LATVIJAS BANKA

BANK OF LATVIA: ANNUAL REPORT 2008

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

Details may not add because of rounding-off.

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

Photos by Ainars Meiers and Andris Tenass.

The cut-off date is 20 April 2009.

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ABBREVIATIONS

BIS	Bank for International Settlements
CEBS	Committee of European Banking Supervisors
CIF	cost, insurance and freight at the importer's border
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
CSB	Central Statistical Bureau of Latvia
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EFC	Economic and Financial Committee
EKS	Bank of Latvia's Electronic Clearing System
EMU	Economic and Monetary Union
ERM II	Exchange Rate Mechanism II
ESCB	European System of Central Banks
EU	European Union
EU10	countries which joined the EU on 1 May 2004
EU12	countries which joined the EU on 1 May 2004 and on 1 January 2007
EU15	EU countries before 1 May 2004
Eurostat	Statistical Bureau of the European Community
FCMC	Financial and Capital Market Commission
FM	Ministry of Finance of the Republic of Latvia
FOB	free on board at the exporter's border
FRS	US Federal Reserve System
GDP	gross domestic product
IMF	International Monetary Fund
ISO	International Organization for Standardization
JSC	joint stock company
LCD	Latvian Central Depository
M0	monetary base
M1	narrow monetary aggregate
M2	intermediate monetary aggregate
M2X	broad money
M3	broad monetary aggregate
MFI	monetary financial institution
NACE	Statistical classification of economic activities within the Community *(Nomenclature statistique des activités économiques dans la Communauté européenne)*
NEER	nominal effective exchange rate
OECD	Organisation for Economic Co-operation and Development
OMXBGI	Baltic equity index
OMXR	*NASDAQ OMX Riga* (Riga Stock Exchange before 12 January 2009) index
OMX Riga	capitalisation-based total return index including all company shares quoted on the Riga Stock Exchange Main List and the Riga Stock Exchange Secondary List
Plc	public limited company
PPI	Producer Price Index
REER	real effective exchange rate
SAMS	Bank of Latvia's Interbank Automated Payment System
SEPA	Single Euro Payments Area
SDR	Special Drawing Rights
SJSC	state joint stock company
UK	United Kingdom
US	United States of America
VAT	value added tax
VNS	the Bank of Latvia securities settlement system

FOREWORD OF THE GOVERNOR

For the Latvian economy, 2008 was a year of radical change: from a gradual levelling off of the economic overheating effects, which had had a hopeful start with the reduction in the GDP growth rate, inflation and the current account deficit to the necessity to request international help in order to prevent a possible insolvency of the state and a wide economic crisis. The reasons behind this are to be found in both local and international developments and their overlaps.

The calls for managing the economy with a budget surplus during the time of buoyant economic growth in order to prepare a coordinated response to the overheating of the economy and develop a security reserve for leaner times were heeded too late. Expectations of quickly achieving the EU standard of living, encouraged by EU accession as well as excessive optimism created by EU funds, direct investment, repatriation of funds by residents employed outside Latvia and, most of all, expansion of lending led to warnings by the central bank and other experts that the economy was in danger of overheating and its further development was thus threatened being ignored. This led to painful consequences as the development cycle entered a downturn and both GDP and tax income diminished sharply. As of the second half of 2008, the rapidly aggravating global financial crisis further undermined Latvia's economic situation.

In November, concerns for the stability of the financial system and smooth functioning of the economy were behind the state taking over the second largest Latvian commercial bank. The required financing became the decisive incentive to approach the international lenders (the European Commission, International Monetary Fund, World Bank, and European Bank for Reconstruction and Development) and an agreement was reached in December on a 3-year credit line amounting to 5.3 billion lats (7.5 billion euro).

The loan is based on several conditions, which, if met, would help to stabilise Latvia's economic situation and create the environment for sustainable growth in the future, i.e. responsible budget policies, reductions in salaries that had outpaced productivity in recent years, stabilisation of the banking system, and implementation of long overdue structural reforms in health care, education, and public administration. The cornerstone of the programme is the introduction of the euro in 2012 and a fixed exchange rate of the lats vis-à-vis the euro, keeping in mind that devaluation of the national currency would lead to loss that for Latvia would be much greater than any perceived or real gains from export competitiveness.

Expecting decreasing inflation over the course of the year and noting that the banks with a slower lending growth have a lesser influence on domestic demand, the Bank of Latvia, in 2008, unwound its tight monetary policy framework. The minimum reserve requirement, a set percentage of their liabilities to be deposited with the central bank, served as the most important monetary policy instrument. The Bank of Latvia gradually decreased the reserve ratio raised during the period of overheating in the economy from 8% to 3% and 5% depending on the maturity of the liabilities over 2008. This policy measure by the central bank lent support to the banking system which thereby gained substantial liquidity at a time of aggravating global financial crisis. The refinancing rate, which, under conditions of a fixed lats exchange rate, has more of a signalling instead of real effect, remained unchanged (at 6%), whereas the deposit facility and marginal lending facility rates were used to foster activity in the interbank market. In March 2009, the refinancing rate was already reduced to 5%.

As for the future, the ability of the government to develop fiscal policies consistent with the stabilisation programme, not exceeding the budget deficit target and implementing the envisioned structural reforms, will be decisive. In view of the fact that the economic downslide, affected by both internal and external factors, will continue, it will not be easy yet vitally important if a balanced and sustainable growth of the economy is expected to resume. Stimulation of lending is no less important: in addition to the monetary policy instruments already in use it should be supported through state guarantees that would help the banking sector to become more decisive under conditions of increased uncertainty.

In 2008, six collector coins were issued; several of them were dedicated to the 90th anniversary of Latvian statehood. Continuing to vary the design of Latvian money with limited issue one-lats coins, the Bank of Latvia issued coins with images of a waterlily and chimney-sweep. In the traditional public survey, Coin of Time II won the title of Latvia's Coin of the Year 2007.

The Bank of Latvia considers the deepening of public understanding of its functions, decisions, and the development of the Latvian economy an important task. In view of this, the most topical issues, including the introduction of the euro, which is both necessary and not to be postponed, became the themes of the reports and discussions at the Bank of Latvia's annual conference.

I would like to extend my heartfelt thanks to the Council and Board of the Bank of Latvia for a successful management of Bank of Latvia's work and to each and every employee for their creativity and responsibility in helping the Bank of Latvia execute its tasks.

Ilmārs Rimšēvičs
Governor of the Bank of Latvia
Riga, 5 April 2009

THE BANK OF LATVIA'S 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.

NATIONAL ECONOMY DEVELOPMENTS AND MONETARY POLICY

GLOBAL ECONOMIC ENVIRONMENT

The financial market tensions that emerged in the US in the summer of 2007, unfolded in the autumn of 2008, turning into a broad-based global economic crisis. Lending started to stagnate, stock markets collapsed, and a number of large financial institutions filed for bankruptcy jeopardising the regular functioning of the international financial system. Huge concerted actions by several governments to ensure liquidity were insufficient to halt a further deterioration of financial markets. Anti-crisis programmes were developed by the governments of both the US and European countries. The situation was brought under partial control; however, a relatively strong uncertainty about the future outlook lingered and overall confidence of consumers and businesses at the end of 2008 was exceptionally low. Almost none of the economies, either industrialised or developing, were able to succeed in avoiding the repercussions from the crisis.

The euro area economy started on a downturn in 2008 and the growth in GDP which had been decelerating since the second quarter, translated into a mere 0.8% increase in GDP in the year overall (2.7% in 2007). All sectors of the economy recorded either moderation or a drop, with manufacturing hit the hardest. Against the backdrop of weakening external demand, production narrowed and producers' confidence worsened sharply. Consequently, at the end of the year, the situation in Germany and France, the major euro area countries, was extremely difficult due to industrial production's historical role as one of the major drivers of economic growth. Private demand contracted notably. Inflation associated with global oil and food price elevations spiked upwards and impaired consumer purchasing power in the summer months. In autumn, despite inflation abating gradually, consumer purchasing power was eroded by tighter credit conditions resulting from the aggravating global financial crisis.

In the initial months of 2008, the Baltic States, Poland, the Czech Republic, and Hungary recorded a relatively buoyant economic growth. In the course of the year overall, the GDP growth rate in these countries was losing momentum, particularly in the fourth quarter when GDP growth became sluggish in the Czech Republic, Estonia, Hungary, and Latvia. The Baltic States reaped the unwelcome fruit of economic overheating of the previous years, while the economic activity in Poland and the Czech Republic was impaired by a drop in external demand as the euro countries, which also suffered from recession, were their major export markets. Industrial production was on a particularly strong downward trend in Poland and the Czech Republic at the end of the year.

In the UK, the financial crisis affected all sectors of the economy; hence, in 2008 overall, GDP growth proceeded at a slow pace (0.7%), with the most pronounced deceleration in the financial sector growth. In the wake of tighter financing conditions constraining household spending, private demand contracted. Financing conditions also affected the non-financial sector, e.g. the situation in construction deteriorated and industrial output shrank.

Sweden's GDP decreased by 0.2% as a substantial economic downturn began in the country in the fourth quarter. It had implications for all sectors of the economy, with foreign trade, where both exports and imports shrank rapidly, impaired the most. As exports account for around 50% of Sweden's GDP, this downturn in the foreign trade turnover strongly hit the economy.

The National Bureau of Economic Research (NBER) announced in December 2008 that the US economy had been in recession since December 2007. In the initial quarters of the year, the GDP growth was positive, whereas in the third quarter GDP dropped 0.5%. During the closing months of the year, the economic situation continued to deteriorate, with GDP decreasing by 6.2% in the fourth quarter. Unemployment rose rapidly, with over 2.5 million people (the largest number since 1945) losing jobs in the US in 2008 when the crisis from the manufacturing and construction sectors spilled over to services.

Russia's economic growth, which at the beginning of 2008 was robust, lost much of its momentum at the year's end; in the year overall, GDP increased by 5.6% (by 8.1% in 2007). In order to give external trade a boost, the Bank of Russia widened the fluctuation band of the Russian ruble on several occasions.

In the first half of 2008, oil prices surged, in early July jumping to a record of 144 US dollars per barrel. In the second half of the year, however, a steep downslide followed and at the end of the year the oil price was 35 US dollars per barrel. Oil price developments depended on many factors. The fundamentals were of essential importance, i.e. in the first half of the year, a fall in the demand for oil in the developed countries was offset by a vigorous rise in the demand for oil in China and India; nevertheless, the global oil supply remained broadly unchanged. In the second half of the year, the demand for oil weakened also in the developing countries. The declining trend in oil prices failed to be substantially affected by the decision of the OPEC countries to cut oil production quotas. The contribution of speculative capital flows was also substantial. In the first half of the year, market players opted for safer investing, e.g. in oil products, of their large financial resources, including loaned funds. In the second half of the year, however, as the financial situation aggravated, many market agents were compelled to close their oil commodity positions in order to obtain the needed funds and, as a result, oil prices were subject to downward pressures. The prices of non-ferrous and precious metals were also down in the second half of the year.

Surging oil prices in the first half of the year pushed up inflation, which is why the ECB raised the euro base rate by 25 basis points (to 4.25%) on 3 July. When inflationary pressures eased and financial crisis unfolded in the second half of the year, the ECB, like many other central banks all over the world, started to loosen monetary policy conditions. The ECB resolved to lower the euro base rate by 50 basis points on 8 October, by additional 50 basis points on 6 November, and by 75 basis points on 4 December (to 2.5%). The Bank of England began lowering the base rate of the British pound sterling already in the initial months of 2008. In order to minimise the risk of the economic downslide in the context of financial market tensions, the Bank of England reduced the base rate of the British pound sterling on five occasions during the year (to 2%). With the risk of potentially slower economic development in the US intensifying, the FRS lowered the base rate of the US dollar by several steps in the course of the year, finally arriving at the 0%–0.25% range. The Bank of Japan, in turn, lowered the base rate of the Japanese yen by 40 basis points (to 0.1%). As central bank base rates were approaching zero, the application of quantitative monetary instruments in the future was considered.

In 2008, the exchange rate of the US dollar was highly volatile against other major world currencies. In the first half of the year, with market players anticipating the euro and US dollar base rate gap to widen, the latter depreciated against the euro. In the second half of the year when the financial market situation aggravated and capital, formerly placed abroad, was flowing back into the US, the exchange rate of the US dollar tended to appreciate. However in December, when the FRS pursued accommodative monetary policy, its rate depreciated again. In the course of the year overall, the euro depreciated against the US dollar from 1.46 to 1.40 and at year's end was 4.3% lower than at its beginning.

In 2008, the global economic outlook deteriorated and the corporate profit growth forecast turned more pessimistic. Against the backdrop of global financial market turmoil and uncertainty, market players' risk aversion increased and they sought higher risk premiums on invested funds. These factors had an adverse effect on stock prices. The US stock market index S&P 500 decreased by 38.5%, more liquid stock index DJIA fell by 33.8%, and NASDAQ Composite shrank by 40.5%. The European stock market index Dow Jones EURO STOXX 50 declined by 45.7%, Japan's stock market index Nikkei 225 lost 42.1%, whereas China's stock market index was down 65.4%. The deteriorating global macroeconomic environment, oil price drops and foreign capital outflows impaired the Russian stock market index RTS, which decreased by 72.4% in 2008.

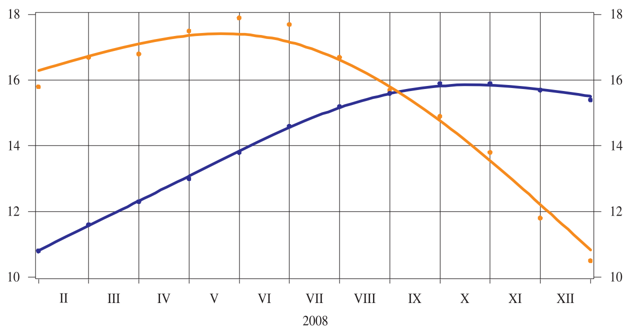
In 2008, yields on debt securities were unstable. In the first three months of the year when uncertainty about the impact of the financial market turmoil on the future economic development predominated, debt security yields went down. In the couple of months to follow, they were up again owing to market participants' expectations of rising base rates due to the impact of surging oil prices. In the second half of the year, however, when market players opted for safer investment and the demand for securities strengthened, debt security yields dropped dramatically. At the close of 2008, the yields on US government 2-year bonds declined to 0.8% (3.1% at the close of 2007), whereas those on 2-year bonds of the German government slid down from 4.0% to 1.8%. The yield on the US government 10-year bonds contracted from 4.1% to 2.1%, while that on the 10-year bonds of the German government shrank from 4.3% to 3.0%.

INFLATION

In the first half of 2008, the annual growth in consumer prices buoyantly continued on an upward trend in Latvia (from 15.8% in January to 17.9% in May). This upswing was triggered by sustained solid domestic demand, global energy price rises, and a subsequent substantial cost increase as well as tax rate harmonisation in compliance with the EU legislation. Starting with June, the economic growth moderated and consumer price rises abated (10.5% in December; see Chart 1). The downslide in inflation was on account of a sizable weakening in the domestic demand, aggravating competition and a sharp drop in global energy prices.

Chart 1

ANNUAL CONSUMER PRICE INFLATION
(%)



Annual consumer price inflation (year-on-year basis)
Latest 12-month average annual inflation

Source: CSB.

Capturing the notable price rises at the beginning of the year and the downward inflationary trend in the second half of the year, the average inflation of 2008 (15.4%) was above the respective indicator of 2007 (10.1%). In 2007 as a whole and in early 2008, world energy prices rose significantly, therefore several administrative decisions regarding the raising of energy prices were taken, with a 3.2 percentage point average contribution of regulated prices to inflation. Compared with 2007, the pickup in natural gas tariffs for households was on average 36.7%, in heat tariffs 44.1%, and in electricity tariffs 29.4%. Regulated prices of certain services also increased substantially (housing related regulated prices by 26.3%, public transportation fares by 23.5%, and fees for pre-school education by 21.7%).

In 2008, due to oil price instability the contribution from fuel prices to inflation initially increased to 1.3 percentage points, sharply melting and turning even negative towards the end of the year; however, the overall contribution from fuel price rises to average annual inflation was 0.8 percentage point. The impact on inflation from unprocessed food price changes was stable at the beginning of the year, but at the end of the year when global food prices stabilised and also due to the base effect this impact on inflation eased (1.0 percentage point on average annually). In the second half of the year, core inflation dropped steeply and its impact on headline inflation weakened from 12.2 percentage points in May to 6.7 percentage points in December primarily due to the falling demand, fuel price drops and base effect, with all components of core inflation posting a decrease. Non-regulated service prices, the most important component of core inflation, increased notably also in 2008 (by 15.8% on average). The upward trend in these prices calmed down only in the last months of the year as a result of falling demand and high basis, with the impact on average inflation albeit remaining strong (3.5 percentage points). Over the year, the contribution from processed food price rises was rather balanced, with a downward trend surfacing towards the end of the year (3.4 percentage points on average annually). At the beginning of the year, the annual consumer price core inflation was largely affected by rising indirect tax rates. In January, the excise tax on tobacco products was increased to harmonise rates in compliance with the EU legislation. As a result, tobacco prices rose by 79.1% on average, with the average annual contribution to inflation of 2.4 percentage points. The contribution from the prices of other tradable goods to inflation decreased in the second half of the year and on average was 0.7 percentage point due to the weakening demand and tightening competition.

The overall producer price rise in manufacturing (11.5%) in 2008 was underpinned by buoyantly rising prices of domestically sold goods (by 15.7%), whereas the growth in producer prices of export good slowed down to 5.2%. The domestic price rises were primarily triggered by more expensive energy (by 31.3% on average annually). Producer prices of durable and non-durable goods continued to go up buoyantly, albeit at a more moderate pace (by 14.5% and 15.4% respectively). Producer price rises of export goods also primarily referred to energy (12.8%) and non-durable goods (11.1%).

In 2008, construction costs posted a 14.4% pickup on average. It was attributable mainly to rising wages and salaries (by 23.6%). At the same time, maintenance costs of machinery and mechanical appliances rose by 15.8%, while construction material costs grew by a mere 3.6%.

In 2008, following a notable increase in the previous years, the export unit value grew by 7.7% but was outpaced by the growth in the import unit value of 8.8% year-on-year. With the import price rises exceeding the export ones, the terms of trade became negative (98.9%), representing a marked deterioration compared with 2007 (107.2%).

Prices of wood and articles of wood dropped 5.8%, while those of all other products and articles dominating goods exports went up steeply. The prices of products of the chemical and allied industries went up by 26.3%, those of base metals and articles of base metals rose by 13.7%, prepared foodstuffs picked up 13.4%, and machinery and mechanical appliances, electrical equipment became 10.5% more expensive. Price rises affected export growth to a larger extent than did the volume expansion (0.9%).

The import unit value recorded a year-on-year decrease for transport vehicles (3.8%) and an increase for all other products and articles dominating imports of goods, among them mineral products (27.5%), products of the chemical and allied industries (23.8%), base metals and articles of base metals (12.7%), prepared foodstuffs (7.6%), and machinery and mechanical appliances, electrical equipment (2.5%). Overall imports shrank, as notably higher import prices did not offset the narrowing in the volume of imports (by 11.9%).

GROSS DOMESTIC PRODUCT

In 2008, real GDP contracted primarily due to the falling domestic demand, private consumption and gross capital formation in particular. This also was an underpinning cause for steeply declining imports of goods and services. At the beginning of the year, exports of goods and services were on an upward trend but towards the end of the year they contracted sharply along with rapidly rising unemployment due to the global downturn and depreciation of national currencies of a number of Latvia's trade partners.

GDP recorded positive annual dynamics at constant prices (0.5% increase) in the first quarter, whereas in the second quarter, a downslide (–1.9%) set in, with its pace gaining momentum in the third and fourth quarters (–5.2% and –10.3% respectively). In the year overall, GDP contracted by 4.6% at constant prices (see Table 1), amounting to 16 243.2 million lats at current prices.

Table 1

GDP AND GROSS VALUE ADDED (SECTORAL CONTRIBUTION)
(at constant prices; year-on-year basis)

	Growth (%)	Contribution to gross value added growth (in percentage points)
GDP	–4.6	x
Gross value added	–2.9	x
Goods-producing sector	–4.0	–1.0
Services sector	–2.5	–1.9

Source: CSB.

Deteriorating financial position of enterprises, falling real estate prices, sluggish activity in construction, negative outlook for external and domestic demand, and moderating pace of lending due to the financial turmoil in global and domestic financial markets were the factors underlying investment contraction. Gross fixed capital formation posted a 15.0% decrease in 2008.

People's uncertainty about their future income was enhanced by the currently rising unemployment level expected to surge further and deteriorating economic situation in the country. The collapse of consumer confidence underpinned restrictions in household spending and a boost in savings, with the procyclical behaviour of previous years continuing. Private consumption narrowed by 20.1% in 2008 and public consumption increased by 0.9%.

Due to an economic downturn in Latvia's major trade partners, the growth in real exports of goods and services from Latvia moderated markedly (from 2.9% in the first quarter to –6.1% in the fourth quarter). In line with the weakening domestic demand, imports of goods and services contracted notably (by 20.7%) and as a result the contribution of net exports to the GDP growth was positive (8.5 percentage points) in 2008.

As indirect tax revenues fell, the contraction in GDP was faster than the drop in gross value added (2.9%). In the situation of weak domestic demand, the contraction in gross value added was primarily determined by trade (shrinking by 8.3% with a 1.9 percentage points contribution to the overall annual drop), and manufacturing (narrowing by 6.5% and contributing 0.8 percentage point).

The retail trade turnover slowed down on account of the weakening domestic demand and deteriorating consumer confidence. The retail trade turnover (including sales of motor vehicles and automotive fuel) decreased by 11.2% at constant prices in 2008. A fall in the demand for motor vehicles accounted for around a half of the decline, with the number of cars newly registered with the Road Traffic Safety Department going down 48.8%).

The output in manufacturing narrowed markedly and was at a low at the end of the year. At the beginning of the year, production declined primarily on account of the falling domestic demand, in the second half of the year to be accompanied by weakening external demand as well. The seasonally adjusted volume index of industrial output in manufacturing contracted by 8.3%, this contraction mostly underpinned by a real slowdown in the manufacture of wood and articles of wood (11.2%), food products and beverages (6.5%), furniture (29.8%), building materials (11.8%), and metals (7.7%).

Over the year, the situation substantially changed in construction as well. In the first and second quarters, when previously commenced projects were underway, the year-on-year upswing in construction output was 9.3% and 5.7% respectively. In the third and fourth quarters, however, notably fewer new orders (for residential buildings in particular) underpinned the diminishing in construction output by 7.3% and 11.2% respectively (seasonally non-adjusted data). As a result, the output in construction decreased by 3.7% for the year as a whole.

As to transport, storage and communication, certain freight transportation indicators testified to a good performance. With transit via Latvian ports expanding, the total freight turnover by rail increased by 7.5% compared with 2007 primarily due to a rise in the turnover of transported coal and chemical cargos. The growth in freight turnover at Latvian ports was more modest (1.9%), with the turnover rising significantly at Riga port (by 14.0%) but falling at Ventspils port (by 8.0%) due to shrinking oil product transit (oil products transported by rail increased by 0.8% but by pipeline decreased by 22.5%). At the same time, the performance of freight transportation by road was worse than in 2007, with freight turnover narrowing by 9.1% as a result of a decrease in both domestic and international transport.

The investment dynamics likewise mirrored the ongoing economic downturn. Non-financial investment in the economy in 2008 was in the amount of 2.8 billion lats (a 9% drop at constant prices). The increase in non-financial investment in the public sector (6%) did not compensate the respective fall in the private sector (19%). The largest investment went to public administration and defence (481.8 million lats; a 7% increase at constant prices), manufacturing (449.2 million lats; a 10% drop), and transport, storage and communication (361.4 million lats; a 3% fall).

LABOUR MARKET

The labour market reflected the steep economic downturn of 2008 with a delay of a couple of quarters. The demand for labour started to weaken from the end of 2007, with a decrease in the number of vacancies as confirmation. Nevertheless, labour supply (economically active population) continued to grow with a couple of quarters' delay against the economic cycle. Thus, although the increase in wages and salaries had been moderating since the end of 2007, employment contraction and unemployment expansion were observed only in the second half of 2008, being particularly sharp in the concluding months of the year. With the number of economically active population decreasing, labour supply abated towards the end of 2008.

The level of registered unemployment rose to 7.0% at the end of 2008 (a 2.1 percentage points rise on an annual basis). In the first half of the year, unemployment remained broadly unchanged and slight rises in unemployment in places with previous labour shortages, e.g. Riga, were offset by a lower unemployment level in Latgale, thus minimising regional unemployment differences. In the second half of the year and in its final months in particular, the unemployment level elevated in all Latvia's largest cities and regions. Over the year, increases were recorded for both cyclical unemployment (due to the economic downturn in all sectors) and structural unemployment (with massive lay-offs in construction and manufacturing).

The number of vacancies registered with the State Employment Service decreased by 82.3% (to 3.2 thousand) over the year. According to the CSB vacancy survey data, all sectors of the economy reported fewer vacancies, with the most dynamic vacancy drops observed in construction, manufacturing and trade. The unemployment to vacancy ratio (the number of unemployed persons per vacancy) increased from 2.9 to 23.8 over the year.

Although the Cabinet of Ministers of the Republic of Latvia substantially reduced costs related to non-residential employment as of 1 July, the number of approved labour permits went down in 2008 (2.9 thousand; primarily in manufacturing and construction). This drop in foreign labour, at the end of the year in particular, was underpinned by narrowing demand for labour and growing numbers of job seekers.

According to the CSB labour survey data, the employment growth in the first half of the year was followed by a fall at its end, particularly for the age group of up to 24, and in the fourth quarter the number of economically active population declined to 67.0% of total population. The rate of jobseekers to economically active population stood at 9.9% at the end of 2008 (4.6 percentage points over the previous year) and posted a particularly swift upward trend in the fourth quarter.

The average monthly gross wages and salaries in the national economy rose to 479 lats in 2008, with its annual pace of growth decelerating to 20.5%. The wage and salary growth was equally dynamic in the private and public sectors (21.0% and 19.2% respectively). Towards the close of the year, the growth in wages and salaries calmed down significantly (to 12.1% in the fourth quarter), as the non-regular component of labour remuneration decreased markedly under the weakening labour demand; the growth in basic wages and salaries was also gradually losing momentum. Despite a high average annual inflation and deceleration in wages and salaries, the purchase power of the employed continued to go up (real net wages and salaries increased by 6.1% in 2008).

FOREIGN TRADE AND THE BALANCE OF PAYMENTS

In 2008, the foreign trade dynamics was affected by the global financial crisis and weakening domestic and external demand. The foreign trade turnover amounted to 11.9 billion lats (see Table 2). Exports of goods expanded by 9.1% (a 15.1% rise in the first nine months of the year and 7.2% drop in the fourth quarter). Imports of goods continued to shrink gradually, recording a 3.8% downslide on an annual basis. The excess of imports of goods over exports of goods decreased to 69.9% (92.6% in 2007) and the foreign trade deficit narrowed by 17.7%.

Foreign trade deficit was the highest for mineral products, machinery and mechanical appliances, electrical equipment, transport vehicles, and the chemical and allied

Table 2

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

	2008	2007
Exports	**4 406.0**	4 040.3
Imports	**7 484.4**	7 780.2
Balance	**–3 078.4**	–3 739.9

Source: CSB.

industries. Only wood and articles of wood recorded a surplus. With imports of goods shrinking, the deficit of machinery and mechanical appliances, electrical equipment, and transport vehicles decreased markedly, whereas with imports of mineral products increasing, their deficit continued to go up in line with the trend of the previous years. A foreign trade deficit was recorded with all country groups. However, it was on a downward trend also with all country groups, except the CIS countries. Foreign trade recorded a surplus with the UK and Norway and the balance turned positive with Estonia. Foreign trade deficit decreased with Germany, Finland and Italy but widened with Russia and Lithuania.

With the sluggish foreign demand persisting, the export structure changed in 2008: wood and articles of wood did not dominate. The most important exports from Latvia were agricultural and food products (16.9% of total exports), base metals and articles of base metals (16.8%), wood and articles of wood (16.7%), machinery and mechanical appliances, electrical equipment (12.4%), and products of the chemical and allied industries (8.4%). The growth in exports was dominated by agricultural and food products (cereals, non-alcoholic and alcoholic beverages), base metals and articles of base metals (ferrous metals), and machinery and mechanical appliances, electrical equipment. Exports of wood and articles of wood (sawn wood and wood in the rough) diminished by 19.2% and exports of textiles and textile articles fell by 10.0%. The increase in exports of base metals and articles of base metals as well as machinery and mechanical appliances, electrical equipment was on account of both the price and volume factors. In all other commodity groups dominating exports, volume contractions were recorded.

In 2008, Latvian goods were primarily exported to the EU countries (73.1% of total exports; 76.1% in 2007). The overall growth in exports to these countries was moderate, with exports to EU12 countries (Lithuania, Estonia and Poland) expanding by 11.0% and EU15 countries (primarily the UK and Sweden) shrinking by 0.9%. Exports to the EU were primarily made up of wood and articles of wood (20.4% of total exports to the EU), base metals and articles of base metals (17.2%), agricultural and food products (14.5%), and machinery and mechanical appliances, electrical equipment (11.4%). Exports to other countries accelerated most (by 37.7%), with the largest contribution from bulky exports of ferrous metals to Peru. Exports to other countries were dominated by base metals and articles of base metals (28.2%), agricultural and food products (20.0%), and wood and articles of wood (10.8%). Exports to the CIS countries (mainly Russia) expanded buoyantly (by 13.2%) and were dominated by agricultural and food products (25.1% of total exports to this group of countries), machinery and mechanical appliances, electrical equipment (19.6%), and products of the chemical and allied industries (15.2%). Latvia's major trade partners in exports of goods were Lithuania (16.6% of total exports), Estonia (14.0%), Russia (10.0%), Germany (8.1%), Sweden (6.7%), and Denmark (4.6%).

In 2008, NEER of the lats was 2.0% above the average of the previous year (3.0% higher against currencies of major developed countries and 0.1% higher against currencies of Lithuania, Estonia, Poland and Russia). Given the high inflation rate, CPI-deflated REER of the lats continued on an upward trend in the first half of the year. In the second half of the year, inflation in Latvia declined markedly along with notably decelerating price changes in its major trade partners as a result of which the price component did not change substantially (except in December) but the nominal component kept on pushing up REER of the lats.

