latvian Certified Auditor
Certificate No. 178
Riga, Latvia

13 March 2018

APPENDICES



MONETARY INDICATORS IN 2017

(at the end of the period; millions of euro)

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
LATVIJAS BANKA												
Latvia's contribution to the euro area monetary base	8 109.5	8 201.1	8 020.7	8 545.8	8 254.9	8 305.3	8 120.4	8 377.1	8 477.4	9 433.6	9 381.4	10 143.0
Currency in circulation	4 199.3	4 206.7	4 217.5	4 256.8	4 260.0	4 300.4	4 322.7	4 317.7	4 326.7	4 339.9	4 334.2	4 430.0
Current accounts (covering the minimum reserve system)	3 910.2	3 994.4	3 803.2	4 289.0	3 994.9	4 005.0	3 797.7	4 059.4	4 150.8	5 093.8	5 047.2	5 713.0
Deposit facility and other liabilities related to monetary policy operations	0	0	0	0	0	0	0	0	0	0	0	0
Foreign assets outside the euro area	3 416.7	3 540.9	3 459.5	3 407.2	3 424.9	3 460.5	3 473.3	3 537.7	3 611.8	3 660.1	3 968.6	3 940.9
Foreign liabilities outside the euro area	6.6	1.1	9.1	13.5	24.3	11.1	19.8	23.5	4.9	1.1	12.2	3.2
Credit	7 059.7	6 741.3	7 011.0	7 239.5	7 402.1	7 039.7	7 683.2	7 818.3	8 004.4	8 176.4	8 539.4	8 731.4
To MFIs in the euro area	520.8	530.2	523.2	519.9	530.6	524.8	504.6	499.2	495.1	482.8	509.6	506.8
To the general government sector in the euro area	2 242.4	1 698.1	1 746.0	1 794.1	1 824.1	1 297.1	1 822.9	1 846.5	1 871.4	1 899.9	2 055.1	2 099.3
To other euro area residents	4 296.5	4 512.9	4 741.8	4 925.5	5 047.4	5 217.7	5 355.8	5 472.6	5 638.0	5 793.7	5 974.7	6 125.3
MFI												
Overnight deposits (Latvia's contribution to M1 of the euro area)	9 937.6	10 216.0	10 275.3	10 441.3	10 274.5	10 235.7	10 135.2	10 305.6	10 023.9	10 359.1	10 586.7	10 762.8
Deposits with an agreed maturity of up to 2 years	1 225.7	1 153.5	1 143.0	1 138.7	1 169.3	1 070.0	1 037.1	1 071.4	1 112.2	1 070.1	1 044.7	1 014.5
Deposits redeemable at notice of up to 3 months	884.7	893.1	881.2	893.2	890.1	895.1	897.9	901.9	904.9	908.1	914.9	951.2
Latvia's contribution to M2 of the euro area	12 048.0	12 262.6	12 299.5	12 473.2	12 333.9	12 200.8	12 070.2	12 278.9	12 041.0	12 337.3	12 546.3	12 728.5
Money market fund shares and units	0	0	0	0	0	0	0	0	0	0	0	0
Debt securities with a maturity of up to 2 years	80.2	40.9	46.5	35.6	33.9	18.5	23.0	27.8	24.1	26.7	25.2	45.1
Latvia's contribution to M3 of the euro area	12 128.2	12 303.5	12 346.0	12 508.8	12 367.8	12 219.3	12 093.2	12 306.7	12 065.1	12 364.0	12 571.5	12 773.7
Net foreign assets outside the euro area	-932.3	-383.9	-595.6	-811.7	-473.1	-1 256.7	-667.3	-859.6	446.4	-164.7	382.8	-152.1
Credit to euro area financial institutions, non-financial corporations and households	14 275.2	14 274.0	14 303.5	14 285.9	14 246.4	14 236.6	14 299.2	14 379.0	13 841.5	14 045.6	14 058.2	14 005.8
Loans to resident financial institutions, non-financial corporations and households	12 735.4	12 736.2	12 752.0	12 767.6	12 702.7	12 746.8	12 784.9	12 786.7	12 243.3	12 408.9	12 449.9	12 392.8
Deposits by resident financial institutions, non-financial corporations and households	10 839.5	11 001.0	10 958.9	11 023.9	10 854.1	10 942.3	10 872.9	10 992.3	10 797.3	11 008.3	11 203.5	11 401.6
INTEREST RATES												
Interest rate on the main refinancing operations (at end of period; %)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Weighted average interest rates on transactions in euro (%)												
Interbank loans	-0.37	-0.42	-0.40	-0.33	-0.40	-0.40	-0.39	-0.40	-0.40	-0.20	-0.40	-0.40
Loans to non-financial corporations and households with a floating interest rate and an initial rate fixation of up to 1 year (new business)	2.8	2.7	2.5	2.8	2.9	2.8	2.6	3.0	2.9	2.6	3.1	2.6
Time deposits by non-financial corporations and households (new business)	0.2	0.1	0.1	0.2	0.2	0.1	0.2	0.1	0.3	0.5	0.4	0.4

MONTH-END BALANCE SHEETS OF LATVIJAS BANKA FOR 2017

(at the end of the month; thousands of euro)

