LATVIJAS BANKA

BANK OF LATVIA: ANNUAL REPORT 2011

ISSN 1407–1800

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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 of the Bank of Latvia coins by Andris Tenass. The holder of the original of the photo "Riga. The Iron Bridge over the Daugava" is Atis Artmanis. Fragment of A.Weger's engraving "The Riga Dome in the mid-19th century"*(Rigascher Almanach für 1877. Riga, 1876)*. Photo of the pfennig (struck in the time of Bishop Albert (1199–1229) in the Bishopric of Riga) by Leons Balodis. The original of the photo "Riga. Maria's Street" is from the collection of the Department of Small Prints and Graphic Documents of the National Library of Latvia.

The cut-off date is 17 April 2012.

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ABBREVIATIONS

ATM	Automated Teller Machine
BIS	Bank for International Settlements
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
ESFS	European System of Financial Supervision
ESRB	European Systemic Risk Board
EU	European Union
Eurostat	Statistical Bureau of the European Union
FCMC	Financial and Capital Market Commission
FRS	US Federal Reserve System
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
IT	Information Technologies
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
MMF	money market fund
OECD	Organisation for Economic Co-operation and Development
OFIs	other financial intermediaries, excluding insurance corporations and pension funds
OTC	over-the-counter trading
PPI	Producer Price Index
RIGIBID	Riga Interbank Bid Rate
RIGIBOR	Riga Interbank Offered Rate
SAMS	Bank of Latvia's Interbank Automated Payment System
SDR	Special Drawing Rights
SEA	State Employment Agency
SEPA	Single Euro Payments Area
SJSC	state joint stock company
UK	United Kingdom
UN	United Nations
US	United States of America
WTO	World Trade Organisation
VAT	Value Added Tax

FOREWORD OF THE GOVERNOR

The Latvian economic data for 2011 and the first quarter of 2012 are an eloquent testimony that the decisions made to overcome the economic crisis were right. As late as the end of 2008, confusion reigned, and a discussion on the need to devalue the lats was on the agenda. The discussion was interesting and substantive and allowed the Bank of Latvia to showcase its well-argued and consistent position: a change in the fixed exchange rate of the lats would not be a good move either before or during the crisis, given the probability of a drastically rising inflation and substantially higher costs of those imported goods that are necessary for the manufacturing of Latvia's export products, as well as taking into account the proportion of euro-denominated loans in the loan portfolio. In recent years, the Government and Saeima have made many difficult and unpopular decisions that are now bearing fruit. This is corroborated by the rapid growth of Latvia's gross domestic product, exports and manufacturing as well as contracting unemployment.

In a number of other countries, however, the situation has unfortunately deteriorated in recent years: the fiscal consolidation decisions and issues have been postponed, their external debt has grown substantially, the national currency has been devalued in some of them, and uncertainty is on the rise. The number of economists who, when analysing Latvia's economic situation, would show their perplexity by asking "How can it be that less is more?" is shrinking. Namely, how can it be that cut budget expenditure and smaller budget deficit are promoting economic growth? How can it be that such decisions lead to new jobs and increased budget revenue? How can it be that, in consolidating the budget, no "squeezing" of the economy has been observed: in Latvia and the other Baltic States where similar processes of reform and balancing expenditure with revenue have taken place, the economy is growing at the fastest rate in the European Union?

In the economists' discussion about how to resolve the country's debt crisis, the realisation that the traditional medicine of the world famous economist John Maynard Keynes will not work this time is becoming ever more pronounced. Up until now, countries have been encouraged to compensate the ebbing of private investment and print money during a crisis in order to revive the economy. Yet debt has only grown this way, exceeding 100% of gross domestic product in both large and small countries in Europe and elsewhere in the world. Moreover, the real economic activity in these countries has been sluggish in recent years, while their credit ratings have plummeted, increasing the amount of debt and debt servicing costs.

In Northern Europe – in the Baltics and Nordic countries – a common conclusion has been reached: it is not very difficult to print money. What is important, however, is to make it flow into the economy, promoting a growth in loans granted by banks and increased investment. Otherwise a paradox arises: money is printed while knowing full well that it will be put into bank accounts to await a better future – one where the government will have stopped printing more money and increasing the budget deficit and public debt.

Over the last year, Europe has also come to a realisation that its difficulties are rooted in the problems stemming from the debt crisis in individual countries, that a common currency requires better discipline, responsibility, more centralised and clear-cut financial policies. It is expected that, correcting the errors made previously, the crisis will make the euro area stronger. Yet Europe's problems are still far from being resolved.

In Latvia, it is important to finish the process started, one that is clear and has proven its validity by promoting growth. Elsewhere it is becoming clearer by the day that in countries which fail to carry out responsible budget policies, the economy stagnates, spiralling through deficit, indebtedness, inability to compete and unemployment.

The cause and effect relationships are simple here.

A larger deficit means a larger debt that diminishes confidence in a country, which in turn means higher interest on loans, limited lending and fewer jobs. Thus there are fewer growing businesses, fewer taxes paid and lower state revenue. As a consequence, the opportunities to invest in people – in education, healthcare, salaries and pensions – are also limited.

Decisive action in straightening out the budget, on the other hand, allows economic growth to resume quickly; what is not earned is no longer spent, and lives of our children and grandchildren are no longer put into jeopardy by borrowing on their account. Both approaches find eloquent illustrations in the different trends in gross domestic product growth in the countries of the European Union in the last two years.

To wit, in those European Union Member States which are still facing serious budget problems and a high level of public debt – Greece, Portugal, Spain, Ireland and Italy, the economy is stagnating or experiencing a downslide. The Baltic countries, which have resolved or almost resolved their budget problems, are current European leaders in terms of gross domestic product and export growth.

I hope that in the coming years the Latvian economy will manage to demonstrate sustainable growth and stop any increase of the external debt. Testimony to such stabilisation would be a full membership in the euro area, which is a strategic goal of the government of Latvia. If in 2012 and 2013 the country is ready for an evaluation of the fulfilment of the Maastricht criteria, the story of overcoming the crisis in Latvia will be completed successfully. At the same time, the fiscal discipline measures already taken in the euro area countries are expected to strengthen the area of common currency, and a successful transition from the lats to the euro in 2014 would thus mean greater stability and better export opportunities for Latvia along with cheaper lending for business development and refinancing of the public debt accumulated during the crisis years.

While as a result of the debt crisis there may be some who are sceptical both regarding the euro and the need to introduce it in Latvia as early as 2014, one should not forget that the small European Union countries, which have made such a strategic choice and introduced the euro in recent years, have managed to use it as protection during the global crisis. We should not forget that for countries that do business responsibly, the euro guarantees much lower interest rates and, should Latvia not introduce the euro, it may have to overpay its debt by about one billion lats in the nearest decade. In 2014 and 2015, Latvia must pay a large part of its public debt, 1.8 billion lats. Since Latvia does not have such additional earnings, it will have to borrow. If we have introduced the euro, the market will lend to Latvia at lower rates. There is a huge difference between borrowing at 2%–3%, if the euro has been introduced, or at 5%–6%, if it has not. At the very worst, it would mean that the annual additional interest payments for using the loan would match the education or healthcare budget instead of helping to reduce the debt servicing costs and promote the country's development.

Getting ready for the introduction of the common currency in Latvia probably will not be easy. For that reason, it is commendable that the Government is ready to look at the dynamics of main macroeconomic indicators and inflation and fiscal discipline developments from the perspective of the euro changeover. The goal-oriented actions of the government in preparations for introducing the euro are therefore most gratifying given the long-lasting consequences of this project. To a significant degree, it will determine how we live in Latvia in the future and not just within one budget year: with the euro and credit ratings attractive to investors and new jobs, or without the euro and strange, distant and uninteresting to investors and thus without new impulses that would promote employment and welfare.

Looking back at the past year of hard work, I would like to express my deep gratitude to the Council and Board of the Bank of Latvia for successful organisation of the Bank of Latvia's work and to each and every employee of the Bank for their committed everyday contribution to and creativity in the implementation of the Bank of Latvia's tasks.

Ilmārs Rimšēvičs
Governor, Bank of Latvia
Riga, 12 April 2012

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.

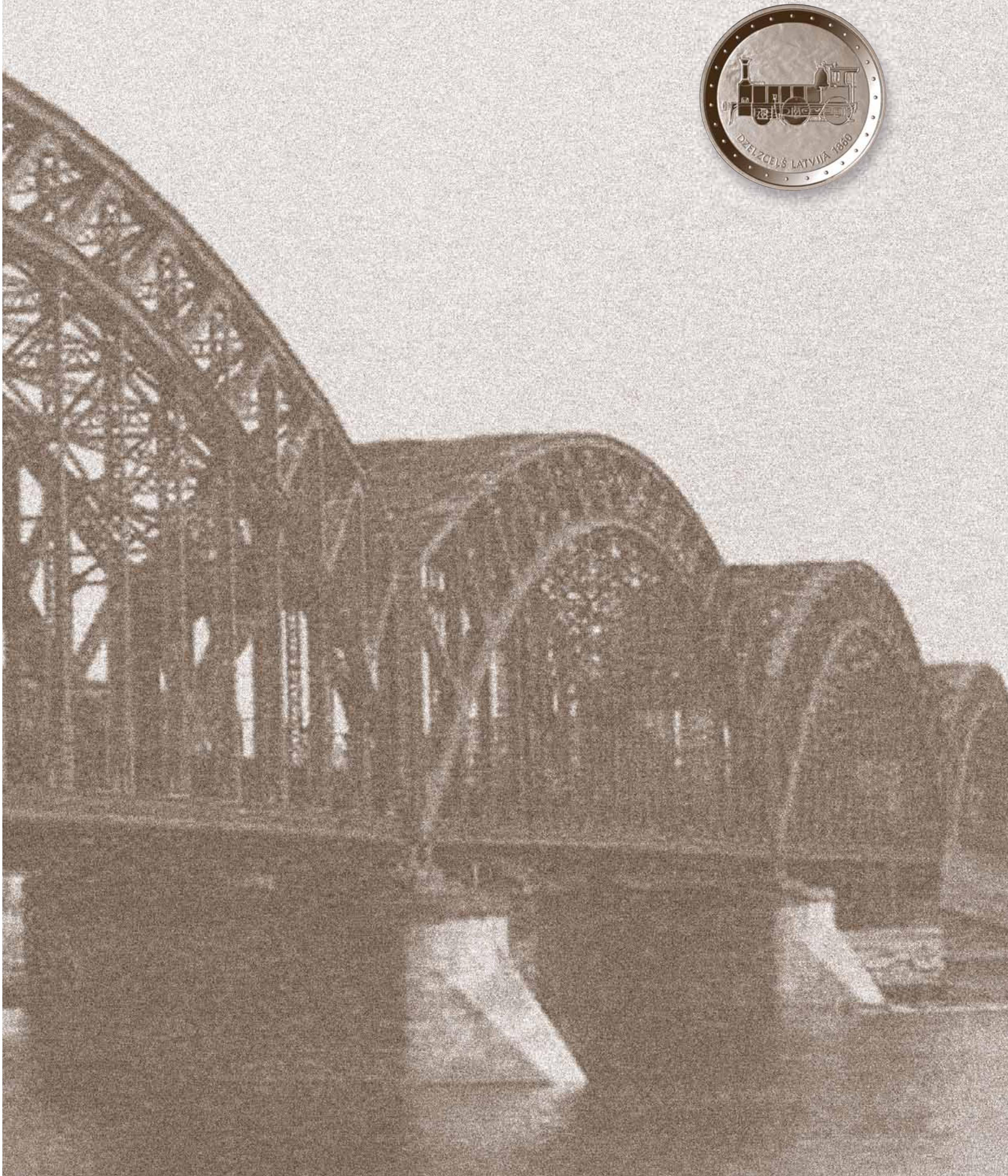
The Bank of Latvia is an active and responsible participant of the ESCB, promoting integration and stability of the financial systems of Latvia and other EU countries.

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.

ECONOMIC ENVIRONMENT



GLOBAL ECONOMIC ENVIRONMENT

The global economic growth was relatively buoyant in the first half of 2011, primarily on account of strengthening world trade and more robust domestic demand in the developing countries and also in several advanced economies. This dynamics supported price hikes in the global commodity and energy markets and pushed up inflation to higher-than-anticipated levels. However in summer, public-debt-related downside risks escalated both in the US and the euro area. The US sovereign credit rating was downgraded, and in a number of euro area countries problems with public finance aggravated. As a result, confidence indicators deteriorated, global economic growth prospects worsened, and international trade lost much of its volume growth momentum.

In the first quarter, the euro area economy showed firm signs of recovery, yet starting with the second quarter, the economy began to slow. Net exports coupled with rising investment at the beginning of the year contributed most to GDP growth. Substantial disparities of economic activity were still in place in a number of euro area countries. Germany and France contributed positively to the euro area GDP growth primarily due to stronger domestic demand. Greece and Portugal, in turn, recorded the largest GDP drop of all euro area countries in 2011. Inflation in the euro area was rising until April, afterwards taking a downward trend in line with the decelerating economic activity. Of euro area countries, Estonia recorded the steepest GDP growth in 2011, primarily on account of higher investment, private consumption and exports. Despite concerns about potentially surging prices after the adoption of the euro, annual inflation in Estonia declined from 5.1% in January to 4.1% in December 2011 due to milder upside pressure of food and energy prices in external markets.

In 2011 overall, the economic recovery, albeit slowing substantially in the fourth quarter, was going on in seven EU countries outside the euro area. Of this country group, Lithuania posted the steepest growth sustained by stronger domestic demand and export expansion. Shrinking unemployment positively supported private demand. Lithuania's annual headline inflation had been on a downward trend since May due to lower global commodity prices. By contrast in Poland, Hungary and the Czech Republic, inflation was on the rise at the close of 2011, while national currencies of these countries depreciated against the euro and imported commodity prices rose. Manufacturing continued to grow robustly in Poland, Hungary and the Czech Republic, yet only Poland posted sustained growth of private consumption.

In terms of economic growth, Sweden continued to hold the leading position among the Scandinavian countries in 2011. The pursuit of a stable public finance policy underpinned Sweden's fast economic development. Domestic demand contributed most to GDP growth. Denmark, on the other hand, recorded fragile economic recovery. Its housing market stagnated, and consumption was encumbered by impressive fiscal consolidation and soaring unemployment. The Danish export dynamics is likely to be affected by a more moderate euro area growth.

In the UK, the economic growth was volatile and primarily supported by expansion in net exports. Private consumption was protractedly undermined by shrinking real incomes of population due to inflation, fiscal consolidation and tight lending standards. Moreover, the labour market situation did not signal any improvement in 2011. Inflation started to decline in late 2011, as no new VAT rate raises were planned, retail energy prices were lowered and global commodity prices eased.

The US economy continued on the recovery track in 2011, with its GDP growth exceeding the euro area pace in the fourth quarter. This growth was mainly driven by gains in net exports, private consumption and investment. However, the US economic outlook aggravated due to weak housing market, elevated unemployment levels and expiration of the economic stimulus programme.

Fast economic growth went on in Russia. Domestic demand contributed most to the GDP increase. It was favourably impacted by a substantial expansion in lending and shrinking unemployment. At the same time, elevated oil prices affected the economy positively, for oil accounted for a significant share in Russia's exports. Though Russia's economic advance was solid, inflation has been on a downward trend since the second quarter due to external factors. Price competitiveness is expected to strengthen and price growth to slow down in the future, both due to Russia's accession to the WTO.

Given improvements in the euro area performance indicators, the financial market situation stabilised in the initial months of 2011. Still, the market tensions heightened again in March, with strains intensifying in Greece, Portugal's government compelled to turn to the EC for assistance when facing excessively high borrowing costs, and the Irish government's expenditure on state support to credit institutions threatening to soar. Some time later, Greek solvency draw the attention of politicians and market participants again, as formerly found solutions provided only a short-lived relief and proved to be insufficiently effective. The euro area debt crisis escalated in September when amid market participants' rising caution the euro area countries and credit institutions operating in them incurred problems with attracting financing. Heightened risk awareness of market participants coupled with their unwillingness to invest in euro area problem countries exerted pressure on the government bond yields in several involved countries and made long-term public debt servicing of these countries unsustainable. The problems aggravating in the financial sector began to spill over to the euro area real sector, with the non-financial corporation and household borrowing from credit institutions becoming more difficult. In 2011, the situation became even more serious when the leading international rating agencies downgraded notably credit ratings of problem-affected euro area countries and their credit institutions. In August, Standard & Poor's downgraded the US AAA credit rating by one notch.

The price of *Brent* crude oil in 2011 rose above that a year ago and stood at 108 US dollars per barrel (93 US dollars per barrel at the end of 2010). It elevated most in the first quarter when a more optimistic assessment of the global economic outlook spurred the demand for oil and a simultaneous aggravation of political situation in the Middle East and countries in North Africa markedly restricted oil supply. Later, although relatively volatile, oil prices lingered at rather high levels overall, as the effects of weakening global economic perspective were dampened by restricted crude oil supply.

The growth in the euro area was affected by the ECB decisions on lowering the euro base rate. Initially by two moves in April and July, the ECB raised the euro base rate to 1.5% (by 25 basis points each time) on the grounds of escalating inflationary risks for the euro area countries. However, already in the second half of the year, the ECB changed its stance, stating that inflationary pressures had abated and the euro area economic outlook had deteriorated. As a result, the euro base rate was lowered, each time by 25 basis points, in November and December. Central banks of the other major world countries left their base rates unchanged in 2011. Consequently, the FRS maintained the US dollar base rate within 0%–0.25% range, the Bank of England's base rate stood at 0.5%, and the Bank of Japan's rate was 0%–0.1%. Moreover, the FRS kept on emphasising that it intended to keep the US dollar base rates on hold at the present level over a longer period of time.

In order to support bank lending and liquidity in the euro area, the ECB Governing Council resolved to launch a number of unconventional easing monetary policy measures, which were temporary by nature. Amid aggravating interbank market tensions, the ECB Governing Council made an announcement in August on reactivation of the Securities Markets Programme, under which purchases had not been made since late March. The Eurosystem provided liquidity to banks in 2011 by way of fixed rate tender procedure with full allotment. In October, the ECB Governing Council noted that it would proceed with the said procedure in all refinancing operations at least until the end of the first six months of 2012. In 2011, several longer-term refinancing operations with maturities of 3-, 6- and 12-months were held. Further, a new covered bond purchase programme worth 40 billion euro was launched, with the Eurosystem purchasing covered bonds in both primary and secondary markets between November 2011 and October 2012. On December 8, the ECB Governing Council resolved to carry out two longer-term refinancing operations with a maturity of 36 months and the option of early repayment after one year (the operations were allotted on 21 December 2011 and 29 February 2012). In addition, collateral availability was increased and the reserve ratio cut from 2% to 1% (in effect as of 18 January 2012). In order to supply foreign currencies needed in bank operations, the FRS, the ECB, the Bank of England, the Bank of Japan, the Bank of Canada and the Swiss National Bank took a decision to return to mutual swap operations. The FRS announced in September that it would increase its holdings of securities with a longer-term maturity in its securities portfolio. The Bank of England unexpectedly announced a 75 billion British pound sterling boost (to 275 billion) to its programme of quantitative easing on 6 October. In response to the effects of the recent earthquake, the Bank of Japan increased its asset purchase programme several times, engaged in more active lending to credit institutions and injected extra liquidity in the market.

In the first quarter, the global government securities market recorded transitory increases in the yields on safer-deemed securities. However, already in March when market participants' risk aversion increased, the yields on such securities were on a downward trend again. The US government bond yields started to stabilise under the impact of several opposite factors in the second half of the year. On the one hand, the FRS decision to extend the maturity of securities holdings supported further yield declines, while the first signs of the US economic recovery, on the other, pushed the yields up. Meanwhile in a number of euro area countries, particularly those with most questionable capacity to attract financing from the market, the yields rose more dynamically. From end-December 2010 to end-2011, the yields on the US government 2-year bonds dropped from 0.7% to 0.3%, whereas those on 10-year bonds contracted from 3.4% to 1.9%. The yields on Germany's 2-year bonds decreased from 0.9% to 0.1%, while those on 10-year bonds went from 3.0% down to 1.7%. Meanwhile, the yields on French government 2- and 10-year bonds declined marginally in the course of the year (by 0.4 and 0.2 percentage point respectively, i.e. to 0.6% and 3.2%), hence in 2011, market participants' concerns about sustainability of the country's AAA credit rating were well-reasoned.

Global stock prices tended to go up in the first months of 2011, as the global economic outlook improved and stock companies earned higher profits than expected. Stock price hikes were halted by market participants' worries about further global economic growth perspectives mostly due to aggravation of the euro area debt crisis and concerns about the downgrading of the US sovereign credit rating. Stock prices in Japan and related markets were substantially affected by the March earthquake and its aftermath. In the concluding months of 2011, stock price indices were volatile. They were on a moderate rise in the US as a result of better-than-anticipated performance of the US economy. In Europe, by contrast, any signs of stock price hikes were absent. In the global stock markets overall, the US stock market index Standard & Poor's 500 did not change much in 2011, the more liquid stock price index DJIA increased by 5.5%, and the US Nasdaq Composite went down by 1.8%. The EU stock price index Dow Jones EURO STOXX 50, in turn, contracted by 17.1%. As market participants worried about the European debt crisis' effects on financial positions of the euro area banks, the European-based bank stock price index DJ Stoxx 600 Banks shrank even more pronouncedly (by 32.5%). Japan's Nikkei 225 index dropped 17.3%, whereas China's SSE A Share lost 21.6%. Market participants' higher risk aversion and falling raw material prices were the drivers behind a 21.9% decrease in Russia's stock market index RTS.

As market participants anticipated a higher euro base rate, the euro against the US dollar appreciated in the period from February to May. Further on from May to September, the euro fluctuated against the US dollar within a narrow band. However, afterwards the euro tended to depreciate against the US dollar. This trend is likely to stem from market participants worries about the future growth in euro area as well as the narrowing of the US dollar and euro base rate gap. Within a year, the euro had depreciated against the US dollar from 1.33 to 1.29.

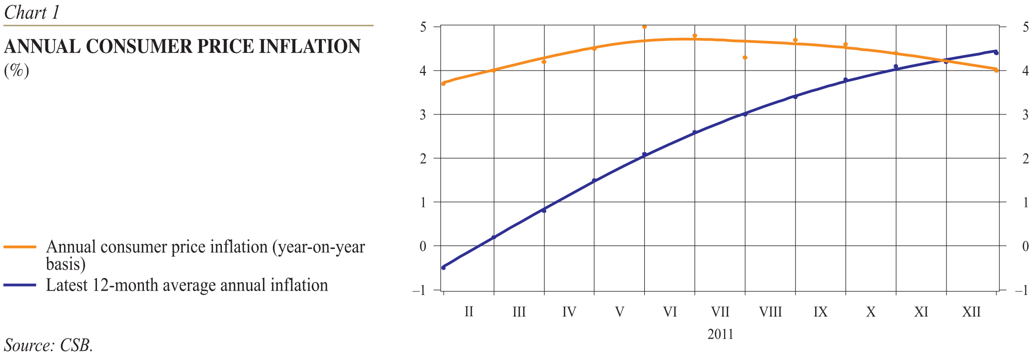
LATVIA'S ECONOMIC ENVIRONMENT

INFLATION AND PRICES

A more buoyant economic growth, stronger consumption and higher consumer prices in Latvia in 2011 notwithstanding, average annual inflation, which amounted to 4.4% (see Chart 1), was primarily driven by supply side factors, while the effect from the domestic demand and labour market on consumer prices was limited.

Chart 1

ANNUAL CONSUMER PRICE INFLATION
(%)



Source: CSB.

In the first half of the year, the annual growth of global food prices was extremely steep, in the first six months of 2011 on average exceeding 35% (according to the data of UN Food and Agriculture Organisation); in the second half of the year, i.e. when the new harvest season set in, it became possible both to increase the global food product stocks and to lower prices of these goods. Global energy price hikes continued, driven by both gradual strengthening in demand as well as military conflicts and political turmoil aggravating within oil producing Middle East regions. Partial and temporary solutions to conflict situations brought about a moderate drop in oil prices in the fourth quarter, yet this trend could not be expected to persist.

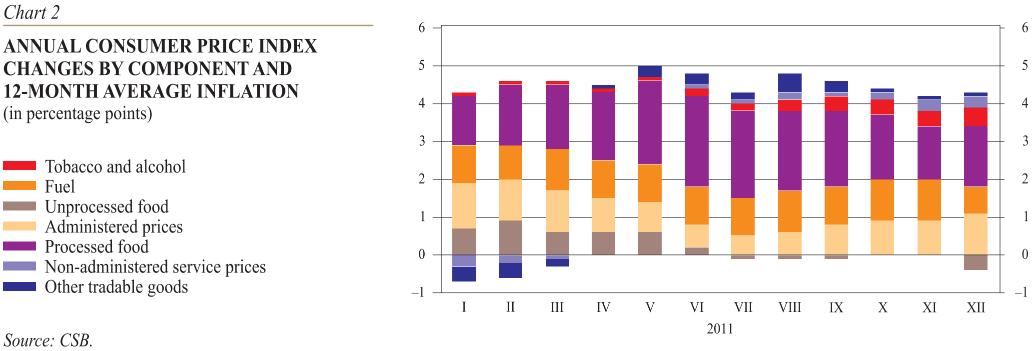
In the course of the year, indirect tax rates were raised on several occasions in Latvia. The standard VAT rate was raised by 1 percentage point (to 22%), the reduced VAT rate was pushed up by 2 percentage points (to 12%), whereas the reduced VAT rate on electricity supply to individual consumers was replaced by the standard one. A raised excise tax rate on fuel and alcoholic beverages came into effect as with June, whereas that on tobacco and natural gas for heating was raised in July. Instead of the reduced VAT rate, natural gas supplies were also subject to standard VAT rate.

As a result of the factors above, food prices contributed 2.1 percentage points to average annual inflation, while energy prices elevated it by additional 2.1 percentage points. Energy prices were also responsible for the contribution from administered prices, but the prices of recompense medicine offset it somewhat. The overall contribution to inflation from administered prices reached 0.9 percentage point (see Chart 2).

A marginal increase in prices of other tradable goods and non-regulated services testifies to a moderate impact of domestic demand on inflation. In annual terms, the respective prices rose by 0.3% on average. In addition, as this commodity group comprises several goods and services for which recurrent discount and sale campaigns are characteristic, these prices on average fell behind those of 2010: by 1.7% for wearing apparel, 3.7%

Chart 2

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



Source: CSB.

for household appliances, 2.6% for sports and recreation goods, 10.9% for audio, video, photo and data processing equipment. Cultural and recreational services prices were on average by 0.8% lower than in 2010.

In 2011, the average HCPI-based inflation was 4.2%, because the share of regulated prices is smaller due to non-resident consumption structure (regulated prices rose faster than average consumer prices). The indirect tax effects above excluding, average HCPI for 2011 would have been 2.7%.

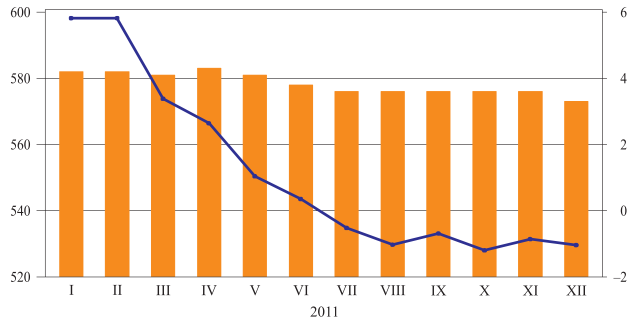
Energy and food price tendencies in world markets notably affected also the producer price dynamics, particularly of output sold in the domestic market where the escalation in prices of food and electricity, gas, heating and air conditioning together accounted for around three fourths of the total producer price rise in manufacturing (8.7% annually on average). Producer price rises in these branches were also reflected by consumer price dynamics. As the structures of production for internal and external markets differ notably (e.g. heat energy is not exported), the producer price dynamics of the output for the two markets differed as well (in 2011, producer prices for exported output grew on average by 6.3%). The upswing in producer prices of exported goods was driven by higher prices of imported resources: prices of wood, metal and agricultural goods used in the manufacture of food posted a year-on-year increase in 2011. The production process became more expensive also due to energy resources costs.

Average construction costs in 2011 increased by 2.1% year-on-year primarily under the impact of increasing maintenance and operational costs of machinery and mechanical appliances due to higher fuel costs. After climbing somewhat in 2010, labour remuneration fell again in 2011 (by 1.0%), while construction material costs remained almost unchanged. In the breakdown by basic group of construction object, construction costs rose most for underground pipelines (by 13.2% mainly on account of rising fuel and metal costs) and transport objects (by 2.9%) and contracted most for office space (by 4.2%) and individual (family) houses (by 3.1%).

The real estate market recorded the so-called "two-speed" growth in 2011. The standard apartment market reported marginal price changes, with an annual drop of 1.0% in average apartment price in Riga (*Latio Ltd.* data; see Chart 3). Tight lending standards of credit institutions (still circumspect about the future outlook), elevated household debt levels (too weak household income recovery to significantly reduce overall debt burden and support saving), and low-quality housing supply (potential buyers were looking for housing without extra investment in renovation, yet such offer was scanty) were among the major restrictive factors. In the market of new housing projects, on the other hand, the demand expanded and prices grew due to the activities of both residents and non-residents. Amendments to the Immigration Law boosted non-residents' demand for high quality estate worth over 100 thousand lats, for such purchases made them eligible for temporary residence permits in Latvia. In the real estate market of Jūrmala, it made new housing project prices soar, as demand exceeded supply markedly. Residents' demand, in turn, focused on new economic housing projects developed in Riga outskirts. Overall

Chart 3

AVERAGE STANDARD APARTMENT PRICE AND ITS ANNUAL GROWTH RATE IN RIGA



Source: Latio Ltd.

activity in the housing market was stronger: the number of real estate purchases registered with the Land Register in 2011 increased by 13.9% year-on-year.

Limited household opportunities to purchase real estate facilitated the activity in the housing rental market and, with the demand augmenting, rent for housing also escalated. In Riga, rented housing prices in new projects went up by some 20% on an annual basis, whereas the rise in standard apartment rent was even stronger (30%). The activity bustled also in the commercial real estate rental market, with unrented commercial space shrinking and rent in some segments going up.

GROSS DOMESTIC PRODUCT

In 2011, the economic growth in Latvia was among most buoyant in Europe. GDP increased by 5.5% in Latvia and by 1.5% in the EU countries overall.

In 2011, real exports of goods and services were the primary drivers of economic progress. Despite adverse developments in the global economy, especially in Europe, Latvian exports posted very dynamic growth of 12.6%. This expansion in exports was supported by regained competitiveness in manufacturing and a solid advance in investment. However, somewhat abating economic growth in major trade partners is likely to reduce the prospects of rapid export development.

Even though the external demand was more solid than the domestic one, strengthening in the latter was quite dynamic as well. Private consumption, the biggest component of domestic demand, picked up 4.4% in 2011. However, due to the low base and a much sharper increase in the other GDP expenditure components, this pickup is to be assessed as moderate for Latvia. The revival of private consumption was encumbered by weak purchasing power and high household debt level. And although improvements in employment and average wages and salaries resulted in higher disposable income, gains in population's purchasing power continued to be curbed by elevated taxes and global price rises (for food in particular). Henceforth, the effects from the increases in taxes and prices are likely to abate, yet the revival of private consumption would still be undermined by a slowdown in overall economic growth due to weaker external demand.

The year 2011 saw a robust upswing in gross fixed capital formation (24.6%), with total investment amounting to 26.4% of GDP in the fourth quarter (of which gross fixed capital formation accounted for 26.3%). The investment structure, with productive investment growing more rapidly, also posted positive changes. Investment in industry and the transport sector accounted for a half of non-financial investment. Investment growth was provided through projects financed from the EU funds, by large domestic companies' investment and improved availability of financing for competitive projects. Also, foreign direct investment contributed substantially to investment growth. Likewise, Latvia's upgraded rating for 2011 by international credit rating agencies played an important role in boosting the attractiveness of country's business environment. But the strong investment inflow may subside due to weakening global economic growth.

The trend of inventory renewal that plummeted during the economic downturn ended in 2011, hence the positive contribution of inventory changes declined to 2.1 percentage points (4.5 percentage points in 2010). The impact of this component on GDP changes is expected to be rather moderate also in the years to come.