The changes in PPI-deflated REER of the lats were less pronounced than those of CPI-deflated REER of the lats despite a still dynamic rise in unit labour costs, a significant cost component. The large unit labour costs were determined by a decline in labour productivity; they are only in part reflected in PPI-deflated REER of the lats as the share of labour costs in total production costs is smaller than, for instance, in the services sector. Producer price rises in manufacturing were slower and the manufacturing PPI-deflated REER of the lats remained stable over the year (except in December). Manufacturing does not comprise the energy sector where the prices of energy imports increased notably in 2008. When the demand weakened, companies cut the profit margin and thus the producer prices compared with those in the major trade partners rose less buoyantly than might be expected under the pressure of labour and energy costs.

In 2008, Latvia's market share in the EU was stable overall and increased in Denmark, Estonia, and Finland, with the growth in exports to these countries exceeding the expansion in their total imports. Latvia's market share shrank in other major trade partners, the UK in particular.

In 2008, the most significant import commodities were machinery and mechanical appliances, electrical equipment (18.1% of total imports), mineral products (15.7%), agricultural and food products (13.6%), transport vehicles (10.7%), base metals and articles of base metals (10.3%), and products of the chemical and allied industries (9.7%). Imports of transport vehicles (passenger cars and trucks), machinery and mechanical appliances, electrical equipment, and wood and articles of wood (sawn wood) contracted substantially. At the same time, imports of mineral products (natural gas and diesel fuel), and agricultural and (miscellaneous) food products increased substantially. Although prices of all significant import goods, except transport vehicles, rose, the decline in imports was on account of volume contractions.

The most notable narrowing was observed for imports of goods from EU countries, with a significant fall from EU15 and almost unchanged from EU12 countries. Imports diminished also from other countries but increased from the CIS countries. Imports from the EU countries (75.8% of total imports) were dominated by machinery and mechanical appliances, electrical equipment (20.2% of total imports from the EU), agricultural and food products (15.8%), transport vehicles (13.0%), and products of the chemical and allied industries (10.1%). Imports from the CIS countries comprised primarily mineral products (52.0% of total imports from the CIS), and base metals and articles of base metals (22.5%); imports from other countries included machinery and mechanical appliances, electrical equipment (27.0% of total imports from this country group), products of the chemical and allied industries (14.9%), agricultural and food products (9.8%), and base metals and articles of base metals (9.3%). In 2008, Latvia's major trade partners in imports of goods were Lithuania (16.6%), Germany (12.9%), Russia (10.7%), Estonia (7.1%), and Poland (7.1%).

According to the data of the international investment position, in 2008, Latvia's external debt to non-residents expanded by 2.0 billion lats and at the end of the year was 20.8 billion lats (128.2% of GDP); net foreign debt stood at 9.2 billion lats (56.5% of GDP). Liabilities of the Latvian government to non-residents increased by 0.6 billion lats, those of the central bank grew by 0.4 billion lats, banking sector's liabilities went up by 0.3 billion lats, while the other sectors recorded an expansion in liabilities by 0.3 billion lats; debt-related direct investment augmented by 0.4 billion lats. Thus the composition of external debt by sector changed: the share of the government and central bank liabilities increased to 8.4% (4.0% in 2007) and so did the share of debt-related direct investment (to 8.4%; 7.4% in 2007); at the same time, the share of banking sector's liabilities decreased to 62.6% (67.7% in 2007) and so did the share of other sector liabilities (to 20.5%; 20.9% in 2007).

In 2008, the current account deficit of the balance of payments was 12.6% of GDP (22.5% of GDP in 2007).

FISCAL POLICY

On the cash flow basis, the consolidated general government budget posted a deficit of 531.1 million lats or 3.3% of GDP in 2008 (the financial surplus of the consolidated general government budget amounted to 94.0 million lats or 0.6% of GDP in 2007). However, on the accrual basis (ESA 95) used to evaluate compliance with the Maastricht criteria, the consolidated general government budget ran a deficit of 4.0% of GDP.

The buoyant but unbalanced growth observed in the previous years was characterised by too high and ineffective budget expenditure in public administration, growing wages and salaries disproportional to the labour productivity growth, weakening of competitiveness and several other factors. The year 2008 marked a turning point in the economic development. The macroeconomic indicators deteriorated with every coming month. As tax revenue decreased sharply, the consolidated general government budget deteriorated more than it was planned in the amendments to the Law "On State Budget 2008" adopted in July (the financial surplus of 8.3 million lats or 0.05% of GDP was projected in the budget).

In 2008, the financial deficit of the consolidated general government budget resulted from the central government basic budget deficit (653.5 million lats) and that of the consolidated local government budget (118.6 million lats), and it could not be offset by the financial surplus of the central government social security budget (227.3 million lats).

In 2008, the consolidated general government budget revenue amounted to 5.7 billion lats or 35.2% of GDP, representing a year-on-year increase of 0.3 billion lats or 6.4%. The growth in tax revenue decelerated substantially in comparison with 2007 – the tax revenue increased by 374.2 million lats or 8.6% in 2008. As a result of dampening economic growth and shrinking domestic demand, the VAT revenue decreased by 7.1%. At the same time, the excise tax revenue grew by 20.7% on account of higher excise tax rates imposed on tobacco products and oil products effective from 1 January 2008. The corporate income tax revenue recorded the highest increase (25.9%). The increase in the personal income tax revenue and social security contributions was lower in comparison with the previous year (by 15.9% and 10.8% respectively). In 2008, non-tax revenue grew by 10.4 million lats or 3.5%. At the same time, with the drawdown from the EU funds shrinking, the foreign financial assistance receipts decreased by 31.2 million lats or 6.8% in comparison with the previous year.

In 2008, the consolidated general government budget expenditure totalled 6.3 billion lats or 38.5% of GDP. The annual increase of expenditure was 1.0 billion lats or 18.4%. Against the background of the growing wages and salaries in the public sector, significant old-age pension indexation and a rise in some social benefits, there was an increase in spending on wages and salaries, subsidies and grants as well as social payments (by

208.4 million lats or 19.7%, 273.6 million lats or 26.6% and 295.6 million lats or 27.2% respectively), driven also by rapid growth in the number of the unemployed persons at the end of the year. The consolidated general government budget expenditure growth was weaker somewhat with the capital investment expenditure decreasing by 29.0 million lats or 3.8%.

At the end of 2008, the general government debt totalled 2.7 billion lats or 16.8% of GDP representing a yearly increase of 1.6 billion lats. The foreign debt increased by 625.1 million lats mainly on account of the first credit tranche of the Supplemental Reserve Facility (589.6 million euro or 414.4 million lats) under the IMF Stand-By Arrangement for economic stabilisation and restoration of growth, whereas the domestic debt expanded on account of a government securities issue by 946.9 million lats.

BANKING DEVELOPMENTS

At the end of 2008, 21 banks (the JSC *Latvijas Pasta banka* was opened in 2008, whereas the JSC *Danske Bank* was transformed into a branch), six branches of foreign banks (including two branches opened in 2008), 35 credit unions, seven electronic money institutions and three money market funds were registered in the Republic of Latvia. All but two Latvian banks are private. At the end of 2008, the government's participating interest in the banking sector's paid-up share capital grew to 11.7% as a result of the government taking over 85.14% of JSC *Parex banka* shares on 5 December.

In 2008, the global financial crisis led to a significant deterioration of the financing opportunities and conditions for the Latvian banks as well, prompting them to tighten their lending standards. With the domestic economic activity slowing rapidly, the growth of the key performance indicators of the financial sector also decelerated and the annual increase of the bank assets amounted to a mere 6.0%. Assets still grew on account of expanding loans granted to residents, yet the increase declined to 12.4% year-on-year at the end of 2008. Lending growth decelerated mainly as a result of drying up mortgage lending: the annual increase of mortgage loans amounted to a mere 12.6%.

The liquidity squeeze on the global financial markets, economic imbalances and economic downturn had a detrimental effect on investor confidence, thereby reducing loan refinancing opportunities for the Latvian banks and inducing deposit outflows from those banks in the fourth quarter. Rumours concerning potential devaluation of the lats also acted to encourage withdrawal of deposits. As a consequence, the banks faced significantly higher liquidity and financing risks. Unable to cope with the liquidity problems, in light of the deteriorating liquidity and quality of the bank's assets depressing the capital adequacy and liquidity ratios of the bank and the bank run fuelled by the global financial crisis, the largest domestic bank turned to the government for support. The government implemented active bail-out measures to stabilise the troubled bank.

Looking at the composition of the funding sources used by the banks, borrowing from foreign MFIs continued to increase and amounted to 40.4% of the total liabilities at the end of year, including 31.2% from associated and affiliated credit institutions.

The banks' profit shrank by 311.0 million lats or six-fold year-on-year (to 60.0 million lats) in 2008, owing to provisions made during the year for doubtful debts and liabilities amounting to 336.0 million lats. The return on equity (ROE) was 3.6% at the end of the year, whereas the return on assets (ROA) totalled 0.3%. The growth of the banks' expenditure outpaced that of the income, *inter alia* the interest expenditure continued to expand faster in comparison with the interest income, resulting in a slight decrease of the contribution of net interest to overall income.

The quality of the bank loans deteriorated substantially in the second half of the year, with loan delinquency increasing. Nevertheless, the capital adequacy ratio remained high overall during the year, ensuring the banks' capacity to absorb any potential shocks.

In response to the financing becoming more expensive on the global markets and interest income growth decelerating, the banks increased their service commissions and fees in the second half of the year.

MONEY SUPPLY

The principal monetary aggregates of the Latvian banking system and the Bank of Latvia are featured in Appendix 1. The behaviour of the monetary aggregates in 2008 mirrored the sharp downturn of the economic development with both domestic and external demand shrinking, as well as the impact of the global financial crisis on the Latvian banking system and money market. M3 decreased by 4.3% (a growth of 14.6% in 2007; see Chart 2) and amounted to 6 039.5 million lats at the end of 2008 (see Chart 3). In the first half of the year, the decline of the economic development was still negligible, liquidity remained ample on the financial markets and M3 grew by 3.1%. With the economic development coming to a halt in the second half of the year, banks cutting down on their lending business remarkably and confidence with regard to the financial sector deteriorating, M3 shrank by 7.2%. The rate of change of M3 decelerated gradually throughout the year, with the steepest monthly rise of 155.3 million lats or 2.5% being reported in April, when deposits with MFIs (except the Bank of Latvia) as well as currency in circulation increased significantly. The highest monthly drop of 136.7 million lats or 2.2% was recorded in November, when deposit outflows were registered in several banks.

Chart 2

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

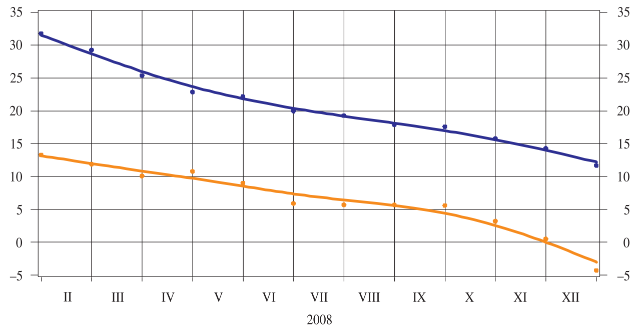
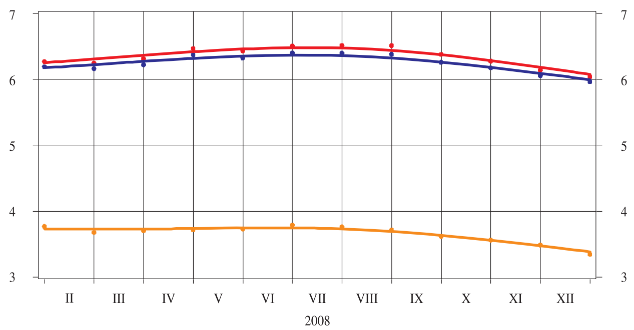


Chart 3

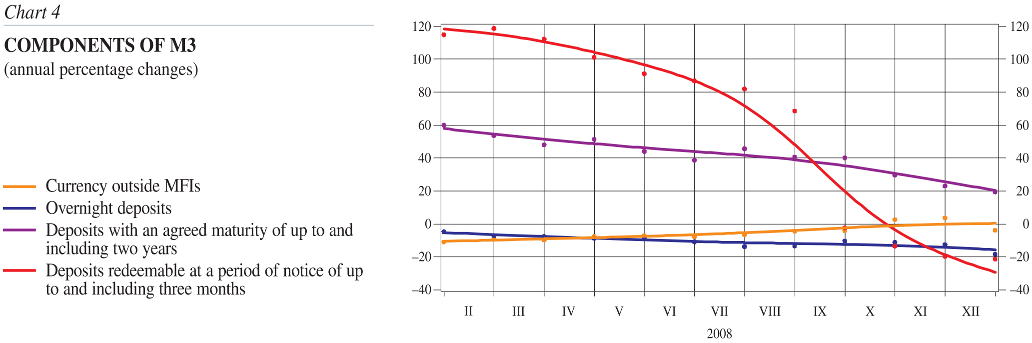
MONETARY AGGREGATES
(at end of period; in billions of lats)



The most liquid assets comprised in M1 contributed significantly to the shrinking of M3. Against the background of decelerating inflation growth and rising rates on time deposits and savings deposits, growing opportunity costs of holding cash and wider use of cashless payments, M1 decreased by 15.0% in 2008 (by 3.2% in 2007), including overnight deposits with MFIs in all currencies contracted by 18.3% (see Chart 4) and currency in circulation (the lats banknotes and coins issued by the Bank of Latvia less vault cash of other MFIs) shrank by 3.8%. The cash component of M3 stabilised (14.3% at the end of 2007 and 2008 respectively), whereas the contribution of overnight deposits declined from 48.1% to 41.0%.

Chart 4

COMPONENTS OF M3
(annual percentage changes)



Time deposits expanded in 2008, partly offsetting the impact of the shrinking of more liquid cash components on the aggregate money supply. M2 decreased by 4.4% in comparison with a 14.4% growth in 2007, with all currency deposits redeemable at a period of notice of up to and including three months contracting by 21.3% and all currency deposits with an agreed maturity of up to and including two years held with MFIs, which are significant in terms of the value, growing by 19.5%. Other components of M3 remained modest, with money market fund shares/units totalling 70.2 million lats at the end of the year and MFI debt securities with a maturity of up to two years amounting to 4.4 million lats, representing a 1.7 times annual increase and a 6.4 times annual decrease respectively. So far, Latvian banks have concluded no repo agreements meeting the definition of M3.

The negative rate of the monetary expansion was primarily a result of the decelerating growth of MFI loans to the private sector, with the total loans outstanding shrinking in the last two months of the year. The money multiplier increased considerably and was 2.86 in December 2008 in comparison with 2.55 in December 2007. Aggravation of the macroeconomic risks and lower savings induced acceleration of the velocity of money, growing from 2.3 in 2007 to 2.7 in 2008.

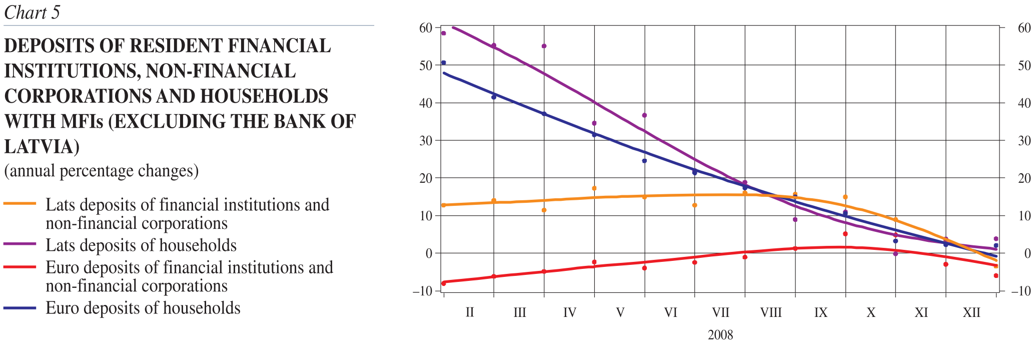
Resident financial institution, non-financial corporation and household deposits with MFIs decreased by 205.9 million lats or 3.9% in 2008 in comparison with an increase of 16.9% in 2007.

Although the lats deposits were better remunerated, under the impact of the above factors those deposits shrank by 128.1 million lats or 4.7% during the year. With the US dollar deposits decreasing, the overall deposits in foreign currencies also contracted by 77.8 million lats or 3.1%, whereas the euro deposits continued to grow (by 56.3 million lats or 2.7%). The euro became increasingly more significant in Latvia's economy, as it was the dominant currency in lending and it had a fixed exchange rate vis-à-vis the lats (see Chart 5 for the developments of the lats and euro deposits by resident financial institutions and non-financial corporations as well as households). At the end of 2007, deposits in lats accounted for 53.2% of resident non-MFI deposits, while at the end of 2008 the respective share contracted to 49.3%. Deposits made in the US dollar shrank from 7.7% to 5.0%. The share of the euro in total deposits grew from 38.3% in 2007 to 45.1% in 2008.

Gradually climbing interest rates on time deposits resulted in a decline of the share of

Chart 5

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



overnight deposits in deposits made by resident financial institutions, non-financial corporations and households from 54.4% at the end of 2007 to 45.6% at the end of 2008, with the share of time deposits expanding accordingly. The share of household deposits contracted slightly and amounted to 58.1% of all deposits in comparison with 59.0% at the end of 2007, and their annual rate of decline at –5.3% was also faster than that of deposits by financial institutions and non-financial corporations at –1.9%. Household deposits accounted for 67.9% of time deposits (71.7% in 2007) and 46.4% of overnight deposits (48.3% in 2007).

The decrease of the monetary aggregate M2X calculated based on the Bank of Latvia's methodology (–3.9%; a 12.6% growth in 2007) was slightly lower than the decline of the aggregate money supply.

The development trends of monetary aggregates were influenced by drying up capital inflows and foreign exchange interventions of the central bank reflected in the changes of net external assets. Negative net foreign assets of MFIs (excluding the Bank of Latvia) grew by 31.9% during the year, amounting to 5 914.6 million lats, whereas the respective indicator of the Bank of Latvia decreased by 16.0% and totalled 2 332.3 million lats at the end of 2008. Thus the growth of the negative net foreign asset position decelerated considerably in comparison with 2007, when it expanded 1.7 times. Non-resident banks (primarily parent banks) were more prudent in granting funds for domestic lending. The foreign liabilities of MFIs (excluding the Bank of Latvia) increased by 439.2 million lats or 3.4% in 2008 (by 4.1 billion lats in 2007), including the liabilities to foreign MFIs grew by 1 401.3 million lats or 17.7% (of which liabilities to associated and affiliated MFIs expanded by 1 441.6 million lats or 25.0%), whereas non-resident non-MFI deposits shrank by 1 049.7 million lats or 23.3%. Foreign assets of banks decreased by 548.9 million lats in 2008, with claims on foreign MFIs declining by 776.3 million lats and claims on non-resident non-MFIs growing by 181.5 million lats (including an increase of 157.3 million lats in loans outstanding). Thus the negative net foreign assets of MFIs (excluding the Bank of Latvia) had grown by 988.1 million lats year-on-year at the end of 2008 (2.2 billion lats more year-on-year at the end of 2007).

The monthly growth of lending to resident financial institutions, non-financial corporations and households gradually decelerated from January to October 2008 before turning negative in December. Moderation of lending was determined both by the contracting demand for loans as well the policy pursued by the banks cutting down on lending in the wake of the global financial crisis. Overall, loans granted to resident financial institutions, non-financial corporations and households expanded by 1.5 billion lats or 11.7% in 2008 (3.3 billion lats or 34.2% in 2007). The annual growth rate of loans declined by 14.2 percentage points to 20.0% in the first half of the year, with the loans outstanding growing by 1.1 billion lats, whereas the rise reported in the second half of the year was considerably lower. At the end of 2008, exposure to domestic lending increased to 63.6% of the aggregate balance sheet assets of MFIs (excluding the Bank of Latvia) in comparison with 60.7% at the end of 2007.

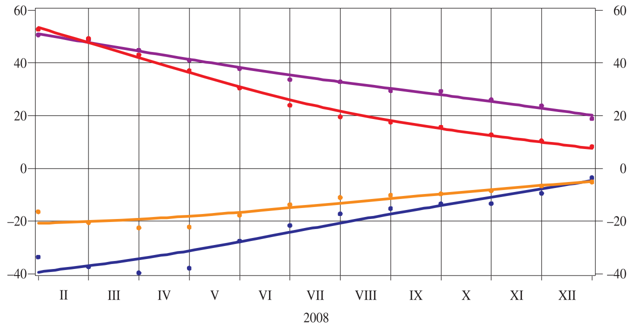
The consolidated general government budget ran a deficit; nevertheless, as a result of higher external borrowing of the government, the negative net MFI claims on the government grew by 282.6 million lats.

Looking at the developments in MFI loans granted to the private sector, loans to non-financial corporations followed an upward trend (an increase of 1 050.4 million lats in 2008), whereas the growth of loans granted to households and financial institutions was much smaller (413.2 million lats and 63.0 million lats respectively). The growth of loans granted to all sectors was very uneven during the year. Loans to non-financial corporations increased by 635.0 million lats in the first half of the year and by 415.4 million lats in the second, with their annual growth decelerating from 36.3% in 2007 to 16.9% in 2008. Household loans also expanded at a quicker rate in the first half of the year (by 305.1 million lats; an increase of only 108.1 million lats in the second half of the year). Consequently, the growth of loans in the household sector also decelerated at a quicker pace: from 39.2% in 2007 to 6.9% in 2008. Having expanded in the first half of the year, loans to financial institutions decreased in the second half of the year (see Chart 6 for the developments in loans granted in lats and euro to resident financial institutions and non-financial corporations as well as households).

Chart 6

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

- Lats loans to financial institutions and non-financial corporations
- Lats loans to households
- Euro loans to financial institutions and non-financial corporations
- Euro loans to financial institutions and non-financial corporations

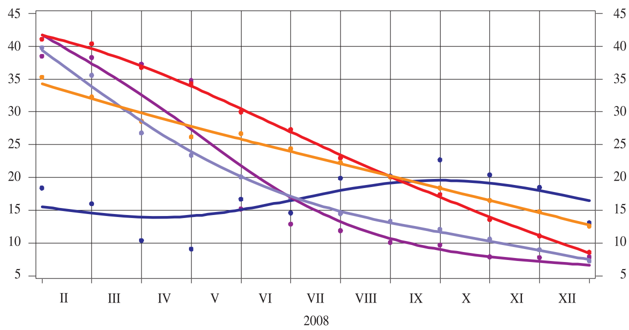


The decline in household lending was primarily the result of a deceleration of the annual growth of household loans for house purchase from 44.5% to 7.3% to (see Chart 7 for developments concerning the main types of lending). At the end of December, loans for house purchase totalled 5.1 billion lats or 78.9% of all loans granted to households (78.7% at the end of 2007). The annual growth of loans for purchasing consumer goods also decelerated from 42.2% in 2007 to 8.6% in 2008, whereas the share of those loans in household loans increased by 0.4 percentage point to stand at 12.4%. The slowdown of lending for house purchase resulted also in deceleration of the annual growth of the overall mortgage loans from 38.6% in 2007 to

Chart 7

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

- Commercial credit
- Industrial credit
- Loans for purchasing consumer goods
- Mortgage loans
- Loans for house purchase



12.6% in 2008 (56.9% of all loans at the end of 2008 in comparison with 56.4% at the end of 2007). Major types of corporate loans continued on an upward trend: commercial credit and industrial credit grew by 13.1% and 7.9% respectively during the year, amounting to 18.6% and 12.8% of all loans at the end of the year (18.4% and 13.2% at the end of 2007 respectively).

Drying up of lending for house purchase had a significant impact on the real estate market. Real estate prices continued to fall in 2008, and the rate of decline picked up in the second half of the year. The average prices of housing in standard apartment blocks in Riga decreased by about 37% (by about 7% in 2007; *Latio Ltd* data). Falling prices of housing in standard apartment blocks and shrinking demand for real estate caused the average prices on housing in new projects to decline considerably, and in some projects with low quality they even almost reached the prices of housing in standard apartment blocks. The low real estate demand triggered also a decline in rent prices, with a progressively larger share of real estate developers and housing owners offering their residential estates for rent instead of sale. The developments on the commercial real estate rental market were similar: rent prices decreased for almost all types of estates, including the rent prices of trading premises also declined in the second half of the year.

Corporate loans were dominated by loans to real estate activities, manufacturing, construction, transport and storage, information and communication services as well as financial and insurance activities. At the end of 2008, the highest growth in corporate loans was reported in real estate activities (by 30.0%), manufacturing (by 14.0%), financial and insurance activities (by 12.3%) and trade (by 12.0%). Looking at manufacturing by sector, the highest growth in loans at the end of the year was recorded in manufacture of food products and beverages (22.6%), manufacture of wood and of products of wood and cork (16.9%) and manufacture of fabricated metal products (15.5%).

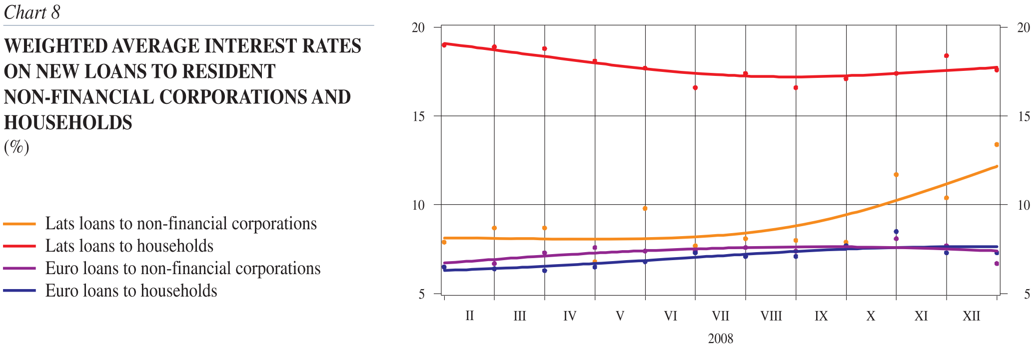
Rapidly rising lats interest rates pushed down the demand for lats loans. The euro rates also increased, yet remained considerably lower; therefore, the loans granted to financial institutions, non-financial corporations and households in euro and other foreign currencies expanded. In 2008, loans to resident financial institutions, non-financial corporations and households granted in lats decreased by 75.7 million lats or 4.2%, whereas the euro loans grew by 1.5 billion lats or 14.1%. Loans granted in other currencies (dominated by US dollar loans at over 75%) expanded by 74.3 million lats or 19.3% in 2008. Thus the share of resident non-MFI loans granted in lats declined by 2.1 percentage points in course of the year and amounted to 11.6% at the end of 2008, that of the loans granted in euro increased by 1.8 percentage points to 85.2%, whereas the share of loans granted in the US dollars remained unchanged at 2.4%.

LENDING AND DEPOSIT RATES

Interest rates on lats loans granted to resident non-financial corporations and households and on lats deposits received from this customer group were quite volatile in 2008, yet overall higher than in 2007. A rise in the lats lending and deposit rates was observed in the first and fourth quarter and mainly mirrored the developments on the lats money market. Euro lending and deposit rates were also slightly higher overall in 2008 in comparison with 2007, yet much lower than the lats lending rates. Thus the euro became the dominant lending and depositing currency. The euro rates followed the euro money market indices, climbing slowly and gradually before declining in the last months of the year (see Chart 8 for the lats and euro lending rate developments). The US dollar lending and deposit rates shrank.

Chart 8

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



As in 2007, bank margins on lats loans were volatile: during the periods of rising lats money market indices, banks set lower margins on their lending to non-financial corporations and households. As a result, the rates on the lats lending to non-financial corporations and households were less volatile in comparison with the lats money market rates. Bank margins on euro loans rose slightly in the second half of the year, mainly as a result of higher customer credit risk, more prudence on behalf of banks and a much tighter credit squeeze.

The weighted average rate on new lats loans granted to resident households remained broadly unchanged (17.5% in December 2008 in comparison with 17.3% in December 2007). By contrast, the weighted average rate on new lats loans granted to non-financial corporations went up from 9.7% in December 2007 to 13.4% in December 2008. The weighted average rate on new household loans granted in foreign currencies grew by 0.7 percentage point to 7.5%, whereas that on loans to non-financial corporations contracted by 0.5 percentage point to 6.7%.

The share of floating interest loans with the initial rate fixation period of up to one year in new loans gradually increased from 78.2% in December 2007 to 84.8% in December 2008. The share of loans with the initial rate fixation period from one to five years, by contrast, slightly contracted from 15.3% in December 2007 to 12.3% in December 2008. As the interest rates on lats loans granted to non-financial corporations and households were higher than those on foreign currency loans, the share of the foreign currency loans in new loans was significant (92.9% in December 2008; 92.2% in December 2007).

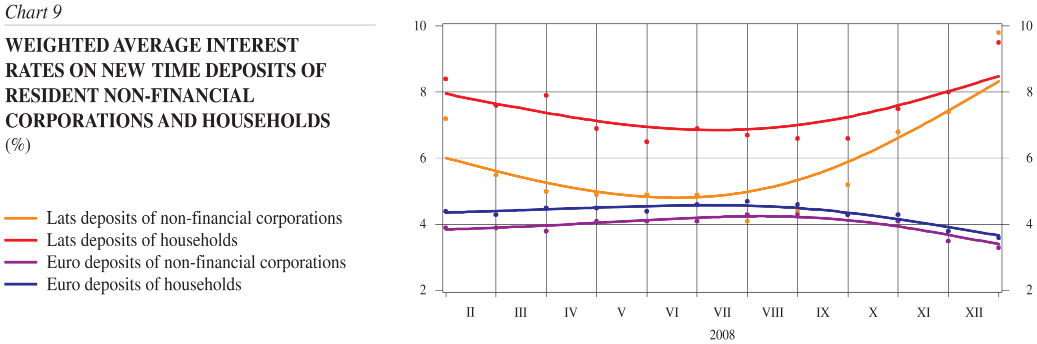
The rates on lats time deposits of resident households grew from 8.7% in December 2007 to 9.5% in December 2008, whereas those on lats time deposits of resident non-financial corporations climbed from 7.3% to 9.8% respectively. The weighted average rate on foreign currency time deposits of households declined by 0.9 percentage point to 3.6%, whereas the respective rate on deposits of non-financial corporations decreased by 1.1 percentage points to 3.0% (see Chart 9 for the developments of lats and euro deposit rates).

Most new time deposits of resident non-financial corporations and households (about 98.5% on average) were with a maturity of up to one year. The share of lats deposits in overall deposits of non-financial corporations and households contracted from 37.2% in December 2007 to 30.5% in December 2008.

Against the background of shrinking inflation, the real interest rates on the lats lending grew and became positive (5.4% in December 2008). The negative real interest rates on the lats time deposits also diminished to stand at –0.8% in December 2008.

