LATVIJAS BANKA

# BANK OF LATVIA: ANNUAL REPORT 2010

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

*Details may not add because of rounding-off.*

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



Photos by Aivars Liepiņš and Andris Tenass.

The cut-off date is 26 April 2011.

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## ABBREVIATIONS

| | |
|---|---|
| BIS | Bank for International Settlements |
| CIS | Commonwealth of Independent States |
| CSB | Central Statistical Bureau of Latvia |
| EBA | European Banking Authority |
| EC | European Commission |
| ECB | European Central Bank |
| EEA | European Economic Area |
| EFC | Economic and Financial Committee |
| EKS | Bank of Latvia's Electronic Clearing System |
| EMU | Economic and Monetary Union |
| ERM II | Exchange Rate Mechanism II |
| ESA 95 | European System of Accounts 1995 |
| ESCB | European System of Central Banks |
| EU | European Union |
| EU12 | countries which joined the EU on 1 May 2004 and 1 January 2007 |
| ESRB | European Systemic Risk Board |
| Eurostat | Statistical Bureau of the European Union |
| FCMC | Financial and Capital Market Commission |
| FRS | US Federal Reserve System |
| GDP | gross domestic product |
| IMF | International Monetary Fund |
| JSC | joint stock company |
| LCD | Latvian Central Depository |
| Ltd. | limited liability company |
| M0 | monetary base |
| M1 | narrow monetary aggregate |
| M2 | intermediate monetary aggregate |
| M2X | broad money |
| M3 | broad monetary aggregate |
| MFI | monetary financial institution |
| Ministry of Finance | Ministry of Finance of the Republic of Latvia |
| OECD | Organisation for Economic Co-operation and Development |
| OFIs | other financial intermediaries, excluding insurance corporations and pension funds |
| OPEC | Organization of the Petroleum Exporting Countries |
| RIGIBID | Riga Interbank Bid Rate |
| RIGIBOR | Riga Interbank Offered Rate |
| SAMS | Bank of Latvia's Interbank Automated Payment System |
| SDR | Special Drawing Rights |
| SEPA | Single Euro Payments Area |
| SJSC | state joint stock company |
| Treasury | Treasury of the Republic of Latvia |
| UK | United Kingdom |
| US | United States of America |

# FOREWORD OF THE GOVERNOR

After a globally unprecedented deep yet brief recession, the Latvian economy in 2010 saw macroeconomic stabilisation supported by recovered export competitiveness. That is one of the structural changes indispensable for sustainable development, which indicates that the path of overcoming the crisis taken by the Latvian government and supported by the monetary policy of the central bank has been chosen correctly.

The difficult and complicated work of balancing the budget is going on. Without it, no new investments, job vacancies or tax revenues would be possible, yet the process was protracted and precluded reaping the benefits of a faster fiscal consolidation. The opportunity to cut expenditure more rapidly, which would have helped to resume economic activity sooner and more tangibly for enterprises, has been left unused for several years. Therefore overall, we must consider last year as a year of lost opportunity.

It was common knowledge at the beginning of the year that to cut the budget deficit to 6% of gross domestic product in 2011 a fiscal consolidation in the approximate amount of 300–400 million lats would be necessary, and the more decisive our actions, the easier we will have it fiscally in 2012. The economic policy makers were well aware also of the need for the work on the budget to proceed briskly, so that the necessary structural reforms could be conducted in a thoughtful and coordinated manner. It could be predicted that the drafters of the budget will run out of time after the parliament elections in autumn, and, in the absence of timely preparation, we will not face economically beneficial and well-thought cuts in expenditure aimed at expedience but raised taxes that hinder the economic growth.

The nine months before the parliament elections were not used to clarify the situation, with economists and investors alike in the dark about the future link between fiscal consolidation and changes in taxation. Cutting the budget deficit took place, to a large extent, at the expense of higher tax revenues (of the approximately 300 million lats fiscal consolidation, expenditure cuts account for only 90 million lats in the 2011 budget).

In order not to cut the budget deficit all at once by 2 billion lats during the crisis, Latvia used the opportunity to gain time to conduct structural reforms gradually, in the course of three years, stabilise the economy and, in time, become capable of paying off the loan. So far, however, the still high budget deficit has meant a growing public debt, which has inevitably raised the costs of debt servicing: in 2011 they will amount to about 270–300 million lats (50 million lats before the crisis). In the absence of better credit ratings in the future, Latvia can be expected to have difficulty in refinancing and paying off the government debt that has grown substantially during the crisis (from 1 billion lats to about 5 billion lats in three years; in 2014 and 2015 combined, a debt of 2.3 billion lats will have to be refinanced).

Latvia spends large resources to service its public debt. Money from the international lenders has given it respite and an opportunity to pay less in interest than currently offered by the world financial markets. Once the loan programme comes to an end at the close of 2011, it will be important for Latvia to appear to potential investors as an attractive country with sustainable growth. This is important for Latvia to borrow cheaper resources.

A balanced budget would also open up the opportunity for Latvia's rating to gradually return to the safe investment category in the assessment of not one but all international credit rating agencies. Barring that, we must reckon with stagnating growth and tax revenue and the need to continue fiscal consolidation also in 2013 in the situation of hindered economic growth, lack of new job vacancies, and growing inflation expectations.

In the period at hand, exports were and to this day still are the driver of the Latvian economy. That was determined both by the growth in foreign demand and increased competitiveness of Latvian producers. In 2010, Latvia exported goods and services in the amount of 6.7 billion lats, a 1 billion year-on-year increase. This is the largest revenue from exports ever registered in the history of Latvian economy and the growth of Latvian goods exports in 2010 (by 30%) was the fourth fastest in the European Union, outpaced only by Estonia, Lithuania, and Bulgaria. In addition, all of these countries are implementing similar exchange rate policies, which have helped along the recovery from the crisis.

The recovery of the Latvian economy at large is, however, still fragile: a gradual slowing down of economic growth was observed at the end of 2010 and beginning of 2011. That was affected by expenditure cutting processes taking place in many European and world countries that are important consumers of Latvian exports; the hiking prices of energy resources in world markets have also had a detrimental effect on economic growth in many countries.

With the economic situation stabilising and taking into account the limited inflation risk, the Bank of Latvia lowered the refinancing rate from 4.0% to 3.5% in March 2010, while also introducing a new monetary instrument, a seven-day deposit facility, to promote predictability of liquidity or the amount of available finances in the banking system. In order to also motivate banks to channel the resources at their disposal into the development of the economy, the interest rate of the overnight deposit facility with the Bank of Latvia was lowered from 1.0% to 0.25% over the year and the interest rate of the seven-day deposit facility from 1% to 0.375%.

Confidence of the Latvian population in the banking sector has increased as evidenced by the growth in deposits with banks (to 5.6 billion lats; an annual increase of 8%; including 21% on deposits in lats). Liquidity or the free finances theoretically available for lending to the economy was high in the banking system. Yet the banks continued to keep a substantial amount of their funds (at times even up to 1 billion lats) with the Bank of Latvia, receiving minimal interest, even though the interest rates on loans are at least ten times higher.

As the country gradually regained confidence of the financial markets, the interbank market interest rates, which determine interest rates on loans in lats granted to enterprises and private persons, dropped substantially, approaching the interest rates set by the Bank of Latvia. Yet the low lending activity has nothing to do with the interest rates: the explanation is still the cautious lending policies of banks. They have been dictated by uncertainty in making investment decisions caused also by unpredictability of the gradual, inevitable fiscal consolidation process and particularly ignorance of borrowers as to possible changes in taxation.

If the Latvian economy proves itself capable of fully regaining competitiveness, demonstrating sustainable growth and arresting the growth of Latvia's foreign debt, it can be safely stated that a side effect of such stabilisation could be the introduction of the euro. That means that in balancing the 2012 budget, cuts in expenditure instead of tax raises would be used, and the budget deficit indicator would be pivotal in measuring the compliance with the Maastricht criteria.

Along with setting and implementing monetary policy, the Bank of Latvia continued to administer foreign reserves, i.e. foreign currencies and gold in the approximate amount of 4 billion lats, that ensured the stability of the lats. The Bank of Latvia also continued to ensure the preparation of financial statistics and state balance of payments statistics as well as an efficient and safe settlement process, the blood circulation of the economy. At the branches of the central bank, the degree of wear and tear and authenticity of banknotes and coins received from banks were tested, examining about 3 billion lats and replacing the banknotes and coins removed from circulation.

2010 also saw the production of five new collector coins. The Bank of Latvia continued the tradition of conducting regular surveys to determine the coin of the year. The title Coin of the Year 2010 went to the Amber Coin.

I would hereby like to express my deep gratitude to the Council and Board of the Bank of Latvia for successful organisation of the Bank's work and to each and every employee for their committed everyday contribution and creativity in the implementation of the Bank of Latvia's tasks in the complicated crisis conditions.

Ilmārs Rimšēvičs
Governor, Bank of Latvia
Riga, 7 April 2011

# THE BANK OF LATVIA VISION AND MISSION





**VISION**

The Bank of Latvia is an independent entity that carries out its tasks in the public interest and with a high sense of professional responsibility. It is a full-fledged participant in the ESCB and cooperates with other EU institutions, developing stable and favourable environment for the economic growth of Latvia.

**MISSION**

The objective of the operation of the Bank of Latvia as the central bank is price stability promoting Latvia's long-term economic growth.

The Bank of Latvia is an active and responsible participant of the ESCB, promoting integration and stability of the financial systems of Latvia and other EU countries.

The Bank of Latvia raises the level of Latvian general public's perception of economic issues, promoting understanding and credibility.

The Bank of Latvia operates effectively in a professional manner ensuring high quality, risk management and business continuity.

The Bank of Latvia is a reliable cooperation partner.


NEATKARĪBAS ATJAUNOŠANA
4.
maijs
1990

# ECONOMIC ENVIRONMENT

## GLOBAL ECONOMIC ENVIRONMENT

In 2010, the world economic recovery, which started in the middle of the previous year, continued to advance mainly on account of intensified global trade flows and a build-up in inventory. Nevertheless, with some economic stimulus measures withdrawn and the positive contribution of inventory cycle abating, the second quarter of the year saw the global growth rates decelerate. Held down by high unemployment and the problems in the euro area peripheral countries, the economic activity posted moderate growth in the developed countries. Meanwhile in the developing countries, capital inflows and a more buoyant economic advance started to suggest higher inflationary pressures.

The economic policy stimuli and inventory build-up spurred the recovery in the US, yet the growth slowed down somewhat in the mid-year. Private consumption was affected by the high unemployment rate, population's debt liabilities and cautious bank lending policies. Nevertheless, towards the end of the year and the inventory cycle, the contribution of private consumption to GDP growth increased, suggesting fundamental-underpinned stabilisation of economic growth. The extension of tax relief period is expected to give an additional impetus to consumption.

Following the buoyant upswing at the beginning of 2010, the euro area economic growth decelerated in the second half of the year in line with the declining global growth rates. The GDP growth was supported by expanding exports, while private consumption remained weak. A drop in unemployment rate and improving consumer confidence suggest, however, that private consumption is likely to strengthen. Higher energy and food prices as well as VAT rates in some countries pushed up inflation in the euro area. Economic activity differed substantially across the euro area countries. It was the strongest in Germany and Finland. In Germany, the activity was encouraged by the expansion in both exports and investment, with a simultaneously low unemployment rate supporting the gradually growing private consumption. Greece and Ireland recorded an ongoing economic downturn, and serious downward risks related to the needed fiscal consolidation and public debt issues to hamper the euro area short-term economic growth remained in place in a number of countries.

Improvements in the economic situation, supported by the robust economic situation in Germany, a major trade partner, were also observed in non-euro area EU Member States. Inflation soared as a result of rising global energy and food prices. Recovery continued in Lithuania's economy primarily on account of production growth in exports-generating industries. Investment and private consumption revived gradually yet were restricted by fiscal consolidation. Estonia recorded the steepest economic revival of all Baltic States due to a more favourable fiscal situation, its entry into the euro area, and improved expectations for its economic outlook. The growth was underpinned by expanding exports of manufacturing output. Meanwhile, rising private consumption increased the pressure on consumer prices and, coupled with intensifying effects from hiking global prices, substantially pushed up inflation. GDP growth in Poland was more pronounced than in 2009 and among the highest in the EU. Growth was supported by increasing inventory and private consumption as well as the fiscal stimulus package that boosted the government budget deficit. Consequently, fiscal consolidation measures are projected for 2011.

The Swedish economy posted the strongest growth in the EU in 2010. It was driven by both the external and domestic demand amidst favourable fiscal environment. Appreciation of the Swedish krona notwithstanding, exports expanded while domestic demand strengthened, supported by both inventory increases and stronger consumption due to progressively improving labour market conditions. The buoyant economic growth was also driven by ever growing lending to households and stronger real estate market activity which was likely to give rise to the risk of surging inflation. In order to anchor inflation, *Sveriges Riksbank* raised its base rates. Despite the implemented fiscal consolidation measures, the Danish economy continued to recover, and annual growth in its GDP resumed in the second quarter.

GDP growth in the UK was positive during most of the year, yet in the fourth quarter it became negative again due to the downturn in services and construction caused by the unfavourable weather conditions. The revival of GDP growth was unstable, and inflation soared. Growing food prices reduced population's purchasing power and slowed down consumption growth. The economic activity is likely to be held down by the massive fiscal consolidation in the near future as well.

In Russia, the GDP growth also became positive in 2010 being mainly fuelled by the rising inventory and private consumption. The unemployment rate was still low, and wages continued to increase notably. Yet in the second half of the year, GDP growth abated on account of developments in the agricultural sector due to the most severe summer heat and drought.

In 2010, global agricultural product prices rose substantially. They were driven by the demand in developing countries and a temporary supply shock triggered by poor weather and smaller-than-expected harvests. In the first half of 2010, the oil price was volatile, while in the second half of the year it continued on a persistent upward trend. Overall, the price of *Brent* crude oil rose from 78 to 93 US dollars per barrel (between the end of 2009 and the end of 2010). This hike was primarily fuelled by the growing demand from different regions (particularly China at the beginning of the year, several OECD countries in the second half of the year due to more robust global development). The expectations of market participants about anticipated oil price hikes in the future were underpinned by the International Energy Agency's forecasts for the rise in oil demand in 2010, which were revised upwards on several occasions. The effects of oil demand were offset by oil supply which gradually grew in both OPEC countries and non-OPEC economies. Speaking about the future oil price dynamics, the supply side suggests higher exposure to oil price hike risks. If OPEC does not expand oil production and restrictions are imposed on oil production outside the organisation, high oil prices may persist.

In the process of recovery, the global economy was supported by both fiscal stimuli and monetary policy measures. The Bank of England and the ECB had not changed their base rates since the first half of 2009, and the FRS base rates had remained unchanged since 2008. In 2010, the Bank of England's base rate stood at 0.5%, and those of the ECB and the FRS at 1% and 0%–0.25% respectively. Although the Bank of Japan lowered its base rate from 0.1% to 0%–0.1% in October, the move had little effect on the economy in real terms. The countries experiecing more pronounced economic recovery and subject to serious inflation risks, including Sweden, Norway, China, and Canada, increased their base rates in 2010. The base rates of many major world central banks were at their lows, with a limited likelihood of further lowering. That is why several countries, having withdrawn some of their fiscal stimuli, resorted to unconventional monetary policy measures. In November 2010, the FRS announced its aim to buy 600 billion US dollar worth of government bonds. Also, the Bank of England announced its asset purchase programme to go up to 200 billion British pound sterling. As the global economic recovery was progressing, in December 2009 the ECB started to gradually limit the employment of quantitative easing policy instruments. As early as May of 2010, however, when the euro area financial market situation deteriorated due to indebtedness of Greece, Italy, Ireland, Portugal, and Spain, the ECB moderated this process of limiting. As market lending conditions are improving and economic recovery is on an upward trend, the employment of quantitative easing measures is likely to be limited further.

The short-lived improvement of the global economic situation in the first quarter of 2010 shot up stock prices in many countries. In the mid-year, stock prices were adversely affected by the aggravating situation in Greece's government securities market and the related market participants' concerns about the financial strength of European banks. Investors' risk aversion increased, and stock prices reversed once again, with investment in precious metals simultaneously increasing. In the second half of the year, with market participants anticipating larger corporate profits, the prices of US and Japanese stocks rose. In Europe, the publishing of the European bank stress test results and the solution to the Greek crisis contributed positively to stock prices. The overall stock price increase in the global stock markets in 2010 was smaller than in 2009. Over the year, the US stock market index Standard & Poor's 500 was up by 12.8%, the more liquid stock index DJIA by 11.0% and the US NASDAQ Composite by 16.9%. At the same time, due to the debt problems of the euro area peripheral countries, the EU Dow Jones EURO STOXX 50 was down by 5.8%. Japan's stock market index Nikkei 225 and China's stock market index SSE A Share both dropped (3.0% and 14.5% respectively). Meanwhile, the rising oil and metal prices were the drivers behind a 22.5% increase in Russia's stock market index RTS.

The Greek debt crisis also affected the global government securities market in terms of market participants' risk aversion which increased. By opting for safe investment patterns, the market participants exerted a downward pressure on yields on government securities of traditionally safe countries, e.g. the US and Germany. When in the middle of 2010 the US economic recovery lost momentum, investors began to anticipate extraordinary economy-boosting measures and purchases of government long-term securities from the FRS. This brought the yields on US government securities down once again. In European countries with a large budget deficit and high government debt, on the other hand, the yields on government securities tended to go up. In line with improving economic outlook, yields on the US and German government bonds began to pick up only in the last quarter of the year. For 2010 as a whole, yields on the US and German 2-year government bonds decreased by 0.5 percentage point and stood at 0.7% and 0.9% respectively at the close of the year. The yield on the US 10-year government bonds contracted from 3.8% to 3.4%, whereas that on Germany's 10-year government bonds dropped from 3.4% to 3.0%. Generally lower interest rates and the excessive inflation risk made investors switch their activities over to the developing countries, thus capital inflows into the latter rose buoyantly. In order to offset currency appreciations, these countries purchased foreign currencies and invested into bond markets of developed countries, thus further pushing down interest rates.

## LATVIA'S ECONOMIC ENVIRONMENT

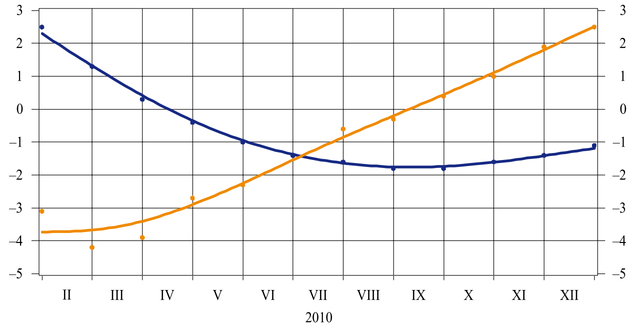
### INFLATION AND PRICES

In 2010, the price dynamics was substantially affected by both demand and supply factors. With the price rise pressure outdoing the price dampening effect, the overhang became well-pronounced. The low domestic demand affected by the crisis-triggered income drop and high unemployment rate, on the one hand, exerted significant downward pressure on prices, which companies managed to lower as labour costs were falling and productivity improving. On the other hand, external factors made raw material prices go up, global energy prices increased throughout the entire 2010, and food prices also rose notably in the second half of the year due to weather conditions unfavourable for agricultural activities. Nevertheless, for 2010 on the whole, the average consumer price level was 1.1% below that of 2009 (see Chart 1).

As the demand continued to be weak, consumer price core inflation was negative during the year. However, due to rising energy and food prices, core inflation rose from its February low of –5.4% to –0.3% in December, and in the year on average stood at –3.2%, reducing overall inflation by 2.3 percentage points. It was non-administered service prices that fell most under the influence of low demand. They were 6.2% lower

*Chart 1*

**ANNUAL CONSUMER PRICE INFLATION**
(%)



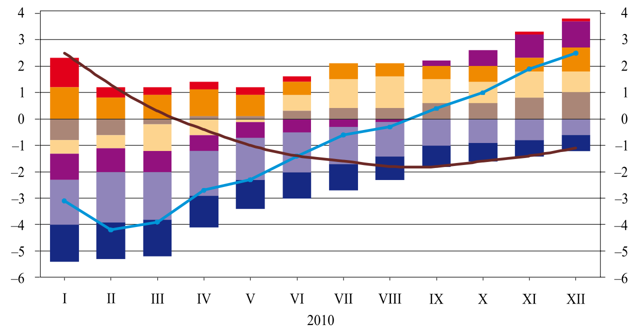

*Source: CSB.*

than a year before and contributed –1.4 percentage points to average annual inflation. As competition among merchants intensified markedly due to population's low purchasing power, non-administered non-food prices also continued to decline; they were 4.0% lower than in 2009 and contributed 1.0 percentage point to overall inflation. The prices of clothing dropped most pronouncedly (by 6.6% on average). The decline in processed food prices observed since the beginning of the year was replaced by an upward trend fuelled by global price rises in the second half of the year; nevertheless on average, food prices were 1.1% lower than a year before.

Administered energy resources prices, with a time lag reflecting the global energy price hikes observed throughout 2010, increased in the middle of the year. Overall, they exceeded the level of previous year by a mere 2.1%, bringing the average annual rate of inflation up by 0.3 percentage point. The prices of unprocessed food whose rise over the year was driven by respectively hiking global prices also exerted upward pressures on the average annual rate of inflation: in the year on average, they were 3.2% higher than in 2009 and contributed 0.2 percentage point to overall inflation. Oil price hikes, which emerged in 2009 and persisted over 2010, pushed up fuel prices significantly: they were 14.6% above the level of previous year, increasing the average annual rate of inflation by 0.7 percentage point (see Chart 2 for consumer price inflation breakdown by component).

*Chart 2*

**ANNUAL CONSUMER PRICE INDEX CHANGES BY COMPONENT AND 12-MONTH AVERAGE INFLATION**
(in percentage points)




*Source: CSB.*

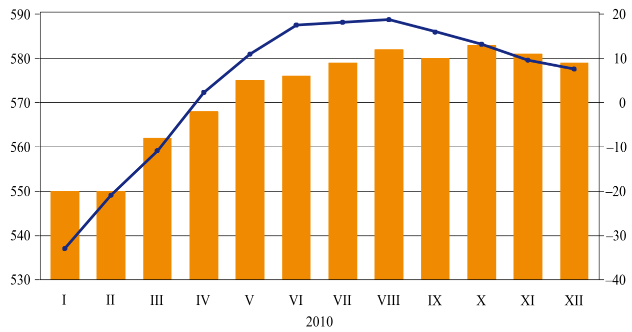
In 2010, amidst the environment of weak domestic demand, the producer price dynamics in Latvia was substantially affected by the recovery of external demand and more expensive imports of raw materials. On average, producer prices were 3.1% higher than a year before, primarily on account of rising export prices (by 7.6%). Conditioned by the low demand, the producer prices for output sold domestically rose only by 0.3%. Even though the global food and energy price hikes intensified at the end of the year, the overall producer price level remained relatively stable. A drop in natural gas prices in October, which lowered the domestic energy production costs, was one of the factors. At the end of the year, however, the global wood prices also declined, pressing down the respective Latvian export prices as well.

In construction, average costs continued on a downward trend in 2010 (a year-on-year decrease of 2.7%); however, the cost dynamics over the year suggested that the downturn kept losing momentum, with some cost increases even emerging in the second half of the year. Growth in labour remuneration renewed most rapidly, by an average of 1.0% in 2010 after the steep drop in the previous year. Costs of construction materials and operation of machinery and mechanical appliances kept going down (by 2.3% and 5.7% respectively). Average annual costs dropped for all basic groups of construction objects, most for construction of underground pipelines (by 6.3%) and least in hotel building (by 0.5%).

With the overall macroeconomic situation improving, the real estate market also stabilised in 2010: real estate prices (see Chart 3) and the number of operations slightly rose above the minimum level recorded in 2009. The persisting low income of households and tight bank lending standards subdued the demand for house purchase loans. Nevertheless, with low-price estate offers disappearing from the market, standard apartment prices in Riga increased by 7.6% over the year. An upswing in demand was primarily observed in the market segment of new quality housing projects.

*Chart 3*

**AVERAGE STANDARD APARTMENT PRICE AND ITS ANNUAL GROWTH RATE IN RIGA**




*Source: Latio Ltd.*

The amendments to the Immigration Law, which took effect in the second half of the year and stipulate the granting of residence permits to foreigners investing significant amounts in real estate in Latvia, did not bring about any pronounced increases in the number of real estate transactions, although certain interest on behalf of foreigners was observed. In line with the contracting supply of quality apartments, rent resumed its upward trend in the housing rental market. With the demand reviving also for retail, warehouse and production premises, the commercial real estate rental market saw some rent increases in the second half of the year.

## GROSS DOMESTIC PRODUCT

Following the lowest GDP level observed in the third quarter of 2009 in the contraction phase of the business cycle, the average quarterly growth in 2010 was 0.7%, with even positive annual changes (a rise from –6.1% in the first quarter to 3.6% in the fourth quarter) recorded for the third quarter.

Real exports of goods and services, the main driver of the economy, overall picked up 10.3% in 2010. Export expansion was supported by both regained competitiveness and improved external demand. A stronger growth in external demand notwithstanding, the dynamics of domestic demand rebounded upwards over the year as well.

Private consumption, the largest component of the domestic demand, strengthened substantially at the beginning of the year when household sentiment improved and precautionary saving abated; nevertheless, a number of factors caused the situation to deteriorate. Population's precautionary spending behaviour intensified once again when the anticipated 2011 government budget fiscal consolidation measures were defined more precisely, confirming an increase in tax burden to be further expected. Negative developments in foreign markets also became more pronounced, thereby intensifying concerns about the outlook for the further economic recovery. In 2010 overall, private consumption remained almost unchanged vis-á-vis the previous year (a drop of 0.1%). At the same time, public consumption contracted by 11.0% due to government budget expenditure cuts.

Over the year, the negative contribution of gross capital formation to GDP changes decreased substantially: in the first quarter, the drop amounted to 44.4%, whereas in the fourth quarter it was a mere 0.8% (due to a lower base and rise in investment in the second half of the year). The changes in capacity assessment had already pointed to the need of new investment inflows. The utilisation of production capacity in manufacturing rose buoyantly in the middle of the year to be followed by a negligible growth afterwards. This suggested maximum production capacity utilisation by most exporting companies and the need for investment to boost it. The statistics of permits issued for the construction of industrial production premises and warehouses since the beginning of the year confirmed a certain growth, substantial amounts of investment also came from the EU funds, including for projects of heat insulation of school buildings and improvement of road infrastructure. Even though the changes were positive, the amount of investment remained insufficient to boost the pace of a more robust economic growth.

In 2010, the positive contribution of inventory changes contracted substantially (from 9.3 percentage points in the first half of the year to 2.5 percentage points in the second half of the year), thereby suggesting the end of the trend towards the renewal of inventory that had plummeted during the economic downturn; henceforth, the inventory will not impact the GDP growth to the same significant extent. The trend will more depend on exports, consumption and investment dynamics.

Imports expanded buoyantly (by 8.6%) on account of stronger domestic demand and larger volumes of raw materials for manufacturing. Due to more swiftly rising exports, however, the contribution of net exports remained positive (0.6 percentage point).

A decrease in total value added in 2010 was determined by a further decline in value added in the construction sector (1.6 percentage point contribution to the total annual drop; 24.2% decrease at constant prices), financial intermediation (0.5 percentage point and 10.5% respectively), and real estate activities (0.3 percentage point and 1.5% respectively). Meanwhile, a positive contribution was from higher value added in manufacturing (1.6 percentage points and 15.4% respectively), transport, storage and communication (0.4 percentage point and 3.0%), and trade (0.6 percentage point and 3.3%).

Having recorded some build-ups at the beginning of 2010, growth in retail trade turnover was slow and unstable. It was determined by a similar dynamics of household sentiment. Due to the base effect, the retail trade turnover, excluding motor vehicle sales, contracted overall by 2.2% vis-á-vis 2009. With motor vehicle sales included, it increased by 3.3%. As to the trade structure, sales of durables (passenger cars, furniture, household appliances, and building materials) increased quite noticeably over the year. This was mainly related to postponed consumption, i.e. a more active disposal of precautionary savings made during the crisis.

At constant prices, manufacturing output increased by 14.0% over the year (working-day adjusted data). The first three quarters of the year recorded the steepest seasonally adjusted quarterly growth (2.2%, 9.0%, and 5.4% in the first, second, and third quarters respectively); meanwhile in the fourth quarter, growth decelerated to 0.3%. This successful manufacturing dynamics in 2010 was fuelled by the revival of external demand and higher raw material (wood and metal) prices at world's stock exchanges. Manufacturing was also enhanced by decreasing unit input costs and depreciation of the lats real effective exchange rate, which boosted international competitiveness of the Latvian industrial output. The turnover of industrial output in the domestic market, on the other hand, remained at a relatively low level due to contracting private consumption.

The increases of 27.3% in the manufacture of wood and 25.1% of fabricated metal products (working-day adjusted data) contributed most to the growth in manufacturing. The majority of sub-sectors recorded positive rates of change, with the steepest rise in manufacture of textiles (19.4%), printing (22.6%), manufacture of chemical substances (18.1%), electrical equipment (36.3%), and motor vehicles and trailers (70.1%). At the same time, food industry, manufacture of basic pharmaceutical products, and furniture were on a somewhat downward trend, decreasing by 0.3%, 2.5%, and 1.6% respectively.

The year 2010 also saw a substantial ongoing downturn in the output of construction, with overall value added thereby shrinking by 23.0% vis-á-vis 2009. According to seasonally adjusted data, the seasonally adjusted construction output index compared with the previous period went down by 12.1% in the first quarter; in the second and third quarters, however, the construction sector grew by 1.6% and 4.8% respectively. Likely due to relatively unfavourable weather conditions, construction output contracted by 5.5% during the concluding quarter of the year. Boosting industrial production and warehouse building in the second half of the year should be assessed as a positive trend.

The sector of transport, storage and communication advanced in 2010 mainly on account of the swiftly expanding freight transport by road. Meanwhile, with the freight turnover at Ventspils port shrinking by 6.8% and turnovers at Riga and Liepāja ports going up (by 2.5% and 0.1% respectively), the volume of cargos loaded and unloaded at Latvia's ports decreased by 1.3%. As a result, freight transported to ports by rail and the overall freight transport by rail contracted by 17.1% and 8.4% respectively.

In 2010, non-financial investment continued on a pronounced downward trend. In the first half of the year, the downslide was determined by still relatively low production capacity utilisation in manufacturing, which did not support the inflow of new investment. Investment was adversely affected by the ongoing fiscal consolidation, which reduced the public funding of investment. The EU funds for financing investment figured as an investment level supporting element, directing funds primarily into the building of infrastructure. Construction and hence also the volumes of investment in some related segments (construction of industrial structures and warehouses, renovation of school buildings) started to expand gradually in the second half of the year.

Total non-financial investment amounted to 1 337.1 million lats in 2010, which was by 21.4% less than in 2009 at current prices. In the breakdown by sector, the largest investment went to the government sector (311.7 million lats; a 22.7% reduction), manufacturing (222.4 million lats; a 7.6% reduction), electricity and water supply (146.2 million lats; a 9.8% reduction), and transport and storage (187.0 million lats; a 0.4% reduction). The other services sector was the only one to report a negligible investment increase.

**LABOUR MARKET**

The year 2010 marked a turning point in the labour market. Following the massive lay-offs and the sharp decline in wages and salaries in 2009, the labour market stabilised and, since spring, started to show some signs of gradual improvement resulting from higher labour demand under the impact of the economic recovery. This came to pass due to both the global economic development and the regained competitiveness of the Latvian economy. The gap accumulated in the years of buoyant growth between the real wages and labour productivity narrowed significantly, the role of productivity in corporate wage-setting grew, thereby laying a foundation for sustainable economic development in the future. At the same time, the ongoing restructuring in the Latvian economy and the rising long-term unemployment pointed to the existence of the problem of structural unemployment, highlighting the significance of the role of public authorities in the skills upgrade of the unemployed.

In 2010, the average monthly full-time equivalent wage was 445 lats, representing a 3.5% decline over 2009. Like in the previous year, the fall in the public sector wages at 6.7% was the steepest. At the turn of the year, however, the average wage and salary resumed growth, with its annual rate accelerating to 3.4% in the fourth quarter. The average weekly working hours stabilised, and labour productivity both per hour worked (already observed in 2009) as well as per person employed increased. Shrinking wages and higher labour productivity resulted in a further decline of unit labour costs both in nominal and real terms by 9.9% and 9.0% respectively during the year, thereby restoring the economic competitiveness.

Registered unemployment rose slightly in the first months of the year, reaching an all-time-high at 17.3% of the economically active population in March. Since spring, the economic recovery stimulated a gradual decline in unemployment, by 0.3–0.6 percentage point every month. In the last three months of the year, the registered unemployment stabilised at 14.3%, marking the end of seasonal summer jobs. Unemployment declined mainly on account of the cyclical component, while the problem of structural unemployment came to the fore when some signs of mismatch between the skills of a part of the unemployed and those demanded by employers appeared. Employment growth was driven by manufacturing and transport sectors, whereas the number of vacancies in construction and trade continued to decrease. The regional disparities in registered unemployment rates widened from the inception of the crisis (at the end of the year, the registered unemployment rate in Riga stood at 10.9% in comparison with 22.3% in Latgale), yet it was partly explained by the differences in the motivation of jobseekers to register with the State Employment Agency: CSB labour survey data revealed considerably smaller regional disparities in unemployment.

According to the CSB labour survey, jobseekers constituted 18.7% of economically active population at the end of 2010. The differences in the rates of jobseekers by age group and educational background persisted: during the crisis, less educated and less experienced workers were generally among the first to be laid off. For example, in the fourth quarter of 2010 when the average rate of jobseekers was 16.9%, it was 30.7% within the age group of 15–24 years and almost four times higher within the group of individuals who had elementary education as compared to the individuals with higher education (30.7% and 8.8% respectively).

The increase in the number of vacancies also pointed to improved job opportunities. Since spring 2010, the number of vacancies registered with the State Employment Service never fell below two thousands. At the end of 2010, there were about 60 unemployed per vacancy (over 100 in the respective period of the previous year). CSB vacancy survey data also pointed to an increase in vacancies starting from spring.

Emigration became a problem after the onset of the crisis, and the emigration flow in 2010 was similar to that in 2009 as implied by the changes in the difference between passenger departures and arrivals at Riga International Airport and Riga Passenger Terminal.

**FOREIGN TRADE, BALANCE OF PAYMENTS AND EXTERNAL DEBT**

Robust recovery was reported in foreign trade activity in 2010, with the trade turnover of goods reaching 10.5 billion lats and representing a 26.4% increase year-on-year. Exports expanded by 29.5% in annual terms due to renewed foreign demand, rising prices on external markets as well as improved producer competitiveness. Growth was reported in almost all commodity groups and to all major trade partners; moreover, it exceeded the pre-crisis levels. Exports of goods regained competitiveness as a result of falling prices and costs, but also on account of a rise in labour productivity and producer value added. Imports moved closely in parallel with the export growth determining a sharp increase in the imports of intermediate and capital goods. Imports of goods accelerated gradually throughout the year, with its annual growth rate exceeding that of exports from October onwards. Nevertheless, the year-on-year rise in imports at 24.0% was slightly lower than the export growth in 2010.

Trade surplus was reported only in the main export commodity groups in 2010: wood and articles of wood, machinery and mechanical appliances, electrical equipment, base metals and articles of base metals. Mineral products, transport vehicles, products of the chemical and allied industries, agricultural products, and plastics and articles thereof retained the largest trade deficits. Trade deficit in goods remained vis-á-vis all country groups and followed a rising trend, except with regard to the CIS countries and EU12 countries. Of the major trade partners, Latvia had a foreign trade surplus only with Poland and Ireland. Nevertheless, the overall foreign trade of goods and services was close to balanced in 2010.

Wood and products of wood regained the dominating role in exports at 19.3% of total exports in 2010, contributing 28.7% to the annual export growth. Exports of wood products expanded due to the rising prices, but also as a result of the limited availability of raw materials and business attempts to find a stable place in specific segments which, in turn, fostered an increase in exports of wood products also on account of producers' value added. Articles of base metals at 19.0% of total exports also contributed significantly to the annual growth of the exports of goods. The most impressive export growth figures were reported for wood (51.3%), articles of paper (49.7%), plastics (48.0%) and articles of base metals (45.2%). Improved competitiveness enabled Latvia to boost market shares with all the main trade partner countries. Latvia's principal export partners were Lithuania (16.2% of total exports), Estonia (13.2%), Russia (10.8%), Germany (8.7%), Sweden (6.3%) and Poland (5.0%). The steepest growth rates were reported for the exports to Russia and Poland: 59.3% and 69.3% respectively. The main exports to Russia were spirits, medicaments, particle board and preserved fish, whereas the exports to Poland were dominated by rods of iron or steel, petroleum oils and oils obtained from bituminous minerals, products of iron or non-alloy steel and particle board.

The growth observed in industry, particularly in the production of export goods, created an additional demand for import goods, including industrial raw materials, energy resources and capital goods. Transport vehicles (54.1%), base metals (23.6%), mineral products (10.7%) and products of the chemical industry (10.0%) were the biggest contributors to the annual growth in the imports of goods. The leap in the imports of transport vehicles is attributable to purchases of new airplanes by the JSC "Air Baltic Corporation". This rise in the imports should be viewed as a positive development, as it should be classified as an increase in investment imports boosting exports of services. In 2010, the most notable expansion was observed in the imports of transport vehicles (3.0 times), base metals (70.3%), wood and articles of wood (45.8%), and plastics and articles thereof (39.1%). Latvia's principal import partners were Lithuania (16.8% of total imports), Germany (11.6%), Russia (10.3%), Poland (7.7%), Estonia (7.1%) and Finland (5.0%). The highest annual growth rates were reported for the imports from USA (84.6%), China (52.6%) and the UK (45.0%).

Price and cost competitiveness continued to improve in 2010. According to the Bank of Latvia's estimate, the real effective exchange rate of the lats calculated on the basis of consumer price changes declined by 6.0% year-on-year in 2010, while the real effective exchange rate of the lats calculated on the basis of producer price changes and changes in unit labour costs in manufacturing decreased by 7.0% and 10.4% respectively. Terms of trade continued to improve, with the average annual growth of export unit value at 8.3% exceeding that of the import unit value at 7.3%. Enhanced productivity and a more favourable price and cost competitiveness position in comparison with 2009 enabled Latvia to expand export market shares with several major trade partners (Russia, Poland, Finland, Denmark, the UK etc).

Price rises and expanding volumes equally contributed to the strengthening of overall exports. Of the dominating export goods, only the prices on food products and transport vehicles declined by 0.8% and 1.6% respectively, whereas the prices of other export commodity groups increased significantly. The highest price rises were reported for wood and articles of wood (51.8%), products of the chemical and allied industries (31.4%) mineral products (23.8%) and vegetable products (21.2%).

A year-on-year decline in the import unit value was reported only for food products (0.9%) and paper (0.2%). Although the prices on wood increased in the second half of the year, the import unit value of wood and articles of wood also decreased by 1.3% on average in annual terms. This was primarily a result of the significant price fall at the beginning of the year (13.4% and 7.4% in the first and second quarter respectively). Of the dominating import goods, the highest price rise was observed for transport vehicles (15.4%), plastics and articles thereof (10.0%) and mineral products (8.9%).

Trade in goods and services was almost balanced: its deficit stood at 33.6 million lats or 0.3% of GDP. External demand remained strong; therefore, in 2010 exports of goods exceeded the pre-crisis peak of 2008 by 3.9% in nominal terms. The sustainability of the external demand contributed also to the recovery of industrial production; therefore, the overall import growth was mainly achieved on account of expanded imports of intermediate and capital goods. Services trade balance was positive in 2010 (787.5 million lats or 6.2% of GDP), with the value of services to non-residents exceeding the level of the previous year by a mere 1.4%; nevertheless, the annual increase in services imports was also moderate at 2.7%. There were overall no positive trends observed in the exports of transportation and travel services, yet the factors affecting various types of transportation differed. Although the volume covered by licences for freight transportation by road in business with Russia was insufficient, the value of the respective transportation services provided to non-residents increased in 2010, while disagreements among port service providers contributed to a further decline in the exports of freight transportation services by sea. The minor increase in the services exports was achieved on account of positive changes in the exports of other business services and construction services. Imports of services remained low in comparison with the pre-crisis level: as a result of the weak demand, travel services imports continued to shrink, whereas the imports of transportation services by air, financial services and other business services increased.

The surplus in the current account of Latvia's balance of payments totalled 455.8 million lats or 3.6% of GDP in 2010 and it practically equalled the contribution of the surplus of the current transfers account (458.6 million lats), as the trade balance in goods and services and income account balance almost offset one another. The changes in the income account resulted in a gradual shrinking of the current account surplus in the course of the year, as the significant bank losses were replaced by the profits earned by foreign direct investment companies of various sectors, and eventually the income account developed a deficit (3.6% of GDP in the fourth quarter). In 2010, the current transfers surplus increased to 3.6% of GDP mainly on account of the inflows of EU funding, particularly the amounts received from the European Social Fund (66.5 million lats more within a year). Larger inflows of EU funding for other purposes, e.g. subsidies on products (in agriculture the increase measured 40.8 million lats), were also registered.