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
ASSETS	14 857 145	14 622 747	14 853 935	15 133 547	15 371 604	15 053 023	15 804 825	16 024 192	16 240 933	16 486 858	17 248 595	17 498 642
Gold and gold receivables	239 028	252 488	247 873	247 627	240 824	232 568	230 788	235 615	232 542	233 259	230 582	230 856
Claims on non-euro area residents denominated in foreign currency	3 058 938	3 158 370	3 101 334	3 048 711	3 070 740	3 104 898	3 121 021	3 189 303	3 263 594	3 307 360	3 635 091	3 608 692
Receivables from the IMF	152 700	154 331	153 437	151 504	149 083	147 343	144 987	144 238	144 601	145 821	144 395	143 477
Balances with credit institutions and security investments, external loans and other external assets	2 906 238	3 004 039	2 947 897	2 897 207	2 921 657	2 957 555	2 976 034	3 045 065	3 118 993	3 161 539	3 490 696	3 465 215
Claims on euro area residents denominated in foreign currency	299 674	310 337	326 004	328 754	307 984	302 318	288 753	294 281	297 793	283 088	339 204	355 065
Claims on non-euro area residents denominated in euro	118 725	130 040	110 307	110 833	113 291	123 082	121 478	112 756	115 712	119 462	102 907	101 333
Lending to euro area credit institutions related to monetary policy operations denominated in euro	257 160	244 660	244 660	244 660	244 660	244 660	244 660	244 660	244 660	244 660	244 660	244 660
Main refinancing operations	–	–	–	–	–	–	–	–	–	–	–	–
Longer-term refinancing operations	257 160	244 660	244 660	244 660	244 660	244 660	244 660	244 660	244 660	244 660	244 660	244 660
Fine-tuning reverse operations	–	–	–	–	–	–	–	–	–	–	–	–
Structural reverse operations	–	–	–	–	–	–	–	–	–	–	–	–
Marginal lending facility	–	–	–	–	–	–	–	–	–	–	–	–
Credits related to margin calls	–	–	–	–	–	–	–	–	–	–	–	–
Other claims on euro area credit institutions denominated in euro	39	9 683	63	66	72	250	1 384	87	1 991	6 507	148	438
Securities of euro area residents denominated in euro	6 502 782	6 176 597	6 440 317	6 665 976	6 849 378	6 492 423	7 148 433	7 279 312	7 459 972	7 642 135	7 955 345	8 131 197
Securities held for monetary policy purposes	4 586 629	4 823 761	5 075 249	5 275 675	5 465 352	5 666 011	5 860 800	6 018 675	6 214 466	6 411 283	6 602 856	6 719 984
Other securities	1 916 153	1 352 836	1 365 068	1 390 301	1 384 026	826 412	1 287 633	1 260 637	1 245 506	1 230 852	1 352 489	1 411 213
Intra-Eurosystem claims	4 177 382	4 196 001	4 221 059	4 272 239	4 311 101	4 355 405	4 399 745	4 441 424	4 466 132	4 502 055	4 518 342	4 604 114
Participating interest in the ECB	115 082	115 082	115 082	115 082	115 082	115 082	115 082	115 082	115 082	115 082	115 082	115 082
Claims equivalent to the transfer of foreign reserves to the ECB	163 480	163 480	163 480	163 480	163 480	163 480	163 480	163 480	163 480	163 480	163 480	163 480
Claims related to TARGET2 and national central bank correspondent accounts (net)	–	–	–	–	–	–	–	–	–	–	–	–
Claims related to other operational requirements within the Eurosystem	3 898 820	3 917 439	3 942 497	3 993 677	4 032 539	4 076 843	4 121 183	4 162 862	4 187 570	4 223 493	4 239 780	4 325 552
Items in course of settlement	–	–	–	–	–	–	–	–	–	–	–	–
Other assets	203 417	144 571	162 318	214 681	233 554	197 419	248 563	226 754	158 537	148 332	222 316	222 287

Appendix 2 (cont.)

(at the end of the month; thousands of euro)

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	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
LIABILITIES	14 857 145	14 622 747	14 853 935	15 133 547	15 371 604	15 053 023	15 804 825	16 024 192	16 240 933	16 486 858	17 248 595	17 498 642
Banknotes in circulation	4 087 019	4 094 190	4 106 763	4 146 565	4 149 741	4 189 399	4 211 203	4 205 499	4 213 849	4 226 702	4 219 498	4 314 088
Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	3 910 189	3 994 387	3 803 222	4 289 043	3 994 866	4 004 951	3 797 675	4 059 402	4 150 761	5 093 762	5 047 181	5 712 980
Current accounts (covering the minimum reserve system)	3 910 189	3 994 387	3 803 222	4 289 043	3 994 866	4 004 951	3 797 675	4 059 402	4 150 761	5 093 762	5 047 181	5 712 980
Deposit facility	–	–	–	–	–	–	–	–	–	–	–	–
Fixed-term deposits	–	–	–	–	–	–	–	–	–	–	–	–
Fine-tuning reverse operations	–	–	–	–	–	–	–	–	–	–	–	–
Deposits related to margin calls	–	–	–	–	–	–	–	–	–	–	–	–
Other liabilities to euro area credit institutions denominated in euro	5 970	–	5 870	9 470	12 170	5 190	18 690	30 420	1 390	–	7 550	22 610
Liabilities to other euro area residents denominated in euro	181 674	225 713	192 870	208 555	190 134	262 660	277 691	324 222	243 553	206 157	204 726	215 712
General government	10 928	55 730	23 674	33 533	15 676	89 019	98 224	145 455	61 453	18 271	17 582	29 516
Other liabilities	170 746	169 983	169 196	175 022	174 458	173 641	179 467	178 767	182 100	187 886	187 144	186 196
Liabilities to non-euro area residents denominated in euro	6 401	1 132	8 695	12 606	22 098	9 794	16 571	18 674	4 002	1 072	10 544	2 535
Liabilities to euro area residents denominated in foreign currency	155 873	163 909	160 337	153 262	149 092	154 502	149 461	146 146	150 409	148 540	150 553	144 324
Liabilities to non-euro area residents denominated in foreign currency	149	–	421	915	2 174	1 349	3 181	4 795	881	–	1 629	634
Intra-Eurosystem liabilities	5 830 138	5 399 788	5 860 489	5 571 983	6 103 949	5 688 722	6 587 960	6 463 362	6 703 435	6 025 663	6 860 056	6 339 683
Liabilities related to TARGET2 and national central bank correspondent accounts (net)	5 830 138	5 399 788	5 860 489	5 571 983	6 103 949	5 688 722	6 587 960	6 463 362	6 703 435	6 025 663	6 860 056	6 339 683
Liabilities related to other operational requirements within the Eurosystem	–	–	–	–	–	–	–	–	–	–	–	–
Items in course of settlement	–	–	–	–	–	–	–	–	–	–	–	–
Other liabilities	272 506	297 981	273 911	279 504	263 421	260 323	264 436	271 352	292 167	301 697	269 665	305 552
Capital and reserves	407 226	445 647	441 357	461 644	483 959	476 133	477 957	500 320	480 486	483 265	477 193	440 524

ORGANISATIONAL UNITS OF LATVIJAS BANKA AT THE END OF 2017

1. ACCOUNTING DEPARTMENT

1.1 Financial Statements and Accounting Policy Division

1.2 Internal Banking Operations Division

2. CASH DEPARTMENT

2.1 Cash Operations Division

2.2 Coin Division

2.3 Cash Technology Division

2.4 Riga Branch

2.5 Liepāja Branch

3. FINANCIAL STABILITY DEPARTMENT

3.1 Financial Stability Division

4. INFORMATION SYSTEMS DEPARTMENT

4.1 System Design and Programming Division

4.2 Computer Network and Server Systems Division

4.3 Bank Information System Maintenance and Development Division

4.4 Information Systems Security Division

4.5 Information Systems Quality Assurance Division

4.6 Systems Maintenance Division

5. INTERNAL AUDIT DEPARTMENT

6. INTERNATIONAL RELATIONS AND COMMUNICATION DEPARTMENT

6.1 Document Management and Library Division

6.2 Publications Division

6.3 Public Relations Division

6.4 International Relations and Protocol Division

7. LEGAL DEPARTMENT

8. MARKET OPERATIONS DEPARTMENT

8.1 Trading and Investment Division

8.2 Risk Management Division

9. MONETARY POLICY DEPARTMENT

9.1 Macroeconomic Analysis Division

9.2 Financial Market Analysis Division

9.3 Monetary Research and Forecasting Division

10. PAYMENT SYSTEMS DEPARTMENT

10.1 Payment Systems Policy Division

10.2 Payment Systems Operations Division

10.3 Payment and Settlement Division

10.4 Credit Register Division

11. PERSONNEL DEPARTMENT

12. SECURITY DEPARTMENT

12.1 Analytical Unit

12.2 Armament Unit

12.3 Central Division

12.4 Riga Division

12.5 Liepāja Division

Appendix 3 (cont.)