Chart 9

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



INTERBANK MARKET

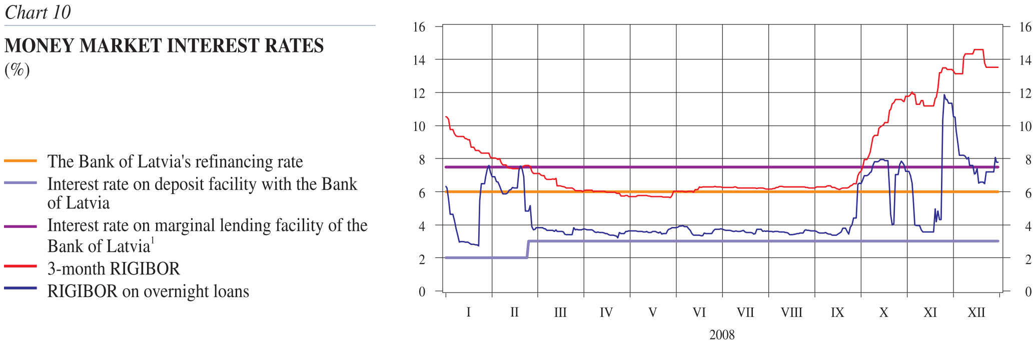
In the wake of the turmoil experienced on the Latvian money market in 2007, the lats money market rates gradually edged down in the first months of 2008. The 3-month RIGIBOR contracted overall from 10.53% at the end of 2007 to 7.09% at the end of February 2008, whereas the 6-month RIGIBOR declined from 11.24% to 8.27% respectively. The Bank of Latvia reduced the reserve ratio for bank liabilities with a maturity of over two years as of 24 February, in order to encourage the banks to give preference to longer-term funding and to free up more liquidity for the banks. After the reduction of the reserve ratio, the banks accumulated a liquidity surplus, thereby supporting a lasting stabilisation of RIGIBOR (until the end of September). 3- and 6-month RIGIBOR fluctuated around 6.00% and 7.00% respectively in the period from March to September.

In mid-September, *Lehman Brothers Holdings Inc.*, one of the major US investment banks, announced the beginning of its insolvency proceedings, thereby considerably aggravating the tensions on the global financial market and deteriorating the mutual confidence among banks. As a result, many banks and other financial market participants faced difficulties when trying to borrow on the interbank market. The credit squeeze fuelled a more rapid decline in prices of other assets. All that triggered speculations about some Latvian banks having difficulties to refinance their borrowing from foreign banks maturing in large amounts in 2009. The extent to which Latvia's financial market could be affected by the global and domestic economic downturn also remained uncertain. Under the influence of those factors, large demand for foreign currencies built up on the foreign exchange market and the Bank of Latvia had to resort to foreign exchange interventions. Previously, during the years of rapid growth, banks accumulated sizeable reserves to comply with the reserve requirements set by the Bank of Latvia. With Latvia's economic growth decelerating and the global financial market tensions intensifying, the Bank of Latvia actively reduced the banks' reserve ratio (the percentage of the reserve base on which the minimum reserve requirement is calculated) and the banks were thus able to free up considerable funds. Even following the above speculations, the Latvian banking system preserved ample lats liquidity at the end of 2008. This meant that the majority of banks had rather low lats money market rates on short-term business, yet the 3-month RIGIBOR reached an all-time-high in mid-December at 14.60%. At the end of 2008, 3- and 6-month RIGIBOR was 10.86 and 12.10% respectively, whereas the weighted average annual rate was 7.98% and 8.91% respectively (8.67% and 9.04% in 2007; see Chart 10 for the Bank of Latvia interest rates and RIGIBOR).

The weighted average unsecured money market rates on overnight business in lats were rather stable in 2008. The average annual rate on such business was 4.1% in comparison with 4.8% in 2007. Financial market turmoil notwithstanding, the turnover of business in lats on the interbank market in 2008 was fairly stable in comparison

Chart 10

MONEY MARKET INTEREST RATES
(%)



[1] As of 9 December, the interest rate applied in case the lending facility has been used no more than 5 working days within the previous 30-day period.

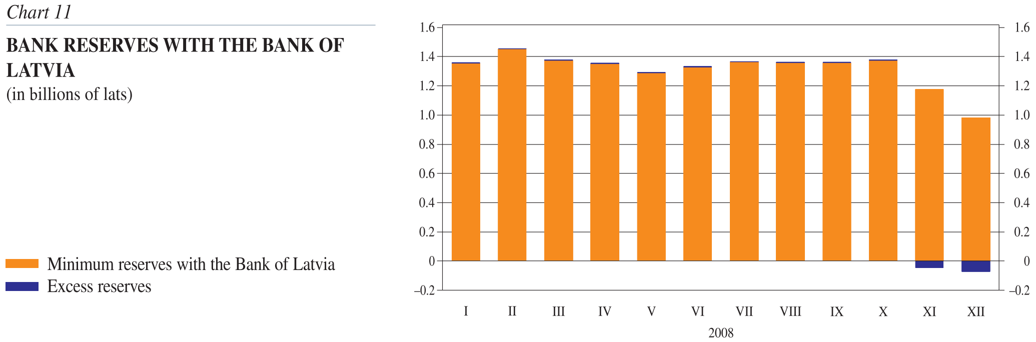
with 2007, with business with a maturity of up to one month decreasing by 12.7%, that with a maturity of 1–3 months growing by 61.0%, and that with a maturity of 3–12 months increasing by 10.9%.

MONETARY BASE

As a result of reducing the reserve ratio on several occasions, with bank deposits growing relatively little, the minimum reserves held by banks on settlement accounts with the Bank of Latvia contracted (see Chart 11). Thus deposits from credit institutions and other financial institutions held by the Bank of Latvia declined by 328.3 million lats or 23.1% in 2008 as opposed to a 21.0% increase in 2007. For the second consecutive year, the demand for cash decreased, and currency in circulation shrank by 31.4 million lats or 3.0% (by 2.3% in 2007). As a result, the central bank's money supply or monetary base M0 decreased by 14.6% in 2008 and totalled 2 111.5 million lats at the end of the year, whereas the cash component of the monetary base grew to 48.2% in comparison with 42.5% at the end of 2007.

Chart 11

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

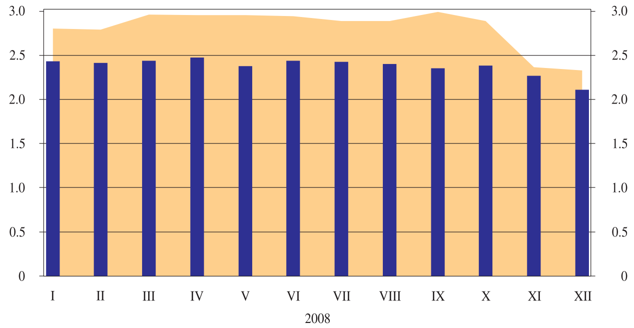


The decline of the monetary base was on account of a decrease in net foreign assets of the Bank of Latvia by 443.7 million lats as a result of the Bank of Latvia selling foreign currency (total net amount of foreign currency sold in 2008 was 784.8 million lats). Foreign currency purchasing from the Bank of Latvia was mainly related to the ample lats liquidity offered on the foreign exchange market in the last three months of the year under the circumstances of the financial market turmoil. Foreign currency outflows were partly offset by the foreign currency funds of the government placed in the foreign assets of the central bank. At the end of 2008, the Bank of Latvia's net foreign assets covered the goods imports of about 3.7 months (of 4.3 months at the end of 2007), whereas the backing of the national currency with the Bank's net foreign assets (see Chart 12) was 110.5% (112.3% at the end of 2007).

The overall changes in the Bank of Latvia's net domestic assets were less pronounced

Chart 12

BACKING OF THE NATIONAL CURRENCY
(in billions of lats)



(their negative value decreased by 84.2 million lats), as domestic loans expanded. Of the domestic loans, loans granted to banks expanded sharply by 632.4 million lats (see Table 3 for the monthly average amounts outstanding). At the same time, government deposit with the Bank of Latvia grew considerably by 466.9 million lats.

Table 3

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

	2008	2007
January	**7.7**	0
February	**10.1**	16.9
March	**0**	6.1
April	**0**	89.1
May	**0**	81.3
June	**0**	3.6
July	**0**	0
August	**0**	36.4
September	**0.5**	66.8
October	**132.9**	31.7
November	**379.2**	13.7
December	**503.6**	10.4

THE FOREIGN EXCHANGE MARKET AND LATVIA'S EXTERNAL DEBT

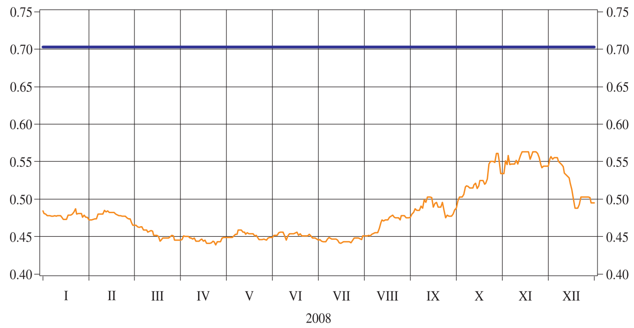
In 2008, the US dollar appreciated against the British pound sterling and the euro on the global foreign exchange market, and depreciated notably against the Japanese yen. The exchange rate fluctuations were mostly driven by the global economic crisis. Against the backdrop of problems in the banking system and housing market in the UK the British pound sterling depreciated against the major currencies. The position of the single European currency on the foreign exchange market deteriorated. Problems in the US housing market and Japan's positive foreign trade balance contributed to the appreciation of the Japanese yen.

In 2008, the euro depreciated against the US dollar by 4.2% (from 1.4589 at the end of 2007 to 1.3971 at the end of 2008), reaching its high on 15 July (1.6038) and standing at a low of 1.2330 on 28 October. Although the US economic growth moderated, the appreciation of the US dollar against many other major currencies was supported by the repatriation of capital to the US. The US dollar depreciated vis-à-vis the Japanese yen (from 111.75 at the end of 2007 to 90.64 at the end of 2008, dropping 18.9%), reaching its high (112.20) on 2 January and low (87.14) on 17 December. The pronounced appreciation of the Japanese yen in the second half of 2008 was underpinned by the growing interest on the part of investors resulting from declining interest rates in other developed countries, and the notable volatility on the foreign exchange market. In 2008, the British pound sterling depreciated against the US dollar by 26.4% (from 1.9850 at the end of 2007 to 1.4593 at the end of 2008), reaching its high (2.0398) on 14 March.

The US dollar appreciated against the lats on the domestic foreign exchange market (from 0.4778 at the end of 2007 to 0.5064 at the end of 2008; a 6.0% increase). The US dollar reached its high (0.5755) on 28 October and a low (0.4354) on 22 April. Over the year, the exchange rate of the euro against the lats fluctuated within the limits of the currency intervention band set by the Bank of Latvia. The euro exchange rate was at its highest (0.7098) in October–December, close to the upper intervention margin set by the Bank of Latvia, and at a low of 0.6958 in February and March, close to the lower intervention margin set by the Bank of Latvia (for the developments of the major exchange rates set by the Bank of Latvia see Chart 13 and Annex 5).

Chart 13

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



The breakdown of the external debt by instrument slightly changed in 2008: as other investment shrank (89.1% to 88.0%), the share of other debt instruments expanded. At the end of 2008, debt-related direct investment, debt securities, currency and deposits, and borrowing amounted to 8.4%, 3.5%, 14.5% and 68.9% of the external debt respectively. At the end of 2008, long-term debt stood at 13.8 billion lats, and short-term debt amounted to 7.0 billion lats.

At the end of 2008, MFI (excluding the Bank of Latvia) external debt amounted to 13.0 billion lats. In 2008, the maturity profile of bank foreign liabilities changed as the received long-term funds increased considerably, reaching 7.7 billion lats or 58.9% of the banks' external debt at the end of 2008 (46.3% at the end of 2007). Loans from parent corporations expanded to 7.2 billion lats (5.8 billion lats in 2007) and their share in the breakdown by creditor increased to 55.4% (45.3% at the end of 2007). In 2008, currency and deposits shrank by 1.3 billion lats, with their share in the bank liabilities declining to 21.2% (31.7% in 2007). At the end of 2008, the banks' net external debt amounted to 8.3 billion lats (7.4 billion lats in 2007).

At the end of 2008, the external debt of other sectors was 4.3 billion lats, including long-term liabilities in the amount of 3.0 billion lats. External liabilities increased by 8.1% in 2008, with the share of loans increasing to 79.7% (74.8% at the end of 2007) and that of trade credit shrinking to 16.5% (22.0% at the end of 2007). Debt liabilities of other sectors and banks to direct investors and direct investment enterprises increased gradually as well. At the end of 2008, they amounted to 1.8 billion lats.

According to the Treasury's official report, the government external debt in foreign currencies increased by 625.3 million lats over 2008, standing at 1 260.4 million lats (7.8% of GDP) at the end of the year. In 2008, the government attracted foreign financial funds in the amount of 800.9 million lats (including an issue of eurobonds in the amount of 400 million euro and the IMF loan in the amount of 535.3 million SDR). To service foreign debt, 201.7 million lats, equalling 3.0% of annual exports, were used (including 172.7 million lats for repaying the principal amount of loans and 200.0 million euro for the redemption of the eurobonds issued in 1998). In 2008, the central government external debt composition by currency changed: the share of euro- and US dollar-denominated liabilities shrank to 65.6% and 1.9% respectively (95.9% and 4.0% in 2007) whereas that of SDR-denominated liabilities stood at 32.5%.

SECURITIES MARKET

In 2008, the primary market of the Latvian government securities saw a change. In the previous years, demand exceeded the amount supplied, but in 2008 investors became more cautious with respect to the Baltic States securities. On 5 March 2008, Latvia issued 10-year eurobonds in the amount of 400 million euro to be traded on the international markets, with the coupon rate set at 5.5% and yield at 5.53% which is 163 basis points higher than the respective yield on German government bonds and exceeds the interest rate on euro swaps by 120 basis points. On the primary market, the breakdown by institution shows that 89% of purchasers were banks, and by geographical breakdown 65% of purchasers were investors from Germany.

The second period of change was observed in September–December, following the bankruptcy of the US investment bank *Lehman Brothers Holding Inc*. It caused a steep drop in stock market prices, a rise in money market interest rates and instability of the financial system. Governments in several countries had to nationalise some banks and inject state budget funds in them. Latvian government also supported the banking sector. Hence, the Treasury increased the initial amount of the Latvian government securities issues and the frequency of the auctions. In order to attract funds more rapidly, the Treasury organised several outright sales of securities and issued euro-denominated government securities in some auctions.

As banks were particularly eager to attract liquidity, they continued to invite their customers to place time deposits in lats with them, offering relatively high interest rates. Therefore buying government securities with low yields would not be financially feasible. In view of the high level of uncertainty, investors were less interested in longer-term securities; however, banks had a positive attitude toward buying shorter-term government securities which could be used as a pledge in transactions with the Bank of Latvia.

In 2008, the Treasury offered lats-denominated debt securities in the amount of 1 367.7 million lats, including outright and extraordinary auctions. The bid amount was 889.4 million lats and the amount sold stood at 692.0 million lats. The demand and the amount sold were 8.3 times and 10.8 times higher respectively in comparison with 2007. Auction participants mostly bid for government short-term securities, and they accounted for 97.7% of the total amount sold.

The stock of outstanding government securities denominated in lats increased 2.7 times, to 1 045.8 million lats, and the breakdown of lats-denominated government securities by holder encountered significant changes: the share of Latvian banks expanded from 43.4% to 77.2%, that of other residents and non-residents shrank from 31.7% to 21.0% and from 24.9% to 1.7% respectively. The developments were also affected by the fact that banks were required a government securities pledge in order to receive loans from the Bank of Latvia, while non-residents chose to dispose of the government securities of the transition economies.

The stock of publicly traded corporate debt securities registered with the LCD in 2008 diminished by 1.9%, to 156.1 million lats. That of publicly traded lats-denominated corporate debt securities registered with the LCD shrank by 41.7%, to 30.6 million lats as there were no new issues of securities denominated in lats, while six issues matured, the issue of the SJSC *Latvijas Hipotēku un zemes banka* one-year Treasury bills in the amount of 10.0 million lats being the largest of them. As a result of growing inflation, there were no new issues of lats-denominated Latvian private sector debt securities. The stock of publicly traded corporate debt securities denominated in euro and registered with the LCD expanded by 6.8%, to 101.2 million lats, the new issue of the SJSC *Latvijas Hipotēku un zemes banka* 3-year mortgage bonds being the largest one.

On NASDAQ OMX Riga, the bid yield on Treasury bonds maturing in August 2018 stood at 5.01% at the end of 2007, rising to 10.50% at the end of 2008. At the end of 2007, the bid rate of the government securities with the time to maturity less than one month was 8.25%, reaching 10.10% at the end of 2008. Similarly to the primary market, the slope of the yield curve in the last months of the year was more flat than usually, pointing to the fact that inflation levels are high and might decline in the future. At the end of 2007, the bid rate of the SJSC *Latvijas Hipotēku un zemes banka* bonds (maturing in 2013; the corporate debt security with the longest maturity on the Riga Stock Exchange) was 6.10%, standing at 9.75% a year later.

The liquidity of longer-term debt securities was low as a result of a lower sovereign rating assigned to Latvia and its negative outlook.

At the end of 2007, the bid yield on Latvian government eurobonds (maturing in 2014) was 4.77%, climbing to 8.82% at the end of 2008, with the spread between the bid yield on German government bonds of the respective maturity swelling from 56 basis points to 649 basis points. The new issue of the Latvian government 10-year bonds was launched on 3 March, the bid yield standing at 5.60% and moving up to 9.86% at the end of 2008, with the spread between the bid yield on German government bonds of the respective maturity surging from 268 basis points to 694 basis points. The spread increased as a result of a fall in the yields on government securities of the developed countries, since they were a safer and more demanded investment in the global financial turmoil, while the yields on government securities of the transition economies rose as their credit risk grew.

In 2008, NASDAQ OMX Riga total turnover of debt securities was 26.9 million lats, down 14.1% year-on-year, despite a more active primary market. In 2008, government bonds posted the highest turnover (25.8 million lats). By issue, the highest turnover (8.5 million lats) was recorded for government 10-year bonds maturing in 2013.

In 2008, the NASDAQ OMX Riga stock turnover stood at 20.0 million lats (3.6 times lower than in 2007). Any monthly turnover in 2008 was smaller than that in 2007. In 2008, shares of the Main List accounted for 84.0% of the total turnover (79.6% in 2007) in Latvia.

In 2008, NASDAQ OMX Riga share price index OMXR shrank by 54.4% and OMXBGI plummeted by 63.0%. At the close of 2008, the NASDAQ OMX Riga capitalisation was 819.8 million lats (44.4% lower than in 2007).

As in 2007, the largest stock turnover was recorded for the shares of JSC *Latvijas kuģniecība* (8.6 million lats; 20.6 million lats in 2007), with the JSC *Grindeks* reporting the second largest turnover (3.8 million lats). The JSC *Latvijas kuģniecība* was less affected by the declining domestic demand, and pharmaceutical companies are among the handful of high-tech companies in Latvia.

The financial performance of some companies listed on the NASDAQ OMX Riga was rather poor in line with the macroeconomic data, since corporate profits continued on their downward trend. Only some of the corporations were able to reorganise and reach higher exports, reduce their costs successfully, and optimise production.

At the end of 2008, as at the end of 2007, shares of 42 corporations were listed on NASDAQ OMX Riga: five corporations were listed on the Baltic Main List (one corporation fewer than in 2007) and 37 corporations were included on the Baltic Secondary List (one corporation was added to the list in comparison with 2007).

THE BANK OF LATVIA IN THE EUROPEAN SYSTEM OF CENTRAL BANKS AND INSTITUTIONS OF THE EUROPEAN UNION

Like the central banks of other EU countries, the Bank of Latvia continued to operate within the ESCB. In its activities, the Bank of Latvia complies with the ECB legal acts in compliance with the Treaty Establishing the European Community and the Statute of the ESCB and ECB. 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 main tasks are as follows:

– establishment and implementation of monetary policy;
– management of foreign currency and gold reserves;
– issue of the national currency, both banknotes and coins;
– organisation and management of the interbank payment system and promotion of a smooth functioning of the payment system in Latvia;
– compiling and publishing financial statistics and Latvia's balance of payments;
– representation of Latvia in foreign central banks and international financial institutions;
– acting as a financial agent for the Latvian government.

The Governor of the Bank of Latvia participated in the ECB General Council meetings. In compliance with the Statute of the ESCB and ECB, the ECB General Council meetings discussed macroeconomic, monetary and financial developments in the EU, reports on functioning of ERM II as well as addressed other issues concerning the central banks of all EU Member States. In May, the ECB General Council approved the ECB Convergence Report on the readiness of Slovakia for the introduction of the euro.

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

The Bank of Latvia's experts also participated in several 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.

The Bank of Latvia's representatives continued their participation in the EC and Eurostat working groups addressing issues related to euro coins, payment systems, economic forecasting and statistics.

In compliance with the provisions of the Statute of the ESCB and ECB, the Bank of Latvia ensured translation of the ECB Annual Report 2007, Chapters 1–4 of the Convergence Report of May 2008 ("Introduction", "Structure of Analysis", "Economic Convergence Position" and "Executive Summary on Countries"), the publication "The Implementation of Monetary Policy in the Euro Area: general documentation on Eurosystem monetary policy instruments and procedures" of November 2008 as well as quarterly versions of the ECB's Monthly Bulletin and its special edition "The 10th Anniversary of the ECB" into Latvian (published on the Internet).

STRATEGIC PLANNING

In 2008, the Bank of Latvia fulfilled its main tasks and planned the activities consistently seeking to reach the objectives stated in its strategic guidelines. The Bank's priorities are as follows:
– price stability and promotion of stability of the financial system. The Bank of Latvia promotes in-depth studies of the economic environment to use the resulting information in its monetary policy decisions;
– preparation for a full-fledged membership of Latvia in the EMU. In cooperation with the government and other institutions, the Bank of Latvia facilitates the implementation of the Maastricht criteria as well as ensures the financial sector settlement infrastructure, the cash changeover, the necessary amendments to the laws and regulations and full-fledged participation in the ESCB;
– promotion of public awareness of the Bank of Latvia's operation, and the decisions it has taken as well as Latvia's economic development. It is essential for the Bank of Latvia to provide transparent and detailed information on the Bank of Latvia's actions and reasons behind them;
– enhancement of the Bank of Latvia's management processes. The Bank of Latvia proceeds with the improvement of management processes, taking into account the best practices of corporate management;
– improvement of the Bank of Latvia's operational efficiency. The Bank of Latvia balances the timing, quality and costs depending on priority set in each task;
– development of the Bank of Latvia as a learning organisation. It is important for the Bank of Latvia that its employees possess a positive attitude towards work, persist in improving their skills to attain the necessary results, collaborate and share their know-how with colleagues;
– increased staff motivation. The Bank of Latvia wishes to attract, engage and retain highly proficient and creative personnel.

The Bank of Latvia continued to improve its management processes. For the first time, the Bank of Latvia operation was assessed in accordance with defined function target indicators. Results of customer and personnel surveys and qualitative and quantitative measurements of different functions were used in the assessment. In view of the results of the above and in order to ensure better operational effectiveness, several processes were improved in 2008.

In 2008, many measures were implemented to facilitate the achievement of goals: for a more detailed description see below.

FOREIGN EXCHANGE POLICY AND FOREIGN RESERVES

Latvia continued to participate in the ERM II to become a full-fledged member of the EMU and introduce the euro. The Maastricht criteria specify that for at least two years prior to the euro changeover the lats is to be pegged to the euro, with the fluctuation of the lats exchange rate against the euro not exceeding ±15% against the central parity rate of the lats vis-à-vis the euro. The Bank of Latvia has unilaterally ensured the lats exchange rate fluctuations against the euro within ±1% of the central parity rate. In 2008, the euro exchange rate against the lats fluctuated within the limits of the currency intervention band set by the Bank of Latvia (EUR 1 = LVL 0.6958/0.7098). From mid-February to mid April, the exchange rate of the lats was close to the lower limit of the currency intervention band set by the Bank of Latvia and the Bank purchased euro, whereas from mid-October to mid-December, the exchange rate of the lats was close to the upper limit of the intervention band set by the Bank of Latvia and the Bank sold euro.

The Bank of Latvia's foreign reserves, which include gold, convertible foreign currencies and SDR, amounted to 2 597.9 million lats at the end of 2008 (2 786.9 million lats at the end of 2007). The decrease in foreign reserves as a result of the Bank of Latvia's interventions on the foreign exchange market was partly offset by income from investing foreign reserves in foreign financial markets in accordance with the guidelines adopted by the Council of the Bank of Latvia.

The Bank of Latvia manages its foreign reserves in compliance with the above guidelines. 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 debt 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 forwards are applied to ensure the optimal currency composition of the foreign reserves.

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

The Bank of Latvia used the services of four external reserve managers. They managed a minor portion of the 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.

MONETARY POLICY INSTRUMENTS

In 2008, the Bank of Latvia resolved to unwind the tight monetary policy stance against the backdrop of internal and external factors. A pronounced fall in the economic growth was observed in Latvia, resulting in a downward pressure on inflation. As a result of a slowdown in lending growth, the role of banks in fuelling the domestic demand decreased, and the developments on the global financial markets made lending more expensive. In 2008, particularly in the second half of it, the external factors deteriorated considerably, hence Latvian banks were not able to borrow funds on the global financial markets as easily as before. Thus the reduction of the reserve ratio provided additional financing to banks, supporting lending and stabilising the economic development. In the last months of 2008, the issue of the stability of Latvia's financial system, requiring additional funds, became topical.

The minimum reserve requirement for banks was the major monetary policy instrument used. In the period of economic overheating in 2005 and 2006, the Bank of Latvia raised the reserve ratio and expanded the minimum reserve base of banks. In 2007, these indicators remained unchanged, but in 2008, with the economic growth posting a sharp downslide, the Bank of Latvia cut the reserve ratio. At the beginning of 2008, the bank reserve ratio stood at 8% but was reduced in February, April, October, November and December (these are the months when the new reserve ratios took effect; see Appendix 10) and at the end of the year stood at 5% for bank liabilities with an agreed maturity of up to two years and 3% for those with an agreed maturity of over two years. At the end of 2008, 20 banks and five branches of EU Member State banks were subject to the minimum reserve requirements. Minimum reserve requirements in lats amounted to 1 355.8 million lats and 796.4 million lats at the end of 2007 and 2008 respectively.

In 2008, the Bank of Latvia left the refinancing rate unchanged at 6.00% but changed the deposit facility rate and marginal lending facility rate. As of 24 February, the deposit facility rate was raised from 2.00% to 3.00%. At the beginning of the year, the marginal lending facility rate stood at 7.50%; as of 9 December, the rate of 7.50% was retained only in case the respective bank had resorted to the lending facility no more than 5 working days within the previous 30-day period; it was raised to 15% in case a bank had resorted to the lending facility 6–10 working days within the previous 30-day period; it was increased to 30% in case a bank had resorted to the lending facility more than 10 working days within the previous 30-day period. In view of the moderating activity on the interbank market at the end of the year, the above changes were aimed at motivating banks to engage in interbank transactions, thus facilitating activity on the interbank market.

The ECB raised its key rate only once in 2008 (by 25 basis points, to 4.25%), followed by further cuts down to 2.50% at the end of the year. The need for reducing the ECB key rate was underpinned by the downslide in the euro area economic growth, resulting in a downward pressure on inflation.

In 2008, the impact of the autonomous liquidity factors was less pronounced than in the previous years, inter alia, the average end-of-day balance of the currency in circulation even posted a decrease, standing at 1 019.3 million lats or 3.3% less than in 2007. The average minimum reserve requirements for banks stood at 1 299.1 million lats (8.1% higher year-on-year). Currency in circulation was affected by a decline in the economic activity, and the rise in the minimum reserve requirements was underpinned by the expanding reserve base (the average balance of the reserve base grew by 22.1% over the year).

The government lats deposit with the Bank of Latvia in 2008 averaged 172.3 million lats (a 12.8% increase year-on-year). Although the government lats deposit with the Bank of Latvia grew on average, budget revenue was not so large as in previous years due to the declining economic growth. Changes in the government deposit monthly balance also increased; to absorb them, a higher level of deposits was required. The government deposit increased on account of an issue of the government eurobonds in March as the government partly converted the funds received in euro in the central bank. At the end of 2008, Latvia received the first instalment of the IMF loan granted within the framework of the Stand-By Arrangement, and the government deposit with the Bank of Latvia increased.

The lats liquidity shrank as a result of lats being sold to the Bank of Latvia in spot transactions in exchange for euro. In 2008, the Bank of Latvia bought lats in exchange for euro in the net amount of 784.8 million lats (in 2007, it sold lats in exchange for euro in the net amount of 158.6 million lats). These transactions mostly reflected a larger lats supply by bank customers on the foreign exchange market. Although in the last few months of the year residents exchanged larger net amounts of lats for euro, it was non-residents who exchanged the largest amounts of lats for euro over the year.

In 2008, the amount allotted in the Bank of Latvia's main refinancing operations was 1.25 billion lats (30.9% lower than in the previous year). A similar decrease was recorded for demand (32.8%; to 976.2 million lats) and the allotted amount (42.4%; to 364.0 million lats). The average daily balance of the main refinancing operations stood at 7.1 million lats (42.3% lower year-on-year). In 2008, the average weighted interest rate on the main refinancing operations was 7.35% (87 basis points higher year-on-year).

In 2008, the Bank of Latvia offered lats-euro swaps in the amount of 2.5 billion lats (a 22.8% year-on-year drop). The demand in the currency swap auctions was 1 462.9 million lats (down 56.4% year-on-year) and the concluded foreign exchange swaps stood at 655.0 million lats (down 50.2%). The average balance of the lats-euro swaps was 12.3 million lats (4.7 times less than in 2007). The average weighted interest rate on lats-euro swaps with 7-day maturity was 7.70% (2 basis points above the level of the previous year).

Similarly to 2007, auctions of the main refinancing operations and currency swaps in 2008 were conducted every working day, with the allotment amount of 5 million lats and 10 million lats respectively. These transactions were not performed in March–August: excess liquidity of the lats was observed as a result of the reserve ratio reduction, and there was no demand for them.

In 2008, the average recourse to the deposit facility amounted to 94.8 million lats (4.4 times higher than in 2007), and the weighted average deposit facility rate stood at 2.96% (2.15% in 2007). The average recourse to the marginal lending facility reached 45.8 million lats (2.6 times higher year-on-year), with the weighted average marginal lending facility rate at 7.50% (6.94% in 2007).