International loan instalments received by the government remained a source of sizeable inflows into the financial account in 2010 (total inflows amounting to 771.4 million lats or 2.4 times less than in 2009), which, at the same time, boosted the Bank of Latvia's reserve assets. Nevertheless, progressive improvement in foreign investors' and depositors' confidence supporting inflows of private capital into the financial account should be viewed as a positive development. Foreign direct investment inflows into equity capital and other capital amounted to 353.2 million lats, yet the related upswing was offset by reinvested losses in the amount of 167.9 million lats, which brought the overall increment down to 185.4 million lats. Overall, the largest foreign direct investment inflows in 2010 were experienced in the financial and real estate sectors, mostly as injections into the equity of forest and agricultural land management companies. Nevertheless, with the competitiveness of Latvian producers improving on the basis of both price competitiveness and also higher productivity, foreign investors also showed more interest in production in 2010. This is confirmed by the inflows of foreign direct investment in manufacturing with a view to expanding the existing production facilities and building new ones in the sectors of building materials and metalworking producing mainly for exports. Banks proceeded with settling their long-term liabilities creating the most significant registered outflows from the financial account, thereby limiting the expansion of net external debt. Consequently, the government's continuous borrowing notwithstanding, the net external debt of Latvia contracted by 5.5 percentage points within a year and at the close of 2010 stood at 6.8 billion lats or 53.2% of GDP.

**FISCAL DEVELOPMENTS**

On a cash flow basis, the consolidated general government budget posted a deficit of 802.7 million lats or 6.3% of GDP in 2010. According to an accrual principle (ESA 95), used to evaluate compliance with the Maastricht criteria, the consolidated general government budget ran a deficit of 983.9 million lats or 7.7% of GDP.

In 2010, as in the previous year, both the central government basic budget and the social security budget recorded a deficit (here and further, on the cash flow basis) of 576.0 million lats and 335.8 million lats. At the same time, the consolidated local government budget and the budget of derived public persons recorded a surplus (52.0 million lats and 39.6 million lats respectively).

The financial stabilisation commenced within the framework of Latvia's Economic Stabilisation and Growth Revival Programme to ensure Latvia's financial sustainability by gradually balancing expenditure with revenue, continued in 2010. On 1 December 2009, the Saeima of the Republic of Latvia adopted the Law "On State Budget for 2010" initially providing for the state budget deficit of 524.0 million lats; however, the projected annual increase in the budget deficit approved by the law by the end of 2010 amounted to 1 031.0 million lats as a result of making budgetary amendments, adjusting the budget and granting additional funding, for example, to projects co-financed from the EU funds, the construction of the Latvian National Library, the social security network and the Ministry of Health of the Republic of Latvia. Several balance-improving measures on the revenue side, i.e. the increase of the personal income tax rate and expansion of the tax base, the increase of the real estate tax rate and expansion of the tax base, the increase of the excise tax rate on cigarettes and wine and its application to natural gas, the expansion of the social security contribution tax base, the increase of the annual transport vehicle duty, the increase of the rate of dividends to be appropriated to the state budget to public enterprises etc. were included in the budget. Measures on the expenditure side focused on compensation cuts in local governments and government budget institutions, the reduction of spending on goods and services, transfers to local governments, capital expenditure etc. The overall impact of these measures on the improving consolidated general government budget is estimated at 582 million lats or 4.6% of GDP.

In 2010, the consolidated general government budget revenue amounted to 4 607.0 million lats or 36.2% of GDP, representing a decrease of 127.7 million lats or 2.7% year-on-year. Revenue fell mostly on account of the contraction of tax revenue (by 112.2 million lats or 3.2%). In 2010, overall tax revenue in Latvia was still affected by the consequences of the economic downturn that started in 2008 and later caused a sharp deterioration of Latvia's fiscal situation. With a decrease of average wages and salaries persisting and the number of employees also falling by the first half of the year, revenue from social security contributions declined by 73.5 million lats or 6.3%. At the same time, revenue from the personal income tax increased by 49.9 million lats or 6.8%. This rise was supported by the said tax revenue increasing measures, particularly the increase of the overall personal income tax rate from 23% to 26% and expansion of the personal income tax base to include also capital income. The increase of real estate tax revenue was also determined by amendments to laws and regulations: in 2010, the tax rate applicable to land and buildings used in business was raised to 1.5% of the cadastral value, the real estate tax was reapplied to engineering structures (1.5%) and residential buildings (0.1%–0.3%) and a higher (3%) rate was imposed on uncultivated agricultural land. Thus revenue from the real estate tax rose by 16.6 million lats or 22.8% in 2010. As in 2009, with corporate profit indicators worsening, corporate income tax revenue recorded a notable decline of 85.0 million lats or 43.1%. Value added tax revenue rose slightly (by 26.8 million lats or 3.4%) in line with domestic demand trends. Non-tax revenue shrank slightly (by 42.0 million lats or 9.9%) over the year and it was mostly on account of the smaller volume of dividends received for the use of state capital and appropriated to the state budget as well as lower proceeds from sales of state-owned greenhouse gas emission units (91.4 million lats in 2009 and 37.0 million lats in 2010). In 2010, at the mid-point of the period of planning EU funds (2007–2013), foreign financial assistance appropriated to the consolidated general government budget exceeded the amount appropriated in 2009 by 70.3 million lats or 13.3%.

In 2010, the consolidated general government budget expenditure amounted to 5 409.7 million lats or 42.5% of GDP, representing a decrease of 217.1 million lats or 3.9% year-on-year. Like in 2009, the largest contribution to the decrease in the expenditure was on account of a drop in compensation to employees (250.5 million lats or 18.7%). Subsidies and grants also posted a decline (by 46.6 million lats or 3.8%), as did the capital expenditure (by 40.8 million lats or 9.5%). As already expected, with the general government debt rising, interest expenditure also grew (by 29.0 million lats or 19.2%). Social expenditure (the expenditure of the central government social security budget and the social benefits of the central government basic budget and the local government budget) increased by 98.5 million lats or 6.0%. This rise is largely explained by the repayment of withheld old age pensions in the first half of 2010 in accordance with the ruling of the Constitutional Court passed on 21 December 2009.

On a cash flow basis, the general government debt totalled 5 069.5 million lats or 39.8% of GDP at the end of 2010, representing an increase of 804.4 million lats year-on-year. It was due to an increase of 882.6 million lats in the central government external debt that was mainly related to the international loan disbursements received from the EC, the IMF and the World Bank to stabilise the Latvian economy and restore growth (818.2 million lats). The domestic debt of the central government shrank by 90.8 million lats over the year. It should be noted that positive shifts were observed in the term structure of the domestic debt, as it was gradually refinanced as a medium and long-term debt.

The general government debt that is recorded in line with ESA 95 methodology reached 5 693.6 million lats at the end of 2010 (44.7% of GDP, representing an increase of 891.7 million lats year-on-year). In line with the said methodology, debt servicing costs amounted to 183.7 million lats in 2010.

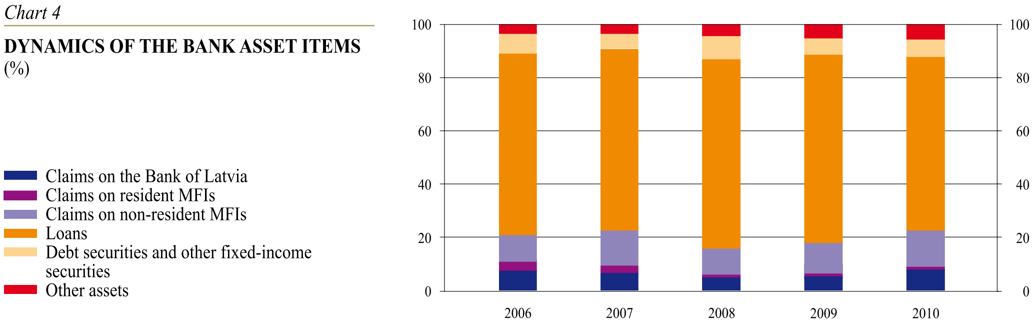
**BANKING DEVELOPMENTS**

At the end of 2010, 21 banks, 10 branches of foreign banks, 34 credit unions, eight electronic money institutions and two money market funds were registered in the Republic of Latvia. The license of the JSC *VEF banka* was revoked in 2010 as well as a new JSC *Citadele banka* was established, two branches of foreign banks and one money market fund launched their business, whereas another money market fund discontinued its operation. The government's participating interest in the paid-up share capital of banks increased to 26.1% at the end of 2010. The rise was partly attributable to the JSC *Citadele banka* established by the government within the framework of restructuring the JSC *Parex banka*. In addition, the government raised the capital of the JSC *Parex banka* and the SJSC *Latvijas Hipotēku un zemes banka*.

Latvian economy resumed growth in 2010 both on account of improved competitiveness and global economic development. Therefore, with the domestic economic activity on a rise, the main performance indicators of the financial sector also improved. Banking assets expanded slightly by 1.3% in the course of the year in comparison with a 6.7% decline in 2009. This expansion was a result of an increase of liquid assets on the banks' balance sheets (particularly claims on the Bank of Latvia and claims on foreign MFIs by 2.6 percentage points and 2.3 percentage points respectively reaching 7.7% and 13.7% of the aggregate assets respectively) as the banks continued to pursue prudent lending policies (see Chart 4). Hence the aggregate portfolio of loans granted to resident and non-resident non-MFIs shrank by 7.1% during the year (by 7.0% in 2009).

*Chart 4*

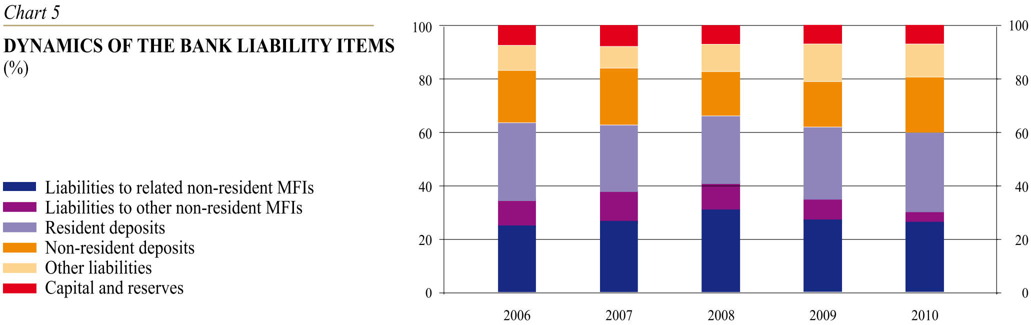
**DYNAMICS OF THE BANK ASSET ITEMS**
(%)




Considering the low sovereign credit ratings, banks still had limited opportunities to draw funds from the financial markets and the non-resident MFI funding contracted by 12.2% in 2010. This was primarily brought about by the syndicated loan repayments by banks, loans being partly replaced by non-bank deposits as well as less financing received from parent banks as a result of the sluggish lending. At the end of the year, non-resident MFI financing accounted for 29.9% of the aggregate bank assets, representing a 4.6 percentage points decline over the previous year. With banks regaining the depositors' trust and the financial position of companies in several economic sectors gradually improving, the financing received from non-banks increased. Resident deposits grew by 9.6%, whereas non-resident deposits expanded by 27.4% in 2010. Overall, deposits reached a historical high exceeding 11 billion lats and accounting for 50.6% of the aggregate bank liabilities (see Chart 5).

*Chart 5*

**DYNAMICS OF THE BANK LIABILITY ITEMS**
(%)

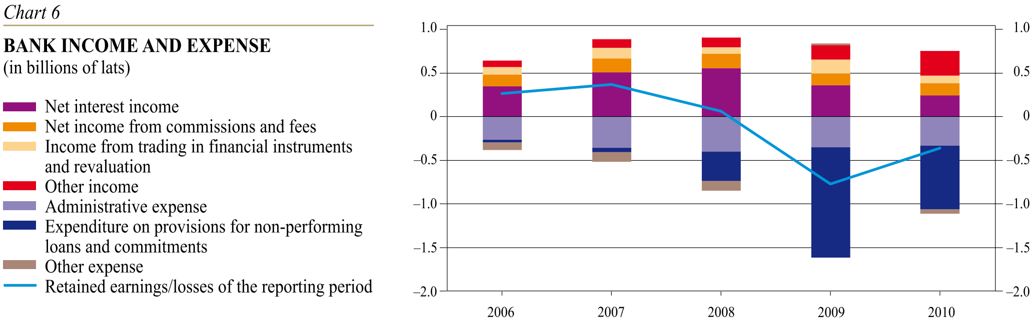



With the macroeconomic background gradually improving, the loan quality in banks stabilised in the second half of the year. Having peaked at the end of the third quarter at 19.4%, the share of loans past due over 90 days in the aggregate loan portfolio of banks contracted to 19.0 % in the fourth quarter. This can be largely explained by delinquent loan write-offs. At the same time, banks continued active debt restructuring measures providing relief to troubled borrowers. Restructured loans amounted to 19.9% of the aggregate loan portfolio of banks at the end of 2010.

Although Latvian banks continued to operate with losses in 2010 (360.7 million lats), these losses shrank by 53.4% year-on-year (773.4 million lats in 2009; see Chart 6). Expenditure on provisions for non-performing loans and commitments, the main contributor to the losses, decreased significantly year-on-year in 2010 and amounted to 727.1 million lats (1 266.1 million lats in 2009). Smaller losses resulted in an improvement of return on equity (ROE), although it still remained in a negative territory (–20.4%; –41.6% in 2009), and return on assets (ROA; –1.6%; –3.5% in 2009). The shrinking credit portfolio and loan delinquency caused a year-on-year decrease of interest income by one third in 2010. Interest expenses also contracted by roughly one third. As a result, net interest income decline by one third year-on-year in 2010 and its share in operating income decreased from 54.1% to 50.7%. Net income from commissions and fees followed an opposite trend, increasing by 7.0% and its share expanded from 19.8% in 2009 to 29.8% in 2010. Operating income shrank by 28.9% (to 471.6 million lats) compared to previous year. It covered the operating costs, albeit was insufficient for making savings. The decrease in the operating costs was minor, as the banks implemented a major review of their costs already in 2009.

*Chart 6*

**BANK INCOME AND EXPENSE**
(in billions of lats)




The capital adequacy ratio of banks was consistent with the regulatory requirements by the FCMC and stood at 14.6% at the end of the year, whereas Tier I capital ratio amounted to 11.5%. Banks continued to boost their capital: 14 banks expanded capital during the year, with the overall increase amounting to 324.4 million lats, including a rise of 278.8 million lats, 20.7 million lats and 24.8 million lats in the paid-up share capital, subordinated capital and reserve capital respectively.

## MONEY SUPPLY

The principal monetary aggregates of the Latvian banking system and the Bank of Latvia are featured in Appendix 1. In 2010, the developments of the monetary aggregates in Latvia reflected the end of the recession period, with the growth in money supply recovering alongside with the real economy. Both higher demand for cash and an impressive increase in deposits by resident non-financial corporations determined by export growth contributed to the expansion of broad money. The gradual recovery of the private consumption and increased retail trade turnover, in turn, dampened the rise of the household deposits.

The upward trend followed by all three monetary aggregates (M1, M2 and M3) confirmed the return of the Latvian financial system to stability (all the aggregates decreased in 2009; see Table 1 for the annual changes in the monetary aggregates). The overall macroeconomic background and the unclear economic outlook determined the economic agents' preference for the most liquid assets. As a result, M1 which is the most liquid component of broad money expanded at a much faster rate (26.6%) in comparison with

*Table 1*

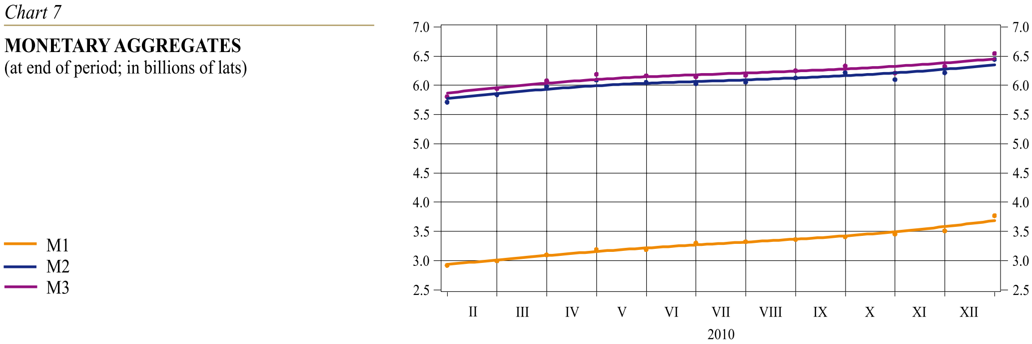
**ANNUAL CHANGES IN MONETARY AGGREGATES**
(%)

| | 2010 | 2009 |
|---|---|---|
| Currency outside MFIs | **21.0** | –23.0 |
| Overnight deposits | **28.2** | –6.7 |
| M1 | **26.6** | –10.9 |
| Deposits with an agreed maturity of up to 2 years | **–5.2** | 8.9 |
| Deposits redeemable at a notice of up to 3 months | **–2.9** | –4.6 |
| M2 | **11.2** | –2.8 |
| Money market fund shares/units and debt securities with a maturity of up to 2 years | **32.5** | 3.2 |
| M3 | **11.5** | –2.8 |

the headline growth of the money supply, whereas the monetary aggregates M2 and M3 reported a slower rise (11.2% and 11.5% respectively). Overall, money supply M3 increased by 674.5 million lats during the year in comparison with a 166.4 million lats decline in 2009, amounting to 6 547.6 million lats at the end of 2010 (see Chart 7) and representing a 0.5% increase over the previous pre-crisis peak of July 2008. The growth of the money supply accelerated in the course of the year: in the first half of the year, M3 increased by 4.7%, whereas in the second half already by 6.5%. The annual rate of change of M3 picked up gradually until September reaching 12.8% and stabilised slightly below this level in the last months of the year. Like in 2009, the steepest monthly rise of 221.4 million lats or 3.5% was reported in December 2010, when deposits with MFIs (except the Bank of Latvia) as well as currency in circulation increased significantly. The highest monthly drop of 120.4 million lats or 1.9% was recorded in October, when the MFI holdings of deposits by financial intermediaries contracted notably as a result of a one-off transaction.

*Chart 7*

**MONETARY AGGREGATES**
(at end of period; in billions of lats)




The increase of the monetary aggregate M2X calculated based on the Bank of Latvia's methodology (9.8%; a decline of 1.9% in 2009) was slightly lower than that of the aggregate money supply.

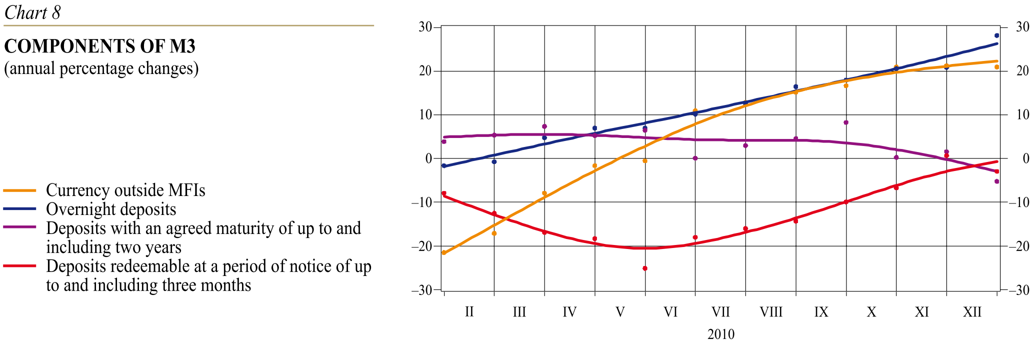
Demand for cash strengthened on account of the stabilisation of retail trade turnover and wages and salaries. To a certain extent, it was probably also stimulated by the payments made in the grey economy as suggested by the increase of 40.3% in ATM cash deposits. Currency in circulation (the lats banknotes and coins issued by the Bank of Latvia less vault cash of other MFIs) expanded in all quarters of 2010, rising by 21.0% in annual terms and representing a 140.1 million lats increase over the end of the previous year. Although the non-cash component retained the dominating role in the aggregate money stock, the share of cash in broad money continued to expand from 11.4% at the end of 2009 to 12.3% at the end of 2010.

In 2010, deposits of resident financial institutions, non-financial corporations and households grew by 8.3% (merely by 1.7% in 2009), with all currency overnight deposits with MFIs expanding notably by 26.1%, whereas all currency MFI deposits with an agreed maturity of up to two years and all currency deposits redeemable at a period of notice of up to 3 months recording a moderate decline of 4.0% and 3.7% respectively. As a result, the share of overnight deposits in broad money grew from 39.4% at the end of 2009 to 45.3% at the end of 2010 (see Chart 8 for the developments in the components of M3).

Against the background of the pick-up in industry, exports and retail trade, deposits by non-financial corporations expanded robustly by 30.8%, whereas household deposits grew by a mere 2.5% reflecting the recovery of private consumption and shrinking savings. Thus the share of household deposits contracted to 52.8% of aggregate deposits in comparison with 55.7% at the end of 2009. Household deposits accounted for 57.5% of all time deposits and 48.0% of overnight deposits (60.3% and 49.6% at the end of 2009 respectively).

*Chart 8*

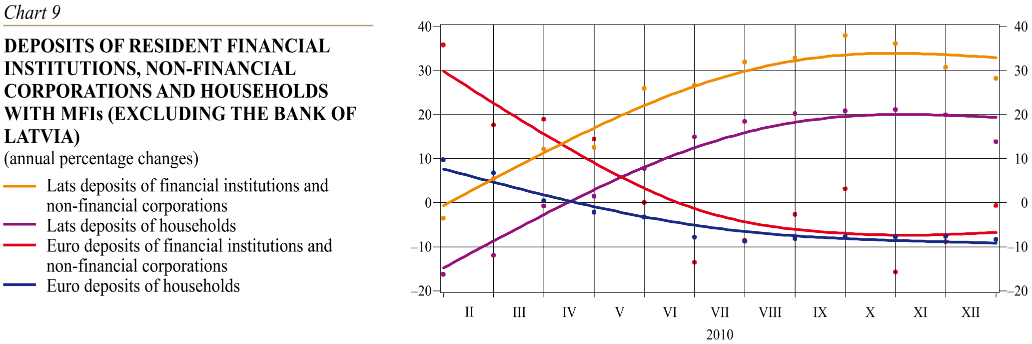
**COMPONENTS OF M3**
(annual percentage changes)




For the purpose of funding the budgetary expenditure, the government gradually converted the international loan into lats throughout the year, thereby boosting the lats deposits made with banks by 21.4% overall. The depreciation of the euro vis-á-vis other major world currencies and the low euro deposit rates discouraged deposits in euro which shrank by 5.4% (see Chart 9 for developments in the lats and euro deposits by households, financial institutions and non-financial corporations). At the same time, other foreign currency (primarily the US dollar) deposits expanded by 26.1%. At the end of 2009, deposits in lats accounted for 40.5% of the deposits of resident non-MFIs, while at the end of 2010 the respective share grew to 45.9%, whereas the share of deposits in euro shrank from 54.4% to 48.2% respectively. The share of the US dollar deposits increased from 4.4% at the end of 2009 to 5.1% at the end of 2010.

*Chart 9*

**DEPOSITS OF RESIDENT FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS WITH MFIs (EXCLUDING THE BANK OF LATVIA)**
(annual percentage changes)



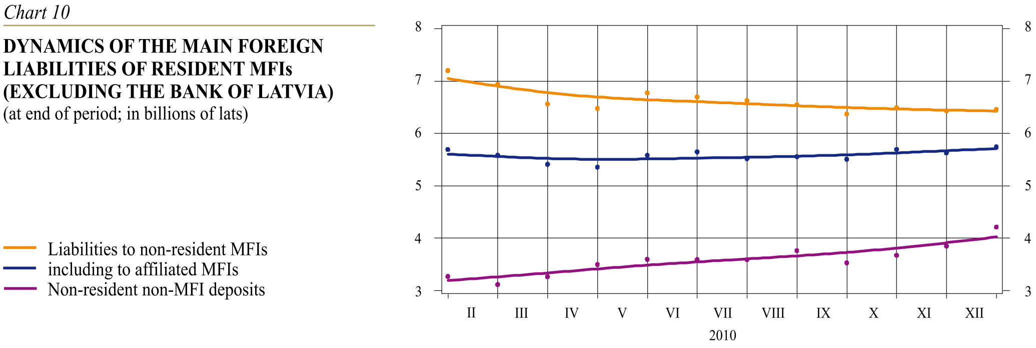

Other components of M3 remained rather modest, with money market fund shares/units totalling 81.4 million lats at the end of 2010 and MFI debt securities with a maturity of up to two years amounting to 20.6 million lats, representing a 7.0% and a 22.9 times increase in annual terms respectively. So far, Latvian banks have concluded no repo agreements meeting the definition of M3.

The money multiplier increased slightly and was 3.73 in December 2010 in comparison with 3.57 in December 2009. Stabilisation of the macroeconomic risks contributed to deceleration of the velocity of money from 2.2 in 2009 to 1.9 in 2010.

Overall, the trust in Latvian banks was not undermined. This was confirmed by a rise in resident deposits as well as the stable growth in inflows of non-resident funding: non-resident non-bank deposits expanded by 29.2% in 2010, while liabilities to foreign parent banks decreased by a modest 2.5% (see Chart 10). Liabilities to other foreign banks shrank more considerably mainly as a result of the repayment of syndicated loans. The foreign loans received by the government had an upward effect on money stock. Negative net foreign assets of MFIs decreased by 59.6% during the year and amounted to 1.2 billion lats. This included a 21.7% increase in the Bank of Latvia's net foreign assets reaching 4.0 billion lats at the end of the year. Consequently, the negative value of the net foreign assets continued to improve for the second consecutive year.

*Chart 10*

**DYNAMICS OF THE MAIN FOREIGN LIABILITIES OF RESIDENT MFIs (EXCLUDING THE BANK OF LATVIA)**
(at end of period; in billions of lats)

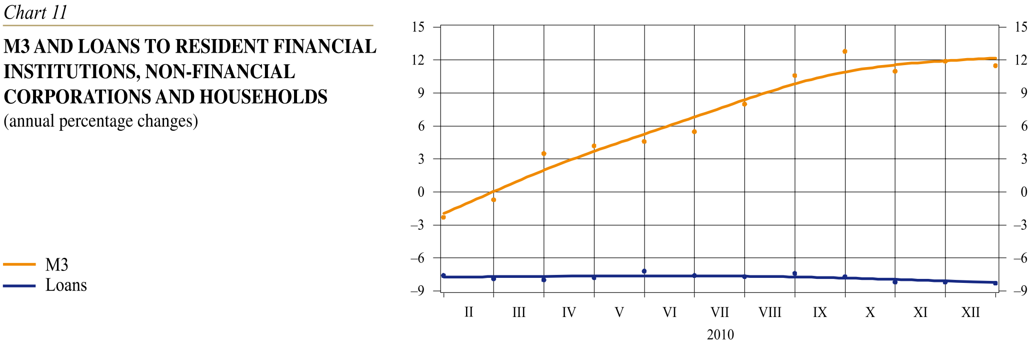



With liabilities to non-resident banks (primarily unrelated MFIs) shrinking, the foreign liabilities of MFIs (excluding the Bank of Latvia) contracted by 0.4 billion lats in 2010 (a 2.0 billion lats decrease in 2009), including a decline of 0.9 billion lats in liabilities to foreign MFIs (of which only a marginal decrease of 0.1 billion lats vis-á-vis associated and affiliated MFIs), whereas non-resident non-MFI deposits increased by 1.0 billion lats. Foreign assets of MFIs (excluding the Bank of Latvia) grew by 0.7 billion lats, with claims on foreign non-MFIs expanding by 0.3 billion lats (including an increase of 0.1 billion lats in credits) and claims on non-resident MFIs growing by 0.3 billion lats. Thus, the negative net foreign assets of MFIs (excluding the Bank of Latvia) had shrunk by 1.1 billion lats year-on-year at the end of 2010 (as at the end of 2009, the negative net foreign assets of MFIs had decreased by 1.9 billion lats year-on-year).

Of the counterparts, the decline in the MFI loans to private sector retained its downward effect on the monetary aggregates (see Chart 11), with loans to resident financial institutions, non-financial corporations and households shrinking by 8.3% in the course of the year (by 7.3% in 2009). Moreover, the monthly fall even accelerated slightly in the second half of the year: the average monthly rate of decline in loans stood at 0.6% in the first half of the year and at 0.8% in the second half of the year. With the market

*Chart 11*

**M3 AND LOANS TO RESIDENT FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS**
(annual percentage changes)



participants holding back in wait for the results of the 10th parliamentary elections and the processes of government formation, adoption of 2011 budget and additional consolidation efforts resulting in adjustments as well as with the downside risks to the external demand strengthening, the moderate recovery of the domestic demand still did not cause any significant surge in the demand for loans. The banks also retained a cautious attitude towards granting new loans. Private sector loans continued to shrink, as throughout the year the share of delinquent loans increased (loans past due over 90 days amounted to 19% of all loans at the end of 2010; 16.4% at the end of 2009), Latvia's sovereign credit rating remained low and the parent banks of the major market players remained sceptical.

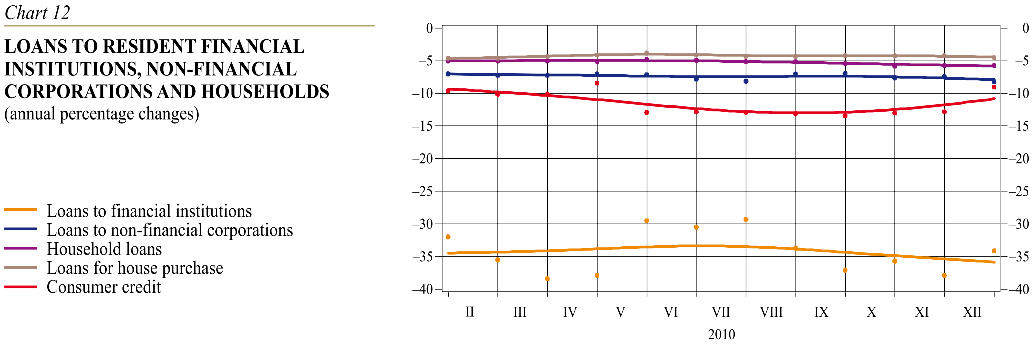
With the dry-up of lending continuing, exposure to loans granted to resident financial institutions, non-financial corporations and households decreased to 57.6% of the aggregated balance sheet assets of MFIs (excluding the Bank of Latvia) at the end of 2010 (63.4% at the end of 2009).

The consolidated general government budget retained a deficit; nevertheless, the negative net MFI claims on the government contracted by merely 43.7 million lats in the course of the year as a result of the external borrowing.

Loans to non-financial corporations contracted at more considerable rate (8.2% in annual terms), the rate of decline of household loans was more moderate (5.7% in annual terms), while that of loans to financial institutions was even faster (a 34.1% year-on-year decrease at the end of December; see Chart 12 for changes in loans granted to resident financial institutions, non-financial corporations and households).

*Chart 12*

**LOANS TO RESIDENT FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS**
(annual percentage changes)




Looking by sector, loans decreased almost in all sectors of the economy in 2010, particularly strongly in real estate, financial services and construction, yet in some export-capable and infrastructural development related industries investment even increased (including manufacture of chemicals, energy and land transport). Nevertheless, at the end of the 2010 the bulk of corporate loans were still concentrated in the sectors of real estate (33.4%; 32.6% at the end of 2009), manufacturing (13.7% and 13.4% respectively), trade (10.9% and 11.2%) and construction (10.5% and 10.7%).

The fall in commercial credit and mortgage loans granted to financial institutions and non-financial corporations as well as in consumer loans granted to households was more notable (19.3%, 16.3% and 9.0% respectively). The contraction in household loans for house purchase, in turn, was more moderate at 4.5%, whereas industrial credit even expanded by 14.7%. At the end of December, loans for house purchase totalled 4.6 billion lats or 80.3% of all loans granted to households, representing a year-on-year decrease of 0.2 billion lats. Hence, industrial credit, commercial credit and loans for house purchase accounted for 17.0%, 14.3% and 37.2% of all loans at the end of the year respectively (13.6%, 16.2% and 35.7% at the end of 2009 respectively).

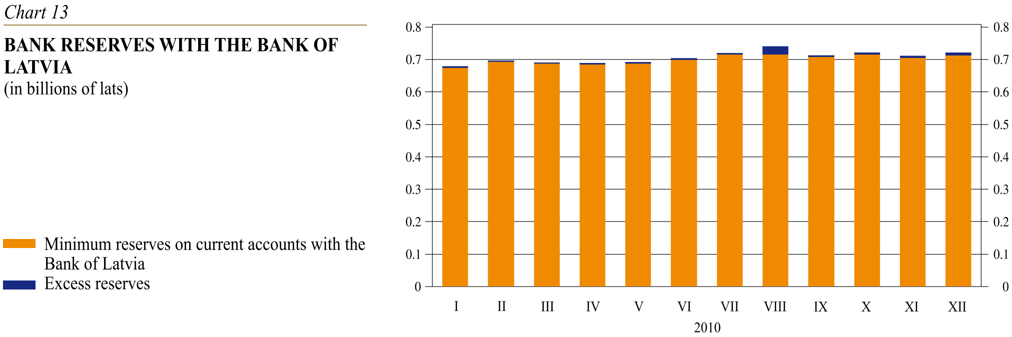
The currency composition of the credit portfolio remained broadly unchanged throughout the year: loans granted in lats declined by 10.5% and amounted to 7.8% of all loans at the end of 2010 (8.0% at the end of 2009), whereas the share of euro loans grew by 0.2 percentage point to 89.3%. Other foreign currency loans contracted at a similar rate (7.7%), with their share in aggregate loans remaining unchanged at 2.9%. As at the end of 2010, 69.6% of those loans were granted in the US dollars and 28.8% in Swiss francs.

## MONETARY BASE

An increase in the liabilities of the banks subject to the minimum reserve requirements resulted in an expansion of the minimum reserves held on the current accounts of the banks with the Bank of Latvia (see Chart 13). Nevertheless, overnight deposits from credit institutions and other financial institutions held by the Bank of Latvia declined by 40.3 million lats or 4.7% in 2010 (a decrease of 21.6% in 2009), because of a considerable increase in recourse to the seven-day deposit facility offered by the central bank. With the demand for cash rising significantly, currency in circulation grew by 149.7 million lats or 19.0% in 2010 in comparison with a decrease of 22.6% in 2009. As a result, the monetary base M0 expanded by 6.7% in 2010 and totalled 1 755.2 million lats at the end of the year, whereas the cash component of the monetary base expanded to 53.4% in comparison with 47.9% at the end of 2009.

*Chart 13*

**BANK RESERVES WITH THE BANK OF LATVIA**
(in billions of lats)




The contraction in the Bank of Latvia's net domestic assets (their negative value increased by 609.4 million lats) had a downward effect on the monetary base. Despite of a minor increase in net domestic loans, other items decreased sharply in net terms as a result of a higher recourse to the deposit facilities. Within the category of domestic loans, up to April loans granted to banks in the previous two years matured, resulting in a reduction of bank loans by 140.4 million lats (see Table 2 for the monthly average loan amounts outstanding), whereas the negative net credit to the government contracted by 210.9 million lats, with the government using the international loan to fund the budgetary deficit and the government deposit with the Bank of Latvia shrinking accordingly.

*Table 2*

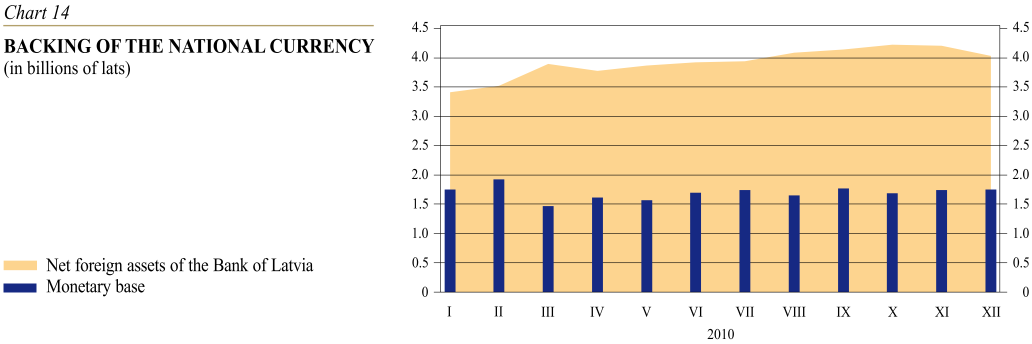
**BANK OF LATVIA LOANS TO MFIs**
(average daily balance; in millions of lats)

| | **2010** | 2009 |
|---|---|---|
| January | **137.1** | 600.6 |
| February | **122.6** | 594.0 |
| March | **117.6** | 393.8 |
| April | **117.5** | 256.8 |
| May | **15.0** | 274.8 |
| June | **0** | 327.7 |
| July | **0** | 245.8 |
| August | **0.1** | 236.1 |
| September | **0** | 228.6 |
| October | **0** | 225.1 |
| November | **0** | 158.8 |
| December | **0** | 142.3 |

Net foreign assets of the Bank of Latvia grew by 719.0 million lats in 2010, mainly as a result of an increase in the foreign currency deposits by the Latvian government. At the end of 2010, the Bank of Latvia's reserve assets covered the goods imports of 8.1 months (unchanged in comparison with the end of the previous year), whereas the backing of the national currency with the Bank's net foreign assets was 229.7% (see Chart 14; 201.3% at the end of 2009).

*Chart 14*

**BACKING OF THE NATIONAL CURRENCY**
(in billions of lats)

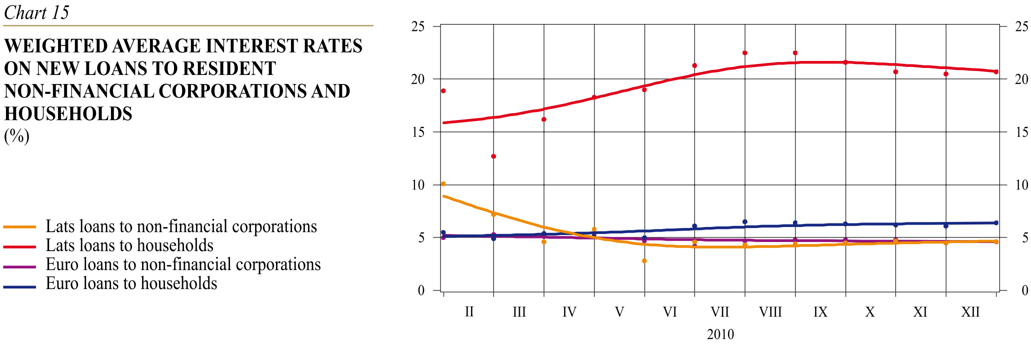



## LENDING AND DEPOSIT RATES

Interest rates on loans granted in lats to resident non-financial corporations and households and on lats deposits received from the respective segments followed a downward trend in 2010, albeit remaining rather volatile. The lats rates fell as a result of the significant decline in the lats money market rates, whereas the volatility can be explained by the persistently low and unsteady lending in lats. The pass-through of the decrease in the lats money market rates was the strongest to the rates applied to household loans for house purchase which had been set higher by MFIs in the previous year. The rates on lats loans granted to non-financial corporations, in turn, had been lower in the previous year and declined less. The weighted average rate on new lats loans granted to resident households climbed from 12.2% in December 2009 to 20.7% in December 2010. By contrast, the weighted average rate on new lats loans granted to non-financial corporations edged down from 6.7% in December 2009 to 4.6% in December 2010 (see Chart 15). Although the rates on lats loans approached those on foreign currency loans, in most cases they remained higher; therefore, euro retained its dominating position in new loans.

*Chart 15*

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

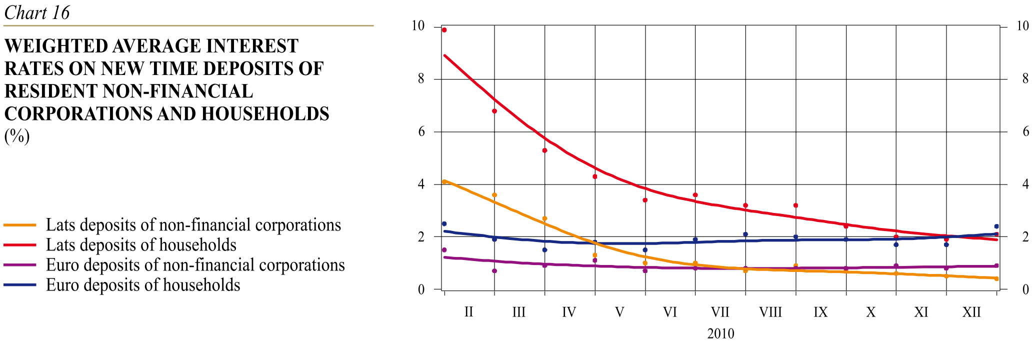



The rates on household loans for house purchase and loans to non-financial corporations granted in euro gradually declined. The downslide of the euro lending rates in the first half of the year could be related to lower euro money market rates. In the second half of the year, however, when the euro money market rates slightly picked up, it was primarily determined by the reduced bank margins. The risk appetite of banks had grown and, with the economy slowly recovering, they started to price in lower credit risk in their interest rates. The weighted average rate on new foreign currency loans to resident households decreased from 5.5% to 5.1%. With the share of loans over 1 million euro in new foreign currency loans granted to non-financial corporations shrinking, the overall interest rate climbed from 4.2% to 4.7%.

The ample liquidity on the money market reduced the bank preference for deposits from resident non-financial corporations and households. With the previously observed upward pressure on deposit rates fading, they contracted sharply (see Chart 16). The significant fall in the lats money market rates was mirrored by the deposit rates which declined at a faster rate in comparison with the rates on foreign currency deposits and slipped below the level of the latter in the last months of the year. The weighted average interest rate on lats term deposits from resident households declined by 9.3 percentage points, to 2.1% in December 2010, whereas that on lats time deposits from resident non-financial corporations decreased by 5.0 percentage points reaching 0.4%. The weighted average rate on time deposits received from households in foreign currencies decreased by 0.8 percentage point to 2.3%, whereas that on the respective non-financial corporation deposits went down 0.5 percentage point to stand at 0.7%. The share of lats deposits in aggregate deposits from resident non-financial corporations and households continued to expand up to the middle of the year. Then, after the lats deposit rates approached the rates on foreign currency deposits and eventually retreated below their level, the preference for foreign currency loans remunerated at roughly the same rates but presumed safer returned.