13. STATISTICS DEPARTMENT

13.1 Financial Market and Monetary Statistics Division

13.2 Balance-of-Payments Statistics Division

13.3 General Economic and Financial Statistics Division

14. TECHNICAL SUPPORT DEPARTMENT

14.1 General Service Division

14.2 Building Systems Division

14.3 Security Systems Division

15. TRAINING CENTRE

**PARTICIPATION OF LATVIJAS BANKA IN THE EUROSISTEM AND
THE EUROPEAN SYSTEM OF CENTRAL BANKS**

Governing Council of the ECB

General Council of the ECB

Supervisory Board of the ECB

Accounting and Monetary Income Committee (AMICO)

Banknote Committee (BANCO)

Budget Committee (BUCOM)

Committee on Controlling (COMCO)

Financial Stability Committee (FSC)

Eurosistem/ESCB Communications Committee (ECCO)

Human Resources Conference (HRC)

Information Technology Committee (ITC)

Internal Auditors Committee (IAC)

International Relations Committee (IRC)

Legal Committee (LEGCO)

Market Infrastructure and Payments Committee (MIPC)

Market Operations Committee (MOC)

Monetary Policy Committee (MPC)

Organisational Development Committee (ODC)

Risk Management Committee (RMC)

Statistics Committee (STC)

REPRESENTATION OF LATVIJAS BANKA IN INTERNATIONAL ORGANISATIONS

EUROPEAN UNION

ESRB

Advisory Technical Committee of the ESRB

Economic and Financial Committee for the Council of the EU (EFC)

JEFC's Euro Coin Sub-Committee (ECSC)

EFC's Sub-Committee on IMF and Related Issues (SCIMF)

Board of Supervisors of the EBA

Permanent Representation of Latvia to the EU

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

EC Public Administration Network (PAN II)

INTERNATIONAL MONETARY FUND

Board of Governors

Nordic-Baltic Monetary and Financial Committee (NBMFC)

Alternates of Nordic-Baltic Monetary and Financial Committee (NBMFC Alternates)

Office of the Nordic-Baltic Executive Director in Washington

Appendix 6

LATVIJAS BANKA PUBLICATIONS AND MAJOR PUBLICATIONS BY THE EXPERTS OF LATVIJAS BANKA IN 2017

The following Latvijas Banka publications are available on Latvijas Banka website (www.bank.lv).

REGULAR PUBLICATIONS AND SERIAL PUBLICATIONS

Financial Stability Report. 2017

Latvijas Banka: Annual Report 2016

Latvijas Maksājumu Bilance. Latvia's Balance of Payments. 2016

Macroeconomic Developments Report (June and December; No. 25 and 26, 2017)

WORKING PAPERS

BUŠS, Ginters (2017). *Wage Formation, Unemployment and Business Cycle in Latvia*. Latvijas Banka Working Paper, No. 1. 69 p.

BENKOVSKIS, Konstantīns, BLUHM, Benjamin, BOBEICA, Elena, OSBAT, Chiara, ZEUGNER, Stefan (2017). *What Drives Export Market Shares? It Depends! An Empirical Analysis Using Bayesian Model Averaging*. Latvijas Banka Working Paper, No. 2. 37 p.

KRASNOPJOROVŠ, Oļegs (2017). *Why Is Education Performance so Different across Latvian Schools?* Latvijas Banka Working Paper, No. 3. 55 p.

BODNÁR, Katalin, FADEJEVA, Ludmila, IORDACHE, Stefania, MALK, Liina, PASKALEVA, Desislava, PESLIAKAITĒ, Jurga, TODORVIĆ JEMEC, Nataša, TÓTH, Peter, WYSZYŃSKI, Robert (2017). *How do Firms Adjust to Rises in the Minimum Wage? Survey Evidence from Central and Eastern Europe*. Latvijas Banka Working Paper, No. 4. 47 p.

PUBLICATIONS

AJEVSKIS, Viktors. Nonlocal Solutions to Dynamic Equilibrium Models: The Approximate Stable Manifolds Approach. *Macroeconomic Dynamics* (Cambridge University Press). Available from 14 February 2018 doi.org/10.1017/S1365100517000803.

AJEVSKIS, Viktors. Semi-Global Solutions to DSGE Models: Perturbation around a Deterministic Path. *Studies in Nonlinear Dynamics & Econometrics*. Ed. by Mizrach, Bruce. Vol. 21, issue 2, De Gruyter. Available from 4 December 2017 doi.org/10.1515/snde-2016-0065.

BENKOVSKIS, Konstantīns, MASSO, Jaan, TKACEVS, Oļegs, VAHTER, Priit, YASHIRO, Naomitsu. *Export and Productivity in Global Value Chains: Comparative Evidence from Latvia and Estonia*. OECD Economics Department Working Papers, No. 1448, OECD Publishing, 2017. 39 p.

BENKOVSKIS, Konstantīns, WÖRZ, Julia. What Drives the Market Share Changes? Price Versus Non-Price Factors. *Structural Change and Economic Dynamics Articles* (Elsevier). Available from 28 December 2017 doi.org/10.1016/j.strueco.2017.12.001.

OSBAT, Chiara, BENKOVSKIS, Konstantīns, BLUHM, Benjamin, BOBEICA, Elena, ZEUGNER, Stefan. *What Drives Export Market Shares? It Depends! An Empirical Analysis Using Bayesian Model Averaging*. European Central Bank Working Paper, No. 2090, July 2017. 40 p.

VILERTS, Karlis, KRASNOPJOROVŠ, Oļegs, BREKIS, Edgars. Returns to Education During and After the Economic Crisis: Evidence from Latvia 2006–2012. *Comparative*

Economic Research, vol. 20, issue 1, De Gruyter. Available from 3 September 2017 doi.org/10.1515/cer-2017-0008.

VILERTS, Kārlis, KRASNOPJOROVŠ, Oļegs. Can Differences in Characteristics Explain Ethnic Wage Gap in Latvia? *Economics and Business*, vol. 30, issue 1, De Gruyter. Available from 4 December 2017 doi.org/10.1515/eb-2017-0001.

HIGHLIGHTS OF EUROSISTEM MONETARY POLICY AND OTHER IMPORTANT TASKS IN 2017

On 11 January, the Governing Council of the ECB adopted Decision (EU) 2017/100 amending Decision (EU) 2015/774 on a secondary markets public sector asset purchase programme (ECB/2017/1), Decision (EU) 2017/101 amending Decision ECB/2014/40 on the implementation of the third covered bond purchase programme (ECB/2017/2), Decision (EU) 2017/102 amending Decision (EU) 2015/5 on the implementation of the asset-backed securities purchase programme (ECB/2017/3), and Decision (EU) 2017/103 amending Decision (EU) 2016/948 on the implementation of the corporate sector purchase programme (ECB/2017/4).