In 2008, recourse to the deposit facility and marginal lending facility intensified as, similarly to developments on the global markets, banks were more cautious with respect to activities on the money market while increasing risk-free transactions with the central bank. Most of the banks had funds in excess but some banks were short of lats. The average recourse to the deposit facility exceeded that of the marginal lending facility, pointing to the fact that the overall liquidity level of the banking system was sufficient. Banks were willing to maintain high level of liquidity to be able to avoid sudden turbulences, as the probability of their materialisation had considerably increased.

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 banks in quotation list that were active on the interbank market and able to conduct market operations at the quoted money market rates on transactions in lats. At the end of 2008, the list of the banks 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 *Hansabanka*, the JSC *Latvijas Krājbanka*, the JSC *SEB banka*, the JSC *Parex banka*, the JSC UniCredit Bank, the Latvian Branch of *Nordea Bank Finland Plc* and the JSC *DnB NORD Banka*.

ECONOMIC RESEARCH, ANALYSIS AND FORECASTING

A modern central bank can effectively pursue monetary policy focussing on an in-depth analysis of the macroeconomic indicator development trends and their interaction, which is performed by applying statistical, mathematical and econometric methods. Economic research and analysis are needed to provide quantitative and scientifically grounded explanations of economic processes, to develop econometric models for forecasting macroeconomic indicators and evaluate alternative scenarios.

Five working papers were published on the Bank of Latvia's website (see Appendix 9), two articles by Bank of Latvia experts were published in international magazines, three experts' roundtables and one conference were held in 2008. The issues tackled encompassed the matters crucial to Latvia's economy: real convergence with the euro area countries, expansion of exports, synchronisation of the business cycles, short-term forecasts for GDP, saving promotion and bank lending channel of monetary policy transmission.

The results of analysis conducted by the Bank of Latvia show that, in recent years, labour productivity has primarily been fuelled by growth in capital per employee, nevertheless, changes in production efficiency have also contributed favourably to the above productivity. Accelerated growth in production efficiency has to be fostered, as it is the key factor behind the labour productivity increase in the long term and may ensure successful convergence with the EU and changeover to the euro (see the materials of the annual conference on economy "Real Convergence on the Road to the Euro: Experience and Prospects" hosted by the Bank of Latvia on 7 October 2008).

One of the criteria for establishing an optimum currency area is the synchronisation of business cycles of the countries within this currency area, thus, given the determination of the Baltic States to become full-fledged participants of the EMU, it is vital to assess an interrelation of the economic activities in the Baltic States and synchronisation with the euro area countries. The conclusions of the study conducted by the Bank of Latvia's experts confirm a common development pattern of the Baltic States. Moreover, the correlation between the growth of Latvia's GDP and a common factor of economic development of the euro area countries and the Baltic States has strengthened since 2000.

The study by the Bank of Latvia's experts on export structure shows that its structural changes may have unfavourable effect, should the share of goods and services with low value added expand in exports. To enhance production of sophisticated export goods, an efficient export promotion strategy should be implemented. This conclusion has been supported by the analysis of Latvia's export prices which indicate that in recent years rapid export growth has primarily been based on price increase, with the real market shares shrinking at the same time (see the Bank of Latvia's experts' round-table discussion materials on the Bank of Latvia's website).

With uncertainty about economic growth rising, short-term forecasting of GDP dynamics may become more important; hence the Bank of Latvia's experts continued to expand the scope of methods applied to GDP forecast. The potential of dynamic factor models is high, as they ensure more accurate forecast than the simpler autoregressive models. Both the bridge equations and state space models containing preliminary M3 monthly data perform better than the autoregressive model.

In Latvia, gross savings were in line with the EU average; a detailed analysis by sector indicated, however, that both household expenditure and government expenditure exceeded the rapidly accelerating income. To study the household savings pattern, the Bank of Latvia's experts built cross-section model on the basis of microeconomic data.

Bank lending channel of monetary policy transmission was also analysed by using the microeconomic data. The study by the Bank of Latvia's staff showed that some banks in Latvia have statistically significantly negative reaction to a domestic monetary shock; the weighted average reaction of the growth in total lats loans is, however, statistically insignificant. A domestic monetary shock has only a distribution effect and it affects banks that are small, domestically owned and have lower liquidity or capitalisation. The bank lending channel is limited only for the supply of lats loans, and thus the importance of this channel has been dramatically reduced.

The econometric models are vital not only for revealing economic processes, but also for forecasting the main macroeconomic indicators. The Bank of Latvia uses a number of forecasting models. The most important is the macroeconomic model of Latvia, similar in structure to that applied by the ECB. The Bank of Latvia experts use this model as a complementary instrument for macroeconomic analysis and for making medium-term forecasts.

The Database of Macroeconomic Indicators has been developed, which allows for a centralised use of the data collated by the CSB (consumer and producer price indices, the volume of exports and imports, retail trade turnover, GDP from expenditure and production side, national accounts, wages and salaries and corporate financial indicators), the Treasury (the consolidated general government budget, the state debt and Latvia's external debt), the data on cars newly registered with the Road Traffic Safety Department, the data of the State Unified Computerised Land Register, the State Land Service and corporate real estate companies. The data monitoring performed in the system, calculation of additional indicators and data retrieval after the current data download have ensured higher data integrity and more extensive data analysis.

CASH MANAGEMENT

At the end of 2008, currency in circulation diminished by 3.0% as compared with 2007 (from 1 049.5 million lats to 1 018.1 million lats). Over five years, the currency in circulation has grown 1.5 times.

Banknotes and coins received from banks were checked for authenticity and suitability for circulation by using automated cash processing systems. In 2008, the amount of processed cash (4 007.9 million lats) exceeded that of currency in circulation 3.9 times (3.2 times in 2007). Of the amount of cash processed, 656.0 million lats or 16.4% was withdrawn from circulation (517.0 million lats or 15.5% in 2007).

The total nominal value of counterfeits detected in 2008 (15.7 thousand lats) accounted for only 0.002% of the currency in circulation.

The Bank of Latvia released a new issue of 1- and 10-santims and 1-lats circulation coins and 10-lats banknotes with improved security features in 2008.

In 2008, the Bank of Latvia issued a 20-lats gold collector coin *Coin of Latvia* (in circulation as of 21 April 2008), since it carried out the project conceived by Teodors Zaļkalns in 1922. Two versions of the coin *Song Festival* were issued within the EU collector coin programme *European Heritage* – a silver coin (in circulation as of 23 May 2008) and a cupro-nickel coin (in circulation as of 2 July 2008) with the denomination of 1 lats. Already the seventh Bank of Latvia 1-lats silver coin *Limbaži* (in circulation as of 28 July 2008) was issued within the international coin programme *Hansa Cities*. 1-lats silver coin *Basketball* (in circulation as of 10 November 2008), the *Lucky Coin* (in circulation as of 3 December 2008) and the coin *90th Anniversary of Latvia's Statehood* (with a colour print) featuring the national flag and the first coat of arms of the Republic of Latvia (in circulation as of 9 October 2008) were also put into circulation.

New special 1-lats coins *Waterlily* (in circulation as of 13 June 2008) and *Chimney-sweep* (in circulation as of 3 December 2008) replenished the stock of circulation coins.

STATISTICS

In 2008, a methodological study of some services provided by the MFIs and financial instruments used was conducted in the field of financial markets and monetary statistics, the implementation of the ECB's new statistical requirements for preparing investment fund statistics was commenced, the scope of reporting agents increased, co-operation with the current data providers strengthened, and statistical information was compiled on a regular basis in accordance with the requirements of the ECB and other data users.

BANK OF LATVIA'S BANKNOTES AND COINS PRINTED AND STRUCK IN 2008

10 LATS

Face value: 10 lats
Size: 130 x 65 mm
Colour: violet
Printed by
Giesecke & Devrient GmbH
(Germany)
Artists:
Imants Žodžiks,
Valdis Ošiņš

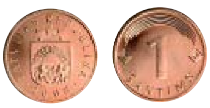
Obverse

A panoramic view of the River Daugava and a stylised oak-leaf (a see-through register) are superimposed on an ornamental background. Two relief inscriptions of the numeral 10 are imprinted above the oak-leaf. Across the top of the banknote, there is a two-coloured inscription LATVIJAS BANKAS NAUDAS ZĪME (money note of the Bank of Latvia) with a serial number of the banknote inscribed underneath in red. Across the bottom of the banknote, there are the inscriptions DESMIT LATU (ten lats) in two-coloured print, LATVIJAS BANKA (Bank of Latvia), the facsimile signature of the Governor of the Bank of Latvia, and the serial number of the banknote in black print. On the right side of the banknote, there is a vertical ornamental band composed of the motif of Lielvārde belt topped by the numeral 10. The nominal value superimposed on the vertical band is visible when viewed at an angle against the light. In the left upper part of the banknote, there are two violet dots (Braille) in relief that are arranged vertically on a white background that is watermarked. Beneath the watermark, there is a horizontal band of fine violet lines in a blend of colours with the numeral 10 in microlettering superimposed. The numeral is printed in special ink creating a colour-changing optical effect depending on the angle of viewing. To the left of the numeral 10, there is a vertical band with the numeral 10 in relief repeated four times in different shades of colour depending on the angle of viewing.

Reverse

A representation of the traditional Latvian bronze bow-brooch is superimposed on a motif of the brooch's elements. A vertical metallic holographic band with the inscription of the nominal value is worked into the paper to the left of the brooch, and a stylised oak-leaf is to the right. Across the top of the banknote, there is the inscription DESMIT LATU (ten lats) and numeral 10. The numeral 10 and two-coloured inscription LATVIJAS BANKAS NAUDAS ZĪME (banknote of the Bank of Latvia) are at the bottom of the banknote. To the left of the brooch motif, there is a vertical band of numerals 10 with diagonal stripes that blend into one another. Along the edge of the band, there is a vertical inscription © LATVIJAS BANKA 1992 (© Bank of Latvia 1992) on a white background. A design of the large coat of arms of the Republic of Latvia with the year 2008 inscribed underneath is depicted on a white background in the lower right corner of the banknote. Above the coat of arms, the paper is watermarked (a profile of a Latvian folk-maid).

1 SANTIMS



Weight: 1.60 g; diameter: 15.65 mm
Metal: copper-clad steel
Struck by *Münze Österreich* (Austria)
Artists: Gunārs Lūsis (graphic design),
Jānis Strupulis (plaster model)

Obverse

The small coat of arms of the Republic of Latvia, encircled by the inscription LATVIJAS REPUBLIKA (Republic of Latvia) and the year, is placed in the centre.

Reverse

The numeral 1 is centred on the coin, with the inscription SANTĪMS arranged in a semicircle beneath it. Two diamond-shaped suns are located on either side of the numeral. At the top of the coin, five arcs (representing the work cycle) join the two diamond-shaped suns.

Edge: plain.

10 SANTIMS

Weight: 3.25 g; diameter: 19.90 mm
Metal: alloy of copper, nickel and zinc
Struck by *Monnaie de Paris* (France)
Artists: Gunārs Lūsis (graphic design),
Jānis Strupulis (plaster model)

Obverse
The small coat of arms of the Republic of Latvia, encircled by the inscription LATVIJAS REPUBLIKA (Republic of Latvia) and the year, is placed in the centre.
Reverse
The numeral 10 is centred on the coin, with the inscription SANTĪMU arranged in a semicircle beneath it. Above the numeral, five arcs (representing the work cycle) join two diamond-shaped suns which are located on either side of the numeral 10.
Edge: plain.

1 LATS

Weight: 4.80 g; diameter: 21.75 mm
Metal: cupro-nickel
Struck by *Monnaie de Paris* (France)
Artists: Gunārs Lūsis (graphic design),
Jānis Strupulis (plaster model)

Obverse
The large coat of arms of the Republic of Latvia with the year 2008 inscribed below is placed in the centre. The inscriptions LATVIJAS and REPUBLIKA, each arranged in a semicircle, are above and beneath the central motif respectively.
Reverse
A salmon, the symbol of Latvia's abundant water resources, is shown jumping out of the water from left to right. The numeral 1 with the inscription LATS in a semicircle beneath it is centred in the lower part of the coin.
Edge
Two inscriptions LATVIJAS BANKA (Bank of Latvia), separated by rhombic dots.

SPECIAL CIRCULATION COINS OF LIMITED MINTAGE

WATERLILY

Face value: 1 lats
Weight: 4.80 g; diameter: 21.75 mm
Metal: cupro-nickel
Struck by *Rahapaja Oy* (Finland)
Artists: Aleksandrs Čhaidze (graphic design),
Laura Medne (plaster model)

CHIMNEY-SWEEP

Face value: 1 lats
Weight: 4.80 g; diameter: 21.75 mm
Metal: cupro-nickel
Struck by *Rahapaja Oy* (Finland)
Artists: Daina Lapiņa (graphic design),
Laura Medne (plaster model)

COLLECTOR COINS

COIN OF LATVIA

Face value: 20 lats
Weight: 10.00 g; diameter: 22.00 mm
Metal: gold of .9999 fineness; quality: UNC
Struck by *Münze Österreich* (Austria)
Author: Teodors Zaļkalns;
the plaster model, based on the author's sample, was made by Ligita Franckeviča

The project conceived by Teodors Zaļkalns (1876–1972), an outstanding Latvian sculptor, to create a 20-lats gold coin in 1922 has been carried out. The plaster model of the coin preserved in the repository of the Latvian National Museum of History contains symbols that are of great significance to Latvia.

THE 90TH ANNIVERSARY OF LATVIA'S STATEHOOD

Face value: 1 lats
Weight: 31.47 g; diameter: 38.61 mm
Metal: silver of .925 fineness; quality: proof
Struck by *Rahapaja Oy* (Finland)
Artist: Aigars Bikše

LUCKY COIN

Face value: 1 lats
Weight: 22.00 g; diameter: 35.00 mm
Metal: silver of .925 fineness; quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists:
Arvīds Priedīte (graphic design),
Jānis Strupulis (plaster model)

BASKETBALL

Face value: 1 lats
Weight: 31.47 g; diameter: 38.61 mm
Metal: silver of .925 fineness; quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists:
Frančeska Kirke (graphic design),
Ligita Franckeviča (plaster model)

THE INTERNATIONAL COLLECTOR COIN PROGRAMME HANSA CITIES

LIMBAŽI

Face value: 1 lats
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)

THE EU COLLECTOR COIN PROGRAMME EUROPEAN HERITAGE

SONG FESTIVAL

Silver coin
Face value: 1 lats
Weight: 31.47 g; diameter: 38.61 mm
Metal: silver of .925 fineness; quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists:
Arvīds Priedīte (graphic design),
Ligita Franckeviča (plaster model)

Cupro-nickel coin
Face value: 1 lats
Weight: 12.40 g; diameter: 30 mm
Metal: cupro-nickel; quality: BU
Struck by *Rahapaja Oy* (Finland)
Artists:
Arvīds Priedīte (graphic design),
Ligita Franckeviča (plaster model)

Methodological work was continued in relation to the ECB plans to implement changes in the MFI statistical requirements, stipulated by Regulation (EC) No 2423/2001 (ECB/2001/13) concerning the consolidated balance sheet of the monetary financial institutions sector and Regulation (EC) No 63/2002 (ECB/2001/18) concerning statistics on interest rates applied by monetary financial institutions to deposits and loans vis-à-vis households and non-financial corporations. A survey on the process of credit risk transfer was conducted in respect of MFI balance sheet statistics, with a particular focus on instruments of credit risk transfer, credit lines and securitisations. Loans to non-financial corporations by initial interest rate fixation period were studied in relation to statistics on MFI interest rates.

In 2008, the SJSC *Latvijas Pasts* became a reporting agent for monetary statistics, and it started to provide data pursuant to Regulation (EC) No 1027/2006 (ECB/2006/8) of 14 June 2006 on statistical reporting requirements in respect of post office giro institutions that receive deposits from non-monetary financial institution euro area residents. To strengthen feedback to reporting MFIs and ensure the use of comprehensive data in market analysis, the Bank of Latvia commenced transmission of MFI aggregated data to the reporting MFIs in the degree of detail similar to that of the submitted data. All MFIs supported the establishment of the feedback.

Significant methodological work was performed to implement new requirements in the field of investment fund statistics, stipulated by Regulation (EC) No 958/2007 (ECB/2007/8) of 27 July 2007 concerning statistics on the assets and liabilities of investment funds and the revised ECB Guideline (ECB/2007/9) of 1 August 2007 on monetary, financial institutions and market statistics. The Bank of Latvia intends to use the current data sources and make the necessary calculations for preparing investment fund statistics, without setting forth any new reporting requirements.

As the ECB continues to cooperate with the IMF in the area of financial stability statistics, the participation of Latvia in the provision of financial stability indicators for drawing up the IMF's *Financial Stability Report* was approved, starting with the data for 2008 (the financial stability indicators for 2005 prepared within the project for the compilation of financial stability data, coordinated by the IMF, are available on the Bank of Latvia's website).

In 2008, methodology improvements were continued in the area of preparing statistical data on Latvia's balance of payments, with the primary focus on the compilation of securities data and transportation services data.

The Bank of Latvia commenced the production of securities data on the basis of the "Monthly Report of Holders of Securities" approved by the Council of the Bank of Latvia in 2007, according to which credit institutions, excluding electronic money institutions, and investment brokerage companies provide item-by-item information on securities held by them and their customers. These data allow for a more accurate monitoring of data on the securities issued in Latvia and stored in the ECB Centralised Securities Database, and information on the issues of securities held by Latvia's residents.

As part of an oversight of the sources and quality of balance of payments statistics, the Bank of Latvia's staff held a meeting with the reporting agents to discuss the methodology of the "Regulation for Compiling the 'Quarterly Report on Transportation and Intermediary Services' " approved by the Council of the Bank of Latvia, and the respective complementary information for the reporting agents was published on the Bank's website. The Bank of Latvia participated in developing the methodology for travellers' statistics to ensure transition to an ongoing travellers' survey at the Riga

International Airport and enhance the quality of travellers' statistics notably subsequent to Latvia joining the Schengen area.

In the area of the government finance statistics, the Bank of Latvia's experts continued to participate in cross-institutional working groups dealing with the issues related to the preparation of notification on the state budget deficit and debt, provision of information on the volume and spending of the EU funds, accounting for public and private partnership projects as well as continued to compile, on a regular basis, the government finance statistics in compliance with the requirements of the ECB.

The Bank of Latvia continued participation in the ECB and Eurostat working groups and committees as well as workshops. At the meeting of the Working Group on External Statistics of the ECB, the Bank of Latvia staff members shared their expertise in using a particular method for marking securities data to market. The Bank of Latvia's representative was also involved in the newly-established Group of the BIS, the ECB and the IMF experts for the review of the Handbook on Securities Statistics. The Bank of Latvia participated in the work of the Seasonal Adjustment Steering Group aimed at developing guidelines for seasonal adjustment of time series and stating common requirements for provision of metadata for statistical purposes and the users of statistics, as well as organising training and sharing expertise, and coordinating the testing and assessment of the current and new software for seasonal adjustment.

The Bank of Latvia continued the regular transmission of statistical data to the BIS and the IMF and also transmitted statistical information to other domestic and foreign data users.

In view of the fact that up-to-date and timely information is furnished to a wide range of users via the Internet, in 2008 the Bank of Latvia conducted a survey of Internet users regarding those sections of the Bank's website where statistical data and regulations for compiling statistics are published. The overall assessment of the usefulness of statistical information provided on the website was a positive one.

To furnish timely information to a wide range of data users, the Bank of Latvia disseminated financial and balance of payments statistics of Latvia via its regular publications and the Bank's website, IMF publications *International Financial Statistics* and *Balance of Payments Statistics Yearbook* and within the IMF Special Data Dissemination Standard. The new publication of quarterly balance of payments statistics has been designed in the form of a database on the Bank of Latvia's website, thus facilitating the use of these data. The Bank of Latvia compiled the data on the Latvian securities market for inclusion in the ECB publication *Bond Markets and Long-term Interest Rates in Non-euro Area EU Member States and in Acceding Countries* and the edition *Review of the International Role of the Euro*. The Bank of Latvia continued to provide regular information on payment system statistics for the ECB publication *Blue Book*, specific macroeconomic indicators for the ECB publication *Orange Book* and structural statistics data for the ECB's report *EU Banking Structures*.

PAYMENT AND SETTLEMENT SYSTEMS

The Bank of Latvia continued to ensure the operation of two payment systems (the SAMS – real-time gross settlement system for interbank and urgent customer payments and the EKS – clearing and settlement of net positions of batch retail payments). On 1 January 2008, the operation of the EKS was expanded by commencing the settlement of payments in euro. The Bank of Latvia in conjunction with other participants of the ESCB continued to ensure the operation of TARGET2, whose component system is

TARGET2-Latvija. TARGET2-Latvija is primarily used for real-time settlement of large value payments in euro in central bank money.

At the end of 2008, 20 banks, three branches of foreign banks and the Bank of Latvia were the participants in the SAMS. In 2008, 87.3% of all interbank payments initiated in Latvia in lats were made via the SAMS and their share of value amounted to 88.8% (93.5% and 90.9% in 2007 respectively). The total volume of payments processed in the SAMS increased by 6.2% year-on-year, reaching 248.4 thousand, while their total value rose by 89.1% and was 181.9 billion lats. On 19 November 2008, the value of the SAMS payments sent in a single day reached a historic high of 2.1 billion lats. This can be primarily attributed to the changes in the interbank market resulting from the global financial market turmoil. The SAMS processed both interbank and customer payments, and their share of volume amounted to 37.9% and 62.1% respectively, while that of value was 92.7% and 7.3% respectively. In 2008, the average value of a single payment processed in the SAMS rose by 78.1% (to 732.2 thousand lats). The volume concentration ratio of the SAMS was 70.3% and the value concentration ratio amounted to 82.8% (70.2% and 76.8% in 2007 respectively). The SAMS ensured 99.97% availability of the system to its participants in 2008 (99.68% in 2007).

At the end of 2008, 20 banks, three branches of foreign banks and the Bank of Latvia participated in the EKS lats settlement. In 2008, the EKS processed 75.2% of all customer payments executed by banks in Latvia in lats and their share of value stood at 71.0% (74.4% and 67.4% in 2007 respectively). The total volume of payments processed in the EKS increased by 10.0% (to 33.2 million) and their total value grew by 5.6% (to 13.1 billion lats). The payments made in the EKS were processed in two clearing cycles. Of the entire payments executed in the EKS in lats, 64.9% and 54.7% were made in the first clearing cycle in terms of volume and value. In 2008, the average value of a single payment made in lats declined by 4.0% (to 393 lats). The volume concentration ratio of the EKS payments in lats was 78.1% and the value concentration ratio amounted to 77.4% (76.8% and 75.2% in 2007 respectively).

At the end of 2008, 20 banks, two branches of foreign banks, the Treasury and the Bank of Latvia participated in the EKS euro settlement. In 2008, the EKS processed 5.6% of all customer payments executed among banks in Latvia in euro (their share of value – 1.3%). The total volume and the total value of payments processed in the EKS in euro amounted to 223.8 thousand and 1.5 billion euro respectively. The payments made in the EKS in euro were processed in two clearing cycles. Of all payments executed in the EKS in euro, 56.0% and 53.2% were processed in the first clearing cycle in terms of volume and value respectively. The average value per payment executed in euro stood at 6 698 euro in 2008. The volume concentration ratio of the euro payments processed in the EKS was 76.8% and the value concentration ratio amounted to 73.3%.

At the end of 2008, 20 banks, two branches of foreign banks, the Treasury, the LCD and the Bank of Latvia were direct participants in TARGET2-Latvija. In 2008, 149.8 thousand payments in the total value of 70.1 billion euro were executed in TARGET2-Latvija. TARGET2-Latvija processed both interbank and customer payments and their share of volume amounted to 20.7% and 79.3% respectively, while that of value was 90.6% and 9.4% respectively. The average value per payment made via TARGET2-Latvija stood at 468.0 euro in 2008. The volume concentration ratio of payments executed via TARGET2-Latvija was 63.1% and the value concentration ratio amounted to 82.6%.

PAYMENT SYSTEM OVERSIGHT

The Bank of Latvia continued to oversee the payment system of Latvia. A day-to-day oversight of the systemically important payment systems (the SAMS and the EKS) continued in compliance with "The Bank of Latvia's Payment System Policy".

With a view to achieving common legal framework for all payment systems maintained by the Bank of Latvia, on 13 November 2008, the Council of the Bank of Latvia approved new regulations related to the operation of the SAMS and the EKS. The operational framework or terms and conditions of the SAMS and the EKS operation were not amended, while the list of institutions eligible to participate therein was expanded. The central banks of the EU Member States and the ECB were extended the right to participate in the SAMS and the EKS as well as in TARGET2-Latvija, and the Bank of Latvia was entitled to acknowledge other institutions, including the Treasury, to be the participants in the above systems.

Pursuant to "The Bank of Latvia's Payment System Policy" concerning the oversight of clearing (net settlement) and retail payment systems, the Bank of Latvia assessed the EKS recurrently and monitored the self assessment made by the limited liability company *First Data Latvia* of its local lats clearing and settlement system in compliance with the BIS "Core Principles for Systemically Important Payment Systems" (hereinafter, the Core Principles). Both the EKS and the local lats clearing and settlement system, the limited liability company *First Data Latvia*, were deemed systemically prominent payment systems in accordance with the ECB *Oversight Standards for Euro Retail Payment Systems*, and were to comply with the Core Principles I and II and VII–X.

Assessing the EKS, the Bank of Latvia identified full compliance with the above Core Principles. Hence, the overall assessment of the EKS against them has remained unchanged in comparison with the assessment conducted in 2004.

A full compliance was identified by the limited liability company *First Data Latvia* in the self assessment of its local lats clearing and settlement system with the Core Principles II, III, VIII, IX and X, an overall level of compliance with the Core Principle I and a partial compliance with the Core Principle VII. Evaluating the above self assessment, the Bank of Latvia acknowledged it to be adequate and appropriate.

Fourteen electronic money institutions that may commence their operation in line with the requirements of the Law "On Credit Institutions" without being granted a licence, had notified the Bank of Latvia by the end of 2008 on the commencement of the operation. Five electronic money institutions commenced operation in 2008.

The Bank of Latvia collated data on the payment instruments used. Payments by payment cards (95.1 million payments or 49.3%) and customer credit transfers (92.6 million payments or 48.0%) accounted for the majority of all payment instruments used in Latvia in 2008. The value of these payments was 1.7 billion lats and 357.5 billion lats respectively. Other payment instruments (direct debit, cheques, e-money) were relatively seldom used.

The Bank of Latvia participated in the SEPA in 2008, engaging in the activities of the SEPA Working Group of the Payment Committee established by the Association of Latvian Commercial Banks. The above Working Group developed "The SEPA Implementation Plan in the Banking Sector of Latvia. Version 1.0." The Plan was approved at the meeting of the Payment Committee of the Association of Latvian Commercial Banks on 29 May 2008. The objective of the SEPA project is to ensure execution of retail payments in euro under the same conditions and from one account, regardless of its location in Europe. According to the Plan, the banking sector of Latvia has undertaken to offer the payments in euro by the end of 2010 in compliance with the SEPA requirements, and to complete the SEPA project with the introduction of the euro in Latvia. The Plan was also made available on the ECB website dedicated to the SEPA project.

Facilitating the implementation of the SEPA Project in Latvia, the Bank of Latvia took part in the establishment of the National SEPA Working Group at the end of 2008, and undertook its steering. The National SEPA Working Group has been established under the Euro project, and one of its key assignments is to develop the National SEPA plan and coordinate the implementation thereof, foster communication with the general public and promote domestic and international cooperation.

OVERSIGHT OF SECURITIES SETTLEMENT SYSTEMS

The operators of the VNS and the DENOS, the LCD settlement system, ensured smooth operation of both systems in 2008. With the VNS participants increasingly engaging in the Bank of Latvia monetary operations, both turnover of transactions executed and outstanding amount in the VNS expanded.

Within the framework of the oversight of securities settlement systems the Bank of Latvia cooperated with the system operators and their participants on evaluating the TARGET2-Securities user requirements under the Project commenced by the Eurosystem, and provided Latvia's opinion thereof. The Bank of Latvia contributed to preparing the ESCB and the Committee of European Securities Regulators (CESR) draft recommendations for the securities settlement systems. Once approved, the recommendations will be used by the overseers of the central banks and the securities market regulators of the EU Member States to enhance the safety and efficiency of securities clearing and settlement and promote the integration and competitiveness of securities market. The above recommendations provide common settlement priciples for the securities settlement systems of the EU Member States.

FINANCIAL STABILITY

To facilitate financial stability, the Bank of Latvia cooperated closely with the FCMC in assessing the major risks to the financial sector stability. As before, the focus was on the banking sector since it continued to dominate in financial intermediation. The Bank of Latvia used econometric models, stress tests, surveys on bank lending, household surveys and bank data for risk assessment.

The Bank of Latvia cooperated with the Ministry of Finance and the FCMC in addressing issues of financial crisis management. The Bank of Latvia supported the measures taken by the Latvian government to facilitate financial stability, and participated in drafting the respective laws and regulations. To foster cooperation among the EU countries and common understanding in the event of potential cross-border crises, the Bank of Latvia together with the Ministry of Finance and the FCMC signed the "Memorandum of Understanding on Co-operation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stabitity" (in effect as of 1 June 2008).

In 2008, representatives of the Bank of Latvia participated in the EFC, the CEBS and the ESCB Banking Supervision Committee as well as working groups established by the above committees. These institutions continued to evaluate the impact of securitisation model "originate and distribute" on the financial stability, assess the implementation of capital requirements directive and the pro-cyclical effects, the influence of population ageing on the financial sector as well as the exposure of the EU banks to the commercial property market risks, and develop a common understanding of crisis management. Structural and conjuncture changes were further identified, the impact of legislation and supervision requirements on the financial stability assessed as well as a potential for improvement of cooperation between the central banks of the EU Member States and supervisory authorities was sought.

OPERATION OF THE CREDIT REGISTER

On 1 January 2008, the Credit Register of the Bank of Latvia was launched, with its technology based on the information system developed by the Bank of Latvia.

The Credit Register has been developed to enable the Credit Register participants (banks and their subsidiaries providing financial services associated with credit risks, credit unions, insurance corporations, as well as the association "Latvian Office of Vehicle Insurance") to assess borrowers' credit worthiness more accurately, manage credit risks more efficiently, provide additional opportunities for performing supervisory functions and secure the Bank of Latvia and FCMC needs for the macroeconomic analysis.

The Credit Register ensured collection, accumulation and permanent storage of data on the borrowers and borrower guarantors, their liabilities and the performance thereof, including the data on any new loan granted, settlement of liabilities, delayed payments and violations. The Credit Register ensured storage of all data that have been collected and accumulated in the Register of Debtors since 2 July 2003. Participants of the Credit Register also submitted data to the Credit Register. At the end of 2008, the Credit Register comprised 106 participants who authorised 901 users to work with the Credit Register.