*Chart 16*

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




The spread between the rates on new loans and new deposits widened notably. Funding availability reduced the role of deposits as a source of bank financing; consequently, the fall in the money market rates had a stronger impact on deposit rates. The persistence of uncertainty and relatively low competition among banks on the lending market prevented a full pass-through of the money market rates to the lending rates. The tendency was the same for the spread between the rates on outstanding loans and deposits.

## INTERBANK MARKET

Contrary to the volatile developments in 2009, economic stabilisation and lower risk perception in 2010 were reflected in the fall of the lats money market rates to their historical lows. At the same time, with the conversion of funding granted by international donors continuing and public expenditure exceeding revenue, the lats liquidity surplus of banks continued to grow. Against this background, the movements in the quoted rates and the business rates were consistent with the changes in the rates on the overnight deposit facility and 7-day deposit facility offered by the Bank of Latvia. The weighted average interest rate on the most liquid transactions on the lats money market, overnight transactions, declined from 1.01% in January to 0.23% in December. The ample liquidity available on the lats money market reduced the impetus for interbank trading, and the average monthly value of lats transactions on the interbank market was 365.8 million lats (920.4 million lats in 2009). By contrast, the weighted average interest rate on the most liquid transactions on the euro money market, overnight transactions, following in the footsteps of the global upward trend in the euro rates, rose from a trough of 0.25% in January to 0.37% in December. The monthly value of euro transactions on Latvia's interbank market remained broadly unchanged at 1 270.0 million lats on average.

Clarity about 2010 budget, economic recovery signals and the results of the parliamentary election in October supported also a decline in longer-term money market rates to which the rates on lats loans to non-banks are linked. The 3-month RIGIBOR contracted overall from 6.80% at the end of 2009 to 0.85% at the end of 2010, whereas the 6-month RIGIBOR declined from 8.81% to 1.39% respectively, closely approaching the same maturity EURIBOR at the turn of the year. The average 3- and 6-month RIGIBOR was 2.00% and 2.83% respectively throughout the year, representing a 11.17 percentage points and 11.62 percentage points decrease over the previous year.

**FOREIGN EXCHANGE MARKET**

In 2010, signs of economic recovery were increasingly observed both in North America and Europe. Nevertheless, given the relatively slow pace of resumed growth, the FRS, ECB, Bank of England and Bank of Japan left their policy rates unchanged. The major stock market indices recorded pronounced increases, and prices of oil, metals and agricultural products rose rapidly. The stock market indices in the US and most of European countries moved up, while the Japanese stock market index remained almost unchanged. The global stock market dynamics was largely driven by accelerated economic growth in the developing countries. However, the overall optimism moderated as the issue of servicing the immense sovereign debts of several countries became topical again. The financial and banking crisis transformed into a sovereign debt crisis, and two euro area countries also turned to the IMF and EU for financial assistance. Greece failed to balance the central government budget and manage the growing sovereign debt; hence it requested international assistance in May. The financial aid of other European countries and the IMF offered brief respite for Greece amid growing market concerns about the stability of other euro area countries. The collapse of the Irish real estate market, bank losses and growing external debt were the major reasons for Ireland's call for help at the end of 2010. Although bank stress tests were conducted in Europe in 2010, confidence in the soundness of banks of some European countries still remains under question. The market participants' concern that these euro area countries would not be the only ones requiring assistance contributed to the downward trend of the euro exchange rate. In the first half of the year, the euro depreciated against the US dollar by 15%. In 2010, the exchange rate of the euro against the US dollar fell by 6.5% (from 1.4321 at the end of 2009 to 1.3384 at the end of 2010), reaching its high and low on 13 January (1.4579) and 7 June (1.1877) respectively.

In the second half of the year economic problems in the US came to the spotlight. The record low US interest rates and the huge amount of currency injected in the national economy notwithstanding, concern about another economic downslide in the future persisted. The real estate market showed no essential improvement, and the unemployment rate remained high. The FRS accommodative monetary policy did not bring the expected results. In 2010, recovery was observed in the US economy while the unemployment rate still remained high. The oil price continued to rise, exceeding 90 US dollars per barrel at the end of the year. The high inflation driven by the increase in oil prices is a threat to the global economy growth in the future. The US banking sector saw signs of stabilisation after the financial crisis of previous years. On the other hand, the financial problems of some euro area countries spoiled the attractiveness of the euro in the eyes of investors, so it was quite unlikely that considerable amounts of funds could be shifted from assets in US dollars to those in euro in the near future. To prevent a recurring economic downturn, the FRS implemented accommodative monetary policy and in November resolved to inject additional funds in the economy. This decision stimulated speculations about high inflation threats over a long horizon. Hence in the second half of the year the exchange rate of the US dollar against the euro shrank by 10% and that against the British pound sterling and Japanese yen also posted a fall with investors preferring more profitable assets. The US dollar depreciated vis-à-vis the Japanese yen by 12.8% (from 93.02 at the end of 2009 to 81.12 at the end of 2010), reaching its high (94.99) on 4 May and low (80.22) on 1 November.

In the second half of 2010, the UK saw its economy recover following an almost two years' downslide; however, neither the commitment of the UK government to implement essential fiscal consolidation measures in the next few years nor the atypically low interest rates for the UK promoted investment inflow in UK assets. In 2010, the fluctuations of the exchange rate of the British pound sterling against the US dollar and euro were relatively moderate in comparison with previous years. Uncertainty observed before the UK election in spring and the need to cut budget expenditure fostered the decline in the exchange rate of the British pound sterling against the US dollar in the first half of the year; nevertheless, similar to the euro, the British pound sterling partly recovered its position in the second half of 2010. Over the year, the British pound sterling depreciated vis-à-vis the US dollar by 3.5% (from 1.6170 at the end of 2009 to 1.5612 at the end of 2010), reaching its high (1.6458) on 19 January and low (1.4231) on 20 May.

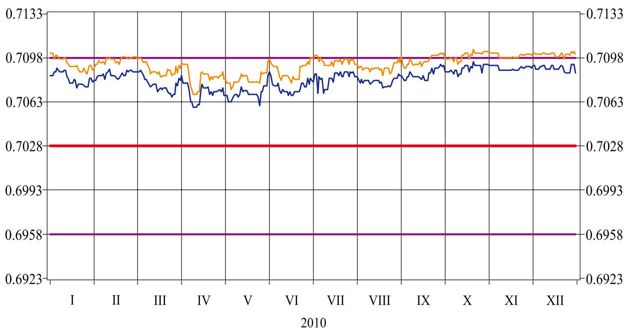
In Japan, the economic growth reached pre-crisis levels, and the traditional current account surplus facilitated the appreciation of the Japanese yen. The low interest rates observed in the developed countries also supported the Japanese yen which has traditionally been used for borrowing funds cheaply in Japan and afterwards investing them in currencies with a higher return. Contrary to the practice of central banks of the US and European countries, the Bank of Japan did not inject huge amounts of funds in the economy and mostly financed the large sovereign debt inside the country. With the purpose of depreciating the Japanese yen and thus supporting the exporters, the Bank of Japan conducted foreign exchange intervention after a lapse of several years; nevertheless, it failed to stop further appreciation of the Japanese yen. In 2010, the Japanese yen appreciated considerably both against the US dollar and the euro.

On the Latvian foreign exchange market the exchange rate of the euro against the lats remained broadly unchanged and fluctuated slightly below the upper limit of the intervention band set by the Bank of Latvia (0.7098; see Chart 17). In 2010, the average euro selling rate quoted by banks was 5 basis points below the upper limit of the intervention band set by the Bank of Latvia (lower than in 2009 when the euro rate against the lats quoted on the interbank market recorded more pronounced fluctuations). In April and May the euro rate against the lats quoted by banks slightly moved away from the upper intervention margin set by the Bank of Latvia as a result of the economic stabilisation and improved outlook, the strict commitment of the government to continue the on-going reforms and fiscal consolidation as well as a more favourable assessment of the Latvian economy by the international credit rating agencies.

*Chart 17*

**LATS PEG RATE TO THE EURO SET BY THE BANK OF LATVIA AND EURO RATE AGAINST THE LATS QUOTED BY BANKS**

Euro purchase rate quoted by banks
Euro selling rate quoted by banks
Lats peg rate to the euro set by the Bank of Latvia
Limits of the intervention band set by the Bank of Latvia



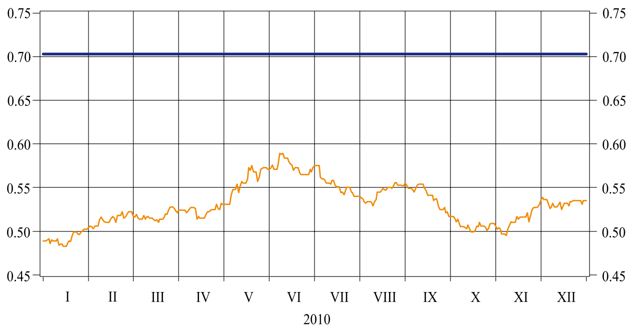

*Sources: Bank of Latvia and Reuters.*

The US dollar appreciated against the lats by 7.1% (from 0.4952 at the end of 2009 to 0.5304 at the end of 2010) on the Latvian foreign exchange market (see Chart 18). The US dollar reached its high (0.5964) on 7 June due to the depreciation of the euro on the global foreign exchange market in early July on account of the intensifying sovereign debt crisis of euro area countries; a low (0.4863) was recorded on 13 January.

In January 2010, the Bank of Latvia Regulation No 41 "Regulation for Compiling Reports on Foreign Currency Purchases and Sales" of 16 July 2009 took effect, stipulating an

*Chart 18*

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




obligation for banks to provide more detailed information about foreign exchange transactions for lats. In 2010, the share of lats transactions on the foreign exchange market remained small (16.0% of total foreign exchange turnover). On the domestic market lats were exchanged for euro in approximately 90% cases and for US dollars – in 9% cases. In both cash and non-cash transactions lats were predominantly exchanged for euro and US dollars. Of non-cash transactions, the share of euro slightly expanded while that of US dollars decreased. Of lats transactions against the euro, 84.2% were made with non-residents (mostly with non-resident MFIs as well as non-resident intermediaries other than MFIs), while of lats transactions against the US dollars, 71.2% of turnover accounted for transactions with residents mainly on the interbank market. A considerable share of lats transactions against other currencies (75.6%) was made by residents mostly on the interbank market. As to cash transactions, their currency profile remained unchanged: the breakdown of lats transactions turnover against the euro, US dollars, Russian rouble and British pound sterling was approximately 60%, 20%, 5% and 5% respectively.

## SECURITIES MARKET

In 2010, risks on the government securities market moderated notably, supported by fiscal consolidation measures and previous financial system stabilisation measures as well as improvement in Latvia's long-term macroeconomic outlook.

The Treasury offered lats-denominated debt securities in the amount of 618.0 million lats at primary auctions of government securities. The bid amount reached 1 893.4 million lats and the amount sold stood at 583.3 million lats. Supply decreased 3.1 times year-on-year as improved credibility enabled the government to borrow funds for a longer term. Despite the reduced supply, the stock of government securities outstanding shrank only slightly (by 3.3%; to 795.8 million lats). At government securities auctions the demand was approximately the same as in the previous year whereas the amount sold decreased twofold. The Treasury resumed issuing 2-, 3- and 5-year bonds as demand in this market segment had recovered in contrast to 2009 when uncertainty about the Latvian financial sector recovery and considerable budget adjustments restricted the demand.

On the primary market, yields on government short-term securities declined considerably. The weighted average yield on 6-month Treasury bills was 1.22% at the last auction in 2010, down from 9.27% a year before. Similar trend was recorded for 12-month Treasury bills: the weighted average yield contracted from 10.25% to 1.78% respectively. In November, the weighted average yield on 6-month Treasury bills even fell below 1.00%, increasing slightly in December in response to the aggravating issue of fiscal sustainability of some euro area countries which caused growing risk awareness on the government securities markets in Europe. Consequently, at the end of 2010 the Treasury offered only Treasury bills and no bonds in the market.

In February 2010, the weighted average yield at the government 2-year bond auction was 6.07% whereas that at the 5-year bond auction held at the end of October stood at 4.35%.

As to the breakdown of government securities by holder, the share of holdings by Latvian banks grew from 53.3% to 59.9% over the year while the shares of other residents and non-residents contracted from 43.9% to 37.8% and from 2.8% to 2.3% respectively. On the one hand, the Treasury could borrow from the international lenders on more favourable terms than in the domestic market; on the other hand, it was also necessary to develop borrowing in the domestic market in order to extend maturities for domestic borrowings.

The stock of publicly traded corporate debt securities registered with the LCD in all currencies grew somewhat (from 157.3 million lats at the end of 2009 to 160.8 million lats at the end of 2010), including a decrease in the stock of publicly traded corporate debt securities denominated in lats and registered with the LCD (from 52.9 million lats to 26.4 million lats). Securities denominated in lats in the amount of 40.7 million lats matured and were redeemed (including short-term securities in the amount of 25.3 million lats), and new securities denominated in lats were issued in the amount of 14.2 million lats (5-year zero coupon securities of the JSC "Air Baltic Corporation"). Since average interest rates on lats transactions over the year were relatively high, the amounts of securities issues denominated in lats were limited.

The market of securities denominated in foreign currencies recorded new debt securities issues in the amount of 63.7 million lats (including 2-year US dollar-denominated securities in the amount of 51.8 million lats).

In the debt securities secondary market, the bid yield on the Latvian government Treasury bonds maturing in July 2019 on NASDAQ OMX Riga declined from 14.00% to 5.75% over the year. The most pronounced fall was recorded in November on account of 5-year Treasury bond primary auctions. The bid yield on the government securities with the time to maturity less than a month shrank to 1.2%–1.6%, down from 4.00%. The bid yield on mortgage bonds of the SJSC *Latvijas Hipotēku un zemes banka*, maturing in August 2013, dropped from 13.00% to 4.25%. Factors causing the interest rate fall on the secondary market were similar to those on the primary market: the decline resulted from the reforms carried out in Latvia and the recovery of the economy.

At the end of 2010, the quoted bid yield on Latvian government eurobonds (maturing in 2018) was 5.32% according to Bloomberg (231 basis points less than a year ago). The spread between the bid yields on the above eurobonds and German government bonds of the respective maturity shrank from 446 basis points to 280 basis points, with the international market players also positively assessing the situation in Latvia.

In 2010, the turnover of debt securities on NASDAQ OMX Riga was 8.0 million lats (a year-on-year decrease of 2.1 times). Government securities recorded the highest turnover (7.1 million lats). Their stock exchange turnover was small as market participants bought government securities at primary auctions, largely for the purpose of holding them long-term rather than selling them on the secondary market.

The NASDAQ OMX Riga stock turnover stood at 14.6 million lats in 2010 (a 49.0% increase year-on-year). As in 2009, the highest turnover was recorded for the shares of the JSC *Grindeks* and the JSC *Olainfarm* (3.5 million lats and 3.1 million lats respectively).

The positive macroeconomic data released in spring 2010 also contributed to the improvement in corporate financial performance, particularly that of export-oriented corporations. That explains the fact that two pharmaceutical companies exporting a large share of their output were the leading ones on the stock exchange list. Another stimulus for the Latvian stock market was the news that Estonia was invited to join the euro area, and foreign investors' interest in Estonia.

The NASDAQ OMX Riga index OMXR rose by 41.1% in 2010, ranking fourth in the EU and tenth in the world according to NASDAQ OMX Riga, and the Baltic share price index OMXBGI surged by 59.5%; at the same time, the major global stock exchange indices recorded increases not exceeding 20%. Although the rise in the index in Latvia was partly related to a more considerable decline before, at the same time it pointed to a more rapid economic recovery than expected.

At the end of 2010, shares of 34 corporations were listed on NASDAQ OMX Riga (one company less than in 2009). Five corporations were listed on the Baltic Main List and 29 corporations were included on the Baltic Secondary List.

# BANK OF LATVIA OPERATIONS AND ACTIVITIES

## LEGAL FRAMEWORK AND FUNCTIONS. THE BANK OF LATVIA IN THE EUROPEAN SYSTEM OF CENTRAL BANKS AND INSTITUTIONS OF THE EUROPEAN UNION

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

The Bank of Latvia is acting as a consultant of the Parliament (Saeima) and the Cabinet of Ministers of the Republic of Latvia in issues related to monetary policy and other issues concerning the Bank of Latvia's performance of its tasks. The Bank of Latvia also ensures the operation of the Credit Register.

The Bank of Latvia is not subject to decisions and instructions by the government or other institutions. The Bank of Latvia is independent in making its own decisions and implementing them. The Bank of Latvia is supervised by the Saeima of the Republic of Latvia.

Like the national central banks of other EU countries, the Bank of Latvia is participating in the ESCB. In its activities, the Bank of Latvia complies with the Republic of Latvia and EU legislation as well as ECB legal acts in compliance with the Treaty on the Functioning of the European Union and the Statute of the ESCB and ECB.

In 2010, the Governor of the Bank of Latvia participated in the work of the ECB General Council. In compliance with the Statute of the ESCB and ECB, the ECB General Council discussed on its meetings reports on the macroeconomic situation and financial stability in the EU countries, reports on functioning of ERM II as well as addressed other issues concerning the national central banks of all EU countries.

The Bank of Latvia's representatives participated in 12 ESCB committees and the Human Resources Conference (see Appendix 7), as well as more than 30 working groups, dealing with issues related to monetary policy, market operations, financial stability, payment systems, euro banknotes, statistics, international relations, accounting etc.

The Bank of Latvia's experts also participated in committees and working groups of the Council of the EU and the EC. Sitting on the EFC and its subcommittees, the representatives of the Bank of Latvia regularly participated in the decision-making concerning the economic and financial development of the EU, discussed the preparation of countries for the introduction of the euro, relations with third countries and policies of international financial institutions as well as took part in drafting proposals addressing the economic policy strategy and instruments. In 2010, the EFC paid particular attention to the issues of financial stability, the supervision reform of the financial sector and the strengthening of the economy policy coordination. The Bank of Latvia's representatives continued their participation in the EC and Eurostat working groups addressing issues related to euro coins, payment systems, economic forecasting and statistics.

In November 2010, the EU supported the supervision reform of the financial sector, inter alia establishing the ESRB, where the Bank of Latvia would be represented by the Governor of the Bank of Latvia. Oversight of systemic risks of the EU financial system is one of the key tasks of the ESRB.

In 2010, the Bank of Latvia updated the changeover plan of the euro implementation and participated in the updating of the National Euro Changeover Plan in compliance with the euro changeover date (2014) established by the government. Significant progress has been made with regard to issues related to SEPA and the communication strategy. The representatives of the Bank of Latvia participated in the *Euro Team* lecturer project delivering lectures to interested individuals and publishing analytical articles about the euro changeover and its importance.

## DEVELOPMENT, ADOPTION AND IMPLEMENTATION OF MONETARY POLICY

### ECONOMIC RESEARCH, ANALYSIS AND FORECASTING

A modern central bank can effectively pursue its monetary policy building on an in-depth analysis of the development trends in macroeconomic indicators and their related interactions, such analysis performed using statistical, mathematical and econometric methods. Economic research and analysis are vital for contributing quantitative and scientifically sound accounts of economic processes, developing econometric forecasting models for macroeconomic indicators, and estimating alternative scenarios.

In 2010, the Bank of Latvia published three working papers and a discussion paper on its website; two articles by the Bank of Latvia experts appeared in international peer-reviewed journals. Four expert roundtables and a regular conference were held. The issues tackled covered a vast range of topics focusing on the problems crucial for the Latvian economy: sustainability of the economic growth, potential effects of the euro changeover on economic growth, the global financial crisis and principles of fiscal policy development, the price setting mechanism, lending, the currency circulation mechanism, the role of financial sector in monetary transmission, quality and variety of exports, and real time forecasting of Latvia's medium-term and long-term economic growth trends.

Duly accounting for exports and their expansion as a major factor supporting sustainable growth, the Bank of Latvia conducted the analysis of export quality and variety. These export indicators are of large significance. Without underestimating the importance of unit values in measuring export quality, the calculations rely also on the size of the market share and the level of company monopolistic power in the market. The estimated relative export quality proved to be a more robust instrument than relative prices, suggesting that the selected relative quality measure serves the purpose better than relative export prices, its conventional substitute, since it does not cover relative production costs but captures structural factors (see Working Paper 2/2010 on the Bank of Latvia website). The working paper has been presented and discussed at a conference hosted by the ECB.

The main outcomes of this working paper were also used at the Bank of Latvia regular conference *Latvia Beyond the Crisis: Towards Sustainable Economic Growth*. It noted that the variety of Latvia's exports expanded notably immediately after the accession to the EU, while of late, the pace of expansion has moderated, with the quality of Latvia's exports, at the same time, among the lowest in the group of Central and East European countries. Although the variety of Latvian exports is increasing, the quality of exported commodities remains almost unchanged; consequently, in order to make larger profits from exports in the future, focus should be on addressing the issue of improving export quality (see materials of the Bank of Latvia Conference of 20 October *Latvia Beyond the Crisis: Towards Sustainable Economic Growth* on the Bank of Latvia website).

Under the Bank of Latvia Discussion Papers, a new publication series launched in 2009, research dedicated to price setting mechanism in Latvia was conducted. Price stickiness ranks among most important issues in macroeconomics: price flexibility determines, in part, how long it takes for inflation and real economic variables to return to their potential levels after a shock. Economic experts of the Bank of Latvia studied and assessed both the degree of overall nominal rigidity of consumer prices in Latvia and in the breakdown by product group (see Discussion Paper 1/2010 on the Bank of Latvia website). The outcomes of research were presented and discussed by the participants of roundtable discussion organised by the Bank of Latvia (see Roundtable Discussion materials on the Bank of Latvia website).

The growth rate of real GDP is the most complete and recognised indicator of the economic activity. Nevertheless, two essential weaknesses are, as a rule, typical for this variable. First, only quarterly and, what is more, strongly delayed data on domestic activity are available. Second, the process of real time analysis, forecasting, and decision-making is impaired by real GDP short-term fluctuations. In order to provide monetary policy makers with information they need in the decision-making process, a method for the assessment of the current state of the national economy using LATCOIN, a new Latvia's Business Cycle Coincidence Indicator, has been developed at the Bank of Latvia. LATCOIN is a monthly estimate of Latvia's medium to long-run real GDP growth, which helps filter out various one-off effects and focus on medium and long-run tendencies (see Working Paper 1/2010 on the Bank of Latvia website). This Bank of Latvia working paper has been published in international peer-reviewed Baltic Journal of Economics.

In the context of Latvia preparing for full-fledged participation in the EMU, the Bank of Latvia proceeded with in-depth studies of Latvia's monetary transmission mechanism in 2010. This time, the purpose was to quantify the role of financial frictions in monetary transmission. The findings of the paper show that tighter credit constraints weaken the transmission of shocks to housing demand and consumption. Meanwhile, higher risk premium elasticity in the event of foreign interest rate and risk premium shocks lessens the effect of monetary transmission on the domestic economy through higher cost of external funds (see Working Paper 3/2010 on the Bank of Latvia website). The working paper has been presented and discussed at a conference hosted by the Tallinn School of Economics and Business Administration and Tallinn University of Technology.

The revised and updated version of the working paper *Measuring Total Factor Productivity and Variable Factor Utilisation: Sector Approach, the Case of Latvia* (see Working Paper 3/2009 on the Bank of Latvia website) has been published in international peer-reviewed journal Eastern European Economics. It estimates the total factor productivity growth in 2000–2008 for six sectors of the Latvian economy using a sectoral quarterly data set. The estimates are obtained by controlling for qualitative changes in production factors and assuming a mechanism for capturing changes in the utilisation of labour and capital.

## MONETARY POLICY DECISIONS

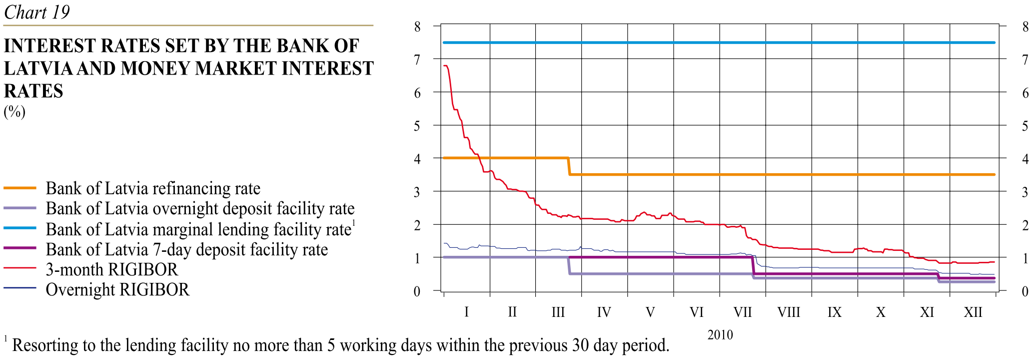
2010 was a year of stabilisation not only in the economy but also in the use of monetary policy instruments of the Bank of Latvia, adjusting them to a lower level of risks and interest rates. In the first half of the year, annual consumer price deflation still persisted whereas in the second half of the year moderate inflation resumed. In 2010, monetary policy decisions of the Bank of Latvia facilitating economic growth were made, and inflation risks were contained. The economic stabilisation measures were also recognised by the international community, preventing speculations observed in the previous years regarding the sustainability of the monetary policy of the Bank of Latvia.

With the economic situation stabilising and given the contained inflation risk, as of 24 March the Bank of Latvia reduced the refinancing rate from 4.00% to 3.50% (see

Chart 19) and introduced a new instrument – 7-day deposit facility (with an interest rate of 1%), whereas the overnight deposit facility rate was cut from 1.0% to 0.5%. As of 24 July 7-day and overnight deposit facility rates were reduced to 0.5% and 0.375% respectively, and as of 24 November further cuts became effective, down to 0.375% and 0.25% accordingly. The deposit facility rate was reduced in order to create additional stimulus for banks to invest their available funds in the development of the economy thus promoting economic stabilisation and growth recovery.

*Chart 19*

**INTEREST RATES SET BY THE BANK OF LATVIA AND MONEY MARKET INTEREST RATES**
(%)




[1] Resorting to the lending facility no more than 5 working days within the previous 30 day period.

The Bank of Latvia left the marginal lending facility rate unchanged: throughout the year it was 7.50% in case the respective bank had resorted to the lending facility no more than 5 working days within the previous 30 day period; 15.0% in case the bank had resorted to the lending facility 6–10 working days within the previous 30 day period; 30.0% in case the bank had resorted to the lending facility for more than 10 working days within the previous 30 day period.

## USE OF MONETARY POLICY INSTRUMENTS

In 2010 the Bank of Latvia implemented its monetary policy by using the minimum reserve requirements, market operations (inter alia main refinancing operations and foreign exchange swaps), and standing facilities (inter alia overnight deposit facility and 7-day deposit facility). The Bank of Latvia offered an opportunity to buy and sell unlimited amounts of euro for lats.

The end-of-day balance of the currency in circulation averaged 847.4 million lats in 2010 (a year-on-year increase of 2.0%). These changes as a leading indicator reflected the economic development: the amount of currency in circulation was relatively stable until March, with an upward trend beginning in April. The average minimum reserve requirements for banks stood at 700.5 million lats (3.7% lower year-on-year). Reserve ratio was left unchanged in the last two years; hence the decrease in reserve requirements resulted from a fall in funds received by banks (reserve base). The government lats deposit with the Bank of Latvia averaged 60.2 million lats, posting a 45.2% decline year-on-year. The solid government deposit in foreign currency with the Bank of Latvia helped to manage the lats liquidity necessary for the government monthly expenditure with a smaller amount of lats deposits. Overall, the total average value of these three indicators decreased, expanding the lats liquidity by 59.7 million lats.

In 2010 the net amount of euro sold to the Bank of Latvia for lats (including transactions in the Cashier's Office of the Bank of Latvia) stood at 790.9 million lats as per transaction date or 851.0 million lats as per settlement date principle. Euro were sold to the Bank of Latvia by the Treasury using the funds granted by international lenders, while lats were sold mostly by banks.

Similarly to 2009, auctions of the main refinancing operations and currency swaps were conducted each business day, with the allotment amount of 5 million lats and 10 million lats respectively; the minimum bid rates in these auctions were linked to the refinancing rate. Due to excess liquidity, however, demand for these instruments was weak.

In 2010, the amount offered in the Bank of Latvia's main refinancing operations was 1 260.0 million lats. Bank demand and the allotted amount was small – 2.1 million lats (as compared to 335.9 million lats in 2009). The average amount at the main refinancing operations contracted from 6.7 million lats in 2009 to 0.04 million lats in 2010. In 2010, the interest rate on the main refinancing operations averaged 3.87% (7.70% in 2009).

As to foreign exchange swaps, the Bank of Latvia offered them in the amount of 2 510.0 million lats but there was no demand from banks (transactions in the amount of 1 101.1 million lats were concluded in 2009, with the average daily balance standing at 22.2 million lats).

Under excess liquidity conditions, the deposit facility continued to be the major monetary policy instrument used. In 2010 the overall average recourse to the overnight deposit facility and 7-day deposit facility reached 723.4 million lats (as compared to 172.8 million lats in 2009). The average deposit facility rate stood at 0.73% (1.52% in 2009). The above changes suggest that availability of funding to banks had improved considerably and there were no banks with shortage of funds. Nevertheless, they continued their prudent approach when lending to the economy as the share of bad loans in the bank loan portfolio remained large.

There was no recourse to the marginal lending facility in 2010 (its average balance in 2009 was 6.3 million lats).

The Bank of Latvia calculated RIGIBID (deposit rates on the interbank market) and RIGIBOR (lending rates on the interbank market) in accordance with the Bank of Latvia's "Regulation for the Calculation of RIGIBID and RIGIBOR", including those banks in quotation list that were active on the interbank market and able to conduct market operations at the quoted money market rates on transactions in lats: at the end of 2010, the JSC Swedbank, JSC *Latvijas Krājbanka*, JSC *SEB banka*, JSC UniCredit Bank, Latvian Branch of Nordea Bank Finland Plc, JSC *DnB NORD Banka* and SJSC *Latvijas Hipotēku un zemes banka*. To promote RIGIBID and RIGIBOR transparency, apart from RIGIBID and RIGIBOR, the Bank of Latvia also published the money market interest rates, quoted by the banks included on the quotation list, on its website as of 1 November 2010.

## FOREIGN CURRENCY AND GOLD RESERVES MANAGEMENT

The Bank of Latvia manages foreign currency and gold reserves in order to ensure stability of the national currency. The Bank of Latvia's foreign reserves, which include gold, convertible foreign currencies and SDR, amounted to 4 068.1 million lats at the end of 2010 (3 376.6 million lats at the end of 2009). The increase in foreign reserves resulted from income gained from investing foreign reserves in foreign financial markets and as a result of inflows of funding received under international loan agreements into the Treasury accounts.

The Bank of Latvia manages its foreign reserves in compliance with the guidelines adopted by the Council of the Bank of Latvia. The base currency of the benchmark portfolio is the euro and the benchmark assets are composed of 50% of euro-denominated assets, 40% of US dollar-denominated assets and 10% of Japanese yen-denominated assets. The Bank of Latvia invests its foreign reserves in safe and liquid financial instruments, primarily in debt securities issued by governments and government agencies of the euro area countries and the US and international organisations, as well as in highly rated bank and corporate debt securities, asset-backed securities and callable bonds. Interest rate futures are used to manage the duration of the reserves. For the purpose of implementing yield curve strategies on the interest rate market, interest rate swaps are used, whereas foreign exchange futures and forwards are applied to ensure the optimal currency composition of the foreign reserves.

Foreign currency reserves of the Bank of Latvia are managed relative to the 1–3 year government bond indices of the US, euro area and Japan; hence investments are made primarily in securities with maturity of 1–3 years. Particular attention is paid to the interest rates of 2-year bonds which declined over 2010 (from 1.33% to 0.86% in the euro area and from 1.14% to 0.59% in the US). Conversely, in Japan the respective interest rate posted a slight rise from 0.15% to 0.18%. In view of the historically very low levels of interest rates, it is quite difficult for the central bank as a conservative investor with a low risk tolerance level to generate high returns. Nevertheless, the forecasts adequate for the market situation and appropriately positioned investment portfolio, particularly duration, positively affected the Bank of Latvia income.

The Bank of Latvia stored its gold reserves with the Bank of England. Foreign exchange futures and forwards, and interest rate swaps were also used in the management of the gold reserves.

The Bank of Latvia uses the services of four external reserve managers. They manage a portion of the Bank of Latvia's foreign reserves pursuant to the guidelines set by the Council of the Bank of Latvia.

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

## PROVISION OF CURRENCY IN CIRCULATION

The Bank of Latvia issues lats banknotes. The Bank of Latvia puts money into circulation through the medium of credit institutions, which, in view of customers' demand, select the nominal value of banknotes and coins. At the end of 2010, banknotes and coins of all denominations issued by the Bank of Latvia (banknotes accounted for 876.6 million lats or 93.5% of the total amount) were in circulation (see Table 3). In the course of 2010, the number of all banknotes and almost all coins increased. At the end of 2010, currency in circulation grew by 19.0% as compared with 2009 (from 788.2 million lats to 937.9 million lats).

*Table 3*

**THE STRUCTURE OF LATS BANKNOTES AND COINS IN CIRCULATION**
(%)

| Face value | **2010** | 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|---|
| Ls 500 | **7.8** | 8.0 | 10.9 | 13.7 | 16.7 |
| Ls 100 | **12.6** | 12.0 | 14.3 | 16.2 | 18.8 |
| Ls 50 | **8.5** | 7.8 | 7.3 | 6.5 | 6.6 |
| Ls 20 | **50.2** | 49.3 | 47.7 | 43.9 | 40.0 |
| Ls 10 | **7.3** | 8.0 | 7.2 | 7.5 | 7.1 |
| Ls 5 | **7.1** | 7.7 | 6.9 | 7.0 | 6.4 |
| Banknotes | **93.5** | 92.8 | 94.3 | 94.8 | 95.6 |
| Ls 100 | **0** | 0.1 | 0 | 0 | 0 |
| Ls 10 | **0** | 0 | 0 | 0 | 0 |
| Ls 2 | **0.9** | 1.0 | 0.9 | 0.8 | 0.7 |
| Ls 1 | **3.4** | 3.5 | 2.8 | 2.6 | 2.1 |
| 50 s | **0.8** | 1.0 | 0.8 | 0.7 | 0.6 |
| 20 s | **0.5** | 0.5 | 0.4 | 0.4 | 0.3 |
| 10 s | **0.3** | 0.3 | 0.3 | 0.2 | 0.2 |
| 5 s | **0.2** | 0.3 | 0.2 | 0.2 | 0.2 |
| 2 s | **0.2** | 0.3 | 0.2 | 0.2 | 0.2 |
| 1 s | **0.2** | 0.2 | 0.1 | 0.1 | 0.1 |
| Coins | **6.5** | 7.2 | 5.7 | 5.2 | 4.4 |
| Total lats in circulation | **100.0** | 100.0 | 100.0 | 100.0 | 100.0 |

## BANK OF LATVIA COINS STRUCK IN 2010 (FACE VALUE: 1 LATS)

### SPECIAL CIRCULATION COINS OF LIMITED MINTAGE

#### TOAD

Weight: 4.80 g; diameter: 21.75 mm
Metal: alloy of copper and nickel
Struck by *Staatliche Münze Berlin* (Germany)
Artists: Edgars Folks (graphic design),
Jānis Strupulis (plaster model)

#### HORSESHOE

Weight: 4.80 g; diameter: 21.75 mm
Metal: alloy of copper and nickel
Struck by *Staatliche Münze Berlin* (Germany)
Artists: Frančeska Kirke (graphic design),
Laura Medne (plaster model)

### COLLECTOR COINS

#### THE LATVIAN ABC BOOK


*Silver coin*
Weight: 31.47 g; diameter: 38.61 mm
Metal: silver of .925 fineness;
quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists: Arvīds Priedīte (graphic design),
Ligita Franckeviča (plaster model)

*Cupro-nickel coin*
Weight: 12.40 g; diameter: 30.00 mm
Metal: alloy of copper and nickel;
quality: BU
Struck by *Rahapaja Oy* (Finland)
Artists: Arvīds Priedīte (graphic design),
Ligita Franckeviča (plaster model)

#### DUKE JACOB'S 400TH ANNIVERSARY

Weight: 31.47 g; diameter: 38.61 mm
Metal: silver of .925 fineness; quality: proof
Struck by *Koninklijke Nederlandse Munt* (the Netherlands)
Artists: Ilze Lībiete (the design after a medal commemorating Duke Jacob),
Ligita Franckeviča and Jānis Strupulis (plaster model)

DECLARATION OF INDEPENDENCE

Weight: 31.47 g; diameter: 38.61 mm
Metal: silver of .925 fineness;
quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists:
Ilmārs Blumbergs (graphic design),
Ligita Franckeviča (plaster model)

AMBER COIN

Weight: 20.70 g; diameter: 35.00 mm
Material: silver of .925 fineness and amber;
quality: proof
Struck by *Rahapaja Oy* (Finland)
Artist: Aigars Bikše

COIN OF TIME III

Weight: 17.15 g (weight of the central circle – 7.15 g, weight of the outer ring – 10.00 g); diameter: 34.00 mm
Metal: the central circle – niobium,
the outer ring – silver of .900 fineness;
quality: UNC
Struck by *Münze Österreich* (Austria)
Artists: Laimonis Šēnbergs (graphic design), Jānis Strupulis (plaster model)

The Bank of Latvia Council establishes the procedure for withdrawing lats banknotes from circulation and replacing the damaged lats banknotes with valid ones. Banknotes and coins received from banks were checked for wear and tear and authenticity by using automated cash processing systems. In 2010, the amount of processed cash (3 088.2 million lats) exceeded that of currency in circulation 3.3 times (5.0 times in 2009). Of the amount of cash processed, 158.5 million lats or 5.1% was withdrawn from circulation (620.3 million lats or 15.8% in 2009).

The total nominal value of counterfeits detected in 2010 (35.8 thousand lats) accounted for only 0.0038% of the currency in circulation.

The Bank of Latvia exercises the right to put collector coins (including the ones made of precious metals) into circulation. In 2010, the Bank of Latvia issued silver collector coins *Duke Jacob's 400th Anniversary* (in circulation as of 22 February 2010) and *Declaration of Independence* (in circulation as of 12 April 2010) to commemorate anniversaries significant to Latvian history. Two versions of the collector coin *The Latvian ABC Book* were issued – a silver coin and a cupro-nickel coin (in circulation as of 12 August 2010) as a dedication to the first Latvian ABC book published more than 300 years ago. To remind of the significant role of amber in Latvian culture and history, *Amber Coin* (in circulation as of 15 November 2010) in which a transparent amber cylinder has been set into silver with the help of a unique technology was issued. At the same time, the silver and green niobium *Coin of Time III* (in circulation as of 2 December 2010) completed the triptych of coins devoted to the theme of time.

Three new special 1-lats coins *Toad* (in circulation as of 7 June 2010) and *Horseshoe* struck in two versions (with the ends facing up and down; in circulation as of 2 December 2010) replenished the stock of circulation coins.

## PAYMENT AND SETTLEMENT SYSTEM OPERATION

The Bank of Latvia promotes smooth operation of the payment systems in the Republic of Latvia and therefore performs oversight of the payment systems and ensures interbank payment systems operation.

### THE BANK OF LATVIA PAYMENT AND SETTLEMENT SYSTEMS

The Bank of Latvia maintains the operation of the interbank payment systems thus ensuring the implementation of monetary policy operations, secure, rapid and efficient settlement between credit institutions as well as final settlement of other payment and securities settlement systems. Hence efficient payment infrastructure is available to credit institutions providing payment services to their customers. Operation of other payment and securities settlement systems in Latvia is ensured by the private sector.

The Bank of Latvia organised and ensured the operation of three payment systems: the SAMS, the EKS and TARGET2-Latvija in the Republic of Latvia. The daily average of payments processed by the Bank of Latvia via all systems totalled 133.3 thousand payments in the value of 1.3 billion lats (for the monthly data of payments processed in the Bank of Latvia's interbank payment systems see Charts 20 and 21).

*Chart 20*

**TOTAL VOLUME OF PAYMENTS PROCESSED IN THE BANK OF LATVIA INTERBANK PAYMENT SYSTEMS**
(in millions)

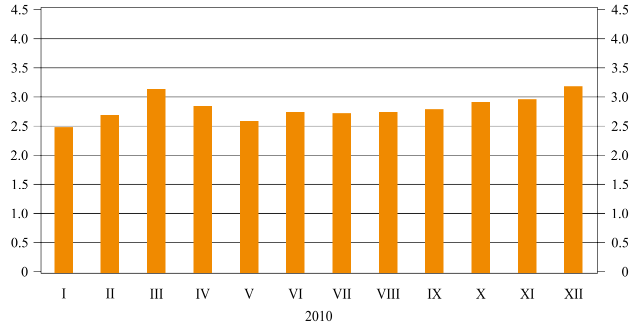
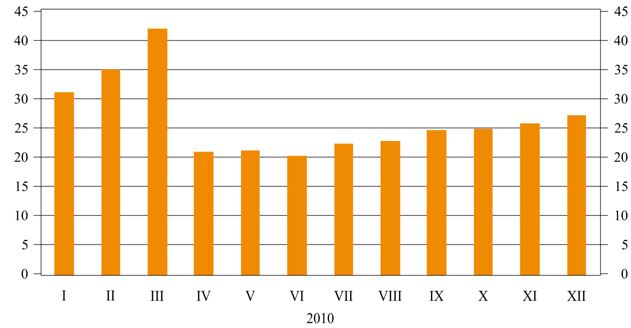



*Chart 21*

**TOTAL VALUE OF PAYMENTS PROCESSED IN THE BANK OF LATVIA INTERBANK PAYMENT SYSTEMS**
(in billions of lats)




The SAMS is a real-time gross settlement system. The SAMS ensured interbank settlement of large-value payments in lats and final settlement of other payment and securities settlement systems as well as the settlement of the Bank of Latvia's monetary policy operations. At the end of 2010, 20 banks, four branches of foreign banks and the Bank of Latvia were the participants in the SAMS. The SAMS processed 193.0 thousand payments (value – 166.3 billion lats; see Table 4). The SAMS ensured 99.93% availability of the system to its participants (99.79% in 2009), i.e. during the year, the SAMS was unavailable to its participants for 1 hour, 6 minutes and 5 seconds overall. In 2010, the SAMS commenced the final settlement of card payment systems MasterCard Europe Sprl and Visa Europe Services Inc. Through the SAMS, MasterCard Europe Sprl and Visa Europe Services Inc. only processed the final settlement of domestic payments executed by the payment cards of Latvia's banks. The SAMS also ensured the final settlement of the securities settlement system of the LCD, the card payment system of First Data Latvia and that of the Bank of Latvia's EKS.