On 19 January, the Governing Council of the ECB decided that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility would remain unchanged at 0.00%, 0.25% and –0.40% respectively, expecting the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of the net asset purchases.

On 19 January, the Governing Council of the ECB confirmed that purchases will be continued under the asset purchase programme (APP) at the current monthly pace of 80 billion euro until the end of March 2017. From April 2017, the net asset purchases are intended to continue at a monthly pace of 60 billion euro until the end of December 2017, or beyond, if necessary, and in any case until the Governing Council of the ECB sees a sustained adjustment in the path of inflation consistent with its inflation aim. The net purchases will be made simultaneously with the reinvestments of the principal payments on the securities purchased under the asset purchase programme as they mature. If the outlook became less favourable, or if financial conditions became inconsistent with further progress towards a sustained adjustment in the path of inflation, the Governing Council of the ECB would stand ready to expand the programme in terms of size and/or duration.

On 25 January, the Governing Council of the ECB confirmed the mandate for the Market Infrastructure Board (established in March 2016 to support the Eurosystem in the operation and development of Eurosystem market infrastructure services) and approved the extension of the mandate of its members from 1 February 2017 to 31 January 2019.

On 25 January, the Governing Council of the ECB authorised the publication of the "Tenth survey on correspondent banking in euro: 2016".

On 26 January, the Governing Council of the ECB adopted Decision (EU) 2017/468 amending Decision (EU) 2010/10 on non-compliance with statistical reporting requirements (ECB/2017/5).

On 2 February, the Governing Council of the ECB authorised the publication of "The use of the Eurosystem's monetary policy instruments and operational framework since 2012" (Occasional Paper Series, No. 188).

On 9 March, the Governing Council of the ECB decided that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility would remain unchanged, expecting the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of the net asset purchases.

On 9 March, the Governing Council of the ECB confirmed that the non-standard monetary policy measures confirmed by the Governing Council of the ECB on 19 January will be continued.

Appendix 7 (cont.)

On 10 March, the Governing Council of the ECB approved a new version of "Good Practices for the selection and mandate of External Auditors according to Article 27.1 of the ESCB/ECB Statute".

On 22 March, the Governing Council of the ECB decided to improve the regulations applied in the framework of the Eurosystem's monetary policy counterparties to liquidation target institutions to ensure consistent attitude with respect to their access to Eurosystem's monetary policy operations (Guideline (EU) 2017/1362 of the European Central Bank of 18 May 2017 amending Guideline (EU) 2015/510 on the implementation of the Eurosystem monetary policy framework (ECB/2017/12); Decision (EU) 2017/1359 of the European Central Bank of 18 May 2017 amending Decision (EU) 2016/948 on the implementation of the corporate sector purchase programme (ECB/2017/13); Decision (EU) 2017/1360 of the European Central Bank of 18 May 2017 amending Decision ECB/2014/40 on the implementation of the third covered bond purchase programme (ECB/2017/14); Decision (EU) 2017/1361 of the European Central Bank of 18 May 2017 amending Decision (EU) 2015/5 on the implementation of the asset-backed securities purchase programme (ECB/2017/15).

On 29 March, the Governing Council of the ECB took note of the 2016 annual progress report on the preparatory measures for the long-term framework for the collection of granular credit data in relation to the analytical credit dataset (AnaCredit) project.

On 6 April, the Governing Council of the ECB took note that the 11th edition of the ECB's report on "Financial integration in Europe" would be published on 19 May 2017 on the occasion of the joint conference of the ECB and the EC on financial market integration and stability in Europe.

On 10 April, in accordance with the Treaty on the Functioning of the European Union, which assigns the ECB the task of monitoring the compliance of EU central banks with the prohibitions referred to in Articles 123 and 124 thereof and the related Regulations, the Governing Council of the ECB approved the report covering the year 2016 (see Section "Compliance with the prohibition of monetary financing and privileged access" of ECB Annual Report 2016).

On 12 April, the Governing Council of the ECB, following a request of Latvijas Banka, adopted Opinion CON/2017/13 on increasing the scope of data contained in the credit register.

On 27 April, the Governing Council of the ECB decided that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility would remain unchanged, expecting the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of the net asset purchases.

On 27 April, the Governing Council of the ECB confirmed that the monthly net asset purchases of 60 billion euro will continue until the end of December 2017, or beyond, if necessary, and in any case until it sees a sustained adjustment in the path of inflation consistent with its inflation aim. The net purchases will be made simultaneously with the reinvestments of the principal payments on the securities purchased under the asset purchase programme as they mature. If the outlook became less favourable, or if financial conditions became inconsistent with further progress towards a sustained adjustment in the path of inflation, the Governing Council of the ECB would stand ready to expand the programme in terms of size and/or duration.

On 5 May, the Governing Council of the ECB confirmed the comprehensive assessment of TARGET2, EURO1 and STEP2-T and took note of the comprehensive assessment of

Appendix 7 (cont.)

CORE(FR) carried out by Banque de France (these four payment systems are classified as systemically important payment systems).

On 5 May, the Governing Council of the ECB adopted a decision to appoint the ECB as the lead overseer of the SEPA Instant Credit Transfer (SCT Inst) Scheme of the European Payments Council and EBA CLEARING, the infrastructure solution for instant payments processing.

On 17 May, the Governing Council of the ECB authorised the publication of the "Financial Stability Review. May 2017".

On 17 May, the Governing Council of the ECB decided to publish the "Agreement on emergency liquidity assistance. 17 May 2017".

On 18 May, the Governing Council of the ECB took note of the "TARGET Annual Report 2016".

On 18 May, the Governing Council of the ECB approved the "Euro area monetary and financial statistics: 2016 quality report".

On 25 May, the ECB published a press release approved by the Governing Council of the ECB and General Council of the ECB, welcoming the publication of the "Foreign Exchange Global Code of Conduct".

On 8 June, the Governing Council of the ECB decided that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility would remain unchanged, expecting the key ECB interest rates to remain at present levels for an extended period of time, and well past the horizon of the net asset purchases.

On 8 June, the Governing Council of the ECB confirmed that the non-standard monetary policy measures confirmed by the Governing Council of the ECB on 27 April will be continued.

On 21 June, the Governing Council of the ECB approved the launching of the development of the pan-European TARGET Instant Payment Settlement (TIPS) service.

On 21 June, the Governing Council of the ECB authorised the publication of the 16th annual review of "The international role of the euro".

On 22 June, the Governing Council of the ECB adopted a Recommendation for a Decision of the European Parliament and of the Council amending Article 22 of the Statute of the European System of Central Banks and of the European Central Bank (ECB/2017/18).

On 5 July, the Governing Council of the ECB adopted a Decision (EU) 2017/1258 on the delegation of decisions on the transmission of confidential statistical information to the Single Resolution Board (ECB/2017/22).

On 18 July, the Governing Council of the ECB approved the ECB response with respect to the assessment of the compliance with the Recommendation of the ESRB on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2015/2). The ECB considers that it fully complies with the ECB-related recommendations.