Imports of goods and services picked up 20.7% in 2011, primarily on account of imports of intermediate goods for export production. Steeply rising investment contributed substantially to the expansion of capital goods imports as well. As imports grew faster than exports, the contribution of net exports was negative (5.2 percentage points).

Total value added increased by 5.5% in 2011. This rise was mainly determined by higher value added in manufacturing (1.4 percentage point contribution to total annual growth; 11.7% increase at constant prices), wholesale and retail trade (1.6 percentage points and 8.7% respectively), transport and storage (1.0 percentage point and 8.0%), professional, scientific and technical activities (0.3 percentage point and 4.2%), accommodation and food services activities (0.3 percentage point and 21.9%) and construction (0.7 percentage point and 12.4%). Meanwhile, a negative contribution to annual growth came from falling value added in real estate activities (0.4 percentage point and 4.5%).

Retail trade turnover increased by 4.6% in 2011, with the demand for furniture, household appliances and building materials contributing most. The growth in retail trade turnover, including motor vehicles, was especially impressive (12.5%). The demand for motor vehicles, furniture and household appliances primarily depended on postponed consumption, i.e. the use of previous savings in the environment of growing confidence about the future.

In 2011, trade turnover was boosted not only by domestic demand but also by non-resident purchases, as part of motor vehicle trade was in fact reexporting; moreover, trade was also spurred by tourists whose numbers grew rapidly, thus stimulating trade, turnover of catering services, accommodation, cultural services, etc.

At constant prices, manufacturing output expanded by 11.5% (working day adjusted data) in 2011 but at current prices it increased by 16.4%. In the first quarter, manufacturing output contracted by 1.0% quarter-on-quarter (seasonally adjusted data), while increases were recorded for the other quarters of the year (6.4% for the second quarter, 1.5% for the third quarter and 1.9% for the fourth quarter). As was the case in 2010, manufacturing was supported by stronger external demand. Hence the development of primarily foreign-market-oriented sectors gained momentum. The manufacture of wood and articles of wood contributed 3.5 percentage points to annual growth in manufacturing (at current prices), with 2.1 percentage points coming from fabricated metal products and 0.9 percentage point from the manufacture of electrical equipment. When the labour market situation gradually improved, food industry selling output in the local market also succeeded well (2.7 percentage points). Fast growth was characteristic also for the manufacture of non-metallic mineral products (1.9 percentage points), which is to be related to on-going expansion of construction volumes.

The manufacture of wood and articles of wood (with output volume increasing by 12.4% at constant prices), fabricated metal products (34.2%), wearing apparel (28.1%), non-metallic mineral products (23.9%) and electric equipment (48.1%) most strongly supported the overall growth of manufacturing in 2011. The growth was negative only in the manufacture of chemicals and chemical products (3.5%), paper and products of paper (3.0%) and beverages (6.3%).

In transport and storage, dynamic growth was still observed in 2011. It was driven by noticeably larger loaded and unloaded cargo volumes at Latvia's ports and freight traffic by road. 68.8 million tons of cargoes were loaded and unloaded at Latvia's ports (12.5% more than in 2010). Railways accounted for transportation of 59.4 million tons (20.8%

more than in 2010). This increase in port and railway freight traffic is mainly associated with a marked rise in coal transit. In the meantime, freight traffic by road accounted for 51.3 million tons (13.4% more than in 2010).

In 2011, non-financial investment increased again after a break of several years, albeit its level remained rather low. At current prices, non-financial investment picked up 28.7%. The investment activity was spurred by several factors. Manufacturing accounted for 5.6 percentage points of the overall annual increase in non-financial investment. Most investment in manufacturing went to the subsector of wood and products of wood for replacing depreciated forest technology with more up-to-date equipment, boosting production capacity and expanding the product range. Regarding transport and storage, investment was basically made in transportation by road, with the contribution to growth amounting to 2.9 percentage points. However, electric energy, gas and heat supply as well as air conditioning were responsible for the largest contribution (6.3 percentage points) to non-financial investment annual growth, as the construction of several energy infrastructure objects continued in 2011. A large contribution to non-financial investment growth (5.0 percentage points) was ensured by public administration and defence due to state procurement in construction of roads and various public buildings.

LABOUR MARKET

The labour market situation continued to improve in 2011. Unemployment notably contracted, yet still remained at a high level both historically and in comparison with the other EU countries. The gap between real wages and productivity closed, and thus the foundation for sustainable growth in the future was laid. Labour remuneration was on an upward trend in all sectors of the economy and, coupled with higher employment, supported the recovery of private consumption. A gradual decrease in the number of long-term unemployed and the share of long-term unemployment in total unemployment was observed in the second half of the year, suggesting that not only the cyclical component but also the structural one is responsible for contracting unemployment.

The average monthly full-time equivalent wage was 464 lats in 2011 (an annual increase of 4.4%). The pace of growth in labour remuneration was similar in the private and public sectors. Productivity gains were broadly based both in terms of per hour worked and per person employed. This brought about a further drop in unit labour costs in real terms (2.1% in the course of the year), thereby improving the economic competitiveness (in nominal terms labour unit costs grew by 2.1%).

All available statistical data sources confirmed that the number of employed was rising in 2011. Thus, for instance, according to the CSB's labour survey data, the number of employed increased by 35.6 thousand quarter-on-quarter in the fourth quarter. The CSB's business survey data, on the other hand, showed that the number of jobs in the economy had grown by 31.0 thousand. Employment increases were reported for all major sectors of the economy. Of the goods sector, they were the largest in agriculture, manufacturing and construction; of the services sector, information and communication as well as professional, scientific and technical activities were the areas recording the most solid employment growth.

Registered unemployment declined by 2.8 percentage points over the year, to 11.5% of economically active population at the year's end. Consequently, registered unemployment (falling to 130.2 thousand) lost approximately one third from its historic high reached in March 2010. Broadly based regional disparities of registered unemployment were still in place (at the end of the year, registered unemployment in Riga was 7.8%, whereas in Latgale it stood at 19.8%), yet it was still partly determined by different motivations of jobseekers for the registration with the State Employment Agency, with the CSB's labour survey data revealing considerably smaller unemployment disparities by region.

According to the CSB's labour survey data, jobseekers constituted 15.4% of economically active population in 2011. Differences in jobseekers' rates by age group and education still persisted: it was relatively more complicated to find employment for less educated and less experienced inhabitants. For example, in the fourth quarter, the average rate of jobseekers in the country was 14.3%, while in the age group of 15–24 year old people it amounted to 26.5%, and was almost five times higher for individuals with elementary education than among university graduates (29.0% and 5.8% respectively).

Job vacancies in the economy increased only moderately, thus, on the one hand, suggesting better opportunities to find a job, but, on the other, implying that only some professions and companies instead of the entire economy might be experiencing labour shortages. At the end of 2011, 2.5 thousand vacancies were registered with the State Employment Agency, while the respective figure according to the CSB's business survey data was 2.8 thousand. The EC confidence survey data suggested that labour shortages were widely spread in construction, with 8.7% of businesses referring to it as the main obstacle to successful business activity at the end of 2011 (by comparison, 4.9% and 5.4% were the respective figures for manufacturing and services).

According to preliminary results of the population census, the total population on 1 March 2011 was 2 067.9 thousand, which was substantially less than the record in the Population Register of the same date (2 225.4 thousand). In the course of last 10 years, Latvia's population shrank by 190 thousand due to migration, and this figure is several times higher than the respective indicator reported in the Population Register. Meanwhile, the dynamics of passenger arrival and departure disparity reported by Riga International Airport and Riga Passenger Terminal indirectly suggests that in 2011 the population loss due to migration was notably smaller than in the two previous years of the recent crisis. Moreover, the number of immigrants increased in 2011, suggesting mainly the return of Latvians from emigration.

FOREIGN TRADE, BALANCE OF PAYMENTS AND EXTERNAL DEBT

In 2011, Latvia's foreign trade activity continued to strengthen. The annual increase in goods turnover reached 28.6% (27.6% in 2010). The annual growth in exports and imports of goods in nominal terms was similar: exports recorded a 27.7% and imports a 29.2% expansion in the course of the year; however, in real terms, the growth in imports was more buoyant, with real exports picking up 14.7% and imports 23.0% within the year.

Nominal exports of goods soared above the pre-crisis level in 2011 and were rising to ever new export records for several months in a row. According to the Eurostat data, in 2011 Latvia recorded the third fastest export growth in the EU. This impressive export dynamics was supported by improved competitiveness of the Latvian producers, favourable price and cost developments, and robust external demand (the latter was significant at the beginning of the year but later during the concluding months moderated somewhat). Latvian exports became more diversified by sector. Speaking about the structure of goods exports, the share of wood and articles of wood contracted from 19.0% in 2010 to 17.0% in 2011, while that of base metals and articles of base metals increased from 13.8% to 14.6% respectively; the share of mineral product exports (oils refined from crude oil and bitumen minerals, electricity and peat) grew markedly (from 6.0% to 8.9% respectively). Exports expanded across all major groups of commodities, while the largest contributors to annual growth were mineral products (8.1 percentage points), base metals and articles of base metals (5.1 percentage points), agricultural and food products (3.1 percentage points), products of the chemical industry, pharmaceuticals in particular (2.9 percentage points), transport vehicles (2.8 percentage points), machinery and electrical equipment (2.7 percentage points), and wood and articles of wood (2.5 percentage points). In the course of the last six years, Latvia's exports of goods have showed positive trends: the share of high-tech and medium-tech sector output has increased (from 15.8% in 2005 to 24.0% in 2011) despite a moderate 0.9 percentage point decline in the high-tech output share year-on-year and only a slight 0.2 percentage point rise in the medium-tech output share.

According to the WTO's information, Latvia's market shares in world exports grew substantially in 2011 at a pace that exceeded the dynamics of the other countries that acceded to the EU simultaneously with Latvia. Export growth to Poland, Lithuania, the Netherlands and Estonia was most buoyant, boosting annual export volumes by 53.0%, 41.5%, 31.7% and 28.7% respectively. Exports to countries in Asia also increased notably by 77.2%, pushing their share in total exports from 5.6% in 2010 up to 7.8% in 2011. By country and country group, the export structure remained broadly unchanged during the year. As before, major trade partners were Lithuania (18.0% of total exports), Estonia (13.6%), Russia (10.6%) and Germany (8.4%), but 72.4% of total exports went to the EU countries (71.6% in 2010).

The expansion of export markets of Latvia's businesses was driven not only by the dynamics of major export commodity groups but also by the emergence of new ones along with the strengthening in formerly less important commodity groups. Thus, for instance, within the machinery and electric equipment group, the export share of data communication (transmitting and receiving) equipment increased, while the biofuel (biodiesel) export share augmented in exports of the chemical industry product group.

An overall increase in commodity imports in 2011, with imports of capital and intermediate goods growing at a faster pace throughout the year, primarily stemmed from the needs of export-oriented industries for resources and investment. Domestic demand in Latvia continued to be low and held down potential growth of consumer goods imports. The highest import growth was posted by transport vehicles (59.9%), mineral products (48.3%), base metals (39.5%), and machinery and electrical goods (34.4%). Major partners in goods imports were Lithuania (18.7% of total imports), Germany (12.1%), Russia (8.6%), Poland (7.9%) and Estonia (7.3%).

In 2011, trade surplus was reported only for wood and articles of wood as well as base metals and articles of base metals. The largest trade deficit was retained by such branches as mineral products and machinery and electrical equipment. Of major trade partners, Latvia's trade balance was positive with Estonia, the UK, Norway, Sweden and Denmark.

The real effective PPI-based exchange rate of the lats suggested cost competitiveness improvements (against the 2010 average, this indicator dropped 0.3%). In the context of more favourable labour productivity conditions, cost competitiveness was driven by declining unit labour costs in Latvia vis-á-vis slightly rising average ones in its major trade partners. The real effective unit-labour-cost-based exchange rate of the lats was estimated to have dropped 1.6% year-on-year in 2011. Inflation in Latvia soared faster than in most major trade partners due to rising indirect tax rates, hence the CPI-based real effective exchange rate of the lats rose somewhat (by 0.2%) in 2011. The nominal effective exchange rate remained robust and did not affect competitiveness significantly.

In 2011, price rises in export commodity groups were more pronounced than in import commodity groups (export unit value rose by 12.2% and that of imports by 6.1% in the course of the year). The highest export price rises were recorded for vegetable products (25.0%) and base metals and articles of base metals (22.1%), while export prices for products of the chemical and allied industries as well as for machinery and electrical equipment dropped (by 5.0% and 2.3% respectively). Of import prices, the most pronounced was the rise for mineral products (26.5%) and the largest decline for transport vehicles (11.3%). Comparatively stronger export price increases underpinned the improvement in overall terms of trade (5.9%). By sector, terms of trade improved most for vegetable products, transport vehicles, plastics and articles thereof, and base metals and articles of base metals.

Net inflows of foreign direct investment amounted to 5.5% of GDP in 2011. They were the largest in financial intermediation, real estate, trade and manufacturing. The increasing interest about Latvia as a place to invest in export production was a positive driver of growth in manufacturing. In the first half of the year, foreign direct investment flows exceeded the aggregate level of 2010, whereas in the second half of the year the inflows continued to increase. The structure of foreign direct investment also changed, with manufacturing, electric energy and transport gaining importance as final destination. Such investment in productive capital forms the foundation for sustainable economic development.

The goods and services trade balance worsened year-on-year in 2011, posting a deficit of 474.9 million lats or 3.4% of GDP. In the first three quarters of 2011, the balance of payments testified to certain improvements in Latvia's external and internal economic environment; however, in the fourth quarter the pace decelerated markedly for exports of goods, while exports of services expanded simultaneously. The services trade balance was positive (930.3 million lats or 6.6% of GDP), setting primarily off the negative balance of external trade in goods; in addition, services exports increased by 14.4% in 2011 vis-á-vis 2010 but the growth in services imports was more moderate (11.0%). Rises were recorded for both transportation and travel services, yet concerns about restrictions imposed on transportation services exports were still in place: already in 2011, the volumes of licensed freight transportation by road agreed with Russia were insufficient. Imports of services, i.e. transportation and travel services as well as communication, insurance and other economic activities, also expanded.

In 2011, the current account deficit of Latvia's balance of payments was 170.9 million lats or 1.2% of GDP. As the income account had posted a deficit since the second half of 2010, its balance was negative also in 2011 (132.9 million lats). Despite losses that foreign investors incurred in some months, the overall income on foreign investors' funding in 2011 grew. A slight downward trend was seen in the dynamics of the current transfers account (around 5%), yet its overall balance was positive, at 437.0 million lats. The inflow of financing from the EU Funds played a decisive role for the current transfers account. Most funding came from the European Agricultural Guarantee Fund and the European Agricultural Fund for Rural Development (totalling 195.8 million lats) as well as from the European Social Fund (91.2 million lats).

In 2011, the government did not use borrowings under international financial aid programmes, except from the World Bank (100 million euro) granted for the implementation of Safety Net and Social Sector Reform Programme following a previously reached agreement. In addition, the repayment of borrowed funds within the private sector, credit institutions primarily, triggered a drop in net external debt by 8.4 percentage points of GDP in the course of the year (to 6.4 billion lats or 45.1% of GDP).

FISCAL DEVELOPMENTS

On a cash flow basis, the consolidated general government budget posted a deficit of 444.9 million lats or 3.1% of GDP in 2011. According to the accrual principle (ESA 95) used to evaluate compliance with the Maastricht criteria, however, the consolidated general government budget provisionally ran a deficit of 502.1 million lats or 3.5% of GDP.

In 2011, as in the previous year, both the central government basic budget and central government social security budget recorded a deficit (here and further, on a cash flow basis) of 300.7 million lats and 124.9 million lats respectively. Contrary to the previous year, the consolidated local government budget also reported a deficit in the amount of

40.0 million lats, whereas the budget of derived public persons ran a surplus of 12.0 million lats at the end of the year.

The three-year-long Latvia's Economic Stabilisation and Growth Revival Programme aimed at ensuring sustainable public finances by gradually balancing the spending with the revenue was completed in 2011. International donors commended Latvia on successful implementation of the austerity measures ensuring the economic recovery in the post-crisis period. Within the first two years of the programme, the fiscal consolidation measures totalled almost 15% of GDP, whereas in 2011 they amounted to 2.0% of GDP and were implemented to lay a foundation for Latvia to meet the Maastricht criterion for the budgetary deficit (3% of GDP) in 2012. Upon closing the programme, it was agreed that Latvia will target a budgetary deficit of up to 2.5% for 2012, while any future planning and execution of the budget will comply with the provisions of the Law on Fiscal Discipline pending approval.

The pace of fiscal consolidation declined in 2011 and the consolidation measures were mostly focussed on the revenue side, as the easier-to-implement expenditure cutting options had already been used up. Major measures included raising the VAT tax by 1 percentage point (to 22%), increasing the employee social insurance contributions by 2 percentage points, introducing a company car tax and other tax changes. In order to offset the impact of higher taxes on household income, the personal income tax rate was reduced by 1 percentage point.

The Law on Fiscal Discipline, currently in the pipeline and scheduled for adoption in 2012, should be considered an important structural improvement within the framework of the stabilisation programme and it will put a legal stop to any attempts to return to a pro-cyclical budgetary policy.

In 2011, the consolidated general government budget revenue amounted to 5 087.4 million lats or 35.9% of GDP, representing an increase of 480.4 million lats or 10.4% year-on-year. The revenue rise was mostly attributable to higher tax collections (an increase of 475.8 million lats or 14.0%). Such an impressive rise in Latvia's tax revenue was supported by the economic recovery and raising the rates of individual taxes. Higher employee social insurance contributions and improvements in labour market conditions resulted in a sizeable contribution of the social tax (136.4 million lats) to the overall revenue rise. The contribution of the VAT was similar (133.4 million lats). With corporate profits rebounding, the contribution of higher corporate income tax collections was significant, whereas the improvements in the average wage and salary and employment offset the downward effect of the reduced personal income tax, resulting in a year-on-year increase of the personal income tax collections. Excise tax and real estate tax revenue also expanded on account of the increased rates. Non-tax revenue shrank by 57.1 million lats or 9.5%. The decline was affected by a combination of several factors: no revenue from sales of state-owned greenhouse gas emission units (37.0 million lats in the previous year), lower revenue from financial derivatives and reclassification of the annual transport vehicle duty into vehicle operation tax. Foreign financial assistance inflows in the consolidated general government budget from the EU funds for the programming period 2007–2013 exceeded the 2010 inflows by 63.4 million lats or 10.6%.

The expenditure of the consolidated general government budget amounted to 5 532.2 million lats or 39.1% of GDP in 2011, representing an annual increase of 122.5 million lats or 2.3%. The increase was accounted for by a steep rise in capital expenditure (by 196.5 million lats) reflecting larger flows of central government budget contributions to projects co-financed from the EU funds. Notable growth was observed for remuneration and spending on goods and services as well as interest expenditure. The overall expenditure increase was significantly offset by the decline in expenditure on social benefits (134.9 million lats or 7.7%) as well as expenditure on subsidies and grants (63.7 million lats).

The social benefits costs shrank in comparison with the previous year when repayments of withheld pensions were made as well as on account of the declining disbursements of unemployment and other social insurance benefits.

On a cash flow basis, the general government debt totalled 5 348.8 million lats or 37.8% of GDP at the end of 2011, representing an year-on-year increase of 267.9 million lats. The rise was determined by a 351.8 million lats increase in the external debt of the central government. The domestic debt of the central government decreased by 83.8 million lats year-on-year, whereas the local government borrowing grew by 27.7 million lats, yet this did not increase the overall debt as it was borrowing from the central government budget. As the government no longer drew from the funding available from the international loan for economic stabilisation and restoration of growth, the increase of the external debt was determined by a 500 million USD worth issue of bonds and a 100 million euro loan from the World Bank within the framework of the Safety Net and Social Sector Reform Programme. The bond issue launched on 9 June confirmed that Latvia had successfully returned to the international financial markets after a break since 2008.

The general government debt recorded based on ESA 95 methodology reached 6 052.2 million lats at the end of 2011 according to preliminary data (42.7% of GDP), representing a year-on-year increase of 357.6 million lats.

CREDIT INSTITUTION DEVELOPMENTS

At the end of 2011, 31 credit institutions, including nine branches of foreign credit institutions, 33 credit unions, five electronic money institutions and two money market funds were registered in the Republic of Latvia. A new credit institution, JSC *Rigensis Bank*, was established in 2011, whereas the JSC *Latvijas Krājbanka* is currently in the middle of insolvency proceedings and its credit institution licence had not been revoked by the end of 2011. One branch of a foreign credit institution, one credit union and three money market funds wound up their business. The government's participating interest in the paid-up share capital of credit institutions increased slightly during the year, reaching 26.9% at the end of 2011.

Latvia's economy continued to grow in 2011, yet the assets of credit institutions contracted by 4.7% as opposed to an increase of 1.3% in 2010 (see Chart 4) due to loan repayments exceeding the new loans and writing off the unrecoverable loans. The portfolio of credit institution loans to resident and non-resident non-MFIs continued to shrink (by 8.1%; by 7.1% in 2010). Non-resident MFI financing also contracted by 27.4% (by 12.2% in 2010), accounting for 22.8% of the aggregate credit institution assets (including financing from parent banks amounted to 22.1%; see Chart 5). Overall, the deposit base remained stable, with deposits by resident non-financial corporations and households growing by 0.5%; nevertheless, the aggregate resident deposits contracted by 9.9%. This was supported by the partial repayment of the government deposits with the JSC *Citadele banka* and the JSC *Parex banka* (116.8 million lats) and the conversion of another part

Chart 4

DYNAMICS OF THE CREDIT INSTITUTION ASSET ITEMS
(%)

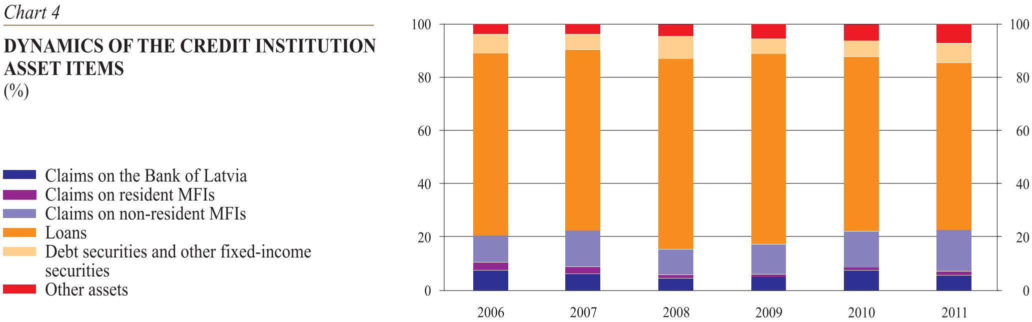
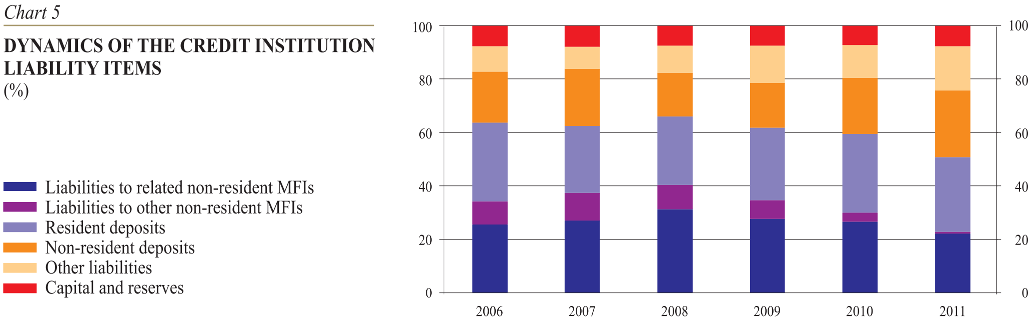


Chart 5

DYNAMICS OF THE CREDIT INSTITUTION LIABILITY ITEMS
(%)



of the government deposits with the JSC *Parex banka* into closed-issue securities (427.8 million lats). Non-resident deposits continued to expand (by 13.0%).

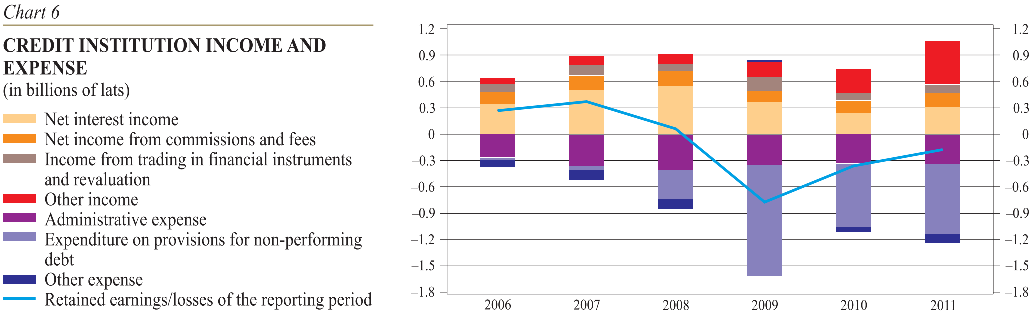
With the lending activity remaining low, the share of liquid assets in total assets was still high (27.4%).

Against the background of the economic growth, the loan quality of credit institutions continued to improve and the share of loans past due over 90 days shrank to 17.5% of the aggregate loan portfolio of credit institutions at the end of 2011. This improvement, however, was mainly achieved on account of writing off delinquent loans. Credit institutions continued active debt restructuring measures providing concessions to troubled borrowers. Restructured loans amounted to 17.5% of the aggregate loan portfolio of credit institutions at the end of 2011.

Although most Latvian credit institutions operated with profit in 2011, overall the credit institutions finished the year with losses (178.7 million lats) which were half as large as in the previous year (360.6 million lats; see Chart 6). The main reason causing the losses was the expenditure on provisions for non-performing loans and commitments of the JSC *Latvijas Krājbanka* and the JSC *Parex banka*. The operating income of credit institutions totalled 571.0 million lats in 2011, representing a year-on-year increase of 21.1%. Net interest income, the most sizeable component of the operating income, had grown year-on-year. Although the interest income of credit institutions shrank in comparison with 2010, the decline in interest expenditure was more pronounced, resulting in a year-on-year rise in net interest income by 27.1% (a 33.3% decrease in 2010). Net interest income accounted for slightly more than a half of the operating income. Net commissions and fees, the second most important income component, continued to expand (by 17.5%; by 7.0% in 2010), still accounting for about 30% of the operating income. Administrative expenses of credit institutions remained broadly unchanged, as the credit institutions had reduced the costs significantly already in the previous years.

Chart 6

CREDIT INSTITUTION INCOME AND EXPENSE
(in billions of lats)



The capital adequacy ratio of credit institutions continued to improve and stood at 17.4% at the end of the year (the minimum capital requirement set by the FCMC is 8%), whereas Tier I capital ratio amounted to 14.2%. Credit institutions continued to boost their capital: within a year, 12 credit institutions increased their capital by 139.4 million lats overall.

MONEY SUPPLY

In 2011, the development of the monetary aggregates in Latvia (see Annex 1) was positively affected by the economic growth and, for most part of the year, also by the high liquidity surplus of the credit institutions. The gradual intensification of external market tensions, the political uncertainty related to the extraordinary elections of the Saeima of the Republic of Latvia and the long period of hesitation with adopting the budget for 2012 hindered the growth in savings and resulted in stagnation of the aggregate money supply. In the last two months of 2011, the financial sector experienced a brief escalation of the situation against the background of suspended operation of the JSC *Latvijas Krājbanka* and a jump in the demand for cash caused by spreading rumours. The concentration of the money supply in the most liquid segments (currency and demand deposits) pointed to the cautious attitude of the economic agents towards accumulation of any longer-term savings which could be related to both the unclear future prospects of the external markets and its effect on the exporter businesses in Latvia as well as a relapse in confidence in credit institutions stemming from the recent problems. Nevertheless, the year-end developments were short-lived and the situation stabilised already at the beginning of 2012.

As a result of the financial sector turbulances experienced around the turn of the year, the overall rise in currency outside credit institutions was the steepest since 1994 (28.8%), with currency in circulation peaking at 1 040.0 million lats. At the same time, the role of overnight deposits, the other most liquid money supply component, in money supply also increased considerably, resulting in a rise in M1, the most liquid component of broad money (15.6%; 26.6% in 2010). M2 and M3 increased only marginally, by 0.3% and 1.7% respectively (by 11.2% and 11.5% in 2010 respectively; see Table 1 for the annual changes in monetary aggregates). Overall, M3 increased by 112.1 million lats in comparison with a 674.5 million lats rise in 2010 and amounted to 6 659.7 million lats at the end of 2011 (see Chart 7), reaching a new peak over the previous one seen in December 2010. Money supply M3 decreased by 1.0% in the first half of the year, whereas in the second half it grew by 2.8%. Considering the high growth rate achieved in the previous year, the annual rate of change of M3 gradually decelerated throughout the year. Similarly to the previous years, the steepest monthly rise of 185.1 million lats or 2.9% was again reported for M3 in December 2011, with both deposits with MFIs (except the Bank of Latvia) as well as currency in circulation increasing significantly. The highest monthly drop of 65.3 million lats or 1.0% was recorded in June, when the MFI holdings of deposits with an agreed maturity of up to two years contracted.

Table 1

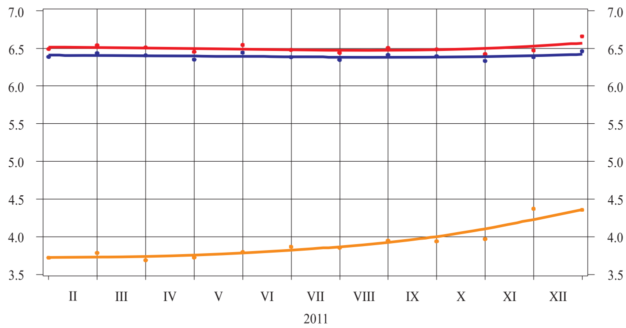
ANNUAL CHANGES IN MONETARY AGGREGATES
(%)

	2011	2010
Currency outside MFIs	**28.8**	21.0
Overnight deposits	**12.0**	28.2
M1	**15.6**	26.6
Deposits with an agreed maturity of up to 2 years	**–22.4**	–5.2
Deposits redeemable at a notice of up to 3 months	**–10.2**	–2.9
M2	**0.3**	11.2
Money market fund shares/units and debt securities with a maturity of up to 2 years	**93.4**	32.6
M3	**1.7**	11.5

The increase of the monetary aggregate M2X calculated based on the Bank of Latvia's methodology (1.5%; 9.8% in 2010) was slightly lower than that of the aggregate money supply.

Chart 7

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



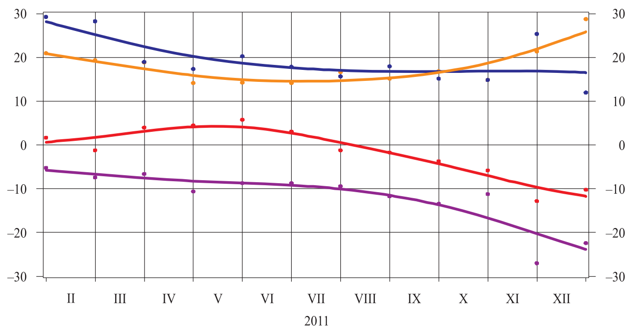
The rise of both M3 and M2X was almost entirely attributable to the expansion of the cash component. Demand for cash strengthened on account of higher retail trade turnover and stabilised wages and salaries. To a certain extent, it was also stimulated by the payments made in the grey economy as implicitly suggested by the continuously growing ATM cash deposits (an increase of 24.4% in 2011 in comparison with 2010).

Two stages were observed in the development of the demand for cash in 2011. With the Latvian economy further stabilising and moderate growth resuming, the rise in the demand for cash was also rather moderate in the first 10 months of 2011 (7.8%). In November and December, however, it was exceptionally high (14.8% in two months). Alongside with the seasonality factor, this was determined by suspending the operations of the JSC *Latvijas Krājbanka* in November and the subsequent disbursements of deposit compensations as well as the rumour-caused run on individual credit institutions in the first half of December when their customers preferred to turn their savings to cash. For this reason, at the end of the year currency in circulation (the lats banknotes and coins issued by the Bank of Latvia less vault cash of MFIs) exceeded the level at the end of 2010 by 232.7 million lats (currency in circulation increased by 140.1 million lats in 2010). Although the non-cash component plays the dominating role in the aggregate money stock, the share of cash in broad money continued to expand from 12.3% at the end of 2010 to 15.6% at the end of 2011.