*Table 4*

**PAYMENTS PROCESSED IN THE SAMS**

| | Volume (thousands) | | | Value (billion lats) | | |
|---|---|---|---|---|---|---|
| | Interbank and ancillary system | Customer | | Interbank and ancillary system | Customer | |
| **2010** | **96.8** | **96.3** | **193.0** | **157.5** | **8.8** | **166.3** |
| 2009 | 101.6 | 98.6 | 200.2 | 156.5 | 11.0 | 167.5 |
| 2008 | 93.4 | 140.7 | 234.1 | 166.0 | 12.9 | 178.9 |
| 2007 | 82.0 | 131.4 | 213.4 | 81.6 | 10.6 | 92.2 |
| 2006 | 62.4 | 114.8 | 177.2 | 36.3 | 11.8 | 48.1 |

The EKS is the Bank of Latvia's net settlement system used for processing retail payments in lats and euro. The EKS is an ACH (Automated Clearing House) system where payment processing is fully automated and only electronic payment documents are accepted and processed. The EKS final settlement in lats is effected in the bank accounts opened with the Bank of Latvia in the SAMS, while that in euro is made in TARGET2-Latvija. On 9 November 2010, the Bank of Latvia completed the project of transforming the EKS into a SEPA compliant system which ensured that on a timely basis prior to the euro changeover the banks of Latvia, the Treasury and the Bank of Latvia could execute rapid, efficient and secure customer payments in euro not only domestically, but also within SEPA (the EU Member States, Iceland, Liechtenstein, Norway, Switzerland and Monaco). 4.5 thousand banks and the economic area comprising 490 million inhabitants may be reached through the EKS. To ensure interoperability with other payment systems of SEPA, the EKS commenced the exchange of euro cross-border credit transfer messages with STEP2, the system of the Euro Banking Association, via the Deutsche Bundesbank system SEPA Clearer. The third clearing cycle for the processing of euro payments was implemented in the EKS at 17.00, ensuring the execution of cross-border euro payments and crediting the customers' accounts within one day. The EKS participants settle their liabilities to other EU credit institutions in TARGET2. The transforming of the EKS into a SEPA compliant payment system also contributes to the establishing of uniform SEPA requirements for the bank-to-customer domain in Latvia.

At the end of 2010, 20 banks, four branches of foreign banks and the Bank of Latvia were the participants in the EKS lats settlement and 16 banks, one branch of a foreign bank, the Treasury and the Bank of Latvia participated in the euro settlements respectively. The EKS processed 33.1 million payments, with their value amounting to 11.6 billion lats (see Table 5). The lats payments executed via the EKS were handled in two clearing cycles – at 10.30 and 15.00. The euro payments executed via the EKS were handled in three clearing cycles – at 11.00, 15.30 and 17.00. The availability ensured by the EKS to its participants was 99.63% (99.60% – in 2009).

*Table 5*

**PAYMENTS PROCESSED IN THE EKS**

| | Volume (thousands) | | | Value (billion lats) | | |
|---|---|---|---|---|---|---|
| | Lats | Euro | | Lats | Euro | |
| **2010** | **32 796.8** | **310.1** | **33 107.0** | **10.5** | **1.1** | **11.6** |
| 2009 | 31 796.8 | 252.5 | 32 049.2 | 10.2 | 0.9 | 11.1 |
| 2008 | 33 227.1 | 223.8 | 33 451.0 | 13.1 | 1.1 | 14.1 |
| 2007 | 30 198.6 | – | 30 198.6 | 12.4 | – | 12.4 |
| 2006 | 27 404.1 | – | 27 404.1 | 10.3 | – | 10.3 |

The Bank of Latvia, together with other participants of the ESCB ensured the operation of TARGET2, the Trans-European Automated Real-time Gross Settlement Express Transfer system. The Bank of Latvia maintained the operation of TARGET2-Latvija, the Latvian component, ensuring mutual payment settlement of the system participants in euro and final settlement of other systems in euro. At the end of 2010, 20 banks, three branches of foreign banks, the Treasury and the Bank of Latvia were direct participants in TARGET2-Latvija. In 2010, 287.1 thousand payments in the value of 200.0 billion euro were processed in TARGET2-Latvija (see Table 6). The Bank of Latvia together with other participants of the ESCB contributed to the development of TARGET2 and implementation of the system's new version as of 22 November 2010.

*Table 6*

**PAYMENTS PROCESSED IN TARGET2-LATVIJA**

| | Volume (thousands) | | | Value (billion lats) | | |
|---|---|---|---|---|---|---|
| | Interbank | Customer | | Interbank | Customer | |
| **2010** | **39.5** | **247.6** | **287.1** | **190.7** | **9.3** | **200.0** |
| 2009 | 43.4 | 126.5 | 169.9 | 194.7 | 5.7 | 200.5 |
| 2008 | 31.1 | 118.7 | 149.8 | 63.5 | 6.6 | 70.1 |
| 2007 | 1.1 | 8.5 | 9.6 | 3.6 | 0.7 | 4.3 |
| 2006 | – | – | – | – | – | – |

## OVERSIGHT OF PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

The Bank of Latvia performed oversight of Latvia's payment systems, thus reducing the probability of systemic risk in the infrastructure of Latvia's payment systems and promoting smooth operation of payment systems. A day-to-day oversight of the systemically important payment system the SAMS as well as the EKS was conducted by the Bank of Latvia in compliance with "The Bank of Latvia's Payment System Policy". The Bank of Latvia primarily analysed the incidents and statistical data of the SAMS and EKS systems within the framework of the day-to-day oversight. Within the framework of payment system oversight, the Bank of Latvia cooperated with institutions ensuring operation of the clearing and payment systems (First Data Latvia, JSC *Itella Information* and banks), providing its advice and opinion on payment system issues.

The Bank of Latvia compiled data on the payment instruments used in Latvia. Customer credit transfers (115.7 million payments or 51.9%) and payments by payment cards (101.9 million payments or 45.7%) accounted for the majority of all payment instruments used in 2010. The value of such payments amounted to 260.7 billion lats and 1.4 billion lats respectively. Other payment instruments (direct debits, cheques and e-money) were relatively seldom used.

To promote integration of Latvia's payment systems into the Single Euro Payments Area, the Bank of Latvia engaged in the SEPA Project by steering the National SEPA Working Group and participating in the SEPA Working Group of the Payment Committee established by the Association of Latvian Commercial Banks, as well as took part in the EU Forum of the National SEPA Coordination Committees organised by the EC. On 14 December, Version 2.0 of Latvia's National SEPA Plan developed by the National SEPA Working Group was approved by the Money and Payment Systems Working Group of the Republic of Latvia Euro Project. The above Plan was supplemented with the SEPA Communication Plan drafted by the communication experts of the National SEPA Working Group. The Bank of Latvia organised seminars about the SEPA card payment implementation issues in cooperation with the Association of Latvian Commercial Banks and First Data Latvia. The Bank of Latvia maintained the SEPA project website. The SEPA payment instruments (SEPA payment cards, credit transfers and direct debit payments) in euro are available to the customers of Latvia as of 2008; however, public will derive full benefit from SEPA once Latvia joins the euro area and all payments previously made in lats are executed in euro pursuant to uniform requirements stipulated by the SEPA for effecting payments.

In 2010, the Bank of Latvia along with the national central banks of 14 other EU Member States and ECB participated in the project assessing the cost efficiency of retail payment instruments. The objective of the project was to estimate the social costs related to the use of retail payment instruments (such as cash, payments with credit and debit cards, credit transfers and direct debits). Based on the methodology developed by the ECB, the Bank of Latvia collected data from banks, JSC *Itella Information*, First Data Latvia, cash collection companies, merchants and other businesses, and completed the data compilation in 2010. The ECB will release the results of the above research in 2011 in accordance with the project plan.

In 2010, the Bank of Latvia performed oversight of the securities settlement systems in Latvia. The Bank of Latvia provided consultations to the LCD and issued opinion on the operation and development of the securities settlement systems, discussed topical issues regarding the system development and operational continuity of the systems, new legislation initiatives and changes of requirements for securities settlement infrastructures in Europe. Within the oversight framework, the Bank of Latvia cooperated with the FCMC, the institution supervising the operation of the LCD.

In the context of the securities settlement system oversight, the Bank of Latvia headed the Latvian User Group of the Eurosystem's TARGET2-Securities Project along with the LCD in order to facilitate the integration of Latvia's securities market into the single European securities market. The Eurosystem launched TARGET2-Securities Project in 2006 to develop a single shared IT platform for securities settlement in Europe, thus eliminating the differences between domestic and cross-border settlements and reducing the securities settlement-related costs. The representatives of the LCD, the Bank of Latvia, the FCMC, the Treasury and Association of Latvian Commercial Banks participate in the Latvian User Group. In 2010, all institutions representing the Latvian User Group of TARGET2-Securities supported "The Strategy for Implementing TARGET2-Securities in Latvia" developed by the Latvian User Group. The Bank of Latvia assessed the impact of TARGET2-Securities Project on the Bank of Latvia regulations, functions, processes and systems. The Bank of Latvia and LCD made presentations to the members of the Latvian User Group regarding the requirements of TARGET2-Securities users for organising the settlement of cash leg of securities transactions and other Project-related requirements, as well as took part in the ESCB committees and working groups reviewing the issues relevant to the implementation of TARGET2-Securities Project. In accordance with the action plan approved by the Governing Council of the ECB, TARGET2-Securities shall be implemented in 2014.

**FINANCIAL STABILITY**

A stable financial environment is an essential prerequisite for successful implementation of the monetary policy. The Bank of Latvia cooperates closely with the FCMC in creating the above environment. To enhance the macro-prudential supervision and identify and evaluate risks to financial stability, the Bank of Latvia developed further the methodology of the financial sector's systemic risk assessment and that of credit risk analysis in particular. Credit risk remains the major risk for the banking sector; therefore a dynamic factor model of Latvian bank credit risk was developed for short-term forecasting of quality changes in the loan portfolio. The above model allows estimating, by applying the key component method, the main factors affecting a wide range of macroeconomic aggregates and financial indicators (53 different indicators overall), on the basis of which any quality changes in the loan portfolio are projected.

Cooperation among the institutions of the Nordic and Baltic countries in safeguarding regional financial stability strengthened. A Cooperation agreement on cross-border financial stability, crisis management and resolution between relevant Ministries, Central Banks and Financial Supervisory Authorities of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden was signed on 17 August 2010. The above agreement stipulates the procedure for information sharing and coordination and the procedures enhancing cooperation of the stakeholders in cross-border financial supervision, crisis management and resolution. The key objective of the agreement is to reduce the risk of cross-border financial crisis and ensure efficient crisis management in the Nordic and Baltic regions.

In 2010, a consensus was reached among the EC, the European Council and the European Parliament about a radical European financial supervisory framework reform fundamentally changing the supervision of the EU banking and securities and insurance market participants. The European Parliament supported the establishment of a new institutional supervisory architecture as of 1 January 2011. The new European Financial Supervisory Framework (EFSF) is composed of two pillars. The first pillar is the ESRB – an independent institution responsible for the macro-prudential supervision of the EU financial system, with the ECB and EU national central banks playing an essential role in its operation. The Bank of Latvia's representatives will participate in the General Board of the ESRB and the respective committees and working groups established by the above Board. The second pillar of the EFSF is a network of supervisory institutions responsible for the micro-prudential supervision of individual financial institutions, with three European Supervisory Authorities (ESAs): the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority as well as an overarching steering committee of the above institutions and supervisory authorities of the EU Member States.

## OPERATION OF THE CREDIT REGISTER

In the Credit Register, the Bank of Latvia accumulates and stores the data of the Credit Register participants (such as banks providing financial services associated with credit risks, companies having close links with banks and providing financial services associated with credit risks, credit unions and insurers) on the borrowers and borrower guarantors, their liabilities and performance thereof. The goal of the Credit Register is to enable the participants to assess borrowers' credit worthiness more accurately, manage credit risks more efficiently, provide additional opportunities for performing supervisory functions, allow the consumer creditors of the EU Member States and EEA countries to assess the consumers' creditworthiness, and furnish information to the Bank of Latvia and FCMC for conducting the economic analysis.

To comply with the provisions of Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers, the reporting of Credit Register data to the individuals of the EU Member States and EEA countries involved in lending to consumers was ensured as of 22 October 2010, enabling them to assess the consumer's creditworthiness.

On 1 April 2010, the Credit Register commenced collection of data on trust loans and at the end of 2010, data on 254 trust loans with the total outstanding obligations amounting to 107 million lats were collected.

At the end of 2010, the Credit Register comprised 96 participants. The number of participants shrank by 14 year-on-year, since no more data on subrogees' obligations were collected by the Credit Register as of 1 April 2010. At the end of 2010, the Credit Register contained data on 939.6 thousand persons and 2.6 million obligations, total outstanding obligations were 1.5 million and loan portfolio of the Credit Register participants amounted to 15.1 billion lats. In 2010, the Credit Register participants submitted 14.7 million requests (4.0 times more year-on-year) since banks commenced an assessment of their clients' solvency in the Credit Register on a regular basis. The Bank of Latvia serviced 2.3 thousand natural and legal persons by providing the Credit Register data on the respective obligations.

**STATISTICS**

The Bank of Latvia collects and compiles financial and monetary statistics as well as prepares government finance statistics. In accordance with the ECB's request, the Bank of Latvia has also been involved in addressing issues related to the methodology of some fields of economic statistics and compiling specific aggregates. The Bank of Latvia uses statistical data to implement its monetary policy, perform analysis of financial stability and macroeconomics as well as raise public awareness of the developments in the financial sector and the economy.

In 2010, the Bank of Latvia continued the regular transmission of statistical data to the ECB, BIS and IMF and provided statistical information to other domestic and foreign data users. To furnish timely information to a wide range of data users, the Bank of Latvia disseminated financial and monetary statistics and balance of payments statistics of Latvia via its regular publications and the Bank's website and compiled data for publishing in the ECB publications and ECB Statistical Data Warehouse as well as the IMF publications and within the IMF Special Data Dissemination Standard.

The Bank of Latvia participated in inter-institutional working group for preparation of the EDP (excessive deficit procedure) notification and updating the methodology. In the area of statistics, meetings and workshops held by the ECB and Eurostat working groups and committees focussed mainly on the implementation of the new European System of Accounts and the IMF's "Balance of Payments Statistics Manual" in 2014 as well as the issue of additional statistical data requests related to the ESFS establishment. The Bank of Latvia continued to participate in the work of the Seasonal Adjustment Steering Group and in 2010 engaged in defining a uniform methodological framework for developing seasonally adjusted time series of national statistics in the EU as well as building efficient models of time series and designing the analysis software solution *Demetra+*.

FINANCIAL AND MONETARY STATISTICS

Several Bank of Latvia regulations became effective in financial market and monetary statistics in 2010.

As of February 2010, collection of statistical data was commenced in accordance with the "Regulation for Compiling Reports on Foreign Currency Purchases and Sales" (the Bank of Latvia's Regulation No 41 of 16 July 2009, in effect as of 1 January 2010), substantially expanding the range of data collected on cash and non-cash transactions both in lats and other currencies. New data are used for an in-depth analysis of the foreign exchange market and published in the Bank of Latvia's "Macroeconomic Developments Report" and on the Bank's website.

As of June 2010, the MFIs reported balance sheet statistics in accordance with the "Regulation for Compiling the Monthly Financial Position Report of Monetary Financial Institutions" (the Bank of Latvia's Regulation No 40 of 16 July 2009, in effect as of 1 May 2010), transposing the requirements of Regulation (EC) No 25/2009 (recast; ECB/2008/32) concerning the balance sheet of the monetary financial institutions sector. The data compiled in line with the above Regulation enable an in-depth analysis and forecasting of macroeconomic processes as well as provide more comprehensive information to international institutions, market participants and other stakeholders about the developments of the banking system in Latvia. The collection of data in the following data categories was commenced: syndicated loans, revolving loans, overdrafts, convenience credit card credit and extended credit card credit as well as collateral for the loans granted to the households and non-financial corporations. As regards the maturity profile of loans, the collection of data on loans by residual maturity and by interest rate reset period was commenced. A new currencies breakdown (the national currency, euro and other foreign currencies) was applied to the items in the monthly financial position report of MFIs.

In July 2010, data were also collected in accordance with the new "Regulation for Compiling Interest Rate Reports of Monetary Financial Institutions" (the Bank of Latvia's Regulation No 42 of 10 September 2009, in effect as of 1 June 2010), transposing the requirements of Regulation (EC) No 290/2009 amending Regulation (EC) No 63/2002 (ECB/2001/18) concerning statistics on interest rates applied by monetary financial institutions to deposits and loans vis-à-vis households and non-financial corporations (ECB/2009/7). Data obtained in line with the above Regulation provide for the implementation of the monetary policy and enhancement of macroeconomic forecasting as well as allow the Bank to inform the general public on interest rates and their dynamics in Latvia. The Bank of Latvia has started publishing the interest rates on revolving loans, overdrafts and payment card credit on its website starting with the data for June 2010.

Following the ECB's request, an in-depth study of several areas, such as the quality of data collected in accordance with the new "Regulation for Compiling the Monthly Financial Position Report of Monetary Financial Institutions", the feasibility of compiling statistical data on securities' holders, the methodological issues related to the new definition of the term 'money market fund' and operational issues of payment institutions, was conducted.

### BALANCE OF PAYMENTS

The methodology for compiling Latvia's balance of payments was further enhanced in 2010. In April 2010, compilation of data on a security-by-security basis regarding securities without ISIN was commenced in accordance with the Bank of Latvia's Regulation No 43 "Regulation for Compiling Reports on Securities" of 10 September 2009. In addition, the main focus was on the quality of the compiled security-by-security data as contained in the Bank of Latvia's single securities issues and holders database in order to ensure the use of the database also for the compilation of banking and monetary statistics and financial accounts statistics.

The Bank of Latvia's Regulation No 47 "Regulation for Compiling the 'Report and Projections on Long-Term Foreign Debt of Monetary Financial Institutions' " of 5 November 2009 took effect on 1 June 2010, providing for information consistent with the requirements of the IMF and EU and necessary for analysing the external debt, balance of payments and national macroeconomic indicators, and for making projections.

As a result of optimising the compilation of statistical data, the compilation of data on external debt was completely integrated into the system of balance of payments statistics compilation in 2010.

### GENERAL ECONOMIC AND GOVERNMENT FINANCE STATISTICS

Pursuant to the requirements of the ECB, an in-depth study of two issues – data available in Latvia on commercial property and remuneration to employees in the government sector – was conducted. The methodology of quarterly financial accounts was developed in preparation for the release of data planned in 2011. To provide quarterly data on residential property prices to the ECB, the Bank of Latvia developed the methodology for calculating the residential property price index based on the State Land Service data on the registered real estate transactions.

Pursuant to the requirements of the ECB and Eurostat, data were compiled on the measures taken by the Latvian government to prevent crisis in the financial sector in 2010, and their impact on the budget deficit and debt.

## PROVIDING FINANCIAL SERVICES TO THE GOVERNMENT

Pursuant to the requirements of the Law "On the Bank of Latvia", the Bank of Latvia renders several services to the Treasury free of charge, ensuring current account management, acceptance of time deposits, foreign exchange transactions, foreign exchange swaps and interest rate swaps. The Treasury uses on the Bank of Latvia's services for effecting settlement and also takes part in the Bank's payment and settlement systems as a direct participant in the system.

In 2010, the Bank of Latvia continued to manage the Treasury's single settlement account in lats ensuring the processing of budgetary payments: taxes, pensions, social benefits and other payments as well as a timely management of the Treasury's financial resources. The infrastructure developed by the Bank of Latvia enabled the Treasury to process the lats payments in the SAMS and EKS.

In 2010, the SAMS processed 11.5 thousand payments executed by the Treasury in the total amount of 2 630 million lats and the EKS processed 12.2 million payments executed by the Treasury in the total amount of 2 886 million lats.

The Treasury executed large-value and urgent payments via TARGET2-Latvija as a direct participant in the system. The Treasury joined the SEPA Credit Transfer Scheme and, by participating in the EKS euro settlement, made payments to the banks located both in Latvia and outside the country. In 2010, the Treasury executed 19.5 thousand payments via TARGET2-Latvija and their total value was 1 230 million euro, while 15.3 thousand payments with the total value of 16.5 million euro were executed by the Treasury via the EKS.

In 2010, the Treasury's settlement accounts were opened with the Bank of Latvia in nine foreign currencies. Over the year, the Bank of Latvia settled 2 462 payments made by the Treasury in foreign currencies in the total value of 5 218 million lats. The Treasury also placed 969 time deposits with the Bank of Latvia in foreign currencies, and the balance of the Treasury's time deposits was 789.8 million lats at the end of 2010.

The Treasury conducted 84 foreign exchange transactions in the Bank of Latvia in 2010, and the national central bank sold lats and purchased euro in the net amount of 1 258 million lats in the above transactions. In 2010, other foreign exchange transactions and foreign exchange swaps were not effected.

## ADVISORY ACTIVITIES AND INFORMATION TO THE PUBLIC

### ADVISING THE GOVERNMENT

One of the tasks of the Bank of Latvia is to provide consultations to the Republic of Latvia Saeima and the Cabinet of Ministers on the monetary policy and other issues related to the Bank of Latvia's performance of its tasks.

In 2010, the Bank's employees were involved in elaborating a number of draft laws, including the Law on Payment Services, drafting amendments to the Credit Institution Law and the Law on Financial Collateral and the Law "On Settlement Finality in Payment and Financial Instrument Settlement Systems".

The Governor of the Bank of Latvia, other officials of the Bank and its employees held meetings with the representatives of the Republic of Latvia government on a regular basis, took part in the meetings of the Cabinet of Ministers of the Republic of Latvia and participated in the work of different committees established both by the Republic of Latvia Ministries and pursuant to the Prime Minister's Order.

The employees of the Bank of Latvia contributed to Latvia's economic development by participating in different working groups and professional organisations and advising them accordingly.

The Bank of Latvia representatives were actively involved in the updating of the National Euro Changeover Plan within the Money and Payment Systems Working Group. The representatives of the Bank of Latvia continued their participation in monitoring the SEPA Project implementation and took part in drafting additional proposals for Appendix 1 "Action Plan for Introduction of the Single European Currency in Latvia" to Latvia's National Euro Changeover Plan as well as developing Version 2.0 of Latvia's National SEPA Plan.

The Bank of Latvia shared its experience in the management of information system security at the meetings held by the Advisory Council on the security issues of electronic communication and information technologies, thereby enhancing the above area of public administration.

The Bank of Latvia representatives participated in cross-institutional working group responsible for developing the draft Regulations of the Cabinet of Ministers of the Republic of Latvia "Regulation for Planning and Implementing the Security Measures for Information Technologies in Critical Infrastructure".

The representative of the Bank of Latvia took part in the activities of the Accounting Council established in accordance with the Law "On Accounting". The goals of the above Council are to improve the quality of financial statements and harmonise the standards and regulations governing the drafting of financial statements with the International Accounting Standards. The Bank of Latvia's representative, in cooperation with the Ministry of Finance experts, engaged in the elaboration of other laws and regulations governing the accounting.

The employees of the Bank of Latvia, in the capacity of experts, took part in the preparation of the CSB Tables of the general government budget deficit and debt notification (for spring and autumn 2010) and dealt with the above methodology-related issues.

The Bank of Latvia representatives were involved in drafting reports on Latvia's credit rating and its driving factors within the working group established for improving cooperation with the international rating agencies, provided proposals for further enhancement of cooperation as well as ensured the exchange of information for the purpose of hosting regular visits of the representatives of the above agencies.

## OPERATION OF THE VISITORS CENTRE

The Bank of Latvia Visitors Centre "Money World" is an informative and educational hub offering a wealth of interactive opportunities and promoting public awareness of central bank functions and financial issues. In 2010, it had 8.5 thousand visitors (6.5 thousand in 2009). Moreover, with the Bank of Latvia participating in the Museum Night 2010, the Centre received around 8.5 thousand more visitors.

Young people studying economics (secondary school seniors and students taking social sciences) are the primary target audience of the Visitors Centre: they accounted for almost 80% of total attendance. Due to the economic crisis, students from more distant Latvian regional schools visit the Centre less frequently already for the second subsequent year.

The overwhelming presence of youth among the visitors is of importance also because the information communicated by the Centre helps them master educational programmes; likewise, dialogues commencing during visits and the demand for materials suggest that the discussion of macroeconomic and financial topics is afterwards kept alive by public at large.

The topics about lats stability, deflation and regaining of economic competitiveness were among the most discussed in 2010. They gave rise to the updating of displays that tackle currency pegging and central bank's intervention mechanism in an interactive way; at the same time, the information about foreign currency management is provided in a more streamlined way. In cooperation with the Association of Latvian Commercial Banks, an interactive stand on commercial bank operation and four supportive educational multimedia programmes have been developed for visitors to grasp the meaning of currency circulation within the two-level banking system more readily. The display on anti-counterfeiting features and measures has been subject to upgrading as well.

The visitor surveys of previous years have produced high estimates of information comprehensiveness and the quality of presentation; this positive estimation and the willingness to devote more time to the exploring of interactive displays individually are alive today as well.

COMMUNICATION ACTIVITIES

The Bank of Latvia's communication with public at large and individual groups was primarily determined by economic and financial market developments in Latvia. On the one hand, the economic growth was characterised by the revival of economic activity, with exports expanding and domestic consumption gradually steadying. On the other hand, it was of crucial importance to keep on along the macroeconomic stabilisation path via minimising the budget deficit and thus aspiring for an environment supporting the reduction of external debt in the medium run. Meanwhile, the external markets were affected by such important events as sovereign debt crises in a number of EU countries, the extension of the euro area with Estonia joining it, and global food and energy price hikes, which adversely impacted the price dynamics in Latvia as well.

The Bank of Latvia furnished ample information on macroeconomic research and financial market analysis carried out by the Bank of Latvia Council and staff, used in consulting the government and required by economic agents for understanding current circumstances and further decision-making trends. After each regular Bank of Latvia Council meeting, the Governor presented an account of macroeconomic developments to mass media. Statistics of Latvia's balance of payments, foreign debt, banking sector, monetary operations, securities transactions and payment systems were released on the Bank of Latvia website. The central bank regularly issued a number of publications communicating comprehensive information about the developments in Latvia's financial sector and national economy. Thus, the *Bank of Latvia: Annual Report 2009* contained information on central bank operations and financial performance, with the economic developments in Latvia analysed in the context of global economic growth. Incorporating the data provided by the Bank of Latvia, CSB, Ministry of Finance, and FCMC, the quarterly *Macroeconomic Developments Report* discussed the developments of external sector and exports, financial markets, domestic demand and supply, costs and prices, and balance of payments, and presented economic growth forecasts and inflation projections. The monthly *Monetary Bulletin* furnished concise information on economic and monetary developments. The *Financial Stability Report* analysed the impact of the changing economic environment on financial developments, while the publication *Payment System Oversight Carried out by the Bank of Latvia in 2009* discussed the implementation of tasks in the area of payment systems stipulated under the Law "On the Bank of Latvia". In order for the central bank to make well-considered and responsible monetary decisions, the Bank of Latvia experts carried out in-depth research, enticing the public into debate on key topics (see Chapter "Economic Research, Analysis and Forecasting" and Appendix 8).

With the volume of information on the Bank of Latvia's website augmenting, a project of the website transformation to improve its functionality and information structure and, thus, streamline the process of information searching, obtaining and using, was launched in 2010. During Phase 1 of the project, the website www.bank.lv was restructured and makroekonomika.lv, a new website dedicated to the Latvian economy and its development, was created. On this website for economic experts, the Bank of Latvia staff members publish their commentaries, articles, presentations, research papers and opinions, which simultaneously constituted a high-quality survey of Latvia's overall economic situation.

In order to promote a deeper understanding of economists and stakeholders about the analysis of and developments in the national economy and to entice them into debate, the related issues were discussed at the conference hosted by the Bank of Latvia, during several roundtable discussion sessions of the central bank's experts, and, likewise were in the focus of the Bank of Latvia management and staff activities in the forums organised by other institutions. At the annual conference *Latvia Beyond the Crisis: Towards Sustainable Economic Growth* hosted by the central bank and held on 20 October 2010, the participants – academics and researchers, entrepreneurs, experts in finance and mass media representatives among them, held a debate about how, amidst the crisis, to lay a foundation for sustainable growth that would boost public and private income and minimise the risk of a new price and real estate bubble.

At the Bank of Latvia roundtable discussions, experts focused on crucial economic problems. Thus, the roundtable *Euro 2014: Why Latvia Needs to Set Such Goal and How to Attain It* summed up the stances on advantages offered by single European currency and issues it would or would not solve, why a target changeover date is necessary, and what should be done to attain the goal set. During the roundtable *Fiscal Policy: 180-degree Change in Thinking*, those involved in government budget planning, social partners and experts gathered information on what, why and by what means should be done in the fiscal domain regarding the 2011 budget and beyond in the context of Latvia's economic situation and European developments. At the discussion *Price Setting Behaviour in Latvia*, the Bank of Latvia experts together with the representatives of merchants and the Public Utilities Commission, sociology and psychology experts sought for the answers to such questions as whether prices react promptly to the changes in economy, how price and cost elasticities affect the process of regaining competitiveness, and what factors make merchants change prices, using a vast set of microdata for the purpose. The roundtable *Currency in Circulation* dealt with the situation in lending, sought to identify factors hampering the operation of the Latvian currency circulation mechanism, assessed processes and mechanisms the interrelation of which would support elimination of the related barriers, and weighed up the other countries' experience.

Public perception and sentiment are important factors for overcoming an economic crisis and achieving future growth, and they are largely dependent on the understanding of macroeconomic processes and decisions. Hence communicating macroeconomic and financial developments to the general public and specific target groups is a key communication area for the Bank of Latvia. In cooperation with the Bank of Latvia and using its staff expertise and analysis, an educational weakly broadcast *Naudas zīmes* was produced by the national TV channel and a radio broadcast *Lata spogulī* by Latvia's Radio, both attracting a vast audience. In cooperation with the EU information centres coordinated by the Ministry of Foreign Affairs of the Latvian Republic, the Bank of Latvia experts delivered open lecture series on economic developments at city libraries. Around 50 analytical articles by the Bank of Latvia economists have appeared on the Internet, and the large number of interviews with the Bank of Latvia Governor and experts testifies to mass media interest.

Within the framework of a long-term project to encourage the addressing of macro-economic issues of the day, the Bank of Latvia organises a competition for students' research papers, with 5 papers (out of 23 submitted) awarded in 2010; they were addressing such crucial economic topics as the maturity of the Baltic States for the euro changeover, internal devaluation scenario and its appraisal, the real effective exchange rate of the lats, Latvia's competitiveness, and convergence of the Latvian households' consumption levels towards the other EU countries.

The Bank of Latvia ensures smooth circulation of cash and non-cash currency for the economy, therefore regular provision of information to the general public and stakeholders on related events and projects is of great significance.

On 15 May 2010, the international Museum Night, the Bank of Latvia opened the doors of its central premises to visitors to share useful and interesting information about the national currency, its issuance, use, security features and artistic value. Visitors could use the opportunity to get first-hand information about economic developments in Latvia from the Bank of Latvia economic experts and to attend "Money World", the information and education centre of the Bank of Latvia.

As since 9 November 2010 the Bank of Latvia ensures safe and effective infrastructure for EKS payments in euro, which banks in Europe provide for their customers, in cooperation with the Association of Latvian Commercial Banks it hosted a seminar for mass media representatives to inform stakeholders, entrepreneurs in particular, about the advantages of the infrastructure and preparatory activities to be performed by bank customers; likewise, analytical materials for business media were disseminated.

In order to test the public assessment of work done in the field of collector coins and to identify the most attractive topics and artistic solutions, the Bank of Latvia held the traditional public survey on the most popular collector coin and welcomed everyone to vote for *Latvia's Coin of the Year 2009*. The survey was supported by the network of public libraries, National Library of Latvia, project *Trešais tēva dēls* of the State Agency "Cultural Information Systems", and *100 g kultūras*, a sequence of TV shows on the national TV channel; 44.1% of the total of 10 120 votes cast and the title *Latvia's Coin of the Year 2009* went to *Water Coin* struck by *Rahapaja Oy* (artists Ilmārs Blumbergs and Jānis Strupulis).

**COOPERATION WITH INTERNATIONAL ORGANISATIONS AND FOREIGN CENTRAL BANKS**

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

In 2010, the Bank of Latvia continued to represent Latvia's interests at the meetings of the IMF Board of Governors as well as in the coordination of routine issues. Latvia's interests in the IMF were represented in the Nordic-Baltic Constituency that includes Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden. One Executive Director represented this constituency on the IMF Executive Board, with a total of 3.43% votes.

Representatives of the Bank of Latvia continued to participate in the work of the Nordic-Baltic Monetary and Financial Committee established for developing strategies and guidelines and preparing a joint opinion on operational issues of the IMF. The most important policy issues on the IMF agenda in 2010 were the IMF quotas and governance reform, IMF finances and lending instruments as well as the strengthening of the financial sector oversight.

Cooperation with the IMF continued in 2010 under a 1.52 billion SDR Stand-By Arrangement towards the implementation of Latvia's economic stabilisation and recovery plan. In February and July, the Executive Board of the IMF completed the second and the third review of Latvia's programme under the Stand-By Arrangement.

Cooperation with the IMF continued in 2010 within the framework of regular monitoring or Article IV Consultations. In July, the Executive Board of the IMF reviewed the IMF Staff report on Latvia's macroeconomic and financial sector developments as well as the implemented economic policy.

The Bank of Latvia continued its membership in the BIS.

In 2010, the Bank of Latvia continued its cooperation with the central banks of other countries, sharing expertise and information. The Bank of Latvia organised several international meetings and seminars. In May, ESCB training seminar "Economics for Non-Economists" was held. The current seminar for the Baltic central banks was organised in June, where the participants discussed topical issues in the fields of macroeconomics, international relations and document management. In July, the Bank of Latvia hosted the meetings of two ESCB committees, Banking Supervision Committee and Internal Auditors Committee, in Latvia. A Nordic-Baltic central bank personnel managers meeting was held in August. In October, the Bank of Latvia hosted an ESCB project management methodology seminar. In November, a seminar entitled "Latest Banking Developments" was organised by the ECB in Riga for translators, terminologists and editors of the ECB and the Bank of Latvia.

In April, the Bank of Latvia experts provided consultations to the State Statistics Committee of Ukraine on compiling and calculating indicators characterising the performance of credit institutions for the purposes of structural business statistics according to the EU standards.

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

The Bank of Latvia's employees participated in courses held by the ECB, the IMF Institute, the Joint Vienna Institute, Société Générale, HSBC, Commerzbank AG and European Institute of Public Administration, and also in seminars organised by the central banks of Austria, Belgium, the Czech Republic, Denmark, France, Italy, Lithuania, the Netherlands, Poland, Switzerland, the UK and Turkey, and the Federal Reserve Bank of New York. The Bank of Latvia's employees also went on experience exchange visits to the central banks of Belgium, Estonia, Italy and Lithuania.

# BANK OF LATVIA MANAGEMENT AND ORGANISATION

## BANK OF LATVIA ORGANISATIONAL STRUCTURE

| | | |
|---|---|---|
| Governor's Office | COUNCIL | Internal Audit Department |
| | BOARD | |
| Monetary Policy Department | Cashier's and Money Operations Department | Market Operations Department |
| Statistics Department | Riga Branch | Payment Systems Department |
| International Relations and Communication Department | Daugavpils Branch | Accounting Department |
| | Liepāja Branch | Information Systems Department |
| Security Department | Personnel Department | |
| Technical Support Department | Training Centre | Legal Department |

### THE COUNCIL OF THE BANK OF LATVIA

The Council of the Bank of Latvia takes decisions on behalf of the Bank of Latvia. The Council of the Bank of Latvia comprises the Governor, Deputy Governor and six members whose term in office is six years. The composition of the Council of the Bank of Latvia, as at the end of 2010, was as follows:

– Governor **Ilmārs Rimšēvičs**;

– Deputy Governor **Andris Ruselis**;

– Members of the Council: **Leonīds Gricenko**, **Vita Pilsuma**, **Arvils Sautiņš**, **Aivars Skopiņš**, **Valentīna Zeile**.

On 1 July 2010, the term in office of four Members of the Council of the Bank of Latvia ended, and the Saeima of the Republic of Latvia appointed Mr. Leonīds Gricenko, Mr. Arvils Sautiņš and Mr. Aivars Skopiņš for another term in office. One position of the Member of the Council of the Bank of Latvia was vacant from July 2010 to February 2011.[1]

The Bank of Latvia's Council meetings are held as appropriate, but at least once a quarter. 14 Bank of Latvia's Council meetings were held in 2010. To establish and implement monetary policy, the Council of the Bank of Latvia conducted an in-depth assessment of monetary and economic developments and adopted legal acts related to the implementation of monetary policy (including three legal acts related to interest rates on transactions and one – to monetary policy instruments).

When performing other tasks set forth by the Law "On the Bank of Latvia", the Council

[1] As of 17 February 2011, the Saeima of the Republic of Latvia appointed Ms. Zoja Razmusa Member of the Council of the Bank of Latvia.

of the Bank of Latvia adopted 129 legal acts overall in 2010 (including 16 legal acts in the area of the operation and oversight of the payment and settlement system, five in the area of the Credit Register operation, two in the area of the foreign reserves management, one in the area of the financial market and monetary statistics, six in the area related to currency in circulation and four in the area of licensing and supervising the purchase and sales of cash foreign currency).

THE BOARD OF THE BANK OF LATVIA

To conduct and manage day-to-day activities, the Council of the Bank of Latvia has established the Board of the Bank of Latvia that is comprised of six members and performs activities on a continuous basis. In 2010, the composition of the Board of the Bank of Latvia was as follows:

| | |
|---|---|
| Chairman of the Board | **Māris Kālis**; |
| Deputy Chairman of the Board | **Reinis Jakovļevs**; |
| Members of the Board: | **Andris Ņikitins**,<br>**Harijs Ozols**,<br>**Ilze Posuma**,<br>**Raivo Vanags**. |

The Board of the Bank of Latvia conducted the daily activities of the Bank in compliance with the requirements of the Law "On the Bank of Latvia" and other legal acts, as well as the Bank of Latvia's Council decisions on monetary policy and other areas of the operational activities of the central bank. The Board of the Bank of Latvia adopted 191 legal acts in the areas of conducting daily activities of the central bank. The Board of the Bank of Latvia drafted 44 legal acts for the Council of the Bank of Latvia and submitted to it 23 reports concerning the operation of the central bank.

EMPLOYEES OF THE BANK OF LATVIA

At the end of 2010, the number of the Bank of Latvia's employees was 570, of which 13 were employees with a fixed term job contract (618 and 17 employees at the end of 2009 respectively). As at the end of 2010, the Bank's staff was 58% male and 42% female.

To ensure exchange of information between the Bank of Latvia and the EU institutions, Counsellor of the Bank of Latvia at the Permanent Representation of Latvia to the EU continued his work in 2010.

Structural improvements continued at the Bank of Latvia in 2010. To improve the efficiency of document management and internal and external communication and to optimise staff resources, structural changes were made, – the functions of the Communication Department, the Public Relations Department and the International Department were merged and the International Relations and Communications Department was created.

In 2010, changes were introduced also in operational organisation of other Bank of Latvia structural units. The staff number has been reduced in the Statistics Department and the Training Centre.

Due to changes introduced in operational organisation of banks operating in Rēzekne region, the Rēzekne Branch was closed in 2010.

COMMISSIONS AND COMMITTEES OF THE BANK OF LATVIA

In order to ensure successful and secure performance of the Bank of Latvia's tasks, several committees, commissions and working groups approved by the Council of the

Bank of Latvia, the Governor of the Bank of Latvia and the Board of the Bank of Latvia continued to work in 2010. The following committees and commissions related to the central bank principal activities have been established at the Bank of Latvia.

| | |
|---|---|
| The Bank of Latvia Audit Committee | The Bank of Latvia Expert Commission |
| The Bank of Latvia Budget Commission | The Bank of Latvia Information Systems Management Committee |
| The Bank of Latvia Coin Design Commission | The Bank of Latvia Licensing Committee |
| The Bank of Latvia Commission for Assessing the Quality of Lats Banknotes | The Bank of Latvia Operational Risk Management Committee |
| The Bank of Latvia Commission for Examination of Lats Banknotes and Coins | The Bank of Latvia RIGIBID and RIGIBOR Commission |
| The Bank of Latvia Ethics Committee | The Bank of Latvia Security Oversight Commission |

The Euro Settlements Implementation Working Group of the Bank of Latvia has made a significant contribution to the preparation for the euro changeover (its task is to ensure successful introduction of euro cash and non-cash settlements in the Republic of Latvia), but the working group dealing with the cooperation with the ESCB coordinated the work and ensured exchange of information.