On 20 July, the Governing Council of the ECB decided that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility would remain unchanged, expecting the key ECB interest rates to remain at present levels for an extended period of time, and well past the horizon of the net asset purchases.

Appendix 7 (cont.)

On 20 July, the Governing Council of the ECB confirmed that the non-standard monetary policy measures confirmed by the Governing Council of the ECB on 8 June will be continued.

On 20 July, the Governing Council of the ECB confirmed the launch of the public consultation on the draft European Central Bank regulation on statistical reporting requirements for pension funds (with the consultation period lasting until 29 September 2017).

On 28 July, the Governing Council of the ECB confirmed the "Eurosystem standards for the use of triparty agents in Eurosystem credit operations".

On 24 August, the Governing Council of the ECB confirmed the Eurosystem policy regarding the identification and oversight of the critical service providers in the financial market infrastructure.

On 24 August, the Governing Council of the ECB approved the Estonian, Latvian and Lithuanian securities settlement systems which, following their planned merger, will operate under the new management of Nasdaq CSD SE as eligible for use in Eurosystem credit operations, as well as the eligibility of Nasdaq CSD SE for accessing TARGET2-Securities services.

On 7 September, the Governing Council of the ECB decided that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility would remain unchanged, expecting the key ECB interest rates to remain at present levels for an extended period of time, and well past the horizon of the net asset purchases.

On 7 September, the Governing Council of the ECB confirmed that the non-standard monetary policy measures confirmed by the Governing Council of the ECB on 20 July will be continued.

On 20 September, the Governing Council of the ECB adopted a decision to develop a euro unsecured overnight interest rate based on data already available to the Eurosystem (this interest rate will be set before 2020, and its key parameters will be announced to market participants in 2018).

On 22 September, the Governing Council of the ECB adopted Guideline (EU) 2017/2082 amending Guideline ECB/2012/27 on a Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET2) (ECB/2017/28).

On 22 September, the Governing Council of the ECB adopted Decision (EU) 2017/2080 amending Decision (EU) 2010/9 on access to and use of certain TARGET2 data (ECB/2017/29).

On 4 October, the Governing Council of the ECB adopted a decision to exclude covered bonds commonly referred to as conditional pass-through covered bonds from purchases under the covered bond purchase programme (CBPP3) if they are issued by an entity with a first-best issuer rating below Credit Quality Step 3, as of 1 February 2018.

On 19 October, the Governing Council of the ECB approved the publication of the ECB "Report on financial structures. October 2017".

On 26 October, the Governing Council of the ECB decided:

1) that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility would remain unchanged, expecting them to remain at present levels for an extended period of time, and well past the horizon of the net asset purchases.

Appendix 7 (cont.)

- 2) that the purchases under the asset purchase programme will continue at a monthly pace of 60 billion euro until the end of December 2017;
- 3) that the monthly pace of net purchases under the extended asset purchase programme will be reduced as of January 2018 from 60 billion euro to 30 billion euro and will continue at that pace until the end of September 2018, or beyond, if necessary, and in any case until the Governing Council of the ECB sees a sustained adjustment in the path of inflation consistent with the ECB's inflation aim. If the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, the Governing Council of the ECB stands ready to increase the APP in terms of size and/or duration;
- 4) to reinvest the principal payments on the securities purchased under the asset purchase programme as they mature for an extended period of time after the end of its net asset purchases, and in any case for as long as necessary to promote both favourable liquidity conditions and accommodative monetary policy stance;
- 5) to continue conducting the main refinancing operations and 3-month longer-term refinancing operations as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the last reserve maintenance period of 2019;
- 6) to provide additional information on the redemption of securities as well as information on reinvestments and the role of private sector asset purchase programmes in order to ensure continuous and smooth asset purchases.

On 3 November, the Governing Council of the ECB adopted Regulation (EU) 2017/2094 amending Regulation (EU) No 795/2014 on oversight requirements for systemically important payment systems (ECB/2017/32), and the legal acts related thereto, i.e. Decision (EU) 2017/2098 on procedural aspects concerning the imposition of corrective measures for non-compliance with Regulation (EU) No 795/2014 (ECB/2017/33), Regulation (EU) 2017/2095 amending Regulation (EC) No 2157/1999 on the powers of the European Central Bank to impose sanctions (ECB/2017/34), and Decision (EU) 2017/2097 on the methodology for calculating sanctions for infringements of the oversight requirements for systemically important payment systems (ECB/2017/35), as well as decided to publish a clarification to foster a better understanding of the amendments and their underlying considerations.

On 8 November, the Governing Council of the ECB, following a request of the EU Council and the European Parliament, adopted Opinion CON/2017/47 on revisions to the Union crisis management framework.

On 15 November, the Governing Council of the ECB took note that the statistics on the euro money market will be published on a regular basis in the future based on the granular data of money market statistical reporting, in compliance with the ECB Statistics Quality Framework and in line with the Public commitment on European Statistics by the ESCB.

On 22 November, the Governing Council of the ECB authorised the publication of the "Financial Stability Review. November 2017".

On 20 November, the Governing Council of the ECB adopted Decision (EU) 2017/2199 amending Decision ECB/2014/40 on the implementation of the third covered bond purchase programme (ECB/2017/37).

On 20 November, the Governing Council of the ECB approved the "Eurosysteem oversight report 2016".

On 22 November, the Governing Council of the ECB confirmed the launch of the public consultation on the key parameters of a new euro unsecured overnight interest rate (with the consultation period lasting until 12 January 2018).

Appendix 7 (cont.)

On 23 November, the Governing Council of the ECB approved the Guideline (EU) 2017/2335 on the procedures for the collection of granular credit and credit risk data (ECB/2017/38).

On 6 December, the Governing Council of the ECB approved the introduction of the following two major projects in the field of market infrastructure and payments.

1) Under the first project, TARGET2 and the TARGET2-Securities platform will be consolidated and will ensure improved liquidity management procedures for market participants (the operation is expected to be launched in November 2021).

2) Under the second project, Eurosystem collateral management system will be created; the system will provide a harmonised platform for collateral-related operations throughout the Eurosystem and will replace a range of the existing national systems' functions (the operation is expected to be launched in November 2022).

On 7 December, the Governing Council of the ECB approved the "T2S financial statements for the fiscal year 2016".

On 8 December, the Governing Council of the ECB adopted:

1) Decision (EU) 2017/2442 amending Decision (EU) 2016/2164 on the approval of the volume of coin issuance in 2017 (ECB/2017/39);

2) Decision (EU) 2017/2443 on the approval of the volume of coin issuance in 2018 (ECB/2017/40);

3) Decision (EU) 2017/2444 amending Decision (EU) 2015/2332 on the procedural framework for the approval of the volume of euro coin issuance (ECB/2017/41).

On 13 December, the Governing Council of the ECB decided on changes to the collateral eligibility criteria applicable to unsecured bonds issued by banks, i.e. unsecured debt instruments issued by credit institutions, investment firms or their closely linked entities.