In 2008, participants of the Credit Register submitted data to the Credit Register step by step. As of 1 January 2008, the Credit Register participants submitted data on any new loan granted within five business days of the day the agreement was signed. The Credit Register participants submitted data on the entire outstanding liabilities, i.e. loan portfolio (as at 1 January 2008) by 30 June 2008. As of 1 July 2008, the Credit Register participants submitted data on the actual outstanding liabilities at the end of the calendar quarter, and the Bank of Latvia reviewed the conformity of these data with the monthly financial position reports submitted by the Credit Register participants.

At the end of 2008, the Credit Register contained data on 840 thousand borrowers and 1.9 million obligations, and the total loan portfolio of the Credit Register participants amounted to 17.9 billion lats at the end of the year.

The data of the Credit Register were accessible to the participants of the Credit Register, the FCMC and the Bank of Latvia, borrowers and borrower guarantors (natural and legal persons regarding their liabilities).

The Credit Register participants submitted 2.53 million requests about persons in 2008, of which 2.40 million were requests about natural persons and 0.13 million requests about legal persons.

The Bank of Latvia provided information to borrowers and borrower guarantors (natural and legal persons). As of 1 October 2008, natural and legal persons may receive information on their liabilities at the Riga, Liepāja, Daugavpils and Rēzekne Branches of the Bank of Latvia (previously at the Riga Branch only).

In 2008, 2 827 requests were submitted to the Bank of Latvia by natural and legal persons regarding the provision of data on their liabilities existing in the Credit Register.

INFORMATION TECHNOLOGIES

The Interbank communication network has been replaced by internet-based information exchange between the Bank of Latvia, banks and other participants, thus setting up a more flexible and extensive communication environment and enabling considerable savings related to maintenance costs.

An enhanced security system has been introduced for the Bank of Latvia network and information systems user authentication. Two-factor authentication system has been implemented and instead of username and password, the system can be accessed with a PIN-code-secured smartcard, thus ensuring a better protection from unauthorised use of the information systems. Moreover, the certificates installed in the smartcard allow encrypting documents and e-mail messages.

The enhancement of the Bank of Latvia's electronic document management system eDPS was continued, adding a feature for electronic processing of procurement documents as well as incorporating general correspondence and records management. Intranet was upgraded, thus making communication more convenient and far-reaching, including advising the Bank of Latvia staff on any amendments to internal regulations in a more timely and accurate fashion.

Server consolidation has been initiated by applying virtualisation technologies. Fewer servers will be needed and their capacities used more efficiently, thus allowing to cut on server infrastructure maintenance costs.

INFORMATION TO THE PUBLIC

Since the beginning of 2008, economic development in Latvia has shifted from a fast and unbalanced growth to a more moderate one, and a slowdown was observed at the end of the year. The population became aware that inflation hikes were being ousted by rising unemployment and economic downturn. During the last three months of the year, the stock of information in mass media regarding the economic outlook was five times as large as in the respective period a year ago.

When communicating the forecasts for economic development, the Bank of Latvia focused on informing the general public on possible development scenarios on a continuous basis and explaining the economic policy moves toward overcoming the economic downturn in a more efficient manner. The main emphasis was laid on the need for a tight monetary policy, loan availability and the need to define priority sectors. Changeover to the euro as soon as possible was pointed out as a national strategic goal for attaining macroeconomic stability.

In 2008, the main communication channels continued to be mass media, the Bank of Latvia website and publications, the Bank of Latvia educational facility Visitors Centre "Money World", a dialogue with stakeholders in the annual conference on economic development in Latvia, experts' roundtable and other.

Collaboration with mass media

The Governor of the Bank of Latvia used to brief the representatives of mass media at press conferences run immediately after the close of the Bank of Latvia's Council meetings and offer macroeconomic analysis, forecasts and reasons thereof, as well as provide a detailed outline of the Bank of Latvia stance when answering journalists' questions. This approach enables the financial market participants to have a better grasp of the rationale behind the decisions, forecasts and corrective policy actions. As of the beginning of 2008, Bank of Latvia's monetary policy decisions were taken to unwind the tight monetary policy, encourage the financial sector to seek for long-term funds, and create more favourable conditions for loans needed for economic growth. This monetary policy stance has been revealed in the Bank of Latvia comments.

Parallel to press conferences, mass media were furnished with written releases. Press releases were dispatched to mass media also on other major events and data releases by the Bank of Latvia, such as quarterly balance of payments, the central bank's balance sheet, currency in circulation, new issues of banknotes and coins as well as other topics. The Bank of Latvia experts provided answers to the questions posed by the media, and also posted weekly comments on the Bank of Latvia website about key macroeconomic and financial developments in Latvia and worldwide. The stability of the lats, price movements, the relevance of the fiscal policy to the actual macroeconomic situation as well as the developments of domestic and external demand were among the dominant topics.

Late in 2008, with economic growth on a steep downturn and financial sector losing some of its strength, certain tensions emerged as to the lats peg rate and its potential revision. The Bank of Latvia offered comprehensive explanations to mass media and general public on the persistence of the central bank's policy stance and implementation mechanism, putting a special emphasis on the backing of lats with foreign currency and gold reserves.

The Governor and the experts of the Bank of Latvia in interviews and publications elaborated on the inflationary developments, the role of the euro in the EU economy, enlargement of the euro area, the structural changes needed in the national economy of Latvia, as well as on the role of a stringent fiscal policy in stabilising the national economy in a recession phase, given the failure to make the necessary provisions during the previous cycle.

Website and publications

Economic experts and other interested parties may access the Bank of Latvia's macroeconomic analysis results both via mass media and directly on the Bank of Latvia website and publications. Statistics on Latvia's balance of payments, external debt, banking sector, monetary operations, securities transactions and payments systems are posted on the Bank of Latvia website. The central bank, on a regular basis, issues publications providing comprehensive information on developments in the financial sector and the national economy. The Bank of Latvia Annual Report for 2007 discloses information on the central bank operations and financial results. Latvia's economic growth was analysed in the context of the global economic development. The Bank of Latvia's quarterly publications *Monetārais Apskats*. *Monetary Review*, *Latvijas Maksājumu Bilance*. *Latvia's Balance of Payments*, monthly publications *Monetary Bulletin* and *Latvia's Balance of Payments (Key Items)*, and the *Financial Stability Report* play an important role in information dissemination.

To enable the central bank to take well-considerate and responsible monetary policy decisions, the Bank of Latvia experts carried out in-depth research and initiated public debate on key topics (see Chapter "Economic Research, Analysis and Forecasting" and Appendix 9).

The bulletin *Averss un Reverss* is a publication where the experts of the Bank of Latvia provide an insight in the results of macroeconomic and financial analysis. The year 2008 issues of the quarterly bulletin contain articles on the lifecycle of real estate market, the Latvian export structure, national and household savings, fiscal policy risks, the breakdown of labour force, and the euro area enlargement.

A dialogue with stakeholders
To facilitate the discussions with other policy makers (including non-governmental organisations, academicians, educators and journalists) on issues that are crucial for macroeconomic stability and growth as well as for monetary policy implementation, the Bank of Latvia approach at conferences, roundtables and lectures is direct dialogue.

On 7 October 2008, the Bank of Latvia organised its annual conference on economic development in Latvia entitled *Real Convergence on the Road to the Euro: Experience and Prospects*. At the centre of discussions was the current experience with real convergence and the challenges to come, covering Latvia as well as Central and Eastern Europe. Growth of productivity was singled out as a vital factor for sustainable real convergence. The central finding of the conference was that a concrete action plan is a prerequisite to, first, becoming the Maastricht criteria-compliant within the most compressed timeframe possible, and subsequently joining the euro area, and, second, promoting increase of labour productivity and competitiveness attained by innovation and knowledge economy. *Juraj Šipko*, Advisor to the Governor of *Národná banka Slovenska*, not only gave a detailed analysis of the steps taken by his country toward the euro changeover but also dealt with the issues to be addressed in the future so that the new euro area country can reap the benefits provided by the single European currency and to converge with the levels of economic development in other euro area countries as soon as possible.

In 2008, the experts' roundtable organised by the Bank of Latvia brought together economists, industry professionals, and representatives of mass media. The discussion topics, among other, included: introduction of the euro as a national strategic goal; the factors determining the savings habits in Latvia; export competitiveness; economic policy. Both experts' round table and the conferences of the Bank of Latvia are webcast and the recording subsequently is posted on the Bank of Latvia Internet website. The size of the audience in live webcasts is over two thousand people, which is rather impressive for such a specialised roundtable.

As to the annual competition of student research papers, the research topics addressed by the prize-winners were in line with the burning issues in the sectors of national economy (parity rate, correlation between the PPI and CPI, macroeconomic development of Latvia, export competitiveness, dynamics of food prices). The current competition was announced in the autumn of 2008, thus enabling the students to combine their academic goals with participation in the competition and select a research subject related to current macroeconomic developments.

To raise the public awareness of core principles underlying the economic and monetary system and of practical issues of macroeconomics and monetary policy, the display at the Bank of Latvia Visitors Centre "Money World" was updated. The Centre had about 8 thousand visitors in 2008 (of this, 76% were school students, 8% – university and college students, 4% – foreigners). According to the survey conducted at the end of the year, 94% of the respondents gave a positive evaluation of the Centre's work.

The Bank of Latvia further evolved its cooperation with students majoring in social sciences, and in 2008 the Bank's experts delivered guest lectures at Liepāja University and organised a discussion on the impacts of developments in global finances on the Latvian economy. Topical issues related to economic development have also been discussed in *Naudas zīmes*, a series of broadcasts on the national TV channel (prepared in cooperation with the Bank of Latvia), as well as in *Lata spogulī*, a sequence of radio broadcasts on financial topics, addressing a vast audience.

ORGANISATIONAL DEVELOPMENT

The composition of the Council of the Bank of Latvia, as at the end of 2008, was as follows:

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

The Board of the Bank of Latvia, as at the end of 2008, 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**.

Since Helmūts Ancāns resigned from his office at the Bank of Latvia, the Council of the Bank of Latvia discharged him from the responsibilities at the Bank of Latvia's Board as of 17 January 2008. On 22 April 2008 it appointed Raivo Vanags, the Head of the Market Operations Department, to the Bank of Latvia's Board.

At the end of 2008, the number of the Bank of Latvia's employees was 644, of which 18 were employees with a fixed term job contract (643 and 19 employees at the end of 2007, respectively). As at the end of 2008, the Bank's staff was 56% male and 44% 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 2008.

To optimise staff resources and improve the efficiency of processes, the Market Operations Department underwent structural changes in 2008. The Analysis Division and External Debt Management Division were closed and their functions were partly transferred to the Balance of Payments Statistics Division of the Statistics Department. The operational organisation was enhanced simultaneously.

To improve the management of the Bank of Latvia's core operational risks, a position of the Operational Risk Manager was opened. With the growth of cash handling volumes, the number of cash handlers has been increased in the Bank of Latvia's branches.

In 2008, changes were introduced in operational organisation of the Bank of Latvia structural units providing support functions. The staff number has been reduced in the Internal Audit Department, Personnel Department and Security Department.

PERSONNEL DEVELOPMENT

Following the best practices of the ECB and other central banks in the EU, the Bank of Latvia Council approved "The Bank of Latvia's Human Resources Policy Framework" on 17 July 2008. It lays down the key principles encouraging the Bank of Latvia to hire well-qualified and professional staff members and establish a long-term working relationship by offering a motivating work environment, possibilities for professional development, and, in return, expecting the employee to demonstrate a high quality performance, reach the set out goals, display initiative, creative approach and loyalty.

Training and development are important elements of human resources policy and a responsibility to be shared between the employees and the Bank of Latvia. On the one hand, the Bank of Latvia provides the budgetary means and the training framework. On the other hand, staff members have to take the necessary steps for learning and development and ensure that their expertise is maintained at the highest level. The Bank of Latvia staff training costs amounted to 2.2% of the total expenses on wages, salaries and other personnel costs (2.7% in 2007).

For the purposes of personnel development, the Bank of Latvia uses internal and external rotation and personnel training. Internal rotation allows the employees to enhance their professional skills and build their careers within the Bank of Latvia. As a result of internal recruitment, in 2008 31 employees were promoted and 13 were appointed replacements for colleagues in longer-term absence. The Bank of Latvia staff members have the opportunity to build external work experience via the ECB short-term secondment scheme and the ESCB external work experience scheme. It is also possible to share experience with other NCBs. These opportunities have been made use of in 2008.

The Bank of Latvia's employees continued with their academic studies and advanced professional training and participated in seminars, workshops, courses and conferences in Latvia and abroad to keep up with the latest developments in the fields of monetary policy, financial stability, macroeconomics, econometrics, foreign exchange operations, foreign reserves, payment systems, statistics, bank accounting and information technologies as well as managerial skills. In-depth studies in the fields of effective interaction, communication, team work, time management continued as did computer skills and foreign language training. A number of the Bank's employees successfully participated in international professional certification programmes.

Special seminars were held for recently hired employees, attended by 21 newcomers to learn about the Bank's tasks and the functions of its structural units. The range of topics covered by the Bank of Latvia's internal seminars expanded in 2008. The seminars were conducted by relevant experts from the Monetary Policy Department, Market Operations Department, Payment Systems Department, International Department, Communications Department (Library). The functions of the Internal Audit Department, strategic management issues, collector coins issued by the Bank of Latvia, the use of digital signature were also among the discourse topics.

In 2008, the Personnel Department launched a talent management project. The main objectives are to identify employees' potential, encourage a motivated staff development and to identify the overall needs in order to enhance the operational efficiency of the Bank of Latvia. As a part of the project, single competency model was developed for the Bank of Latvia, where seven key competencies – result and achievement orientation, timeliness and quality of the work done, analytical thinking, problem solution skills, communication and information sharing skills, teamwork and collaboration, and flexibility and capability to adapt oneself – have been graded in four levels.

In 2008, competency evaluation interviews were conducted in the Personnel Department, Macroeconomic Analysis Division of the Monetary Policy Department and Payments Division of the Market Operations Department.

The Personnel Department developed Guidelines for Developing Competencies with the purpose to facilitate the attainment of goals set by the Bank of Latvia and to enhance the key competencies of the Bank of Latvia's employees.

A long-term training project designated for the Bank of Latvia's managers continued in 2008. The second training group comprised 17 managers with human resource management experience of less than five years. The key topics were: increasing management effectiveness, personality development, enhancement of communication skills and development and motivation of subordinates. Considering the positive feedback from the trainees and assessing the training results, the Bank of Latvia is going to proceed with the training programme for managers in 2009 and 2010, involving the rest of managers with human resource management experience over five years in this project.

The Bank of Latvia continued to use the premises of its Training and Recreation Centre as the venue for staff training in view of its high quality technical support.

In November 2008, the Bank of Latvia hosted the second part of the ESCB seminar "Changing Leadership in a European Context" (the first part took place in Italy). The audience was the heads of structural units of the central banks of 13 EU Member States.

RISK AND QUALITY MANAGEMENT

In 2008, the Bank of Latvia's Board continued to develop risk management in line with the core principles stipulated in the "The Security Policy of the Bank of Latvia", taking into consideration the development of the financial market and the Bank of Latvia's operation. "The Security Policy of the Bank of Latvia" stipulates also risk management oversight which is carried out by the Bank of Latvia's Security Supervision Commission comprising four members of the Bank of Latvia's Council. The Bank of Latvia's financial risks are managed in line with the "Guidelines for Managing the Bank of Latvia's Foreign Reserves", which the Council of the Bank of Latvia reviews and, if necessary, amends at least once a year.

A risk analysis for all essential information systems of the Bank of Latvia was carried out. Such analysis is also performed as part of any information system development or upgrading project.

The management of the Bank of Latvia's core operational risks was coordinated by the Bank's Risk Manager who assessed and summarised risk reports drafted by the Bank's organisational units and classified the risks thereby maintaining and updating its risk matrix.

In April 2008, the Board reviewed and approved the Bank's risk report as well as reported to the Bank of Latvia's Council on the situation in the area of risk management. Personnel training in the field of information and information system security, operations continuity and risk management also took place.

In 2008, the Bank of Latvia defined the development directions of its risk management process and the related actions to be taken. The Board approved the project "Improvements to the Bank of Latvia's Operational Risk Management Process", to be implemented in 2009.

The Bank of Latvia proceeded with the enhancement of its business continuity measures and fine-tuned its incident management procedures, centralised the incident registration, tested and updated the business continuity plans of the Bank's structural units, as well as tested the necessary stand-by working stations and equipment.

Quality management system is in place in the Bank of Latvia. The Bank of Latvia continued to maintain its quality management system compliant with the ISO 9001:2000 standard. In 2008, a comprehensive internal audit of the Bank of Latvia's quality management system and two certification oversight audits were conducted.

The development of integrated management system concept, launched back in 2007, was finalised. The quality management system is intended to become a part of this system.

INTERNAL AND EXTERNAL AUDIT

Through an unbiased examination of the Bank's functions and processes the internal audit provides the Bank of Latvia's management with an independent evaluation of the effectiveness of risk management, control systems and processes and gives recommendations for improvements. The internal audit of the Bank of Latvia is conducted by the Internal Audit Department. An Audit Committee operates in the Bank of Latvia, supervising and facilitating improvements to internal audit.

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

The internal audit addresses all operational areas of the Bank of Latvia. Internal audits are planned and conducted on the basis of risk assessment. The results of each internal audit are reported to the Bank of Latvia's Governor. On a quarterly basis, the Bank of Latvia's Audit Committee is informed about the findings of the conducted internal audits, recommendations and implementation progress thereof. As to the accomplished internal audits and the key findings, the Bank of Latvia's Council is briefed on a yearly basis.

In 2008, external assessment of the internal audit quality was conducted. The assessment recognised that the internal audit practice of the Bank of Latvia is partly compliant with "International Standards for the Professional Practice of Internal Auditing" and fully compliant with "Code of Ethics"; it is also compliant with the requirements of ESCB Internal Auditors Committee Manual. On the basis of these findings, an action plan has been prepared towards enhancement of the internal audit operations.

The Internal Audit Department participated in the work of the Internal Auditors Committee (IAC) of the ESCB and conducted internal audits of the Bank of Latvia according to the annual plan.

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

ACCOUNTING AND BUDGET MANAGEMENT

The Bank of Latvia's accounting system has been established and managed in line with the "Financial Accounting Policy of the Bank of Latvia" approved by the Bank of Latvia's Council, "Bank of Latvia Accounting Manual" approved by the Board of the Bank of Latvia and other regulations of the Bank, in compliance with the Law "On the Bank of Latvia" and other laws and regulations binding on the Bank of Latvia. "Financial Accounting Policy of the Bank of Latvia" stipulates that events and financial transactions of the Bank of Latvia relating to the implementation of monetary policy and management of foreign reserves are accounted for in accordance with the principal accounting policies established by the ECB Guideline of 10 November 2006 on the legal framework for accounting and financial reporting in the ESCB (ECB/2006/16), at the same time taking into consideration that the Bank of Latvia is not yet a participant of the Eurosystem.

The Bank of Latvia publishes a monthly balance sheet, annual financial statements and other financial information. This information is also available on the Bank of Latvia's website. The integrated information system of the Bank ensures standardised, automated, safe and efficient execution of the Bank of Latvia's financial transactions and uniform accounting for and financial reporting on them. The management of the Bank of Latvia and specialists receive updated 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 budget; management of the budget proceeds 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. To support the independence of the internal audit, the Bank of Latvia's Council approves a separate expenditure plan for the Bank of Latvia's Internal Audit Department. For the purposes of budget evaluation, the Bank of Latvia's Council has set up a Budget Commission, comprising six members of the Bank of Latvia's Council. The main tasks of the Budget Commission are evaluation of the draft budget prepared by the Bank of Latvia's Board and oversight of the budget execution. The key budget management tasks of the Bank of Latvia's Board are to prepare the draft budget in collaboration with the heads of relevant organisational units, and to submit to the Bank of Latvia's Budget Commission and the Council, as well as to report on budget execution on a regular basis.

COOPERATION WITH INTERNATIONAL ORGANISATIONS

The Bank of Latvia continued to represent Latvia's interests at the meetings of the IMF Board of Governors as well as participated 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 3.44% 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.

On 23 December the IMF Executive Board approved a Stand-By Arrangement of 1.52 billion SDR for the implementation of the stabilisation and rehabilitation plan for the Latvian economy. Cooperation with the IMF, based on consultations under Article IV of the IMF Articles of Agreement, continued.

In 2008, Latvia continued its activities as a member of the International Bank for Reconstruction and Development, the International Development Association, the International Finance Corporation and the EBRD. The Bank of Latvia continued its membership in the BIS.

COOPERATION WITH FOREIGN CENTRAL BANKS AND TECHNICAL ASSISTANCE

In 2008, the Bank of Latvia continued its cooperation with the central banks of other countries, sharing expertise and information.

In February, staff members of the Accounting Department advised the specialists of the Central Bank of Armenia on issues of accounting policies and financial reporting.

In April and October, the Bank of Latvia employees advised the specialists of the National Bank of Georgia on issues of accounting practices, payment systems, market operations, information systems, human resources management and public relations.

Employees of the Personnel Department shared their know-how in human resources policy matters with their counterparts from the National Bank of Kazakhstan.

In November, a staff member of the Statistics Department, as a part of the ECB and national central bank technical assistance programme, offering her expertise in the area of balance of payments statistics to the specialists of the National Bank of Serbia.

The Bank of Latvia organised several international meetings. In May, meetings of the Working Group on Accounting Issues and Financial Reporting and Working Group on Allocation of Monetary Income, both under the ESCB Accounting and Monetary Income Committee, were held in Riga. In September, Riga hosted the annual Nordic-Baltic financial stability seminar. In November, the Statistics Department conducted a meeting on enforcement of amendments to the ECB Regulation (EC) No 2423/2001 concerning the consolidated balance sheet of the monetary financial institutions sector, and to the ECB Regulation (EC) No 958/2007 of 27 July 2007 concerning statistics on the assets and liabilities of investment funds (ECB/2007/8) for the purpose of compiling the MFI and investment fund balance sheet statistics. Central banks of Austria, Finland and Slovakia were represented in the meeting. The participants of the meeting also learned about familiarised with the practices of the *Oesterreichische Nationalbank* in the area of preparing statistical publications for the Internet, and with the experience of *Národná banka Slovenska* with preparing MFI statistics in the process of becoming a full-fledged member of the EMU. In November, a seminar entitled "Financial Crises (Context and Terminology)" was organised in Riga for translators, editors and terminologists of the ECB and the Bank of Latvia. The objective of the seminar was to provide a more profound insight in the financial market developments as well as to raise awareness on the recent trends in the terminology concerning financial instruments.

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

The Bank of Latvia's employees participated in a number of courses held by the ECB, the IMF Institute, the Joint Vienna Institute and the BIS, as well as seminars organised by the central banks of Austria, Bulgaria, the Czech Republic, Finland, France, Germany, Italy, Lithuania, the Netherlands, Poland, Switzerland and the UK and Federal Reserve Bank of New York. The Bank of Latvia staff members paid exchange-of-experience visits to the central banks of the Czech Republic, Lithuania, and Sweden, and obtained consultations on central banking matters.

FINANCIAL STATEMENTS OF THE BANK OF LATVIA FOR THE YEAR ENDED 31 DECEMBER 2008

BALANCE SHEET

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

ASSETS	Notes[1]	**2008**	2007
FOREIGN ASSETS		**2 734 395**	2 806 790
Gold	4	108 998	99 130
Special Drawing Rights	6	187	83
Convertible foreign currencies	5	2 488 693	2 687 707
Participating interest in the European Central Bank	7	743	743
Participating interest in the Bank for International Settlements	8	1 763	1 763
Other foreign assets	9	134 011	17 364
DOMESTIC ASSETS		**679 200**	41 211
Loans to credit institutions	10	639 263	6 850
Fixed assets	11	34 626	32 646
Other domestic assets	12, 13	5 311	1 715
TOTAL ASSETS		**3 413 595**	2 848 001

[1] The accompanying notes set out on pages 70 to 103 are an integral part of these financial statements.

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

LIABILITIES, CAPITAL AND RESERVES	Notes	**2008**	2007
FOREIGN LIABILITIES		**402 145**	30 825
Convertible foreign currencies	14	131 252	5 330
International Monetary Fund	6	256	254[1]
Other international institution deposits in lats	15	6 503	6 049
Foreign bank deposits in lats	16	247 001	35
Other foreign liabilities	17	17 133	19 157
LATS IN CIRCULATION	18	**1 018 092**	1 049 473
DOMESTIC LIABILITIES		**1 751 384**	1 597 218
Balances due to credit institutions	19	1 094 295	1 416 802
Balances due to the Government	20	638 056	171 241
Balances due to other financial institutions		1 705	4 876
Other domestic liabilities	21, 22	17 328	4 299
CAPITAL AND RESERVES		**241 974**	170 485
Nominal capital	23	25 000	25 000
Reserve capital	23	95 533	59 508
Valuation account	23	68 004	34 513
Profit of the reporting year	23	53 437	51 464
TOTAL LIABILITIES, CAPITAL AND RESERVES		**3 413 595**	2 848 001
OFF-BALANCE SHEET ACCOUNTS	35		

The financial statements, which are set out on pages 64 to 103, were authorised by the Board of the Bank of Latvia on 26 February 2009.

BOARD OF THE BANK OF LATVIA

M. Kālis

R. Jakovļevs

A. Ņikitins

H. Ozols

I. Posuma

R. Vanags

[1] At the end of 2008, Latvia's quota in the IMF and the promissory note issued by the Latvian Government as its security were excluded from the foreign assets and liabilities respectively, and is reported in the financial statements of the Latvian Government.

PROFIT AND LOSS STATEMENT

(in thousands of lats)

	Notes	**2008**	2007
INTEREST INCOME			
Foreign operations	24	**143 646**	125 829
Interest on securities		96 553	94 921
Interest on deposits with foreign credit institutions and other foreign financial institutions		11 613	10 625
Interest on derivative financial instruments		35 480	20 283
Domestic operations	24	**7 264**	3 278
Interest on loans to credit institutions		6 723	2 026
Interest on derivative financial instruments		541	1 252
INTEREST EXPENSE			
Foreign operations	24	**11 923**	24 255
Interest on deposits		237	5
Interest on derivative financial instruments		11 686	24 250
Domestic operations	24	**54 461**	36 122
Interest on deposits of credit institutions		39 996	24 830
Interest on government deposits		14 366	11 198
Interest on deposits of other financial institutions		99	94
NET INTEREST INCOME	24	**84 526**	68 730

(cont.) (in thousands of lats)

	Notes	2008	2007
REALISED GAINS/LOSSES (–) FROM FINANCIAL OPERATIONS	25	**34 886**	14 310
Foreign operations		**23 488**	11 610
Securities		3 151	–4 161[1]
Derivative financial instruments		20 337	15 771[2]
Foreign currency exchange transactions		**11 398**	2 700
WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS	26	**38 087**	5 862
Foreign operations		**37 349**	5 504
Securities		30 941	5 504
Derivative financial instruments		6 408	–
Foreign currency position		**738**	358
INCOME FROM PARTICIPATING INTEREST	27	**206**	216[3]
OTHER OPERATING INCOME	28	**3 433**	1 190
BANKNOTE PRODUCTION AND COINAGE COSTS	29	**4 046**	3 772[4]
OTHER OPERATING EXPENSES		**27 481**	23 348
Remuneration	30	15 326	12 587
Social security costs	30	3 063	2 284
Depreciation and amortisation charges	11, 13	3 729	3 628
Maintenance and operation of information systems		1 574	1 548
Other operating expenses	31	3 789	3 301
PROFIT OF THE REPORTING YEAR		**53 437**	51 464

[1] Reported in the financial statements of 2007 under the profit and loss statement caption "Gain on investment in debt securities".
[2] Reported in the financial statements of 2007 under the profit and loss statement caption "Gain/losses from derivative financial instruments".
[3] Reported in the financial statements of 2007 under the profit and loss statement caption "Dividends on shares in the Bank for International Settlements".
[4] Reported in the financial statements of 2007 under the profit and loss statement caption "Other operating expenses".

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

(in thousands of lats)

	Notes	**2008**	2007
RESULT ON REVALUATION			
Result on revaluation of foreign currency and gold		–98	3 813
Result on revaluation of interest rate swap contracts		–2 781	–98
Result on revaluation of securities		–1 717	8 494
Write-downs on financial assets and positions		38 087	5 862
NET RESULT ON REVALUATION	23	**33 491**	18 071
PROFIT OF THE REPORTING YEAR		**53 437**	51 464
TOTAL		**86 928**	69 535

CASH FLOW STATEMENT

(in thousands of lats)

	Notes	**2008**	2007
CASH FLOW FROM OPERATING ACTIVITIES			
Profit of the reporting year		**53 437**	51 464
Non-cash transaction adjustments	32 (1)	**41 823**	9 492
Net movements in balance sheet positions	32 (1)	**372 221**	60 740
Net cash and cash equivalents inflow from operating activities		**467 481**	121 696
CASH FLOW FROM INVESTING ACTIVITIES			
Decrease of participating interest in the European Central Bank		–	17
Dividends on shares of the Bank for International Settlements		**206**	216
Acquisition of fixed assets		**–5 291**	–3 038
Acquisition of intangible assets		**–55**	–54
Net cash and cash equivalents outflow from investing activities		**–5 140**	–2 859
CASH FLOW FROM FINANCING ACTIVITIES			
Profit appropriated to the state budget		**–15 439**	–1 976
Net cash and cash equivalents outflow from financing activities		**–15 439**	–1 976
NET CASH AND CASH EQUIVALENTS INFLOW		**446 902**	116 861
Cash and cash equivalents at the beginning of the year	32 (2)	**240 807**	123 946
Cash and cash equivalents at the end of the year	32 (2)	**687 709**	240 807

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".

The primary goal of the Bank of Latvia is to maintain price stability in Latvia. Pursuant to the Law "On the Bank of Latvia", its primary tasks are as follows:
– establishment and implementation of monetary policy;
– management of foreign currency and gold reserves;
– issue of the national currency, both banknotes and coins;
– organisation and management of the interbank payment system and promotion of a smooth functioning of the payment system in Latvia;
– compiling and publishing 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.

On 1 January 2008, the Credit Register of the Bank of Latvia was launched. It has been developed pursuant to the provisions of the Law "On Credit Institutions" and other legal acts.

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 management.

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

2. RISK MANAGEMENT

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

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

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

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

Parameters for a benchmark portfolio reflecting the return target and acceptable level of financial risks, as well as the target structure of investments are set out for each portfolio type in the Guidelines. On a 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 financial risk management, the Investment Committee of the Bank of Latvia that develops the investment management strategy, approves tactical decisions and sets detailed limits for financial risks in accordance with the Guidelines. The Investment Committee of the Bank of Latvia reviews the investment strategy once a quarter, and on a weekly basis receives and reviews reports and forecasts for developments in financial markets, which are prepared by foreign reserves investment portfolio managers, and approves the investment management tactical decisions for the forthcoming week.