The Bank of Latvia Audit Committee for and on behalf of the Council of the Bank of Latvia conducted the oversight of the internal auditing function, the activities of the Bank of Latvia's external auditors and the drafting of financial statements, as well as enhanced the operation of the Bank of Latvia's internal control system. A wide range of issues related to security were addressed by the Bank of Latvia Security Oversight Commission with a view to monitor the compliance with the requirements of "The Bank of Latvia Risk Management Policy", "The Bank of Latvia Business Continuity Policy", "The Bank of Latvia Physical Security Policy" and "The Bank of Latvia Information and Information Systems Security Policy". The Bank of Latvia Information Systems Management Committee monitored and coordinated the issues related to the operation of the Bank of Latvia's information systems, the security and development, as well as the processing of personal data. At the same time, the Bank of Latvia Operational Risk Management Committee supervised the operational risk management at the Bank of Latvia.

The Bank of Latvia Commission for Assessing the Quality of Lats Banknotes monitored the degree of wear-and-tear, cleanliness and damage of the Bank of Latvia banknotes, while the Commission examining the Bank of Latvia's banknotes identified the counterfeits of lats banknotes and established the procedure for identifying the damaged lats banknotes as legal tender and replacing the damaged banknotes with valid ones. To ensure that the specific requirements set out for purchasing and selling cash foreign currency in a way of a financial service, including in the area of customers' physical security and confidentiality of transactions, the protection of consumer rights, the prevention of laundering of proceeds derived from criminal activity, are met as well as to establish the reputation of the financial transaction market of the Republic of Latvia in the area of commercial activity that is related to purchasing and selling cash foreign currency, the Bank of Latvia Licensing Committee licensed capital companies, i.e. granted, re-registered, rewrote, suspended and revoked licenses for purchasing and selling cash foreign currency.

The Bank of Latvia Budget Commission whose aim is to submit the draft budget of the Bank of Latvia to the Bank of Latvia's Council for approval, provided that the Bank of Latvia's financial resources are balanced and used in alignment with the envisaged purposes, and to follow the process of monitoring the utilisation of the financial resources, contributed to the management of the Bank of Latvia's operational activity. The Bank of Latvia RIGIBID and RIGIBOR Commission coordinated all the measures related to the calculation of RIGIBID and RIGIBOR. At the same time, the Bank of Latvia Expert Commission whose aim is to examine the value of documents, to prepare the document nomenclature, to establish the terms of document storage and to address other issues related to the document management, ensured the fulfilment of the requirements of "The Procedure for the Document Management at the Bank of Latvia" within the context of the Bank of Latvia's archive activities and the preparation for the fulfilment of the requirements of the Law "On Archives" (in effect as of 1 January 2011). The Bank of Latvia Ethics Committee monitored the compliance with the "Bank of Latvia's Code of Conduct".

**MANAGEMENT PRINCIPLES AND DEVELOPMENT**

The Bank of Latvia's management must ensure an excellent implementation of the tasks stipulated in the law "On the Bank of Latvia" on a sustainable basis. The Bank of Latvia's management is based on the Plan, Do, Check and Act cycle.

Objectives set during the planning process are reflected in the Bank of Latvia's statements of its vision, mission and values. Strategic guidelines of the Bank of Latvia outline the core development concepts of the Bank of Latvia for the period of 2008–2011 on the basis of which work plans are prepared. Their implementation ensures the achievement of the strategic goals and improvement of management processes.

The fulfilment of the daily tasks and duties of the Bank of Latvia is ensured by its staff; therefore, motivation, creative approach and responsibility are essential for the Bank to operate successfully. The Bank of Latvia's basic values are as follows: orientation towards service quality and result, use of modern technologies and corporate governance principles, teamwork, maintaining favourable working environment, professionalism, ethical attitude towards work and colleagues and civic qualities.

Every year, the progress towards achieving the set objectives is measured. Implementation of functions and processes is monitored daily, implementation of work plans is reviewed on a quarterly basis and customer satisfaction surveys are conducted every year asking customers to assess the quality of the Bank of Latvia's services, the level of their accessibility and convenience, competence and responsiveness of staff. The Board of the Bank of Latvia evaluates the overall performance of the Bank of Latvia and submits an annual report to the Council of the Bank of Latvia on the achievement of the strategic goals, functional goals, results of the customer satisfaction survey and employee survey, employee and customer complaints and suggestions, results of operational risk and business continuity management.

In 2010, Bank of Latvia services scored 4.37 on a scale of 1 to 5 with the customers (4.51 in 2009). The performance of the Bank of Latvia in providing cash currency, settlement services, operation of payment systems and providing statistics is valued the most highly by the customers.

The Bank of Latvia's employee survey provided quality evaluation of the implementation of support functions. Areas with lower scores were analysed on their merits, identifying the required improvements in conducting of functions and processes.

Various improvements were introduced in 2010 on the basis of the previous year results, including the operation of the Credit Register was improved, information search facilities on the Bank of Latvia's website were upgraded, shorter deadlines for publishing statistics were provided, communication with the general public and document management system were improved.

The following development measures were implemented in 2010: more efficient Personnel and salary management system was introduced, securities oversight function was restructured, the technological solution for data storage was improved, structural changes in the area of communication were implemented and the level of the physical security services was improved.

In further improvement of the Bank of Latvia's management processes, Common Assessment Framework was used. It enables detection of any gaps in the management of strategy, resources, staff and processes, and in leadership, as well as provides an opportunity to measure the results achieved vis-á-vis customers, staff and general public.

## RESOURCE MANAGEMENT

### HUMAN RESOURCES

In 2010, the Bank of Latvia continued to pursue its key principles of human resource policy: it hired well-qualified and professional staff members and established long-term working relationships, creating a motivating work environment, providing professional development opportunities, and, in return, expecting the employee to demonstrate a high quality performance, reach the pre-set goals, display initiative, creative approach and loyalty.

With a view to improving the quality of the human resource management and accessibility of information as well as to achieving more efficient use of the human resource management resources, the Bank of Latvia implemented an integrated Personnel and salaries management system in 2010, which complies with modern demands and ensures an easy-to-use IT environment and wide functionality.

In 2010, the staff position evaluation methodology was improved, evaluation criteria were further specified and, on the basis of that, qualification requirements were approved for each staff position stating the required type and degree of education, specialised expertise and professional qualifications, duration of professional work experience, foreign language proficiency, IT skills and levels of social competencies.

Similar to the previous years, for the purposes of personnel development the Bank of Latvia used internal and external rotation and personnel training. Internal rotation allows the employees to enhance their professional knowledge, develop skills and build their careers within the Bank of Latvia. External rotation enables the staff to broaden their international work experience.

In 2010, two employees were promoted to other structural units of the Bank of Latvia as a result of internal recruitment, 34 employees were promoted within the same structural unit, and 2 employees were replacing colleagues in long-term absence. Four Bank of Latvia staff members were on short-term secondment with the ECB and complemented their knowledge in the area of economics, whereas one employee gained work experience with the IMF.

Sharing the responsibility about training and development between the employees and the Bank of Latvia is an important element of human resource policy. Implementing this principle, the Bank of Latvia provides budgetary resources and a training programme, whereas the employees are expected to upgrade their expertise and skills on a continuous basis. The Bank of Latvia staff training costs amounted to 1.5% of the total expenses on remuneration (1.9% in 2009).

The Bank of Latvia staff continued to broaden their expertise in the fields of monetary policy, financial stability, macroeconomics, econometrics, financial markets, statistics, bank accounting, audit, personnel management, law, risk management and information technologies. A number of the Bank's employees successfully participated in international professional certification programmes.

Improvement of the social competencies of staff that started in 2009 within the framework of the Talent Management Project continued: appropriate training courses, coaching and other practical methods were used, particularly emphasising the direct managers' responsibility for developing employee competencies. Four seminars were organised in 2010 to develop communication and information sharing skills as well as problem solving skills, and a teambuilding workshop. The heads of the structural units of the Bank of Latvia strengthened the management skills acquired under the management training programme in 2009 in "The Best Practice Day" as well as discussed topical human resource management issues.

With the aim to increase awareness about the functions of the Bank of Latvia and to inform about the latest developments, various seminars were delivered by the Bank of Latvia experts. In 2010, such seminars were held on market operations, latest macroeconomic developments and other significant issues relating to the Bank of Latvia operation.

## FINANCIAL RESOURCES

The Bank of Latvia financial management system has been developed to support decision making, financial risk management and ensure spending efficiency.

The Bank of Latvia's operation is mainly financed from income received from foreign currency and gold reserves management. The Bank of Latvia does not receive financing from the state budget. Instead, it transfers 65% of its profit of the reporting year to the state budget. In 2010, the Bank of Latvia earned 23.8 million lats in profit; of that, 15.4 million lats will be transferred to the state budget. The Bank of Latvia has appropriated a total of 103.4 million lats from its profit earned in 2005–2009 to the state budget.

Major financial transactions of the Bank of Latvia are related to the management of foreign reserves and implementation of monetary policy. Foreign reserves are managed in compliance with the basic principles set out in the "Guidelines for Managing the Bank of Latvia's Foreign Reserves" as approved by the Council of the Bank of Latvia, inter alia preserving the value of foreign reserves, ensuring their liquidity and earning income within the framework of acceptable risk, and without prejudice to the monetary policy pursued by the Bank of Latvia. The Bank of Latvia performs operations related to the implementation of monetary policy in line with the "Regulation for the Use of the Bank of Latvia's Monetary Policy Instruments" as adopted by the Council of the Bank of Latvia.

In order to ensure comprehensive and transparent information about the Bank of Latvia's financial transactions, financial risks and their management as well as the Bank of Latvia's operational results, the Bank of Latvia prepares and publishes annual financial statements. They are prepared in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Bank of Latvia's Council, organising accounting in line with the "Bank of Latvia Financial Accounting Regulation" approved by the Board of the Bank of Latvia and other regulations of the Bank, in compliance with the Law "On the Bank of Latvia" and other laws and regulations binding on the Bank of Latvia. "Financial Accounting Policy of the Bank of Latvia" stipulates that events and financial transactions of the Bank of Latvia relating to the implementation of monetary policy and management of foreign reserves are accounted for in accordance with the principal accounting policies established by the ECB Guideline of 10 November 2006 on the legal framework for accounting and financial reporting in the ESCB (ECB/2006/16), at the same time taking into consideration that the Bank of Latvia is not yet a participant of the Eurosystem. It also stipulates requirements regarding Notes to annual financial statements.

The Bank of Latvia publishes a monthly closing balance sheet and notes to it, as well as other financial information, also available on the Bank of Latvia's website. The Bank's integrated information system ensures a standardised, automated, safe and efficient execution of the Bank of Latvia's financial transactions and uniform accounting for and financial reporting on them. The management of the Bank of Latvia and other employees also receive information about the Bank of Latvia's financial position, performance results and budget implementation on a daily basis. Within the framework of the internal financial control system, the Bank of Latvia's top management assesses, on a regular basis, changes in the Bank of Latvia's assets and liabilities as well as income and expenses, paying particular attention both to the results from managing foreign currency and gold reserves as well as to the consistency of operating costs and long-term investment with the Bank's approved budget.

The Council of the Bank of Latvia approves the Bank of Latvia's annual budget; the management of the budget is carried out in compliance with the "Regulation for Managing the Bank of Latvia's Budget" approved by the Council of the Bank of Latvia and aimed at ensuring spending efficiency. The Regulation provides for the procedure of drafting, approving and monitoring the execution of the Bank's budget. Within the budget management framework, the Bank of Latvia assesses the effectiveness, costs and human resources of each project on a continuous basis in order to ensure efficient use of funds. To support the independence of internal audit, the Bank of Latvia's Council approves a separate expenditure plan for the Internal Audit Department.

The Bank of Latvia's Council has set up a Budget Commission, comprising at least five members of the Bank of Latvia's Council. The main tasks of the Bank of Latvia Budget Commission are evaluation of the draft budget prepared by the Board of the Bank of Latvia and oversight of the budget execution. The key budget management tasks of the Bank of Latvia's Board are to prepare the draft budget in collaboration with the heads of relevant organisational units and to submit it to the Bank of Latvia Budget Commission and the Council as well as to report on budget execution on a regular basis.

## INFRASTRUCTURE RESOURCES

### Engineering and technical infrastructure resources

*Buildings*

The Bank of Latvia maintains the infrastructure necessary for its operation in good condition. In preparation for the euro changeover and taking into account the need to service customers in comfortable and safe conditions in several cashier's offices simultaneously, in 2010, continuing the implementation of the restoration and reconstruction project of the Bank of Latvia building at K. Valdemāra iela 1B in Riga, the development of the construction plan has been completed and as a result of public procurement procedure a construction works contract has been awarded to *Skonto Būve Ltd*., the successful tenderer, in the amount of 4.2 million lats. The building is planned to be ready for use in the middle of 2012. The Statistics Department, Payment Systems Department and Cashier's and Money Operations Department will have their work premises in the renovated building. The ground floor will house cashier's offices, and recipients of Credit Register data will be serviced on the first floor. The second floor of the building is planned for conference, workshop and training premises.

Given the fact that the work premises of the Statistical Department are in the building under reconstruction, the department had to move to the premises at Pils laukums 4 in Riga, rented for this purpose from the SJSC *Valsts nekustamie īpašumi* since May 2010.

To enhance the security of cash unloading and loading operations, the cash loading hall at the Liepāja Branch building was reconstructed in 2010. Minor construction works were also performed at the building of the Daugavpils Branch and the Training Centre building in Jūrmala.

*Engineering and technical systems*

In order to strengthen security at the Bank of Latvia, the reconstruction project of the Bank of Latvia video surveillance and video recording systems was continued in 2010, completing its implementation at the Riga Branch building and beginning its final stage in other Bank of Latvia buildings.

Reconstruction of the building access system of the Liepāja and Daugavpils Branches was carried out, installing a uniform system in all the buildings of the Bank of Latvia (except the Training Centre); also, the reconstruction of the security alarm system of the Liepāja Branch building was completed at the end of the year.

In 2010, drafting of construction plans of new external power supply lines for the Bank of Latvia's buildings at K. Valdemāra iela 2A and K. Valdemāra iela 1B in Riga was completed and a connection agreement on the construction of a new power supply line for the building at K. Valdemāra iela 2A was signed with the JSC *Sadales tīkls*. The construction of the lines is planned in 2011 after a connection agreement has been signed with the JSC *Sadales tīkls* also for the building at K. Valdemāra iela 1B in Riga.

**Information technologies**

In 2010, an electronic management system for the users of the Bank of Latvia's payment systems, the Credit Register, and the statistical data reporting system was implemented, thus enabling the participants of the above systems to manage the relevant system users on-line.

The enhancement of the Bank of Latvia's electronic document management system continued in 2010, expanding the function of electronic circulation of general correspondence and official documents, thus notably improving and accelerating the electronic document flow. The function of electronic reconciliation of invoices issued by the Bank of Latvia was introduced, ensuring that majority of these invoices were mailed electronically. The scope of counterparties using digitally signed documents in correspondence expanded considerably.

The implementation of the server consolidation project continued. By way of using virtualisation technologies and further reducing the number of individual physical servers, both maximum utilisation of server capacity and cuts in costs related to the maintenance of the server infrastructure, inter alia those of power consumption and software licences, were achieved. The use of virtualisation technologies was expanded, ensuring more efficient management and higher level of availability of the respective resources.

The green computing approach was applied also in 2010, further reducing the volume of power consumption and increasingly using a more environment-friendly and economical way of printing as well cutting down the total volume of printing work, inter alia on account of an increase in the share of electronically exchanged information.

Optimisation of external communications infrastructure was implemented successfully, reducing the number of specialised connections and using internet on a wider scale instead, thus decreasing the solutions related to ensuring the respective communications without expanding risk levels and at the same time upgrading the internet connection. Now higher speed and availability is ensured by two independent service providers at a lower total cost.

Modernisation of the Bank of Latvia's centralised data storage and management system was implemented in 2010, providing high-speed and high-availability data storage resources for the Bank of Latvia critical and top-importance information systems thus ensuring additional space for saving and processing the increasingly growing volume of information as well as improving the system business continuity and speed levels.

The unified telecommunications solution project was continued to ensure a larger part of the Bank of Latvia staff with a considerably expanded functionality, including a faster and more comprehensive communication and information flow relevant for quality performance of job duties.

**RISK MANAGEMENT**

The Bank of Latvia manages strategic, financial and operational risks. The Bank of Latvia's risks are managed pursuant to "The Bank of Latvia Risk Management Policy", "The Bank of Latvia Business Continuity Policy", "The Bank of Latvia Information and Information Systems Security Policy", and "The Bank of Latvia Physical Security Policy" adopted by the Council of the Bank of Latvia. The Bank of Latvia's Security Supervision Commission carries out a comprehensive and uniform oversight of the policies.

The Bank of Latvia's financial risks are managed in line with the "Guidelines for Managing the Bank of Latvia's Foreign Reserves" reviewed by the Bank of Latvia Council at least once a year and amended as necessary.

The Bank of Latvia manages its operational risks related to processes and projects in compliance with the "Regulation for the Management of the Bank of Latvia Operational Risks" adopted by the Board of the Bank of Latvia. The processes are classified by significance and criticality, depending on their impact on the execution of the Bank of Latvia core functions or attainment of the Bank of Latvia objectives. Risks are identified, analysed and appraised, opting for the most appropriate risk hedging measures. The management of operational risks is conducted by the Bank of Latvia employees who are responsible for the Bank of Latvia processes. Operational risk management is supervised by the Bank of Latvia Operational Risk Management Committee appointed by the Board of the Bank of Latvia, which ensures the coordination of the daily activities under the risk management process and gives support to the Board of the Bank of Latvia in the area of risk management.

Within the framework of the Bank of Latvia business continuity management process, the main focus in 2010 was on the improvement of business continuity management, including structural updating of action plans; likewise, tested and improved were the solutions to ensure Bank of Latvia's business continuity in the case of unavailability of central bank buildings in Riga.

Based on the information system risk management methodology, the risk analysis of Bank of Latvia's critical and top-importance information systems was carried on in 2010. The risk analysis of information system development and upgrading projects was also conducted.

In April 2010, the Board of the Bank of Latvia reviewed and approved the Bank's risk report and submitted to the Council of the Bank of Latvia a statement about the situation in the area of risk management in the previous year. The Bank of Latvia was not exposed to such risks that would have substantially interfered with its business. The staff members received training in the areas of information and information system security, business continuity and risk management.

**INTERNAL AND EXTERNAL AUDIT**

By an unbiased examination of the Bank's functions and processes, the internal audit provides the management of the Bank of Latvia with an independent evaluation of the effectiveness of risk management, control systems and processes and gives recommendations for their improvement. At the Bank of Latvia, the internal audit is conducted by the Internal Audit Department. The Audit Committee of the Bank of Latvia supervises the internal audit process and supports its development.

The internal audit is organised and conducted according to "The Internal Audit Policy of the Bank of Latvia" approved by the Council of the Bank of Latvia. In its conduct, the Institute of Internal Auditors' "International Standards for the Professional Practice of Internal Auditing" and the "Code of Ethics", as well as CobiT (Control Objectives for Information and Related Technology) and ISACA (Information System Audit and Control Association) standards are applied.

The internal audit covers all business areas of the Bank of Latvia operation. Internal audits are planned and conducted on the basis of risk assessment. The outcomes of each internal audit are reported to the Bank of Latvia Governor and the Audit Committee. The Bank of Latvia Audit Committee jointly with the Head of Internal Audit Department reviews the findings of internal audit, recommendations and their implementation on a quarterly basis. The results of internal auditing are reported to the Council of the Bank of Latvia once a year.

The Internal Audit Department carries out internal auditing at the Bank of Latvia also in line with the audit plan of the ESCB Internal Audit Committee; in 2010, an employee of the Internal Audit Department of the Bank of Latvia conducted such an audit at the Central Bank of Malta.

In 2010, the external assessment of internal audit quality confirmed that the internal audit practice of the Bank of Latvia complies with the Institute of Internal Auditors' "International Standards for the Professional Practice of Internal Auditing" and the "Code of Ethics" as well as the requirements of the Audit Manual of the ESCB Internal Auditors Committee. The external assessor of internal audit quality submitted recommendations for further improvements of the internal audit quality. To implement them, an action plan for improving the internal audit process was approved at the end of 2010, including the implementation of specific internal audit management and documentation software.

In compliance with the Law "On the Bank of Latvia", the central bank's business activities and financial statements of the reporting year are audited by an Audit Commission whose composition is approved by the State Audit Office of the Republic of Latvia.

# FINANCIAL STATEMENTS OF THE BANK OF LATVIA FOR THE YEAR ENDED 31 DECEMBER 2010

# BALANCE SHEET





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

| ASSETS | Notes[1] | **2010** | 2009 |
|---|---|---|---|
| FOREIGN ASSETS | | **4 074 611** | 3 384 585 |
| Gold | 7 | 187 179 | 134 365 |
| Special Drawing Rights | 8 | 99 356 | 91 237 |
| Convertible foreign currencies | 9 | 3 782 167 | 3 150 992 |
| Participating interest in the European Central Bank | 10 | 750 | 750 |
| Participating interest in the Bank for International Settlements | 11 | 1 763 | 1 763 |
| Other foreign assets | 12 | 3 396 | 5 478 |
| DOMESTIC ASSETS | | **32 722** | 175 719 |
| Loans to credit institutions | 13 | – | 140 449 |
| Fixed assets | 14, 15 | 31 003 | 33 232 |
| Other domestic assets | 16, 17 | 1 719 | 2 038 |
| TOTAL ASSETS | | **4 107 333** | 3 560 304 |

[1] The accompanying notes set out on pages 80 to 117 are an integral part of these financial statements.

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

| LIABILITIES, CAPITAL AND RESERVES | Notes | **2010** | 2009 |
|---|---|---|---|
| FOREIGN LIABILITIES | | **42 556** | 71 469 |
| Convertible foreign currencies | 18 | 13 682 | 19 006 |
| International Monetary Fund | 8 | 274 | 256 |
| Other international institution deposits in lats | 19 | 8 505 | 32 502 |
| Foreign bank deposits in lats | | 726 | 499 |
| Other foreign liabilities | 20 | 19 369 | 19 206 |
| LATS IN CIRCULATION | 21 | **937 904** | 788 155 |
| DOMESTIC LIABILITIES | | **2 830 233** | 2 412 922 |
| Balances due to credit institutions | 22 | 1 690 230 | 1 115 677 |
| Balances due to the government | 23 | 1 081 010 | 1 291 942 |
| Balances due to other financial institutions | | 56 738 | 1 948 |
| Other domestic liabilities | 24, 25 | 2 255 | 3 355 |
| CAPITAL AND RESERVES | | **296 640** | 287 758 |
| Nominal capital | 26 | 25 000 | 25 000 |
| Reserve capital | 26 | 140 273 | 114 236 |
| Valuation account | 26 | 107 613 | 74 129 |
| Profit of the reporting year | 26 | 23 754 | 74 393 |
| TOTAL LIABILITIES, CAPITAL AND RESERVES | | **4 107 333** | 3 560 304 |
| OFF-BALANCE SHEET ACCOUNTS | 39 | | |

The financial statements, which are set out on pages 74 to 117, were authorised by the Board of the Bank of Latvia on 14 March 2011.

BOARD OF THE BANK OF LATVIA

M. Kālis

R. Jakovļevs

A. Ņikitins

H. Ozols

I. Posuma

R. Vanags

# PROFIT AND LOSS STATEMENT

(in thousands of lats)

| | Notes | **2010** | 2009 |
|---|---|---|---|
| INTEREST INCOME | | | |
| Foreign operations | 27 | **57 055** | 59 245 |
| Interest on securities | | 52 405 | 51 702 |
| Interest on deposits with foreign credit institutions and other foreign financial institutions | | 2 792 | 3 305 |
| Interest on derivative financial instruments | | 1 858 | 4 238 |
| Domestic operations | 27 | **3 618** | 26 925 |
| Interest on loans to credit institutions | | 3 618 | 24 696 |
| Interest on derivative financial instruments | | – | 2 229 |
| INTEREST EXPENSE | | | |
| Foreign operations | 27 | **967** | 1 662 |
| Interest on deposits | | 1 | 93 |
| Interest on derivative financial instruments | | 966 | 1 569 |
| Domestic operations | 27 | **13 362** | 18 515 |
| Interest on deposits of credit institutions | | 9 140 | 11 895 |
| Interest on government deposits | | 4 127 | 6 592 |
| Interest on deposits of other financial institutions | | 95 | 28 |
| NET INTEREST INCOME | 27 | **46 344** | 65 993 |

| *(cont.)* | | | (in thousands of lats) |
|---|---|---|---|
| | Notes | **2010** | 2009 |
| REALISED GAINS/LOSSES (–) FROM FINANCIAL OPERATIONS | 28 | **9 147** | 36 959 |
| Foreign operations | | **–6 315** | 22 521 |
| Securities | | 17 599 | 28 069 |
| Derivative financial instruments | | –23 914 | –5 548 |
| Foreign currency exchange transactions | | **15 462** | 14 438 |
| WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS | 26, 29 | **12 995** | 5 474 |
| Foreign operations | | **11 639** | 5 462 |
| Securities | | 11 639 | 5 462 |
| Foreign currency position | | **1 356** | 12 |
| INCOME FROM PARTICIPATING INTEREST | 30 | **611** | 221 |
| OTHER OPERATING INCOME | 31 | **1 278** | 4 683 |
| BANKNOTE PRODUCTION AND COINAGE COSTS | 32 | **541** | 4 695 |
| OTHER OPERATING EXPENSES | | **20 090** | 23 294 |
| Remuneration | 33 | 10 278 | 12 643 |
| Social security costs | 33 | 2 449 | 2 886 |
| Depreciation and amortisation charges | 14, 17 | 3 044 | 3 373 |
| Maintenance and operation of information systems | | 1 554 | 1 510 |
| Other operating expenses | 34 | 2 765 | 2 882 |
| PROFIT OF THE REPORTING YEAR | | **23 754** | 74 393 |

# STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

(in thousands of lats)

| | Notes | **2010** | 2009 |
|---|---|---|---|
| REVALUATION | 26 | **35 482** | 27 907 |
| Foreign currency and gold | | 36 680 | 18 812 |
| Securities | | –1 198 | 9 095 |
| REALISATION OF ACCUMULATED REVALUATION RESULT | 26 | **–14 993** | –27 256 |
| Foreign currency and gold | | –3 889 | –1 238 |
| Interest rate swap contracts | | – | –3 263 |
| Securities | | –11 104 | –22 755 |
| WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS | 26, 29 | **12 995** | 5 474 |
| PROFIT OF THE REPORTING YEAR | | **23 754** | 74 393 |
| TOTAL | | **57 238** | 80 518 |

# CASH FLOW STATEMENT

(in thousands of lats)

| | Notes | **2010** | 2009 |
|---|---|---|---|
| CASH FLOW FROM OPERATING ACTIVITIES | | | |
| Profit of the reporting year | | **23 754** | 74 393 |
| Non-cash transaction adjustments | 35 (1) | **16 294** | 8 850 |
| Net movements in balance sheet positions | 35 (1) | **–378 945** | 209 535 |
| Net cash and cash equivalents inflow/outflow (–) from operating activities | | **–338 897** | 292 778 |
| CASH FLOW FROM INVESTING ACTIVITIES | | | |
| Increase of participating interest in the European Central Bank | 10 | **–** | –7 |
| Dividends on shares of the Bank for International Settlements | 30 | **611** | 221 |
| Acquisition of fixed assets | 14 | **–788** | –1 692 |
| Acquisition of intangible assets | 17 | **–146** | –50 |
| Net cash and cash equivalents outflow from investing activities | | **–323** | –1 528 |
| CASH FLOW FROM FINANCING ACTIVITIES | | | |
| Profit appropriated to the state budget | 26 | **–48 355** | –34 734 |
| Net cash and cash equivalents outflow from financing activities | | **–48 355** | –34 734 |
| NET CASH AND CASH EQUIVALENTS INFLOW/OUTFLOW (–) | | **–387 575** | 256 516 |
| Cash and cash equivalents at the beginning of the year | 35 (2) | **944 225** | 687 709 |
| Cash and cash equivalents at the end of the year | 35 (2) | **556 650** | 944 225 |

# NOTES TO THE FINANCIAL STATEMENTS

## 1. PRINCIPAL ACTIVITIES

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

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

The Bank of Latvia ensures the operation of the Credit Register as of 1 January 2008. The Bank of Latvia also issues licences to legal persons listed in the Republic of Latvia Register of Enterprises, except credit institutions, for the purchase and sale of foreign currency cash as a commercial activity, and controls compliance with the procedure it has established for effecting foreign currency cash purchase and sales transactions.

In the execution of its tasks and control in accordance with the Law "On the Bank of Latvia" and the Law "On Credit Institutions", the Bank of Latvia neither seeks nor takes instructions from the government or any other institution. The Bank of Latvia is independent in setting and implementing policy under its legal mandate. The Bank of Latvia is supervised by the Parliament (Saeima) of the Republic of Latvia.

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

The Head Office of the Bank of Latvia is situated in Riga, K. Valdemāra Street 2A. The Bank of Latvia manages the storage, processing and circulation of cash through its Riga Branch and the regional branches in Daugavpils and Liepāja. In 2010, the Bank of Latvia closed its Rēzekne Branch, redirecting customers' cash delivery and withdrawal to the other Bank of Latvia branches.

## 2. RISK MANAGEMENT

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

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

The Bank of Latvia manages financial risks related to foreign reserves in accordance with the "Guidelines for Managing the Bank of Latvia's Foreign Reserves" (hereinafter, the Guidelines), as approved by the Council of the Bank of Latvia. The basic principles of investment policy set out in the Guidelines are provided in Note 5. Foreign reserves 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 portfolio type in the Guidelines. On a business day basis, the Risk Management Division of the Market Operations Department monitors the compliance of foreign reserves with the requirements set out in the Guidelines.

For the purpose of foreign reserves management, including management of related financial risks, the Investment Committee of the Bank of Latvia that develops the investment management strategy, approves tactical decisions and sets detailed limits for financial risks within the framework of the Guidelines as well as oversees the operation of external foreign reserve managers. The Investment Committee of the Bank of Latvia reviews the investment strategy once a quarter, and on a weekly basis receives and reviews reports and forecasts for developments in financial markets, which are prepared by foreign reserves investment portfolio managers, reviews the reports by financial risk managers and approves the investment management tactical decisions for the forthcoming week. Once every two months the Market Operations Department informs the Council and the Board of the Bank of Latvia about the results of management of foreign reserves.

*MARKET RISK*

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

The Bank of Latvia is exposed to interest rate risk primarily due to investing in foreign debt securities and interest rate derivatives that are subject to interest rate fluctuations and used within the course of foreign reserve management. The Bank of Latvia manages the interest rate risk by using a modified duration limit set individually for each investment portfolio.

Bank of Latvia's exposure to gold price and currency risk is determined by the structure of its foreign currency and gold reserves, which cannot be formed in compliance with the Bank of Latvia's liability parameters. The Bank of Latvia manages the gold price and currency risk by determining open currency position limits or using tracking error. Tracking error is calculated as the expected annualised standard deviation of the difference in return between the investment portfolio and a respective benchmark. The aggregate market and credit risk of portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark (see also Note 5) is managed by determining the portfolio tracking error limit. Tracking error in 2010 and 2009 is provided in Note 42.

For investment portfolios, except for portfolios of borrowed funds, the benchmark currency is the euro. For portfolios of borrowed funds, the benchmark currency structure is formed in compliance with the parameters of respective liabilities. 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, the Bank of Latvia hedges the currency (including gold price) risk by using forward exchange rate and currency future contracts.

Every business day, the Risk Management Division of the Market Operations Department monitors the compliance of the modified duration limits and open currency positions with the Guidelines and the related resolutions passed by the Investment Committee of the Bank of Latvia.

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

Exposure of the Bank of Latvia to market risk (as at the end of 2010 and 2009) is provided in Notes 41 and 42.

*CREDIT RISK*

Credit risk is exposure to losses resulting from counterparty default. The Bank of Latvia's exposure to credit risk results mainly from investments in foreign financial instruments, including short-term cash and gold deposits, and short-term lending to domestic credit institutions.

The Bank of Latvia manages exposure to credit risk related to investments made in foreign financial instruments, including short-term cash and gold deposits, by establishing limits on investments of different credit quality in the Guidelines. Credit quality is evaluated on the basis of ratings assigned by the international credit rating agencies Fitch Ratings, Moody's Investors Service and Standard & Poor's. The Bank of Latvia is allowed to invest in financial instruments of the OECD countries, whose long-term credit rating in foreign currencies is at least A–/A–/A3. Limits are set also on the maximum investment in financial instruments of the same class and counterparty, as well as in financial instruments of one issuer. In order to monitor the Bank's exposure to credit risk associated with its foreign operations, the Risk Management Division of the Market Operations Department is involved in monitoring of the Bank of Latvia's compliance with the Guidelines on a business day basis.

Short-term loans granted to domestic credit institutions are secured by collateral of Latvian government securities (hereinafter, government securities) and such private sector debt securities, according to the requirements established by the Council of the Bank of Latvia. The Market Operations Department reviews the compliance of ratings assigned to issuers of these securities with the requirements of the Council of the Bank of Latvia and monitors the adequacy of collateral on a regular basis. Exposure of the Bank of Latvia to credit risk (as at the end of 2010 and 2009) is provided in Notes 44 to 46.

*LIQUIDITY RISK*

Liquidity risk is associated with a failure to meet liabilities timely. Bank of Latvia's exposure to liquidity risk arises mainly from the need to ensure foreign currency for conducting interventions and repaying deposits of the Latvian government and other institutions. The Bank of Latvia manages liquidity risk by investing foreign reserves 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. Investments are made so as to ensure timely meeting of the Bank of Latvia's liabilities. The structure of the Bank of Latvia's cash and its equivalents is provided in Note 35. The liquidity profile of the Bank of Latvia's assets and liabilities as at the end of 2010 and 2009 is provided in Note 43.

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

OPERATIONAL RISKS

Operational risk is exposure to financial and non-financial losses resulting from an unexpected interruption of operation, unauthorised use of information or threats to the employees of the Bank of Latvia, its information, information systems and technical resources, or material values.

The basic principles of the Bank of Latvia's operational risk management are determined by the Council of the Bank of Latvia. The Bank of Latvia's operational risk management is implemented by the Board of the Bank of Latvia, which has established the Committee for Managing the Bank of Latvia's Operational Risks to coordinate, on a daily basis, the activities under the operational risk management process and to provide support to the Board of the Bank of Latvia on operational risk management issues. The Committee is presided by a member of the Board of the Bank of Latvia and includes the Risk Management Officer, Operational Continuity Officer, Information Security Officer, Information Systems Security Officer, and the Head of Security Department.

In 2010, operational risks to the Bank of Latvia processes and projects were identified, analysed and assessed, with a set of relevant risk limiting measures being developed and assessed. The information thus obtained is compiled in the Risk Register of the Bank of Latvia, a new information system, which is available to the Bank of Latvia employees who are responsible for the Bank of Latvia processes as well as the department heads, project managers and other authorised staff of the Bank of Latvia involved in these processes.

In order to ensure confidentiality, authorised access to and integrity of information, the Bank of Latvia information systems are classified. The Bank of Latvia has appointed owners of information systems who are responsible for determination of security requirements and regulations for use and approve the risk analysis results of the respective information system. Information systems security manager of the Bank of Latvia coordinates the implementation of information systems risk analysis and oversees the introduction of measures aimed at minimising the identified risks. The Head of Information Systems Department ensures logical and physical security of the Bank of Latvia information systems, including accessibility to information systems and compliance with other security requirements coordinated with the information system owners. The Bank of Latvia conducts, on a regular basis, the analysis of information systems security risks and improves security measures and tools.

The management of Bank of Latvia business continuity is organised and conducted in accordance with the "Bank of Latvia Business Continuity Policy", approved by the Council, abiding by the principles of best practice and taking into account the ECB recommendations regarding business continuity management.

In 2010, the Bank of Latvia was not exposed to the risks that could substantially affect or hamper its operation.

The Bank of Latvia conducts, on a regular basis, educational sessions for employees on information and information systems security, risk management and management of operational continuity.

Under the total operational risk minimisation system, the Bank of Latvia is insured against certain types of operational risks.

## 3. PRINCIPAL ACCOUNTING POLICIES

A summary of the principal accounting policies adopted by the Bank of Latvia in the preparation of these financial statements is set out below.

### BASIS OF PRESENTATION

These financial statements have been prepared in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Bank of Latvia's Council, and the Law "On the Bank of Latvia".

The "Financial Accounting Policy of the Bank of Latvia" requires that events and financial transactions of the Bank of Latvia relating to the implementation of monetary policy and management of foreign reserves are accounted for in accordance with the principal accounting policies established by the ECB Guideline of 10 November 2006 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2006/16).

BASIS OF MEASUREMENT

These financial statements have been prepared in accordance with the historical cost basis of accounting except gold, debt securities and interest rate derivatives and currency futures contracts, which are accounted for at fair value. Forward exchange rate contracts and currency swap arrangements are valued according to the principles described in Note 3 under "Derivative financial instruments". The reconciliation of the book value and fair value of these instruments is provided in Note 39.

FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

Fair value of financial instruments is determined by the Bank of Latvia 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 and liabilities measured at fair value, taking into account the hierarchy of fair value determination, is provided in Note 6.

Fair value of the Bank of Latvia's financial assets and financial liabilities does not differ materially from the reported book value of the respective assets and liabilities, if not specified otherwise in particular notes to the financial statements.

FOREIGN CURRENCY TRANSLATION

Transactions denominated in foreign currencies are recorded in lats at the exchange rates quoted by the Bank of Latvia for the day of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into lats at the exchange rates set by the Bank of Latvia at the end of the reporting period. Non-monetary assets and liabilities, measured at cost or amortised cost, are translated into lats at the exchange rate for the respective foreign currency set by the Bank of Latvia on the day of the transaction. Taking into account the lats peg to the euro, the Bank of Latvia sets the exchange rates for other currencies on the basis of the exchange rate of euro against the US dollar and the exchange rates of the US dollar against other currencies as quoted in the electronic information system *Reuters*.

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 currency positions are credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 3 under "Recognition of gains or losses on financial instruments".

The exchange rates of principal foreign currencies and the price of gold set by the Bank of Latvia and used in the preparation of the balance sheet for the year ended 31 December 2010 and the year ended 31 December 2009 are as follows:

(at the end of the year)

| | **2010** | 2009 | Changes (%) |
|---|---|---|---|
| Euro (EUR) | **0.702804** | 0.702804 | 0 |
| US dollar (USD) | **0.535** | 0.489 | 9.4 |
| Japanese yen (JPY) | **0.00651** | 0.00533 | 22.1 |
| Gold (XAU) | **752.612** | 540.256 | 39.3 |
| Special Drawing Rights (XDR) | **0.82** | 0.766 | 7.0 |

RECOGNITION AND DERECOGNITION OF FINANCIAL ASSETS AND LIABILITIES

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

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

OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

USE OF ESTIMATES

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

GOLD

Gold reserves are stated at market value in the balance sheet in accordance with the principles described in Note 3 under "Foreign currency translation".

Any gain or loss arising from transactions in gold and revaluation of gold reserves is credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles described in Note 3 under "Recognition of gains or losses on financial instruments".

SECURITIES

Securities are stated at fair value in the balance sheet.

Interest on securities, including premium and discount, is recognised in the profit and loss statement as interest income. Gain or loss arising from transactions in securities and revaluation are credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 3 under "Recognition of gains or losses on financial instruments".

REVERSE REPURCHASE AGREEMENTS

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

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

REPURCHASE AGREEMENTS

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

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

SECURITIES LENDING

Securities lent under automatic securities lending programme agreements are retained in the Bank of Latvia's balance sheet caption "Convertible foreign currencies" along with other securities that are not involved in these transactions. Only cash collateral placed on the account of the Bank of Latvia, is recognised in the balance sheet.

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

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

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

PARTICIPATING INTEREST

Participating interest includes long-term investments of the Bank of Latvia in equity instruments. The Bank of Latvia has no control or significant influence in any institution, therefore participating interest is not accounted for as an investment in a subsidiary or an associate. Equity instruments which do not have a quoted price in an active market and whose fair value cannot be reliably measured are reported in the balance sheet at cost. An increase or decrease in participating interest due to acquisition or sale of equity instruments is recognised considering the historical cost basis.

DERIVATIVE FINANCIAL INSTRUMENTS

The Bank of Latvia 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 transaction day at the spot rate of the transaction and are recorded in the balance sheet in lats at the exchange rate of the respective currency set by the Bank of Latvia 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. Any gain or loss arising from a change in fair value of interest rate and currency future contracts is included in the profit and loss statement upon 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 caption "Valuation account" in accordance with the principles referred to in Note 3 under "Recognition of gains or losses on financial instruments".

ACCRUED INTEREST INCOME AND EXPENSE

Accrued interest income on securities is included in the carrying amount of the respective interest bearing securities. Accrued interest income and expense on other financial instruments are reported under relevant balance sheet captions of other assets or other liabilities.

FIXED ASSETS

Fixed assets are tangible long-term investments with the useful life over one year. These assets are used in the provision of services as well as in the maintenance of other fixed assets and to ensure the Bank of Latvia's operation.

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.