On 14 December, the Governing Council of the ECB decided that the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility would remain unchanged, expecting the key ECB interest rates to remain at present levels for an extended period of time, and well past the horizon of the net asset purchases.

On 14 December, the Governing Council of the ECB confirmed that the non-standard monetary policy measures confirmed by the Governing Council of the ECB on 26 October will be continued.

**2017 HIGHLIGHTS OF REGULATORY DOCUMENTS ADOPTED IN
PURSUIT OF THE MAIN TASKS OF LATVIJAS BANKA**

Regulatory document	No.	Date of adoption (effective date)	Title of the regulatory document adopted by the Council of Latvijas Banka
Regulation	149	23.03.2017 (01.04.2017)	"Amendments to Regulation No. 132 'Regulation for Compiling the 'Monthly Financial Position Report' of Monetary Financial Institutions' of Latvijas Banka of 16 May 2014"
Regulation	150	23.03.2017 (01.04.2017)	"Amendments to Regulation No. 133 'Regulation for Compiling Interest Rate Reports of Monetary Financial Institutions' of Latvijas Banka of 16 May 2014"
Procedure	254/6	23.03.2017 (01.05.2017)	"Amendments to Procedure No. 232/5 'Participation Procedure in Cash Transactions at Latvijas Banka' of the Council of Latvijas Banka of 27 April 2015"
Procedure	256/2	31.05.2017 (14.07.2017)	"Amendment to Procedure No. 183/3 'Participation Procedure in the Electronic Clearing System of Latvijas Banka' of the Council of Latvijas Banka of 9 September 2010"
Procedure	258/2	13.07.2017 (21.07.2017)	"Amendments to Procedure No. 217/1 'Participation Procedure in the Eurosystem Monetary Policy Operations Organised by Latvijas Banka' of the Council of Latvijas Banka of 12 December 2013"
Procedure	258/3	13.07.2017 (18.09.2017)	"Amendments to Procedure No. 216/7 'Participation Procedure in the VNS System of Latvijas Banka' of the Council of Latvijas Banka of 11 November 2013"
Regulation	151	13.07.2017 (01.08.2017)	"Amendments to Regulation No. 130 'Regulation for Electronic Information Exchange with Latvijas Banka' of Latvijas Banka of 12 December 2013"
Procedure	260/2	14.09.2017 (31.10.2017)	"Amendments to Procedure No. 217/1 'Participation Procedure in the Eurosystem Monetary Policy Operations Organised by Latvijas Banka' of the Council of Latvijas Banka of 12 December 2013"
Regulation	152	14.09.2017 (01.01.2018)	"Amendments to Regulation No. 132 'Regulation for Compiling the 'Monthly Financial Position Report' of Monetary Financial Institutions' of Latvijas Banka of 16 May 2014"
Regulation	153	14.09.2017 (01.01.2018)	"Amendments to Regulation No. 136 'Regulation for Compiling Reports on Securities' of Latvijas Banka of 16 May 2014"
Regulation	154	14.09.2017 (01.01.2018)	"Regulation for Compiling the 'Quarterly Financial Accounts (1-FP)'"
Regulation	155	14.09.2017 (01.01.2018)	"Amendments to Regulation No. 110 'Regulation for Compiling the 'Quarterly Report on Foreign Assets and Liabilities (1-MB)' of Latvijas Banka of 11 July 2013"
Regulation	156	14.09.2017 (01.01.2018)	"Amendments to Regulation No. 111 'Regulation for Compiling the 'Annual Report on Foreign Assets and Liabilities (1-MB)' of Latvijas Banka of 11 July 2013"
Procedure	261/1	27.10.2017 (13.11.2017)	"Amendments to Procedure No. 186/4 'Participation Procedure in TARGET2-Latvija' of the Council of Latvijas Banka of 4 November 2010"
Procedure	261/2	27.10.2017 (21.11.2017)	"Amendments to Procedure No. 183/3 'Participation Procedure in the Electronic Clearing System of Latvijas Banka' of the Council of Latvijas Banka of 9 September 2010"
Regulation	157	30.10.2017 (09.11.2017)	"Amendments to Regulation No. 36 'Regulation for Purchasing and Selling Cash Foreign Currencies' of Latvijas Banka of 13 May 2009"
Regulation	158	30.10.2017 (09.11.2017)	"Requirements for the Prevention of Money Laundering and Terrorism Financing in Purchasing and Selling Cash Foreign Currencies"

GLOSSARY

Asset-backed securities purchase programme (ABSPP): a programme under which the Eurosystem purchases eligible asset-backed securities.

Balance of payments: a statistical statement summarising transactions between Latvia's residents and the residents of the rest of the world. It incorporates the current account, the capital account and the financial account.

Bank for International Settlements (BIS): an international financial organisation operating to facilitate international monetary and financial cooperation. The BIS acts as a bank for central banks.

Banking union: an EU-level framework for banking supervision and resolution operating based on a single rulebook applicable in the entire EU. Euro area countries and those EU countries outside the euro area opting to participate in the banking union are members of the banking union.

Blockchain: a continuously growing list of records forming blocks of records which are linked and secured using cryptography. Each block of records typically contains a cryptographic hash of the previous block, timestamp and transaction data.

Capital account: a balance sheet component reflecting gross acquisitions/disposals of non-produced non-financial assets and capital transfers between Latvia's residents and the residents of the rest of the world.

Central government: public institutional units, including ministries, embassies, representative offices, agencies, councils, educational, healthcare, law enforcement, cultural and other public institutions whose competence covers the whole economic territory of the country, except for the administration of social security funds. The list of the institutional units of the Latvian central government is prepared by the CSB.

Clearing: the process of transmitting, processing and reconciling payment documents or securities transfer orders prior to settlement, resulting in establishment of the net position of each settlement participant by netting all payment documents submitted by the settlement participants, i.e. establishing net cash liabilities to or claims on other settlement participants.

Collateral: assets that are pledged or otherwise transferred to secure repayment of a loan, as well as those sold under repurchase agreements. The collateral used in the Eurosystem's reverse transactions should meet certain eligibility criteria.

Corporate sector purchase programme (CSPP): a programme within the framework of which the Eurosystem purchases euro-denominated investment grade bonds issued by corporations established in the euro area.

Council of the EU (EU Council): the institution representing the governments of EU countries. The ministers of EU countries meet in the EU Council to adopt legislative acts and coordinate policies. The EU Council is an essential EU decision-maker. It is a single legal entity, but it meets in 10 different configurations, depending on the subject being discussed. The most significant tasks of the EU Council include negotiating and adopting legislative acts, developing common foreign and security policy of the EU, signing international agreements on behalf of the EU as well as adopting the EU budget together with the European Parliament.

Covered bond purchase programme (CBPP): a programme under which the Eurosystem purchases eligible covered bonds.

Appendix 9 (cont.)

Credit institution: a capital company 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.