MARKET RISK

Market risk is exposure to losses due to adverse changes in financial markets (for example, movements in interest rates or exchange rates). The Bank of Latvia manages interest rate risk inherent mainly in financial instruments sensitive to interest rate fluctuations by using a modified duration limit set individually for each investment portfolio. The Bank of Latvia incurs interest rate risk mainly from investment in foreign debt securities and interest rate financial derivatives that are used within the framework of foreign reserves management.

The Bank of Latvia monitors the currency risk by determining open currency position limits. In accordance with the exchange rate policy of the Bank of Latvia for foreign reserves portfolios, except for portfolios of borrowed funds, the benchmark portfolio currency is euro. For portfolios of borrowed funds, the benchmark currency structure is formed in compliance with parameters of respective liabilities. Deviations from the benchmark currency structure give rise to the open currency position. Pursuant to the Guidelines, substantial deviation from the benchmark position is not permissible.

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.

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

The Bank of Latvia manages interest rate risk arising from foreign reserves by investing only in financial instruments denominated in the currencies of the OECD countries which have been assigned a definite credit rating.

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 objectives pursued by the Bank.

Exposure of the Bank of Latvia to market risk (as at the end of 2008 and 2007) is provided in Notes 37 and 38.

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

Short-term loans granted to domestic credit institutions are secured by collateral of Latvian Government securities (hereinafter, government securities) and such private sector debt securities, according to the requirements established by the Council of the Bank of Latvia. The Market Operations Department reviews the compliance of ratings assigned to issuers of 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 2008 and 2007) is provided in Notes 40 to 42.

LIQUIDITY RISK

Liquidity risk is associated with a failure to meet liabilities timely. The Bank of Latvia manages liquidity risk by investing foreign exchange reserves in liquid debt securities and other financial instruments issued by international institutions, foreign governments and the corporate sector, while investing its gold reserves in short-term deposits with foreign financial institutions. Investments are made so as to ensure timely meeting of the Bank of Latvia's liabilities. The structure of the Bank of Latvia's cash and its equivalents is provided in Note 32. The liquidity profile of the Bank of Latvia's assets and liabilities as at the end of 2008 and 2007 is provided in Note 39.

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

OPERATIONAL RISKS

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

The goal and basic principles of the Bank of Latvia's security policy are determined by the Council of the Bank of Latvia. "The Security Policy of the Bank of Latvia", approved by the Council, covers risk management, management of operational continuity, security of information and information systems, and physical security; it also lays down regulations for uninterrupted and secure execution of the Bank of Latvia's tasks.

The Board of the Bank of Latvia determines the procedure for Bank of Latvia's risk management. "The Regulation for Managing the Bank of Latvia's Risks" covers the procedure for identifying, documenting, assessing and minimising risks. The management of the Bank of Latvia's operational risks is coordinated by the Head of Risk Management. In order to improve the risk management procedures, in 2008 the Bank of Latvia specified the risk management improvement areas, and the set and scope of activities to be undertaken.

To minimise the operational risks related to security and information systems, the Operational Risk Expert Group whose main task is to provide opinion to the Board of the Bank of Latvia on operational risks identified and initiate activities that would minimise these risks, and the Committee for Managing the Bank of Latvia's Information Systems to review, on a regular basis, the operational risk management system related to information systems, have been established at the Bank of Latvia.

In order to ensure confidentiality, authorised accessibility and integrity, information and relevant technical resources are classified under the internal control system. The Bank of Latvia has appointed owners of information and information systems who are responsible for classification, risk analysis and protection of relevant information or information systems, as well as determination of access rights and their application procedure. In 2008, the methodological improvement of the internal risk analysis based on the methods and tools developed by Information Security Forum Limited began.

"The Procedure for Managing the Continuity of the Bank of Latvia's Operation" approved by the Bank of Latvia's Council sets out general procedure for managing Bank of Latvia's operational continuity. An operational continuity management system to ensure timely identification of incidents and emergency situations and their prevention, to develop proposals for prevention of incidents and emergency situations in the future, to organise education and training of employees, to test and update action plans for ensuring operational continuity has been established at the Bank of Latvia. The Bank of Latvia's Board is responsible for the management of incidents and emergency situations at the Bank of Latvia. "The Procedure for Managing Incidents and Emergency Situations at the Bank of Latvia" approved by the Board covers timely identification of incidents and emergency situations and provides for coordinated and effective activities of the Bank of Latvia's departments in the event of an incident or emergency situation.

The Bank of Latvia has specified the functions whose discontinuity may cause emergency; specified also are the maximum permissible periods of forced discontinuity and the critical resources used in the implementation of these functions. On a regular basis, the Bank of Latvia's Board revises and evaluates the specified functions and critical resources as well as reviews the adequacy and availability of the resources for ensuring the continuity of the Bank's operations in case of emergency.

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

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

UNCERTAIN FINANCIAL MARKETS

In 2008 the stresses on the global financial system, which had been sparked by losses incurred by financial institutions on securities backed by US sub-prime mortgages, intensified further. Tensions in the financial sector have increasingly spilled over to the real economy. As uncertainty grew about the global economic outlook, risk aversion among financial market participants rose, with most financial asset prices falling as a result. Financial market liquidity and funding conditions deteriorated markedly, and securitisation became inactive. In the conditions of persistent liquidity stresses, financial institutions were facing mounting challenges in accessing short-term funding and capital markets. These and other factors have had an adverse effect on Latvia's financial sector and the real economy. The financial turmoil has affected, and may continue to affect, the financial position and financial performance of the Bank of Latvia The Bank of Latvia's transactions have been affected by the restrained operation of the interbank market in the fourth quarter of 2008, which resulted in a substantial increase in the Bank of Latvia's short-term lending to credit institutions and the demand for euro due to which the Bank of Latvia sold a part of its foreign currency reserves in the fourth quarter of 2008. The income of the Bank of Latvia has been determined by the changes in interest rates and financial instrument liquidity. The impact of the respective developments and also other factors on the financial position and financial performance of the Bank of Latvia is reported in the notes to the financial statements dealing with the Bank of Latvia's exposure to financial risks and also in Notes 23–26. The future developments in financial markets may differ from the assessment of the Bank of Latvia's management.

3. PRINCIPAL ACCOUNTING POLICIES

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

BASIS OF PRESENTATION

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

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

BASIS OF MEASUREMENT

These financial statements have been prepared in accordance with the historical cost basis of accounting except gold, debt securities and derivatives, which are accounted for at fair value.

USE OF ESTIMATES

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

FOREIGN CURRENCY TRANSLATION

Transactions denominated in foreign currencies are recorded in lats at the exchange rates quoted by the Bank of Latvia for the day of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into lats at the exchange rates set by the Bank of Latvia at the end of the reporting period. Non-monetary items, measured at cost or amortised cost, are translated into lats at the exchange rate for the respective foreign currency set by the Bank of Latvia on the day of the transaction. Taking into account the lat's 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 information system Reuters.

Transactions in foreign currencies are included in the net foreign currency position of the respective currency. The transactions in foreign currencies reducing the respective currency position result in realised gains or losses. Any gain or loss arising from revaluation of transactions in foreign currencies and currency positions are credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 3 under "Recognition of profit or loss on the financial instruments".

The principal exchange rates of foreign currencies and gold set by the Bank of Latvia and used in the preparation of the balance sheet for the year ended 31 December 2008 and the year ended 31 December 2007 are as follows:

(at the end of the year)

	2008	2007	Changes (%)
Euro (EUR)	**0.702804**	0.702804	–
US dollar (USD)	**0.495**	0.484	2.3
Japanese yen (JPY)	**0.00547**	0.00424	29.0
Gold (XAU)	**438.259**	398.591	9.95
Special Drawing Rights (XDR)	**0.764**	0.759	0.7

RECOGNITION AND DERECOGNITION OF FINANCIAL ASSETS AND LIABILITIES

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

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

FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

Fair value of the Bank of Latvia's financial assets and financial liabilities at the end of 2008 and 2007 did not differ materially from the reported book value of the respective assets and liabilities.

OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

GOLD

Gold reserves are recorded at market value in the balance sheet.

Any gain or loss arising from the 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 referred to in Note 3 under "Recognition of profit or loss on the financial instruments".

SECURITIES

Securities are stated at fair value in the balance sheet.

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

REVERSE REPURCHASE AGREEMENTS

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

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

REPURCHASE AGREEMENTS

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

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

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

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

PARTICIPATING INTEREST

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

FINANCIAL DERIVATIVES

The Bank of Latvia enters into commitments involving forward exchange rate contracts, currency and interest rate swap arrangements, and interest rate 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 financial derivatives are reported in the balance sheet at fair value.

Interest on financial derivatives, including the spot and forward interest rate spread of forward exchange rate contracts and currency swap arrangements, are 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 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 financial derivatives is credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 3 under "Recognition of profit or loss on the financial instruments".

ACCRUED INTEREST INCOME AND EXPENSE

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

FIXED ASSETS

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

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

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

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

(%)

	2008	2007
Buildings		
– structures	**1**	1
– outer finishing	**5**	5
– interior decorations	**5–20**	5–20
– engineering communications	**5**	5
– other components	**10–20**	10–20
Improvement of territory	**10**	10
Transport vehicles	**10**	10
Office furniture	**10**	10
Computer equipment	**20–33**	20–33
Other office equipment	**20**	20
Cash processing equipment	**10–20**	10–20
Tools	**50**	50
Other fixed assets	**7–20**	7–20

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

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

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

INTANGIBLE ASSETS

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

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

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

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

IMPAIRMENT OF ASSETS

An asset is impaired when its carrying amount exceeds its recoverable amount. With a view to detecting any indications of impairment of an asset, the Bank of Latvia's organisational units assess the quality of the Bank of Latvia's assets that have not been recognised at their fair value on a regular basis. Upon detecting any indications of impairment of an asset, the recoverable amount of the respective asset is estimated. If the recoverable amount is less than the carrying amount of the respective asset, adequate allowances for the relevant asset are made. Such allowances are recognised in the profit and loss statement with a respective reduction in the asset's carrying amount.

LATS IN CIRCULATION

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

GOLD CIRCULATION COINS

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

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

COLLECTOR COINS

Collector coins sold are not included in the balance sheet caption "Lats in circulation", as the repurchasing probability of those coins is low or the value of precious metals of which the coins are made exceeds repurchase value. Proceeds from sales of collector coins are recognised in the profit and loss statement when incurred.

PROVISIONS

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

CASH AND CASH EQUIVALENTS

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

RECOGNITION OF PROFIT OR LOSS ON FINANCIAL INSTRUMENTS

Gains or losses on financial instruments are recognised in accordance with the following principles:
(a) realised gains and losses shall be recorded in the profit and loss statement;
(b) unrealised gains shall be recognised in the balance sheet caption "Valuation account";
(c) unrealised losses recognised in the balance sheet caption "Valuation account" at the end of the reporting year shall be transferred to the profit and loss statement if they exceed previous revaluation gain on the respective financial instrument, foreign currency or gold holding;
(d) unrealised losses recognised in the profit and loss statement at the end of the reporting year shall not be reversed and offset by unrealised gains of the respective financial instrument, foreign currency or gold holding in the subsequent years;
(e) there shall be no netting of unrealised losses in a financial instrument, foreign currency or gold holding against unrealised gains in other financial instrument, foreign currency or gold holding.

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

INTEREST INCOME AND EXPENSE

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

Interest income includes interest on acquired securities, deposits, loans granted, forward exchange rate contracts, and currency and interest rate swap arrangements. Interest on acquired 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 institutions, as well as forward exchange rate contracts, and currency and interest rate swap arrangements.

REALISED GAINS OR LOSSES FROM INVESTMENT IN FINANCIAL INSTRUMENTS

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

INCOME FROM PARTICIPATING INTEREST
Dividends on participating interest are recognised in the profit and loss statement when received.

BANKNOTE PRODUCTION AND COINAGE COSTS
Banknote production and coinage costs, except gold circulation coin production costs, are charged to the profit and loss statement when incurred.

OTHER EXPENSE AND INCOME
Bank's other operational expense and income is recognised in the profit and loss statement on an accrual basis. Lease payments are recognised in the profit and loss statement proportionally over the term of the respective agreement.

4. GOLD

Movements in gold reserves in 2008 and 2007 were as follows:

	Troy ounces	Amount in thousands of lats
As at 31 December 2006	248 701	83 668
Increase in gold market value	x	15 462
As at 31 December 2007	248 701	99 130
Increase in gold market value	x	9 866
Net change resulting from gold depositing and deposit withdrawal	6	2
As at 31 December 2008	**248 707**	**108 998**

The Bank of Latvia hedges the risk related to fluctuations in gold reserves market value by entering into forward exchange rate contracts (see also Note 37).

5. CONVERTIBLE FOREIGN CURRENCIES

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

The carrying amount of interest bearing debt securities includes both interest income purchased at the date of acquisition and interest income accrued subsequent to the date of acquisition of securities (28 568 thousand lats at the end of 2008 and 24 658 thousand lats at the end of 2007).

At the end of 2008 and 2007, the balance sheet asset caption "Convertible foreign currencies" was comprised of the following assets:

(in thousands of lats)

	2008	2007
Debt securities of foreign governments, financial institutions and non-financial corporations	**1 800 987**	2 398 148
Demand deposits with foreign central banks, credit institutions and international institutions	**661 741**	223 530
Time deposits with foreign credit institutions and other foreign financial institutions	**19 679**	63 564
Foreign currency in cash	**6 286**	2 465
Total	**2 488 693**	2 687 707

6. 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. The Latvian quota in the IMF is 126 800 thousand SDR.

In 2008, the Bank of Latvia changed its balance sheet reporting of assets and liabilities relating to the IMF. Latvia's quota in the IMF and the Latvian Government promissory note have been excluded from the foreign assets and liabilities respectively and are reported in the financial statements of the Latvian Government. There was no impact on the Bank of Latvia's financial performance of this decision.

At the end of 2008, the liabilities to the IMF reported on the Bank of Latvia's balance sheet consisted of the funds at the disposal of the IMF in the amount of 256 thousand lats (254 thousand lats at the end of 2007) held on its Accounts No. 1 and No. 2.

At the end of 2008 and 2007, Latvia's net claims on the IMF were as follows:

	(in thousands of lats)		(in thousands of SDR)	
	2008	2007	**2008**	2007
Latvian quota in the IMF	**96 875**	96 241	**126 800**	126 800
IMF holdings in lats	**–505 850**	–96 212	**–662 106**	–126 762
Promissory notes of the Latvian Government	**–505 594**	–95 958	**–661 772**	–126 428
Account No. 1	**–242**	–241	**–317**	–317
Account No. 2	**–14**	–13	**–17**	–17
Stand-by Arrangement for Latvia	**409 003**	–	**535 344**	–
Reserve position in IMF	**42**	42	**55**	55
Special Drawing Rights	**187**	83	**245**	109
Latvia's net claims on IMF	**229**	125	**300**	164

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 expressed in lats at the SDR exchange rate set by the Bank of Latvia at the end of the year.

7. PARTICIPATING INTEREST IN THE EUROPEAN CENTRAL BANK

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 the ECB, the share of the Bank of Latvia in the ECB's capital was calculated on the basis of the EU states' population and GDP data and is adjusted every five years or at shorter intervals depending on changes in the number of the EU Member States.

On 31 December 2008, the share of the Bank of Latvia in the ECB's capital was 0.2813% which corresponds to 16 205 thousand euro (11 389 thousand lats). As Latvia does not participate in the euro area, pursuant to the transitional provisions of the Statute of the ESCB and the ECB, the Bank of Latvia has paid up a minimum 7% contribution of its total subscribed capital in the ECB amounting to 1 134 thousand euro or 743 thousand lats (see also Note 36).

8. PARTICIPATING INTEREST IN THE BANK FOR INTERNATIONAL SETTLEMENTS

At the end of 2008 and 2007, 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 25% or 1 338 thousand SDR (see also Note 36). The deemed cost of this holding as at 31 December 2008 and 31 December 2007 is reported in the Bank of Latvia's balance sheet in the amount of 1 763 thousand lats (see also Note 27).

9. OTHER FOREIGN ASSETS

At the end of 2008 and 2007, other foreign assets consisted of the following items:

(in thousands of lats)

	2008	2007
Non-traded financial derivative contracts with foreign financial institutions	**133 551**	16 523
Prepaid expense	**392**	250
Advance payment for delivered goods	–	325
Interest accrued on deposits	**27**	217
Other	**41**	49
Total	**134 011**	17 364

10. LOANS TO CREDIT INSTITUTIONS

At the end of 2008, loans to domestic credit institutions included the main refinancing operations, the marginal lending facility and other short-term loans in the amount of 639 263 thousand lats (6 850 thousand lats at the end of 2007). In the fourth quarter of 2008, due to tensions in the financial system impaired functioning of the interbank market was observed; hence, the Bank of Latvia granted a considerably larger amount of short-term loans than in 2007, providing liquidity support to credit institutions that had difficulty in accessing funding on the interbank market.

Loans granted to domestic credit institutions are secured by collateral of Latvian Government securities and private sector debt securities with the fair value of 678 027 thousand lats at the end of 2008 (6 970 thousand lats at the end of 2007; see also the section "Credit risk" in Note 2).

11. FIXED ASSETS

The following changes in fixed assets took place in 2008 and 2007:

(in thousands of lats)

	Buildings improvement of territory, and land	Furniture and office equipment	Cash processing equipment	Transport vehicles	Other fixed assets	Total
As at 31 December 2006						
Cost	31 245	6 885	4 240	1 113	4 650	48 133
Accumulated depreciation	–3 802	–4 711	–2 393	–731	–3 733	–15 370
Net book value	27 443	2 174	1 847	382	917	32 763
During 2007						
Additions	971	478	1 225	47	317	3 038
Disposals	–	–514	–24	–128	–182	–848
Net change in cost	971	–36	1 201	–81	135	2 190
Depreciation charge	–1 766	–658	–247	–72	–410	–3 153
Accumulated depreciation on disposals	–	513	24	128	181	846
Net change in accumulated depreciation	–1 766	–145	–223	56	–229	–2 307
As at 31 December 2007						
Cost	32 216	6 849	5 441	1 032	4 785	50 323
Accumulated depreciation	–5 568	–4 856	–2 616	–675	–3 962	–17 677
Net book value	26 648	1 993	2 825	357	823	32 646
During 2008						
Additions	3 833	361	254	279	564	5 291
Change in classification	2	–9	9	–1	–1	–
Disposals	–	–405	–1 061	–23	–234	–1 723
Net change in cost	3 835	–53	–798	255	329	3 568
Depreciation charge	–1 945	–587	–379	–71	–322	–3 304
Change in classification	–1	2	–2	1	–	–
Accumulated depreciation on disposals	–	400	1 061	23	232	1 716
Net change in accumulated depreciation	–1 946	–185	680	–47	–90	–1 588
As at 31 December 2008						
Cost	36 051	6 796	4 643	1 287	5 114	53 891
Accumulated depreciation	–7 514	–5 041	–1 936	–722	–4 052	–19 265
Net book value	**28 537**	**1 755**	**2 707**	**565**	**1 062**	**34 626**

At the end of 2008, the total cadastral value of land under the ownership and possession of the Bank of Latvia was 3 171 thousand lats (724 thousand lats at the end of 2007). Land is reported in the balance sheet of the Bank of Latvia at cost (264 thousand lats at the end of 2008 and 2007).

During the year, the Bank of Latvia acquired additional building premises for 3 200 thousands lats for operational needs to ensure expansion of the cash processing function and customer servicing area in preparation for the euro changeover. Part of the building is currently leased to another entity under an operating lease until 2011.

12. OTHER DOMESTIC ASSETS

At the end of 2008 and 2007, other domestic assets consisted of the following items:

(in thousands of lats)

	2008	2007
Accrued interest on loans to credit institutions	**2 714**	5[1]
Intangible assets	**1 001**	1 371
Non-traded financial derivative contracts with domestic credit institutions	**211**	2[1]
Tax claims	**209**	–
Prepaid expense	**183**	135
Other	**993**	202
Total	**5 311**	1 715

13. INTANGIBLE ASSETS

The following changes in intangible assets took place in 2008 and 2007:

(in thousands of lats)

As at 31 December 2006	
Cost	4 311
Accumulated amortisation	–2 479
Net book value	1 832
During 2007	
Additions	54
Derecognised assets	–615
Net change in cost	–561
Amortisation charge	–475
Accumulated amortisation on disposals	575
Net change in accumulated amortisation	100
As at 31 December 2007	
Cost	3 750
Accumulated amortisation	–2 379
Net book value	1 371

[1] In the financial statements for 2007, reported in item "Other" under "Other domestic assets".

(cont.)	(in thousands of lats)
During 2008	
Additions	55
Derecognised assets	–85
Net change in cost	–30
Amortisation charge	–425
Accumulated amortisation on derecognised assets	85
Net change in accumulated amortisation	–340
As at 31 December 2008	
Cost	3 720
Accumulated amortisation	–2 719
Net book value	**1 001**

14. CONVERTIBLE FOREIGN CURRENCIES

Convertible foreign currency liabilities consist of repurchase agreements (repos) concluded with foreign financial institutions and funds on the EC account, as well as other liabilities. The EC account is used by the EC for the distribution of EU budgetary funds (see also Note 15).

At the end of 2008 and 2007, convertible foreign currency liabilities consisted of the following items:

(in thousands of lats)

	2008	2007
Repurchase agreements	**123 953**	–
European Commission demand deposits	**6 230**	5 330
Other liabilities	**1 069**	–
Total	**131 252**	5 330

15. OTHER INTERNATIONAL INSTITUTION DEPOSITS IN LATS

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

At the end of 2008 and 2007, the breakdown of deposits of other international institutions in lats was as follows:

(in thousands of lats)

	2008	2007
European Commission demand deposits	**6 273**	5 819
Other deposits	**230**	230
Total	**6 503**	6 049

16. FOREIGN BANK DEPOSITS IN LATS

Foreign bank deposits in lats comprise short term deposits of *Sveriges Riksbank* and *Danmarks Nationalbank* resulting from the exchange of the lats to the euro under foreign currency swaps.

17. OTHER FOREIGN LIABILITIES

At the end of 2008 and 2007, other foreign liabilities consisted of the following items:

(in thousands of lats)

	2008	2007
Non-traded financial derivative contracts and spot exchange rate contracts with foreign financial institutions	**16 292**	18 874
Accrued expense	**304**	244
Other	**537**	39
Total	**17 133**	19 157

18. LATS IN CIRCULATION

At the end of 2008 and 2007, the following units of lats (LVL) and santims (s) were in circulation:

Nominal	Amount (in thousands of lats)		Number (in thousands of units)		Percentage (%)	
	2008	2007	**2008**	2007	**2008**	2007
Banknotes						
LVL 500	**110 872**	143 413	**222**	287	**10.9**	13.7
LVL 100	**145 212**	170 275	**1 452**	1 703	**14.3**	16.2
LVL 50	**73 889**	68 481	**1 478**	1 370	**7.3**	6.5
LVL 20	**485 292**	458 353	**24 265**	22 918	**47.7**	43.9
LVL 10	**73 773**	79 128	**7 377**	7 913	**7.2**	7.5
LVL 5	**70 781**	73 922	**14 156**	14 784	**6.9**	7.0
Total banknotes	**959 819**	993 572	**x**	x	**94.3**	94.8
Coins						
LVL 100	**405**	404	**4**	4	**0**	0
LVL 10	**145**	145	**15**	14	**0**	0
LVL 2	**8 673**	8 811	**4 337**	4 405	**0.9**	0.8
LVL 1	**28 345**	26 997	**28 345**	26 997	**2.8**	2.6
50 s	**7 744**	7 374	**15 489**	14 747	**0.8**	0.7
20 s	**4 376**	4 168	**21 881**	20 842	**0.4**	0.4
10 s	**2 723**	2 596	**27 224**	25 961	**0.3**	0.2
5 s	**2 082**	1 966	**41 638**	39 329	**0.2**	0.2
2 s	**2 166**	1 940	**108 294**	97 001	**0.2**	0.2
1 s	**1 614**	1 500	**161 425**	149 985	**0.1**	0.1
Total coins	**58 273**	55 901	**x**	x	**5.7**	5.2
Total lats in circulation	**1 018 092**	1 049 473	**x**	x	**100.0**	100.0

At the end of 2008, the total nominal value of gold circulation coins (fineness .999) issued, with the denomination of LVL 100, was 1 988 thousand lats (1 988 thousand lats at the end of 2007). 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.

As at the end of 2008, collector coins with the total nominal value of 1 449 thousand lats had been issued (1 346 thousand lats at the end of 2007). These coins are not included in the balance sheet caption "Lats in circulation".

19. 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 deposit facility and time deposits in lats received from the above financial institutions. The respective credit institutions place their funds with the Bank of Latvia in order to comply with its minimum reserve requirement, as well as to effect interbank and customer payments, the Bank of Latvia's monetary policy operations and other settlements in the Bank of Latvia's payment systems.

At the end of 2008 and 2007, balances due to domestic credit institutions consisted of the following items:

(in thousands of lats)

	2008	2007
Current account balances in lats	**1 071 869**	1 407 539
Current account balances in euro	**22 426**	9 263
Total	**1 094 295**	1 416 802

20. BALANCES DUE TO THE GOVERNMENT

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

At the end of 2008 and 2007, the breakdown of Latvian Government deposits was as follows:

(in thousands of lats)

	2008	2007
Demand deposits in foreign currencies	**467 188**	43 744
Time deposits in lats	**170 868**	75 646
Time deposits in foreign currencies	**–**	51 851
Total	**638 056**	171 241

21. OTHER DOMESTIC LIABILITIES

At the end of 2008 and 2007, other domestic liabilities consisted of the following items:

(in thousands of lats)

	2008	2007
Money in transit	**11 192**	498
Accrued expense and similar liabilities	**3 148**	2 192
Accrued interest expense	**600**	728
Non-traded currency swap arrangements with domestic credit institutions	**403**	101
Tax liabilities	**–**	170
Other	**1 985**	610
Total	**17 328**	4 299

22. TAX

In 2008 and 2007, 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
Liabilities as at 31 December 2006	0	7	3	0	35	0	45
During 2007							
Calculated	2 631	2 285	886	144	437	2	6 385
Decrease in deferred liabilities	–	70	–	–	–	–	70
Paid	–2 631	–2 356	–887	–144	–310	–2	–6 330
Liabilities as at 31 December 2007	0	6	2	0	162	0	170
During 2008							
Calculated	3 015	3 063	1 065	88	309	1	7 541
Increase in deferred liabilities	–	–230	–	–	–	–	–230
Recalculation of liabilities	–	–	–	–	–362	–	–362
Paid	–3 015	–2 839	–1 067	–88	–318	–1	–7 328
Claims as at 31 December 2008	**0**	**0**	**0**	**0**	**–209**	**0**	**–209**

In addition to the tax payments indicated herein, the Bank of Latvia transfers 30% of the profit for the reporting year, including the payment for the usage of state capital (15 439 thousand lats in 2008; 1 976 thousand lats in 2007; see also Notes 23 and 33) to the state budget. The Bank of Latvia is not subject to corporate income tax.

23. CAPITAL AND RESERVES

In 2008 and 2007, 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	EU grant	Capital and reserves
As at 31 December 2006	25 000	54 898	16 442	6 586	533	103 459
During 2007						
Net result on revaluation	x	x	18 071	x	x	18 071
Profit appropriated to the state budget	x	x	x	–1 976	x	–1 976
Profit transferred to the reserve capital	x	4 610	x	–4 610	x	–
Decrease in EU grant	x	x	x	x	–533	–533
Profit of the reporting year	x	x	x	51 464	x	51 464
As at 31 December 2007	25 000	59 508	34 513	51 464	–	170 485
During 2008						
Net result on revaluation	x	x	33 491	x	x	33 491
Profit appropriated to the state budget	x	x	x	–15 439	x	–15 439
Profit transferred to the reserve capital	x	36 025	x	–36 025	x	–
Profit of the reporting year	x	x	x	53 437	x	53 437
As at 31 December 2008	**25 000**	**95 533**	**68 004**	**53 437**	**x**	**241 974**

The capital of the Bank of Latvia is comprised of the nominal capital, reserve capital and the balance sheet item "Valuation account", as well as the undistributed profit. The Bank of Latvia does not take decisions affecting the formation of the nominal capital, reserve capital, and the profit distribution as they are provided for by the Law "On the Bank of Latvia". The balance sheet item "Valuation account" comprises the positive result on revaluation of the financial instruments. The accounting policies described in Note 3 stipulate that the realised gains are recognised in the profit and loss statement only after the disposal of a financial instrument while unrealised gains are recorded under the balance sheet item "Valuation account", thus facilitating the preservation of the capital under the impact of unfavourable financial instrument price, interest rate and exchange rate fluctuations.

No external capital adequacy requirements have been stipulated for the Bank of Latvia capital; nevertheless, is should be adequate to promote credibility of the monetary policy implemented by the Bank of Latvia, and to ensure implementation of its operations and financial independence when performing the tasks set forth by the Law "On the Bank of Latvia". The Bank of Latvia does not hedge financial risks where a conflict with the policy objectives 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 15% of the profit of the reporting year for the usage of state capital shall be transferred to the state budget. At the end of 2008 and 2007, the corporate income tax rate applicable to residents of Latvia was 15%. Therefore, 30% 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 by the Council of the Bank of Latvia.

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

In 2008 and 2007, changes in the balance sheet caption "Valuation account" were as follows:

(in thousands of lats)

	2008	Other changes	Write-offs	2007	Other changes	Write-offs	Valuation difference	Reclassification	2006
Initial valuation account	**24 067**	–	3 352	20 715	–	4 070	203	16 442	x
Deferred result on revaluation of foreign currencies and gold	24 018	–	–	24 018	717	–	203	23 098	x
Deferred result on revaluation of non-traded interest rate swap arrangements	–	–	545	–545	–557	278	x	–266	x
Deferred result on revaluation of securities	49	–	2 807	–2 758	–160	3 792	x	–6 390	x
Result on revaluation of foreign currencies and gold	**3 891**	–98	738	3 251	2 893	358	x	–23 098	23 098
Result on revaluation of non-traded interest rate swap arrangements	**3 263**	–3 326	6 408	181	181	–	x	266	–266
Result on revaluation of securities	**36 783**	–4 524	30 941	10 366	4 862	5 504	x	6 390	–6 390
Total	**68 004**	–7 948	41 439	34 513	7 936	9 932	203	0	16 442

The initial valuation account was established by transferring thereto the result on revaluation prior to the change in the accounting policies on 1 January 2007. The change in the balance of the initial valuation account in 2008 is related to the recognition of the profit or loss or result on revaluation of the financial instruments of the Bank of Latvia in the amount of 3 352 thousand lats (4 070 thousand lats in 2007) outstanding at the end of 2006. At the end of 2008, balances of other items comprise the positive result on revaluation of the respective financial instruments, calculated from the beginning of 2007 (the negative result on revaluation at the end of 2008 has been recognised in the caption "Write-downs on financial assets and positions" of the profit and loss statement; see also Note 3).