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

(%)

| | **2010** | 2009 |
|---|---|---|
| Buildings | | |
| – structures | **1** | 1 |
| – outer finishing | **5** | 5 |
| – interior decorations | **5–20** | 5–20 |
| – engineering communications | **5** | 5 |
| – other components | **10–14** | 10–14 |
| Buildings and structures not accounted by components | **3** | 3 |
| External systems and networks | **7** | 7 |
| Improvement of territory | **10** | 10 |
| Transport vehicles | **10** | 10 |
| Office equipment and inventories, of which | **4–20** | 10–20 |
| – office furniture | **7** | 10 |
| – office electrical equipment | **20** | 20 |
| Cash processing and verifying equipment | **7–20** | 10–20 |
| Computer and telecommunications equipment | **14–50** | 14–33 |
| Equipment and inventory of building systems and technical security systems | **10–20** | 10–20 |
| Other fixed assets | **7–20** | 20–50 |

The Board of the Bank of Latvia assessed the useful life of fixed assets and applied the extension to the following major groups of fixed assets: furniture, safes and strong-boxes, tools, security equipment, and cash processing equipment.

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.

Pursuant to the Law "On Disposal of the State and Local Government Property", the Bank of Latvia disposes of fixed assets to the state and local government institutions without charge. Loss on disposal of fixed assets is determined on the basis of the carrying amount of the fixed assets as at the time of disposal and is reported under the profit and loss statement caption "Other operating expenses".

INTANGIBLE ASSETS

Intangible assets are long-term investments without physical substance with a useful life of over one year. 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 relevant assets using the straight-line method; however, this period may not exceed 10 years.

Costs related to software development by the Bank of Latvia are recognised in the profit and loss statement when incurred.

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 allowances for the relevant asset are made. Such allowances are recognised in the profit and loss statement with a respective reduction in the asset's carrying amount.

LATS IN CIRCULATION

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

GOLD CIRCULATION COINS

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

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

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 repurchase value. Proceeds from sales of collector coins are recognised in the profit and loss statement when incurred.

PROVISIONS

Provisions are recognised in the financial statements when the Bank of Latvia 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 the Bank of Latvia.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents stated in the cash flow statement include convertible foreign currency in cash, demand deposits and deposits with an original maturity up to 5 business days made with foreign credit institutions and other foreign financial institutions.

RECOGNITION OF GAINS OR LOSSES ON FINANCIAL INSTRUMENTS

Gains or losses on financial instruments are recognised in accordance with the following principles, established by the ECB Guideline of 10 November 2006 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2006/16):

(a) realised gains and losses shall be recognised in the profit and loss statement;

(b) unrealised gains shall be recognised in the balance sheet caption "Valuation account";

(c) unrealised losses recognised in the balance sheet caption "Valuation account" at the end of the reporting year shall be transferred to the profit and loss statement if they exceed previous revaluation gain on the respective financial instrument, foreign currency or gold holding;

(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 holding in the subsequent years;

(e) there shall be no netting of unrealised losses in a financial instrument, foreign currency or gold holding against unrealised gains in other financial instrument, foreign currency or gold holding.

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

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, deposits, loans granted, forward exchange rate contracts, and currency and interest rate swap arrangements. 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, domestic credit institutions and other financial market participants, as well as forward exchange rate contracts, and currency and interest rate swap arrangements.

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 moment of settlement.

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

INCOME FROM PARTICIPATING INTEREST

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

BANKNOTE PRODUCTION AND COINAGE COSTS

Banknote production and coinage costs, except gold circulation coin production costs, are charged to the profit and loss statement at the moment of banknote and coin acquisition.

OTHER EXPENSE AND INCOME

Bank's other operating expense and income is 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.

## 4. SUMMARY OF THE BANK OF LATVIA'S FINANCIAL POSITION AND FINANCIAL PERFORMANCE

FINANCIAL POSITION

In 2010, the Bank of Latvia assets grew by 547.0 million lats mainly on account of an increase in foreign assets.

Convertible foreign currencies posted an increase of 631.2 million lats mainly on account of the loans to the Latvian government granted by the EC, the IMF and other international lenders, which was deposited on the Treasury accounts with the Bank of Latvia. Meanwhile, currency interventions, with the Bank of Latvia selling a part of its foreign currency reserves to credit institutions, had a decreasing effect. Although the reverse currency interventions, with the Bank of Latvia buying the euro from the Treasury, amounted to 1 268.4 million lats[1] in 2010, these interventions did not affect the balance sheet caption "Convertible foreign currencies", because, in order to conduct these interventions, the Treasury used its euro deposits with the Bank of Latvia. As a result of currency interventions in 2010, the Bank of Latvia bought euro in exchange for lats in the net amount of 851.0 million lats.

Given the excess liquidity in the banking sector, the Bank of Latvia had not granted loans to credit institutions at the end of 2010, and deposits of credit institutions increased by 574.6 million lats.

With the demand for cash growing, the amount of cash in circulation grew in 2010, hence the Bank of Latvia balance sheet caption "Lats in circulation" increased by 149.7 million lats.

Capital and reserves of the Bank of Latvia grew by 8.9 million lats on account of earned profit (23.8 million lats) and net changes in valuation of financial instruments (33.5 million lats) in 2010, while profits remitted to the state budget revenue in the amount of 48.4 million lats had a decreasing effect.

## FINANCIAL PERFORMANCE

In 2010, the Bank of Latvia's profit amounted to 23.8 million lats.

In 2010, net interest income was by 19.6 million lats lower than in 2009, primarily determined by the contraction in the average lending to credit institutions. As a result, interest income from loans to credit institutions decreased by 21.1 million lats. Net interest income was also adversely affected by low interest rates in the US and euro area, such impact, however, being partly offset by an increase in the Bank of Latvia's foreign reserves and investment decisions, which ensured a higher return on foreign reserves in comparison with that on the benchmark.

Net interest on derivative financial instruments declined by 4.0 million lats, because domestic credit institutions did not use currency swap arrangements and the narrowing spread between the euro and US dollar short-term interest rates resulted in lower net interest income from financial derivatives used by the Bank of Latvia for hedging currency risk exposure.

Notwithstanding the increase in deposits of credit institutions with the Bank of Latvia in 2010 as a result of excess bank liquidity, upon decreasing the interest rates on these deposits the interest expense on credit institution deposits, including remuneration for holding the minimum reserves, fell by 2.8 million lats. Lower lats interest rates accounted also for a 2.5 million lats drop in interest expense on government deposits.

Realised gains arising from investment in financial operations contracted by 27.8 million lats primarily due to the increase of 18.4 million lats in the negative result of currency future contracts concluded for the purpose of hedging currency risks, while the positive revaluation result of the hedged balance sheet items is reported in the balance sheet caption "Valuation account" in equal value. Realised gains from the disposal of debt securities declined by 10.5 million lats, as the drop in interest rates in the US and euro area stabilised, thus reducing the positive effect on the market value of the Bank of Latvia's debt securities.

[1] On a settlement date basis.

The write-downs on financial assets and positions increased by 7.5 million lats in comparison with 2009. The increase was mainly driven by increase in interest rates in the US and euro area at the end of 2010, negatively affecting the market value of the Bank of Latvia's debt securities.

Banknote production and coinage costs contracted by 4.2 million lats, as in 2010 the Bank of Latvia replenished its banknote and coin stocks in a small amount.

With the Bank of Latvia cutting its administrative expense, including remuneration of employees, the Bank of Latvia's other operating expense decreased year-on-year by 3.2 million lats in 2010.

The uncertainty of the Bank of Latvia's further financial performance is mostly related to interest rate developments in the euro area and US financial markets since the Bank of Latvia is exposed to the interest rate risk. In view of the very low levels of interest rates, a further interest rate fall is potentially negligible in comparison with a potential rise; thus, the expected pickup in interest rates in foreign financial markets may negatively affect the income on the fixed income securities.

**5. INVESTMENT POLICY**

Managing of foreign reserves is conducted in compliance with the basic principles set out in the Guidelines, including preserving the value of foreign reserves, ensuring their liquidity and earning income within the framework of acceptable risk without contradicting to the Bank of Latvia's monetary policy.

Foreign reserves include the assets reported under "Gold", "Special Drawing Rights" and "Convertible foreign currencies" as well as derivative financial instruments and spot exchange rate contracts whose book value is reported under relevant balance sheet captions of other assets or other liabilities.

Foreign reserves are managed by classifying them into different investment portfolios by investment strategy and source of funding. Portfolios of borrowed funds include foreign reserves which correspond to the Bank of Latvia's liabilities in foreign currencies to other institutions, mainly foreign reserves arising from the Treasury of the Republic of Latvia deposits and foreign exchange swaps conducted in pursuit of monetary policy. Foreign reserves that are not included in the portfolios of borrowed funds (net reserves) are included in the portfolios of gold reserves, portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark. A part of foreign currency reserves included in the portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark are managed by external foreign reserves managers.

The parameters for a benchmark reflecting the acceptable level of financial risks and return target are set out for each portfolio type in the Guidelines.

The breakdown of foreign reserves by type of investment portfolio at the end of 2010 and 2009 was as follows:

| | Amount (in thousands of lats) | | Percentage (%) | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Portfolios managed against multi-currency fixed income securities benchmark | **2 602 693** | 1 762 219 | **64.9** | 53.1 |
| Portfolios of borrowed funds | **1 061 213** | 1 270 522 | **26.4** | 38.2 |
| Gold reserves portfolio | **184 090** | 134 128 | **4.6** | 4.0 |
| Portfolios managed against asset-backed securities benchmark | **165 090** | 154 934 | **4.1** | 4.7 |
| Total | **4 013 086** | 3 231 803 | **100.0** | 100.0 |

The benchmark of portfolios managed against multi-currency fixed income securities benchmark is pledged to the weighted 1–3 year government securities index of the euro area countries, US and Japan and denominated in euro, eliminating the currency risk.

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

The benchmark of gold reserves portfolio is pledged to the euro money market short-term index.

The benchmark of portfolios managed against asset-backed securities benchmark is pledged to the US mortgage-backed securities index and denominated in euro, eliminating the currency risk.

According to the exchange rate policy of the Bank of Latvia, the Guidelines provide that, except for portfolios of borrowed funds, the currency of the foreign reserves benchmark is the euro. For portfolios of borrowed funds, the benchmark currency structure is formed in compliance with the parameters of respective liabilities.

The description of the main methods used in financial risk management is provided in Note 2.

### 6. ASSETS AND LIABILITIES AT FAIR VALUE

Fair value of Bank of Latvia's assets and liabilities is determined using the following hierarchy:
– quoted 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 models where significant inputs are not observable.

At the end of 2010 and 2009, Bank of Latvia's investments in debt securities were generally valued on the basis of quoted price. At the end of 2010 and 2009, the Bank of Latvia did not have such assets and liabilities whose fair value is determined by using non-observable data. At the end of 2010 and 2009, the breakdown of assets and liabilities carried at fair value according to the fair value hierarchy was as follows:

(in thousands of lats)

| | Quoted price | Observable data | Total |
|---|---|---|---|
| **As at 31 December 2010** | | | |
| FOREIGN ASSETS | | | |
| Gold | 187 179 | – | 187 179 |
| Convertible foreign currencies | | | |
| Debt securities | 2 223 881 | 465 531 | 2 689 412 |
| Other foreign assets | | | |
| Forward transactions in debt securities | 63 | – | 63 |
| **Total foreign assets at fair value** | **2 411 123** | **465 531** | **2 876 654** |
| FOREIGN LIABILITIES | | | |
| Other foreign liabilities | | | |
| Forward transactions in debt securities | 319 | 1 | 320 |
| **Total foreign liabilities at fair value** | **319** | **1** | **320** |
| As at 31 December 2009 | | | |
| FOREIGN ASSETS | | | |
| Gold | 134 365 | – | 134 365 |
| Convertible foreign currencies | | | |
| Debt securities | 1 796 323 | 215 937 | 2 012 260 |
| Other foreign assets | | | |
| Forward transactions in debt securities | 275 | – | 275 |
| Total foreign assets at fair value | 1 930 963 | 215 937 | 2 146 900 |
| FOREIGN LIABILITIES | | | |
| Other foreign liabilities | | | |
| Forward transactions in debt securities | 417 | – | 417 |
| Total foreign liabilities at fair value | 417 | – | 417 |

The average market prices on the last trading day of the reporting year are obtained from the electronic information systems Bloomberg and Interactive Data. Where the above price for a financial instrument is inaccessible or absent in the electronic information systems, the latest available market price or the price determined by applying the discounted cash flow approach is used for evaluating the financial instrument.

## 7. GOLD

Movements in gold reserves in 2010 and 2009 were as follows:

| | Troy ounces | In thousands of lats |
|---|---|---|
| As at 31 December 2008 | 248 707 | 108 998 |
| During 2009 | | |
| Increase in gold market value | x | 25 367 |
| As at 31 December 2009 | 248 707 | 134 365 |
| **During 2010** | | |
| Increase in gold market value | x | 52 815 |
| Net change resulting from gold depositing and deposit withdrawal | –1 | –1 |
| **As at 31 December 2010** | **248 706** | **187 179** |

The Bank of Latvia hedges the risk related to fluctuations in gold reserves market value by entering into forward exchange rate and currency future contracts (see also Note 41). Revaluation of gold reserves and forward exchange rate contracts is recognised in the balance sheet caption "Valuation account", whereas revaluation of currency future contracts is recognised in the profit and loss statement caption "Realised gains/losses from financial operations".

## 8. INTERNATIONAL MONETARY FUND

Pursuant to the Law "On the Republic of Latvia Joining the International Monetary Fund" the Bank of Latvia serves as a depository for the IMF and services the IMF accounts in the member state currency without compensation. The IMF holdings in lats 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 is recorded as an asset denominated in SDR. Latvia's quota in the IMF is 126 800 thousand SDR.

Latvia's liabilities to the IMF are made up of the IMF holdings in lats and IMF allocations. In 2010, liabilities to the IMF increased by 268 448 thousand SDR as a result of the loan granted to the Latvian government.

At the end of 2010, the claims on the IMF in SDR as recorded on the Bank of Latvia's balance sheet were equivalent to 99 356 thousand lats (at the end of 2009 – 91 237 thousand lats), whereas the liabilities to the IMF are made up of funds at the disposal of the IMF in the amount of 274 thousand lats (at the end of 2009 – 256 thousand lats) held on its Accounts No. 1 and No. 2.

At the end of 2010 and 2009, Latvia's net claims and liabilities to the IMF were as follows:

| | (in thousands of lats) | | (in thousands of SDR) | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Latvia's quota in the IMF | **103 976** | 97 129 | **126 800** | 126 800 |
| IMF holdings in lats | **–909 382** | –643 865 | **–1 109 002** | –840 554 |
| Promissory notes of the Latvian government | –909 108 | –643 609 | –1 108 668 | –840 220 |
| Account No. 1 | –260 | –243 | –317 | –317 |
| Account No. 2 | –14 | –13 | –17 | –17 |
| Stand-by Arrangement for Latvia | **805 437** | 546 765 | **982 240** | 713 792 |
| Reserve position in IMF | **45** | 42 | **55** | 55 |
| SDR | **99 356** | 91 237 | **121 166** | 119 108 |
| General allocation | **–77 077** | –72 002 | **–93 998** | –93 998 |
| Special allocation | **–21 996** | –20 547 | **–26 824** | –26 824 |
| Latvia's net claims/liabilities (–) to the IMF | **328** | –1 270 | **399** | –1 659 |

The reserve position in the IMF is the difference between the total Latvian quota in the IMF and the IMF holdings in lats, excluding the balance on Account No. 2 and adding the amount of the IMF loan.

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

### 9. CONVERTIBLE FOREIGN CURRENCIES

Bank of Latvia's foreign assets in convertible foreign currencies are invested primarily in debt securities of high liquidity and short-term deposits.

The carrying amount of interest bearing debt securities includes accrued interest income (24 234 thousand lats at the end of 2010 and 16 947 thousand lats at the end of 2009).

At the end of 2010 and 2009, the balance sheet asset caption "Convertible foreign currencies" was comprised of the following assets:

(in thousands of lats)

| | **2010** | 2009 |
|---|---|---|
| Debt securities of foreign governments, financial institutions and non-financial corporations | **2 689 412** | 2 012 260 |
| Demand deposits with foreign central banks, credit institutions and international institutions | **531 735** | 805 403 |
| Time deposits with foreign credit institutions and other foreign financial institutions | **545 307** | 313 986 |
| Foreign currency in cash | **15 713** | 19 343 |
| Total | **3 782 167** | 3 150 992 |

### 10. PARTICIPATING INTEREST IN THE EUROPEAN CENTRAL BANK

With Latvia's accession to the EU, the Bank of Latvia became a subscriber of the capital of the ECB. In accordance with the Statute of the ESCB and of the ECB, the share of the Bank of Latvia in the ECB's capital was calculated on the basis of the EU states' population and GDP data and is adjusted every five years or at shorter intervals depending on changes in the number of the EU Member States.

The Bank of Latvia's percentage share in the ECB's capital is 0.2837%. Pursuant to the decision of the Governing Council of the ECB, on 29 December 2010 the ECB's subscribed capital was increased by 5 billion euro; as a result, the share of the Bank of Latvia in the ECB's capital increased from 16 343 thousand euro (11 486 thousand lats) to 30 528 thousand euro (21 455 thousand lats). The ECB's General Council decided that the minimum contribution of the non-euro area central banks should be 3.75% of their total subscribed capital in the ECB (7% at the end of 2009). As a result of the above decisions, the Bank of Latvia's contribution to the ECB subscribed capital amounted to 1 145 thousand euro (750 thousand lats) at the end of 2010 (1 144 thousand euro or 750 thousand lats at the end of 2009; see also Note 40).

Participating interest in the ECB's capital has been reported at cost in the balance sheet of the Bank of Latvia. ECB's capital shares are not traded in the public securities market, and the share of the Bank of Latvia in the ECB's capital can be increased or decreased only in the cases referred to in this Note.

### 11. PARTICIPATING INTEREST IN THE BANK FOR INTERNATIONAL SETTLEMENTS

At the end of 2010 and 2009, the Bank of Latvia owned 1 070 shares in the BIS, which correspond to 0.20% of the total subscribed and paid-up BIS capital.

The nominal value of the Bank of Latvia's shareholding in the BIS is 5 350 thousand SDR (the nominal value per share is 5 thousand SDR), paid up in the amount of 1 338 thousand SDR or 25%. The deemed cost of this holding at the end of 2010 and 2009 is reported in the Bank of Latvia's balance sheet in the amount of 1 763 thousand lats (see also Note 40).

BIS shares are not traded in the public securities market. Pursuant to the Statutes of the BIS, only central banks can be shareholders in the BIS. The fair value of BIS shares, defined as 70% of the Bank of Latvia's share in the BIS net assets[1], differs from their book value and was 17 741 thousand lats at the end of 2010 (14 409 thousand lats at the end of 2009).

## 12. OTHER FOREIGN ASSETS

At the end of 2010 and 2009, other foreign assets consisted of the following items:

(in thousands of lats)

| | 2010 | 2009 |
|---|---|---|
| Non-traded financial derivative and spot exchange rate contracts with foreign financial institutions | **2 825** | 5 056 |
| Prepaid expense | **459** | 326 |
| Interest accrued on deposits | **79** | 17 |
| Other | **33** | 79 |
| Total | **3 396** | 5 478 |

## 13. LOANS TO CREDIT INSTITUTIONS

In 2010, ample liquidity was maintained in the banking sector, hence the Bank of Latvia had not granted loans to credit institutions at the end of 2010. At the end of 2009, loans to domestic credit institutions included short-term loans to JSC *Parex banka* in the amount of 140 449 thousand lats, fully repaid in May 2010. These loans were secured by collateral of government securities and private sector debt securities with the fair value of 211 501 thousand lats at the end of 2009 (see also the section "Credit risk" in Note 2).

## 14. FIXED ASSETS

The following changes in fixed assets took place in 2010 and 2009:

(in thousands of lats)

| | Buildings, improvement of territory, and land | Furniture and office equipment | Cash processing equipment | Transport vehicles | Other fixed assets | Total |
|---|---|---|---|---|---|---|
| As at 31 December 2008 | | | | | | |
| Cost | 36 051 | 6 796 | 4 643 | 1 287 | 5 114 | 53 891 |
| Accumulated depreciation | –7 514 | –5 041 | –1 936 | –722 | –4 052 | –19 265 |
| Net book value | 28 537 | 1 755 | 2 707 | 565 | 1 062 | 34 626 |
| During 2009 | | | | | | |
| Additions | 1 107 | 241 | 15 | 128 | 201 | 1 692 |
| Change in classification | – | 9 | – | – | –9 | – |
| Disposals and write-offs | –1 | –701 | –29 | –130 | –123 | –984 |
| Net change in cost | 1 106 | –451 | –14 | –2 | 69 | 708 |
| Depreciation charge | –1 806 | –545 | –387 | –96 | –249 | –3 083 |
| Change in classification | – | –12 | – | – | 12 | – |
| Accumulated depreciation on disposals and write-offs | 1 | 698 | 29 | 130 | 123 | 981 |
| Net change in accumulated depreciation | –1 805 | 141 | –358 | 34 | –114 | –2 102 |

[1] The BIS applies this valuation method for calculating the price of its shares; the International Court at the Hague has recognised it as appropriate for the valuation of shares when repurchasing them from former private shareholders of the BIS.

*(cont.)* (in thousands of lats)

| | Buildings, improvement of territory, and land | Furniture and office equipment | Cash processing equipment | Transport vehicles | Other fixed assets | Total |
|---|---|---|---|---|---|---|
| As at 31 December 2009 | | | | | | |
| Cost | 37 157 | 6 345 | 4 629 | 1 285 | 5 183 | 54 599 |
| Accumulated depreciation | –9 319 | –4 900 | –2 294 | –688 | –4 166 | –21 367 |
| Net book value | 27 838 | 1 445 | 2 335 | 597 | 1 017 | 33 232 |
| **During 2010** | | | | | | |
| Additions | 206 | 430 | – | – | 152 | 788 |
| Change in classification | –66 | –29 | – | – | 95 | – |
| Disposals and write-offs | –297 | –378 | –49 | –50 | –297 | –1 071 |
| Net change in cost | –157 | 23 | –49 | –50 | –50 | –283 |
| Depreciation charge | –1 800 | –365 | –243 | –104 | –250 | –2 762 |
| Change in classification | 23 | 12 | – | – | –35 | – |
| Accumulated depreciation on disposals and write-offs | 55 | 375 | 49 | 49 | 288 | 816 |
| Net change in accumulated depreciation | –1 722 | 22 | –194 | –55 | 3 | –1 946 |
| **As at 31 December 2010** | | | | | | |
| Cost | 37 000 | 6 368 | 4 580 | 1 235 | 5 133 | 54 316 |
| Accumulated depreciation | –11 041 | –4 878 | –2 488 | –743 | –4 163 | –23 313 |
| **Net book value** | **25 959** | **1 490** | **2 092** | **492** | **970** | **31 003** |

At the end of 2010, the total cadastral value of land under the ownership and possession of the Bank of Latvia was 1 999 thousand lats (3 168 thousand lats at the end of 2009; the change is mostly related to a change in the cadastral value of land). Land is reported in the balance sheet of the Bank of Latvia at cost (1 669 thousand lats at the end of 2009 and 2010).

## 15. LEASING

The Bank of Latvia's assets subject to leases are buildings, land, and equipment. In the balance sheet they are reported as fixed assets. All lease agreements where the Bank of Latvia acts as a lessor are operating leases. Lease payments, except those that are directly transferred to the state budget, are recognised in the profit and loss statement proportionally over the term of the respective agreement. The depreciation of the leased assets is calculated on the basis of the depreciation policy described in Note 3 under "Fixed assets" and reported in the profit and loss statement as depreciation charges.

Carrying amount of leased assets at the end of 2010 and 2009 was as follows:

(in thousands of lats)

| | |
|---|---|
| As at 31 December 2009 | |
| Cost | 1 086 |
| Accumulated depreciation | –381 |
| Net book value | 705 |
| **As at 31 December 2010** | |
| Cost | 1 059 |
| Accumulated depreciation | –422 |
| **Net book value** | **637** |

## 16. OTHER DOMESTIC ASSETS

At the end of 2010 and 2009, other domestic assets consisted of the following items:

(in thousands of lats)

| | **2010** | 2009 |
|---|---|---|
| Intangible assets | **625** | 761 |
| Non-traded spot exchange rate contracts with domestic institutions | **532** | 147 |
| Prepaid expense | **124** | 160 |
| Accrued interest on loans to credit institutions | **–** | 763 |
| Other | **438** | 207 |
| Total | **1 719** | 2 038 |

## 17. INTANGIBLE ASSETS

The following changes in intangible assets took place in 2010 and 2009:

(in thousands of lats)

| | |
|---|---|
| As at 31 December 2008 | |
| Cost | 3 720 |
| Accumulated amortisation | –2 719 |
| Net book value | 1 001 |
| During 2009 | |
| Additions | 50 |
| Derecognised assets | –1 |
| Net change in cost | 49 |
| Amortisation charge | –290 |
| Accumulated amortisation on disposals | 1 |
| Net change in accumulated amortisation | –289 |
| As at 31 December 2009 | |
| Cost | 3 769 |
| Accumulated amortisation | –3 008 |
| Net book value | 761 |
| **During 2010** | |
| Additions | 146 |
| Derecognised assets | –37 |
| Net change in cost | 109 |
| Amortisation charge | –282 |
| Accumulated amortisation on derecognised assets | 37 |
| Net change in accumulated amortisation | –245 |
| **As at 31 December 2010** | |
| Cost | 3 878 |
| Accumulated amortisation | –3 253 |
| **Net book value** | **625** |

## 18. CONVERTIBLE FOREIGN CURRENCIES

At the end of 2010 convertible foreign currency liabilities mostly consisted of funds on the EC account for settlements in euro, as well as the cash collateral in the amount of

503 thousand lats received by the Bank of Latvia for securing transactions in derivative financial instruments. The EC account is used by the EC for the distribution of EU budgetary funds (see also Note 19).

At the end of 2010 and 2009, convertible foreign currency liabilities consisted of the following items:

(in thousands of lats)

| | **2010** | 2009 |
|---|---|---|
| EC demand deposits | **13 121** | 19 006 |
| Other liabilities | **561** | – |
| Total | **13 682** | 19 006 |

## 19. OTHER INTERNATIONAL INSTITUTION DEPOSITS IN LATS

Other international institution deposits in lats mostly consist of funds on the EC account for settlements in lats, which is used for effecting Latvian government payments to the EU budget (see also Note 18).

At the end of 2010 and 2009, the breakdown of deposits of other international institutions in lats was as follows:

(in thousands of lats)

| | **2010** | 2009 |
|---|---|---|
| EC demand deposits | **8 258** | 32 252 |
| Other deposits | **247** | 250 |
| Total | **8 505** | 32 502 |

## 20. OTHER FOREIGN LIABILITIES

At the end of 2010 and 2009, other foreign liabilities consisted of the following items:

(in thousands of lats)

| | **2010** | 2009 |
|---|---|---|
| Non-traded financial derivative contracts and spot exchange rate contracts with foreign financial institutions | **19 074** | 18 826 |
| Accrued expense | **245** | 332 |
| Other | **50** | 48 |
| Total | **19 369** | 19 206 |

## 21. LATS IN CIRCULATION

At the end of 2010 and 2009, the following units of lats (LVL) and santims (s) were in circulation:

| Nominal | Amount (in thousands of lats) | | Number (in thousands of units) | | Percentage (%) | |
|---|---|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 | **2010** | 2009 |
| Banknotes | | | | | | |
| LVL 500 | **72 549** | 62 842 | **145** | 126 | **7.7** | 8.0 |
| LVL 100 | **118 390** | 94 337 | **1 184** | 943 | **12.6** | 12.0 |
| LVL 50 | **79 637** | 61 163 | **1 593** | 1 223 | **8.5** | 7.8 |
| LVL 20 | **471 147** | 388 305 | **23 557** | 19 415 | **50.2** | 49.3 |
| LVL 10 | **68 574** | 63 321 | **6 857** | 6 332 | **7.3** | 8.0 |
| LVL 5 | **66 273** | 61 313 | **13 255** | 12 263 | **7.3** | 7.7 |
| Total banknotes | **876 570** | 731 281 | **x** | x | **93.5** | 92.8 |
| Coins | | | | | | |
| LVL 100 | **405** | 405 | **4** | 4 | **0** | 0.1 |
| LVL 10 | **145** | 145 | **15** | 15 | **0** | 0 |
| LVL 2 | **8 317** | 7 985 | **4 159** | 3 993 | **0.9** | 1.0 |
| LVL 1 | **31 358** | 27 936 | **31 359** | 27 937 | **3.4** | 3.5 |
| 50 s | **7 820** | 7 677 | **15 639** | 15 353 | **0.8** | 1.0 |
| 20 s | **4 481** | 4 287 | **22 405** | 21 435 | **0.5** | 0.5 |
| 10 s | **2 736** | 2 638 | **27 362** | 26 375 | **0.3** | 0.3 |
| 5 s | **2 093** | 2 018 | **41 852** | 40 352 | **0.2** | 0.3 |
| 2 s | **2 268** | 2 163 | **113 417** | 108 159 | **0.2** | 0.3 |
| 1 s | **1 711** | 1 620 | **171 138** | 161 959 | **0.2** | 0.2 |
| Total coins | **61 334** | 56 874 | **x** | x | **6.5** | 7.2 |
| Total lats in circulation | **937 904** | 788 155 | **x** | x | **100.0** | 100.0 |

At the end of 2010 and 2009, the total nominal value of gold circulation coins (fineness .999) issued, with the denomination of LVL 100, was 1 988 thousand lats. The respective coins in circulation are not included in the balance sheet caption "Lats in circulation", since their nominal value is directly supported by their content of gold (see also principles described in Note 3 under "Gold circulation coins").

As at the end of 2010, collector coins with the total nominal value of 1 528 thousand lats had been issued (1 480 thousand lats at the end of 2009). These coins are not included in the balance sheet caption "Lats in circulation".

## 22. BALANCES DUE TO CREDIT INSTITUTIONS

Balances due to credit institutions include balances on the settlement accounts of domestic credit institutions opened with the Bank of Latvia, as well as overnight and 7-day deposits (deposit facility) received from them. The respective credit institutions place their funds with the Bank of Latvia in order to comply with its minimum reserve requirement, as well as to effect interbank and customer payments, the Bank of Latvia's monetary policy operations and other settlements. At the end of 2010, the overnight deposit facility rate and 7-day deposit facility rate as set by the Bank of Latvia was 0.25% and 0.375% respectively (in 2009, the overnight deposit facility rate was 1.0% whereas no 7-day deposit facility existed at that time).

At the end of 2010 and 2009, balances due to domestic credit institutions consisted of the following items:

(in thousands of lats)

| | 2010 | 2009 |
|---|---|---|
| Overnight deposit facility | **800** | 260 020 |
| 7-day deposit facility | **873 000** | – |
| Current account balances in lats | **796 405** | 835 761 |
| Current account balances in euro | **20 025** | 19 896 |
| Total | **1 690 230** | 1 115 677 |

## 23. BALANCES DUE TO THE GOVERNMENT

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

At the end of 2010 and 2009, the breakdown of Latvian government deposits was as follows:

(in thousands of lats)

| | 2010 | 2009 |
|---|---|---|
| Time deposits in foreign currencies | **789 809** | 1 063 849 |
| Demand deposits in foreign currencies | **236 674** | 197 870 |
| Demand deposits in lats | **54 527** | 30 223 |
| Total | **1 081 010** | 1 291 942 |

## 24. OTHER DOMESTIC LIABILITIES

At the end of 2010 and 2009, other domestic liabilities consisted of the following items:

(in thousands of lats)

| | 2010 | 2009 |
|---|---|---|
| Accrued expense and similar liabilities | **1 598** | 1 689 |
| Accrued interest expense | **169** | 252 |
| Tax liabilities | **80** | 18 |
| Other | **408** | 1 396 |
| Total | **2 255** | 3 355 |

## 25. TAX

In 2010 and 2009, the Bank of Latvia calculated and paid the following taxes:

(in thousands of lats)

| | Personal income tax | Compulsory social security contributions (by employer) | Compulsory social security contributions (by employee) | Tax on real estate | Value added tax | Other taxes and duties | Total |
|---|---|---|---|---|---|---|---|
| Claims as at 31 December 2008 | 0 | 0 | 0 | 0 | –209 | 0 | –209 |
| During 2009 | | | | | | | |
| Calculated | 2 477 | 2 886 | 1 142 | 93 | 247 | 1 | 6 846 |
| Increase in deferred liabilities | 0 | 146 | 0 | 0 | 0 | 0 | 146 |
| Paid | –2 477 | –3 032 | –1 142 | –93 | –20 | –1 | –6 765 |
| Liabilities as at 31 December 2009 | 0 | 0 | 0 | 0 | 18 | 0 | 18 |
| **During 2010** | | | | | | | |
| Calculated | 2 294 | 2 449 | 924 | 91 | 359 | 1 | 6 118 |
| Increase in deferred liabilities | 0 | 24 | 0 | 0 | 0 | 0 | 24 |
| Paid | –2 294 | –2 473 | –924 | –91 | –297 | –1 | –6 080 |
| **Liabilities as at 31 December 2010** | **0** | **0** | **0** | **0** | **80** | **0** | **80** |

In addition to the tax payments indicated herein, the Bank of Latvia transfers 65% of the profit for the reporting year, including the payment for the usage of state capital (48 355 thousand lats in 2010; 34 734 thousand lats in 2009; see also Notes 26 and 36) to the state budget. The Bank of Latvia is not subject to corporate income tax.

## 26. CAPITAL AND RESERVES

In 2010 and 2009, changes in the Bank of Latvia's capital and reserves were as follows:

(in thousands of lats)

| | Nominal capital | Reserve capital | Valuation account | Profit of the reporting year | Capital and reserves |
|---|---|---|---|---|---|
| As at 31 December 2008 | 25 000 | 95 533 | 68 004 | 53 437 | 241 974 |
| During 2009 | | | | | |
| Revaluation, realisation, and write-downs | x | x | 6 125 | x | 6 125 |
| Profit appropriated to the state budget | x | x | x | –34 734 | –34 734 |
| Profit transferred to the reserve capital | x | 18 703 | x | –18 703 | 0 |
| Profit of the reporting year | x | x | x | 74 393 | 74 393 |
| As at 31 December 2009 | 25 000 | 114 236 | 74 129 | 74 393 | 287 758 |
| **During 2010** | | | | | |
| Revaluation, realisation, and write-downs | x | x | 33 484 | x | 33 484 |
| Profit appropriated to the state budget | x | x | x | –48 355 | –48 355 |
| Profit transferred to the reserve capital | x | 26 037 | x | –26 037 | 0 |
| Profit of the reporting year | x | x | x | 23 754 | 23 754 |
| **As at 31 December 2010** | **25 000** | **140 273** | **107 613** | **23 754** | **296 640** |

The capital of the Bank of Latvia is comprised of the nominal capital, reserve capital and the balance sheet item "Valuation account", as well as the undistributed profit. The Bank of Latvia does not take decisions affecting the formation of the nominal capital, reserve capital, and the profit distribution as they are provided for by the Law "On the Bank of Latvia". The balance sheet item "Valuation account" comprises the positive result on revaluation of the financial instruments. The accounting policies, harmonised with the principal accounting policies established by the ECB Guideline of 10 November 2006 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2006/16) and described in Note 3 stipulate 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 "Valuation account", thus facilitating the preservation of the capital under the impact of financial instrument price, interest rate and exchange rate fluctuations.

No external capital adequacy requirements have been stipulated for the Bank of Latvia capital; nevertheless, is should be adequate to promote credibility of the monetary policy implemented by the Bank of Latvia, and to ensure implementation of its operations and financial independence when performing the tasks set forth by the Law "On the Bank of Latvia". The Bank of Latvia does not hedge interest rate risk related to domestic financial assets where a conflict with the monetary policy pursued by it could arise. The implementation of the monetary policy as well as exposure to other financial and operational risks may adversely affect the Bank of Latvia income or cause losses to be covered from the capital of the Bank of Latvia.

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

The Law "On the Bank of Latvia" establishes that a part of the Bank of Latvia's 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. At the end of 2010 and 2009, the corporate income tax rate applicable to residents of Latvia was 15%. Therefore, 65% of the Bank of Latvia's profit of the reporting year shall be transferred to the state budget within 15 days following the approval of the Annual Report of 2010 by the Council of the Bank of Latvia. In 2011, the Bank of Latvia will transfer 15 440 thousand lats from its profit earned in 2010 to the state budget.

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

In 2010 and 2009, changes in the balance sheet caption "Valuation account" were as follows:

(in thousands of lats)

| | **2010** | Write-downs | Revalua-tion | Reali-sation | 2009 | Write-downs | Revalua-tion | Reali-sation | 2008 |
|---|---|---|---|---|---|---|---|---|---|
| Initial valuation account | **24 093** | x | x | –190 | 24 283 | x | x | 216 | 24 067 |
| Deferred result on revaluation of foreign currencies and gold | 24 018 | x | x | – | 24 018 | x | x | – | 24 018 |
| Deferred result on revaluation of securities | 75 | x | x | –190 | 265 | x | x | 216 | 49 |
| Result on revaluation of foreign currencies and gold | **55 624** | 1 356 | 36 680 | –3 889 | 21 477 | 12 | 18 812 | –1 238 | 3 891 |
| Result on revaluation of non-traded interest rate swap arrangements | **–** | – | – | – | – | – | – | –3 263 | 3 263 |
| Result on revaluation of securities | **27 896** | 11 639 | –1 198 | –10 914 | 28 369 | 5 462 | 9 095 | –22 971 | 36 783 |
| Total | **107 613** | 12 995 | 35 482 | –14 993 | 74 129 | 5 474 | 27 907 | –27 256 | 68 004 |

The initial valuation account was established by transferring thereto the result on revaluation prior to the change in the accounting policies on 1 January 2007. The change in the balance of the initial valuation account in 2010 is related to the recognition of the net profit from the financial instruments held by the Bank of Latvia at the end of 2006 and disposed of in the reporting year in the amount of 190 thousand lats (net loss in the amount of 216 thousand lats in 2009).

**27. NET INTEREST INCOME**

In 2010, the Bank of Latvia's net interest income amounted to 46 344 thousand lats (65 993 thousand lats in 2009). The income was mainly derived from investing foreign currency reserves. The fall in net interest income was mostly on account of a decrease in loans granted to domestic credit institutions, with the low levels of interest rates in the US and euro area also contributing to it.

In 2010, interest income from foreign operations shrank by 2 190 thousand lats in comparison with 2009, and interest expense contracted by 695 thousand lats year-on-year.

Interest income from domestic operations fell by 23 307 thousand lats in comparison with 2009 as lending to domestic credit institutions contracted.

Interest expense on domestic operations (13 362 thousand lats; 18 515 thousand lats in 2009) was largely comprised of interest on deposits of domestic credit institutions and the Latvian government.

Interest expense on credit institution deposits decreased by 2 755 thousand lats. Although the excess bank liquidity resulted in an increase in the amount of bank deposits, interest expense decreased on account of lower interest rates paid on these deposits.

In 2010 the Bank of Latvia received a larger average amount of Latvian government funds as deposits than in 2009; however, interest paid on these deposits fell, therefore interest expense on government deposits decreased by 2 465 thousand lats.

**28. REALISED GAINS/LOSSES FROM FINANCIAL OPERATIONS**

Realised gains or losses from financial operations comprise the gains and losses from the disposal of securities, gains and losses on derivative financial instruments, as well as realised gains and losses on foreign exchange transactions.

Realised results from financial operations were positively affected by the interest rate fall in the US and euro area in the first half of 2010, increasing profits gained from securities disposal. The Bank of Latvia also realised the positive securities revaluation result of 10 914 thousand lats, accumulated on the valuation account in previous reporting years. Gains from the disposal of foreign securities decreased by 10 470 thousand lats in comparison with 2009 on account of a moderating positive impact of the decline in US and euro area interest rates on the market value of debt securities held by the Bank of Latvia.

The realised gains or losses from financial operations were negatively affected by the negative result on derivative financial instruments, exceeding the result of 2009 by 18 366 thousand lats, mostly on account of currency future contracts concluded for the purpose of hedging currency risk exposure, while the positive revaluation result of the hedged balance sheet items is reported in the balance sheet caption "Valuation account" in equal value.

**29. WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS**

The revaluation result of several securities and foreign currency positions at the end of 2010 and 2009 was negative, and it has been recognised as write-downs on financial assets and positions in the profit and loss statement while the positive result on the revaluation of securities and foreign currency positions has been reported in the balance sheet caption "Valuation account" (see also Note 26).

### 30. INCOME FROM PARTICIPATING INTEREST

Income from participating interest in the amount of 611 thousand lats (221 thousand lats in 2009) comprises the dividends received from the participating interest in the BIS (see also Note 11). The increase in dividends paid in 2010 is related to the BIS decision, in view of the BIS financial performance results, to pay normal dividends as well as supplementary dividends.

### 31. OTHER OPERATING INCOME

Other operating income in 2010 and 2009 was as follows:

(in thousands of lats)

| | 2010 | 2009 |
|---|---|---|
| Income from sale of collector coins | **702** | 525 |
| Income from payment and securities settlement services | **310** | 301 |
| Other | **266** | 3 857 |
| Total | **1 278** | 4 683 |

### 32. BANKNOTE PRODUCTION AND COINAGE COSTS

The breakdown of banknote production and coinage costs in 2010 and 2009 was as follows:

(in thousands of lats)

| | 2010 | 2009 |
|---|---|---|
| Banknote production | **–** | 3 322 |
| Coinage of circulation coins | **83** | 842 |
| Coinage of collector coins | **458** | 531 |
| Total | **541** | 4 695 |

### 33. REMUNERATION AND SOCIAL SECURITY COSTS

Remuneration and social security costs in 2010 and 2009 were as follows:

(in thousands of lats)

| | 2010 | 2009 |
|---|---|---|
| Remuneration | | |
| Remuneration of Members of the Council and the Board | **873** | 1 106 |
| Remuneration of other personnel | **9 405** | 11 537 |
| Total remuneration | **10 278** | 12 643 |
| Social security costs | **2 449** | 2 886 |
| Total remuneration and social security costs | **12 727** | 15 529 |

Remuneration of those Members of the Bank of Latvia's Board who are also Heads of Departments of the Bank of Latvia includes remuneration for performance of operational duties.