Current account: a balance sheet component reflecting flows in goods, services, primary income and secondary income between Latvia's residents and the residents of the rest of the world.

Debt security: a security representing an obligation on the part of the issuer to make one or more payment(s) to the holder of the security at a specified future date or dates. Such security usually carries a specific rate of interest (the coupon) or is sold at a discount/premium to the amount that will be repaid at maturity.

Deposit facility: a standing facility of the Eurosystem which credit institutions registered in the Republic of Latvia and branches, registered in Latvia, of credit institutions registered in other countries may use to make overnight deposits with Latvijas Banka at a pre-specified interest rate.

Deposit redeemable at notice: funds 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.

Deposits: funds placed on the accounts of MFIs for a specified or unspecified period of time, with or without earning interest.

Direct investment: investment by an investor (direct investor) made directly or indirectly (through subsidiaries or associated companies) to acquire a lasting interest (corresponding to at least 10% ownership of ordinary shares or voting rights) in an enterprise (direct investment enterprise). The components of direct investment are equity and debt instruments.

Distributed ledger technology: a technology using protocols and support infrastructure to enable nodes in various locations to propose and validate transactions and synchronised record updates across all network.

EBA Clearing (*EBA Clearing S.A.S. à capital variable*): a capital company established by the major European and international banks, which provides pan-European payment infrastructure solutions, offering clearing and settlement services for both high-value and low-value euro payments to a wide community of banks in the EU.

Economic and Financial Committee (EFC): a counselling body set up to promote economic and financial policy coordination among the EU countries. In its fields of competence, the EFC provides opinions at the request of the EU Council or the EC, as well as ensures a dialogue between the Council and the ECB and provides assistance related to the preparatory work for the Council. The EFC is composed of representatives of the governments (usually Ministries of Finance) and central banks of the EU Member States as well as representatives of the EC and ECB.

Electronic Clearing System of Latvijas Banka (EKS): net settlement system of Latvijas Banka ensuring the processing of retail payment orders and the settlement of net positions.

EONIA (euro overnight index average): a measure of the effective interest rate prevailing in the euro interbank overnight market. It is calculated as a weighted average of the interest rates on unsecured overnight loans denominated in euro, as reported by a panel of contributing banks.

Appendix 9 (cont.)

Equities: securities representing ownership of a stake in a commercial company. They comprise shares traded on stock exchanges (quoted shares), unquoted shares and other forms of equity. Equities usually produce income in the form of dividends.

EURIBOR (euro interbank offered rate): the rate at which euro interbank term deposits are being offered within the euro area by one credit institution which is an active euro money market participant to another credit institution of such type in the euro area at 11.00 a.m. CET.

Euro area: EU countries which have adopted the euro as their single currency in accordance with the Treaty on the Functioning of the European Union and in which a single monetary policy is conducted under the responsibility of the Governing Council of the ECB. As at the end of 2017, the euro area comprised Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

European Banking Authority (EBA): an EU body with legal personality which forms part of the European System of Financial Supervisors and works to ensure effective and consistent prudential regulation and supervision across the European banking sector. Its overall objective is to maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector.

European Central Bank (ECB): the central institution of the ESCB and the Eurosystem having a legal personality under the EU law. The ECB implements the tasks conferred upon the Eurosystem and the ESCB pursuant to the Statute of the ESCB and the ECB in cooperation with the national central banks of the EU Member States.

European Council: an EU institution defining the EU's overall political direction and priorities. It is comprised of the heads of state or government of the EU Member States, the President of the European Council and the President of the EC.

European System of Central Banks (ESCB): includes the ECB and the national central banks of the EU Member States. The national central banks of those EU countries that have not yet adopted the euro implement an independent monetary policy according to their national law and are thus not involved in the conduct of the monetary policy of the Eurosystem.

European Systemic Risk Board (ESRB): an independent EU body which is a part of the European System of Financial Supervision and is responsible for the macro-prudential oversight of the financial system within the EU in order to contribute to the prevention or mitigation of systemic risks to financial stability in the EU that arise from developments within the financial system, taking into account macroeconomic developments, so as to avoid periods of widespread financial distress. It contributes to the smooth functioning of the internal market and thereby ensures a sustainable contribution of the financial sector to economic growth.

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

Expanded asset purchase programme (APP): includes all public and private sector asset purchase programmes that the Eurosystem implements to address the risks of a too prolonged period of low inflation. APP includes CBPP3, ABSPP, PSPP and CSPP.

Financial account: a balance sheet component reflecting financial assets and financial liabilities (direct investment, portfolio investment, financial derivatives, other investment and reserve assets) between Latvia's residents and the residents of the rest of the world.

Appendix 9 (cont.)

Financial stability: the condition in which the financial system (financial intermediaries, markets and market infrastructures) is capable of withstanding shocks, without significant disruptions in the financial intermediation process and the supply of general financial services.

Fine-tuning operation: an open market operation executed by the Eurosystem in order to deal with unexpected liquidity fluctuations in the market. The frequency and maturity of these operations are not standardised.

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

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 the central banks of all EU countries.

General government: public institutional units engaged in production of goods or provision of services intended for individual or collective consumption free of charge or at economically insignificant prices, primarily financed from the compulsory payments (taxes and duties) imposed on economic agents, as well as institutional units engaged in redistribution of national income or wealth. General government in the Republic of Latvia includes central government, local governments and social security funds. The list of the institutional units of the Latvian central government is prepared by the CSB.

Governing Council of the ECB: the main decision-making body of the ECB. It consists of members of the Executive Board of the ECB and the governors of the national central banks of the euro area.

Gross settlement system: a transfer system in which the settlement concerning each cash or securities transfer order occurs on an instruction-by-instruction basis in the order of receipt.

Household: a natural person or group of natural persons in the capacity of a consumer and producer of goods and a provider of non-financial services for exclusively own final use; a sole proprietor which is an economic unit established by a natural person or a group of natural persons; this natural person or group of natural persons is liable for the settlement of the obligations of the economic unit with its entire property and the unit's accounting is organised in accordance with the single-entry system.

Instant payments: cash transfers provided 24 hours a day, 7 days a week, 365 days a year, including holidays and weekends. Credit institution customer payments are executed within a matter of seconds and the money received by those customers can be reused immediately.

International investment position: a statistical statement reflecting the value and composition of financial claims (assets) on and financial obligations (liabilities) between Latvia's residents and the residents of the rest of the world, on a specific date, as well as changes in the residual values in the respective time period.

International Monetary Fund (IMF): an international organisation operating to facilitate international monetary cooperation, exchange rate stability, national economic growth and employment growth, and provide short-term financial assistance to IMF member countries for balancing the payment flow.

Key ECB interest rates: the interest rates on the main refinancing operations, on the marginal lending facility and on the deposit facility set by the Governing Council of the ECB.

Appendix 9 (cont.)

Local government: institutional units of the local public administration, whose competence covers only a local economic territory. The list of the institutional units of the Latvian central government is prepared by the CSB.