In 2011, deposits of resident financial institutions, non-financial corporations and households contracted by 2.4% in comparison with an increase of 8.3% recorded in 2010. This overall contraction masked an increase of 12.0% for all currency overnight deposits with MFIs and a decline of 22.4% and 10.2% for 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 respectively. As a result, the share of overnight deposits in broad money grew from 45.3% at the end of 2010 to 49.8% at the end of 2011 (see Chart 8 for the developments in the components of M3).

Chart 8

COMPONENTS OF M3
(annual percentage changes)



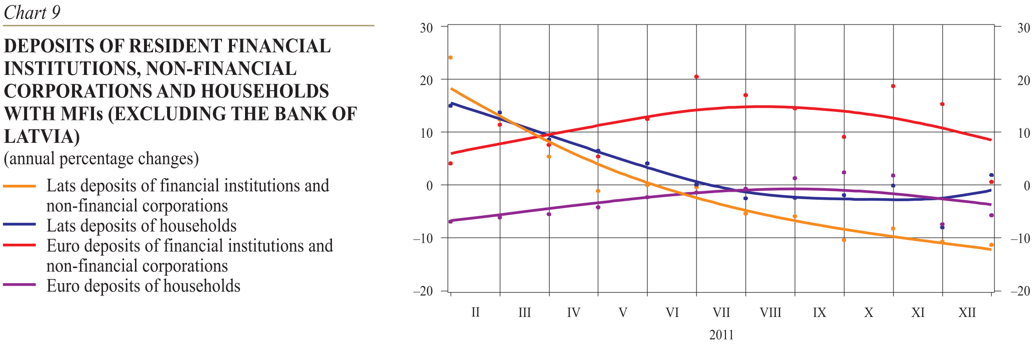
The growth observed in industry, exports and retail trade in 2011 contributed to a rise in deposits by non-financial corporations by 2.0%, whereas household deposits decreased by 0.5% reflecting the recovery of consumption, shrinking savings and debt service costs.

Thus the share of household deposits grew to 53.8% of aggregate deposits in comparison with 52.8% at the end of 2010, as the MFI holdings of deposits by financial institutions contracted significantly.

Year-end developments in the domestic financial market and the problems of the euro area economy reduced the attractiveness of both the lats and the euro as a deposit currency. Thus MFI deposits in lats decreased by 5.3% in the course of the year, whereas the deposits in euro shrank by 3.1%. At the same time, deposits in other foreign currencies grew by 22.8% (see Chart 9 for the developments in lats and euro deposits made by households as well as financial institutions and non-financial corporations). In other currency deposits group, the most sizeable increase was recorded for the US dollar deposits which expanded by 15.1%, whereas the highest growth rate at 24.9% was reported for the deposits made in British pound sterling. At the end of 2010, deposits in lats accounted for 49.7% of the deposits of resident financial institutions, non-financial corporations and households, while at the end of 2011 the respective share declined to 48.3%, whereas the share of the same category deposits in euro shrank from 43.5% to 43.2% respectively. The share of the US dollar deposits, on the contrary, grew from 5.1% to 6.5%.

Chart 9

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



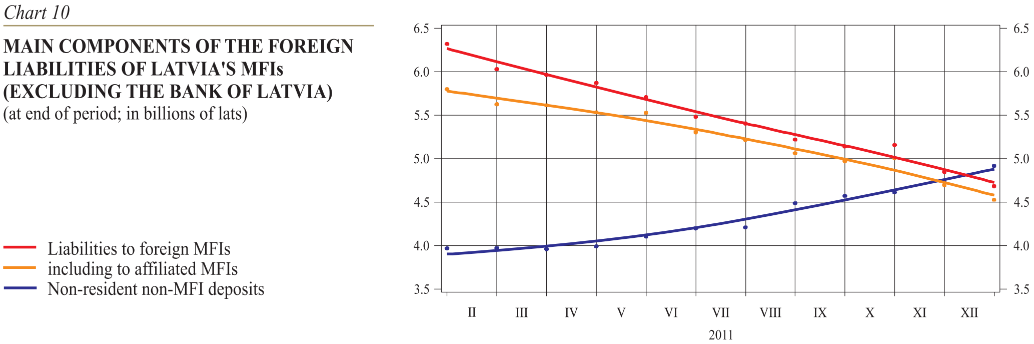
The share of other components of M3 remained relatively small, although the bonds issued by two credit institutions in December did increase the outstanding amount of the MFI debt securities with a maturity of up to two years to 133.1 million lats.

The money multiplier decreased slightly and was 3.07 in December 2011 in comparison with 3.73 in December 2010. Aggravating macroeconomic risks associated with the developments in Europe supported acceleration of the velocity of money to stand at 2.1 in comparison with 1.9 in 2010.

Due to the persistently low lending activity, repayments of loans from foreign parent banks continued and the remaining syndicated loans were also repaid. Non-resident non-bank deposits grew by 16.7% and exceeded the amount of loans received from foreign credit institutions (see Chart 10). Thus the impact of the changes in capital inflows in credit institutions on the money supply development waned. Negative net foreign assets of MFIs decreased 5.4 times in 2011 amounting to 224.8 million lats, including a decrease in the Bank of Latvia's net foreign assets by 14.8% to 3 435.2 million lats.

Chart 10

MAIN COMPONENTS OF THE FOREIGN LIABILITIES OF LATVIA'S MFIs (EXCLUDING THE BANK OF LATVIA)
(at end of period; in billions of lats)



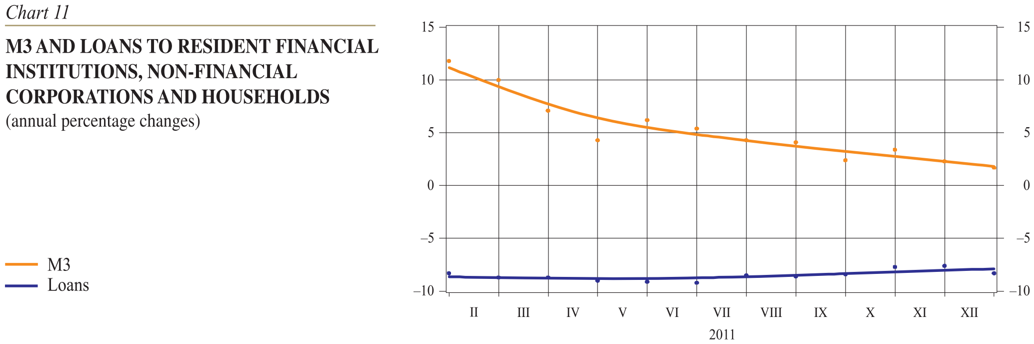
Foreign liabilities of MFIs (excluding the Bank of Latvia) contracted by 1.1 billion lats in 2011 (a 0.4 billion lats decrease in 2010), including a decline of 1.8 billion lats in liabilities to foreign MFIs (of which a decrease of 1.2 billion lats vis-á-vis associated and affiliated MFIs), whereas non-resident non-MFI deposits increased by 0.7 billion lats. Foreign assets of credit institutions grew by 0.5 billion lats in 2011, whereas claims on non-resident MFI expanded by 0.4 billion lats. Thus, the negative net foreign assets of MFIs (excluding the Bank of Latvia) had shrunk by 1.6 billion lats year-on-year at the end of 2011 (in 2010, the negative net foreign assets of MFIs decreased by 1.1 billion lats year-on-year).

Of the M3 counterparts, the decline in the MFI loans to private sector retained its downward effect on the monetary aggregates, with loans to resident financial institutions, non-financial corporations and households shrinking by 8.3%, the same as in 2010 (see Chart 11). Nevertheless, the monthly fall decelerated slightly in the second half of the year: the average monthly rate of decline in loans stood at 0.8% in the first half of the year and at 0.6% in the second half of the year. The shrinking of the loan portfolio was partly determined by the write-offs of lost loans (especially in December); the recovery in the lending activities, however, was primarily dampened by the growing downside risks to the external demand. As a result of the moderate demand and the cautious behaviour of the credit institutions, the amount of new loans was smaller than that of repaid loans, thus the loan portfolio of credit institutions continued to shrink. At the same time, the share of loans past due decreased (loans past due over 90 days amounted to 17.2% of the aggregate loans at the end of 2011 in comparison with 19.0% at the end of 2010).

Chart 11

M3 AND LOANS TO RESIDENT FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS

(annual percentage changes)



With the loan portfolio of credit institutions continuing on a downward trend, exposure to loans granted to resident financial institutions, non-financial corporations and households decreased to 55.2% of the aggregated balance sheet assets of MFIs (excluding the Bank of Latvia) at the end of 2011 (57.6% at the end of 2010).

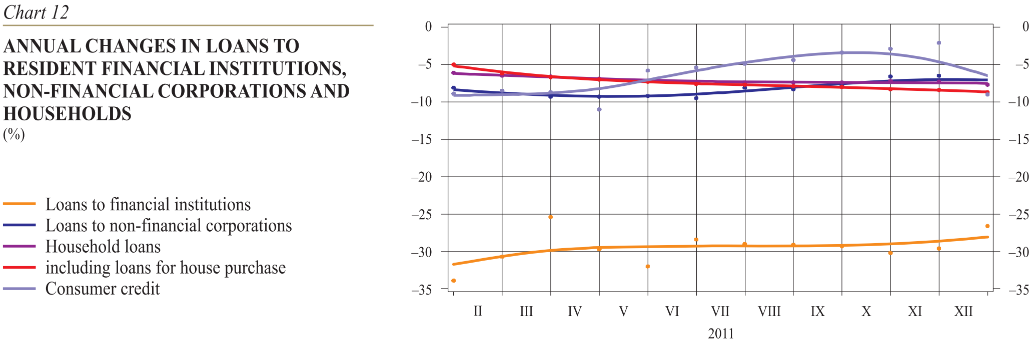
Net government deposits with MFIs contracted by 767.0 million lats in the course of the year.

The attitude of credit institutions vis-á-vis non-financial corporations and households did not differ significantly: the annual rate of decline in lending to both customer groups was equal at 7.7%, with loans to financial institutions shrinking faster (a 26.6% year-on-year decrease for this type of loans; see Chart 12 for changes in loans granted to resident financial institutions, non-financial corporations and households). Lending to households has been declining at an almost unchanged rate month-on-month for several years already. This was a result of a gradual repayment of loans for house purchase. Loans to non-financial corporations, in turn, following a rather steep decline in the first quarter of 2011, stabilised and even slightly expanded in the summer and winter months, reversing again only at the turn of the year.

Looking by sector, loans decreased in most sectors of the economy in 2011, particularly strongly in real estate and construction, yet some export-capable and infrastructural

Chart 12

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



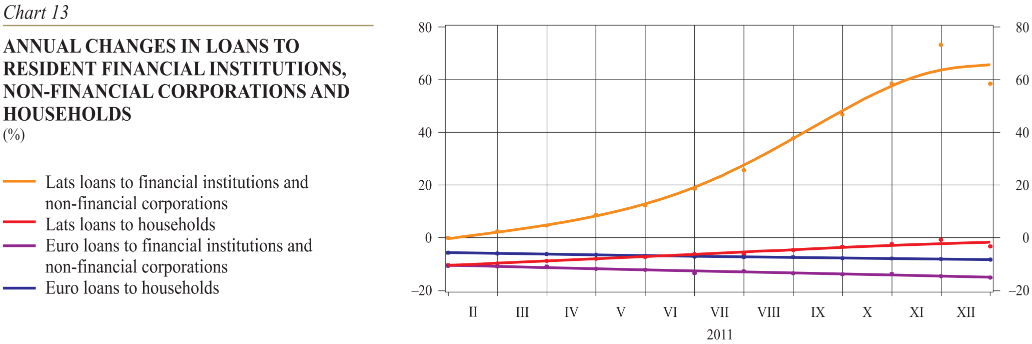
development related industries investment experienced an increase in investment (including manufacture of wood, crop and animal production and land transport). Nevertheless, at the end of the 2011 the bulk of corporate loans were still concentrated in the sectors of real estate (34.3%; 33.4% in 2010), manufacturing (13.7%, the same as in the previous year), trade (10.9%, the same as in the previous year) and construction (9.1%; 10.5% in 2010).

The most significant contraction during the year was observed for the mortgage loans granted to non-financial corporations as well as household loans for house purchase (by 14.1% and 8.7% respectively). The fall in commercial credit and consumer credit granted to households was more moderate (6.4% and 6.3% respectively), whereas industrial credit decreased by merely 4.4%. At the end of December, loans for house purchase totalled 4.2 billion lats or 79.5% of all loans granted to households, representing a year-on-year decrease of 0.4 billion lats. Hence, loans for house purchase, industrial credit and commercial credit accounted for 37.1%, 17.8% and 14.6% of aggregate loans at the end of the year respectively (37.2%, 17.0% and 14.3% at the end of 2010 respectively).

Market developments as well as the lats and the euro interest rate movements throughout the year slightly changed the currency composition of the loan portfolio: the lats loans increased by 23.6% amounting to 10.5% of the aggregate loans at the end of 2011 (7.8% at the end of 2010), whereas the share of the euro loans contracted by 3.5 percentage points to 85.8% (see Chart 13 for the developments in lats and euro loans granted to households as well as financial institutions and non-financial corporations).

Chart 13

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

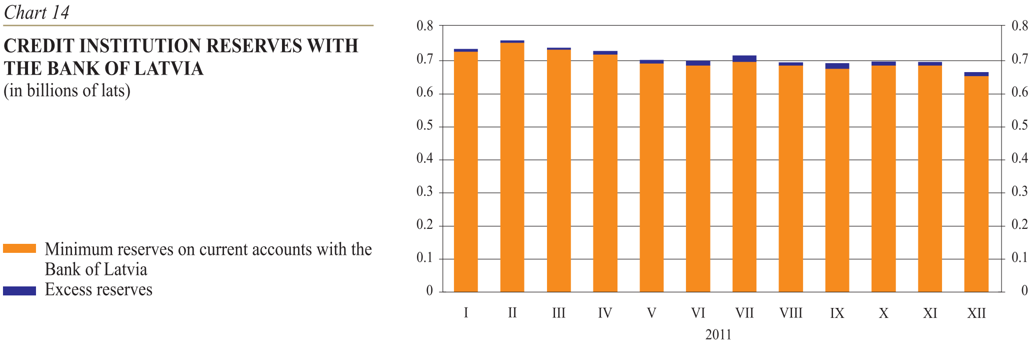


MONETARY BASE

A decrease in the liabilities of the credit institutions subject to the minimum reserve requirements resulted in a contraction of the minimum reserves held on the current accounts of the credit institutions with the Bank of Latvia (see Chart 14). Nevertheless, overnight deposits of credit institutions and other financial institutions held by the Bank of Latvia grew by 191.4 million lats or 23.4% in 2011 (a decrease of 4.7% in 2010) because of a considerable decrease in the recourse to the Bank of Latvia deposit facilities. Demand for cash increased steeply under the impact of the developments observed in the domestic

Chart 14

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



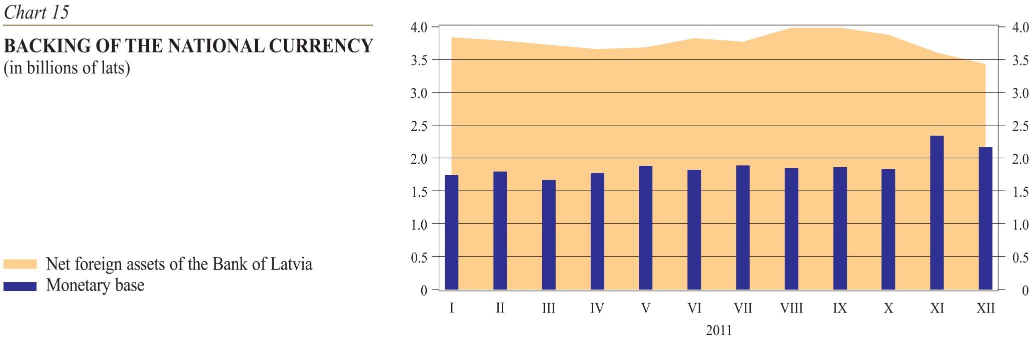
financial market at the end of 2011, and currency in circulation grew by 222.3 million lats or 23.7% (by 19.0% in 2010). As a result, the monetary base M0 expanded by 23.6% and totalled 2 168.9 million lats at the end of 2011, whereas the cash component of the monetary base grew to 53.5% in comparison with 53.4% at the end of 2010.

The decrease in the government deposits with the Bank of Latvia by 343.9 million lats and in the banks' recourse to the Bank of Latvia deposit facilities by 666.7 million lats had an upward effect on the monetary base.

The Bank of Latvia's net foreign assets declined by 596.9 million lats in 2011 primarily on account of shrinking Latvian government deposits in foreign currencies. At the end of 2011, the Bank of Latvia's reserve assets covered the goods imports of 5.1 months (of 7.9 months at the end of 2010), whereas the backing of the national currency with the Bank's net foreign assets was 158.4% (see Chart 15; 229.7% at the end of 2010).

Chart 15

BACKING OF THE NATIONAL CURRENCY
(in billions of lats)



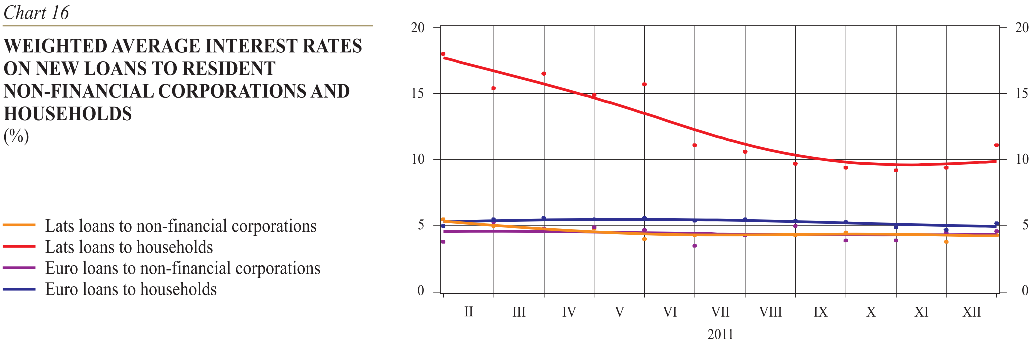
LENDING AND DEPOSIT RATES

The euro lending rates did not exhibit any large volatility in 2011: during the episodes of rising euro money market interest rates, credit institutions lowered their margins, whereas once the money market interest rates reversed the margins could be raised again. Until November, the lats lending rates followed a downward trend mirroring the contraction of the money market interest rates and the margins. With credit institutions retaining ample liquidity, deposit rates also followed a downward path, except in November and December when the rates on new household deposits in lats increased under the impact of short-lived financial market turbulences associated with the suspension of the JSC *Latvijas Krājbanka* operations.

The weighted average rate on new euro loans granted to resident non-financial corporations remained broadly unchanged in 2011: 4.6% in both December 2010 and December 2011 (see Chart 16). Despite a decline in the weighted average rate on new euro-denominated loans to resident non-financial corporations of up to 250 thousand euro (from 6.0% to 5.4%) and that of the respective loans over 0.25 and up to 1 million euro (from 5.9% to 5.2%), the weighted average rate on loans exceeding 1 million

Chart 16

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



euro increased marginally (from 4.2% to 4.4%; specifically those loans constituted the bulk of the new euro-denominated loans granted to resident non-financial institutions). In the first half of the year, when the EURIBOR followed an upward trend, credit institutions gradually narrowed their margins over the money market indices for new euro-denominated loans to non-financial corporations, whereas in the second half of the year when the EURIBOR declined and risk aversion increased the margins widened again.

The weighted average rate on new lats-denominated loans granted to resident non-financial corporations edged down from 5.2% in December 2010 to 4.3% in December 2011, mainly on account of shrinking margins. The most significant fall was witnessed for the weighted average rate on new lats-denominated loans to resident non-financial corporations of up to 250 thousand euro (from 7.8% to 5.0%), whereas for the loans over 0.25 and up to 1 million euro it declined from 5.5% to 4.6% and loans exceeding 1 million euro from 5.0% to 4.0%. In the last three months of 2011, the rates on lats-denominated loans to non-financial corporations were affected by the rising RIGIBOR, yet this rise was more than offset by the shrinking margins.

The access of resident non-financial corporations to loans with a longer initial interest rate fixation period also improved. The weighted average rate on new lats-denominated loans with the initial interest rate fixation period over 1 year declined from 6.7% to 5.2% from December 2010 to December 2011, whereas for euro-denominated loans it went down from 6.2% to 4.3%. For lats-denominated loans with a floating interest rate and an initial interest rate fixation period of up to one year the rate declined from 5.0% to 4.1%, whereas in the case of the euro-denominated loans it edged up from 4.4% to 4.7%.

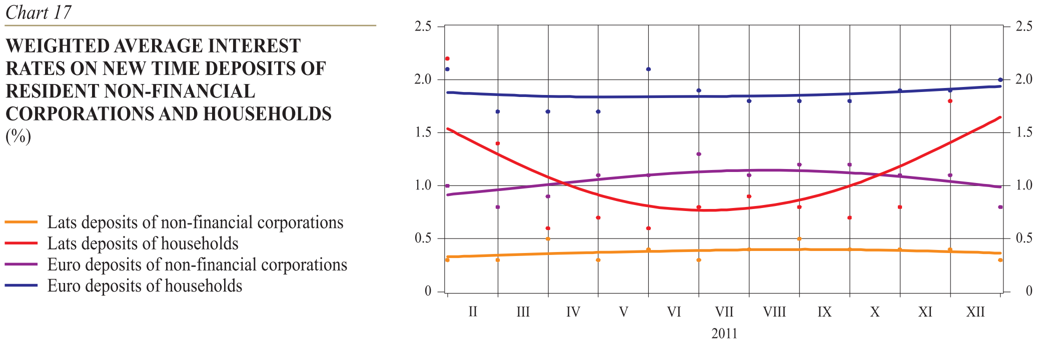
The weighted average rate on new euro-denominated loans for house purchase granted to resident households remained broadly unchanged (4.0% in December 2010; 4.1% in December 2011), with the margins narrowing in the episodes of rising EURIBOR and widening or remaining broadly unchanged during the episodes of the EURIBOR declining. Interest rates on new lats-denominated household loans for house purchase followed a downward trend. However, in December they increased significantly against the background of financial market turmoils and rising RIGIBOR. Thus the comparison of the data for December 2010 against the data for November 2011 reveals that the weighted average rate on new lats-denominated household loans for house purchase decreased by 2.1 percentage points to 3.6%, whereas against December 2011 the decline was 1.0 percentage point reaching 4.7%.

As the rates on the lats-denominated loans had become friendlier, new lats-denominated loans as well as the share of the lats loans in aggregate loans expanded. This tendency was more characteristic of the non-financial corporations segment than of the household segment.

With the exception of November and December, credit institutions lacked any strong motivation to attract deposits from resident non-financial corporations and households in 2011; therefore, the time deposit rates for resident non-financial corporations and households remained low (see Chart 17). In November and December, however, the credit institutions raised the interest rates on new lats-denominated time deposits from households as a result of the short-lived turbulence observed in the financial sector in association with the suspension of the JSC *Latvijas Krājbanka* operation. Consequently, the weighted average rate on new lats-denominated time deposits from resident households declined from 2.1% to 0.8% from December 2010 to October 2011, returning to 2.0% in December 2011. The weighted average rate on new lats-denominated time deposits of resident non-financial corporations fluctuated within the boundaries of 0.3%–0.5%. The weighted average rate on new euro-loans declined from 2.4% to 2.0% in the case of deposits by households and from 0.9% to 0.8% in that of deposits by non-financial corporations.

Chart 17

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



The share of lats-denominated deposits in the aggregate deposits by resident households gradually shrank until mid-year, with the interest rates on new lats-denominated time deposits sliding below the level of the respective euro rates, whereas towards the end of the year it expanded again. The share of the lats-denominated deposits in the aggregate deposits by resident non-financial corporations remained high, yet volatile.

Lending and deposit rate spreads slowly widened. This was supported by the decline observed in deposit rates. Easier access to financing reduced the role of deposits as a source of credit institution financing; consequently, deposit rates have experienced lower increases in the episodes of rising money market interest rates and stronger falls in the episodes of declining money market interest rates.

INTERBANK MARKET

The lats money market rates lingered around a very low level in 2011. This was supported by both the persistently high liquidity surplus of the credit institutions as well as the confirmed ability of Latvia to return to the path to sound public finances and strengthen confidence in the financial market. Thus interest rates on the interbank market dominated by the maturities of up to one month, stuck close to the interest rates of the overnight deposit facility (0.25% in 2011) and the 7-day deposit facility (0.375% in 2011) of the Bank of Latvia. The weighted average monthly interest rate on interbank overnight loans, the most liquid segment of the lats money market, ranged from 0.23% to 0.36% in 2011. The downward tendency in the interbank market business observed in the previous year continued in the first half of 2011, while in the second half of the year, with the liquidity surplus shrinking, the interbank market saw an increase in the activity. Therefore, the average monthly amount of interbank lats-denominated loans (354.1 million lats) was only slightly lower than that in 2010.

The regained macroeconomic stability enabled also the longer-term RIGIBOR rates (to which the rates of lats-denominated non-MFI loans are linked) to remain at their historical lows throughout the year. The 3-month RIGIBOR stood at 0.96% in 2011, whereas the 6-month RIGIBOR was 1.51%. A minor increase in longer-term RIGIBOR rates was observed only at the very turn of the year. Contrary to the domestic market trends, the

EURIBOR rates (to which the rates of euro-denominated non-MFI loans are linked) rose throughout the first half of the year reflecting the monetary policy pursued by the ECB and started to reverse at the turn of the year mirroring a change in this policy. Thus the money market interest rate spread measured as the difference between RIGIBOR and EURIBOR of the same maturities was negative in 2011: –0.43 percentage point in the case of loans with a 3-month maturity and –0.13 percentage point in the case of loans with a 6-month maturity.

FOREIGN EXCHANGE MARKET

In the first half of 2011, the foreign exchange market saw a fall in the US dollar value; in the second half of the year, however, with the demand for US dollar increasing the US dollar exchange rate gained slightly against the euro and the British pound sterling but weakened against the Japanese yen in annual terms. In 2011, most developed countries posted only moderate economic growth and some countries even an economic downfall. In March, a devastating earthquake shook Japan. Political turmoil in Middle East and North Africa and the relatively more rapid pace of growth in the developing economies allowed to keep energy prices high. In the first half of 2011, markets were focused on the US's economic problems, which were overshadowed by the euro area sovereign debt crisis in the second half of the year. Escalation of the situation in Greece added to market concerns about financial stability of other euro area countries and even encouraged speculations about potential collapse of the euro area. European banks' investments in government securities of the euro area countries affected by the sovereign debt crisis resulted in a loss of confidence in banks. Therefore in the second half of the year many investors shifted their funds to US financial assets thus enhancing the trend towards appreciation of the US dollar. US production data released at the end of the year signalled of positive trends while the decline in unemployment gave rise to expectations of growing domestic consumption, which has traditionally been the driving force of the US economy.

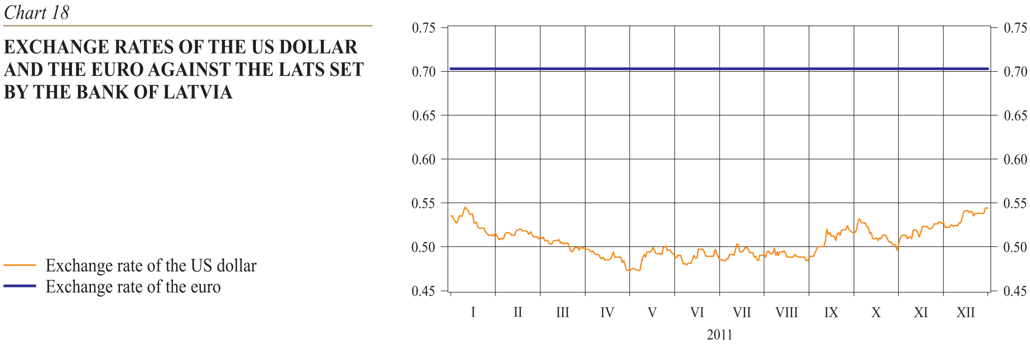
Though the beginning of the year was promising for the euro area countries, further developments marked a considerable difference between two groups of euro area countries. The relatively strong economic growth in Germany was in a marked contrast with the challenges faced by the Southern European countries (Greece, Portugal and Italy). The restructuring of Greek government debt securities set back the potential default of the country, at the same time, however, escalating investors' concerns about the future of the euro area, and the exchange rate of the euro against currencies of other developed countries continued to weaken. Sluggish economic growth in the US, especially in the first half of the year, and crises in the euro area countries led to increasing interest by investors in buying Japanese assets. The trend towards negative trade balance in Japan was due to the negative effects of the damage caused by the earthquake on the production and the related growth in imports of raw materials, as well as to the increasing competition with other Asian counties. Furthermore, the upward trend of the exchange rate of Japanese yen had an unfavourable impact on Japanese exports and the Bank of Japan performed a number of interventions in the currency market in 2011 aiming at depreciating the Japanese yen, but they brought no effect. UK's economic growth was poor in 2011 and its GDP growth decelerated in the fourth quarter while the unemployment rate reached its maximum level for the past few years. Market participants, however, perceived UK to be safer than the euro area countries and the second half of the year saw financial outflows from the euro area countries to the UK, which supported strengthening of the British pound sterling against the euro. Monetary policy of the developed countries was aimed at providing market liquidity. Central banks of the USA, the UK and Japan left their base rates unchanged in 2011 (0.25%, 0.5% and 0.1% respectively). Only the ECB raised its base rate twice (by 25 basis points each time) in the first half of the year in the light of the potential price increases but with the crisis in the euro area intensifying the ECB brought the base rate back to its previous level of 1.0% at the end of the year by decreasing it in November and December. The weak economic growth of the developed economies also reflected in their stock markets. In 2011, the USA stock market remained virtually unchanged, while European and Japanese stock market indices fell. At the same time, the global stock market growth was driven mainly by the pick-up in the stock markets of the developing countries.

In 2011, the euro weakened by 3.2% against the US dollar (from 1.3384 at the end of 2010 to 1.2961 at the end of 2011), reaching its high (1.4940) on 4 May and its low (1.2858) on 29 December. In the first half of the year, despite the accommodative monetary policy of the US central bank, the weak economic growth and high unemployment in the USA raised concerns about the economy lapsing back into recession. In the beginning of August, the international rating agency Standard & Poor's lowered the US sovereign credit rating. Relatively better economic data for the second half of the year, stock market boost, stabilisation of oil prices and confidence that the US corporate sector will be to a lesser degree affected by the euro area crises, however, contributed to the appreciation of the US dollar. The US housing market was showing signs of stabilising housing prices. The euro area sovereign debt crises among other things decreased the likelihood of the US dollar losing its status as a reserve currency in the coming years. At the same time, the southern euro area countries with very high sovereign debt levels were increasingly under pressure. Economic downturn in the majority of euro area countries made impossible a considerable reduction of sovereign debt. European banks' investments in the debt securities of the unsustainable countries gave rise to concerns about solvency of the banks. In order to diminish tensions in the interbank market, the ECB adopted a number of measures to provide the necessary liquidity to banks. The US dollar depreciated vis-à-vis the Japanese yen from 81.12 at the end of 2010 to 76.91 at the end of 2011 recording a drop by 5.2%, and reaching its high (85.53) on 6 April and its low (75.35) on 31 October. Japanese assets have typically been attractive to investors during crisis periods, even despite their low yields. 2011 was no exception. The low interest rates and the weak outlook for recovery in other developed countries was a sufficiently strong stimulus for the Japanese yen to strengthen. During the year, the British pound sterling depreciated vis-à-vis the US dollar by 0.4% (from 1.5612 at the end of 2010 to 1.5543 at the end of 2011), reaching its high (1.6747) on 28 April and its low (1.5272) on 6 October.

In the period between May and October the exchange rate of the euro against the lats was close to the upper limit of the intervention band set by the Bank of Latvia (0.7098) while at the close of the year the exchange rate of the euro vis-à-vis the lats was 0.6995 (for movements of the US dollar exchange rate set by the Bank of Latvia and the euro exchange rate see Chart 18). On the Latvian foreign exchange market, the US dollar appreciated against the lats from 0.5304 at the end of 2010 to 0.5401 at the end of 2011, recording an increase of 1.8%. The US dollar reached its high (0.5445) on 10 January and its low (0.4748) on 4 May.