The number of employees in 2010 and 2009 was as follows:

| | **2010** | 2009 |
|---|---|---|
| Number of employees at the end of the year | | |
| Members of the Council and the Board | **13** | 14 |
| Other personnel | **557** | 604 |
| Total at the end of the year | **570** | 618 |
| Average number of employees per period | **605** | 634 |

From July 2010 to February 2011 the position of a Member of the Council of the Bank of Latvia was vacant. A decrease in the number of employees in 2010 is mostly related to the closing down of the Rēzekne Branch as well as other changes in the operational organisation of the Bank of Latvia.

### 34. OTHER OPERATING EXPENSES

Other operating expenses in 2010 and 2009 were as follows:

(in thousands of lats)

| | **2010** | 2009 |
|---|---|---|
| Municipal services | **577** | 565 |
| Maintenance of buildings, territory and equipment | **328** | 415 |
| Risk insurance | **294** | 291 |
| Disposal of material values | **255** | 3 |
| Business travel | **192** | 235 |
| Telecommunications services and system maintenance | **189** | 228 |
| Information and public relations | **180** | 222 |
| Personnel training | **156** | 240 |
| Transport provision | **126** | 147 |
| Acquisition of low value office supplies | **113** | 197 |
| Tax on real estate | **89** | 91 |
| Audit, advisory and legal services | **34** | 26 |
| Other | **232** | 222 |
| Total | **2 765** | 2 882 |

An increase in the expenses of disposal of material values in 2010 is mostly related to the closing down of the Rēzekne Branch.

The audit, advisory and legal services expenses also comprise the remuneration in the amount of 22 thousand lats paid to Deloitte Audits Latvia SIA for the audit of 2010 financial statements (22 thousand lats in 2009).

## 35. CASH FLOW STATEMENT

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

(in thousands of lats)

| | **2010** | 2009 |
|---|---|---|
| Profit before appropriation | **23 754** | 74 393 |
| Non-cash transaction adjustments | | |
| Depreciation of fixed assets and amortisation of intangible assets | 3 044 | 3 373 |
| Losses on disposal of fixed assets | 255 | 3 |
| Write-downs on financial assets and positions | 12 995 | 5 474 |
| Net non-cash transaction adjustments | **16 294** | 8 850 |
| Change in balance sheet items | | |
| Net decrease of gold | 1 | – |
| Net increase in Special Drawing Rights | –1 687 | –91 050 |
| Net increase in foreign debt securities and other foreign investments | –1 056 008 | –300 030 |
| Net decrease in loans to domestic credit institutions | 140 449 | 498 814 |
| Net decrease in other assets | 419 | 3 007 |
| Net decrease in foreign convertible currency liabilities | –5 324 | –112 246 |
| Net decrease in foreign bank and other international institution deposits in lats | –23 770 | –220 503 |
| Net increase/decrease (–) in lats in circulation | 149 749 | –229 937 |
| Net increase in deposits of domestic credit institutions | 574 553 | 21 382 |
| Net increase/decrease (–) in Latvian government deposits | –210 932 | 653 886 |
| Net increase in deposits of other financial institutions | 54 790 | 243 |
| Net decrease in other liabilities | –1 185 | –14 031 |
| Net change in balance sheet items | **–378 945** | 209 535 |
| Net cash and cash equivalents inflow/outflow (–) arising from operating activities | **–338 897** | 292 778 |

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

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

| | **2010** | Change | 2009 | Change | 2008 |
|---|---|---|---|---|---|
| Convertible foreign currencies in cash | **15 713** | –3 630 | 19 343 | 13 057 | 6 286 |
| Demand deposits with foreign credit institutions and other foreign financial institutions | **531 735** | –273 668 | 805 403 | 143 662 | 661 741 |
| Time deposits with foreign credit institutions and other foreign financial institutions with original maturity up to 5 business days | **9 202** | –110 277 | 119 479 | 99 797 | 19 682 |
| Total cash and cash equivalents | **556 650** | –387 575 | 944 225 | 256 516 | 687 709 |

## 36. TRANSACTIONS WITH THE LATVIAN GOVERNMENT

The Bank of Latvia is wholly owned by the Republic of Latvia and carries out transactions with the Treasury of the Republic of Latvia, acting as the financial agent of the Latvian government. Performing this function, the Bank of Latvia services the Treasury's accounts in lats and foreign currency, as well as conducts foreign exchange transactions. The Bank of Latvia conducts government securities transactions in the secondary securities market in order to implement monetary policy (in 2010 and 2009 the Bank of Latvia did not perform such transactions). In the above transactions, the Bank of Latvia is not subject to the decisions and orders of the government or its institutions, and is independent in making its own decisions.

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

At the end of 2010 and 2009, the breakdown of the Bank of Latvia claims on and liabilities to the Latvian government and the respective interest rates were as follows:

| | Amount (in thousands of lats) | | Interest rate (%) | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Liabilities/claims (–) | | | | |
| Time deposits in foreign currencies | **789 809** | 1 063 849 | **0.22–0.57** | 0.17–0.38 |
| Demand deposits in foreign currencies | **236 674** | 197 870 | **0.01–0.34** | 0.00–0.05 |
| Demand deposits in lats | **54 527** | 30 223 | **0.41** | 1.18 |
| Accrued interest expense | **95** | 4 | **x** | x |
| Tax liabilities | **80** | 18 | **x** | x |
| Spot exchange rate contracts | **–** | –105 | **x** | x |
| Total net liabilities | **1 081 185** | 1 291 859 | **x** | x |

In 2010 and 2009, the breakdown of the Bank of Latvia's income and expense related to the Latvian government, as well as the Bank of Latvia's profit of the previous reporting year appropriated to the state budget was as follows (see also Notes 25–27):

(in thousands of lats)

| | **2010** | 2009 |
|---|---|---|
| Expense and the Bank of Latvia's profit appropriated to the state budget | | |
| Interest on government deposits | **4 127** | 6 592 |
| Taxes | **6 118** | 6 846 |
| Profit appropriated to the state budget | **48 355** | 34 734 |
| Total expense and the Bank of Latvia's profit appropriated to the state budget | **58 600** | 48 172 |

## 37. PLEDGED ASSETS

Securities and other financial instruments with the market value of 18 968 thousand lats, as at the end of 2010 (14 905 thousand lats at the end of 2009), have been pledged to provide collateral for interest rate and currency future contracts. These financial instruments are included in the balance sheet asset caption "Convertible foreign currencies".

## 38. SECURITIES LENDING

On behalf of the Bank of Latvia its agents conclude securities lending transactions, as part of an automatic securities lending programme, where Bank of Latvia's securities are lent against cash or other securities collateral. Securities lending transactions provide additional income without any material impact on foreign currency reserve liquidity as the securities lent are readily available to the Bank of Latvia. The Bank of Latvia's agent administers the securities lending programme and monitors the securities lending and related collateral.

At the end of 2010, the fair value of Bank of Latvia's securities lent was 474 421 thousand lats (99 625 thousand lats as at the end of 2009).

At the end of 2010 and 2009, the fair value of collateral provided in securities lending transactions was as follows:

(in thousands of lats)

| | **2010** | 2009 |
|---|---|---|
| Foreign currency cash | **323 344** | 95 155 |
| Debt securities of foreign governments, financial institutions and non-financial corporations | **158 698** | 6 521 |
| Total | **482 042** | 101 676 |

Foreign currency cash or securities provided as collateral in securities lending transactions is not recognised in the Bank of Latvia's balance sheet (see also principles described in Note 3 under "Securities lending").

### 39. OFF-BALANCE SHEET ACCOUNTS

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

At the end of 2010 and 2009, the Bank of Latvia's off-balance sheet account profile was as follows:

(in thousands of lats)

| | Contract or notional amount | | Book value | | | |
|---|---|---|---|---|---|---|
| | | | Assets | | Liabilities | |
| | **2010** | 2009 | **2010** | 2009 | **2010** | 2009 |
| Non-traded financial derivative and spot exchange rate contracts with foreign financial institutions | | | | | | |
| Forward exchange rate contracts and currency swap arrangements | **1 803 979** | 1 365 021 | **1 292** | 4 676 | **18 542** | 18 216 |
| Spot exchange rate contracts | **54 523** | 68 664 | **1 152** | – | **6** | 137 |
| Total | **x** | x | **2 444** | 4 676 | **18 548** | 18 353 |
| Traded financial derivative contracts with foreign financial institutions | | | | | | |
| Interest rate future contracts | **2 336 784** | 1 307 220 | **–3 820** | –668 | **1 156** | 1 971 |
| Currency future contracts | **319 217** | 210 230 | **1 774** | –1 241 | **–3 220** | 6 745 |
| Total | **x** | x | **–2 046** | –1 909 | **–2 064** | 8 716 |
| Non-traded spot exchange rate contracts with domestic institutions | | | | | | |
| Spot exchange rate contracts | **53 448** | 14 654 | **532** | 147 | **–** | – |
| Total | **x** | x | **532** | 147 | **–** | – |

*(cont.)* (in thousands of lats)

| | Contract or notional amount | | Book value | | | |
|---|---|---|---|---|---|---|
| | | | Assets | | Liabilities | |
| | **2010** | 2009 | **2010** | 2009 | **2010** | 2009 |
| Other transactions | | | | | | |
| Agreements concluded on a regular way placement and receipt of time deposits | **233 331** | 520 045 | **x** | x | **x** | x |
| Forward transactions in securities | **202 350** | 123 547 | **381** | 380 | **526** | 467 |
| Contracted commitments related to acquisition of fixed assets | **4 456** | 79 | **x** | x | **x** | x |

As at the end of 2010 and 2009, the book value and the fair value of non-traded contracts concluded by the Bank of Latvia were not materially different. At the end of 2010 and 2009, the comparison of the book value of the off-balance sheet instruments and their net fair value was as follows:

(in thousands of lats)

| | Net fair value | | Net book value | | Difference | |
|---|---|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 | **2010** | 2009 |
| Non-traded financial derivative contracts with foreign financial institutions and spot exchange rate contracts | | | | | | |
| Forward exchange rate contracts and currency swap arrangements | **–17 388** | –13 552 | **–17 250** | –13 540 | **–138** | –12 |
| Spot exchange rate contracts | **1 146** | –137 | **1 146** | –137 | **0** | 0 |
| Total | **–16 242** | –13 689 | **–16 104** | –13 677 | **–138** | –12 |
| Traded financial derivative contracts with foreign financial institutions | | | | | | |
| Interest rate future contracts | **–2 664** | 1 303 | **–2 664** | 1 303 | **0** | 0 |
| Currency futures contracts | **–1 446** | 5 504 | **–1 446** | 5 504 | **0** | 0 |
| Total | **–4 110** | 6 807 | **–4 110** | 6 807 | **0** | 0 |
| Spot exchange rate contracts with domestic credit institutions | | | | | | |
| Spot exchange rate contracts | **532** | 147 | **532** | 147 | **0** | 0 |
| Total | **532** | 147 | **532** | 147 | **0** | 0 |

## 40. CONTINGENT LIABILITIES AND COMMITMENTS

In 2005, the liquidator of the bankrupt JSC *Banka Baltija* filed a claim against the Bank of Latvia on behalf of the creditors of JSC *Banka Baltija* in the Riga Regional Court for the recovery of losses the amount of which was increased to 238.3 million lats in February 2010 (the amount of claim was 185.6 million lats at the end of 2009). The claimant alleges that the Bank of Latvia, as the institution in charge of banking supervision at that time, is responsible for losses arising from the bankruptcy of JSC *Banka Baltija* in 1995. On 12 October 2010, the court of first instance ruled as follows: to satisfy the claim against the Bank of Latvia in part, collecting 60 million lats from the Bank of Latvia for the benefit of the JSC *Banka Baltija* undergoing liquidation for the purpose of reimbursing losses, and 32 thousand lats as stamp duty for the benefit of the State. The Bank of Latvia is confident that the claim is without merits; therefore no provision is recognised in the financial statements. The Bank of Latvia has appealed the judgement of the court of first instance, thus it has not taken effect. The final ruling on the case is expected no earlier than in 2012.

The Bank of Latvia has not paid up 96.25% of the Bank of Latvia's share in the ECB subscribed capital, which is payable following the decision of the General Council of the ECB. At the end of 2010, the Bank of Latvia's unpaid share in the ECB subscribed capital was 29 383 thousand euro (20 651 thousand lats; at the end of 2009 – 15 199 thousand euro or 10 682 thousand lats, see also Note 10).

The Bank of Latvia's uncalled portion of the BIS shares is 75% of their nominal value. These shares are callable following the decision of the BIS Board. At the end of 2010, the uncalled portion of the BIS share holding was 4 013 thousand SDR (3 291 thousand lats; 4 013 thousand SDR or 3 074 thousand lats at the end of 2009; see also Note 11).

At the end of 2010, the Bank of Latvia had issued collector coins in the nominal value of 1 528 thousand lats (1 480 thousand lats at the end of 2009) and gold circulation coins with a nominal value of 1 988 thousand lats (1 988 thousand lats at the end of 2009). These coins may be represented to the Bank of Latvia in exchange for lats at a nominal value. In the opinion of management, the probability that the Bank of Latvia will be required to repurchase these coins from their holders is considered low and no provisions have been made.

## 41. CURRENCY PROFILE

At the end of 2010 and 2009, the currency profile of the Bank of Latvia's assets, liabilities and off-balance sheet accounts was as follows:

(in thousands of lats)

| | LVL | XDR | USD | EUR | JPY | Gold | Other | Total |
|---|---|---|---|---|---|---|---|---|
| **As at 31 December 2010** | | | | | | | | |
| Assets | | | | | | | | |
| Foreign assets | 2 715 | 101 119 | 1 311 889 | 2 200 244 | 262 317 | 187 179 | 9 148 | 4 074 611 |
| Domestic assets | 32 691 | – | – | 31 | – | – | – | 32 722 |
| **TOTAL ASSETS** | **35 406** | **101 119** | **1 311 889** | **2 200 275** | **262 317** | **187 179** | **9 148** | **4 107 333** |
| Liabilities | | | | | | | | |
| Foreign liabilities | 28 030 | – | 1 269 | 13 215 | 2 | – | 40 | 42 556 |
| Lats in circulation | 937 904 | – | – | – | – | – | – | 937 904 |
| Domestic liabilities | 1 783 437 | 99 356 | 129 463 | 798 750 | 10 792 | – | 8 435 | 2 830 233 |
| **TOTAL LIABILITIES** | **2 749 371** | **99 356** | **130 732** | **811 965** | **10 794** | **–** | **8 475** | **3 810 693** |
| Net position on balance sheet | –2 713 965 | 1 763 | 1 181 157 | 1 388 310 | 251 523 | 187 179 | 673 | 296 640 |
| Net position on financial instruments' off-balance sheet accounts | 53 980 | – | –1 185 852 | 1 552 017 | –252 006 | –187 400 | 1 167 | –18 094 |
| Net position on balance sheet and off-balance sheet accounts | –2 659 985 | 1 763 | –4 695 | 2 940 327 | –483 | –221 | 1 840 | 278 546 |
| Net position on balance sheet and off-balance sheet accounts exposed to currency risk | x | –274[1] | –4 695 | 2 939 577 | –483 | –221 | 1 840 | 2 935 744 |
| Foreign currency profile of the net position on balance sheet and off-balance sheet accounts exposed to currency risk (%) | x | –0.01 | –0.15 | 100.13 | –0.02 | –0.01 | 0.06 | 100.00 |
| Benchmark currency structure (%) | x | 0 | 0 | 100.00 | 0 | 0 | 0 | 100.00 |
| As at 31 December 2009 | | | | | | | | |
| TOTAL ASSETS | 180 387 | 93 000 | 931 603 | 2 057 175 | 160 863 | 134 365 | 2 911 | 3 560 304 |
| TOTAL LIABILITIES | 1 969 908 | 91 237 | 92 856 | 1 118 161 | 71 | – | 313 | 3 272 546 |

[1] Net SDR position on balance sheet and off-balance sheet accounts exposed to currency risk comprises liabilities to the IMF (274 thousand lats) and does not include participating interest in the BIS (1 763 thousand lats).

*(cont.)* (in thousands of lats)

| | LVL | XDR | USD | EUR | JPY | Gold | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Net position on balance sheet | –1 789 521 | 1 763 | 838 747 | 939 014 | 160 792 | 134 365 | 2 598 | 287 758 |
| Net position on financial instruments' off-balance sheet accounts | –6 178 | – | –839 079 | 1 126 027 | –160 143 | –134 524 | –170 | –14 067 |
| Net position on balance sheet and off-balance sheet accounts | –1 795 699 | 1 763 | –332 | 2 065 041 | 649 | –159 | 2 428 | 273 691 |
| Net position on balance sheet and off-balance sheet accounts exposed to currency risk | x | –256 | –332 | 2 064 291 | 649 | –159 | 2 428 | 2 066 621 |
| Foreign currency profile of the net position on balance sheet and off-balance sheet accounts exposed to currency risk (%) | x | –0.01 | –0.02 | 99.89 | 0.03 | –0.01 | 0.12 | 100.00 |
| Benchmark currency structure (%) | x | 0 | 0 | 100.00 | 0 | 0 | 0 | 100.00 |

## 42. REPRICING MATURITY AND TRACKING ERROR

The table below reflects the sensitivity of the Bank of Latvia'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 items reported in this table.

(in thousands of lats)

| | Interest bearing | | | | | Non-interest bearing | Total |
|---|---|---|---|---|---|---|---|
| | Up to 3 months | 3–6 months | 6–12 months | 1–3 years | Over 3 years | | |
| **As at 31 December 2010** | | | | | | | |
| Foreign assets | | | | | | | |
| Gold | – | – | – | – | – | 187 179 | 187 179 |
| Special Drawing Rights | 99 356 | – | – | – | – | – | 99 356 |
| Convertible foreign currencies | 1 753 723 | 102 874 | 144 036 | 904 889 | 857 959 | 18 686 | 3 782 167 |
| Participating interest in the European Central Bank | – | – | – | – | – | 750 | 750 |
| Participating interest in the Bank for International Settlements | – | – | – | – | – | 1 763 | 1 763 |
| Other foreign assets | 79 | – | – | – | – | 3 317 | 3 396 |
| Domestic assets | | | | | | | |
| Fixed assets | – | – | – | – | – | 31 003 | 31 003 |
| Other domestic assets | – | – | – | – | – | 1 719 | 1 719 |
| **TOTAL ASSETS** | **1 853 158** | **102 874** | **144 036** | **904 889** | **857 959** | **244 417** | **4 107 333** |
| Foreign liabilities | | | | | | | |
| Convertible foreign currencies | 561 | – | – | – | – | 13 121 | 13 682 |
| International Monetary Fund | – | – | – | – | – | 274 | 274 |
| Other international institution deposits in lats | – | – | – | – | – | 8 505 | 8 505 |
| Foreign bank deposits in lats | – | – | – | – | – | 726 | 726 |
| Other foreign liabilities | – | – | – | – | – | 19 369 | 19 369 |

*(cont.)* (in thousands of lats)

| | Interest bearing | | | | | Non-interest bearing | Total |
|---|---|---|---|---|---|---|---|
| | Up to 3 months | 3–6 months | 6–12 months | 1–3 years | Over 3 years | | |
| Lats in circulation | – | – | – | – | – | 937 904 | 937 904 |
| Domestic liabilities | | | | | | | |
| Balances due to credit institutions | 1 670 205 | – | – | – | – | 20 025 | 1 690 230 |
| Balances due to the government | 979 733 | – | – | – | – | 101 277 | 1 081 010 |
| Balances due to other financial institutions | 55 960 | – | – | – | – | 778 | 56 738 |
| Other domestic liabilities | 129 | – | – | – | – | 2 126 | 2 255 |
| **TOTAL LIABILITIES** | **2 706 588** | **–** | **–** | **–** | **–** | **1 104 105** | **3 810 693** |
| Net position on balance sheet | –853 430 | 102 874 | 144 036 | 904 889 | 857 959 | x | x |
| Assets on financial instruments' off-balance sheet accounts | 3 548 301 | – | – | 913 397 | 293 321 | x | x |
| Liabilities on financial instruments' off-balance sheet accounts | 3 414 636 | – | – | 1 072 461 | 283 494 | x | x |
| Net position on balance sheet and off-balance sheet accounts | –719 765 | 102 874 | 144 036 | 745 825 | 867 786 | x | x |
| As at 31 December 2009 | | | | | | | |
| TOTAL ASSETS | 2 052 710 | 55 039 | 98 054 | 677 366 | 477 515 | 199 620 | 3 560 304 |
| TOTAL LIABILITIES | 2 385 405 | – | – | – | – | 887 141 | 3 272 546 |
| Net position on balance sheet | –332 695 | 55 039 | 98 054 | 677 366 | 477 515 | x | x |
| Assets on financial instruments' off-balance sheet accounts | 1 991 053 | 54 933 | 72 372 | 840 742 | 116 861 | x | x |
| Liabilities on financial instruments' off-balance sheet accounts | 2 503 204 | 175 715 | 58 845 | 178 583 | 173 144 | x | x |
| Net position on balance sheet and off-balance sheet accounts | –844 846 | –65 743 | 111 581 | 1 339 525 | 421 232 | x | x |

The exposure to aggregate market risk and credit risk of foreign reserves, included in portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark 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 a respective benchmark (see also risk management principles described in Note 2 under "Financial risks"). In 2010 and 2009, the actual *(ex-post)* tracking error of the portfolios managed against multi-currency fixed income securities benchmark was 65 basis points and 55 basis points respectively, whereas the tracking error of the portfolios managed against asset-backed securities benchmark was 81 basis points and 116 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 lats) | Expected tracking error (number of business days) | | | |
|---|---|---|---|---|---|
| | | 10–39 | 40–69 | 70–99 | 100–130 |
| **During 2010** | | | | | |
| Portfolios managed against multi-currency fixed income securities benchmark | 2 602 693 | – | 219 | 30 | – |
| Portfolios managed against asset-backed securities benchmark | 165 090 | – | 231 | 18 | – |
| During 2009 | | | | | |
| Portfolios managed against multi-currency fixed income securities benchmark | 1 762 219 | – | 181 | 66 | 1 |
| Portfolios managed against asset-backed securities benchmark | 154 934 | 5 | 212 | 31 | – |

## 43. LIQUIDITY PROFILE

At the end of 2010 and 2009, the liquidity profile of the Bank of Latvia's assets and liabilities was as follows:

(in thousands of lats)

| | | | **2010** | | | 2009 |
|---|---|---|---|---|---|---|
| | Up to 3 months | No fixed maturity | **Total** | Up to 3 months | No fixed maturity | Total |
| Assets | | | | | | |
| Foreign assets | 4 071 606 | 3 005 | **4 074 611** | 3 381 667 | 2 918 | 3 384 585 |
| Domestic assets | 690 | 32 032 | **32 722** | 141 511 | 34 208 | 175 719 |
| TOTAL ASSETS | 4 072 296 | 35 037 | **4 107 333** | 3 523 178 | 37 126 | 3 560 304 |
| Liabilities | | | | | | |
| Foreign liabilities | 42 522 | 34 | **42 556** | 71 437 | 32 | 71 469 |
| Lats in circulation | – | 937 904 | **937 904** | – | 788 155 | 788 155 |
| Domestic liabilities | 2 830 233 | – | **2 830 233** | 2 412 922 | – | 2 412 922 |
| TOTAL LIABILITIES | 2 872 755 | 937 938 | **3 810 693** | 2 484 359 | 788 187 | 3 272 546 |
| Net position on balance sheet | 1 199 541 | –902 901 | **x** | 1 038 819 | –751 061 | x |

In the Note, asset items are reported on the basis of the Bank of Latvia's capability to convert them into cash. Liabilities items are reported by their expected settlement date.

### 44. SECTORAL PROFILE OF ASSETS

The sectoral profile of the Bank of Latvia's assets at the end of 2010 and 2009 was as follows:

| | Amount (in thousands of lats) | | Percentage (%) | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Foreign central governments and other governmental institutions | **1 234 527** | 1 327 922 | **30.1** | 37.3 |
| Foreign local governments | **64 268** | 86 146 | **1.6** | 2.4 |
| Foreign central banks and credit institutions | **1 809 206** | 1 480 509 | **44.0** | 41.6 |
| Other foreign financial institutions | **704 888** | 376 264 | **17.2** | 10.6 |
| Foreign non-financial corporations | **65 687** | 12 427 | **1.6** | 0.3 |
| International institutions | **196 395** | 141 194 | **4.8** | 4.0 |
| Latvian central government | **–** | 101 110 | **–** | 2.8 |
| Domestic credit institutions | **584** | 47 | **0** | 0 |
| Unclassified assets | **31 778** | 34 685 | **0.7** | 1.0 |
| Total | **4 107 333** | 3 560 304 | **100.0** | 100.0 |

For the purposes of credit risk analysis, loans issued to domestic credit institutions and secured by pledged securities are classified herein according to the issuer of the security.

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

At the end of 2010 and 2009, the Bank of Latvia's foreign assets broken down by their location or the counterparty's domicile were as follows:

| | Amount (in thousands of lats) | | Percentage (%) | |
|---|---|---|---|---|
| | **2010** | 2009 | **2010** | 2009 |
| Euro area | **1 910 391** | 2 003 361 | **46.9** | 59.2 |
| Other EU countries | **697 914** | 324 963 | **17.1** | 9.6 |
| US | **594 517** | 588 869 | **14.6** | 17.4 |
| Japan | **256 361** | 160 300 | **6.3** | 4.7 |
| Other countries and international institutions | **615 428** | 307 092 | **15.1** | 9.1 |
| Total | **4 074 611** | 3 384 585 | **100.0** | 100.0 |

## 46. ASSETS BY CREDIT RATINGS ASSIGNED TO THE COUNTERPARTY

At the end of 2010 and 2009, the Bank of Latvia's assets broken down by categories of credit ratings assigned to the counterparty were as follows:

| | Credit rating | Amount (in thousands of lats) | | Percentage (%) | |
|---|---|---|---|---|---|
| | | **2010** | 2009 | **2010** | 2009 |
| FOREIGN ASSETS | | | | | |
| Gold | AAA | **187 179** | 134 365 | **4.6** | 3.8 |
| Special Drawing Rights | AAA | **99 356** | 91 237 | **2.4** | 2.6 |
| Foreign debt securities | AAA | **1 814 171** | 1 597 094 | **44.1** | 44.9 |
| | AA+ | **78 814** | 97 909 | **1.9** | 2.8 |
| | AA | **154 700** | 37 236 | **3.8** | 1.0 |
| | AA– | **483 514** | 183 745 | **11.8** | 5.2 |
| | A+ | **129 596** | 65 680 | **3.2** | 1.8 |
| | A | **24 238** | 3 565 | **0.6** | 0.1 |
| | A– | **3 646** | 2 389 | **0.1** | 0.1 |
| | BBB+ | **733** | 23 966 | **0** | 0.7 |
| | BBB | **–** | 445 | **–** | 0 |
| | BBB– | **–** | 231 | **–** | 0 |
| Deposits with foreign financial institutions | AAA | **518 452** | 758 524 | **12.7** | 21.3 |
| | AA+ | **2 454** | 487 | **0.1** | 0 |
| | AA | **59 918** | 93 001 | **1.5** | 2.6 |
| | AA– | **133 053** | 15 805 | **3.2** | 0.4 |
| | A+ | **190 607** | 177 692 | **4.6** | 5.0 |
| | A | **144 444** | 56 310 | **3.5** | 1.6 |
| | A– | **28 114** | 17 570 | **0.7** | 0.5 |
| Foreign currency in cash | AAA | **15 713** | 19 343 | **0.4** | 0.5 |
| Participating interest in the European Central Bank | AAA | **750** | 750 | **0** | 0 |
| Participating interest in the Bank for International Settlements | AAA | **1 763** | 1 763 | **0** | 0.1 |
| Derivative financial instruments | AAA | **385** | 1 084 | **0** | 0 |
| | AA | **115** | 316 | **0** | 0 |
| | AA– | **470** | 19 | **0** | 0 |
| | A+ | **1 503** | 1 567 | **0** | 0.1 |
| | A | **315** | 1 521 | **0** | 0 |
| | A– | **37** | 549 | **0** | 0 |
| Accrued interest income | Different | **79** | 17 | **0** | 0 |
| Other foreign assets | Different | **492** | 405 | **0** | 0 |
| DOMESTIC ASSETS | | | | | |
| Loans to credit institutions | Different | **–** | 140 449 | **–** | 3.9 |
| Other | Different | **32 722** | 35 270 | **0.8** | 1.0 |
| TOTAL | | **4 107 333** | 3 560 304 | **100.0** | 100.0 |

At the end of 2010 and 2009, the Bank of Latvia's foreign assets broken down by major categories of credit ratings assigned to the counterparty were as follows:

| | Credit rating category | Amount (in thousands of lats) | | Percentage (%) | |
|---|---|---|---|---|---|
| | | **2010** | 2009 | **2010** | 2009 |
| Foreign assets | AAA | **2 637 769** | 2 604 160 | **64.8** | 76.9 |
| | AA | **913 038** | 428 518 | **22.4** | 12.7 |
| | A | **522 500** | 326 843 | **12.8** | 9.7 |
| | BBB | **733** | 24 642 | **0** | 0.7 |
| | Different | **571** | 422 | **0** | 0 |
| Total | | **4 074 611** | 3 384 585 | **100.0** | 100.0 |

Based on Standard & Poor's credit ratings or other equivalent credit ratings assigned by other international credit rating agency to the counterparty, the above tables show the breakdown of the Bank of Latvia's assets as at the end of the 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. Ratings below "AAA" are modified by marks "+" or "–" to show the relative standing within the major categories of an international agency's ratings.

# INDEPENDENT AUDITORS' REPORT





**TO THE COUNCIL OF THE BANK OF LATVIA**

We have audited the accompanying financial statements of the Bank of Latvia ("the Bank"), which comprise the balance sheet as at 31 December 2010, and the related statements of profit and loss, total recognised gains and losses and cash flows for the year then ended, and a summary of principal accounting policies and other explanatory notes to the financial statements, as set out on pages 74 to 117.

*Board's Responsibility for the Financial Statements*

The Board of the Bank is responsible for the preparation and fair presentation of these financial statements in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Council of the Bank, and the law "On the Bank of Latvia", and 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.

*Auditors' Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the financial statements 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 entity's internal control. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by the Board of the Bank, as well as evaluating the overall presentation of the financial statements.

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

*Opinion*

In our opinion, the financial statements of the Bank give a true and fair view of the financial position of the Bank as at 31 December 2010, and of its financial performance and its cash flows for the year then ended in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Council of the Bank, and the law "On the Bank of Latvia".

Deloitte Audits Latvia SIA
Licence No. 43

Inguna Stasa
Board Member

Riga, Latvia
14 March 2011

The State Audit Office
of the Republic of Latvia

Inguna Sudraba
Auditor General

Riga, Latvia
14 March 2011

# APPENDICES

*Appendix 1*

## MONETARY INDICATORS IN 2010

(at end of period; in millions of lats)

| | I | II | III | IV | V | VI | VII | VIII | IX | X | XI | **XII** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **BANK OF LATVIA** | | | | | | | | | | | | |
| M0 | 1 746.3 | 1 923.5 | 1 464.9 | 1 611.8 | 1 564.2 | 1 700.4 | 1 741.2 | 1 652.7 | 1 771.2 | 1 682.6 | 1 744.2 | **1 755.2** |
| Currency in circulation | 752.4 | 767.7 | 774.2 | 827.1 | 819.0 | 838.3 | 856.4 | 864.5 | 866.8 | 885.5 | 888.9 | **937.9** |
| Demand deposits with the Bank of Latvia | 993.9 | 1 155.8 | 690.7 | 784.8 | 745.3 | 862.1 | 884.8 | 788.3 | 904.4 | 797.1 | 855.2 | **817.3** |
| Currency vs monetary base (%) | 43.1 | 39.9 | 52.9 | 51.3 | 52.4 | 49.3 | 49.2 | 52.3 | 48.9 | 52.6 | 51.0 | **53.4** |
| Net foreign assets | 3 412.9 | 3 524.3 | 3 899.7 | 3 779.3 | 3 868.1 | 3 920.4 | 3 939.4 | 4 088.0 | 4 139.8 | 4 224.2 | 4 203.5 | **4 032.1** |
| Net domestic assets | –1 666.6 | –1 600.8 | –2 434.9 | –2 167.4 | –2 303.9 | –2 220.0 | –2 198.2 | –2 435.3 | –2 368.6 | –2 541.6 | –2 459.4 | **–2 276.8** |
| Credit | –1 316.6 | –1 216.8 | –1 460.3 | –1 314.4 | –1 421.5 | –1 400.8 | –1 347.0 | –1 372.3 | –1 327.7 | –1 399.7 | –1 326.8 | **–1 081.0** |
| To MFIs | 131.7 | 117.6 | 117.6 | 116.3 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | **0** |
| To government (net) | –1 448.3 | –1 334.4 | –1 578.0 | –1 430.8 | –1 421.5 | –1 400.8 | –1 347.0 | –1 372.3 | –1 327.7 | –1 399.7 | –1 326.8 | **–1 081.0** |
| Other assets (net) | –350.0 | –384.0 | –974.5 | –853.0 | –882.4 | –819.2 | –851.2 | –1 063.0 | –1 041.0 | –1 141.9 | –1 132.5 | **–1 195.8** |
| **MFI** | | | | | | | | | | | | |
| M1 | 2 921.4 | 2 997.5 | 3 100.4 | 3 192.7 | 3 191.7 | 3 303.5 | 3 326.1 | 3 364.0 | 3 408.9 | 3 454.5 | 3 511.9 | **3 770.6** |
| M2 | 5 714.1 | 5 841.8 | 5 982.7 | 6 091.3 | 6 053.1 | 6 028.7 | 6 055.6 | 6 128.1 | 6 217.7 | 6 099.6 | 6 216.9 | **6 445.6** |
| M3 | 5 806.3 | 5 944.5 | 6 081.0 | 6 189.6 | 6 165.4 | 6 147.4 | 6 173.7 | 6 252.0 | 6 332.9 | 6 212.5 | 6 326.2 | **6 547.6** |
| M2X | 5 734.8 | 5 851.3 | 5 981.2 | 6 079.5 | 6 104.1 | 6 046.5 | 6 061.1 | 6 120.1 | 6 190.3 | 6 039.1 | 6 129.2 | **6 390.0** |
| Currency outside MFIs | 653.0 | 666.5 | 669.2 | 713.9 | 715.3 | 733.6 | 750.8 | 758.5 | 760.1 | 776.6 | 775.5 | **807.4** |
| Deposits of resident financial institutions, non-financial corporations and households | 5 081.8 | 5 184.9 | 5 312.0 | 5 365.5 | 5 388.8 | 5 312.9 | 5 310.4 | 5 361.6 | 5 430.2 | 5 262.5 | 5 353.7 | **5 582.7** |
| In foreign currencies | 2 814.5 | 2 792.7 | 2 833.0 | 2 822.3 | 2 776.3 | 2 720.7 | 2 685.0 | 2 729.7 | 2 749.1 | 2 617.2 | 2 684.0 | **2 807.9** |
| Net foreign assets | –2 827.8 | –2 551.9 | –1 939.7 | –1 893.8 | –1 826.7 | –1 720.4 | –1 658.0 | –1 470.6 | –1 320.1 | –1 360.5 | –1 266.0 | **–1 219.8** |
| Net domestic assets | 8 562.6 | 8 403.2 | 7 920.9 | 7 973.3 | 7 930.8 | 7 766.9 | 7 719.1 | 7 590.7 | 7 510.4 | 7 399.6 | 7 395.2 | **7 609.8** |
| Loans to resident financial institutions, non-financial corporations and households | 13 444.6 | 13 352.9 | 13 217.3 | 13 136.5 | 13 124.0 | 13 007.8 | 12 893.7 | 12 885.2 | 12 808.1 | 12 669.6 | 12 596.6 | **12 399.3** |
| **INTEREST RATES** | | | | | | | | | | | | |
| Bank of Latvia refinancing rate (at end of period; %) | 4.0 | 4.0 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | **3.5** |
| Weighted average interest rates on transactions in lats (%) | | | | | | | | | | | | |
| Interbank loans | 1.1 | 1.0 | 1.0 | 0.9 | 0.9 | 0.9 | 0.9 | 0.5 | 0.5 | 0.5 | 0.5 | **0.2** |
| Loans to non-financial corporations and households with a floating interest rate and an initial rate fixation of up to 1 year (new business) | 19.5 | 10.1 | 7.0 | 8.3 | 5.1 | 10.6 | 5.6 | 10.0 | 12.7 | 10.4 | 9.7 | **5.7** |
| Time deposits of non-financial corporations and households (new business) | 5.6 | 4.1 | 3.1 | 1.7 | 1.2 | 1.4 | 1.1 | 1.2 | 0.9 | 0.8 | 0.6 | **0.8** |

*Appendix 2*

## THE BANK OF LATVIA MONTH-END BALANCE SHEETS FOR 2010

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

| | I | II | III | IV | V | VI | VII | VIII | IX | X | XI | **XII** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| FOREIGN ASSETS | 3 454 523 | 3 564 269 | 3 921 668 | 3 821 609 | 3 917 469 | 3 938 673 | 3 960 571 | 4 117 493 | 4 175 818 | 4 279 393 | 4 268 294 | **4 074 611** |
| Gold | 135 931 | 141 763 | 143 853 | 154 137 | 172 072 | 176 931 | 156 608 | 169 658 | 168 716 | 167 696 | 179 860 | **187 179** |
| SDR | 93 262 | 96 661 | 95 693 | 96 782 | 102 262 | 103 236 | 99 659 | 101 309 | 97 058 | 102 394 | 99 717 | **99 356** |
| Convertible foreign currencies | 3 221 688 | 3 322 058 | 3 674 729 | 3 567 330 | 3 639 543 | 3 649 115 | 3 667 191 | 3 840 196 | 3 847 849 | 4 003 053 | 3 984 943 | **3 782 167** |
| Participating interest in the ECB | 750 | 750 | 750 | 750 | 750 | 750 | 750 | 750 | 750 | 750 | 750 | **750** |
| Participating interest in the BIS | 1 763 | 1 763 | 1 763 | 1 763 | 1 763 | 1 763 | 1 763 | 1 763 | 1 763 | 1 763 | 1 763 | **1 763** |
| Other foreign assets | 1 129 | 1 274 | 4 880 | 847 | 1 079 | 6 878 | 34 600 | 3 817 | 59 682 | 3 737 | 1 261 | **3 396** |
| DOMESTIC ASSETS | 167 395 | 154 055 | 152 218 | 151 331 | 33 261 | 33 132 | 33 170 | 33 082 | 33 083 | 32 714 | 32 517 | **32 722** |
| Loans to credit institutions | 131 702 | 117 644 | 117 644 | 116 349 | – | – | – | – | – | – | – | **–** |
| Fixed assets | 33 005 | 32 783 | 32 550 | 32 326 | 32 106 | 31 915 | 31 992 | 31 800 | 31 698 | 31 500 | 31 290 | **31 003** |
| Other domestic assets | 2 688 | 3 628 | 2 024 | 2 656 | 1 155 | 1 217 | 1 178 | 1 282 | 1 385 | 1 214 | 1 227 | **1 719** |
| **TOTAL ASSETS** | 3 621 918 | 3 718 324 | 4 073 886 | 3 972 940 | 3 950 730 | 3 971 805 | 3 993 741 | 4 150 575 | 4 208 901 | 4 312 107 | 4 300 811 | **4 107 333** |
| FOREIGN LIABILITIES | 41 658 | 39 989 | 21 956 | 42 335 | 49 355 | 18 295 | 21 178 | 29 484 | 35 992 | 55 206 | 64 747 | **42 556** |
| Convertible foreign currencies | 6 996 | 6 690 | 3 451 | 6 981 | 1 689 | 2 142 | 2 506 | 3 047 | 16 020 | 16 470 | 2 149 | **13 682** |
| IMF | 262 | 267 | 265 | 268 | 281 | 284 | 274 | 279 | 267 | 267 | 274 | **274** |
| Other international institution deposits in lats | 6 666 | 2 481 | 8 379 | 14 486 | 2 832 | 7 716 | 16 985 | 5 018 | 16 111 | 27 274 | 17 054 | **8 505** |
| Foreign bank deposits in lats | 459 | 409 | 907 | 304 | 253 | 228 | 463 | 453 | 453 | 430 | 776 | **726** |
| Other foreign liabilities | 27 275 | 30 142 | 8 954 | 20 296 | 44 300 | 7 925 | 950 | 20 687 | 3 141 | 10 765 | 44 494 | **19 369** |
| LATS IN CIRCULATION | 752 428 | 767 738 | 774 179 | 827 064 | 818 954 | 838 336 | 856 439 | 864 462 | 866 836 | 885 505 | 888 924 | **937 904** |
| DOMESTIC LIABILITIES | 2 529 852 | 2 603 054 | 2 967 587 | 2 835 111 | 2 807 141 | 2 833 605 | 2 830 063 | 2 957 651 | 3 007 510 | 3 076 607 | 3 052 734 | **2 830 233** |
| Balances due to credit institutions | 1 075 944 | 1 263 111 | 1 359 987 | 1 396 756 | 1 378 640 | 1 425 712 | 1 469 574 | 1 562 394 | 1 636 952 | 1 624 836 | 1 666 253 | **1 690 230** |
| Balances due to the government | 1 448 269 | 1 334 432 | 1 577 965 | 1 430 790 | 1 421 544 | 1 400 768 | 1 346 975 | 1 372 293 | 1 327 671 | 1 399 664 | 1 326 845 | **1 081 010** |
| Balances due to other financial institutions | 2 530 | 2 364 | 2 087 | 3 009 | 3 626 | 4 004 | 11 231 | 20 200 | 40 160 | 49 279 | 56 293 | **56 738** |
| Other domestic liabilities | 3 109 | 3 147 | 27 548 | 4 556 | 3 331 | 3 121 | 2 283 | 2 764 | 2 727 | 2 828 | 3 343 | **2 255** |
| CAPITAL AND RESERVES | 297 980 | 307 543 | 310 164 | 268 430 | 275 280 | 281 569 | 286 061 | 298 978 | 298 563 | 294 789 | 294 406 | **296 640** |
| **TOTAL LIABILITIES, CAPITAL AND RESERVES** | 3 621 918 | 3 718 324 | 4 073 886 | 3 972 940 | 3 950 730 | 3 971 805 | 3 993 741 | 4 150 575 | 4 208 901 | 4 312 107 | 4 300 811 | **4 107 333** |

*Appendix 3*

## THE BANK OF LATVIA YEAR-END BALANCE SHEETS FOR THE YEARS 2006–2010

(at end of year; in thousands of lats)

| | 2006 | 2007 | 2008 | 2009 | **2010** |
|---|---|---|---|---|---|
| FOREIGN ASSETS | 2 451 207 | 2 806 790 | 2 734 395 | 3 384 585 | **4 074 611** |
| Gold | 83 668 | 99 130 | 108 998 | 134 365 | **187 179** |
| SDR | 85 | 83 | 187 | 91 237 | **99 356** |
| Convertible foreign currencies | 2 333 279 | 2 687 707 | 2 488 693 | 3 150 992 | **3 782 167** |
| Participating interest in the ECB | 760 | 743 | 743 | 750 | **750** |
| Participating interest in the BIS | 1 763 | 1 763 | 1 763 | 1 763 | **1 763** |
| Other foreign assets | 31 652 | 17 364 | 134 011 | 5 478 | **3 396** |
| DOMESTIC ASSETS | 34 913 | 41 211 | 679 200 | 175 719 | **32 722** |
| Loans to credit institutions | – | 6 850 | 639 263 | 140 449 | **–** |
| Fixed assets | 32 763 | 32 646 | 34 626 | 33 232 | **31 003** |
| Other domestic assets[1] | 2 150 | 1 715 | 5 311 | 2 038 | **1 719** |
| **TOTAL ASSETS** | 2 486 120 | 2 848 001 | 3 413 595 | 3 560 304 | **4 107 333** |
| FOREIGN LIABILITIES | 36 881 | 30 825 | 402 145 | 71 469 | **42 556** |
| Convertible foreign currencies | 21 158 | 5 330 | 131 252 | 19 006 | **13 682** |
| IMF[1] | 269 | 254 | 256 | 256 | **274** |
| Other international institution deposits in lats | 1 348 | 6 049 | 6 503 | 32 502 | **8 505** |
| Foreign bank deposits in lats | 448 | 35 | 247 001 | 499 | **726** |
| Other foreign liabilities | 13 658 | 19 157 | 17 133 | 19 206 | **19 369** |
| LATS IN CIRCULATION | 1 073 851 | 1 049 473 | 1 018 092 | 788 155 | **937 904** |
| DOMESTIC LIABILITIES | 1 271 929 | 1 597 218 | 1 751 384 | 2 412 922 | **2 830 233** |
| Balances due to credit institutions | 1 212 263 | 1 416 802 | 1 094 295 | 1 115 677 | **1 690 230** |
| Balances due to the government | 49 818 | 171 241 | 638 056 | 1 291 942 | **1 081 010** |
| Balances due to other finantial instruments | 6 308 | 4 876 | 1 705 | 1 948 | **56 738** |
| Other domestic liabilities | 3 540 | 4 299 | 17 328 | 3 355 | **2 255** |
| CAPITAL AND RESERVES | 103 459 | 170 485 | 241 974 | 287 758 | **296 640** |
| Nominal capital | 25 000 | 25 000 | 25 000 | 25 000 | **25 000** |
| Reserve capital | 54 898 | 59 508 | 95 533 | 114 236 | **140 273** |
| Valuation account | 16 442 | 34 513 | 68 004 | 74 129 | **107 613** |
| Undistributed profit | 6 586 | 51 464 | 53 437 | 74 393 | **23 754** |
| EU grant | 533 | – | – | – | **–** |
| **TOTAL LIABILITIES, CAPITAL AND RESERVES** | 2 486 120 | 2 848 001 | 3 413 595 | 3 560 304 | **4 107 333** |

[1] In the financial statements for 2006–2007, Latvia's quota in the IMF, secured by a promissory note issued by the government of Latvia, is reported in the asset and liability item "The International Monetary Fund" respectively. In 2008, the Bank of Latvia changed the reporting of assets and liabilities related to the IMF on its balance sheet. Latvia's quota in the IMF, secured by a promissory note issued by the government of Latvia, has been excluded from the foreign assets and liabilities respectively and reported in the financial statements of the government of Latvia.