24. NET INTEREST INCOME

In 2008, the Bank of Latvia's net interest income amounted to 84 526 thousand lats (68 730 thousand lats in 2007). The income was mainly derived from investing foreign currency reserves.

Interest income from foreign operations increased by 17 817 thousand lats while interest expense decreased by 12 332 thousand lats in comparison with 2007. Net interest income grew mostly on account of interest on forward exchange rate contracts and currency swap arrangements concluded by the Bank of Latvia for the purpose of hedging currency risk exposure, and the excess of interest income over the expenditure resulted from higher euro interest rates in comparison with those of other foreign currencies included in the foreign currency reserves and gold in 2008.

In comparison with 2007, interest income from domestic operations increased by 3 986 thousand lats in 2008 on account of larger amounts of loans granted to domestic credit institutions.

Interest expense on domestic operations (54 461 thousand lats; 36 122 thousand lats in 2007) was largely comprised of interest on deposits of domestic credit institutions and the Latvian Government. Interest expense on credit institution deposits increased by

15 166 thousand lats as the Bank of Latvia raised its deposit facility rate from 2% to 3% and the average balance of credit institution deposits grew. The Bank of Latvia also received a larger amount of Latvian Government funds as deposits than in 2007; moreover, interest paid on these deposits rose, therefore interest expense on Government deposits increased by 3 168 thousand lats in 2008.

25. REALISED GAINS/LOSSES FROM FINANCIAL OPERATIONS

Realised gains or losses on investment in financial instruments comprises the realised gains and losses on exchange rate contracts, gains and losses from the disposal of securities as well as realised gains and losses on financial derivatives.

The increase in profit on foreign exchange rate contracts mostly resulted from the interventions conducted in the foreign exchange market in the amount of 1 027 million lats in October, November and December 2008. Profit from investment in financial instruments resulted from the interest rate drop in the US and euro area, positively affecting both the result on disposal of foreign debt securities and interest rate future contracts.

26. WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS

The unrealised negative result on the revaluation of several securities positions as well as other financial instruments at the end of the reporting year was primarily produced by a fall in the financial instrument liquidity related to the adverse developments on the global financial market and hence also by a drop in the market value. The unrealised negative result on the revaluation of financial instruments has been recognised as a write-down on financial instruments in the profit and loss statement while the positive result on the revaluation of other financial instruments, mostly foreign government bonds, has been reported in the balance sheet caption "Valuation account" (see also Note 23).

27. INCOME FROM PARTICIPATING INTEREST

Income from participating interest in the amount of 206 thousand lats (216 thousand lats in 2007) comprises the dividends received from the participating interest in the BIS (see also Note 8).

28. OTHER OPERATING INCOME

Other operating income in 2008 and 2007 was as follows:

(in thousands of lats)

	2008	2007
Income from sale of collector coins	**1 113**	776
Income from payment and securities settlement services	**317**	205
Other	**2 003**	209
Total	**3 433**	1 190

29. BANKNOTE PRODUCTION AND COINAGE COSTS

The breakdown of banknote production and coinage costs in 2008 and 2007 was as follows:

(in thousands of lats)

	2008	2007
Banknote production	**1 612**	2 191
Coinage of circulation coins	**1 612**	1 214
Coinage of collector coins	**822**	367
Total	**4 046**	3 772

30. REMUNERATION AND SOCIAL SECURITY COSTS

Remuneration and social security costs in 2008 and 2007 were as follows:

(in thousands of lats)

	2008	2007
Remuneration		
Remuneration of members of the Council and the Board	**1 470**	1 261
Remuneration of other personnel	**13 856**	11 326
Total remuneration	**15 326**	12 587
Social security costs	**3 063**	2 284
Total remuneration and social security costs	**18 389**	14 871

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 2008 and 2007 was as follows:

	2008	2007
Number of employees at the end of the year		
Members of the Council and the Board	**14**	14
Other personnel	**630**	629
Total at the end of the year	**644**	643
Average number of employees per period	**649**	635

31. OTHER OPERATING EXPENSES

Other operating expenses in 2008 and 2007 were as follows:

(in thousands of lats)

	2008	2007
Municipal services	**534**	414
Maintenance of buildings, territory and equipment	**475**	447
Personnel training	**331**	314
Business travel	**288**	317
Telecommunications services and system maintenance	**265**	279
Information and public relations	**251**	303

(cont.)		(in thousands of lats)
Risk insurance	**250**	266
Acquisition of low value office supplies	**215**	178
Transport provision	**172**	149
Tax on real estate	**86**	138
Audit, advisory and legal services	**47**	49
Other	**875**	447
Total	**3 789**	3 301

The audit, advisory and legal services expenses also comprise the remuneration in the amount of 28 thousand lats (33 thousand lats in 2007) to *KPMG Baltics SIA* for the audit of 2008 financial statements and the internal audit quality assessment costs in the amount of 9 thousand lats.

32. CASH FLOW STATEMENT

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

(in thousands of lats)

	2008	2007
Profit before appropriation	**53 437**	51 464
Non-cash transaction adjustments		
Depreciation of fixed assets and amortisation of intangible assets	**3 729**	3 628
Losses on disposal of fixed assets	**7**	2
Write-downs on financial assets and positions	**38 087**	5 862
Net change in balance sheet items		
Net increase in gold	**–2**	–
Net increase in Special Drawing Rights	**–103**	–3
Net increase (–)/decrease in foreign debt securities and other foreign investments	**511 732**	–220 942
Net increase in loans to domestic credit institutions	**–632 413**	–6 850
Net increase in other assets	**–3 376**	–263
Net increase/decrease (–) in foreign convertible currency liabilities	**125 922**	–15 828
Net increase in foreign bank and other international institution deposits in lats	**247 420**	4 288
Net decrease in lats in circulation	**–31 381**	–24 378
Net increase/decrease (–) in time deposits of domestic credit institutions	**–322 507**	204 539
Net increase in Latvian Government time deposits	**466 815**	121 423
Net decrease in time deposits of other financial institutions	**–3 171**	–1 432
Net increase in other liabilities	**13 285**	186
Net cash and cash equivalents inflow arising from operating activities	**467 481**	121 696

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

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

	2008	Change	2007	Change	2006
Convertible foreign currencies in cash	**6 286**	3 821	2 465	2 321	144
Demand deposits with foreign credit institutions and other foreign financial institutions	**661 741**	438 211	223 530	107 232	116 298
Time deposits with foreign credit institutions and other foreign financial institutions with original maturity up to 5 business days	**19 682**	4 870	14 812	7 308	7 504
Total cash and cash equivalents	**687 709**	446 902	240 807	116 861	123 946

33. TRANSACTIONS WITH THE LATVIAN GOVERNMENT

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

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

At the end of 2008 and 2007, the breakdown of the Bank of Latvia claims on and liabilities to the Latvian Government and the respective interest rates were as follows:

	Amount (in thousands of lats)		Yield (%)	
	2008	2007	**2008**	2007
Claims (–)/liabilities				
Demand deposits	**467 188**	43 744	**0.01–2.10**	3.22–3.89
Time deposits	**170 868**	127 497	**5.53**	3.99–5.81
Tax claims (–)/liabilities	**–209**	190	**x**	x
Accrued interest expense	**52**	114	**x**	x
Total net liabilities	**637 899**	171 545	**x**	x

In 2008 and 2007, the breakdown of the Bank of Latvia's income and expense related to the Latvian Government, as well as the Bank of Latvia's profit appropriated to the state budget in 2008 and 2007 was as follows (see also Note 24):

(in thousands of lats)

	2008	2007
Expense and the Bank of Latvia's profit appropriated to the state budget		
Interest on government deposits	**14 366**	11 198
Taxes	**7 541**	6 385
Bank of Latvia's profit appropriated to the state budget	**15 439**	1 976
Total expense and the Bank of Latvia's profit appropriated to the state budget	**37 346**	19 559

34. PLEDGED ASSETS

Securities and other financial instruments with the market value of 180 840 thousand lats, as at the end of 2008 (7 409 thousand lats at the end of 2007), have been sold in repurchase agreements (repos) or pledged to provide collateral for interest rate future contract and other transactions. These financial instruments are included in the balance sheet asset caption "Convertible foreign currencies".

35. OFF-BALANCE SHEET ACCOUNTS

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

At the end of 2008 and 2007, the Bank of Latvia's off-balance sheet account profile was as follows:

(in thousands of lats)

	Contract or notional amount		Book value			
			Assets		Liabilities	
	2008	2007	**2008**	2007	**2008**	2007
Non-traded financial derivative contracts with foreign financial institutions						
Forward exchange rate contracts and currency swap arrangements	**1 468 024**	1 814 172	**127 451**	15 332	**7 141**	17 782
Gold interest rate swap arrangements	**28 049**	25 510	**27**	317	**72**	8
Other interest rate swap arrangements	**248 292**	70 280	**5 648**	874	**8 437**	1 084
Total	**x**	x	**133 126**	16 523	**15 650**	18 874
Traded financial derivative contracts with foreign financial institutions						
Interest rate future contracts	**1 329 814**	1 710 251	**6 276**	–6 014	**–2 909**	188
Non-traded financial derivative contracts with domestic credit institutions						
Currency swap arrangements	**60 403**	10 101	**211**	2	**403**	101
Total	**x**	x	**211**	2	**403**	101
Other transactions						
Agreements concluded on a regular way placement and receipt of time deposits	**–**	4 920	**x**	x	**x**	x
Contracted commitments related to acquisition of fixed assets	**136**	174	**x**	x	**x**	x

As at the end of 2008 and 2007, the book value and the fair value of non-traded contracts concluded by the Bank of Latvia were not materially different. At the end of 2008 and 2007, the comparison of the book value of the off-balance sheet instruments and their net fair value was as follows:

(in thousands of lats)

	Net fair value		Net book value		Difference	
	2008	2007	**2008**	2007	**2008**	2007
Non-traded financial derivative contracts with foreign financial institutions						
Forward exchange rate contracts and currency swap arrangements	**119 326**	–2 900	**120 310**	–2 450	**–984**	–450
Gold interest rate swap arrangements	**–45**	309	**–45**	309	**0**	0
Other interest rate swap arrangements	**–2 789**	–210	**–2 789**	–210	**0**	0
Total	**116 492**	–2 801	**117 476**	–2 351	**–984**	–450
Traded financial derivative contracts with foreign financial institutions						
Interest rate future contracts	**3 367**	–6 202	**3 367**	–6 202	**0**	0
Non-traded financial derivative contracts with domestic credit institutions						
Currency swap arrangements	**–173**	–98	**–192**	–99	**19**	1
Total	**–173**	–98	**–192**	–99	**19**	1

36. CONTINGENT LIABILITIES AND COMMITMENTS

In May 2005, the company *BDO Invest Rīga* being the liquidator of the bankrupt JSC *Banka Baltija* filed a claim against the Bank of Latvia on behalf of the creditors of JSC *Banka Baltija* in the Riga Regional Court for the recovery of losses in the amount of 185.6 million lats. The claimant alleges that the Bank of Latvia, as the institution in charge of banking supervision at that time, is responsible for losses arising from the bankruptcy of JSC *Banka Baltija* in 1995. The Bank of Latvia is confident that the claim is without merits; therefore no provision is recognised in the financial statements. The final ruling on the case is expected no earlier than in 2010.

The Bank of Latvia has not paid up 93% of the Bank of Latvia's share in the ECB subscribed capital, which is payable following the decision of the General Council of the ECB. At the end of 2008, the Bank of Latvia's unpaid share in the ECB subscribed capital was 15 070 thousand euro (10 592 thousand lats).

The Bank of Latvia's uncalled portion of the BIS shares is 75% of their nominal value. These shares are callable following the decision of the BIS Board. At the end of 2008, the uncalled portion of the BIS share holding was 4 013 thousand SDR (3 230 thousand lats).

At the end of 2008, the Bank of Latvia had issued collector coins in the nominal value of 1 449 thousand lats (1 346 thousand lats at the end of 2007) and gold circulation coins with a nominal value of 1 988 thousand lats (1 988 thousand lats at the end of 2007). These coins may be represented to the Bank of Latvia in exchange for lats at a nominal value. In the opinion of management, the probability that the Bank of Latvia will be required to repurchase these coins from their holders is considered minimal and no provisions have been made.

37. CURRENCY PROFILE

At the end of 2008 and 2007, the currency profile of the Bank of Latvia's assets, liabilities and off-balance sheet accounts was as follows:

(in thousands of lats)

	LVL	XDR	USD	EUR	JPY	Gold	Other	Total
As at 31 December 2008								
Foreign assets								
Gold	–	–	–	–	–	108 998	–	108 998
Special Drawing Rights	–	187	–	–	–	–	–	187
Convertible foreign currencies	–	–	782 303	1 541 784	160 427	–	4 179	2 488 693
Participating interest in the European Central Bank	–	–	–	743[1]	–	–	–	743
Participating interest in the Bank for International Settlements	–	1 763[1]	–	–	–	–	–	1 763
Other foreign assets	129 913	–	3 880	86	98	28	6	134 011
Domestic assets								
Loans to credit institutions	435 450	–	–	203 813	–	–	–	639 263
Fixed assets	34 626	–	–	–	–	–	–	34 626
Other domestic assets	4 994	–	–	273	–	–	44	5 311
TOTAL ASSETS	**604 983**	**1 950**	**786 183**	**1 746 699**	**160 525**	**109 026**	**4 229**	**3 413 595**
Foreign liabilities								
Convertible foreign currencies	–	–	6 019	125 233	–	–	–	131 252
International Monetary Fund	256[2]	–	–	–	–	–	–	256
Other international institution deposits in lats	6 503	–	–	–	–	–	–	6 503
Foreign bank deposits in lats	247 001	–	–	–	–	–	–	247 001
Other foreign liabilities	13 475	–	3 171	410	–	41	36	17 133
Lats in circulation	1 018 092	–	–	–	–	–	–	1 018 092
Domestic liabilities								
Balances due to credit institutions	1 071 869	–	–	22 426	–	–	–	1 094 295
Balances due to the Government	170 868	187	978	466 014	9	–	–	638 056
Balances due to other financial institutions	1 685	–	18	2	–	–	–	1 705
Other domestic liabilities	15 512	–	776	1 040	–	–	–	17 328
TOTAL LIABILITIES	**2 545 261**	**187**	**10 962**	**615 125**	**9**	**41**	**36**	**3 171 621**
Net position on balance sheet	–1 940 278	1 763	775 221	1 131 574	160 516	108 985	4 193	241 974
Net position on financial instruments' off-balance sheet accounts	266 672	–	–776 975	900 383	–158 494	–111 872	–2 430	117 284
Net position on balance sheet and off-balance sheet accounts	–1 673 606	1 763	–1 754	2 031 957	2 022	–2 887	1 763	359 258
Net position on balance sheet and off-balance sheet accounts exposed to currency risk	x	–256[3]	–1 754	2 031 214	2 022	–2 887	1 763	2 030 102

[1] The respective assets are recorded in the balance sheet at cost and the Bank of Latvia is not exposed to currency risk related to these assets.
[2] The Bank of Latvia is exposed to the SDR currency risk related to IMF holdings in lats based on changes in the underlying SDR balances determined in accordance with the exchange rate set by the IMF.
[3] Net XDR position on balance sheet and off-balance sheet accounts exposed to currency risk comprises liabilities to the IMF (256 thousand lats) and does not include participating interest in BIS (1 763 thousand lats).

(cont.) (in thousands of lats)

	LVL	XDR	USD	EUR	JPY	Gold	Other	Total
Foreign currency profile of the net position on balance sheet and off-balance sheet accounts exposed to currency risk (%)	x	–0.01	–0.09	100.05	0.10	–0.14	0.09	100.00
Benchmark currency structure (%)	x	0	0	100.00	0	0	0	100.00
As at 31 December 2007								
TOTAL ASSETS	54 446	1 846	1 288 173	1 145 798	239 104	99 165	19 469	2 848 001
TOTAL LIABILITIES	2 565 167	83	3 299	108 900	6	8	53	2 677 516
Net position on balance sheet	–2 510 721	1 763	1 284 874	1 036 898	239 098	99 157	19 416	170 485
Net position on financial instruments' off-balance sheet accounts	10 002	–	–1 284 008	1 622 463	–236 783	–98 893	–15 231	–2 450
Net position on balance sheet and off-balance sheet accounts	–2 500 719	1 763	866	2 659 361	2 315	264	4 185	168 035
Net position on balance sheet and off-balance sheet accounts exposed to currency risk	x	–215	866	2 658 618	2 315	264	4 185	2 666 033
Foreign currency profile of the net position on balance sheet and off-balance sheet accounts exposed to currency risk (%)	x	–0.01	0.03	99.72	0.09	0.01	0.16	100.00
Benchmark currency structure (%)	x	0	0	100.00	0	0	0	100.00

38. REPRICING MATURITY AND TRACKING ERROR

The table below reflects the sensitivity of the Bank of Latvia's assets, liabilities off-balance sheet accounts to a change in interest rates. Items reported in this table are stated at carrying amounts, except for traded interest rate future contracts that are stated at notional amounts and included in off-balance sheet accounts. A nearest contractual interest reprising 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 2008							
Foreign assets							
Gold	–	–	–	–	–	108 998	108 998
Special Drawing Rights	187	–	–	–	–	–	187
Convertible foreign currencies	901 594	81 187	122 809	864 863	508 813	9 427	2 488 693
Participating interest in the European Central Bank	–	–	–	–	–	743	743
Participating interest in the Bank for International Settlements	–	–	–	–	–	1 763	1 763
Other foreign assets	2 550	–	–	–	–	131 461	134 011
Domestic assets							
Loans to credit institutions	639 263	–	–	–	–	–	639 263
Fixed assets	–	–	–	–	–	34 626	34 626
Other domestic assets	2 714	–	–	–	–	2 597	5 311
TOTAL ASSETS	**1 546 308**	**81 187**	**122 809**	**864 863**	**508 813**	**289 615**	**3 413 595**

(cont.) (in thousands of lats)

	Interest bearing					Non-interest bearing	Total
	Up to 3 months	3–6 months	6–12 months	1–3 years	Over 3 years		
Foreign liabilities							
Convertible foreign currencies	123 953	–	–	–	–	7 299	131 252
International Monetary Fund	–	–	–	–	–	256	256
Other international institution deposits in lats	–	–	–	–	–	6 503	6 503
Foreign bank deposits in lats	–	–	–	–	–	247 001	247 001
Other foreign liabilities	2 326	–	–	–	–	14 807	17 133
Lats in circulation	–	–	–	–	–	1 018 092	1 018 092
Domestic liabilities							
Balances due to credit institutions	1 071 869	–	–	–	–	22 426	1 094 295
Balances due to the Government	638 055	–	–	–	–	1	638 056
Balances due to other financial institutions	1 006	–	–	–	–	699	1 705
Other domestic liabilities	600	–	–	–	–	16 728	17 328
TOTAL LIABILITIES	**1 837 809**	**–**	**–**	**–**	**–**	**1 333 812**	**3 171 621**
Net position on balance sheet	–291 501	81 187	122 809	864 863	508 813	x	x
Assets on financial instruments' off-balance sheet accounts	1 868 363	2 559	–	1 383 681	5 174	x	x
Liabilities on financial instruments' off-balance sheet accounts	2 941 077	–	11 069	4 094	186 253	x	x
Net position on balance sheet and off-balance sheet accounts	–1 364 215	83 746	111 740	2 244 450	327 734	x	x
As at 31 December 2007							
TOTAL ASSETS	1 026 297	76 252	318 624	726 027	592 211	108 590	2 848 001
TOTAL LIABILITIES	1 583 293	–	–	–	–	1 094 223	2 677 516
Net position on balance sheet	–556 996	76 252	318 624	726 027	592 211	x	x
Assets on financial instruments' off-balance sheet accounts	2 009 520		75 315	1 533 964	10 828	x	x
Liabilities on financial instruments' off-balance sheet accounts	3 445 667	59 165	38 159	19 844	69 242	x	x
Net position on balance sheet and off-balance sheet accounts	–1 993 143	17 087	355 780	2 240 147	533 797	x	x

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

was 50 and 28 basis points respectively, and lay within the following basis points intervals during the year:

Tracking error (in basis points)	Number of business days	
	2008	2007
10–20	**7**	48
20–30	**52**	91
30–40	**9**	79
40–50	**26**	25
50–60	**88**	5
60–70	**40**	–
70–85	**25**	–
Total	**247**	248

39. LIQUIDITY PROFILE

At the end of 2008 and 2007, the liquidity profile of the Bank of Latvia's assets and liabilities was as follows:

(in thousands of lats)

	2008			2007		
	Up to 3 months	No fixed maturity	**Total**	Up to 3 months	No fixed maturity	Total
Assets						
Foreign assets	2 731 466	2 929	**2 734 395**	2 803 659	3 131	2 806 790
Domestic assets	643 135	36 065	**679 200**	6 980	34 231	41 211
TOTAL ASSETS	3 374 601	38 994	**3 413 595**	2 810 639	37 362	2 848 001
Liabilities						
Foreign liabilities	402 112	33	**402 145**	30 786	39	30 825
Lats in circulation	–	1 018 092	**1 018 092**	–	1 049 473	1 049 473
Domestic liabilities	1 750 741	643	**1 751 384**	1 597 218	–	1 597 218
TOTAL LIABILITIES	2 152 853	1 018 768	**3 171 621**	1 628 004	1 049 512	2 677 516
Net position on balance sheet	1 221 748	–979 774	**x**	1 182 635	–1 012 150	x

40. SECTORAL PROFILE OF ASSETS

The sectoral profile of the Bank of Latvia's assets at the end of 2008 and 2007 was as follows:

	Amount (in thousands of lats)		Percentage (%)	
	2008	2007	**2008**	2007
Claims				
Foreign central governments and other governmental institutions	**1 148 514**	1 318 772	**33.6**	46.3
Foreign local governments	**79 057**	19 992	**2.3**	0.7
Foreign central banks and credit institutions	**1 149 663**	882 651	**33.7**	31.0
Other foreign financial institutions	**365 159**	517 398	**10.7**	18.2
Foreign non-financial corporations	**9 967**	33 683	**0.3**	1.2
International institutions	**42 674**	34 280	**1.3**	1.2
Latvian central government	**589 843**	6 893	**17.3**	0.2
Domestic credit institutions	**836**	40	**0**	0
Unclassified assets	**27 882**	34 292	**0.8**	1.2
Total	**3 413 595**	2 848 001	**100.0**	100.0

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

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

At the end of 2008 and 2007, 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 (%)	
	2008	2007	**2008**	2007
Euro area	**1 415 730**	1 027 351	**51.8**	36.6
Other EU countries	**378 361**	353 419	**13.8**	12.6
US	**579 994**	849 142	**21.2**	30.3
Japan	**175 362**	256 734	**6.4**	9.1
Other countries	**142 274**	285 865	**5.2**	10.2
International institutions	**42 674**	34 279	**1.6**	1.2
Total	**2 734 395**	2 806 790	**100.0**	100.0

42. ASSETS BY CREDIT RATINGS ASSIGNED TO THE COUNTERPARTY

At the end of 2008 and 2007, 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 (%)	
		2008	2007	**2008**	2007
FOREIGN ASSETS					
Gold	AAA	**108 998**	25 754	**3.2**	0.9
	AA	–	73 376	**0**	2.6
Special Drawing Rights	AAA	**187**	83	**0**	0
Foreign debt securities	AAA	**1 310 234**	1 526 129	**38.4**	53.6
	AA+	**123 443**	115 141	**3.6**	4.0
	AA	**19 019**	208 368	**0.6**	7.3
	AA–	**199 854**	183 680	**5.9**	6.4
	A+	**64 241**	304 369	**1.9**	10.7
	A	**62 777**	57 656	**1.8**	2.0
	A–	**1 366**	2 169	**0**	0.1
	BBB	**12 766**	–	**0.4**	–
	BBB–	–	316	–	0
	BB	**7 287**	–	**0.2**	–
	B	–	320	–	0
Deposits with foreign financial institutions	AAA	**589 371**	183 401	**17.3**	6.5
	AA+	**1 353**	1 586	**0**	0.1
	AA	**14 122**	26 009	**0.4**	0.9
	AA–	**46 945**	11 995	**1.4**	0.4
	A+	–	53 208	–	1.9
	A	**29 629**	3 669	**0.9**	0.1
	A–	–	7 226	–	0.3
Foreign currency in cash	AAA	**6 286**	2 465	**0.2**	0.1
Participating interest in the European Central Bank	AAA	**743**	743	**0**	0
Participating interest in the Bank for International Settlements	AAA	**1 763**	1 763	**0.1**	0.1
Derivative financial instruments	AAA	**11 139**	591	**0.3**	0
	AA	**9 395**	3 345	**0.3**	0.1
	AA–	**57 112**	7 969	**1.6**	0.3
	A+	**31 698**	3 921	**0.9**	0.2
	A	**20 732**	697	**0.6**	0
	A–	**3 475**	–	**0.1**	–
Accrued interest income	Different	**27**	217	**0**	0
Other foreign assets	Different	**443**	624	**0**	0
DOMESTIC ASSETS					
Loans to credit institutions	Different	**639 263**	6 850	**18.7**	0.2
Other	Different	**39 937**	34 361	**1.2**	1.2
TOTAL		**3 413 595**	2 848 001	**100.0**	100.0

At the end of 2008 and 2007, 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 (%)	
		2008	2007	**2008**	2007
Foreign assets	AAA	**2 028 722**	1 740 929	**74.2**	62.1
	AA	**471 242**	631 469	**17.2**	22.5
	A	**213 918**	432 915	**7.8**	15.4
	BBB	**12 766**	316	**0.5**	0
	BB	**7 287**	–	**0.3**	–
	B	**–**	320	**–**	0
	Different	**460**	841	**0**	0
Total		**2 734 395**	2 806 790	**100.0**	100.0

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

INDEPENDENT AUDITORS' REPORT TO THE COUNCIL OF THE BANK OF LATVIA

REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying financial statements of the Bank of Latvia ("the Bank"), which comprise the balance sheet as at 31 December 2008, and the related statements of profit and loss, total recognised gains and loses and cash flow for the year then ended, and a summary of principal accounting policies and other explanatory notes to the financial statements, as set out on pages 64 to 103.

Management's Responsibility for the Financial Statements
Management 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 Bank of Latvia's Council, and the law "On the Bank of Latvia". This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

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 relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by management, 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 give a true and fair view of the financial position of the Bank as at 31 December 2008, 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 Bank of Latvia's Council, and the law "On the Bank of Latvia".