Longer-term refinancing operation (LTRO): an open market operation with a maturity longer than that of the main refinancing operation. Regular LTROs have a maturity of three months and are carried out through monthly standard tenders in the form of reverse transactions. The Eurosystem may also conduct non-standard LTROs with a maturity longer than three months (up to 48 months), aiming to provide additional longer-term liquidity and support the monetary policy objectives.

M1: a narrow monetary aggregate comprising currency in circulation and overnight deposits held with MFIs by euro area residents.

M2: an intermediate monetary aggregate comprising M1 and deposits held with MFIs by euro area residents and redeemable at a period of notice of up to and including 3 months (i.e. short-term savings deposits) and those with an agreed maturity of up to and including 2 years (i.e. short-term time deposits).

M3: a broad monetary aggregate comprising M2 and marketable instruments, in particular repurchase agreements, money market fund shares/units, and debt securities with a maturity of up to and including two years issued by MFIs.

Main refinancing operation: a regular open market operation executed by the Eurosystem in the form of reverse transactions. Such operations are carried out through a weekly standard tender and normally have a maturity of one week.

Marginal lending facility: a standing facility, offered by the Eurosystem, which credit institutions registered in the Republic of Latvia and branches, registered in Latvia, of credit institutions registered in other countries may use to receive overnight credit from Latvijas Banka at a pre-specified interest rate against eligible assets.

Market risk: the risk related to fluctuations of the fair value or cash flow of financial instruments on account of movements in market prices. Market risk reflects the interest rate risk, currency risk and price risk.

Monetary base (base money): currency (banknotes and coins) in circulation, the minimum reserves credit institutions are required to hold with the Eurosystem as well as any excess reserves they may hold under the Eurosystem's deposit facility or as other liabilities related to the monetary policy operations.

Monetary financial institution (MFI): a central bank, credit institution, credit union, money market fund and other financial institution 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, as well as an electronic money institution whose core business is to issue electronic money. Latvijas Banka sets up, maintains and regularly updates the List of Monetary Financial Institutions of the Republic of Latvia (see section Statistics on Latvijas Banka's website www.bank.lv). The list is also available on the ECB website where the ECB publishes the list of MFIs of the EU Member States on a regular basis. As at the end of 2017, there were 57 MFIs in Latvia.

Monetary income: income accruing to the national central banks of the euro area in the process of the Eurosystem's monetary policy implementation, derived from assets earmarked in accordance with guidelines established by the Governing Council and held against banknotes in circulation and credit institutions' deposits with central banks of the euro area.

Appendix 9 (cont.)

Non-financial corporation: an economic entity producing goods or providing non-financial services, including an economic unit established by a natural person or a group of natural persons; this natural person or group of natural persons is liable for the settlement of the obligations of the economic unit with its entire property and the unit's accounting is organised in accordance with the double-entry system.

Open market operation: an operation executed in the financial market on the initiative of a central bank. With regard to their aims, regularity and procedures, Eurosystem's open market operations can be divided into four categories: main refinancing operations, longer-term refinancing operations, fine-tuning operations and structural operations.

Organisation for Economic Co-operation and Development (OECD): an intergovernmental organisation, a forum providing a platform for seeking answers to common problems, identifying good practices and coordinate domestic and stimulating policies that improve the economic and social well-being of persons.

Outright transactions: open market operations where the Eurosystem purchases or sells eligible assets outright in the market. Outright transactions are executed only for structural purposes.

Price stability: the maintenance of price stability is the primary objective of the Eurosystem. The Governing Council of the ECB has defined price stability as a year-on-year increase in the HICP for the euro area that is below 2%. The Governing Council has also stated that, in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2%.

Public sector purchase programme (PSPP): a programme within the framework of which the Eurosystem purchases bonds issued by the euro area central and local governments, agencies, international organisations and multilateral development banks in the secondary market.

Real-Time Gross Settlement (RTGS) system: a settlement system in which processing of cash or securities transfer orders and settlement takes place on an individual basis and in a consecutive order (without netting) in real time.

Reserve requirement: a requirement for credit institutions and credit unions to hold their minimum reserves with the national central bank over the reserve maintenance period. Compliance with the requirement is determined on the basis of the average end-of-day balance on the reserve account over the reserve maintenance period.

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

Reverse transaction: a transaction whereby the Eurosystem buys or sells assets under a repurchase agreement or conducts credit operations against collateral.

Securities settlement system: an agreement between at least three participants, apart from the operator of the system, on the execution of securities' transfer orders between those participants in accordance with uniform regulations and standardised procedures.

Single Euro Payments Area (SEPA): a project proposed by the European banks and supported by the Eurosystem and the EC to harmonise the way retail payments in euro are made, making payments in euro across European countries as fast, secure and effective as domestic payments. SEPA enables consumers, businesses and other economic agents to make both domestic and cross-border payments in euro on the same main terms and conditions, with the same rights and obligations, regardless of their location. As at the

Appendix 9 (cont.)

end of 2017, SEPA encompassed all EU Member States, Iceland, Liechtenstein, Monaco, Norway, San Marino and Switzerland.

Single Supervisory Mechanism (SSM): an EU-level framework for a prudential supervision of credit institutions in the euro area countries and in those EU countries outside the euro area opting to participate in the mechanism. The SSM is one of the central pillars of the banking union, comprising the ECB as the final responsible supervisory authority and the relevant national competent authorities of the EU countries.

STEP2: a payment system maintained by the EBA Clearing for the processing of retail payments in euro. STEP2 is a Pan-European Automated Clearing House (PE-ACH) system that fully complies with the requirements for SEPA clearing and settlement infrastructures set out by the European Payments Council, and is the sole system providing reachability of all EU credit institutions within SEPA.

Structural operations: open market operations executed by the Eurosystem on a regular or non-regular basis whenever the ECB wishes to adjust the structural liquidity position of the Eurosystem vis-à-vis the financial sector.

Systemic risk: the risk that the inability of one participant to meet its obligations in a system will cause other participants to be unable to meet their obligations when they become due, potentially with spillover effects threatening the stability of or confidence in the financial system. That inability to meet obligations can be caused by operational or financial problems.

TARGET (Trans-European Automated Real-time Gross Settlement Express Transfer system): the Eurosystem's real-time gross settlement system for the euro. The first generation TARGET system was replaced by TARGET2 in May 2008.

TARGET2: the second-generation TARGET system. It settles payments in euro in central bank money and functions on the basis of a single IT platform, to which all payment orders are submitted for processing.

TARGET2-Latvija: a component system of TARGET2 in Latvia. Its operation is ensured by Latvijas Banka in conjunction with the national central banks of the ESCB participating in TARGET2.

TARGET2-Securities (T2S): the Eurosystem's single technical platform enabling central securities depositories and national central banks to provide borderless and neutral core securities settlement services in the central bank money in Europe.

Targeted longer-term refinancing operations (TLTROs): reverse operations of the Eurosystem providing longer-term liquidity to credit institutions on attractive terms, so that they can continue easing the terms and conditions of lending to the private sector and to encourage their lending to the real economy.