Chart 18

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



According to Latvian credit institutions statistics the turnover for foreign exchange transactions continued a downward trend in 2011 declining by 7.2% during the year (at a slower pace than in 2010). The turnover in exchange transactions involving the lats also declined albeit slower than the total turnover (by 3.9%) which led to a slight increase of the share of exchange transactions in lats (to 17%). As in previous years, the lats continued to be traded predominantly against the euro and the US dollar (89.5% and 9.4% respectively) and mainly through non-cash interbank market swaps.

Credit institutions' counterparts in non-cash foreign exchange transactions between the euro and the lats were predominantly non-residents representing 83.9% of total turnover (mainly non-resident MFIs). In the USD/LVL currency pair, transactions with non-residents decreased significantly in 2011 (to 13.0%) while transactions with residents increased to approximately the same extent (by 12.7 percentage points; representing 83.9% of total turnover in the respective currency pair). The turnover in other non-cash foreign exchange transactions involving the lats increased by 26% during 2011 compared to 2010 with its share, however, still remaining insignificant.

In 2011, the currencies most actively traded against the lats in cash transactions were the euro (58.5%), the US dollar (22.5%), the Russian ruble (6.6%) and the British pound sterling (5.9%). The share of the euro in cash currency exchange transactions involving the lats shrank by 1.2 percentage points, while shares of the US dollar and the Russian ruble rose by a total of 1.1 percentage points.

Of the total turnover in all non-cash foreign exchange transactions, the US dollar-euro pair was dominant with its share amounting on average to 38.9% of the total currency turnover in 2011, and a significant share of total currency market turnover (18.1%) was accounted for by the Russian ruble exchange transactions against the US dollar.

SECURITIES MARKET

Fiscal consolidation measures and the improving macroeconomic indicators in 2011 contributed to the reduction in the government securities market risks. In the last months of the year, however, risks increased somewhat due to the sovereign debt crisis faced by a number of European countries as the acceleration of crisis in Europe might have a negative impact on Latvia's future growth.

The volume of government securities offered by the Treasury through primary market auctions was 435.0 million lats (down by 29.6% compared to last year). With demand reaching 1 246.1 million lats, government securities worth 417.1 million lats were sold. The offered amount was lower due to the resumed issuance of 10-year government bonds (bonds with a similar maturity of 11 years were previously issued in 2008) as Treasury's choice in favour of longer maturities led to a less frequent need to refinance the securities, which in turn gave rise to a reduction of the total offer at the auctions. The 2011 10-year bond auctions were successful: the weighted average yield in the February auction was 6.72% while in the June auction it had already dropped to 5.71%. Weighted average yields on short-term Treasury bills also fell, though to a lesser extent, as they stood at low levels already. The weighted average yield on 12-month Treasury bills fell by 16 basis points during the year (to 1.69%). The drop in yields was due to the rising level of general confidence in reforms in Latvia, with a number of international credit rating agencies upgrading Latvia's credit rating and Fitch Ratings lifting its credit assessment to investment grade (from BB+ to BBB–) in the first half of the year.

With financial markets uncertainty accelerating temporarily due to the developments around the JSC *Latvijas Krājbanka*, no Latvian government securities were issued by the Treasury since mid November and accordingly the stock of government securities outstanding decreased by 181.7 million lats (to 712.1 million lats) over the last two months of 2011 resulting in a total annual reduction of 83.7 million lats. As to the breakdown of government securities by holder, in 2011 Latvian credit institutions' government securities holdings shrank from 59.9% to 54.8%, while other residents' share increased from 37.8% to 42.8% and non-residents' share from 2.3% to 2.4%.

In June Latvia issued 10-year bonds amounting to 500 million US dollars, with demand reaching 3.6 billion US dollars. The bond yield at issue was 5.49% while the quoted bid yield climbed from 5.35% to 6.27% until the end of the year according to Bloomberg due to global developments, with other countries' government bonds also showing a similar trend. The spread of the bid yield with that on US bonds also grew accordingly (from 237 basis points to 437 basis points). This represented Latvia's successful return to international markets after the crisis, which was supported by its fiscal consolidation efforts and structural reforms, and boosted confidence that Latvia should not be facing any problems in refinancing its existing debt in the international markets provided that it continues to pursue fiscal discipline given the relatively material debt repayments scheduled for 2014 and 2015 (mainly repayments on the EC/IMF loan). In February 2012 the Treasury successfully completed a further bond issue of 1 billion US dollars.

The stock of publicly traded corporate debt securities registered with the LCD in all currencies expanded to 166.5 million lats compared to 160.8 million lats at the end of 2010. 13 issues out of 28 matured and six new issues were launched, among those the stock of outstanding corporate debt securities denominated in lats decreased from 26.4 million lats to 23.1 million lats as the issues of the SJSC *Latvijas Hipotēku un zemes banka* and the JSC *GE Money Bank* mortgage bonds matured. Of the new issues, the euro and US dollar bond issues by the JSC *ABLV Bank* amounting in total to 33.8 million lats have to be noted.

The bid yield on Latvian government bonds maturing in February 2021 on NASDAQ OMX Riga fell from 6.72% to 6.00% during the year as the favourable developments both in Latvia and in the primary market prevailed over the deterioration of the external environment. At the end of the year, the bid yield on the government securities with time to maturity less than one month was around 1.25% – the same as at the beginning of the year.

The bid yield on mortgage bonds of the SJSC *Latvijas Hipotēku un zemes banka* maturing in August 2013 was 4.25% at the beginning of the year, 3.50% in September and 5.00% in the last months of the year. These developments were driven by a temporary rise in uncertainty due to the suspension of JSC *Latvijas Krājbanka* operations, with risk perception regarding credit institutions' debt securities surging more rapidly than in the government securities market at the end of the year.

At the end of 2011, the quoted bid yield on Latvian government eurobonds (maturing in 2018) was 5.04% according to Bloomberg (28 basis points lower than a year ago). The spread with the bid yields on German government bonds of the respective maturity grew from 280 basis points to 407 basis points. This growth was related to a decrease in bid yields on German government bonds due to the growing demand for high quality assets and expanding sovereign debt crisis in peripheral euro area countries.

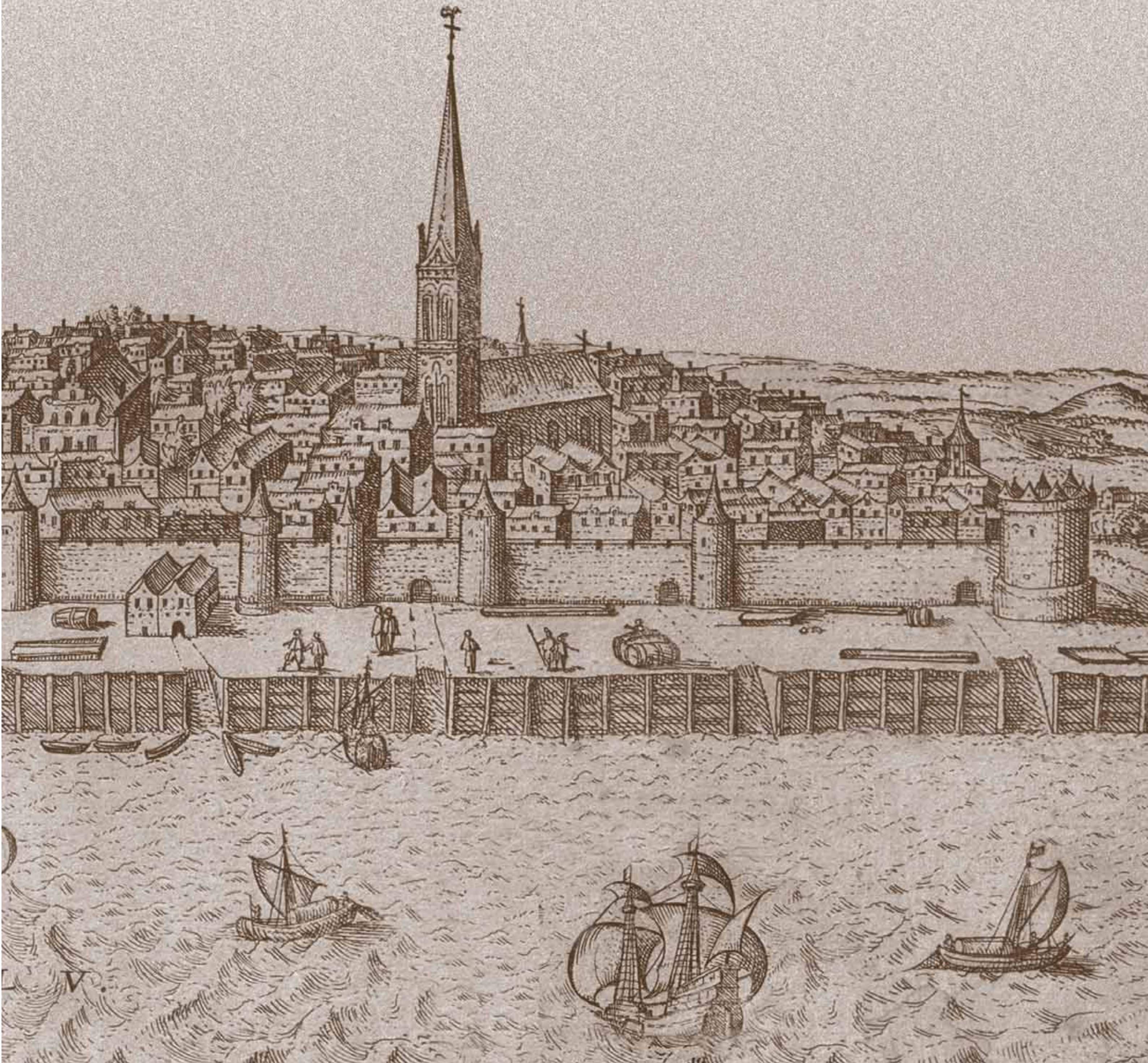
The annual turnover in debt securities on NASDAQ OMX Riga shrank from 8.0 million lats in 2010 to 1.0 million lats in 2011 with participants opting for OTC transactions. The SJSC *Latvijas Hipotēku un zemes banka* mortgage bonds recorded the largest turnover (0.9 million lats).

Turnover in shares on NASDAQ OMX Riga increased from 14.6 million lats in 2010 to 26.1 million lats in 2011. As in the two previous years, shares of the JSC *Grindeks*, the JSC *Latvijas kuģniecība* and the JSC *Olainfarm* recorded the largest turnover of 7.0 million lats, 5.8 million lats and 4.2 million lats respectively.

Latvia's stock market was largely influenced by the rather disappointing situation in European stock exchanges, with stock market indices in Germany and France declining by 15%–18%. Furthermore, forecasts for Europe were suggesting ongoing weak growth or even recession, which could also have an effect on businesses operating in Latvia. At the same time macroeconomic and corporate financial indicators in Latvia continued to be strong. Most listed companies still recorded growth in profit and turnover, though growth rates were decelerating.

In 2011, NASDAQ OMX Riga index OMXR dropped by 5.7% and the Baltic gross index OMXBGI shrunk by 22.7%. This difference was mainly due to 2010 results when both indices recorded growth of 41.1% and 59.5% respectively. At the end of 2011, shares of 32 corporations were listed on NASDAQ OMX Riga (two companies less than at the end of 2010). Five corporations were listed on the Baltic Main List and 27 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;
– promotion of a smooth functioning of the payment systems in Latvia and organisation and management of the interbank payment system;
– compiling and publishing financial statistics and Latvia's balance of payments;
– 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 and implementing decisions. 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 2011, 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 2011, the EFC paid particular attention to the issues of the EU financial stability, the supervision reform of the financial sector as well the strengthening of the economy policy coordination and crisis management instruments. The Bank of Latvia's representatives participated in the EC and Eurostat working groups addressing issues related to euro coins, payment systems, economic forecasting and statistics.

In 2011, the Governor of the Bank of Latvia participated in the work of the ESRB addressing issues related to the oversight of systemic risks of the EU financial system. The representatives of the Bank of Latvia participated in the Advisory Technical Committee of the ESRB and its working groups dealing with the issues related to financial stability.

The Bank of Latvia updated the changeover plan of the euro implementation, inter alia, assessing the euro introduction experience gained by Estonia. 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.

In compliance with the requirements of the Statute of the ESCB and ECB, the Bank of Latvia ensured translation of the ECB Annual Report 2010 and summaries of the quarterly versions of the ECB's Monthly Bulletin (published on the Internet).

DEVELOPMENT, ADOPTION AND IMPLEMENTATION OF MONETARY POLICY

ECONOMIC RESEARCH, ANALYSIS AND FORECASTING

Economic research and analysis are indispensable for a central bank to provide quantitative and scientifically sound accounts of economic processes, to develop econometric models for forecasting macroeconomic indicators and to estimate alternative scenarios. In 2011, the Bank of Latvia published three working papers and one discussion paper on its website; in addition, two more research papers were co-written together with researchers from other national central banks and published within the series of the ECB and *Oesterreichische Nationalbank* working papers. Three articles written by Bank of Latvia specialists were published in international peer-reviewed journals.

As a part of the on-going project on Latvia's price setting mechanism, a working paper on factors determining price adjustment decisions of businesses was published (see Working Paper 1/2011 on the Bank of Latvia website). The findings of this research suggest that businesses in Latvia (a substantial part of them at least) use a state-dependent price setting strategy. The frequency of price adjustments in Latvia depends on inflation and demand/supply conditions and can be viewed as a precondition for a more dynamic price adjustment in situations of economic imbalances. Another working paper on the sensitivity of inflation to economic activity discusses a different aspect of inflation. The research was conducted in cooperation with specialists from other national central banks and is published on the ECB website (see ECB Working Paper No 1357, 22 June 2011). It analyses the interrelation between economic activity and inflation and the impact of economic slowdown on prices in the euro area and individual non-euro area countries.

The researchers of the Bank of Latvia further developed the general equilibrium (DSGE) model in 2011, using longer time series and applying the model to a larger number of countries (see Working Paper 2/2011 on the Bank of Latvia website). The empirical analysis conducted therein shows that the monetary policy pursued in all the reviewed countries (Latvia, Lithuania, Estonia, the UK, Sweden, Poland and the Czech Republic) guarantees more stable inflation and output than under alternative monetary regimes.

The recent financial crisis highlighted the importance of financial factors for macroeconomic developments and distribution of financial shocks. A general equilibrium model developed by Bank of Latvia experts is useful in analysing the impact financial frictions have on the distribution of economic and financial shocks; it is likewise useful in the estimation of the impact of changes in financial sector's regulatory framework (see Working Paper 3/2011 on the Bank of Latvia website). With due account given to ever stronger links between macroeconomics and the financial sector, this model can be used when studying the potential of macro-prudential instruments and their relationship with other macroeconomic and monetary policy instruments.

As economic convergence ranks among the preconditions for effective functioning of the EMU, the Bank of Latvia specialists regularly examine the convergence level between Latvia and the euro area countries. A research conducted in 2011 showed that a buoyant period of real income convergence was followed by a gradual divergence of the Latvian economic structure from that of the countries in Europe. With the onset of the global financial crisis, the income convergence in Latvia halted, and, in fact, real divergence set in. This, in turn, supported structural convergence, and imbalances that had emerged in the period of fast growth diminished (see Discussion Paper 1/2011 and materials of the conference *Global Challenges and Local Opportunities: Achievements and Prospects in the Baltic States* held on 12 October 2011 on the Bank of Latvia website).

The Bank of Latvia was actively involved in international research projects and publishing in peer-reviewed journals. The revised and updated version of Bank of Latvia Working Paper 2/2010 *The Quality and Variety of Exports from the New EU Member States: Evidence from Very Disaggregated Data* was published in international peer-reviewed journal *Economics of Transition*. Together with experts from *Oesterreichische Nationalbank*, the Bank of Latvia researchers developed and updated previously presented methodology for import and export quality assessment and applied it to imports of a number of major EU countries (see Working Paper 175/2011 of *Oesterreichische Nationalbank*). Cooperative efforts have resulted also in a research paper about euro area monetary policy transmission in various Central European countries (published in international peer-reviewed journal *Focus on European Economic Integration*). Finally, a Bank of Latvia's research paper expanding the Krugman's target zone model for exchange rate and the currency corridor regime prior to entering a single currency area was published in international peer-reviewed journal *Applied Economics Letters*. According to the model developed in this paper, national central banks maintain some degree of monetary independence until the moment of entering a single currency area.

MONETARY POLICY DECISIONS

Following the downturn observed in the previous years, the economic recovery continued in 2011, driven by the regained macroeconomic stability and improved competitiveness as well as the relatively dynamic development of the external demand. Despite the increase in inflation on account of external factors (more expensive energy and food in the global markets) and higher tax rates, the impact of domestic factors on inflation was limited and risks to price stability remained low in the medium term. As the Bank of Latvia had already adjusted its monetary policy instruments to the new economic conditions in 2010, the Bank's interest rates and also credit institution reserve ratio remained unchanged in 2011.

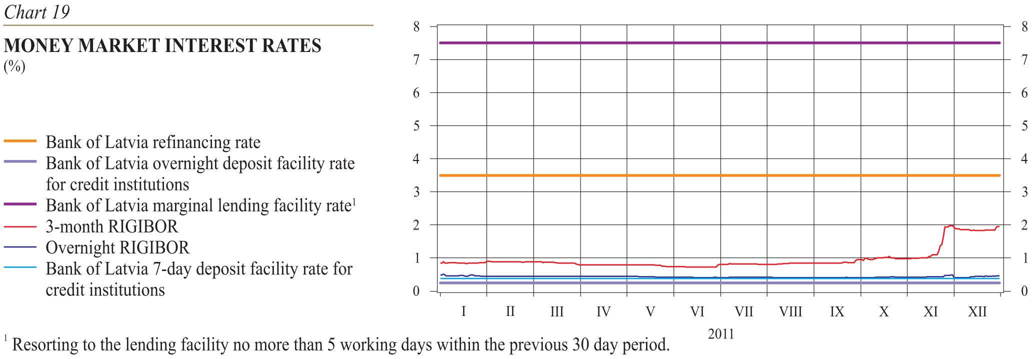
The external factor dynamics also played an important role in the decision-making process. With the sovereign debt crisis in the European countries exacerbating, the economic development prospects of the region deteriorated considerably, towards the end of the year in particular. The economic development outlook for the European countries for 2012 pointed to the risks of recession. Therefore the Latvian economic growth was also expected to decelerate, thereby limiting further risks to inflation. Against such background, the strengthening of monetary policy provisions was not on the agenda and low lats money market rates were consistent with the economic situation.

The fiscal policy played an important role in the process of economic stabilisation and resumption of growth. With the budget deficit-reducing measures contributing to the stabilisation of the macroeconomic situation and fostering the restoration of sustainable public finances and Latvia's return to the international capital markets, in 2011, the economic agents and financial market participants had no more doubt about the Bank of Latvia's capacity to maintain the fixed lats exchange rate against the euro.

In 2011, the following interest rates set by the Bank of Latvia were effective: the refinancing rate – 3.50%, the overnight deposit facility rate – 0.25% and 7-day deposit facility rate – 0.375% (see Chart 19). The marginal lending facility rate was 7.50% in case the respective credit institution had resorted to the lending facility no more than 5 working days within the previous 30 day period; 15% in case the credit institution had resorted to the lending facility 6–10 working days within the previous 30 day period; 30% in case the credit institution had resorted to the lending facility for more than 10 working days within the previous 30 day period. The credit institution reserve ratio stipulated for deposits with an agreed maturity of over two years, deposits redeemable at notice of over two years, and non-callable debt securities issued by a credit institution with an original maturity of over two years was 3%, for repo transactions – 0% and for other liabilities included in the reserve ratio – 5%.

Chart 19

MONEY MARKET INTEREST RATES
(%)



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

USE OF MONETARY POLICY INSTRUMENTS

In 2011, Latvian credit institutions sold lats in exchange for euro in the net amount of 181.9 million lats to the Bank of Latvia as per transaction date principle (235.9 million lats as per settlement date principle). Another 2.1 million lats were sold for euro cash to the Bank of Latvia at its Cashier's Office. The Treasury converted the funding at its disposal only in Latvian credit institutions since the beginning of the year.

The end-of-day balance of the currency in circulation averaged 989.7 million lats in 2011, representing a year-on-year increase of 16.8% (a rise of 2.0% in 2010). At the end of the year, household concerns about the stability of some credit institutions substantially affected currency in circulation, thus strengthening household willingness to keep higher amount of money in cash than usual. The average balance of credit institution minimum reserve requirements stood at 697.5 million lats (0.4% lower year-on-year). The government lats deposit with the Bank of Latvia averaged 179.9 million lats (3.0 times rise year-on-year). The increase in the government lats deposit with the Bank of Latvia was on account of both the changes in currency conversion practice and higher budget revenue. In 2011, the overall impact of currency in circulation, the minimum reserve requirements for credit institutions and the government deposits contributed to a 259.0 million lats decrease in the lats liquidity.

As in the previous year, auctions of the main refinancing operations and currency swaps were conducted each business day in 2011, 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 2011, the credit institution demand and amount allotted in the main refinancing operations was only 0.1 million lats, the average interest rate stood at 3.50% (the amount allotted in the above operations was also small in the previous year – 2.1 million lats). The volume of foreign exchange swaps offered by the Bank of Latvia doubled as compared to the previous year, credit institution demand and the allotted amount was 20.1 million lats, the average interest rate and refinancing rate were the same (there was no demand from credit institutions for foreign exchange swaps in the previous year).

Under excess liquidity conditions, the deposit facility continued to be the major monetary policy instrument used (the same as in the previous year). In 2011, the overall average recourse to the overnight deposit facility and 7-day deposit facility stood at 618.8 million lats, 14.5% lower than in the previous year when it reached record high. The average interest rate on the deposit facility contracted from 0.73% in 2010 to 0.37% in 2011 (in 2011, the deposit facility rate remained unchanged, while it stood at 1.00% at the beginning of 2010). There was no recourse to the marginal lending facility for the second consecutive year.

The Bank of Latvia continued to calculate 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 credit institutions in quotation list that were active on the interbank market and able to conduct market operations at their quoted money market rates on transactions in lats actively. At the end of 2011, the list of the credit institutions whose money market quotes are used in RIGIBID and RIGIBOR calculations in accordance with the Bank of Latvia's "Regulation for the Calculation of RIGIBID and RIGIBOR" include the JSC *Swedbank*, JSC *SEB banka*, JSC *UniCredit Bank*, Latvian Branch of *Nordea Bank Finland Plc*, JSC *DNB banka* and SJSC *Latvijas Hipotēku un zemes banka*.

FOREIGN CURRENCY AND GOLD RESERVES MANAGEMENT

The Bank of Latvia's foreign reserves, which include gold, convertible foreign currencies and SDR, amounted to 3 472.9 million lats at the end of 2011 (4 068.1 million lats at the end of 2010). The decline in foreign reserves was mainly attributable to the outflows of funding received under international loan agreements from the Treasury accounts and sales of foreign currency to credit institutions.

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.

The majority of 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 2011 (from 0.86% to 0.14% in the euro area, from 0.59% to 0.24% in the US and from 0.18% to 0.14% in Japan). 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. However, the substantial decline in interest rates contributed to the increase in the value of investments and positively affected the Bank of Latvia income in 2011.

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 small 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 daily basis and the risk allocation by various investment decisions is managed.

PROVISION OF CURRENCY IN CIRCULATION

Against the end of 2010, currency in circulation at the end of 2011 increased by 23.7% (from 937.9 million lats to 1 160.2 million lats).

The cash received from credit institutions was checked for wear and tear and authenticity by automated cash processing systems. The amount of cash processed in 2011 (3 226.9 million lats) exceeded the amount of currency in circulation 2.8 times (3.3. times in 2010). As a result, the total value of cash withdrawn from circulation was 249.9 million lats or 7.7% of all processed currency (158.5 million lats or 5.1% in 2010).

The nominal value of detected counterfeits (37.6 thousand lats) accounted only for 0.0032% of the currency in circulation (0.0038% in 2010).

Jointly with the central banks of Belgium, Ireland, Luxemburg, the Netherlands and Finland, the Bank of Latvia implemented a cash circulation management improvement project in 2011. The project comprised the launching of CashSSP and MyCashSSP, two new IT systems, and the transition to sealed currency packs and using barcodes for their identification; it also provided for standardised exchange of information about cash transactions in lats between the Bank of Latvia and credit institutions and their authorised merchants as well as ensured higher internal logistics and cash processing efficiency. CashSSP and MyCashSSP were put in operation on 21 November.

In 2011, to mark significant cultural and historic events, the Bank of Latvia issued silver collector coins *Rundāle Palace* (in circulation as of 23 May 2011), *Riga* (the eighth concluding coin under the international coin programme *Hansa Cities*; in circulation as of 15 June 2011), *Riga Cathedral* (in circulation as of 22 July 2011), *Riga Money 800* (in circulation as of 15 August 2011) and *Railway in Latvia* (in circulation as of 12 September 2011). The collector coin *Fog Mists the Pane* (in circulation as of 15 April 2011) is a dedication to the Latvian poet Aleksandrs Čaks and his creative work. To honour the Latvian basic values, *Stone Coin* featuring a granite disc encircled by an outer silver ring was issued (in circulation as of 10 January 2012).

Beer Mug (in circulation as of 15 June 2011) and *Gingerbread Heart* (in circulation as of 9 December 2011), two new 1-lats special circulation coins, were added to the circulation coin collection.

BANK OF LATVIA COINS STRUCK IN 2011 (FACE VALUE: 1 LATS)

SPECIAL CIRCULATION COINS OF LIMITED MINTAGE

BEER MUG

Weight: 4.80 g, diameter: 21.75 mm
Metal: alloy of cooper and nickel
Struck by *Koninklijke Nederlandse Munt* (the Netherlands)
Artists: Juris Dimiters (graphic design), Andris Vārpa (plaster model)

GINGERBREAD HEART

Weight: 4.80 g, diameter: 21.75 mm
Metal: alloy of cooper and nickel
Struck by *Koninklijke Nederlandse Munt* (the Netherlands)
Artists: Rūta Briede (graphic design), Laura Medne (plaster model)

COLLECTOR COINS

RIGA

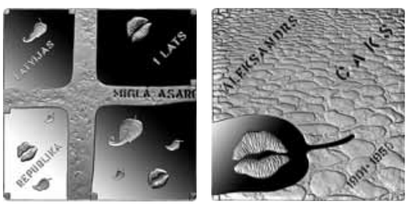
The coin is issued within the international coin programme *Hansa Cities*.
Weight: 31.47 g; diameter: 38.61 mm
Metal: silver of .925 fineness; quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists: Gunārs Krollis (graphic design), Jānis Strupulis (plaster model)

RUNDĀLE PALACE

Weight: 31.47 g; diameter: 38.61 mm
Metal: silver of .925 fineness; quality: proof
Struck by *Koninklijke Nederlandse Munt* (the Netherlands)
Artists: Guntars Sietiņš (graphic design), Jānis Strupulis (plaster model)

FOG MISTS THE PANE

Weight: 26.00 g; shape: square; area measurement: 32 x 32 mm
Metal: silver of .925 fineness; quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists: Ilmārs Blumbergs (graphic design), Ligita Franckeviča (plaster model)



RIGA CATHEDRAL

Weight: 22.00 g; diameter: 35.00 mm
Metal: silver of .925 fineness; quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists: Kristaps Ģelzis (graphic design),
Ligita Franckeviča (plaster model)

RIGA MONEY 800

Weight: 12.50 g; diameter: 28.00 mm
Metal: silver of .925 fineness; quality: proof
Struck *by Rahapaja Oy* (Finland)
Artists: Inta Sarkane (graphic design),
Jānis Strupulis (plaster model)

RAILWAY IN LATVIA

Weight: 22.00 g; diameter: 35.00 mm
Metal: silver of .925 fineness; quality: proof
Struck by *Koninklijke Nederlandse Munt*
(the Netherlands)
Artists: Aigars Ozoliņš (graphic design),
Ligita Franckeviča (plaster model)

STONE COIN

Diameter: 35.00 mm (diameter of central disc: 22.00 mm), weight of outer ring: 13.60 g
Material: central disc of granite, outer ring of silver of .925 fineness, quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists:
Laimonis Šēnbergs (graphic design),
Jānis Strupulis (plaster model)

PAYMENT AND SETTLEMENT SYSTEM 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. In Latvia, operation of other payment and securities settlement systems 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 140.6 thousand payments in the value of 1.2 billion lats (for the monthly data of payments processed in the Bank of Latvia's interbank payment systems see Charts 20 and 21).

The SAMS is a real-time gross settlement system processing payments in lats. The SAMS enabled the following: the settlement of the Bank of Latvia's monetary policy

Chart 20

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

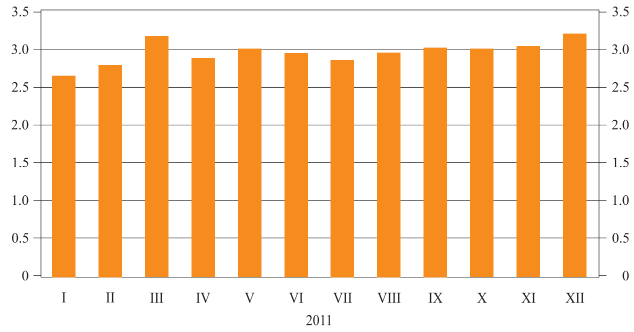
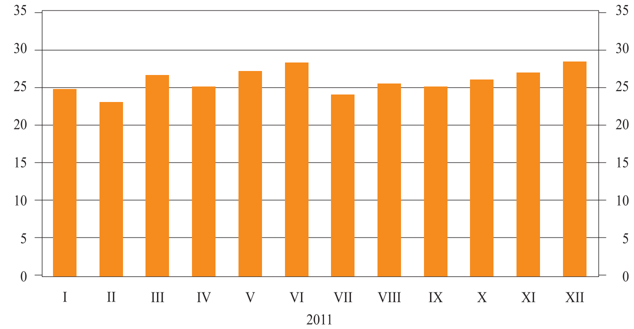


Chart 21

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



operations, interbank settlement of large-value payments and final settlement in lats for the securities settlement system of the LCD, the card payment systems, such as First Data Latvia Ltd., MasterCard Europe Sprl and Visa Europe Services Inc., and final settlement in lats for the Bank of Latvia EKS. At the end of 2011, 24 credit institutions (including four branches of foreign banks), the Treasury and the Bank of Latvia were the participants in the SAMS. The SAMS processed 216.4 thousand payments (value – 137.8 billion lats; see Table 2). The SAMS ensured 99.93% availability of the system to its participants, i.e. of total operating hours, the SAMS was unavailable to its participants for one hour, eight minutes and 52 seconds over the year.

Table 2

PAYMENTS PROCESSED IN THE SAMS

	Volume (in thousands)			Value (in billions of lats)		
	Interbank and ancillary system	Customer		Interbank and ancillary system	Customer	
2011	**106.9**	**109.6**	**216.4**	**126.2**	**11.6**	**137.8**
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

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 participants' accounts opened with the Bank of Latvia in the SAMS, while that in euro is executed in the participants' accounts opened with the Bank of Latvia in TARGET2-Latvija. The EKS, as a SEPA compliant payment system, also contributes to establishing the uniform SEPA requirements regarding the credit institution relations with customers in Latvia. On 21 November 2011, the Bank of Latvia implemented the new version of the EKS enabling the EKS participants to execute payments in euro with no limit set on any payment, by exercising the prepayment option, and providing an opportunity to submit and receive payments indirectly from the EKS via any of the direct participants in the system. Another clearing cycle for the processing of payments in euro was implemented in the EKS (at 9.30), ensuring even faster execution of cross-border payments in euro and crediting the customers' accounts on the same day. The euro payments were handled in four clearing cycles – at 9.30, 11.30, 14.30 and 17.00. The lats payments were processed in two clearing cycles – at 10.30 and 15.00. At the end of 2011, 24 credit institutions (including four branches of foreign banks), the Treasury and the Bank of Latvia were the participants in the EKS lats settlement and 15 credit institutions (including one branch of a foreign bank), the Treasury and the Bank of Latvia participated in the euro settlements respectively. The EKS processed 35.1 million payments, with their value amounting to 14.0 billion lats (see Table 3). The EKS provided 99.77% availability of the system to its participants, i.e. over the year, the EKS clearing cycle was delayed on three occasions.