*Appendix 4*

## THE BANK OF LATVIA PROFIT AND LOSS STATEMENTS FOR THE YEARS 2006–2010

(in thousands of lats)

| | 2006 | 2007[1] | 2008 | 2009 | **2010** |
|---|---|---|---|---|---|
| INTEREST INCOME | | | | | |
| Foregn operations | 51 057 | 125 829 | 143 646 | 59 245 | **57 055** |
| Domestic operations | –3 167 | 3 278 | 7 264 | 26 925 | **3 618** |
| INTEREST EXPENSE | | | | | |
| Foregn operations | 8 | 24 255 | 11 923 | 1 662 | **967** |
| Domestic operations | 20 188 | 36 122 | 54 461 | 18 516 | **13 362** |
| NET INTEREST INCOME | 27 694 | 68 730 | 84 526 | 65 993 | **46 344** |
| REALISED GAINS OR LOSSES FROM FINANCIAL OPERATIONS (–)[2] | – | 14 310[3] | 34 886 | 36 959 | **9 147** |
| INCOME FROM PARTICIPATING INTEREST[4] | 211 | 216 | 206 | 221 | **611** |
| WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS | – | 5 862 | 38 087 | 5 474 | **12 995** |
| OTHER OPERATING INCOME | 712 | 1 195 | 3 433 | 4 683 | **1 278** |
| BANKNOTE PRODUCTION AND COINAGE COSTS[5] | 1 071 | 3 772 | 4 046 | 4 695 | **541** |
| OTHER OPERATING EXPENSES | 20 960 | 23 353 | 27 481 | 23 294 | **20 090** |
| PROFIT OF THE REPORTING YEAR | 6 586 | 51 464 | 53 437 | 74 393 | **23 754** |
| Profit transferrable to the reserve capital | 4 610 | 36 025 | 18 703 | 26 038 | **8 314** |
| Profit transferrable to the state budget | 1 976 | 15 439 | 34 734 | 48 355 | **15 440** |

*Appendix 5*

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

(LVL vs foreign currency)

| 2010 | GBP | | | | JPY | | | | USD | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Maximum | Average | Minimum | At end of period | Maximum | Average | Minimum | At end of period | Maximum | Average | Minimum | At end of period |
| I | 0.8120 | 0.7938 | 0.7790 | 0.8120 | 0.5590 | 0.5379 | 0.5250 | 0.5560 | 0.5020 | 0.4916 | 0.4830 | 0.5020 |
| II | 0.8130 | 0.8039 | 0.7970 | 0.8000 | 0.5840 | 0.5685 | 0.5560 | 0.5840 | 0.5220 | 0.5131 | 0.5030 | 0.5220 |
| III | 0.7910 | 0.7791 | 0.7710 | 0.7820 | 0.5820 | 0.5729 | 0.5630 | 0.5640 | 0.5280 | 0.5175 | 0.5100 | 0.5210 |
| IV | 0.8160 | 0.8009 | 0.7900 | 0.8060 | 0.5720 | 0.5609 | 0.5520 | 0.5660 | 0.5320 | 0.5231 | 0.5140 | 0.5310 |
| V | 0.8300 | 0.8194 | 0.8020 | 0.8300 | 0.6350 | 0.6031 | 0.5650 | 0.6270 | 0.5750 | 0.5564 | 0.5310 | 0.5710 |
| VI | 0.8650 | 0.8445 | 0.8260 | 0.8650 | 0.6460 | 0.6290 | 0.6180 | 0.6460 | 0.5890 | 0.5739 | 0.5650 | 0.5730 |
| VII | 0.8660 | 0.8431 | 0.8270 | 0.8440 | 0.6510 | 0.6310 | 0.6150 | 0.6200 | 0.5750 | 0.5535 | 0.5400 | 0.5400 |
| VIII | 0.8600 | 0.8527 | 0.8410 | 0.8570 | 0.6600 | 0.6357 | 0.6170 | 0.6470 | 0.5560 | 0.5441 | 0.5290 | 0.5520 |
| IX | 0.8580 | 0.8407 | 0.8190 | 0.8190 | 0.6630 | 0.6403 | 0.6180 | 0.6180 | 0.5550 | 0.5408 | 0.5170 | 0.5170 |
| X | 0.8190 | 0.8031 | 0.7890 | 0.8040 | 0.6270 | 0.6177 | 0.6090 | 0.6230 | 0.5170 | 0.5068 | 0.4990 | 0.5090 |
| XI | 0.8310 | 0.8204 | 0.8020 | 0.8290 | 0.6320 | 0.6233 | 0.6120 | 0.6310 | 0.5310 | 0.5126 | 0.4950 | 0.5310 |
| XII | 0.8410 | 0.8307 | 0.8220 | 0.8240 | 0.6510 | 0.6368 | 0.6290 | 0.6510 | 0.5390 | 0.5324 | 0.5250 | 0.5350 |

[1] Data of 2007–2010 have been prepared in line with the accounting principles applied as of 1 January 2007 (for the description of changes in the accounting policies see Note 3 to the Bank of Latvia's financial statements for 2007).
[2] In the financial statements for 2006–2007, realised gains or losses from financial operations are reported under the profit and loss statement caption "Interest and similar income".
[3] Realised profit on exchange rate contracts that was reported separately in the financial statements for 2007 is also included.
[4] In the financial statements for 2006–2007, income from participating interest is reported under the profit and loss statement caption "Interest and similar income".
[5] In the financial statements for 2006–2007, banknote production and coinage costs are reported under the profit and loss statement caption "Other operating expense".

*Appendix 6*

**THE BANK OF LATVIA ORGANISATIONAL UNITS AT THE END OF 2010**

1. ACCOUNTING DEPARTMENT
(Chief Accountant of the Bank of Latvia – Jānis Caune; Deputy Chief Accountant of the Bank of Latvia – Iveta Medne)
1.1 Financial Statements and Accounting Policy Division (Head of Division – Gatis Gersons)
1.2 Internal Banking Operations Division (Head of Division – Anita Jakāne)

2. CASHIER'S AND MONEY OPERATIONS DEPARTMENT
(Head of Department – Jānis Blūms; Deputy Heads of Department – Veneranda Kausa, Vilnis Kepe)
2.1 Cash Operations Division (Head of Division – Oskars Zaltans)
2.2 Coin Division (Head of Division – Maruta Brūkle)
2.3 Money Expertise and Equipment Maintenance Division (Head of Division – Andris Tauriņš)

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

4. INFORMATION SYSTEMS DEPARTMENT
(Head of Department – Harijs Ozols; Deputy Head of Department – Ivo Odītis)
4.1 System Design and Programming Division (Head of Division – Ilgvars Apinis)
4.2 Computer Network and Server Systems Division (Head of Division – Uldis Kristapsons)
4.3 Bank Information System Maintenance and Development Division (Head of Division – Valdis Spūlis)
4.4 Information Systems Security Division (Head of Division – Ilona Etmane)
4.5 Information Systems Quality Assurance Division (Head of Division – Askolds Kālis)
4.6 Systems Maintenance Division (Head of Division – Edvīns Mauriņš)

5. INTERNAL AUDIT DEPARTMENT
(Head of Department – Leo Ašmanis; Deputy Heads of Department – Anita Hāznere, Juris Ziediņš)

6. INTERNATIONAL RELATIONS AND COMMUNICATION DEPARTMENT
(Head of Department – Juris Kravalis)
6.1 Document Management and Library Division (Head of Division – Ineta Strade)
6.2 Publications Division (Head of Division, Deputy Head of Department – Aina Raņķe)
6.3 Public Relations Division (Head of Division, Deputy Head of Department – Kristaps Otersons)
6.4 International Relations and Protocol Division (Head of Division, Deputy Head of Department – Aleksandra Bambale)

7. LEGAL DEPARTMENT
(Head of Department – Ilze Posuma; Deputy Heads of Department – Iveta Krastiņa, Edvards Kušners)

8. MARKET OPERATIONS DEPARTMENT
(Head of Department – Raivo Vanags)
8.1 Trading and Investment Division (Head of Division – Vadims Zaicevs)
8.2 Risk Management Division (Head of Division, Deputy Head of Department – Daira Brunere)
8.3 Payments Division (Head of Division – Una Ruka)

*Appendix 6*
*(cont.)*

9. MONETARY POLICY DEPARTMENT
(Head of Department – Kārlis Bauze; Deputy Heads of Department – Zoja Razmusa[1], Uldis Rutkaste)
9.1 Macroeconomic Analysis Division (Head of Division – Santa Bērziņa)
9.2 Financial Market Analysis Division (Head of Division[2] – Elmārs Zakulis)
9.3 Monetary Research and Forecasting Division (Head of Division – Konstantīns Beņkovskis)
9.4 Financial Stability Division (Head of Division – Jeļena Zubkova)

10. PAYMENT SYSTEMS DEPARTMENT
(Head of Department – Egons Gailītis; Deputy Head of Department – Agnija Jēkabsone)
10.1 Payment Systems Policy Division (Head of Division – Anda Zalmane)
10.2 Payment Systems Operations Division (Head of Division – Natālija Popova)
10.3 Account Service and Maintenance Division (Head of Division – Andra Gailīte)
10.4 Credit Register Division (Head of Division – Laura Ausekle)

11. PERSONNEL DEPARTMENT
(Head of Department – Inta Lovnika; Deputy Head of Department – Vineta Veikmane)

12. SECURITY DEPARTMENT
(Head of Department – Romualds Namnieks; Deputy Heads of Department – Imants Kravals, Sandis Mackēvičs)
12.1 Analytical Unit (Head of Unit – Māris Dzelme)
12.2 Armament Unit (Head of Unit – Juris Kušķis)
12.3 Central Division (Head of Division – Guntars Ezeriņš)
12.4 Riga Division (Head of Division[3] – Normunds Puzulis)
12.5 Daugavpils Division (Head of Division – Ilmārs Suhockis)
12.6 Liepāja Division (Head of Division – Gints Liepiņš)

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

14. TECHNICAL SUPPORT DEPARTMENT
(Head of Department – Andris Ņikitins)
14.1 General Service Division (Head of Division – Einārs Cišs)
14.2 Building Systems Division (Head of Division, Deputy Head of Department – Jānis Kreicbergs)
14.3 Security Systems Division (Head of Division – Viesturs Balodis)

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

[1] As of 1 April 2011, Mr. Elmārs Zakulis.
[2] As of 1 April 2011, Acting Head of Division.
[3] As of 7 April 2011, vacancy.

*Appendix 6*
*(cont.)*

16. DAUGAVPILS BRANCH
(Branch Manager – Ināra Brauna; Deputy Branch Manager – Bernarda Kezika)

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

18. TRAINING CENTRE
(Head of Centre – Zaiga Blūma; Deputy Head of Centre – Dace Miķilpa)

*Appendix 7*

## REPRESENTATION OF THE BANK OF LATVIA IN INTERNATIONAL ORGANISATIONS

EUROPEAN UNION[1]

**EFC**
Kārlis Bauze, Head of Monetary Policy Department
Juris Kravalis, Head of International Relations and Communication Department (Alternate)

**EFC's Euro Coin Sub-Committee (ECSC)**
Maruta Brūkle, Head of Coin Division, Cashier's and Money Operations Department

**EFC's Sub-Committee on IMF and Related Issues (SCIMF)**
Juris Kravalis, Head of International Relations and Communication Department

**Committee of European Banking Supervisors (CEBS)**[2]
Vita Pilsuma, Member of the Bank of Latvia's Council (Banking Supervisory Institution is represented by Jānis Placis, Member of the Council of the FCMC)

**Committee on Monetary, Financial and Balance of Payments Statistics (CMFB)**
Agris Caune, Head of Statistics Department
Ilmārs Skarbnieks, Deputy Head of Statistics Department

**Eurostat Balance of Payments Committee**
Agris Caune, Head of Statistics Department
Ilmārs Skarbnieks, Deputy Head of Statistics Department

**Permanent Representation of Latvia to the EU**
Aldis Austers, Counsellor of the Bank of Latvia at the Permanent Representation of Latvia to the EU[3]

**Public Administration Network (PAN II)**
Vilnis Kepe, Deputy Head of Cashier's and Money Operations Department[4]

EUROPEAN SYSTEM OF CENTRAL BANKS

**General Council of the ECB**
Ilmārs Rimšēvičs, Governor of the Bank of Latvia

**Accounting and Monetary Income Committee (AMICO)**
Jānis Caune, Chief Accountant of the Bank of Latvia
Gatis Gersons, Head of Financial Statements and Accounting Policy Division, Accounting Department

**Banking Supervision Committee (BSC)**[5]
Zoja Razmusa, Deputy Head of Monetary Policy Department (Banking Supervisory Institution is represented by Ludmila Vojevoda, Member of the Council of the FCMC)

**Banknote Committee (BANCO)**
Jānis Blūms, Head of Cashier's and Money Operations Department
Veneranda Kausa, Deputy Head of Cashier's and Money Operations Department

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[1] The Advisory Technical Committee of the ESRB (the Bank of Latvia is represented by Ms. Zoja Razmusa, Member of the Council of the Bank of Latvia, but the Banking Supervisory Institution is represented by Ms. Ludmila Vojevoda, Member of the Council of the FCMC) was established on 20 January 2011.
[2] As of 1 January 2011, EBA (the Bank of Latvia is represented by Ms. Vita Pilsuma, Member of the Council of the Bank of Latvia, but the Banking Supervisory Institution is represented by Ms. Irēna Krūmane, Chairperson of the FCMC).
[3] As of 26 February 2011, vacancy.
[4] As of 7 March 2011, Ms. Sanita Bajāre, Advisor to the Deputy Governor of the Bank of Latvia, and Ms. Antra Trenko, Senior Economist of the International Relations and Protocol Division, the International Relations and Communication Department.
[5] As of 1 January 2011, the Financial Stability Committee (the Bank of Latvia is represented by Ms. Jeļena Zubkova, Head of the Financial Stability Division, the Monetary Policy Department, and Ms. Zoja Razmusa, Member of the Council of the Bank of Latvia).

*Appendix 7*
*(cont.)*

**Eurosystem/ESCB Communications Committee (ECCO)**
Kristaps Otersons, Deputy Head of International Relations and Communication Department
Mārtiņš Grāvītis, Press Secretary of the Bank of Latvia

**Human Resources Conference (HRC)**
Inta Lovnika, Head of Personnel Department

**Information Technology Committee (ITC)**
Harijs Ozols, Member of the Bank of Latvia's Board, Head of Information Systems Department
Ivo Odītis, Deputy Head of Information Systems Department

**Internal Auditors Committee (IAC)**
Leo Ašmanis, Head of Internal Audit Department
Anita Hāznere, Deputy Head of Internal Audit Department

**International Relations Committee (IRC)**
Andris Ruselis, Deputy Governor of the Bank of Latvia
Juris Kravalis, Head of International Relations and Communication Department

**Legal Committee (LEGCO)**
Ilze Posuma, Member of the Bank of Latvia's Board, Head of Legal Department
Iveta Krastiņa, Deputy Head of Legal Department

**Market Operations Committee (MOC)**
Raivo Vanags, Member of the Bank of Latvia's Board, Head of Market Operations Department
Harijs Zuļģis, Chief Analyst of Financial Market Operations, Market Operations Department

**Monetary Policy Committee (MPC)**
Kārlis Bauze, Head of Monetary Policy Department
Uldis Rutkaste, Deputy Head of Monetary Policy Department

**Payment and Settlement Systems Committee (PSSC)**
Egons Gailītis, Head of Payment Systems Department
Agnija Jēkabsone, Deputy Head of Payment Systems Department

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

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

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

**Nordic-Baltic Monetary and Financial Committee, Group of Alternates (NBMFC Alternates)**
Juris Kravalis, Head of International Relations and Communication Department

**Nordic-Baltic IMF Office in Washington**
Gundars Dāvidsons, Advisor to the Executive Director of the Nordic-Baltic Constituency of the IMF, Latvia's representative in IMF

*Appendix 8*

**THE BANK OF LATVIA PUBLICATIONS AND MAJOR PUBLICATIONS BY THE BANK OF LATVIA EXPERTS IN 2010**

*The following Bank of Latvia's publications are available on the Bank of Latvia's website (www.bank.lv). Those prepared in print are available free of charge both at the Bank of Latvia and by mail (unless indicated otherwise and if a sufficient number of copies are available) sending a request to the address indicated on the last page of this publication or by e-mailing to: info@bank.lv.*

REGULAR PUBLICATIONS

Bank of Latvia: Annual Report 2009
Financial Stability Report (2009)
*Latvijas Maksājumu Bilance*. Latvia's Balance of Payments (3, 4/2009)
Macroeconomic Developments Report (February, June and September (No 2–4) 2010)
Monetary Bulletin (11, 12/2009 and 1–11/2010)
Payment System Oversight Carried Out by the Bank of Latvia in 2009

WORKING PAPERS

BEŅKOVSKIS, Konstantīns (2010) – LATCOIN: *Determining Medium to Long-Run Tendencies of Economic Growth in Latvia in Real Time*. *Latvijas Banka* Working Paper, No 1.
BEŅKOVSKIS, Konstantīns, RIMGAILAITE, Ramune (2010) – *The Quality and Variety of Exports from the New EU Member States: Evidence from Very Disaggregated Data. Latvijas Banka* Working Paper, No 2.
VĪTOLA, Kristīne, FADEJEVA, Ludmila (2010) – *Asset Prices and Financial Frictions in Monetary Transmission: the Case of Latvia. Latvijas Banka* Working Paper, No 3.

DISCUSSION PAPER

BEŅKOVSKIS, Konstantīns, KALNBĒRZIŅA, Krista, FADEJEVA, Ludmila (2010) – *Price Setting Behaviour in Latvia: Descriptive Evidence from CPI Microdata. Latvijas Banka* Discussion Paper, No 1.

PUBLICATIONS

AJEVSKIS, Viktors, VITOLA, Kristine (2010) – A Convergence Model of the Term Structure of Interest Rates. *Review of Finance*, vol. 14, No 4, October, pp. 727–747.
BEŅKOVSKIS, Konstantīns (2010) – LATCOIN: Determing Medium to Long-Run Tendencies of Economic Growth in Latvia in Real Time. *Baltic Journal of Economics*, vol. 10, No 2, Autumn, pp. 27–48.
FADEJEVA, Ludmila, MEĻIHOVS, Aleksejs (2010) – *Measuring Total Factor Productivity and Variable Factor Utilization: Sector Approach, the Case of Latvia.* Eastern European Economics, Armonk : M. E. Sharpe, vol. 48, No 5, pp. 63–101.
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*Appendix 9*

## 2010 HIGHLIGHTS OF REGULATORY DOCUMENTS ADOPTED IN PURSUIT OF THE BANK OF LATVIA MAIN TASKS

| Regulatory document | No | Date of adoption (effective date) | Title of the regulatory document adopted by the Bank of Latvia's Council |
|---|---|---|---|
| Regulation | 51 | 14.01.2010 (01.04.2010) | "Regulation for the Credit Register" |
| Regulation | 52 | 14.01.2010 (01.04.2010) | "The Amount of and the Payment Procedure for the Fees to Be Paid for the Use of the Credit Register" |
| Regulation | 53 | 14.01.2010 (01.02.2010) | "Regulation for Electronic Information Exchange with the Bank of Latvia" |
| Regulation | 54 | 11.03.2010 (24.03.2010) | "Amendments to the Bank of Latvia Regulation No 5 'Regulation for the Use of the Bank of Latvia's Monetary Policy Instruments' of 17 May 2007" |
| Regulation | 55 | 11.03.2010 (24.03.2010) | "Interest Rates on Transactions". The refinancing rate and the Bank of Latvia's overnight deposit facility rate were reduced by 0.5 percentage point (to 3.50% and 0.50% per annum respectively), as well as a new monetary instrument – a 7-day deposit facility with the Bank of Latvia – was introduced, stipulating the interest rate of 1.00% per annum. The Bank of Latvia's marginal lending facility rate was left unchanged (7.50% per annum in case a bank has resorted to the lending facility no more than 5 working days within the previous 30 day period; 15% per annum in case a bank has resorted to the lending facility 6–10 working days within the previous 30 day period; 30% per annum in case a bank has resorted to the lending facility for more than 10 working days within the previous 30 day period). |
| Regulation | 178/5 | 11.03.2010 (01.07.2010) | "Amendment to the Bank of Latvia's Council Regulation No 172/11 'System Rules for Participation in TARGET2-Latvija' of 5 November" |
| Regulation | 56 | 13.05.2010 (01.06.2010) | "On Deeming Invalid the Bank of Latvia's Council Resolution No 96/4 'On Approval of the 'Regulation for Credit Transfers' of 11 July 2002" |
| Regulation | 57 | 13.05.2010 (01.06.2010) | "On Deeming Invalid the Bank of Latvia's Council Resolution No 89/9 'On Approval of the 'Recommendations for Transactions Effected by Means of Electronic Payment Instruments' ' of 13 September 2001" |
| Regulation | 58 | 13.05.2010 (01.06.2010) | "Regulation for the Use of the IBAN" |
| Regulation | 59 | 13.05.2010 (01.06.2010) | "Amendments to the Bank of Latvia Regulation No 36 'Regulation for Purchasing and Selling Cash Foreign Currency' of 13 May 2009" |
| Regulation | 60 | 13.05.2010 (07.06.2010) | "Amendment to the Bank of Latvia Regulation No 38 'Description of Lats Banknotes and Coins' of 13 May 2009" |
| Regulation | 61 | 15.07.2010 (24.07.2010) | "Interest Rates on Transactions". The Bank of Latvia's 7-day deposit facility rate was reduced by 0.5 percentage point (to 0.5% per annum) and the Bank of Latvia's overnight deposit facility rate was lowered by 0.125 percentage point (to 0.375% per annum). The refinancing rate (3.50%) and the Bank of Latvia's marginal lending facility rate were left unchanged (7.50% per annum in case a bank has resorted to the lending facility no more than 5 working days within the previous 30 day period; 15% per annum in case a bank has resorted to the lending facility 6–10 working days within the previous 30 day period; 30% per annum in case a bank has resorted to the lending facility for more than 10 working days within the previous 30 day period). |
| Regulation | 183/3 | 09.09.2010 (09.11.2010) | "System Rules for Participation in the Bank of Latvia's Electronic Clearing System" |
| Regulation | 62 | 18.10.2010 (22.10.2010) | "Regulation for the Credit Register" |
| Regulation | 63 | 18.10.2010 (22.10.2010) | "Amendments to the Bank of Latvia Regulation No 52 'The Amount of and the Payment Procedure for the Fees to Be Paid for the Use of the Credit Register' of 14 January 2010" |
| Regulation | 64 | 18.10.2010 (22.10.2010) | "Regulation for Electronic Information Exchange with the Bank of Latvia" |

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*(cont.)*

| Regulatory document | No | Date of adoption (effective date) | Title of the regulatory document adopted by the Bank of Latvia's Council |
|---|---|---|---|
| Regulation | 186/4 | 04.11.2010 (22.11.2010) | "System Rules for Participation in TARGET2-Latvija" |
| Regulation | 65 | 04.11.2010 (24.11.2010) | "Interest Rates on Transactions". The Bank of Latvia's 7-day deposit facility rate was reduced by 0.125 percentage point (to 0.375% per annum) and the Bank of Latvia's overnight deposit facility rate was lowered by 0.125 percentage point (to 0.250% per annum). The refinancing rate (3.50%) and the Bank of Latvia's marginal lending facility rate were left unchanged (7.50% per annum in case a bank has resorted to the lending facility no more than 5 working days within the previous 30 day period; 15% per annum in case a bank has resorted to the lending facility 6–10 working days within the previous 30 day period; 30% per annum in case a bank has resorted to the lending facility for more than 10 working days within the previous 30 day period). |
| Regulation | 66 | 04.11.2010 (06.11.2010) | "The Amount of and the Payment Procedure for the Fees to Be Paid for the Use of the Credit Register" |
| Regulation | 67 | 04.11.2010 (01.01.2011) | "Amendments to the Bank of Latvia Regulation No 40 'Regulation for Compiling the Monthly Financial Position Report of Monetary Financial Institutions' of 16 July 2009" |
| Regulation | 68 | 04.11.2010 (02.12.2010) | "Amendment to the Bank of Latvia Regulation No 38 'Description of Lats Banknotes and Coins' of 13 May 2009" |
| Regulation | 67 | 04.11.2010 (01.01.2011) | "Amendments to the Bank of Latvia Regulation No 40 'Regulation for Compiling the Monthly Financial Position Report of Monetary Financial Institutions' of 16 July 2009" |
| Regulation | 68 | 04.11.2010 (02.12.2010) | "Amendment to the Bank of Latvia Regulation No 38 'Description of Lats Banknotes and Coins' of 13 May 2009" |

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## GLOSSARY

**Automatic loan**: a collateralised loan granted to a bank registered in the Republic of Latvia under marginal lending facility of the Bank of Latvia until the next business day to cover the bank's overdraft.

**Balance of payments**: a statistical report that reflects Latvia's economic transactions with other countries within a specific period. This report includes the transactions related to goods, services, income and transfers, and such net transactions that result in financial claims ("Assets") or financial obligations ("Liabilities") to the rest of the world.

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

**Central government**: public institutions, including ministries, embassies, representative offices, agencies, councils, educational, healthcare, law enforcement, cultural and other public institutions whose competence covers the whole economic territory of the country. The list of the institutional units of the Latvian central government is prepared in accordance with the requirements of ESA 95 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 multilateral net position of each bank by netting all payment documents submitted by the bank, i.e. establishing net cash liabilities to or claims on other banks.

**Concentration ratio**: market share of the five largest senders of payment messages in each payment system in terms of the total volume and value of transactions. The five largest senders in terms of the volume of payment transactions may be different from the five largest senders in terms of the value of payment transactions. The concentration ratio of the Bank of Latvia's payment systems includes also the Bank of Latvia's transactions.

**Credit institution**: a corporation whose business is to receive deposits or other repayable funds from the public and to grant credits on its own account and provide other financial services, or electronic money institutions issuing means of payment in the form of electronic money. Credit institutions of the Republic of Latvia are included in the List of Monetary Financial Institutions of the Republic of Latvia (see the Bank of Latvia's website (www.bank.lv), section Lists of MFIs and other financial intermediaries under Statistics).

**Credit risk**: the risk to incur losses as a result of a counterparty default.

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

**Demand loan**: a collateralised loan granted to a bank registered in the Republic of Latvia at its request under marginal lending facility of the Bank of Latvia until the next business day.

**Deposit facility**: a standing facility enabling banks registered in the Republic of Latvia to make overnight deposits and 7-day deposits with the Bank of Latvia on their own initiative.

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

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

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

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

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

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

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

**Euro area**: 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 2010, the euro area comprised Austria, Belgium, Cyprus, Finland, France, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, Spain and Germany (Estonia also joined the euro area on 1 January 2011).

**European Banking Authority (EBA)**: an EU body with legal personality which is a part of the EFSF and has been established pursuant to Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC. The objective of the EBA is to protect the public interest by contributing to the short-, medium- and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses. The EBA comprises a Board of Supervisors, a Management Board, a Chairperson, an Executive Director and a Board of Appeal.

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*(cont.)*

**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 ECB in cooperation with the central banks of the EU Member States. The ECB is governed by the Governing Council and the Executive Board, and, until all EU Member States adopt the euro, by a third decision-making body, the General Council.

**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 Member States 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 System of Financial Supervision (ESFS):** comprises ESRB, EBA, European Insurance and Occupational Pensions Authority, European Securities and Markets Authority, Joint Committee of the European Supervisory Authorities and the supervisory authorities in the EU Member States. The main objective of the ESFS is to ensure that the rules applicable to the financial sector are adequately implemented to preserve financial stability and to ensure confidence in the financial system as a whole and sufficient protection for the customers of financial services.

**European Systemic Risk Board (ESRB)**: forms part of the ESFS established as specified in Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board. The ESRB 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 and 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 ensure a sustainable contribution of the financial sector to economic growth. The ESRB has a General Board, a Steering Committee, a Secretariat, an Advisory Scientific Committee and an Advisory Technical Committee.

**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.

**Exchange rate mechanism II (ERM II)**: the exchange rate arrangement that ensures the framework for exchange rate policy cooperation between the euro area countries and the EU Member States not participating in Stage Three of EMU. As at the end of 2010, Denmark, Estonia, Latvia and Lithuania were members of the ERM II. (With the introduction of the euro on 1 January 2011, Estonia ceased to participate in ERM II).

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

**Financial institutions other than monetary financial institutions (MFIs)**: OFIs, financial auxiliaries, insurance corporations and pension funds.

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

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

**Foreign exchange swap**: a simultaneous spot purchase/sale and forward sale/purchase of one currency against another. Within the framework of market operations, the Bank of Latvia purchases foreign currency from banks registered in the Republic of Latvia for lats, simultaneously concluding a forward foreign currency sales deal, or sells foreign currency to banks registered in the Republic of Latvia, simultaneously concluding a forward foreign currency purchase deal. The foreign currency used in foreign exchange swap auctions by the Bank of Latvia is euro only. In foreign exchange swaps, the minimum lats bid rate used in foreign currency purchase/resale transactions with banks equals the refinancing rate of the Bank of Latvia, and the maximum lats bid rate used in foreign currency sales/repurchase deals equals the refinancing rate of the Bank of Latvia. The Bank of Latvia sets the total allotment amount for each auction.

**General Council of the ECB**: one of the decision-making bodies of the ECB, comprising the President and the Vice-President of the ECB and the Governors of all central banks of the EU Member States.

**General government**: public institutions engaged in production of non-market goods or provision of services intended for individual or collective consumption, or public institutions engaged in redistribution of national income or wealth. General government in the Republic of Latvia includes central government and local government. The list of the institutional units of the Latvian central government is prepared in accordance with the requirements of ESA 95 by the CSB.

**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.

**Households**: natural persons or groups of natural persons as consumers and producers of goods and non-financial services exclusively for their own final consumption. Sole proprietors are also regarded as households in Latvia provided that they have not registered their activity with the Commercial Register of the Enterprise Register of the Republic of Latvia. When aggregating data, the household sector usually includes also the data of non-profit institutions serving households.

**Interbank automated payment system (SAMS)**: the Bank of Latvia's real time gross settlement system used for settlements concerning the Bank of Latvia's monetary policy operations, large-value interbank transfers and other payments in lats.

**International investment position**: a statistical report reflecting the value and composition of Latvia's outstanding financial claims on ("Assets") and financial liabilities to ("Liabilities") other countries.

**International Monetary Fund (IMF)**: an international organisation, founded in July 1944, to facilitate international monetary cooperation, exchange rate stability, national economic growth and employment growth, and provide short-term financial assistance to IMF Member States for balancing the payment flow.

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

**Local government**: public institutions, whose competence covers only a local economic territory. In Latvia, the local government level is comprised of the local authorities. The list of the institutional units of the Latvian local governments is prepared in accordance with the requirements of ESA 95 by the CSB.

**Longer-term refinancing operations**: market operations of the Bank of Latvia organised in the form of auctions of reverse transactions, whereby banks registered in the Republic of Latvia are granted collateralised loans. The minimum bid rate at the auction equals the Bank of Latvia's refinancing rate. The Bank of Latvia sets the total allotment amount for each auction. The maturity of the loan is 91 days.

**M0**: monetary base calculated on the basis of the Bank of Latvia's methodology and comprising the lats banknotes and coins issued by the Bank of Latvia and demand deposits of resident MFIs and financial institutions (overnight deposits) with the Bank of Latvia.

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

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

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

**M3**: broad monetary aggregate calculated on the basis of the ECB methodology and comprising M2, repurchase agreements, debt securities with a maturity of up to and including two years issued by MFIs, and money market fund shares and units.

**Main refinancing operations**: market operations of the Bank of Latvia organised in the form of auctions of reverse transactions, whereby banks registered in the Republic of Latvia are granted collateralised loans. The minimum bid rate at the auction equals the Bank of Latvia's refinancing rate. The Bank of Latvia sets the total allotment amount for each auction. The maturity of the loan is 7 days.

**Marginal lending facility**: a standing facility enabling banks registered in the Republic of Latvia to receive collateralised overnight loans either automatically or on demand.

**Market operations**: financial market operations initiated by the central bank. The Bank of Latvia's market operations fall into four categories used by the Eurosystem: main refinancing operations, longer-term refinancing operations, structural operations and

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*(cont.)*

fine-tuning operations. The main instruments of the Bank of Latvia's market operations are reverse transactions. Outright transactions are available for the conduct of structural operations, whereas outright transactions, foreign exchange swaps and time deposits are available for the conduct of fine-tuning operations.

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

**Monetary financial institution (MFI)**: a credit institution, credit union, money market fund and other financial corporation 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 the national central bank. The Bank of Latvia maintains the List of Monetary Financial Institutions of the Republic of Latvia (see the Bank of Latvia's website (www.bank.lv), section Lists of MFIs and other financial intermediaries under Statistics). At the end of 2010, Latvia's MFIs were: the Bank of Latvia, 39 credit institutions, two money market funds and 34 other MFIs (credit unions). The ECB publishes the "List of MFIs of the EU Member States" regularly on its website (see Links on the Bank of Latvia's website at www.bank.lv).

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

**Non-profit institutions serving households**: non-profit institutions that provide goods and services to natural persons or groups of natural persons and that derive resources mainly from voluntary contributions in cash or kind, from payments made by general governments and from property income. Such institutions are, for instance, trade unions, professional or educational associations, consumer associations, political parties, churches, religious communities as well as culture, recreation and sports clubs, charity, support and aid organisations.

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

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

**Other financial intermediaries (OFIs)**: financial institutions other than insurance corporations and pension funds primarily engaged in financial intermediation by incurring liabilities in forms other than currency, non-MFI deposits and close substitutes for deposits or insurance technical reserves. OFIs are corporations engaged in lending (e.g. financial leasing companies, factoring companies, export/import financing companies), investment funds, investment brokerage companies, financial vehicle corporations, financial holding corporations, venture capital corporations as well as other financial institutions provided that their activity complies with the given definition.

**Outright purchase and sales of securities**: transactions as a result of outright purchase and sales auctions of securities organised by the Bank of Latvia. At auctions, the Bank of Latvia offers banks registered in the Republic of Latvia to purchase or sell lats-denominated debt securities. The maximum purchase price in outright purchases of

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*(cont.)*

securities and minimum sales price in outright sales of securities respectively is set according to the market price of the relevant securities. The Bank of Latvia defines the amount of securities to be bought or sold at each auction.

**Outright transactions**: transactions concluded between the Bank of Latvia and banks registered in the Republic of Latvia as a result of organised outright purchase or sales auctions of securities or purchase or sales of non-cash foreign currency.

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

**Real-Time Gross Settlement (RTGS) system**: a settlement system in which processing of cash or securities transfer orders and settlement takes place on an individual basis and in a consecutive order (without netting) in real time.

**Reserve base**: liabilities of banks registered in the Republic of Latvia subject to the minimum reserve requirements.

**Reserve holdings**: money holdings of banks registered in the Republic of Latvia with the Bank of Latvia serving to fulfil reserve requirements.

**Reserve ratio**: percentage share of the reserve base or minimum reserve ratio defined by the Bank of Latvia. The central bank may also define a ratio for each category of balance sheet items included in the reserve base. The ratios are used to calculate reserve requirements.

**Reserve requirement**: requirement for banks registered in the Republic of Latvia to hold an amount of reserves compliant with the reserve ratio with the Bank of Latvia.

**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 Bank of Latvia grants collateralised loans to banks registered in the Republic of Latvia.

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

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

**SEPA (Single Euro Payment Area)**: area in which consumers, companies and other economic agents will be able to make and receive payments in euro both across countries and within the borders of each country regardless of their location in accordance with

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*(cont.)*

one and the same main provisions, rights and obligations. As at the end of 2010, SEPA encompassed all EU Member States, Iceland, Liechtenstein, Monaco, Norway and Switzerland.

**Standing facility**: a central bank facility available to counterparties on demand. The Bank of Latvia offers two standing facilities to banks registered in the Republic of Latvia: marginal lending facility and deposit facility.

**TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system)**: the real-time gross settlement system for the euro used for settlements concerning the central banks' monetary policy operations, large-value interbank transfers and other payments in euro.

**TARGET2**: a new generation of the TARGET system in which the current decentralised technical structure has been replaced by a single shared platform offering a harmonised service with a uniform pricing scheme.

**TARGET2-Latvija**: a component system of TARGET2 in Latvia. Its operation is ensured by the Bank of Latvia in conjunction with other central banks of the ESCB.

**TARGET2-Securities**: the Eurosystem's single technical platform enabling central securities depositories and national central banks to provide core, borderless and neutral securities settlement services in Europe using cash accounts with the central bank.

**Time deposits with the Bank of Latvia**: fixed rate lats deposits of a specified maturity made by banks registered in the Republic of Latvia with the Bank of Latvia as a result of time deposit auctions organised by the Bank of Latvia. The maximum deposit rate equals the Bank of Latvia's refinancing rate. The Bank of Latvia sets the total allotment amount for each auction.

Bank of Latvia: Annual Report 2010

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