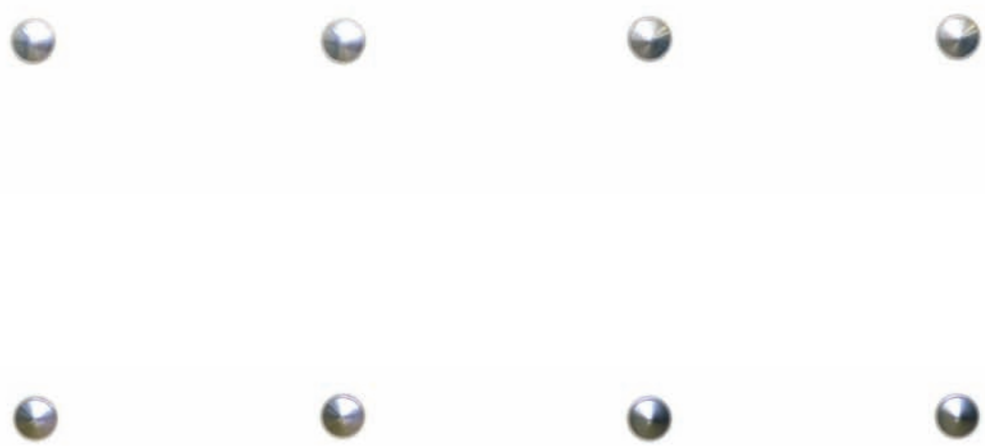
KPMG Baltics SIA
Licence No 55

Stephen Young
Chairman of the Board
Riga, Latvia
26 February 2009

The State Audit Office
of the Republic of Latvia

Inguna Sudraba
Auditor General
Riga, Latvia
26 February 2009

APPENDICES



Appendix 1

MONETARY INDICATORS IN 2008

(at end of period; in millions of lats)

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	**XII**
BANK OF LATVIA												
M0	2 432.2	2 415.1	2 437.3	2 475.1	2 377.8	2 441.1	2 429.7	2 401.2	2 354.5	2 383.4	2 267.6	**2 111.5**
Currency in circulation	958.9	969.6	961.3	1 003.9	988.4	998.7	1 003.2	1 018.1	998.9	1 037.0	1 044.5	**1 018.1**
Demand deposits with the Bank of Latvia	1 473.3	1 445.4	1 476.0	1 471.2	1 389.4	1 442.3	1 426.5	1 383.1	1 355.6	1 346.4	1 223.1	**1 093.4**
Currency vs monetary base (%)	39.4	40.1	39.4	40.6	41.6	40.9	41.3	42.4	42.4	43.5	46.1	**48.2**
Net foreign assets	2 807.0	2 791.2	2 961.0	2 954.6	2 958.1	2 946.3	2 891.0	2 887.7	2 990.2	2 888.3	2 367.1	**2 332.3**
Net domestic assets	–374.8	–376.1	–523.7	–479.5	–580.3	–505.2	–461.3	–486.5	–635.7	–504.9	–99.5	**–220.7**
Credit	–203.6	–188.1	–347.6	–318.3	–456.2	–390.6	–336.3	–344.7	–471.8	–313.6	106.6	**1.2**
To MFIs	25.0	0	0	0	0	0	0	0	10.0	187.9	554.6	**639.3**
To central government (net)	–228.6	–188.1	–347.6	–318.3	–456.2	–390.6	–336.3	–344.7	–481.8	–501.5	–448.0	**–638.1**
Other assets (net)	–171.2	–188.0	–176.1	–161.2	–124.2	–114.6	–125.0	–141.9	–163.9	–191.3	–206.1	**–222.0**
MFI												
M1	3 769.7	3 678.8	3 704.9	3 718.0	3 731.2	3 788.5	3 761.2	3 716.4	3 617.3	3 562.2	3 487.5	**3 345.1**
M2	6 192.9	6 164.7	6 222.9	6 373.1	6 324.5	6 401.9	6 399.0	6 382.8	6 260.5	6 175.9	6 057.3	**5 964.9**
M3	6 270.5	6 247.2	6 314.9	6 470.2	6 432.6	6 507.6	6 517.4	6 514.3	6 380.7	6 277.7	6 141.0	**6 039.5**
M2X	6 099.0	6 076.2	6 117.0	6 215.6	6 160.3	6 256.9	6 266.8	6 265.1	6 148.8	6 052.6	5 927.0	**5 931.4**
Currency outside MFIs	850.2	852.4	842.7	870.0	866.1	874.4	885.6	899.6	876.9	912.4	913.2	**866.1**
Deposits of resident financial institutions, non-financial corporations and households	5 248.7	5 223.8	5 274.2	5 345.6	5 294.2	5 382.5	5 381.2	5 365.4	5 271.9	5 140.3	5 013.8	**5 065.3**
In foreign currencies	2 574.6	2 512.1	2 514.4	2 492.4	2 497.7	2 521.6	2 521.4	2 539.4	2 506.3	2 401.6	2 421.7	**2 463.4**
Net foreign assets	–4 640.3	–4 820.5	–4 711.3	–4 786.3	–4 933.0	–5 158.8	–5 397.1	–5 496.6	–5 692.1	–5 951.5	–6 184.8	**–5 914.6**
Net domestic assets	10 739.3	10 896.7	10 828.2	11 001.9	11 093.2	11 415.7	11 663.9	11 761.7	11 840.8	12 004.1	12 111.8	**11 846.1**
Loans to resident financial institutions, non-financial corporations and households	13 169.4	13 368.3	13 500.0	13 664.1	13 916.6	14 108.5	14 290.9	14 460.6	14 594.0	14 668.9	14 643.0	**14 577.7**
INTEREST RATES												
Bank of Latvia refinancing rate	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	**6.0**
Weighted average interest rates on transactions in lats												
Interbank loans	4.0	5.2	3.4	3.3	3.4	3.5	3.4	3.4	3.7	6.5	5.0	**5.7**
Loans to non-financial corporations and households with a floating interest rate and an initial rate fixation of up to 1 year (new business)	10.5	11.9	12.9	8.8	13.2	9.2	11.1	10.5	10.0	13.9	13.5	**16.8**
Time deposits of non-financial corporations and households (new business)	7.6	6.2	5.9	5.5	5.4	5.5	5.2	5.0	5.5	7.0	7.6	**9.7**

Appendix 2

THE BANK OF LATVIA'S MONTH-END BALANCE SHEETS FOR 2008

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

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	**XII**
FOREIGN ASSETS	2 830 952	2 803 801	2 981 182	2 973 126	2 976 093	2 960 225	2 905 261	2 950 527	3 058 566	3 015 987	2 439 883	**2 734 395**
Gold	109 063	110 683	104 667	99 589	100 758	101 217	102 830	98 543	105 882	101 770	110 274	**108 998**
SDR	83	82	81	81	81	80	81	84	86	89	92	**187**
Convertible foreign currencies	2 700 431	2 639 454	2 803 265	2 826 424	2 847 373	2 817 175	2 777 500	2 822 861	2 926 581	2 884 257	2 308 997	**2 488 693**
Participating interest in the ECB	743	743	743	743	743	743	743	743	743	743	743	**743**
Participating interest in the BIS	1 763	1 763	1 763	1 763	1 763	1 763	1 763	1 763	1 763	1 763	1 763	**1 763**
Other foreign assets	18 869	51 075	70 663	44 526	25 375	39 247	22 343	26 533	23 510	27 363	18 013	**134 011**
DOMESTIC ASSETS	59 311	34 475	34 347	34 160	37 117	36 918	37 034	36 791	46 647	224 494	591 624	**679 200**
Loans to credit institutions	25 000	0	0	0	0	0	0	0	10 000	187 920	554 600	**639 263**
Fixed assets	32 385	32 199	31 947	31 780	31 632	34 757	34 564	34 492	34 329	34 193	34 137	**34 626**
Other domestic assets	1 926	2 276	2 400	2 380	5 485	2 161	2 470	2 298	2 318	2 380	2 887	**5 311**
TOTAL ASSETS	2 890 263	2 838 275	3 015 529	3 007 287	3 013 210	2 997 143	2 942 295	2 987 318	3 105 212	3 240 480	3 031 507	**3 413 595**
FOREIGN LIABILITIES	23 982	12 653	20 249	18 539	18 048	13 961	14 337	62 859	68 417	127 737	72 851	**402 145**
Convertible foreign currencies	10 089	2 811	6 402	6 608	3 771	4 975	1 682	2 461	231	2 682	17 270	**131 252**
IMF	253	249	245	245	245	243	246	250	256	266	272	**256**
Other international institution deposits in lats	5 489	1 272	4 170	3 460	5 291	2 708	2 197	968	3 356	3 237	5 716	**6 503**
Foreign bank deposits in lats	115	52	88	48	261	150	271	266	271	341	349	**247 001**
Other foreign liabilities	8 036	8 269	9 344	8 178	8 480	5 884	9 942	58 915	64 303	121 211	49 244	**17 133**
LATS IN CIRCULATION	958 933	969 634	961 308	1 003 871	988 353	998 747	1 003 242	1 018 072	998 896	1 036 967	1 044 504	**1 018 092**
DOMESTIC LIABILITIES	1 706 942	1 643 519	1 828 503	1 817 960	1 860 997	1 839 300	1 768 502	1 733 575	1 842 840	1 856 996	1 680 479	**1 751 384**
Balances due to credit institutions	1 459 320	1 447 722	1 472 627	1 487 130	1 396 282	1 439 525	1 419 080	1 380 516	1 353 238	1 343 879	1 224 915	**1 094 295**
Balances due to the government	228 564	188 117	347 571	318 302	456 154	390 645	336 259	344 655	481 753	501 512	447 994	**638 056**
Balances due to other financial institutions	13 953	3 723	3 376	7 691	3 141	2 810	7 382	3 240	2 473	6 662	2 065	**1 705**
Other domestic liabilities	5 105	3 957	4 929	4 837	5 420	6 320	5 781	5 164	5 376	4 943	5 505	**17 328**
CAPITAL AND RESERVES	200 406	212 469	205 469	166 916	145 812	145 135	156 213	172 811	195 059	218 780	233 673	**241 974**
TOTAL LIABILITIES, CAPITAL AND RESERVES	2 890 263	2 838 275	3 015 529	3 007 287	3 013 210	2 997 143	2 942 295	2 987 318	3 105 212	3 240 480	3 031 507	**3 413 595**

Appendix 3

THE BANK OF LATVIA'S YEAR-END BALANCE SHEETS FOR THE YEARS 2004–2008

(at end of year; in thousands of lats)

	2004	2005	2006	2007	**2008**
FOREIGN ASSETS	1 069 461	1 405 794	2 451 207	2 806 790	**2 734 395**
Gold	56 901	76 170	83 668	99 130	**108 998**
SDR	77	85	85	83	**187**
Convertible foreign currencies	986 458	1 323 520	2 333 279	2 687 707	**2 488 693**
Participating interest in the ECB	760	760	760	743	**743**
Participating interest in the BIS	1 000	1 763	1 763	1 763	**1 763**
Other foreign assets	24 265	3 496	31 652	17 364	**134 011**
DOMESTIC ASSETS	144 923	159 530	34 913	41 211	**679 200**
Loans to credit institutions	12 880	23 300	–	6 850	**639 263**
Government securities	93 208	98 817	–	–	**–**
Fixed assets	35 931	34 878	32 763	32 646	**34 626**
Other domestic assets[1]	2 904	2 535	2 150	1 715	**5 311**
TOTAL ASSETS	1 214 384	1 565 324	2 486 120	2 848 001	**3 413 595**
FOREIGN LIABILITIES	29 787	15 606	36 881	30 825	**402 145**
Convertible foreign currencies	2 445	3 295	21 158	5 330	**131 252**
IMF[1]	269	285	269	254	**256**
Other international institution deposits in lats	21 515	1 105	1 348	6 049	**6 503**
Foreign bank deposits in lats	396	486	448	35	**247 001**
Other foreign liabilities[2]	5 162	10 435	13 658	19 157	**17 133**
LATS IN CIRCULATION	727 354	877 274	1 073 851	1 049 473	**1 018 092**
DOMESTIC LIABILITIES	361 513	575 762	1 271 929	1 597 218	**1 751 384**
Balances due to credit institutions	228 872	502 669	1 212 263	1 416 802	**1 094 295**
Balances due to the government	107 156	68 389	49 818	171 241	**638 056**
Other international institution deposits	1 300	2 004	6 308	4 876	**1 705**
Other domestic liabilities[3]	24 185	2 700	3 540	4 299	**17 328**
CAPITAL AND RESERVES	95 730	96 682	103 459	170 485	**241 974**
Nominal capital	25 000	25 000	25 000	25 000	**25 000**
Reserve capital[3]	45 787	48 090	54 898	59 508	**95 533**
Valuation account	21 121	13 333	16 442	34 513	**68 004**
Undistributed profit[3]	3 289	9 726	6 586	51 464	**53 437**
EU grant	533	533	533	–	**–**
TOTAL LIABILITIES, CAPITAL AND RESERVES	1 214 384	1 565 324	2 486 120	2 848 001	**3 413 595**

[1] In the financial statements for 2004–2007, Latvia's quota in the IMF, secured by a promissory note issued by the government of Latvia, is reported in the asset and liability item "The International Monetary Fund" respectively. In 2008, the Bank of Latvia changed the reporting of assets and liabilities related to the IMF on its balance sheet. Latvia's quota in the IMF, secured by a promissory note issued by the government of Latvia, has been excluded from the foreign assets and liabilities respectively and reported in the financial statements of the government of Latvia.

[2] Liabilities in non-convertible currencies that were reported under the caption "Non-convertible currencies" in the financial statements for the years 2004 and 2005 are also included.

[3] In the financial statements for years 2004 and 2005, profit was divided across several captions: profit appropriated to the state budget was reported under the caption "Other domestic liabilities", and increase in reserve capital was reported under the caption "Reserve capital".

Appendix 4

THE BANK OF LATVIA'S PROFIT AND LOSS STATEMENTS FOR THE YEARS 2004–2008

(in thousands of lats)

	2004	2005	2006	2007[1]	**2008**
INTEREST AND SIMILAR INCOME					
Foreign operations	21 580	33 473	51 057	125 829	**143 646**
Domestic operations	7 005	5 080	–3 167	3 278	**7 264**
INTEREST EXPENSE					
Foreign operations	8	9	8	24 255	**11 923**
Domestic operations	5 282	10 018	20 188	36 122	**54 461**
NET INTEREST AND SIMILAR INCOME	23 295	28 526	27 694	68 730	**84 526**
REALISED GAINS OR LOSSES FROM INVESTMENT IN FINANCIAL INSTRUMENTS[2]	–	–	–	14 310[3]	**34 886**
INCOME FROM PARTICIPATING INTEREST[4]	–	–	–	5 862	**38 087**
IMPAIRMENT OF FINANCIAL ASSETS AND POSITION VALUE	180	200	211	216	**206**
OTHER OPERATING INCOME	447	577	712	1 195	**3 433**
BANKNOTE PRODUCTION AND COINAGE COSTS[5]	888	296	1 071	3 772	**4 046**
OTHER OPERATING EXPENSE	19 745	19 281	20 960	23 353	**27 481**
PROFIT OF THE REPORTING YEAR	3 289	9 726	6 586	51 464	**53 437**

[1] Data of 2007 and 2008 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 2004–2007, 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 2004–2007, income from participating interest is reported under the profit and loss statement caption "Interest and similar income".
[5] In the financial statements for 2004–2007, banknote production and coinage costs are reported under the profit and loss statement caption "Other operating expense".

Appendix 5

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

(LVL vs foreign currency)

2008	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	0.9630	0.9418	0.9250	0.9470	0.4600	0.4416	0.4240	0.4460	0.4870	0.4785	0.4730	0.4760
II	0.9470	0.9379	0.9230	0.9230	0.4520	0.4449	0.4370	0.4380	0.4850	0.4772	0.4650	0.4650
III	0.9230	0.9083	0.8920	0.8930	0.4580	0.4482	0.4380	0.4460	0.4650	0.4534	0.4440	0.4450
IV	0.8950	0.8823	0.8700	0.8940	0.4470	0.4352	0.4260	0.4310	0.4510	0.4454	0.4390	0.4490
V	0.8960	0.8875	0.8780	0.8890	0.4410	0.4333	0.4290	0.4290	0.4590	0.4513	0.4450	0.4490
VI	0.8950	0.8880	0.8770	0.8880	0.4340	0.4231	0.4150	0.4170	0.4560	0.4519	0.4450	0.4470
VII	0.8950	0.8863	0.8780	0.8940	0.4230	0.4179	0.4150	0.4180	0.4510	0.4453	0.4410	0.4510
VIII	0.9000	0.8869	0.8730	0.8730	0.4380	0.4280	0.4160	0.4360	0.4790	0.4671	0.4510	0.4750
IX	0.8930	0.8790	0.8610	0.8870	0.4730	0.4574	0.4370	0.4570	0.5030	0.4881	0.4750	0.4860
X	0.9080	0.8937	0.8750	0.8850	0.6020	0.5221	0.4670	0.5420	0.5610	0.5247	0.4880	0.5340
XI	0.8990	0.8522	0.8170	0.8380	0.5910	0.5706	0.5420	0.5710	0.5630	0.5523	0.5340	0.5440
XII	0.8500	0.7833	0.7280	0.7280	0.5980	0.5721	0.5470	0.5470	0.5570	0.5224	0.4880	0.4950

Appendix 6

THE BANK OF LATVIA'S ORGANISATIONAL UNITS AT THE END OF 2008

1. ACCOUNTING DEPARTMENT
(Head of Department, Chief Accountant – Jānis Caune; Deputy Chief Accountants – Leo Ašmanis[1], Iveta Čavare)
1.1 Financial Statements and Accounting Policy Division (Head of Division – Gatis Gersons)
1.2 Internal Banking Operations Division (Head of Division – Anita Jakāne)

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

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

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

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

6. INTERNAL AUDIT DEPARTMENT
(Head of Department)[2]
6.1 Operational Audit Division (Head of Division, Deputy Head of Department – Anita Hāznere)
6.2 Information System Audit Division (Head of Division – Juris Ziediņš)

7. INTERNATIONAL DEPARTMENT
(Head of Department – Juris Kravalis; Deputy Head of Department – Aleksandra Bambale)

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[1] As of 1 January 2009, vacancy.
[2] Vacancy. As of 1 January 2009, Mr. Leo Ašmanis.

Appendix 6
(cont.)

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

9. MARKET OPERATIONS DEPARTMENT
(Head of Department – Raivo Vanags)
9.1 Trading and Investment Division (Head of Division – Vadims Zaicevs)
9.2 Risk Management Division (Head of Division, Deputy Head of Department – Daira Brunere)
9.3 Payments Division (Head of Division – Una Ruka)

10. MONETARY POLICY DEPARTMENT
(Head of Department – Kārlis Bauze; Deputy Heads of Department – Zoja Razmusa, Uldis Rutkaste)
10.1 Macroeconomic Analysis Division (Head of Division – Vilnis Purviņš[1])
10.2 Financial Market Analysis Division (Head of Division – Elmārs Zakulis)
10.3 Monetary Research and Forecasting Division (Head of Division – Konstantīns Beņkovskis)
10.4 Financial Stability Division (Head of Division – Nataļja Beņkovska)

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

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

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

14. SECURITY DEPARTMENT
(Head of Department – Romualds Namnieks; Deputy Heads of Department – Imants Kravals, Sandis Mackēvičs)
14.1 Analytical Unit (Head of Unit – Māris Dzelme)
14.2 Armament Unit (Head of Unit – Juris Kušķis)
14.3 Central Division (Head of Division – Guntars Ezeriņš)
14.4 Riga Division (Head of Division – Normunds Puzulis)
14.5 Daugavpils Division (Head of Division – Ilmārs Suhockis)
14.6 Liepāja Division (Head of Division – Gints Liepiņš)
14.7 Rēzekne Division (Head of Division – Andrejs Gugāns)

15. STATISTICS DEPARTMENT
(Head of Department – Agris Caune; Deputy Head of Department – Ilmārs Skarbnieks)

[1] As of 5 January 2009, Ms. Santa Bērziņa.

Appendix 6
(cont.)

15.1 Financial Market and Monetary Statistics Division (Head of Division – Zigrīda Aušta)
15.2 Balance-of-Payments Statistics Division (Head of Division – Daiga Gaigala-Ližbovska)
15.3 General Economic and Financial Statistics Division (Head of Division – Iveta Salmiņa)

16. TECHNICAL SUPPORT DEPARTMENT
(Head of Department – Andris Ņikitins)
16.1 General Service Division (Head of Division, Deputy Head of Department – Einārs Cišs[1])
16.2 Building Systems Division (Head of Division – Jānis Kreicbergs[2])
16.3 Security Systems Division (Head of Division – Viesturs Balodis)

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

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

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

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

21. TRAINING AND RECREATION CENTRE
(Head of Centre – Zaiga Blūma; Deputy Head of Centre – Dace Miķilpa)

[1] As of 16 January 2009, Head of Division.
[2] As of 16 January 2009, Head of Division, Deputy Head of Department.

Appendix 7

THE BANK OF LATVIA'S STRUCTURE AT THE END OF 2008

Governor's Office

COUNCIL

Internal Audit Department

BOARD

Monetary Policy Department	Cashier's and Money Operations Department	Market Operations Department
Statistics Department	Riga Branch	Payment Systems Department
International Department	Daugavpils Branch	Accounting Department
Public Relations Department	Liepāja Branch	Information Systems Department
Communications Department	Rēzekne Branch	Legal Department
Technical Support Department	Security Department	Personnel Department
	Training and Recreation Centre	

Appendix 8

REPRESENTATION OF THE BANK OF LATVIA IN INTERNATIONAL ORGANISATIONS

EUROPEAN UNION
EFC
Kārlis Bauze, Head of Monetary Policy Department
Juris Kravalis, Head of International Department (Alternate)

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

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

Committee of European Banking Supervisors (CEBS)
Vita Pilsuma, Member of the Bank of Latvia's Council (Banking Supervisory Institution is represented by Jānis Placis, Member of the Council of 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
Daiga Gaigala-Ližbovska, Head of Balance of Payments Statistics Division, Statistics Department
Valters Zīle, Deputy Head of Balance of Payments Statistics Division, Statistics Department

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

Republic of Latvia Mission to the EU
Aldis Austers, Counsellor of the Bank of Latvia at the Permanent Representation of Latvia to the EU

EUROPEAN SYSTEM OF CENTRAL BANKS
General Council of the ECB
Ilmārs Rimšēvičs, Governor of the Bank of Latvia

Accounting and Monetary Income Committee (AMICO)
Jānis Caune, Chief Accountant of the Bank of Latvia
Leo Ašmanis, Deputy Chief Accountant of the Bank of Latvia[1]

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

Banknote Committee (BANCO)
Veneranda Kausa, Head of Cashier's and Money Operations Department
Vilnis Kepe, Deputy Head of Cashier's and Money Operations Department

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

[1] As of 16 January 2009, Mr. Gatis Gersons, Head of Financial Statements and Accounting Policy Division.

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(cont.)

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

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

Internal Auditors Committee (IAC)
Modris Briedis, Head of Internal Audit Department[1]
Anita Hāznere, Deputy Head of Internal Audit Department, Head of Operational Audit Division

International Relations Committee (IRC)
Andris Ruselis, Deputy Governor of the Bank of Latvia
Juris Kravalis, Head of International 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 Expert of Market Operations Analysis, 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
Elmārs Zakulis, Head of Financial Market Analysis Division, Monetary Policy Department

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

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

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

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

Nordic-Baltic IMF Office in Washington
Mārtiņš Bitāns, Advisor to the Executive Director of the Nordic-Baltic Constituency of the IMF, Latvia's representative in IMF

[1] As of 16 January 2009, Mr. Leo Ašmanis, Head of Internal Audit Department.

Appendix 9

THE BANK OF LATVIA'S 2008 PUBLICATIONS

This list contains publications prepared and issued by the Bank of Latvia in 2008. These 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 (if not indicated otherwise and a sufficient number of copies are available) sending a request to the address indicated on the last page of this publication or by e-mailing to: info@bank.lv.

REGULAR PUBLICATIONS

Bank of Latvia: Annual Report 2007
Monetārais Apskats. Monetary Review (3, 4/2007 and 1, 2/2008)
Monetary Bulletin (11, 12/2007 and 1–10/2008)
Financial Stability Report (2007)
Latvijas Maksājumu Bilance. Latvia's Balance of Payments (3, 4/2007 and 1, 2/2008)
Latvia's Balance of Payments (Key Items) (11, 12/2007 and 1–10/2008)

WORKING PAPERS

1. *Beņkovskis K.* Is There a Bank Lending Channel of Monetary Policy in Latvia? Evidence from Bank Level Data
2. *Ajevskis V.*, *Dāvidsons G.* Dynamic Factor Models in Forecasting Latvia's Gross Domestic Product
3. *Fadejeva L.*, *Meļihovs A.* The Baltic States and Europe: Common Factors of Economic Activity
4. *Vītola K.*, *Dāvidsons G.* Structural Transformation of Exports in a Product Space Model
5. *Beņkovskis K.* Short-Term Forecasts of Latvia's Real Gross Domestic Product Growth Using Monthly Indicators

Appendix 10

2008 HIGHLIGHTS OF RESOLUTIONS AND REGULATIONS ADOPTED IN PURSUIT OF THE BANK OF LATVIA'S MAIN TASKS

17 January

The Council of the Bank of Latvia approved Regulation No. 14 "Interest Rates on Transactions", increasing the bank deposit facility rate by 1.0 percentage point, to 3.00%, and leaving the refinancing rate unchanged at 6.00% and the marginal lending facility rate at 7.50% (in effect as of 24 February 2008).

The Council of the Bank of Latvia approved Regulation No. 15 "Minimum Reserve Ratio", lowering the reserve ratio by 1.0 percentage point, to 7%, for the amounts received under the following categories on the liabilities side: deposits with an agreed maturity of over two years, deposits redeemable at a period of notice of over two years and non-callable (without the right to be redeemed prior to maturity) debt securities issued by a bank with an original maturity of over two years (in effect as of 24 February 2008).

13 March

The Council of the Bank of Latvia approved Regulation No. 16 "Minimum Reserve Ratio", lowering the reserve ratio by 1.0 percentage point, to 6%, for the amounts received under the following categories on the liabilities side: deposits with an agreed maturity of over two years, deposits redeemable at a period of notice of over two years and non-callable (without the right to be redeemed prior to maturity) debt securities issued by a bank with an original maturity of over two years (in effect as of 24 April 2008).

17 July

The Council of the Bank of Latvia approved Regulation No. 17 "Amendments to the Bank of Latvia Regulation No. 7 'The Description of the Lats Banknotes' " of 12 July 2007 (in effect as of 17 July 2008).

11 September

The Council of the Bank of Latvia approved Regulation No. 18 "Minimum Reserve Ratio", lowering the reserve ratio by 1.0 percentage point, to 5%, for the amounts received under the following categories on the liabilities side: deposits with an agreed maturity of over two years, deposits redeemable at notice of over two years, and non-callable (without the right to be redeemed prior to maturity) debt securities issued by a bank with an original maturity of over two years, as well as lowering the reserve ratio by 1.0 percentage point, to 7%, for the rest of the liabilities included in the reserve base (in effect as of 24 October 2008).

The Council of the Bank of Latvia approved Regulation No. 19 "The Regulation for the Lats Banknotes" (in effect as of 11 September 2008).

13 November

The Council of the Bank of Latvia approved the "System Rules for Participation in the SAMS" and "System Rules for Participation in the EKS".

The Council of the Bank of Latvia approved Regulation No. 20 "Minimum Reserve Ratio", lowering the reserve ratio by 1.0 percentage point, to 4%, for the amounts received under the following categories on the liabilities side: deposits with an agreed maturity of over two years, deposits redeemable at a period of notice of over two years and non-callable (without the right to be redeemed prior to maturity) debt securities issued by a bank with an original maturity of over two years, as well as lowering the

Appendix 10
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reserve ratio by 1.0 percentage point, to 6%, for the rest of the liabilities included in the reserve base (in effect as of 24 November 2008).

The Council of the Bank of Latvia approved Regulation No. 21 "Minimum Reserve Ratio", lowering the reserve ratio by 1.0 percentage point, to 3%, for the amounts received under the following categories on the liabilities side: deposits with an agreed maturity of over two years, deposits redeemable at a period of notice of over two years and non-callable (without the right to be redeemed prior to maturity) debt securities issued by a bank with an original maturity of over two years, as well as lowering the reserve ratio by 1.0 percentage point, to 5%, for the rest of the liabilities included in the reserve base (in effect as of 24 December 2008).

The Council of the Bank of Latvia approved Regulation No. 22 "Amendments to the Bank of Latvia Regulation No. 7 'The Description of the Lats Banknotes' " of 12 July 2007 (in effect as of 15 December 2008).

5 December
The Council of the Bank of Latvia approved Regulation No. 23 "Interest Rates on Transactions", stipulating the Bank of Latvia's marginal lending facility rate at 7.5% per annum, when a bank has resorted to the lending facility for no more than 5 working days within the previous 30-day period; 15% per annum, when a bank has resorted to the lending facility 6–10 working days within the previous 30-day period; 30% per annum, when a bank has resorted to the lending facility for more than 10 working days within the previous 30-day period, and leaving the refinancing rate and the deposit facility rate unchanged at 6.00% and 3.00% respectively (in effect as of 9 December 2008).

Appendix 11

GLOSSARY

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

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

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

Central government: public institutions, including ministries, embassies, representative offices, agencies, councils, educational, healthcare, law enforcement, cultural and other public institutions whose competence covers the whole economic territory of a country. Central government includes state non-profit institutions managed and financed by the central government. The list of institutional units of the Latvian central government is prepared in accordance with the requirements of the European System of Accounts (ESA 95) by the Central Statistical Bureau of Latvia.

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

Concentration ratio: market share of the five largest senders of payment messages in each payment system in terms of the total volume and value of transactions. The five largest senders in terms of the volume of payment transactions may be different from the five largest senders in terms of the value of payment transactions. The concentration ratio of the Bank of Latvia's payment systems does not include the Bank of Latvia's transactions.

Credit institution: a corporation whose business is to receive deposits or other repayable funds from the public and to grant credits on its own account and provide other financial services, or electronic money institutions issuing means of payment in the form of electronic money. The credit institutions of the Republic of Latvia (banks and electronic money institutions) have been included on the "List of Monetary Financial Institutions of the Republic of Latvia" (see Statistical Reporting Forms under Legal section on the Bank of Latvia's website at www.bank.lv).

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

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

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

Appendix 11
(cont.)

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

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

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

Euro area: EU countries which have adopted the euro as their single currency in accordance with the Treaty establishing the European Community and in which a single monetary policy is conducted under the responsibility of the Governing Council of the ECB. As at the end of 2008, the euro area comprised Austria, Belgium, Cyprus, Finland, France, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovenia, Spain and Germany (Slovakia also joined the euro area on 1 January 2009).

European Central Bank (ECB): the central institution of the ESCB and the Eurosystem having a legal personality under the Community 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 national central banks. The ECB is governed by the Governing Council and the Executive Board, and, until all EU Member States introduce the euro, by a third decision-making body, the General Council.

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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 which have not adopted the euro implement an independent monetary policy according to national law and are thus not involved in the conduct of the monetary policy of the Eurosystem.

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

Exchange rate mechanism II (ERM II): the exchange rate arrangement that ensures 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 2008, Denmark, Estonia, Latvia, Lithuania and Slovakia were members of the ERM II (with the introduction of the euro on 1 January 2009, Slovakia ceased to participate in ERM II).

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

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

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

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

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

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

General government: public institutions engaged in production of non-market goods and services intended for individual and collective consumption or public institutions

Appendix 11
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engaged in redistribution of national income or wealth. General government in the Republic of Latvia includes central government and local government. The list of institutional units of the Latvian government is prepared in accordance with the requirements of the European System of Accounts (ESA 95) by the Central Statistical Bureau of Latvia.

Gross settlement system: a transfer system in which the settlement concerning each cash or securities transfer order occurs on an instruction-by-instruction basis in the order of receipt.

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

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

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

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

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

Local government: public institutions, whose competence covers only a local economic territory. Local government includes state non-profit institutions managed and financed by the local government. In the Republic of Latvia, the local government level is comprised of the local authorities. The list of institutional units of the Latvian local government is prepared in accordance with the requirements of the European System of Accounts (ESA 95) by the Central Statistical Bureau of Latvia.

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

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

M1: narrow monetary aggregate calculated on the basis of the ECB methodology and comprising the lats banknotes and coins issued by the Bank of Latvia (less vault cash of MFIs) and overnight deposits in lats and foreign currencies held with MFIs by

Appendix 11
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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 aggregate calculated on the basis of the Bank of Latvia's methodology and comprising 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 non-financial corporations, financial institutions, households and non-profit institutions serving households. M2X incorporates deposits made by local governments as a net item on the demand side.

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

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

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

Market operations: operations executed on the initiative of the central bank in the financial market. 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 institutions (MFIs): institutions forming the money-issuing sector. The Bank of Latvia maintains the "List of Monetary Financial Institutions of the Republic of Latvia" (see Statistical Reporting Forms under Legal section on the Bank of Latvia's website at www.bank.lv) which comprised the Bank of Latvia, 34 credit institutions, three money market funds and 35 other MFIs (credit unions) as at the end of 2008. The ECB regularly publishes the "List of the EU MFIs" on its website (see Links on the Bank of Latvia's website at www.bank.lv).

Non-financial corporation: an economic entity producing goods or providing non-financial services with the aim of gaining profit or other yield. In the Republic of 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.

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Non-profit institutions serving households: 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. 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 or non-financial losses as a result of an unexpected disruption of operations, unsanctioned use of information, non-compliance with security requirements and other internal or external circumstances relating to gaps in the internal control system.

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

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

Outright purchase and sales of securities: transactions as a result of outright purchase and sales auctions of securities organised by the Bank of Latvia. At auctions, the Bank of Latvia offers banks registered in the Republic of Latvia to purchase or sell lats-denominated debt securities. The maximum purchase price in outright purchases of securities and minimum sales price in outright sales of securities respectively is set according to the market price of the relevant securities. The Bank of Latvia defines the amount of securities to be bought or sold at each auction.

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

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

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

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

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

Appendix 11
(cont.)

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

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

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

Reverse transaction: a transaction whereby the Bank of Latvia grants collateralised loans to banks registered in the Republic of Latvia.

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

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

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

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

TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system): the real-time gross settlement (RTGS) 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.

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

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