Table 3

PAYMENTS PROCESSED IN THE EKS

	Volume (in thousands)			Value (in billions of lats)		
	Lats	Euro		Lats	Euro	
2011	**34 597.9**	**464.0**	**35 061.9**	**12.0**	**2.0**	**14.0**
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

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, providing for mutual payment settlement of the system participants in euro and final settlement of the EKS in euro. At the end of 2011, 22 credit institutions (including three branches of foreign banks), the Treasury and the Bank of Latvia were direct participants in TARGET2-Latvija. In 2011, 307.4 thousand payments in the value of 227.8 billion euro were processed in TARGET2-Latvija (see Table 4). On 21 November 2011, the Bank of Latvia along with other participants of the ESCB implemented the new release of TARGET2, enhancing liquidity management options for the participants.

Table 4

PAYMENTS PROCESSED IN TARGET2-LATVIJA

	Volume (in thousands)			Value (in billions of lats)		
	Interbank	Customer		Interbank	Customer	
2011	**35.2**	**272.2**	**307.4**	**215.2**	**12.6**	**227.8**
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

OVERSIGHT OF PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

Pursuant to Order No 189/6 of 13 January 2011, the Council of the Bank of Latvia approved "The Bank of Latvia's Payment and Securities Settlement System Policy", stipulating the role and key tasks of the Bank of Latvia regarding the oversight of payment and securities settlement systems.

The Bank of Latvia conducted day-to-day oversight of the payment systems maintained by it and the securities settlement system operated by the LCD, analysing the technical and operational functions of the systems, and compiling statistical data on the systems. Within the framework of the payment system oversight, the Bank of Latvia cooperated with institutions operating the clearing and payment systems (*First Data Latvia Ltd.*, JSC *Itella Information* and credit institutions), providing them consultations and opinion on payment system issues.

In 2011, the Bank of Latvia assessed within the scope of the payment system oversight the compliance of the EKS and the direct debit payment system of the JSC *Itella Information* with the *Core Principles for Systemically Important Payment Systems* published by the Committee on Payment and Settlement Systems of the BIS. According to the assessment, the EKS observed the above Core Principles and the direct debit payment system of the JSC *Itella Information* broadly observed these Core Principles.

In 2011, the Bank of Latvia performed oversight of the securities settlement system of the LCD. 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 changing requirements regarding the 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. The Bank of Latvia, in cooperation with the FCMC and LCD, commenced the compliance assessment of the securities settlement system of the LCD and the related infrastructure in accordance with the recommendations issued by the ESCB-CESR (ESCB and Committee of European Securities Regulators (CESR) – the European Securities and Markets Authority (ESMA) as of 1 January 2011), and planned to finalise the above in 2012.

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 representatives of the LCD, the Bank of Latvia, the FCMC, the Treasury and Association of Latvian Commercial Banks participate in the Latvian User Group. The Latvian User Group approved Latvia's overall impact assessment of TARGET2-Securities system. The Bank of Latvia and LCD took part in the meetings of the ESCB committees and working groups reviewing the issues relevant to the implementation of TARGET2-Securities Project. Pursuant to the decision taken by the Governing Council of the ECB in 2011, TARGET2-Securities is planned to be launched in June 2015.

The Bank of Latvia compiled data on the payment instruments used in Latvia (see Table 5). Customer credit transfers amounted to 119.3 million payments or 50% and payments by payment cards comprised 114.0 million payments or 47.8% of all payment instruments used in 2011. The value of such payments stood at 297.1 billion lats and 1.7 billion lats respectively. Other payment instruments (direct debit, cheques and e-money) were relatively seldom used.

Table 5

PAYMENT INSTRUMENTS USED IN LATVIA

	Volume (in millions)				Value (in billions of lats)			
	Customer credit transfers	Card payments	Direct debits, cheques and e-money payments		Customer credit transfers	Card payments	Direct debits, cheques and e-money payments	
2011	**119.3**	**114.0**	**5.3**	**238.6**	**297.1**	**1.7**	**0.1**	**298.9**
2010	115.7	101.9	5.3	222.9	260.7	1.4	0.2	262.3
2009	114.3	97.8	5.2	217.2	242.7	1.4	0.2	244.3
2008	121.9	95.1	5.3	222.3	364.5	1.7	0.3	366.5
2007	117.4	76.6	4.7	198.7	410.8	1.4	0.2	412.4

To promote integration of Latvia's payment systems into the Single Euro Payments Area, the Bank of Latvia continued to coordinate the SEPA Project in Latvia. The Bank of Latvia engaged in the SEPA project by steering the National SEPA Working Group and taking part in the activities of the SEPA Working Group of the Payment Committee established by the Association of Latvian Commercial Banks.

In 2011, the Bank of Latvia, in cooperation with the FCMC, participated in the European Forum on the Security of Retail Payments established by the ECB and was involved in developing draft recommendations for card payments for online purchases and banks' electronic payment services.

FINANCIAL STABILITY

In 2011, the risk assessment instruments of the financial system were further enhanced both in Latvia and at the EU level.

Given the significance of credit institutions' credit risk, the Bank of Latvia continued to update the methodology for credit risk assessment. The micro-data from the Credit Register were employed to obtain the estimates of amount-weighted probability of default ensuring high degree of elasticity in data aggregation and structuring for the purpose of credit risk analysis. Probability of default is one of the core elements of credit risk assessment methodology. On the basis of the obtained default probability estimates, a model of credit risk was developed for house purchase loans. This model presents the relationship between the dynamics of default probability and macroeconomic indicators. This model is used for macroeconomic stress testing.

In 2011, the first survey of household borrowers, representing households with at least one loan for house purchase, repairs or refurbishment was conducted. The objective of the survey was to collect information about the household borrowers' obligations, income and expenses in order to assess their financial situation at the moment of the survey and model the impact of diverse financial shocks on the household borrowers' solvency.

The European Systemic Risk Board (ESRB) launched its operation at the beginning of 2011. The Bank of Latvia is a participant of the ESRB and has engaged actively in the work of the ESRB through participation in the Advisory Technical Committee and its working groups (Analysis Working Group, Instruments Working Group and Foreign Currency Lending Experts Group) for the purpose of drafting the ESRB policy and analysis documents and defining opinion.

In spring 2011, the European Banking Authority (EBI) conducted comprehensive stress tests of credit institutions of the EU countries, employing consolidated data on 90 major groups of banks. Latvian credit institutions were not included in the above list of banks; however, the parent banks of Latvia's credit institutions – *Swedbank*, SEB, DNB, *Nordea* and *Unicredit* – were represented. The Bank of Latvia conducted stress tests of all credit institutions in Latvia on the basis of the key aspects of the EBI methodology.

Close cooperation between the Bank of Latvia and FCMC has become ever more important for the performance of the above tasks. The exchange-of-experience programme launched for the staff of both institutions is a significant project in this area aimed at improving the credit institution risk analysis both on a micro-level and on a macro-level.

OPERATION OF THE CREDIT REGISTER

In the Credit Register, the Bank of Latvia collects, accumulates and stores the data of the Credit Register participants (such as credit institutions providing financial services associated with credit risks, companies having close links with credit institutions 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 Credit Register participants to assess the creditworthiness of the borrowers more accurately and manage credit risks more efficiently, provide the FCMC with additional opportunities of receiving data necessary for performing supervision, enable the consumer creditors of the EU Member States and

EEA countries to assess the consumers' creditworthiness, and furnish data to the Bank of Latvia and the FCMC necessary for macroeconomic analysis.

In 2011, the Bank of Latvia continued to enhance the Credit Register in order to include new data on the status of the borrower's obligations and origin of obligations and type of settlement as well as to specify the procedure for data entering and modification, where the participant of the Credit Register loses the status of a participant. The above improvements enable the participants of the Credit Register to assess the creditworthiness of the current and potential borrowers more accurately and provide the FCMC and the Bank of Latvia with additional opportunities in the area of financial market and macroeconomic analysis. In the Credit Register, the Bank of Latvia will not continue to accumulate data on the borrower's income, type of interest rate stated in the loan agreement and violation of laws and regulations and other types of violations, except data on delayed payments. Moreover, all Credit Register data pertaining to a person are made available to that person as a direct mail delivery, where the person has submitted a written application to the Bank of Latvia and the authenticity of the person's signature is notarised or certified in an equivalent way or the application is signed with a secure digital signature.

At the end of 2011, the Credit Register comprised 95 participants who authorised 760 users to work with the Credit Register. At the end of 2011, the Credit Register contained data on 965.4 thousand persons and 2.8 million obligations (at the end of 2010, on 939.6 thousand persons and 2.6 million obligations). Total outstanding obligations were 1.3 million and loan portfolio of the Credit Register participants amounted to 14.0 billion lats (at the end of 2010, 1.5 million obligations with total outstanding obligations amounting to 15.1 billion lats). In 2011, the Credit Register participants submitted 16.2 million requests, representing a 10% year-on-year increase. The Bank of Latvia serviced 3.1 thousand natural and legal persons (a year-on-year rise of 35%) by providing the Credit Register data on the relevant obligations.

STATISTICS

The Bank of Latvia collects and compiles financial and monetary statistics and balance of payments statistics as well as prepares quarterly financial account statistics and 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 2011, the publication of statistical data was substantially expanded and improved by developing and restructuring the section Statistics on the Bank of Latvia's website. This section provides explanations regarding the Bank of Latvia's statistical activities, confidentiality and guidelines for compiling statistics, data revision policy, classification systems used in statistics and descriptions of data. News items related to statistics are published in the section Statistics on a regular basis. Two subsections Data room and Reporting agents' room are provided to reflect the process of data compilation and that of data release and to address the target audience in a more focused manner. The subsection Data room contains statistical data disseminated by the Bank of Latvia and the related information. The subsection Reporting agents' room presents information on compilation of data for each group of reporting agents, providing targeted and easy access to information.

In 2011, the Bank of Latvia started to develop an internet statistical database for the purpose of providing users with modern, user friendly and adaptable means for data access and analysis of data using graphic tools.

The Bank of Latvia continued the regular transmission of statistical data to the ECB, BIS and IMF and transmitted statistical information to other domestic and foreign data users in 2011. To furnish a wide range of data users with timely information, the Bank of Latvia disseminated financial and monetary statistics and balance of payments statistics of Latvia via its regular publications and the Bank of Latvia website and compiled data for publishing in the ECB publications and the ECB Statistical Data Warehouse as well as the IMF publications and within the framework of the IMF Special Data Dissemination Standard. The Bank of Latvia commenced transmission of new data categories to the BIS and, in addition to the annual financial soundness indicators, started compilation and transmission of quarterly financial soundness indicators to the IMF.

The Bank of Latvia participated in the meetings and workshops held by the ESCB and Eurostat committees and working groups focussing on statistics as well as took part in an inter-institutional working group dealing with the issues of compiling the general government deficit and debt notification and developing the related methodology.

FINANCIAL AND MONETARY STATISTICS

The range of financial market and monetary statistics disseminated on the Bank of Latvia's website was notably expanded in 2011. The table Selected items in the monthly financial position report of MFIs (excluding the Bank of Latvia) by group of countries was supplemented by commencing the release of 48 new indicators. With this new data the Bank of Latvia provided detailed information on the types of loans granted in Latvia and enabled the users of statistics to perform broad-based study of data on Latvia's credit market and compare the above data with those of other EU countries.

In accord with the new ECB requirements for ensuring the quality of MFI statistics, the system of quality controls was improved at the level of aggregated data. Data quality controls are applied both to MFI balance sheet data and interest rate statistics.

In view of the amendments to the Law "On Credit Institutions" stipulating the exclusion of electronic money institutions from the population of credit institutions as well as the amendments to the Law "On Investment Management Companies" and regulatory documents of the FCMC introducing the requirements of the European Securities Regulator regarding MMFs, the Bank of Latvia amended the Bank's Regulation No 40 "Regulation for Compiling the Monthly Financial Position Report of Monetary Financial Institutions" to change the definitions of MFIs and MMFs (the Bank of Latvia's Regulation No 82; in effect as of 1 January 2012).

Following the ECB's request, an in-depth study of the quality of data on loans secured by real estate was conducted and impact of the amended definitions of MFIs and MMFs on the range of reporting agents and scope of the collected data was reviewed.

BALANCE OF PAYMENTS STATISTICS

At the end of 2011, the securities issues and holders database was launched, providing data for the balance of payments statistics and enabling the above data to be used also for the compilation of credit institution and monetary statistics and financial accounts statistics. The relevant methodological study has been initiated in preparation for the implementation of the IMF's "Balance of Payments Statistics Manual" in 2014.

In 2011, the Bank of Latvia updated the data quality. The Bank of Latvia started to collect more detailed foreign trade statistics, as compiled by the CSB. The above data enable the Bank of Latvia to improve the quality of balance of payments and conduct an in-depth study of such data. At the same time, the Bank of Latvia adopted measures to improve the quality of securities statistical data on a security-by-security basis.

GENERAL ECONOMIC AND GOVERNMENT FINANCE STATISTICS

In April, the Bank of Latvia began to publish the quarterly financial accounts statistics on its website, disseminating financial system's data on households, non-financial corporations, financial institutions and government, their interaction as well as interaction with non-residents.

To provide quarterly data on residential property prices to the ECB, in May, the Bank of Latvia started to compile the quarterly residential property price index based on the State Land Service data on the registered real estate transactions.

In February, the Bank of Latvia, in the capacity of expert, took part in the Eurostat Dialogue Visit to Latvia devoted to the issues of the Excessive Deficit Procedure. The Bank of Latvia also conducted tests verifying that the Bank's profit appropriated to the state budget has been classified in national accounts pursuant to the requirements of Eurostat.

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 2011, and their impact on the general government 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, ensuring current account management, acceptance of time deposits, foreign exchange transactions and other transactions. The Treasury uses the Bank of Latvia services for effecting settlement and also takes part in the Bank of Latvia payment and settlement systems as a direct participant in the system.

The Bank of Latvia managed the Treasury's single settlement account in lats ensuring the processing of budgetary payments: taxes, pensions, social benefits and other payments until 23 September 2011. Thereafter the Treasury became a participant in the SAMS and EKS with respect to the settlement in lats and executed payments of other participants of the Bank of Latvia's payment systems without the intermediation of the Bank of Latvia.

In 2011, the SAMS processed 12.0 thousand payments and the EKS processed 12.1 million payments executed by the Treasury in the total amount of 2.6 billion lats and 3.4 billion lats respectively.

The Treasury executed large-value and urgent payments in euro via TARGET2-Latvija as a direct participant in the system. The Treasury took part in the EKS euro settlement by executing the SEPA credit transfers. In 2011, the Treasury effected 2.8 thousand payments via TARGET2-Latvija and 61.9 thousand payments via the EKS and their total value amounted to 3.1 billion euro and 77.1 million euro respectively.

The Treasury's settlement accounts were opened with the Bank of Latvia in nine foreign currencies in 2011. Over the year, the Bank of Latvia settled 2.7 thousand payments made by the Treasury in foreign currencies in the total value of 5.7 billion lats. The Treasury also placed 578 time deposits with the Bank of Latvia in foreign currencies, and the balance of the Treasury's time deposits was 259.1 million lats at the end of 2011.

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.

The Bank of Latvia's employees were involved in elaborating the draft Law "On Credit Register" in 2011. 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, including participation in the meetings of the Cabinet of Ministers of the Republic of Latvia and 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 cooperated actively with other institutions of Latvia involved in negotiations with the international rating agencies, participated in drafting reports on Latvia's credit rating and its driving factors, put forth proposals for further enhancement of cooperation and provided information exchange for the purpose of hosting regular visits of the representatives of the above agencies.

At the working group related to the establishment of a credit scoring registry, the Bank of Latvia employees took part in drafting an informative report and conducting negotiations regarding the fundamental principles of establishment and operation of such credit scoring registry.

The Bank of Latvia experts took part in the meetings of the Public Expenditure and Audit Committee of the Saeima of the Republic of Latvia where the issues of the financial system developments were dealt with. They provided explanations for the above issues and prepared information for some of the meetings.

The representatives of the Bank of Latvia continued their participation in monitoring the SEPA Project implementation. Version 3.0 of Latvia's National SEPA Plan was approved. The Bank of Latvia employees submitted proposals for updating and enhancement of Annex 1 "Action Plan for Introduction of the Single European Currency in Latvia" to Latvia's National Euro Changeover Plan.

The Bank of Latvia experts provided consultations to the CSB on the issues of preparing the general government budget deficit and debt notification. The Bank of Latvia employees, in the capacity of experts, took part in the preparation of the Tables of the general government budget deficit and debt notification (for spring and autumn 2011) and dealt with the above methodology-related issues. The working group for the preparation of the general government budget deficit and debt notification harmonised the data on the measures taken by the Latvian government to support the crisis-hit MFIs, to be transmitted to the ECB and Eurostat.

The Bank of Latvia, in cooperation with the CSB, participated in a number of surveys conducted by Eurostat, such as the deposit accounting by multi-national development banks and accounting of trade credit, as well as jointly discussed the methodology developed by the Bank of Latvia for calculating the residential property price index based on the State Land Service data on the registered real estate transactions and indices calculated on the basis of the above methodology, also the harmonised house price index compiled by the CSB within the Eurostat's pilot project.

The best practice of strategic management and corporate governance was presented to internal auditors of public authorities; the theory and practical experience in strategic management and creating performance management system were presented to heads of the Quality Systems of public authorities.

Constitution Protection Bureau of the Republic of Latvia expressed appreciation to the Bank of Latvia employees for their contribution to the establishment of information technologies' security system in the Republic of Latvia.

OPERATION OF THE VISITORS CENTRE

In 2011, the Bank of Latvia's Visitors Centre "Money World" had 8 224 visitors (the number of visitors was broadly similar to that of the previous years). With the Bank of Latvia repeatedly participating in the International Museum Night, the Centre received around 2 715 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. 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, dialogue arouses interest in macroeconomic and financial topics also stirring up discussions by public at large.

Topics about the planned changeover to the euro in Latvia, stability of the euro zone, the general government debt, lats stability and recovery of the economic competitiveness were among the most discussed in 2011. They gave rise to the updating of displays that tackle exchange rate 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. A multi-media programme has been implemented in order to explain the value of currency and exchange rate regimes. A new display stand and digital storytelling application providing information about the history of the Bank of Latvia's building have been developed. To promote public awareness, a mechanism explaining the significance of prudence in the monetary policy regarding the maintenance of price stability has been created.

The visitor survey has produced high estimates of information comprehensiveness and the quality of presentation, showing their willingness to devote more time to exploring displays individually via a diverse and interactive exposition, and receive comprehensive handouts.

COMMUNICATION ACTIVITIES

Performing the advisory role of the central bank, the Bank of Latvia communication focussed on presenting macroeconomic forecasts and underlying reasons to experts, analysts and competent institutions in order to enable the government and its partners to prepare the state budget for 2012 in line with the requirements (deficit within the limits set by the Maastricht criterion). At the same time, the role of stabilising macroeconomic indicators for the economic development of the country and welfare of the population had to be explained to various target audiences and public at large.

In 2011, higher tax rates and growing global energy resource and food prices contributed to a rising inflation in Latvia, while this trend reversed in the middle of the year. Given the above developments, the Bank of Latvia emphasised the significance of the supply side factors, hence moderating the formation of unreasonable inflation expectations.

The Bank of Latvia furnished ample information on macroeconomic research and financial market analysis carried out by the Bank of Latvia, used in consulting the government and required by economic agents for understanding current circumstances and further decision-making trends. Following the Council meetings, the Governor of the Bank of Latvia presented an account of macroeconomic developments to mass media. 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 Bank of Latvia compiled and published Latvia's Balance of Payments, providing information and analysing financial statistics for 2010, and *Payment* *and Securities Settlement System Oversight Carried Out by the Bank of Latvia in 2010*, describing the progress made in promoting the smooth operation of Latvia's payment system. The Bank of Latvia publication *Financial Stability Report* reflects financial developments in the context of the economic growth. Three studies by the Bank of Latvia's experts on the dynamics of inflation, the advantages of a fixed exchange rate and developments of real estate and credit institution sector in a small and open economy were presented to economists. The above publications and working papers are available on the Bank of Latvia's website (at macroeconomics.lv and bank.lv).

At the beginning of 2011, the Bank of Latvia new website dedicated to macroeconomic analysis gained popularity among experts and individuals as a credible source of information and site for exchange of views, with the total number of visitors reaching nine thousand people – a notable amount, given such a dedicated website. On this website for economic experts, the Bank of Latvia staff members publish their commentaries, articles, blogs, presentations, research papers and opinions, which simultaneously constituted high-quality survey of Latvia's overall economic situation.

The Bank of Latvia economists also published their working papers in scientific journals in economics, including the analytical periodical *Baltic Journal of Economics* providing analysis of the economic developments in the Baltic States.

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 topical issues were widely discussed at the conference on economic development 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 on economic development *Global challenges and local opportunities: achievements and prospects in the Baltic States* hosted by the Bank of Latvia and held on 12 October 2011, the participants – international experts, academics and researchers, entrepreneurs, experts in finance and mass media representatives among them – focussed on the recently implemented changeover to the euro in Estonia and the prospective one in Latvia and debated about the long-term sustainability of the export growth achieved in Latvia and practical activities to be undertaken to improve corporate competitiveness.

The matters crucial to the national economy were focussed on and discussed at the roundtable discussions of the central bank's experts. At the roundtable discussion dedicated to *The general government debt: how much, what, whom and why it costs*, the experts debated about the issue of a price deemed too high for the government debt in the context of the global debt crisis, tackled the situation in Latvia and outlined future prospects as well as summarised information on the measures taken and planned in Europe regarding the sovereign debt reduction. A discussion *Investment in Latvia after the global financial crisis* was held when the country regained the confidence of international investors, on the one hand, and companies required investment to boost production capacity, on the other hand. At the end of the year, the experts' roundtable discussion *Implications of global development trends for Latvian exports* focussed on the outlook for the global economic development and the best way for Latvian companies and public authorities to achieve export growth in vigorously expanding markets of BRICS countries.

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. This is why communicating the macroeconomic and financial developments to the general public and to specific target groups is one of the key communication areas 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. The Bank of Latvia's experts prepared weekly publications on the economic developments in Latvia and worldwide for mass media and public at large.

Within the framework of another long-term project to encourage the addressing of macroeconomic issues of the day, the Bank of Latvia organises a competition for students' research papers, with six papers (out of 23 submitted) awarded in 2011. Moreover, following a longer break, the jury recognised the single first-place winner and awarded the first prize accordingly.

In addition to the implementation of the monetary policy and consulting the government about the monetary policy related issues, the Bank of Latvia also carries out other tasks enhancing the efficiency of national economy and financial system performance, for instance, ensures smooth circulation of cash and non-cash currency for the economy. Hence the Bank of Latvia furnishes information to the general public and stakeholders on the issues of interest, news and projects related to them in the area of cash and non-cash currency.

On 14 May 2011, the International Museum Night, the Bank of Latvia opened the doors of its historic premises again. The motto of the Museum Night *Neighbours*, construed in the global financial language, was *Currency Routes in Latvia, the Baltic States and Europe*. Visitors saw not only gold and silver collector coins that were awarded prizes worldwide, but also the invisible routes of non-cash currency which connect those executing a payment (credit institutions, companies and individuals) with a payee via the Bank of Latvia's payment systems. The Bank of Latvia's economists explained the economic developments in Estonia and underlying reasons, and visitors examined exhibits of "Money World", the information and education centre.

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 2010*. The survey was supported by the network of public libraries, 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; 4 192 votes of the total 11 718 votes cast and the title *Latvia's Coin of the Year 2010* went to *Amber Coin* struck by *Rahapaja Oy* (artist Aigars Bikše).

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 2011, 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 3.39% 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. In 2011, the most important policy issues on the IMF agenda were the strengthening of the international monetary system, the IMF finances and lending instruments as well as the issues of bilateral and multilateral surveillance.

Cooperation with the IMF continued in 2011 under a 1.52 billion SDR Stand-By Arrangement towards the implementation of Latvia's economic stabilisation and recovery plan. In May, the Executive Board of the IMF completed the fourth review of Latvia's programme under the Stand-By Arrangement, while in December, the Executive Board of the IMF completed the fifth review under the programme.

The Bank of Latvia continued its membership in the BIS in 2011.

In 2011, 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 February, ESCB training seminar "Economics for Non-Economists" was held. In May, the Bank of Latvia hosted a meeting of the ESCB Payment Systems Policy Working Group. In October, the Bank of Latvia's experts advised the specialists of the central bank of Kazakhstan on the issues of modernisation of the bank information system and its practical use. In November, the Bank of Latvia organised two ESCB training seminars on leadership and presentation skills.

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.

In 2011, the Bank of Latvia's employees participated in courses held by the ECB, the IMF Institute, the Joint Vienna Institute, Société Générale, the EC and Study Center Gerzensee, and also in seminars organised by the central banks of Austria, Belgium, Denmark, France, Iceland, Italy, the UK, Finland and Hungary and those held by the World Bank. The Bank of Latvia's employees went on experience exchange visits to the central banks of Belgium, Estonia, Italy, Lithuania and Sweden.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BANK OF LATVIA MANAGEMENT AND ORGANISATION

BANK OF LATVIA ORGANISATIONAL STRUCTURE

Governor's Office	COUNCIL	Internal Audit Department
	BOARD	
Monetary Policy Department	Cash Department	Market Operations Department
Statistics Department	Accounting Department	Payment Systems Department
International Relations and Communication Department	Legal Department	Information Systems Department
	Personnel Department	
Security Department	Training Centre	Technical Support 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 2011, was as follows:

– Governor **Ilmārs Rimšēvičs**;

– Deputy Governor **Andris Ruselis**;

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

On 17 February 2011, the Saeima of the Republic of Latvia appointed Ms. Zoja Razmusa Member of the Council of the Bank of Latvia. On 11 August 2011, the term in office of the Member of the Council of the Bank of Latvia Ms. Valentīna Zeile expired. One position of the Member of the Council of the Bank of Latvia has been vacant from 12 August 2011.

The Bank of Latvia's Council meetings are held as appropriate, but at least once a quarter. 10 Bank of Latvia's Council meetings were held in 2011. 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 the use of monetary policy instruments).

When performing other tasks set forth by the Law "On the Bank of Latvia", the Council of the Bank of Latvia adopted 81 legal acts overall in 2011 (including 10 legal acts in the area of the operation and oversight of the payment and securities settlement system, three in the area of the Credit Register operation, three in the area of the foreign reserves management, three in the area of the financial market and monetary statistics, four 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 2011, 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**, **Harijs Ozols**, **Ilze Posuma**, **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 138 legal acts in the areas of conducting daily activities of the central bank. The Board of the Bank of Latvia drafted 32 legal acts for the Council of the Bank of Latvia and submitted to it 20 reports concerning the operation of the central bank.

EMPLOYEES OF THE BANK OF LATVIA

At the end of 2011, the number of the Bank of Latvia's employees was 556, of which 15 were employees with a fixed term job contract (570 and 13 employees at the end of 2010 respectively). As at the end of 2011, 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 2011.

Structural improvements continued at the Bank of Latvia in 2011. To improve the organisation of the operational activities of the Bank of Latvia and ensure more effective fulfilment of its function – the provision of the Bank of Latvia's currency in circulation –, the Cash Department including the Riga Branch, Daugavpils Branch and Liepāja Branch, underwent structural changes.

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 2011. The following committees and commissions related to the central bank principal activities have been established at the Bank of Latvia.

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 Bank of Latvia working group for 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

The Bank of Latvia Audit Committee	The Bank of Latvia Information Systems Management Committee
The Bank of Latvia Budget Commission	The Bank of Latvia Investment 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 Document and Archives Management Expert Commission	The Bank of Latvia Security Oversight Commission
The Bank of Latvia Ethics Committee	

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. 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 requirements set out for purchasing and selling cash foreign currency in a way of a financial service are met, the Bank of Latvia Licensing Committee granted licenses for purchasing and selling cash foreign currency to capital companies as a commercial activity.

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 Investment Committee developed and defined the strategy and approach for foreign reserves management according to the Bank of Latvia Council Regulation "Guidelines for Managing the Bank of Latvia's Foreign Reserves". 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 Document and Archives Management 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" and the Law "On Archives" within the context of the Bank of Latvia's archive activities. 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 excellent implementation of the tasks stipulated in the Law "On the Bank of Latvia" on a sustainable basis. The Bank of Latvia's management applies the "Plan-Do-Check-Act" cycle which also serves as the basis for the Common Assessment Framework used by the Bank of Latvia for streamlining its managerial processes. It enables detection of any gaps in the strategies, in the management of 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.

The Bank of Latvia's vision, mission and values statement form the foundation for its operations and development planning. 2011 saw the completion of the strategic planning phase and identification of strategic goals for the next four years. Four areas were determined which will be a special focus for the Bank of Latvia. During this period it will be essential to ensure high quality implementation of the core tasks, advance Latvia's entry into the euro area, strengthen links with the general public, raise the professional competence and improve performance.

The fulfilment of the Bank of Latvia's daily tasks and duties 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 include orientation towards the quality and outcomes of services, 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. The execution of functions and processes is monitored daily, implementation of work plans is reviewed on a biannual basis and customer satisfaction surveys are conducted biennially asking customers to assess the quality of the Bank of Latvia's services, the level of their accessibility and convenience, competence and responsiveness of the 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 the employee survey, employee and customer complaints and suggestions, results of operational risk and business continuity management.

The employee survey provided a quality evaluation of the implementation of support functions. Highest scores in 2011 were attributed to the physical security provision, accounting, library, office equipment maintenance and communication services. Areas with lower scores were analysed on their merits, identifying the improvements required regarding the execution of functions and processes. No customer survey was conducted in 2011, the next survey being scheduled for 2012.

A variety of measures aimed at enhancing daily working environment and efficiency were implemented in 2011. Stage two of the pilot project to implement the performance management system was completed. The document management procedure was streamlined though putting into practice the internal audit recommendations, implementing requirements of the ECB Guideline on the common rules and minimum standards for the treatment of sensitive ESCB information and ensuring higher electronisation degree of the document flows resulting from the changes made to the procedure for submitting the Bank of Latvia draft legal acts. A new system for submitting draft legal acts was set up specifying, among other things, the procedure for using document templates. In 2011, a new electronic library of the Bank of Latvia's legal acts with an improved document search facility was set up and a project aimed at streamlining the Accident and Incident Register was launched. Members of staff have improved their knowledge in the area of risk management and information security. Computer telephone connection was improved and better service process for the Bank of Latvia's information line was introduced.

RESOURCE MANAGEMENT

HUMAN RESOURCES

In 2011, 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.

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.

The pilot project to develop a new performance management system, which was launched in 2010, continued in 2011. The Accounting Department, Internal Audit Department, Market Operations Department, Cash Department and Personnel Department were involved in the pilot project. One of the main reasons driving the need for designing a new performance management system was the commitment to creating structured performance management arrangements, which would facilitate the achievement of the Bank of Latvia's goals and allow ensuring a more rational development and implementation of personnel development.

The new performance management system ensures that objectives and tasks of each staff member are based on the Bank of Latvia's strategic, functional and procedural goals and that staff performance is aimed at fulfilling specific objectives and tasks of the Bank of Latvia. All objectives and tasks are translated into measurable performance indicators. The planning and implementation of personnel development is determined by the need to improve the professional and social competencies of the staff. The new performance management system will be implemented in full from 2012.

In 2011, three employees were promoted to other business areas of the Bank of Latvia, 21 employees were promoted within the same business area, and one employee replaced another employee in long-term absence. Four Bank of Latvia staff members gained additional work experience by complementing their knowledge in economics through the ECB short-term secondment programme, three staff members undertook secondment at other central banks (*Oesterreichische Nationalbank*, *Sveriges Riksbank* and *Banca d'Italia*) and one staff member attained work experience with the IMF. In 2011, one staff member of the Bank of Latvia took up short-term employment with the EC in the capacity of a national expert.

Shared responsibility for training and development of the employees and the Bank of Latvia is an important element of the human resources policy. As part of this, the Bank of Latvia provides budgetary resources and a training programme, whereas the employees are expected to upgrade their professional expertise and skills on a continuous basis. The Bank of Latvia staff training costs amounted to 1.4% of the total expenses on remuneration (1.5% in 2010).

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

Towards the end of 2011 workshops for the heads of all structural units of the Bank of Latvia were held in order to brief them on the new performance management system and to improve their skills in conducting performance appraisal meetings.

In 2011, the Personnel Department organised seminars delivered by the Bank of Latvia experts on the SEPA project in Latvia and the national payment system, on the latest macroeconomic developments, the management of bank's operational risks and other key topics related to the operations of the Bank of Latvia in order to extend the staff members' knowledge on the Bank of Latvia's functions and keep them up-to-date on the current issues.

FINANCIAL RESOURCES

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

The Bank of Latvia's operation is mainly financed from the 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 profits for the accounting year to the state budget. The Bank of Latvia's profit for 2011 was 32.0 million lats of which 20.8 million lats will be transferred to the state budget. The Bank of Latvia has contributed to the state budget a total of 115.9 million lats from its profits earned between 2006 and 2010.

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 related to the implementation of the monetary policy, management of foreign reserves, as well as with the participation in the capital of the ECB are accounted for in accordance with the legal framework for accounting and reporting in the ESCB, at the same time taking into consideration that the Bank of Latvia is not a member of the Eurosystem. This Policy also sets forth requirements regarding notes to annual financial statements. In 2011, the Council of the Bank of Latvia amended "Financial Accounting Policy of the Bank of Latvia" stipulating that equity instruments are reported in the balance sheet at fair value, with the exception of the participation in the capital of the ECB, which is stated in the balance sheet at initial cost.

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 ensure the independence of internal audit, the Bank of Latvia's Council approves a special 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 structural 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 2011, continuing the implementation of the restoration and reconstruction project of the Bank of Latvia building at K. Valdemāra iela 1B, in Riga, construction works have begun in compliance with the construction works contract awarded to *Skonto Būve* Ltd. in the amount of 4.2 million lats as a result of public procurement procedure. The building is planned to be ready for use in the middle of 2012. The Statistics Department, Payment Systems Department and Cash Department will have their work premises in the renovated and reconstructed building. Conference, workshop and training premises, premises for servicing recipients of Credit Register data as well as the cashier's offices will be housed in the above building.

Given the fact that the work premises of the Statistics 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.

In 2011, roof repairs of the Bank of Latvia building at K. Valdemāra iela 2A, in Riga, were carried. Minor construction works were also performed at the buildings of the Daugavpils Branch and Liepāja Branch and the Training Centre building in Jūrmala.

Engineering and technical security 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 2011, completing its implementation at the Daugavpils Branch and Liepāja Branch buildings.

In 2011, reconstruction of the fire detection and alarm equipment at the Daugavpils Branch building was performed, installation 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. To improve operational continuity of electric facilities at the Bank of Latvia's buildings, the implementation of the project has commenced in all the buildings of the Bank of Latvia (except the Training Centre building).

The reconstruction project of the Bank of Latvia video surveillance and video recording systems and electric facilities of the buildings is expected to be completed in 2012.

Resources of information technologies

In 2011, the information system infrastructure required for the implementation of CashSSP system in Latvia was developed at the Bank of Latvia, incorporating both computers and other devices into a single computer network and establishing secure external connections and connections with other information systems of the Bank of Latvia, and relevant changes thereto.

The enhancement of the Bank of Latvia's electronic document management system continued in 2011, signicantly improving the unified library of the Bank of Latvia's legal acts and draft legal acts and meetings' management service, enabling unified monitoring of the entire Bank of Latvia's legal acts, their detailed description, more versatile means of selection and search, standardisation of draft legal acts' management process and ensuring the relevant electronic format, as well as providing other options for improving work performance, given an ever increasing volume of information and accelerating information flow. The technical solution of the Bank of Latvia archive of the audiovisual documents has been developed and implemented. The above archive will ensure the accumulation, description and availability of all the Bank of Latvia substantial audiovisual materials.

In 2011, the Bank of Latvia's local computer network modernisation project was commenced and partly implemented in order to ensure successful functioning of the Bank of Latvia computer network by means of an advanced, functional, high-speed, secure and overall implementation and maintenance costs related efficient solution, thus not requiring any substantial additional investments in several coming years.

The server virtualisation project enabling additional consolidation of server resources and reduction of the number of physical servers continued in 2011, hence fostering more efficient utilisation of server resources.

All centrally created information system data bases were modernised, thus providing all information systems developed at the Bank of Latvia with a unified, secure and functional technical platform open for future development.

The unified telecommunications solution project was continued to ensure technical modernisation of the current information system providing expanded functionality and quality operation, and 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.

More efficient use of environmental resources

The Bank of Latvia is an environment friendly institution. In recent years, the Bank of Latvia has implemented a number of projects to ensure more efficient utilisation of environmental resources in different areas.

Several measures were taken to reduce the use of paper (and production resources required for its production respectively). The document circulation is fully provided in electronic format at the Bank of Latvia, resulting in a substantial reduction of document printing work. The used paper is handed over for recycling.

Raw materials (toner, ink and paper) efficient printing mode of the printers has been installed, providing for lower consumption and smaller amount of paper needed (applying duplex printing option). The staff is encouraged to use a more efficient printing mode by evaluating the necessity of printing (colour material printing in particular). A request to assess the above printing needs is attached to the Bank of Latvia e-mail messages, requesting to contain a useless consumption of natural resources.

In the Bank of Latvia, a number of technical equipment modernisation projects were implemented in the area of power efficiency, thus reducing the necessary amount of electricity consumed to operate the relevant equipment. Energy efficiency ratio is also taken into account when upgrading hardware and other technical equipment.

Successful implementation of server virtualisation and consolidation of server resources resulted in a notable decrease in electricity consumed by servers and the generated heat (consequently also the consumption of resources needed for their cooling). A substantial decrease in the electricity consumption was achieved by replacing a desktop and a portable computer at the user's disposal with a portable computer and docking station solution, thus cutting down the total number of computers as well as ensuring that computers which do not prevent the servicing of computer systems have been turned off after office hours.

The Bank of Latvia took care of efficient utilisation of power. The reconstruction of the Bank of Latvia's building at K. Valdemāra iela 1B, in Riga, involves implementation of several measures in order to ensure maximum power efficient maintenance of the building.

RISK MANAGEMENT

The Bank of Latvia manages strategic, financial and operational risks. Risks at the Bank of Latvia 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 manages financial risks related to the foreign exchange reserves in accordance with "The Guidelines for Managing the Bank of Latvia's Foreign Reserves", reviewed by the Council of the Bank of Latvia 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 structural units, project managers and other employees of the Bank of Latvia.

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.

The aim of the Bank of Latvia business continuity management is to ensure the implementation continuity of the Bank of Latvia critical process or, in the event of its interruption, its re-establishment at an appropriate level and in acceptable timeframe as well as efficient management of the incident and crisis. In 2011, within the framework of Bank of Latvia business continuity management, the main focus was on the updating and improving the action plans for ensuring business continuity.

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 2011. It was also conducted under information system development and upgrading projects.

In April 2011, the Board of the Bank of Latvia reviewed and approved the Bank of Latvia 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 operational risk management.

INTERNAL AND EXTERNAL AUDIT

By an unbiased examination of the Bank of Latvia 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 improvement.

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 the ISACA (Information System Audit and Control Association) standards are applied.

The compliance of internal audit activities with "The International Standards for the Professional Practice of Internal Auditing" and the "Code of Ethics" has been approved by the external assessment of internal audit quality in 2010.

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 by the Head of Internal Audit Department. 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 on an annual basis.

The Internal Audit Department carries out internal auditing at the Bank of Latvia also in accordance with the audit plan approved by the ESCB Internal Auditors Committee (IAC); in 2011, an employee of the Internal Audit Department of the Bank of Latvia conducted such an audit at *Magyar Nemzeti Bank*.

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 the Audit Commission whose composition is approved by the State Audit Office of the Republic of Latvia. In 2011, the Audit Commission for auditing economic activities and financial statements of the Bank of Latvia comprised the auditors from the State Audit Office and *SIA Deloitte Audits Latvia*.

FINANCIAL STATEMENTS OF THE BANK OF LATVIA
FOR THE YEAR ENDED 31 DECEMBER 2011

BALANCE SHEET

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

ASSETS	Notes[1]	**2011**	2010
FOREIGN ASSETS		**3 507 542**	4 074 611
Gold	7	210 066	187 179
Special Drawing Rights	8	79 069	99 356
Convertible foreign currencies	9	3 184 920	3 782 167
Participating interest in the European Central Bank	10	750	750
Participating interest in the Bank for International Settlements	11	18 997	1 763
Other foreign assets	12	13 740	3 396
DOMESTIC ASSETS		**31 683**	32 722
Fixed assets	13, 14	30 675	31 003
Other domestic assets	15, 16	1 008	1 719
TOTAL ASSETS		**3 539 225**	4 107 333

[1] The accompanying notes set out on pages 80 to 116 are an integral part of these financial statements.

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

LIABILITIES, CAPITAL AND RESERVES	Notes	**2011**	2010
FOREIGN LIABILITIES		**72 372**	42 556
Convertible foreign currencies	17	9 560	13 682
International Monetary Fund	8	313	274
Other international institution deposits in lats	18	18 271	8 505
Foreign bank deposits in lats		712	726
Other foreign liabilities	19	43 516	19 369
LATS IN CIRCULATION	20	**1 160 183**	937 904
DOMESTIC LIABILITIES		**1 979 508**	2 830 233
Balances due to credit institutions	21	1 197 740	1 690 230
Balances due to the government	22	737 088	1 081 010
Balances due to other financial institutions		42 715	56 738
Other domestic liabilities	23, 24	1 965	2 255
CAPITAL AND RESERVES		**327 162**	296 640
Nominal capital	25	25 000	25 000
Reserve capital	25	148 587	140 273
Valuation account	25	121 547	107 613
Profit of the reporting year	25	32 028	23 754
TOTAL LIABILITIES, CAPITAL AND RESERVES		**3 539 225**	4 107 333

The financial statements, which are set out on pages 74 to 116, were authorised by the Board of the Bank of Latvia on 13 March 2012.

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	**2011**	2010
INTEREST INCOME			
Foreign operations	26	**73 265**	57 055
Interest on securities		58 813	52 405
Interest on deposits with foreign credit institutions and other foreign financial institutions		5 832	2 792
Interest on derivative financial instruments		8 620	1 858
Domestic operations	26	**13**	3 618
Interest on loans to credit institutions		1	3 618
Interest on derivative financial instruments		12	–
INTEREST EXPENSE			
Foreign operations	26	**–494**	–967
Interest on deposits		–7	–1
Interest on derivative financial instruments		–487	–966
Domestic operations	26	**–11 475**	–13 362
Interest on deposits of credit institutions		–4 057	–9 140
Interest on government deposits		–7 125	–4 127
Interest on deposits of other financial institutions		–293	–95
NET INTEREST INCOME	26	**61 309**	46 344

(cont.) (in thousands of lats)

	Notes	**2011**	2010
REALISED GAINS/LOSSES (–) FROM FINANCIAL OPERATIONS	27	**5 942**	9 147
Foreign operations		**–3 505**	–6 315
Debt securities		11 836	17 599
Derivative financial instruments		–15 341	–23 914
Foreign currency exchange transactions		**9 447**	15 462
WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS	25, 28	**–16 556**	–12 995
Foreign operations		**–14 905**	–11 639
Debt securities		–14 905	–11 639
Foreign currency position		**–1 651**	–1 356
INCOME FROM PARTICIPATING INTEREST	29	**245**	611
OTHER OPERATING INCOME	30	**1 261**	1 278
BANKNOTE PRODUCTION AND COINAGE COSTS	31	**–582**	–541
OTHER OPERATING EXPENSES		**–19 591**	–20 090
Remuneration	32	–9 902	–10 278
Social security costs	32	–2 373	–2 449
Depreciation and amortisation charges	13, 16	–2 948	–3 044
Maintenance and operation of information systems		–1 670	–1 554
Other operating expenses	33	–2 698	–2 765
PROFIT OF THE REPORTING YEAR		**32 028**	23 754

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

(in thousands of lats)

	Notes	**2011**	2010
REVALUATION	25	**27 871**	35 482
Equity instruments		17 233	–
Foreign currency and gold		6 068	36 680
Non-traded interest rate swap arrangements		25	–
Debt securities		4 545	–1 198
REALISATION OF ACCUMULATED REVALUATION RESULT	25	**–30 493**	–14 993
Foreign currency and gold		–13 761	–3 889
Debt securities		–16 732	–11 104
WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS	25, 28	**16 556**	12 995
PROFIT OF THE REPORTING YEAR		**32 028**	23 754
TOTAL		**45 962**	57 238

CASH FLOW STATEMENT

(in thousands of lats)

	Notes	**2011**	2010
CASH FLOW FROM OPERATING ACTIVITIES			
Profit of the reporting year		**32 028**	23 754
Non-cash transaction adjustments	34 (1)	**19 506**	16 294
Net movements in balance sheet positions	34 (1)	**6 178**	–378 945
Net cash and cash equivalents inflow/outflow (–) from operating activities		**57 712**	–338 897
CASH FLOW FROM INVESTING ACTIVITIES			
Dividends on shares of the Bank for International Settlements	29	**245**	611
Acquisition of fixed assets	13	**–2 345**	–788
Acquisition of intangible assets	16	**–92**	–146
Net cash and cash equivalents outflow from investing activities		**–2 192**	–323
CASH FLOW FROM FINANCING ACTIVITIES			
Profit appropriated to the state budget	25	**–15 440**	–48 355
Net cash and cash equivalents outflow from financing activities		**–15 440**	–48 355
NET CASH AND CASH EQUIVALENTS INFLOW/OUTFLOW (–)		**40 080**	–387 575
Cash and cash equivalents at the beginning of the year	34 (2)	**556 650**	944 225
Cash and cash equivalents at the end of the year	34 (2)	**596 730**	556 650

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;
– promotion of a smooth operation of the payment systems in Latvia and organisation and management of the interbank payment system;
– collecting, 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 also ensures the operation of the Credit Register as of 1 January 2008. The Bank of Latvia 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 K. Valdemāra iela 2A, Riga. The Bank of Latvia manages the storage, processing and circulation of cash through its Riga Branch and the regional branches in Daugavpils and Liepāja.

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 risks are 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.

2.1. 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 currency and gold price risk (hereinafter, currency risk) is determined by the structure of its foreign reserves, which cannot be formed in compliance with the Bank of Latvia's liability parameters. The Bank of Latvia manages the 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 tracking error limit. Tracking error in 2011 and 2010 is provided in Note 41.

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 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 2011 and 2010) is provided in Notes 40 and 41.

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 certain credit quality of the OECD countries. 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 and 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 credit 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 2011 and 2010) is provided in Notes 43 to 45.

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 foreign exchange transactions with credit institutions 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 34. The liquidity profile of the Bank of Latvia's assets and liabilities as at the end of 2011 and 2010 is provided in Note 42.

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.

2.2. OPERATIONAL RISKS

Operational risk is exposure to financial and non-financial losses resulting from inadequate or failed internal processes, individual's actions, operation of information or technical systems, or from external events.

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 Operational

Risk Manager, Operational Continuity Manager, Information Security Manager, Information Systems Security Manager, and the Head of Security Department.

In 2011, the risks were reviewed and revaluated taking into account the incurred incidents and disturbances, and new operational risks were identified, analysed and assessed, with relevant risk limiting measures being developed and appraised. The information thus obtained is compiled in the Risk Register of the Bank of Latvia, an information system which is available to the Bank of Latvia department heads responsible for processes, project managers and other authorised Bank of Latvia staff.

In order to ensure confidentiality, authorised access to and integrity of information, the Bank of Latvia information systems are classified into levels depending on their significance. 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 internationally recognised standards and taking into account the ECB recommendations regarding business continuity management.

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.

Within the overall limitation of operational risks, the Bank of Latvia is insured against certain types of operational risks.

In 2011, the Bank of Latvia was not exposed to the risks that could substantially affect or hamper its operation.

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.

3.1. CHANGE IN ACCOUNTING POLICY

In order to promote the presentation of useful information in the financial statements and in the light of developments of the financial reporting framework, in 2011, the Council of the Bank of Latvia introduced amendments to the "Financial Accounting Policy of the Bank of Latvia" providing for the reporting of equity instruments at fair value in the balance sheet, except the participating interest in the ECB, which is reported at cost in the balance sheet in accordance with the legal framework for accounting and financial reporting in the ESCB. The change in fair value of participating interest is reported in the balance sheet caption "Valuation account". Previously, participating interest was reported at cost. The change in the accounting policy has been applied prospectively as of 31 December 2011.

As a result of this change in the accounting policy, book value of participating interest increased by 17 233 thousand lats in 2011 (see also Notes 11 and 25).

3.2. 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 as well as participating interest in the ECB are reported in accordance with the legal framework for accounting and financial reporting in the ESCB.

3.3. BASIS OF MEASUREMENT

These financial statements have been prepared in accordance with the historical cost basis of accounting except gold, debt securities, participating interest (except the participating interest in the ECB), currency future contracts and interest rate derivatives, which are accounted for at fair value. Forward exchange rate contracts and currency swap arrangements are valued according to the principles described in Note 3.16. The reconciliation of the book value and fair value of these instruments is provided in Note 38.

3.4. 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.

3.5. FOREIGN CURRENCY AND GOLD 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 3.26. The principles referred to herein and in Note 3.26 for valuation and recording of transactions denominated in foreign currencies shall be applicable also to gold reserves and transactions in gold.

The exchange rates of principal foreign currencies set by the Bank of Latvia and used in the preparation of the balance sheet for the year ended 31 December 2011 and the year ended 31 December 2010 are as follows:

(at the end of the year)

	2011	2010	Changes (%)
Euro (EUR)	**0.702804**	0.702804	0
US dollar (USD)	**0.544**	0.535	1.7
Japanese yen (JPY)	**0.007**	0.00651	7.5
Gold (XAU)	**844.634**	752.612	12.2
Special Drawing Rights (XDR)	**0.839**	0.82	2.3

3.6. 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 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.

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

3.7. 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.

3.8. 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.

3.9. GOLD

Gold reserves are stated at market value in the balance sheet in accordance with the principles described in Note 3.5.

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 3.26.

3.10. DEBT SECURITIES

Debt 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 debt 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 3.26.

3.11. 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.

3.12. 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.

3.13. 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.

3.14. 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.

3.15. 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 are reported at fair value in the balance sheet, except participating interest in the ECB, which is reported at cost in the balance sheet (see also Note 3.1).

3.16. 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 3.26.

3.17. 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.

3.18. FIXED ASSETS

Fixed assets are tangible long-term investments with the useful life over one year. Capitalisation limit of fixed assets is 100 lats, except the costs related to real estate improvements and replacement of fixed asset parts for which the Board of the Bank of Latvia has set a higher capitalisation limit depending on their significance. 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. Buildings and structures are accounted by separate components, with individual useful life set for each such component.

In 2010 and 2011, the useful life set for fixed assets was as follows:

	(years)
Buildings and their components, improvement of territory	**5–100**
Transport vehicles	**10**
Office equipment and inventories	**5–25**
Cash processing and verifying equipment	**5–15**
Computer and telecommunication equipment	**2–7**
Other fixed assets	**5–15**

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

3.19. INTANGIBLE ASSETS

Intangible assets are long-term investments without physical substance with a useful life of over one year. Capitalisation limit of intangible assets is 100 lats. 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.

3.20. 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.

3.21. 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.

3.22. 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.

3.23. COLLECTOR COINS

Collector coins sold are not included in the balance sheet liabilities, as the reselling 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.

3.24. 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.

3.25. 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.

3.26. RECOGNITION OF GAINS OR LOSSES ON FINANCIAL INSTRUMENTS

Gains or losses on financial instruments are recognised in accordance with the following principles provided by the legal framework for accounting and financial reporting in the ESCB:

(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.

3.27. INTEREST INCOME AND EXPENSE
Interest income and expense are recognised in the profit and loss statement on an accrual basis.

Interest income includes interest on securities, securities lending, deposits, 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.

3.28. 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 derivative financial instruments, disposal of debt securities, and foreign exchange transactions.

3.29. INCOME FROM PARTICIPATING INTEREST
The change in fair value of participating interest is reported in the balance sheet caption "Valuation account".

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

3.30. BANKNOTE PRODUCTION AND COINAGE COSTS
Banknote and coin acquisition costs, except gold circulation coin acquisition costs, are charged to the profit and loss statement at the moment of banknote and coin acquisition.

3.31. 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

4.1. FINANCIAL POSITION
The Bank of Latvia's assets dropped by 568.1 million lats in 2011, primarily on account of a decrease in foreign assets.

Convertible foreign currencies posted a decrease of 597.2 million lats mainly on account of a reduction in the amount of 524.8 million lats of the Latvian government deposits with the Bank of Latvia. The Bank of Latvia foreign exchange transactions with credit institutions in the amount of 235.9 million lats[1] had a decreasing effect, while deposits in foreign currencies of credit institutions with the Bank of Latvia increased by 123.7 million lats.

Although credit institutions' deposits in lats decreased by 616.2 million lats, credit institutions had excess liquidity and by the end of 2011, the Bank of Latvia had not issued any loans to credit institutions.

[1] On a settlement date basis.

With the demand for cash growing, the amount of cash in circulation grew in 2011, hence the Bank of Latvia balance sheet caption "Lats in circulation" increased by 222.3 million lats.

Capital and reserves of the Bank of Latvia grew by 30.5 million lats on account of profits earned in 2011 (32.0 million lats) and net changes in valuation of financial instruments (13.9 million lats), whereas profits remitted to the state budget revenue (15.4 million lats) had a decreasing effect.

4.2. FINANCIAL PERFORMANCE
In 2011, the Bank of Latvia profit amounted to 32.0 million lats (23.7 million lats in 2010).

Net interest income was by 15.0 million lats higher in 2011 than in 2010. Interest income continued to be adversely affected by low interest rates in the US and euro area. Interest income on securities grew by 6.4 million lats primarily on account of higher euro area interest rates in the first half of 2011. The spread between the euro and US dollar short-term interest rates widened in this period as well and pushed up income from financial derivatives used for hedging currency risk exposure.

Given the excess lats liquidity of credit institutions, the Bank of Latvia issued loans to credit institutions in minimum amounts in 2011, bringing the respective interest income down to 1 thousand lats.

With credit institution deposits in lats with the Bank of Latvia decreasing and duly accounting for the lower average interest rates on these deposits than in 2010, the interest expense on credit institution deposits contracted by 5.1 million lats. Higher interest rates accounted for a 3.0 million lats rise in interest paid on government deposits in foreign currencies.

Realised gains arising from financial operations decreased by 3.2 million lats, while write-downs of the negative revaluation result on financial assets and positions were by 3.6 million lats higher than in 2010. It was primarily driven by an increase in the euro area interest rates in the first half of 2011 and uneven interest rate changes in debt securities markets of the euro area countries at the end of 2011, which had a negative effect on market value of these securities. Realised gains arising from financial operations were impacted also by the result of currency future contracts concluded for the purpose of hedging the currency risk and realised gains on foreign exchange transactions. The positive revaluation result of the hedged balance sheet items is reported in the balance sheet caption "Valuation account".

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 0.5 million lats in 2011.

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 foreign 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 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 2011 and 2010 was as follows:

	Amount (in thousands of lats)		Percentage (%)	
	2011	2010	**2011**	2010
Portfolios managed against multi-currency fixed income securities benchmark	**2 388 804**	2 602 693	**72.7**	64.9
Portfolios of borrowed funds	**507 330**	1 061 213	**15.4**	26.4
Gold reserves portfolio	**215 374**	184 090	**6.5**	4.6
Portfolios managed against asset-backed securities benchmark	**175 883**	165 090	**5.4**	4.1
Total	**3 287 391**	4 013 086	**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 portfolios 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 2.1.

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 2011 and 2010, Bank of Latvia's investments in debt securities were generally valued on the basis of quoted price.

At the end of 2011, participating interest in the BIS was assessed using non-observable data. The assessment was conducted using the 70% net asset value model (see also Note 11).

At the end of 2011 and 2010, 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	Non-observable data	Total
As at 31 December 2011				
FOREIGN ASSETS				
Gold	210 066	–	–	210 066
Convertible foreign currencies				
Debt securities	2 404 354	38 355	–	2 442 709
Participating interest in the Bank for International Settlements	–	–	18 997	18 997
Other foreign assets				
Forward transactions in securities	560	–	–	560
Non-traded interest rate swap arrangements	–	25	–	25
Total foreign assets at fair value	**2 614 980**	**38 380**	**18 997**	**2 672 357**
FOREIGN LIABILITIES				
Other foreign liabilities				
Forward transactions in securities	147	–	–	147
Total foreign liabilities at fair value	**147**	**–**	**–**	**147**
As at 31 December 2010				
FOREIGN ASSETS				
Gold	187 179	–	–	187 179
Convertible foreign currencies				
Debt securities	2 637 581	51 831	–	2 689 412
Other foreign assets				
Forward transactions in securities	63	–	–	63
Total foreign assets at fair value	2 824 823	51 831	–	2 876 654
FOREIGN LIABILITIES				
Other foreign liabilities				
Forward transactions in securities	319	1	–	320
Total foreign liabilities at fair value	319	1	–	320

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 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. The method for assessing fair value of assets falling into the group of non-observable data is described in Note 11.

7. GOLD

Movements in gold reserves in 2011 and 2010 were as follows:

	Troy ounces	In thousands of lats
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
During 2011		
Increase in gold market value	x	22 887
As at 31 December 2011	**248 706**	**210 066**

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 40). 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. SPECIAL DRAWING RIGHTS, 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. In March 2011, Latvia's quota in the IMF was increased to 142 100 thousand SDR.

Latvia's liabilities to the IMF are made up of the IMF holdings in lats and IMF allocations. In 2011, liabilities to the IMF increased by 15 300 thousand SDR as a result of the increased quota.

At the end of 2011, the claims on the IMF in SDR as recorded on the Bank of Latvia's balance sheet were equivalent to 79 069 thousand lats (at the end of 2010 – 99 356 thousand lats), whereas the liabilities to the IMF are made up of funds at the disposal of the IMF in the amount of 313 thousand lats (at the end of 2010 – 274 thousand lats) held on its Accounts No. 1 and No. 2.

At the end of 2011 and 2010, Latvia's net claims and liabilities to the IMF were as follows:

	(in thousands of lats)		(in thousands of SDR)	
	2011	2010	**2011**	2010
Latvia's quota in the IMF	**119 222**	103 976	**142 100**	126 800
IMF holdings in lats	**–943 290**	–909 382	**–1 124 302**	–1 109 002
Promissory notes of the Latvian government	–942 977	–909 108	–1 123 930	–1 108 668
Account No. 1	–298	–260	–355	–317
Account No. 2	–15	–14	–17	–17
Stand-by Arrangement for Latvia	**824 099**	805 437	**982 240**	982 240
Reserve position in IMF	**46**	45	**55**	55
SDR	**79 069**	99 356	**94 242**	121 166
General allocation	**–78 864**	–77 077	**–93 998**	–93 998
Special allocation	**–22 505**	–21 996	**–26 824**	–26 824
Latvia's net claims/liabilities (–) to the IMF	**–22 254**	328	**–26 525**	399

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 (19 604 thousand lats at the end of 2011 and 24 234 thousand lats at the end of 2010).

At the end of 2011 and 2010, the balance sheet asset caption "Convertible foreign currencies" was comprised of the following assets:

(in thousands of lats)

	2011	2010
Debt securities of foreign governments, financial institutions and non-financial corporations	**2 442 709**	2 689 412
Demand deposits with foreign central banks, credit institutions and international institutions	**519 867**	531 735
Time deposits with foreign credit institutions and other foreign financial institutions	**208 733**	545 307
Foreign currency in cash	**13 611**	15 713
Total	**3 184 920**	3 782 167

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 gross domestic product data and is adjusted every five years or at shorter intervals depending on changes in the number of the EU Member States.

At the end of 2011 and 2010, the Bank of Latvia's percentage share in the ECB's capital was 0.2837% equivalent to 30 528 thousand euro (21 455 thousand lats). As Latvia does not participate in the euro area, pursuant to the transitional provisions of the Statute of the ESCB and of the ECB and Decision of the ECB's General Council, the Bank of Latvia has paid up a 3.75% minimum contribution of its total subscribed capital in the ECB amounting to 1 145 thousand euro or 750 thousand lats (1 145 thousand euro or 750 thousand lats at the end of 2010; see also Note 39).

In accordance with the legal framework for accounting and financial reporting in the ESCB 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 2011 and 2010, 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%. In 2011, the Bank of Latvia changed its valuation policy of the BIS shares; at the end of 2011, the BIS shareholding is reported in the Bank of Latvia balance sheet at fair value (see also Notes 3.1 and 39). In the opinion of the Bank of Latvia's management, the most appropriate method for establishing the fair value of the BIS shares is 70% of the BIS net assets based on the latest audited financial statements of the BIS. The BIS applied this valuation method for calculating the price of its shares; the International Court at the Hague has also recognised it as appropriate for the valuation of shares when repurchasing them from former private shareholders of the BIS. 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. At the end of 2011, the fair value of BIS shares was 18 997 thousand lats (17 320 thousand lats at the end of 2010). In the Bank of Latvia financial statements for 2010, the BIS shareholding was reported at cost (1 763 thousand lats).

The Bank of Latvia balance sheet items restated to show the figures in the case the accounting policy referred to in Note 3.1 had been applied retrospectively:

(in thousands of lats)

	2011	2010		
		Published	Restated	Difference
Foreign assets	**3 507 542**	4 074 611	4 090 168	15 557
Participating interest in the Bank for International Settlement	**18 997**	1 763	17 320	15 557
Domestic assets	**31 683**	32 722	32 722	–
Total assets	**3 539 225**	4 107 333	4 122 890	15 557
Foreign liabilities	**72 372**	42 556	42 556	–
Lats in circulation	**1 160 183**	937 904	937 904	–
Domestic liabilities	**1 979 508**	2 830 233	2 830 233	–
Capital and reserves	**327 162**	296 640	312 197	15 557
Valuation account	**121 547**	107 613	123 170	15 557
Total liabilities	**3 539 225**	4 107 333	4 122 890	15 557

Items of the Bank of Latvia statement of total recognised gains and losses restated to show the figures in the case the accounting policy referred to in Note 3.1 had been applied retrospectively:

(in thousands of lats)

	Published		Restated		Difference	
	2011	2010	**2011**	2010	**2011**	2010
Revaluation	**27 871**	35 482	**12 314**	38 545	**–15 557**	3 063
Equity instruments	**17 233**	–	**1 676**	3 063	**–15 557**	3 063
Realisation of accumulated revaluation result	**–30 493**	–14 993	**–30 493**	–14 993	**–**	–
Write-downs of revaluation result on financial assets and positions	**16 556**	12 995	**16 556**	12 995	**–**	–
Profit of the reporting year	**32 028**	23 754	**32 028**	23 754	**–**	–
Total recognised gains and losses	**45 962**	57 238	**30 405**	60 301	**–15 557**	3 063

12. OTHER FOREIGN ASSETS

At the end of 2011 and 2010, other foreign assets consisted of the following items:

(in thousands of lats)

	2011	2010
Non-traded financial derivative and spot exchange rate contracts with foreign financial institutions	**13 143**	2 825
Prepaid expense	**461**	459
Interest accrued on deposits	**59**	79
Other	**77**	33
Total	**13 740**	3 396

13. FIXED ASSETS

The following changes in fixed assets took place in 2011 and 2010:

(in thousands of lats)

	Buildings, improvement of territory, and land	Furniture and office equipment	Cash processing equipments	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
During 2011						
Additions	1 566	306	30	–	443	2 345
Change in classification	–	88	–37	–	–51	–
Disposals and write-offs	–	–64	–3	–24	–169	–260
Net change in cost	1 566	330	–10	–24	223	2 085
Depreciation charge	–1 694	–372	–238	–102	–265	–2 671
Change in classification	–	–39	36	–	3	–
Accumulated depreciation on disposals and write-offs	–	63	3	24	168	258
Net change in accumulated depreciation	–1 694	–348	–199	–78	–94	–2 413
As at 31 December 2011						
Cost	38 566	6 698	4 570	1 211	5 356	56 401
Accumulated depreciation	–12 735	–5 226	–2 687	–821	–4 257	–25 726
Net book value	**25 831**	**1 472**	**1 883**	**390**	**1 099**	**30 675**

At the end of 2011, the total cadastral value of land under the ownership and possession of the Bank of Latvia was 1 811 thousand lats (1 999 thousand lats at the end of 2010; the change is 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 2011 and 2010).

At the end of 2011, the Bank of Latvia's contractual commitments related to acquisition of fixed assets were 3 338 thousand lats (4 456 thousand lats at the end of 2010), mostly related to the reconstruction of the building at K. Valdemāra iela 1B, Riga.

14. LEASING

The Bank of Latvia's assets subject to leases are premises, land, and equipment. In the balance sheet they are reported as fixed assets. Asset 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 3.18 and reported in the profit and loss statement as depreciation charges.

Carrying amount of leased assets at the end of 2011 and 2010 was as follows:

(in thousands of lats)

As at 31 December 2010	
Cost	1 059
Accumulated depreciation	–422
Net book value	637
As at 31 December 2011	
Cost	1 146
Accumulated depreciation	–538
Net book value	**608**

15. OTHER DOMESTIC ASSETS

At the end of 2011 and 2010, other domestic assets consisted of the following items:

(in thousands of lats)

	2011	2010
Intangible assets	**440**	625
Spot exchange rate contracts with domestic institutions	**–**	532
Prepaid expense	**108**	124
Other	**460**	438
Total	**1 008**	1 719

16. INTANGIBLE ASSETS

The following changes in intangible assets took place in 2011 and 2010:

(in thousands of lats)

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 disposals	37
Net change in accumulated amortisation	–245
As at 31 December 2010	
Cost	3 878
Accumulated amortisation	–3 253
Net book value	625

(cont.)	(in thousands of lats)
During 2011	
Additions	92
Net change in cost	92
Amortisation charge	–277
Net change in accumulated amortisation	–277
As at 31 December 2011	
Cost	3 970
Accumulated amortisation	–3 530
Net book value	**440**

17. CONVERTIBLE FOREIGN CURRENCIES

At the end of 2011 convertible foreign currency liabilities mostly consisted of funds on the EC account for settlements in euro, as well as the cash collateral 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 18).

At the end of 2011 and 2010, convertible foreign currency liabilities consisted of the following items:

(in thousands of lats)

	2011	2010
EC demand deposits	**5 681**	13 121
Cash collateral	**3 580**	503
Other liabilities	**299**	58
Total	**9 560**	13 682

18. 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 17).

At the end of 2011 and 2010, the breakdown of deposits of other international institutions in lats was as follows:

(in thousands of lats)

	2011	2010
EC demand deposits	**18 024**	8 258
Other deposits	**247**	247
Total	**18 271**	8 505

19. OTHER FOREIGN LIABILITIES

At the end of 2011 and 2010, other foreign liabilities consisted of the following items:

(in thousands of lats)

	2011	2010
Non-traded financial derivative contracts and spot exchange rate contracts with foreign financial institutions	**43 210**	19 074
Accrued expense	**272**	245
Other	**34**	50
Total	**43 516**	19 369

20. LATS IN CIRCULATION

At the end of 2011 and 2010, the following units of lats (LVL) and santims (s) were in circulation:

Nominal	Amount (in thousands of lats)		Number (in thousands of units)		Percentage (%)	
	2011	2010	**2011**	2010	**2011**	2010
Banknotes						
LVL 500	**94 815**	72 549	**190**	145	**8.1**	7.8
LVL 100	**171 438**	118 390	**1 714**	1 184	**14.8**	12.6
LVL 50	**94 227**	79 637	**1 885**	1 593	**8.1**	8.5
LVL 20	**584 562**	471 147	**29 228**	23 557	**50.4**	50.2
LVL 10	**76 695**	68 574	**7 669**	6 857	**6.6**	7.3
LVL 5	**71 576**	66 273	**14 315**	13 255	**6.2**	7.1
Total banknotes	**1 093 313**	876 570	**x**	x	**94.2**	93.5
Coins						
LVL 100	**405**	405	**4**	4	**0**	0
LVL 10	**145**	145	**15**	15	**0**	0
LVL 2	**8 636**	8 317	**4 318**	4 159	**0.7**	0.9
LVL 1	**35 316**	31 358	**35 316**	31 359	**3.0**	3.4
50 s	**8 299**	7 820	**16 599**	15 639	**0.7**	0.8
20 s	**4 757**	4 481	**23 785**	22 405	**0.5**	0.5
10 s	**2 901**	2 736	**29 011**	27 362	**0.3**	0.3
5 s	**2 190**	2 093	**43 795**	41 852	**0.2**	0.2
2 s	**2 417**	2 268	**120 828**	113 417	**0.2**	0.2
1 s	**1 804**	1 711	**180 446**	171 138	**0.2**	0.2
Total coins	**66 870**	61 334	**x**	x	**5.8**	6.5
Total lats in circulation	**1 160 183**	937 904	**x**	x	**100.0**	100.0

At the end of 2011, the total nominal value of gold circulation coins (fineness .999) issued, with the denomination of 100 lats, was 1 989 thousand lats (1 988 thousand lats at the end of 2010). 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 3.22).

As at the end of 2011, collector coins with the total nominal value of 1 556 thousand lats had been issued (1 528 thousand lats at the end of 2010). These coins are not included in the balance sheet caption "Lats in circulation" (see also Note 3.23).

21. 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, and settlements related to the Bank of Latvia's monetary policy operations. At the end of 2011, the overnight deposit facility rate and 7-day deposit facility rate as set by the Bank of Latvia were 0.25% and 0.375% respectively (at the end of 2010, the overnight deposit facility rate and 7-day deposit facility rate were 0.25% and 0.375% respectively).

At the end of 2011 and 2010, balances due to domestic credit institutions consisted of the following items:

(in thousands of lats)

	2011	2010
Overnight deposit facility	**2 220**	800
7-day deposit facility	**227 000**	873 000
Current account balances in lats	**824 840**	796 405
Current account balances in euro	**143 680**	20 025
Total	**1 197 740**	1 690 230

22. BALANCES DUE TO THE GOVERNMENT

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

At the end of 2011 and 2010, the breakdown of Latvian government deposits was as follows:

(in thousands of lats)

	2011	2010
Time deposits in foreign currencies	**259 124**	789 809
Demand deposits in foreign currencies	**242 523**	236 674
Demand deposits in lats	**235 441**	54 527
Total	**737 088**	1 081 010

23. OTHER DOMESTIC LIABILITIES

At the end of 2011 and 2010, other domestic liabilities consisted of the following items:

(in thousands of lats)

	2011	2010
Accrued expense and similar liabilities	**1 571**	1 598
Tax liabilities	**69**	80
Accrued interest expense	**63**	169
Other	**262**	408
Total	**1 965**	2 255

24. TAX

In 2011 and 2010, 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 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
During 2011							
Calculated	2 044	2 373	1 086	92	427	1	6 023
Increase in deferred liabilities	0	5	0	0	0	0	5
Paid	–2 044	–2 378	–1 086	–92	–438	–1	–6 039
Liabilities as at 31 December 2011	**0**	**0**	**0**	**0**	**69**	**0**	**69**

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 (15 440 thousand lats in 2011; 48 355 thousand lats in 2010; see also Notes 25 and 35) to the state budget. The Bank of Latvia is not subject to corporate income tax.

25. CAPITAL AND RESERVES

In 2011 and 2010, 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 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
During 2011					
Revaluation, realisation, and write-downs	x	x	13 934	x	13 934
Profit appropriated to the state budget	x	x	x	–15 440	–15 440
Profit transferred to the reserve capital	x	8 314	x	–8 314	0
Profit of the reporting year	x	x	x	32 028	32 028
As at 31 December 2011	**25 000**	**148 587**	**121 547**	**32 028**	**327 162**

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 and gold. The accounting policy, harmonised with the principal accounting policies established by the legal framework for accounting and financial reporting in the ESCB and described in Note 3, stipulates that the realised gains are recognised in the profit and loss statement only after the disposal of a financial instrument or settlement while unrealised gains are recorded under the balance sheet item "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, it 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 2011 and 2010, 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 2011 by the Council of the Bank of Latvia. In 2012, the Bank of Latvia will transfer 20 818 thousand lats from its profit earned in 2011 to the state budget.

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

In 2011 and 2010, changes in the balance sheet caption "Valuation account" were as follows:

(in thousands of lats)

	2011	Write-downs	Revaluation	Realisation	2010	Write-downs	Revaluation	Realisation	2009
Initial valuation account	**24 018**	x	x	–75	24 093	x	x	–190	24 283
Deferred result on revaluation of foreign currencies and gold	**24 018**	x	x	–	24 018	x	x	–	24 018
Deferred result on revaluation of debt securities	**–**	x	x	–75	75	x	x	–190	265
Revaluation reserve for equity instruments	**17 233**	–	17 233	–	–	–	–	–	–
Result on revaluation of foreign currencies and gold	**49 582**	1 651	6 068	–13 761	55 624	1 356	36 680	–3 889	21 477
Result on revaluation of non-traded interest rate swap arrangements	**25**	–	25	–	–	–	–	–	–
Result on revaluation of debt securities	**30 689**	14 905	4 545	–16 657	27 896	11 639	–1 198	–10 914	28 369
Total	**121 547**	16 556	27 871	–30 493	107 613	12 995	35 482	–14 993	74 129

The initial valuation account was established by transferring thereto the result on revaluation prior to the change in the accounting policy on 1 January 2007. The change in the balance of the initial valuation account in 2011 is related to the recognition of the net profit from the debt securities held by the Bank of Latvia at the end of 2006 and disposed of in the reporting year in the amount of 75 thousand lats (net profit in the amount of 190 thousand lats in 2010).

Revaluation reserve for equity instruments has been established to account for the result on revaluation of the BIS shares.

26. NET INTEREST INCOME

In 2011, the Bank of Latvia's net interest income amounted to 61 309 thousand lats (46 344 thousand lats in 2010). The income was mainly derived from investing foreign currency reserves.

Interest income from foreign operations increased by 16 210 thousand lats in comparison with 2010 while interest expense decreased by 473 thousand lats year-on-year. The interest income grew mostly on account of higher interest rate levels in the euro area in the first half of 2011 as well as the amortisation of the negative revaluation result of debt securities recognised in the profit and loss statement at the end of 2010. Net interest income from financial derivatives used by the Bank of Latvia for hedging currency risk exposure grew by 7.3 million lats as a result of the widening spread between the euro and US dollar short-term interest rates in the first half of 2011.

Interest income from domestic operations fell to 1 thousand lats (a 3 617 thousand lats decline in comparison with 2010) as lending to domestic credit institutions contracted due to the excess lats liquidity in credit institutions.

Interest expense on domestic operations (11 475 thousand lats; 13 362 thousand lats in 2010) was largely comprised of interest on deposits of domestic credit institutions and the Latvian government. Interest expense on credit institution deposits decreased by 5 083 thousand lats. With the credit institution deposits in lats with the Bank of Latvia decreasing and in view the fall in interest rates paid on these deposits at the end of 2010 and lower interest rate levels throughout 2011, interest expense on the credit institution deposits, including remuneration for holding the minimum reserves, decreased accordingly. In 2011, the Bank of Latvia received a lower average amount of Latvian government funds as deposits than in 2010; however, interest rates on deposits in foreign currencies increased, therefore interest expense on government deposits grew by 2 998 thousand lats.

27. REALISED GAINS/LOSSES FROM FINANCIAL OPERATIONS

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

Gains from the disposal of debt securities amounted to 11 836 thousand lats, 5 763 thousand lats less than in 2010. Although a larger amount of the positive debt securities revaluation result accumulated on the valuation account in previous reporting years was realised in comparison with 2010, lower gains from the disposal of debt securities mostly resulted from the interest rate rise in the euro area in the first half of 2011.

The realised gains or losses from financial operations were negatively affected by the negative result on derivative financial instruments, despite the fact that it was 8 573 thousand lats smaller than in 2010, mostly on account of the result of interest rate future contracts as well as the result of currency future contracts concluded for the purpose of hedging currency risks. The negative result of the currency future contracts concluded for the purpose of hedging currency risk exposure is offset in equal value by the positive revaluation result of the hedged balance sheet items reported in the balance sheet caption "Valuation account" as well as the realised gains on foreign exchange transactions recognised in the profit and loss account.

28. WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS

The revaluation result of several debt securities and foreign currency positions at the end of 2011 and 2010 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 debt securities and foreign currency positions has been reported in the balance sheet caption "Valuation account" (see also Note 25).

29. INCOME FROM PARTICIPATING INTEREST

Income from participating interest in the amount of 245 thousand lats (611 thousand lats in 2010) comprises the dividends received from the participating interest in the BIS (see also Note 11). In 2011, normal dividends were paid. The increase in dividends paid in 2010 was related to the BIS decision to pay normal dividends as well as supplementary dividends in view of the BIS financial performance results.

30. OTHER OPERATING INCOME

Other operating income in 2011 and 2010 was as follows:

(in thousands of lats)

	2011	2010
Income from sale of collector coins	**581**	702
Income from payment and securities settlement services	**379**	310
Other	**301**	266
Total	**1 261**	1 278

31. BANKNOTE PRODUCTION AND COINAGE COSTS

The breakdown of banknote production and coinage costs in 2011 and 2010 was as follows:

(in thousands of lats)

	2011	2010
Coinage of circulation coins	**–101**	–83
Coinage of collector coins	**–481**	–458
Total	**–582**	–541

32. REMUNERATION AND SOCIAL SECURITY COSTS

Remuneration and social security costs in 2011 and 2010 were as follows:

(in thousands of lats)

	2011	2010
Remuneration		
Remuneration of Members of the Council and the Board	**–895**	–873
Remuneration of other personnel	**–9 007**	–9 405
Total remuneration	**–9 902**	–10 278
Social security costs	**–2 373**	–2 449
Total remuneration and social security costs	**–12 275**	–12 727

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 2011 and 2010 was as follows:

	2011	2010
Number of employees at the end of the year		
Members of the Council and the Board	**13**	13
Other personnel	**543**	557
Total at the end of the year	**556**	570
Average number of employees per period	**563**	605

33. OTHER OPERATING EXPENSES

Other operating expenses in 2011 and 2010 were as follows:

(in thousands of lats)

	2011	2010
Municipal services	**–553**	–577
Maintenance of buildings, territory and equipment	**–398**	–328
Risk insurance	**–267**	–294
Acquisition of low value office supplies	**–227**	–113
Information and public relations	**–214**	–180
Business travel	**–209**	–192
Telecommunications services and system maintenance	**–167**	–189
Personnel training	**–139**	–156
Transport provision	**–109**	–126
Tax on real estate	**–91**	–89
Audit, advisory and legal services	**–27**	–34
Disposal of material values	**–3**	–255
Other	**–294**	–232
Total	**–2 698**	–2 765

The increase in the expenses for low value office supplies is mostly related to the implementation of a project for improving the organisation of the cash circulation process. The audit, advisory and legal services expenses also comprise the remuneration in the amount of 23 thousand lats paid to Deloitte Audits Latvia SIA for the audit of 2011 financial statements (22 thousand lats in 2010).

34. CASH FLOW STATEMENT

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

(in thousands of lats)

	2011	2010
Profit before appropriation	**32 028**	23 754
Non-cash transaction adjustments		
Depreciation of fixed assets and amortisation of intangible assets	2 948	3 044
Losses on disposal of fixed assets	2	255
Write-downs of revaluation result on financial assets and positions	16 556	12 995
Net non-cash transaction adjustments	**19 506**	16 294
Change in balance sheet items		
Net decrease of gold reserves	–	1
Net increase (–)/decrease in Special Drawing Rights	22 589	–1 687
Net increase (–)/decrease in foreign debt securities and other foreign investments	606 426	–1 056 008
Net decrease in loans to domestic credit institutions	–	140 449
Net increase (–)/decrease in other assets	–32	419
Net decrease in foreign convertible currency liabilities	–4 122	–5 324
Net increase/decrease (–) in foreign bank and other international institution deposits in lats	9 752	–23 770
Net increase in lats in circulation	222 279	149 749
Net increase/decrease (–) in deposits of domestic credit institutions	–492 490	574 553
Net decrease in Latvian government deposits	–343 922	–210 932
Net increase/decrease (–) in deposits of other financial institutions	–14 023	54 790
Net decrease in other liabilities	–279	–1 185
Net change in balance sheet items	**6 178**	–378 945
Net cash and cash equivalents inflow/outflow (–) arising from operating activities	**57 712**	–338 897

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

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

	2011	Change	2010	Change	2009
Convertible foreign currencies in cash	**13 611**	–2 102	15 713	–3 630	19 343
Demand deposits with foreign credit institutions and other foreign financial institutions	**519 867**	–11 868	531 735	–273 668	805 403
Time deposits with foreign credit institutions and other foreign financial institutions with original maturity up to 5 business days	**63 252**	54 050	9 202	–110 277	119 479
Total cash and cash equivalents	**596 730**	40 080	556 650	–387 575	944 225

35. TRANSACTIONS WITH THE LATVIAN GOVERNMENT

The Bank of Latvia is wholly owned by the Republic of Latvia and carries out transactions with the Treasury, 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 2011 and 2010 the Bank of Latvia did not perform such transactions). In the above transactions, the Bank of Latvia 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 2011 and 2010, the breakdown of the Bank of Latvia liabilities to the Latvian government and the respective interest rates were as follows:

	Amount (in thousands of lats)		Interest rate (%)	
	2011	2010	**2011**	2010
Liabilities				
Time deposits in foreign currencies	**259 124**	789 809	**0.32–0.51**	0.22–0.57
Demand deposits in foreign currencies	**242 523**	236 674	**0.00–0.22**	0.01–0.34
Demand deposits in lats	**235 441**	54 527	**0.57**	0.41
Accrued interest expense	**20**	95	**x**	x
Tax liabilities	**69**	80	**x**	x
Total net liabilities	**737 177**	1 081 185	**x**	x

In 2011 and 2010, 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 24–26):

(in thousands of lats)

	2011	2010
Expense and the Bank of Latvia's profit appropriated to the state budget		
Interest on government deposits	**7 125**	4 127
Taxes	**6 023**	6 118
Profit appropriated to the state budget	**15 440**	48 355
Total expense and the Bank of Latvia's profit appropriated to the state budget	**28 588**	58 600

36. PLEDGED ASSETS

Securities and other financial instruments with the market value of 23 720 thousand lats, as at the end of 2011 (18 968 thousand lats at the end of 2010), 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".

37. 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 2011, the fair value of Bank of Latvia's securities lent was 278 577 thousand lats (474 421 thousand lats at the end of 2010).

At the end of 2011 and 2010, the fair value of collateral provided in securities lending transactions was as follows:

(in thousands of lats)

	2011	2010
Foreign currency cash	**241 602**	323 344
Debt securities of foreign governments, financial institutions and non-financial corporations	**41 987**	158 698
Total	**283 589**	482 042

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 3.13).

38. DERIVATIVE FINANCIAL INSTRUMENTS AND SPOT EXCHANGE RATE CONTRACTS

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.

At the end of 2011 and 2010, the breakdown of the Bank of Latvia's derivative financial instruments and spot exchange rate contracts was as follows:

(in thousands of lats)

	Contract or notional amount		Book value			
			Assets		Liabilities	
	2011	2010	**2011**	2010	**2011**	2010
Non-traded financial derivative and spot exchange rate contracts with foreign financial institutions						
Forward exchange rate contracts and currency swap arrangements	**1 775 002**	1 803 979	**12 211**	1 292	**43 026**	18 542
Spot exchange rate contracts	**114 643**	54 523	**347**	1 152	**37**	6
Forward transactions in securities	**152 949**	202 350	**560**	381	**147**	526
Interest rate swap arrangements	**870**	–	**25**	–	**–**	–
Total	**x**	x	**13 143**	2 825	**43 210**	19 074
Spot exchange rate contracts with domestic institutions						
Spot exchange rate contracts	**–**	53 448	**–**	532	**–**	–
Total	**x**	x	**–**	532	**–**	–
Traded financial derivative contracts with foreign financial institutions						
Interest rate future contracts	**1 189 194**	2 336 784	**x**	x	**x**	x
Currency future contracts	**151 365**	319 217	**x**	x	**x**	x

The book value of the non-traded financial derivative contracts and spot exchange rate contracts is reported in the respective balance sheet captions of other assets or other liabilities (see also Notes 12, 15 and 19). Since settlement has been made for the change in the fair value of future contracts, it is reported as demand deposits in the balance sheet asset caption "Convertible foreign currencies".

At the end of 2011 and 2010, the book value and the fair value of non-traded contracts concluded by the Bank of Latvia and not reported at their fair value, were not materially different. The reconciliation of the book value and net fair value of these instruments at the end of 2011 and 2010 was as follows:

(in thousands of lats)

	Net fair value		Net book value		Difference	
	2011	2010	**2011**	2010	**2011**	2010
Non-traded financial derivative contracts with foreign financial institutions and spot exchange rate contracts						
Forward exchange rate contracts and currency swap arrangements	**–31 290**	–17 388	**–30 815**	–17 250	**–475**	–138
Spot exchange rate contracts	**311**	1 146	**310**	1 146	**1**	0
Total	**–30 979**	–16 242	**–30 505**	–16 104	**–474**	–138
Spot exchange rate contracts with domestic credit institutions						
Spot exchange rate contracts	–	532	–	532	–	0
Total	–	532	–	532	–	0

39. 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; in February 2010, the amount of the claim was increased from 185.6 million lats to 238.3 million lats. The claimant alleges that the Bank of Latvia, as the institution in charge of banking supervision at that time, is responsible for losses arising from the bankruptcy of JSC *Banka Baltija* in 1995. On 12 October 2010, the Civil Court Collegium of Riga District Court as 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 appealed the judgement of the court of first instance, thus it did not take effect. On 21 February 2012, the Chamber of Civil Court of the Supreme Court announced a condensed judgement whereby the court ruled that the claim against the Bank of Latvia be completely rejected and court expenses in the amount of 16 thousand lats and legal services in the amount of 150 thousand lats be collected from the JSC *Banka Baltija* undergoing liquidation. The claimant may appeal the judgement under cassation procedure to the Senate of the Supreme Court within 30 days of the date of producing a complete judgement. The Bank of Latvia is confident that the claim is without merits; therefore no provisions are recognised in the financial statements. In case of cassation claim is submitted, the final ruling on the case is expected no earlier than in 2014.

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 2011 and 2010, the Bank of Latvia's unpaid share in the ECB subscribed capital was 29 383 thousand euro (20 651 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 2011, the uncalled portion of the BIS share holding was 4 013 thousand SDR (3 367 thousand lats; 4 013 thousand SDR or 3 291 thousand lats at the end of 2010; see also Note 11).

At the end of 2011, the Bank of Latvia had issued collector coins in the nominal value of 1 556 thousand lats (1 528 thousand lats at the end of 2010) and gold circulation coins with a nominal value of 1 989 thousand lats (1 988 thousand lats at the end of 2010). These coins may be represented to the Bank of Latvia in exchange for lats at a nominal value. In the opinion of management of the Bank of Latvia, 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.

40. CURRENCY PROFILE

At the end of 2011 and 2010, the currency profile of the Bank of Latvia's assets, liabilities and off-balance sheet accounts was as follows:[1]

(in thousands of lats)

	LVL	EUR	USD	JPY	Gold	Other	Total
As at 31 December 2011							
Assets							
Foreign assets	13 312	1 851 498	1 176 038	238 913	210 066	17 715	3 507 542
Domestic assets	31 648	30	–	–	–	5	31 683
TOTAL ASSETS	**44 960**	**1 851 528**	**1 176 038**	**238 913**	**210 066**	**17 720**	**3 539 225**
Liabilities							
Foreign liabilities	61 916	5 910	4 442	33	–	71	72 372
Lats in circulation	1 160 183	–	–	–	–	–	1 160 183
Domestic liabilities	1 334 073	590 939	35 143	8 131	–	11 222	1 979 508
TOTAL LIABILITIES	**2 556 172**	**596 849**	**39 585**	**8 164**	**–**	**11 293**	**3 212 063**
Net position on balance sheet	–2 511 212	1 254 679	1 136 453	230 749	210 066	6 427	327 162
Net position on financial instruments' off-balance sheet accounts	–	1 542 642	–1 131 368	–227 796	–210 314	–3 231	–30 067
Net position on balance sheet and off-balance sheet accounts	–2 511 212	2 797 321	5 085	2 953	–248	3 196	297 095
Profile of the net position on balance sheet and off-balance sheet accounts (%)	**x**	**99.6**	**0.2**	**0.1**	**0**	**0.1**	**100.0**
Benchmark currency structure (%)	x	100.0	0	0	0	0	100.0
As at 31 December 2010							
TOTAL ASSETS	35 406	2 236 908	1 355 399	272 023	187 179	20 418	4 107 333
TOTAL LIABILITIES	2 749 097	848 059	173 601	20 357	–	19 579	3 810 693
Net position on balance sheet	–2 713 691	1 388 849	1 181 798	251 666	187 179	839	296 640
Net position on financial instruments' off-balance sheet accounts	53 980	1 552 017	–1 185 852	–252 006	–187 400	1 167	–18 094
Net position on balance sheet and off-balance sheet accounts	–2 659 711	2 940 866	–4 054	–340	–221	2 006	278 546
Profile of the net position on balance sheet and off-balance sheet accounts (%)	x	100.1	–0.2	0	0	0.1	100.0
Benchmark currency structure (%)	x	100.0	0	0	0	0	100.0

41. 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

[1] The assets, liabilities and off-balance sheet accounts as well as liabilities to the IMF (313 thousand lats) denominated in SDR and exposed to the SDR currency risk are reported as per the SDR basket of currencies.

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 2011							
Foreign assets							
Gold	–	–	–	–	–	210 066	210 066
Special Drawing Rights	79 069	–	–	–	–	–	79 069
Convertible foreign currencies	1 272 248	12 221	84 090	1 089 024	710 297	17 040	3 184 920
Participating interest in the European Central Bank	–	–	–	–	–	750	750
Participating interest in the Bank for International Settlements	–	–	–	–	–	18 997	18 997
Other foreign assets	22	–	–	–	–	13 718	13 740
Domestic assets							
Fixed assets	–	–	–	–	–	30 675	30 675
Other domestic assets	–	–	–	–	–	1 008	1 008
TOTAL ASSETS	**1 351 339**	**12 221**	**84 090**	**1 089 024**	**710 297**	**292 254**	**3 539 225**
Foreign liabilities							
Convertible foreign currencies	3 879	–	–	–	–	5 681	9 560
International Monetary Fund	–	–	–	–	–	313	313
Other international institution deposits in lats	–	–	–	–	–	18 271	18 271
Foreign bank deposits in lats	–	–	–	–	–	712	712
Other foreign liabilities	–	–	–	–	–	43 516	43 516
Lats in circulation	–	–	–	–	–	1 160 183	1 160 183
Domestic liabilities							
Balances due to credit institutions	1 029 688	–	–	–	–	168 052	1 197 740
Balances due to the government	655 637	–	–	–	–	81 451	737 088
Balances due to other financial institutions	41 027	–	–	–	–	1 688	42 715
Other domestic liabilities	27	–	–	–	–	1 938	1 965
TOTAL LIABILITIES	**1 730 258**	**–**	**–**	**–**	**–**	**1 481 805**	**3 212 063**
Net position on balance sheet	–378 919	12 221	84 090	1 089 024	710 297	x	x
Assets on financial instruments' off-balance sheet accounts	2 637 476	1 088	3 264	566 165	146 078	x	x
Liabilities on financial instruments' off-balance sheet accounts	2 753 163	865	3 264	376 752	250 094	x	x
Net position on balance sheet and off-balance sheet accounts	**–494 606**	**12 444**	**84 090**	**1 278 437**	**606 281**	**x**	**x**
As at 31 December 2010							
TOTAL ASSETS	1 853 158	102 874	144 036	904 889	857 959	244 417	4 107 333
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

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 2.1). In 2011 and 2010, the actual *(ex-post)* tracking errors of the portfolios managed against multi-currency fixed income securities benchmark were 54 basis points and 65 basis points respectively, whereas the tracking errors of the portfolios managed against asset-backed securities benchmark were 84 basis points and 81 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	100–110
During 2011					
Portfolios managed against multi-currency fixed income securities benchmark	2 388 804	–	253	–	–
Portfolios managed against asset-backed securities benchmark	175 883	–	171	76	6
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	–

42. LIQUIDITY PROFILE

At the end of 2011 and 2010, the liquidity profile of the Bank of Latvia's assets and liabilities was as follows:

(in thousands of lats)

	2011			2010		
	Up to 3 months	No fixed maturity	**Total**	Up to 3 months	No fixed maturity	Total
Assets						
Foreign assets	3 487 257	20 285	**3 507 542**	4 071 606	3 005	4 074 611
Domestic assets	376	31 307	**31 683**	690	32 032	32 722
TOTAL ASSETS	3 487 633	51 592	**3 539 225**	4 072 296	35 037	4 107 333
Liabilities						
Foreign liabilities	72 339	33	**72 372**	42 522	34	42 556
Lats in circulation	–	1 160 183	**1 160 183**	–	937 904	937 904
Domestic liabilities	1 979 508	–	**1 979 508**	2 830 233	–	2 830 233
TOTAL LIABILITIES	2 051 847	1 160 216	**3 212 063**	2 872 755	937 938	3 810 693
Net position on balance sheet	1 435 786	–1 108 624	**x**	1 199 541	–902 901	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.

43. SECTORAL PROFILE OF ASSETS

The sectoral profile of the Bank of Latvia's assets at the end of 2011 and 2010 was as follows:

	Amount (in thousands of lats)		Percentage (%)	
	2011	2010	**2011**	2010
Foreign central governments and other governmental institutions	**1 104 267**	1 234 527	**31.2**	30.1
Foreign local governments	**51 437**	64 268	**1.5**	1.6
Foreign central banks and credit institutions	**1 493 624**	1 809 206	**42.2**	44.0
Other foreign financial institutions	**668 356**	704 888	**18.9**	17.2
Foreign non-financial corporations	**78 127**	65 687	**2.2**	1.6
International institutions	**110 837**	196 395	**3.1**	4.8
Domestic credit institutions	**53**	584	**0**	0
Unclassified assets	**32 524**	31 778	**0.9**	0.7
Total	**3 539 225**	4 107 333	**100.0**	100.0

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

At the end of 2011 and 2010, 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 (%)	
	2011	2010	**2011**	2010
Euro area countries	**1 526 724**	1 910 391	**43.5**	46.9
Other EU countries	**725 868**	697 914	**20.7**	17.1
US	**519 974**	594 517	**14.8**	14.6
Japan	**231 590**	256 361	**6.6**	6.3
Other countries and international institutions	**503 386**	615 428	**14.4**	15.1
Total	**3 507 542**	4 074 611	**100.0**	100.0

45. ASSETS BY CREDIT RATINGS ASSIGNED TO THE COUNTERPARTY

At the end of 2011 and 2010, 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 (%)	
		2011	2010	**2011**	2010
FOREIGN ASSETS					
Gold	AAA	**210 066**	187 179	**5.9**	4.6
Special Drawing Rights	AAA	**79 069**	99 356	**2.2**	2.4
Foreign debt securities	AAA	**838 391**	1 814 171	**23.8**	44.1
	AA+	**361 359**	78 814	**10.2**	1.9
	AA	**149 536**	154 700	**4.2**	3.8
	AA–	**475 843**	483 514	**13.5**	11.8
	A+	**238 576**	129 596	**6.8**	3.2
	A	**350 477**	24 238	**9.9**	0.6
	A–	**6 662**	3 646	**0.2**	0.1
	BBB+	**806**	733	**0**	0
	BBB–	**373**	–	**0**	–
	BB+	**20 686**	–	**0.6**	–
Deposits with foreign financial institutions	AAA	**438 969**	518 452	**12.4**	12.7
	AA+	**31 985**	2 454	**0.9**	0.1
	AA	**25 867**	59 918	**0.7**	1.5
	AA–	**45 396**	133 053	**1.3**	3.2
	A+	**129 163**	190 607	**3.7**	4.6
	A	**57 220**	144 444	**1.6**	3.5
	A–	**–**	28 114	**–**	0.7
Foreign currency in cash	AAA	**13 607**	15 713	**0.4**	0.4
	AA+	**4**	–	**0**	–
Participating interest in the European Central Bank	AAA	**750**	750	**0**	0
Participating interest in the Bank for International Settlements	AAA	**18 997**	1 763	**0.5**	0
Derivative financial instruments	AAA	**560**	385	**0**	0
	AA	**–**	115	**–**	0
	AA–	**82**	470	**0**	0
	A+	**7 791**	1 503	**0.2**	0
	A	**4 609**	315	**0.1**	0
	A–	**101**	37	**0**	0
Accrued interest income	Different	**59**	79	**0**	0
Other foreign assets	Different	**538**	492	**0**	0
DOMESTIC ASSETS	Different	**31 683**	32 722	**0.9**	0.8
TOTAL		**3 539 225**	4 107 333	**100.0**	100.0

At the end of 2011 and 2010, 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 (%)	
		2011	2010	**2011**	2010
Foreign assets	AAA	**1 600 409**	2 637 769	**45.6**	64.8
	AA	**1 090 072**	913 038	**31.1**	22.4
	A	**794 599**	522 500	**22.7**	12.8
	BBB	**1 179**	733	**0**	0
	BB	**20 686**	–	**0.6**	–
	Different	**597**	571	**0**	0
Total		**3 507 542**	4 074 611	**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. "BBB" is a medium grade considered to be the lowest level of investment-grade rating, while BB" is a rating below investment grade implying that the counterparty's long-term creditworthiness is risky. Ratings below "AAA" are modified by marks "+" or "–" to show the relative standing within the major categories of credit ratings of an international credit rating agency.

TO THE COUNCIL OF THE BANK OF LATVIA

We have audited the accompanying financial statements of the Bank of Latvia ("the Bank") set out on pages 74 to 116, which comprise the balance sheet as at 31 December 2011, 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.

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 the auditor's 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, the auditor considers 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 policies 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 2011, 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	The State Audit Office of the Republic of Latvia
Inguna Stasa Member of the Board	Inguna Sudraba Auditor General
Riga, Latvia 13 March 2012	Riga, Latvia 15 March 2012

APPENDICES


LATVIJAS
1 LATS
REPUBLIKA


ALEKSANDRS
ČAKS
1901-1950


ALPINA

Appendix 1

MONETARY INDICATORS IN 2011

(at end of period; in millions of lats)

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	**XII**
BANK OF LATVIA												
M0	1 740.6	1 796.6	1 665.9	1 775.6	1 884.2	1 824.2	1 891.2	1 851.4	1 860.5	1 832.1	2 340.4	**2 168.9**
Currency in circulation	905.7	910.7	909.3	935.2	935.6	955.0	990.2	993.0	1 012.3	1 010.6	1 070.2	**1 160.2**
Demand deposits with the Bank of Latvia	834.9	885.9	756.6	840.3	948.7	869.2	900.9	858.4	848.2	821.5	1 270.2	**1 008.8**
Currency vs monetary base (%)	52.0	50.7	54.6	52.7	49.7	52.4	52.4	53.6	54.4	55.2	45.7	**53.5**
Net foreign assets	3 837.3	3 794.2	3 723.6	3 657.1	3 684.6	3 827.3	3 769.6	3 984.2	3 987.5	3 881.0	3 602.9	**3 435.2**
Net domestic assets	–2 096.7	–1 997.6	–2 057.7	–1 881.5	–1 800.4	–2 003.2	–1 878.4	–2 132.8	–2 126.9	–2 048.8	–1 262.5	**–1 266.2**
Credit	–1 108.0	–1 011.5	–930.9	–917.3	–895.6	–1 138.8	–1 207.4	–1 385.2	–1 388.0	–1 361.3	–950.3	**–737.1**
To MFIs	0	0	0	0	0	0	0	0	0	0	0	**0**
To government (net)	–1 108.0	–1 011.5	–930.9	–917.3	–895.6	–1 138.8	–1 207.4	–1 385.2	–1 388.0	–1 361.3	–950.3	**–737.1**
Other assets (net)	–988.7	–986.1	–1 126.8	–964.2	–904.8	–864.4	–671.0	–747.6	–738.9	–687.5	–312.2	**–529.1**
MFI												
M1	3 722.4	3 786.7	3 689.7	3 725.6	3 797.8	3 867.9	3 855.3	3 949.2	3 940.6	3 970.5	4 372.2	**4 357.4**
M2	6 388.3	6 436.7	6 407.4	6 351.1	6 443.6	6 383.7	6 347.9	6 413.9	6 395.6	6 333.3	6 384.0	**6 462.4**
M3	6 492.3	6 541.5	6 513.4	6 454.4	6 545.3	6 480.0	6 441.1	6 506.5	6 486.5	6 424.1	6 474.6	**6 659.7**
M2X	6 339.1	6 383.3	6 338.2	6 270.9	6 372.3	6 333.8	6 268.9	6 319.9	6 310.2	6 246.4	6 135.6	**6 486.1**
Currency outside MFIs	790.1	795.8	795.6	815.6	817.7	838.1	876.0	873.4	888.6	892.5	941.6	**1 040.0**
Deposits of resident financial institutions, non-financial corporations and households	5 549.0	5 587.5	5 542.6	5 455.3	5 554.6	5 495.7	5 393.0	5 446.5	5 421.6	5 354.0	5 194.0	**5 446.1**
In foreign currencies	2 831.7	2 884.0	2 893.1	2 851.1	2 893.9	2 906.8	2 874.1	2 927.7	2 915.0	2 829.3	2 777.2	**2 818.3**
Net foreign assets	–1 180.2	–1 081.1	–1 075.4	–1 109.2	–1 010.5	–656.7	–771.9	–567.7	–466.9	–543.8	–435.6	**–224.8**
Net domestic assets	7 519.3	7 464.4	7 413.7	7 380.2	7 382.7	6 990.5	7 040.8	6 887.6	6 777.1	6 790.2	6 571.2	**6 710.9**
Loans to resident financial institutions, non-financial corporations and households	12 326.6	12 193.2	12 072.0	11 960.8	11 927.4	11 808.6	11 794.5	11 773.6	11 736.4	11 697.0	11 634.2	**11 369.4**
INTEREST RATES												
Bank of Latvia refinancing rate (at end of period; %)	3.5	3.5	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	0.3	0.3	0.2	0.4	0.4	0.2	0.3	0.3	0.3	0.3	0.4	**0.4**
Loans to non-financial corporations and households with a floating interest rate and an initial rate fixation of up to 1 year (new business)	9.9	5.6	9.1	7.4	6.6	5.6	6.0	5.5	5.8	5.7	4.1	**5.4**
Time deposits of non-financial corporations and households (new business)	0.6	0.4	0.5	0.4	0.4	0.4	0.5	0.6	0.5	0.5	0.6	**0.8**

Appendix 2

THE BANK OF LATVIA MONTH-END BALANCE SHEETS FOR 2011

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

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	**XII**
FOREIGN ASSETS	3 874 998	3 804 178	3 742 555	3 687 502	3 710 995	3 853 996	3 820 650	4 027 599	4 036 849	3 924 270	3 642 204	**3 507 542**
Gold	167 324	178 018	176 158	180 013	188 066	183 022	196 644	216 084	207 259	215 263	224 068	**210 066**
SDR	97 054	91 325	93 313	87 205	84 527	83 880	84 958	78 705	81 628	79 511	77 090	**79 069**
Convertible foreign currencies	3 562 532	3 516 232	3 451 452	3 371 749	3 429 669	3 577 239	3 525 603	3 710 064	3 740 389	3 576 361	3 336 202	**3 184 920**
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	**18 997**
Other foreign assets	45 575	16 090	19 119	46 022	6 220	7 342	10 932	20 233	5 060	50 622	2 331	**13 740**
DOMESTIC ASSETS	31 877	32 080	32 264	32 104	32 032	31 663	31 699	31 684	31 747	31 672	31 541	**31 683**
Loans to credit institutions												**–**
Fixed assets	30 785	30 581	30 464	30 382	30 190	30 026	30 057	30 110	30 108	30 236	30 321	**30 675**
Other domestic assets	1 092	1 499	1 800	1 722	1 842	1 637	1 642	1 574	1 639	1 436	1 220	**1 008**
TOTAL ASSETS	3 906 875	3 836 258	3 774 819	3 719 606	3 743 027	3 885 659	3 852 349	4 059 283	4 068 596	3 955 942	3 673 745	**3 539 225**
FOREIGN LIABILITIES	37 688	9 958	18 951	30 430	26 359	26 683	51 074	43 449	49 381	43 312	39 343	**72 372**
Convertible foreign currencies	16 551	4 452	7 768	14 691	1 534	7 142	14 707	7 685	2 185	12 770	2 135	**9 560**
IMF	268	267	294	284	292	290	294	291	302	294	305	**313**
Other international institution deposits in lats	19 278	3 448	6 481	12 178	3 033	9 643	19 202	12 475	15 693	25 892	6 400	**18 271**
Foreign bank deposits in lats	474	608	620	350	902	376	6 190	656	1 551	1 698	1 236	**712**
Other foreign liabilities	1 117	1 183	3 788	2 927	20 598	9 232	10 681	22 342	29 650	2 658	29 267	**43 516**
LATS IN CIRCULATION	905 744	910 719	909 307	935 221	935 564	955 010	990 210	993 018	1 012 337	1 010 605	1 070 242	**1 160 183**
DOMESTIC LIABILITIES	2 680 708	2 631 587	2 559 984	2 479 062	2 494 552	2 616 382	2 521 328	2 716 924	2 700 917	2 595 395	2 277 424	**1 979 508**
Balances due to credit institutions	1 506 228	1 549 259	1 531 867	1 467 969	1 516 688	1 394 798	1 226 064	1 243 618	1 225 616	1 140 380	1 060 951	**1 197 740**
Balances due to the government	1 107 989	1 011 498	930 915	917 308	895 570	1 138 765	1 207 432	1 385 227	1 388 022	1 361 271	950 267	**737 088**
Balances due to other financial institutions	63 742	67 973	72 413	79 632	79 508	80 038	84 879	85 221	84 957	90 728	263 400	**42 715**
Other domestic liabilities	2 749	2 857	24 789	14 153	2 786	2 781	2 953	2 858	2 322	3 016	2 806	**1 965**
CAPITAL AND RESERVES	282 735	283 994	286 577	274 893	286 552	287 584	289 737	305 892	305 961	306 630	286 736	**327 162**
TOTAL LIABILITIES, CAPITAL AND RESERVES	3 906 875	3 836 258	3 774 819	3 719 606	3 743 027	3 885 659	3 852 349	4 059 283	4 068 596	3 955 942	3 673 745	**3 539 225**

Appendix 3

THE BANK OF LATVIA YEAR-END BALANCE SHEETS FOR THE YEARS 2007–2011

(at end of year; in thousands of lats)

	2007	2008	2009	2010	**2011**
FOREIGN ASSETS	2 806 790	2 734 395	3 384 585	4 074 611	**3 507 542**
Gold	99 130	108 998	134 365	187 179	**210 066**
SDR	83	187	91 237	99 356	**79 069**
Convertible foreign currencies	2 687 707	2 488 693	3 150 992	3 782 167	**3 184 920**
Participating interest in the ECB	743	743	750	750	**750**
Participating interest in the BIS	1 763	1 763	1 763	1 763	**18 997**
Other foreign assets	17 364	134 011	5 478	3 396	**13 740**
DOMESTIC ASSETS	41 211	679 200	175 719	32 722	**31 683**
Loans to credit institutions	6 850	639 263	140 449	–	**–**
Fixed assets	32 646	34 626	33 232	31 003	**30 675**
Other domestic assets[1]	1 715	5 311	2 038	1 719	**1 008**
TOTAL ASSETS	2 848 001	3 413 595	3 560 304	4 107 333	**3 539 225**
FOREIGN LIABILITIES	30 825	402 145	71 469	42 556	**72 372**
Convertible foreign currencies	5 330	131 252	19 006	13 682	**9 560**
IMF[1]	254	256	256	274	**313**
Other international institution deposits in lats	6 049	6 503	32 502	8 505	**18 271**
Foreign bank deposits in lats	35	247 001	499	726	**712**
Other foreign liabilities	19 157	17 133	19 206	19 369	**43 516**
LATS IN CIRCULATION	1 049 473	1 018 092	788 155	937 904	**1 160 183**
DOMESTIC LIABILITIES	1 597 218	1 751 384	2 412 922	2 830 233	**1 979 508**
Balances due to credit institutions	1 416 802	1 094 295	1 115 677	1 690 230	**1 197 740**
Balances due to the government	171 241	638 056	1 291 942	1 081 010	**737 088**
Balances due to other financial institutions	4 876	1 705	1 948	56 738	**42 715**
Other domestic liabilities	4 299	17 328	3 355	2 255	**1 965**
CAPITAL AND RESERVES	170 485	241 974	287 758	296 640	**327 162**
Nominal capital	25 000	25 000	25 000	25 000	**25 000**
Reserve capital	59 508	95 533	114 236	140 273	**148 587**
Valuation account	34 513	68 004	74 129	107 613	**121 547**
Profit of the reporting year	51 464	53 437	74 393	23 754	**32 028**
TOTAL LIABILITIES, CAPITAL AND RESERVES	2 848 001	3 413 595	3 560 304	4 107 333	**3 539 225**

[1] In the financial statements for 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. Since 2008, 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 2007–2011

(in thousands of lats)

	2007[1]	2008	2009	2010	**2011**
INTEREST INCOME					
Foregn operations	125 829	143 646	59 245	57 055	**73 265**
Domestic operations	3 278	7 264	26 925	3 618	**13**
INTEREST EXPENSE					
Foregn operations	–24 255	–11 923	–1 662	–967	**–494**
Domestic operations	–36 122	–54 461	–18 515	–13 362	**–11 475**
NET INTEREST INCOME	68 730	84 526	65 993	46 344	**61 309**
REALISED GAINS OR LOSSES FROM FINANCIAL OPERATIONS (–)[2]	14 310[3]	34 886	36 959	9 147	**5 942**
INCOME FROM PARTICIPATING INTEREST[4]	216	206	221	611	**245**
WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS	–5 862	–38 087	–5 474	–12 995	**–16 556**
OTHER OPERATING INCOME	1 195	3 433	4 683	1 278	**1 267**
BANKNOTE PRODUCTION AND COINAGE COSTS[5]	–3 772	–4 046	–4 695	– 541	**– 582**
OTHER OPERATING EXPENSES	–23 353	–27 481	–23 294	–20 090	**–19 597**
PROFIT OF THE REPORTING YEAR	51 464	53 437	74 393	23 754	**32 028**
Profit transferrable to the reserve capital	36 025	18 703	26 038	8 314	**11 210**
Profit transferrable to the state budget	15 439	34 734	48 355	15 440	**20 818**

Appendix 5

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

(LVL vs foreign currency)

2011	GBP				100 JPY				USD			
	Maximum	Average	Minimum	At end of period	Maximum	Average	Minimum	At end of period	Maximum	Average	Minimum	At end of period
I	0.8460	0.8298	0.8120	0.8150	0.6550	0.6391	0.6200	0.6200	0.5450	0.5276	0.5120	0.5120
II	0.8400	0.8296	0.8190	0.8210	0.6310	0.6230	0.6180	0.6200	0.5200	0.5142	0.5080	0.5090
III	0.8290	0.8135	0.7990	0.7990	0.6370	0.6165	0.6020	0.6020	0.5110	0.5031	0.4940	0.4990
IV	0.8050	0.7967	0.7900	0.7910	0.6010	0.5854	0.5730	0.5790	0.4970	0.4881	0.4730	0.4730
V	0.8110	0.7996	0.7810	0.8110	0.6160	0.6016	0.5790	0.6090	0.5010	0.4885	0.4730	0.4920
VI	0.8080	0.7949	0.7820	0.7820	0.6170	0.6066	0.5980	0.6030	0.4970	0.4886	0.4790	0.4890
VII	0.8040	0.7920	0.7770	0.7990	0.6320	0.6181	0.5990	0.6290	0.5030	0.4912	0.4840	0.4900
VIII	0.8100	0.8024	0.7920	0.7940	0.6450	0.6350	0.6210	0.6300	0.4980	0.4904	0.4840	0.4840
IX	0.8220	0.8039	0.7940	0.8070	0.6870	0.6615	0.6360	0.6740	0.5240	0.5080	0.4870	0.5160
X	0.8220	0.8074	0.7970	0.7970	0.6940	0.6705	0.6530	0.6530	0.5320	0.5137	0.4960	0.4960
XI	0.8270	0.8191	0.8030	0.8170	0.6820	0.6679	0.6330	0.6740	0.5280	0.5180	0.5020	0.5260
XII	0.8440	0.8315	0.8170	0.8400	0.7000	0.6845	0.6710	0.7000	0.5440	0.5328	0.5220	0.5440

[1] Data of 2007 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 2007, realised gains or losses from investment in financial instruments 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 2007, income from participating interest is reported under the profit and loss statement caption "Interest and similar income".
[5] In the financial statements for 2007, banknote production and coinage costs are reported under the profit and loss statement caption "Other operating expenses".

Appendix 6

THE BANK OF LATVIA ORGANISATIONAL UNITS AT THE END OF 2011

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. CASH 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 Cash Technology Division (Head of Division – Andris Tauriņš)
2.4 Riga Branch (Branch Manager – Jānis Strēlnieks)
2.5 Liepāja Branch (Branch Manager – Gundars Lazdāns)
2.6 Daugavpils Branch (Branch Manager – Ināra Brauna)

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

4. INFORMATION SYSTEMS DEPARTMENT
(Head of Department – Harijs Ozols; Deputy Head of Department[1])
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[2] – 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 – Valērijs Kondratjevs)

5. INTERNAL AUDIT DEPARTMENT
(Head of Department – Leo Ašmanis; Deputy Heads of Department – Anita Hāznere[3], 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)

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[1] Vacancy.
[2] As of 23 January 2012, Head of Division, Deputy Head of Department.
[3] Until 16 January 2012.

Appendix 6 (cont.)

8.2 Risk Management Division (Head of Division, Deputy Head of Department – Daira Brunere)
8.3 Payments Division (Head of Division – Una Ruka)

9. MONETARY POLICY DEPARTMENT
(Head of Department – Kārlis Bauze; Deputy Heads of Department – Uldis Rutkaste, Elmārs Zakulis)
9.1 Macroeconomic Analysis Division (Head of Division – Santa Bērziņa)
9.2 Financial Market Analysis Division (Acting Head of Division – 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[1] – 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 – Igo Peičs)
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. TRAINING CENTRE
(Head of Centre – Zaiga Blūma)

[1] Vacancy.

Appendix 7

REPRESENTATION OF THE BANK OF LATVIA IN INTERNATIONAL ORGANISATIONS

EUROPEAN UNION

ESRB

Ilmārs Rimšēvičs, Governor of the Bank of Latvia (Banking Supervisory Institution is represented by Irēna Krūmane[1], Chairperson of the FCMC)

Advisory Technical Committee of the ESRB

Zoja Rasmusa, Member of the Bank of Latvia's Council (Banking Supervisory Institution is represented by Ludmila Vojevoda, Member of the Council of the FCMC)

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, Cash Department

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

Aleksandra Bambale, Deputy Head of International Relations and Communication Department, Head of International Relations and Protocol Division

EBA

Vita Pilsuma, Member of the Bank of Latvia's Council (Banking Supervisory Institution is represented by Irēna Krūmane[2], Chairperson 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

Inese Allika, Counsellor of the Bank of Latvia at the Permanent Representation of Latvia to the EU

Public Administration Network (PAN II)

Antra Trenko, Senior Economist of International Relations and Protocol Division, International Relations and Communication Department

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, Head of Accounting Department, Chief Accountant of the Bank of Latvia
Gatis Gersons, Head of Financial Statements and Accounting Policy Division, Accounting Department

Banknote Committee (BANCO)

Jānis Blūms, Head of Cash Department
Veneranda Kausa, Deputy Head of Cash Department

[1] As of 31 January 2012, Mr. Kristaps Zakulis, Chairman of the FCMC.
[2] As of 25 January 2012, Mr. Kristaps Zakulis, Chairman of the FCMC.

Appendix 7 (cont.)

Financial Stability Committee
Jeļena Zubkova, Head of Financial Stability Division, Monetary Policy Department
Elmārs Zakulis, Deputy Head of Monetary Policy Department

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

Human Resources Conference (HRC)
Vineta Veikmane, Deputy 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[1]

Internal Auditors Committee (IAC)
Leo Ašmanis, Head of Internal Audit Department
Anita Hāznere, Deputy Head of Internal Audit Department[2]

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

[1] Until 30 December 2011. Aso f 2 January 2012, Mr. Valdis Spūlis, Head of the Bank Information System Maintenance and Development Division of the Information Systems Department (as of 23 January 2012, Deputy Head of the Information Systems Department, Head of the Bank Information System Maintenance and Development Division).
[2] Until 16 January 2012. As of 25 January 2012, Mr. Juris Ziediņš, Deputy Head of Internal Audit Department.

Appendix 7 (cont.)

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 2011

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 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 2010
Financial Stability Report (2010)
Latvijas Maksājumu Bilance. Latvia's Balance of Payments (2010)
Macroeconomic Development Report (January, April, July and October (No 1–4) 2011)
Payment and Securities Settlement System Oversight Carried Out by the Bank of Latvia in 2010

WORKING PAPERS

BEŅKOVSKIS, Konstantīns, FADEJEVA, Ludmila, KALNBĒRZIŅA, Krista (2011) – *Price Setting Behaviour in Latvia: Econometric Evidence from CPI Micro Data. Latvijas Banka* Working Paper, No 1.
VĪTOLA, Kristīne, AJEVSKIS, Viktors (2011) – *Fixed Exchange Rate Versus Inflation Targeting: Evidence from DSGE Modelling. Latvijas Banka* Working Paper, No 2.
VĪTOLA, Kristīne, AJEVSKIS, Viktors (2011) – *Housing and Banking in a Small Open Economy DSGE Model. Latvijas Banka* Working Paper, No 3.

DISCUSSION PAPER

MEĻIHOVS, Aleksejs, KASJANOVS, Igors (2011) – *The Convergence Processes in Europe and Latvia. Latvijas Banka* Discussion Paper, No 1.

PUBLICATIONS

AJEVSKIS, Viktors (2011) – A Target Zone Model with the Terminal Condition of Joining a Currency Area. *Applied Economics Letters*, vol. 18, No 13, pp. 1273–1278. Available at: http://www.tandfonline.com/doi/abs/10.1080/13504851.2010.534053.
BEŅKOVSKIS, Konstantīns, BESSONOVS, Andrejs, FELDKIRCHER, Martin, WÖRZ, Julia (2011) – The Transmission of Euro Area Monetary Shocks to the Czech Republic, Poland and Hungary: Evidence from a FAVAR Model. *Focus on European Economic Integration*, No 3, pp. 8–36. Available at: http://www.oenb.at/en/img/feei_2011_q3_studies_01_tcm16-237365.pdf.
BEŅKOVSKIS, Konstantīns, RIMGAILAITE, Ramune (2011) – The Quality and Variety of Exports from the New EU Member States. *Economics of Transition*, vol. 19, No 4, pp. 723–747. Available at: http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0351.2011.00423.x/abstract.
BENKOVSKIS, Konstantins, CAIVANO, Michele, D'AGOSTINO, Antonello, DIEPPE, Alistair, HURTADO, Samuel, KARLSSON, Tohmas, ORTEGA, Eva, VÁRNAI, Tímea (2011) – *Assessing the Sensitivity of Inflation to Economic Activity*. ECB Working Paper, No 1357, 22 June. Available at: http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1357.pdf.
BENKOVSKIS, Konstantins, WÖRZ, Julia (2011) – *How Does Quality Impact on Import Prices? Oesterreichische Nationalbank* Working Paper, No 175. Available at: http://www.oenb.at/en/img/wp175_tcm16-242934.pdf.

Appendix 9

2011 HIGHLIGHTS OF RESOLUTIONS AND REGULATIONS ADOPTED IN PURSUIT OF THE BANK OF LATVIA'S MAIN TASKS

Regulatory document	No	Date of adoption (effective date)	Title of the regulatory document adopted by the Bank of Latvia's Council
Regulation	189/5	13.01.2011 (01.02.2011)	"Amendments to the Bank of Latvia's Council Regulation No 166/1 'Regulation on Participation in the Securities Settlement System of the Bank of Latvia' of 20 April 2009"
Order	189/6	13.01.2011	"On 'The Bank of Latvia's Payment and Securities Settlement System Policy' "
Regulation	69	13.01.2011 (24.01.2011)	"Amendment to the Bank of Latvia Regulation No 26 'Regulation for Calculating and Fulfilling the Minimum Reserve Requirements for Banks' of 15 January 2009"
Regulation	70	13.01.2011 (01.02.2011)	"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	71	26.04.2011 (30.04.2011)	"On Deeming Invalid the Bank of Latvia's Council Resolution No 98/6 'On Approval of the 'Regulation for Issuance and Maintenance of Electronic Money' ' of 14 November 2002"
Regulation	72	12.05.2011 (14.05.2011)	"Amendments to the Bank of Latvia Regulation No 26 'Regulation for Calculating and Fulfilling the Minimum Reserve Requirements for Banks' of 15 January 2009"
Regulation	73	12.05.2011 (13.05.2011)	"On Deeming Invalid the Bank of Latvia's Council Resolution No 45/3 'On Approval of the 'Regulation for Compiling Bank Statements' ' of 12 March 1998"
Regulation	74	12.05.2011 (20.05.2011)	"Regulation for Compiling 'Credit Institution and Electronic Money Institution Payment Statistics Report' "
Regulation	75	12.05.2011 (20.05.2011)	"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	76	12.05.2011 (15.06.2011)	"Amendment to the Bank of Latvia Regulation No 38 'Description of Lats Banknotes and Coins' of 13 May 2009"
Regulation	77	12.05.2011 (01.09.2011)	"Amendments to the Bank of Latvia Regulation No 36 'Regulation for Purchasing and Selling Cash Foreign Currency' of 13 May 2009"
Regulation	193/6	12.05.2011 (01.06.2011)	"Amendments to the Bank of Latvia's Council Regulation No 183/3 'Regulation for the Participation Procedure in the Bank of Latvia's Electronic Clearing System' of 9 September 2010"
Regulation	193/7	12.05.2011 (01.06.2011)	"Amendments to the Bank of Latvia's Council Regulation No 172/9 'Regulation for the Participation Procedure in the Bank of Latvia's Interbank Automated Payment System' of 5 November 2009"
Regulation	193/8	12.05.2011 (01.06.2011)	"Amendments to the Bank of Latvia's Council Regulation No 186/4 'Regulation for the Participation Procedure in TARGET2-Latvija' of 4 November 2010"
Regulation	78	13.07.2011 (25.07.2011)	"Amendments to the Bank of Latvia Regulation No 62 'Regulation for the Credit Register' of 18 October 2010"
Regulation	79	13.07.2011 (25.07.2011)	"Amendments to the Bank of Latvia Regulation No 66 'The Amount of and the Payment Procedure for the Fees to Be Paid for the Use of the Credit Register' of 4 November 2010"
Regulation	80	13.07.2011 (25.07.2011)	"Amendments to the Bank of Latvia Regulation No 64 'Regulation for Electronic Information Exchange with the Bank of Latvia' of 18 October 2010"
Regulation	195/10	13.07.2011 (01.09.2011)	"Regulation for the Participation Procedure in the Lats Cash Transactions at the Bank of Latvia"
Regulation	196/3	15.09.2011 (21.11.2011)	"Amendment to the Bank of Latvia's Council Regulation No 183/3 'Regulation for the Participation Procedure in the Bank of Latvia's Electronic Clearing System' of 9 September 2010"
Regulation	197/4	15.11.2011 (21.11.2011)	"Amendments to the Bank of Latvia's Council Regulation No 186/4 'Regulation for the Participation Procedure in TARGET2-Latvija' of 4 November 2010"

Appendix 9 (cont.)

Regulatory document	No	Date of adoption (effective date)	Title of the regulatory document adopted by the Bank of Latvia's Council
Regulation	197/5	15.11.2011 (21.11.2011)	"Amendments to the Bank of Latvia's Council Regulation No 172/9 'Regulation for the Participation Procedure in the Bank of Latvia's Interbank Automated Payment System' of 5 November 2009"
Regulation	81	15.11.2011 (25.11.2011)	"Amendments to the Bank of Latvia Regulation No 62 'Regulation for the Credit Register' of 18 October 2010"
Regulation	82	15.11.2011 (01.01.2012)	"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	83	15.11.2011 (09.12.2011)	"Amendment to the Bank of Latvia Regulation No 38 'Description of Lats Banknotes and Coins' of 13 May 2009"

Appendix 10

GLOSSARY

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

Balance of payments: a statistical report that reflects Latvia's economic transactions with the rest of the world 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.

Bank of Latvia's 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.

Bank of Latvia's 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.

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 net position of each settlement participant by netting all payment documents submitted by the settlement participants, i.e. establishing net cash liabilities to or claims on other settlement participants.

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. Latvian credit institutions 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 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 to make one or more payment(s) to the holder of the securities at a specified future date or dates (e.g. bonds, notes). 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. Short-term debt securities are debt securities issued with an original maturity of up to one year (inclusive). Long-term debt securities are debt securities issued with an original maturity of over one year.

Appendix 10 (cont.)

Demand loan: a collateralised loan granted to credit institutions 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 credit institutions registered in the Republic of Latvia to make overnight deposits and 7-day deposits with the Bank of Latvia on their own initiative.

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.

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 2011, the euro area comprised Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

European Banking Authority (EBA): an EU body with legal personality which is a part of the EFSF. 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.

Appendix 10 (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): an independent body of the EU which forms part of the ESFS. 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, taking into account macroeconomic developments, so as to avoid periods of widespread financial distress. It contributes to the smooth functioning of the internal market and thereby ensures a sustainable contribution of the financial sector to economic growth. 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 2011, Denmark, Latvia and Lithuania were members of the ERM II.

Financial auxiliary: a financial institution that is 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. The FCMC, NASDAQ OMX Riga, the LCD, insurance brokerage companies, capital companies engage in cash buying and selling of foreign currencies as well as investment management corporations are regarded as financial auxiliaries.

Financial institutions other than MFIs: other financial intermediaries, financial auxiliaries, insurance corporations and pension funds.

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

Appendix 10 (cont.)

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 credit institutions registered in the Republic of Latvia for lats, simultaneously concluding a forward foreign currency sales deal, or sells foreign currency to credit institutions 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 credit institutions 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 general 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.

Household: a natural person or group of natural persons in the capacity of a consumer and a producer of goods and a provider of non-financial services exclusively for its own final consumption. In Latvia, a household is also a sole proprietor who has not registered its activity with the Commercial Register of the Enterprise Register of the Republic of Latvia.

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.

Liquidity risk: a risk of a failure to meet liabilities when due.

Local government: public institutions, whose competence covers only a local economic territory. The list of the institutional units of the Latvian general government 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 credit institutions registered in the Republic of Latvia are granted collateralised loans. The minimum bid rate at the

Appendix 10 (cont.)

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 credit institutions 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 credit institutions 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 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 central bank, credit institution, credit union, money market fund and other financial institution whose business is to receive deposits or close substitutes for deposits from customers other than MFIs and, on their own account, to grant credits and invest in securities, as well as an electronic money institution whose core business is to issue electronic money. 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 Statistics). The list is also available on the ECB website where the ECB publishes on a regular basis the list of MFIs of (see Links on the Bank of Latvia's website at www.bank.lv). At the end of 2011, Latvia's MFIs were: the Bank of Latvia, 31 credit institutions, two money market funds and 38 other MFIs (including 33 credit unions and five electronic money institutions).

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, or threats to the employees of the Bank of Latvia, its information, information systems and technical resources, or material values.

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: 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. Other financial intermediaries 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 credit institutions registered in the Republic of Latvia to purchase or sell lats-denominated debt securities. The maximum purchase price in outright purchases of 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 credit institutions 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

Appendix 10 (cont.)

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 credit institutions registered in the Republic of Latvia subject to the minimum reserve requirements.

Reserve holdings: money holdings of credit institutions 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 credit institutions 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 credit institutions 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 credit institutions included on the quotation list at which these credit institutions are willing to borrow cash assets in lats from other credit institutions. 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 credit institutions included on the quotation list at which these credit institutions are willing to lend cash assets in lats to other credit institutions. 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): an 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 one and the same main provisions, rights and obligations. As at the end of 2011, 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 credit institutions 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 credit institutions 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 2011

Latvijas Banka (Bank of Latvia)
K. Valdemāra iela 2A, Riga, LV-1050, Latvia
Tel.: +371 67022300   Fax: +371 67022420
http://www.bank.lv
info@bank.lv
Printed by *McĀbols poligrāfija Ltd*.