

Rīga, 31.10.2008.

Mr. Jean-Claude Trichet
President of the European Central Bank
Kaiserstrasse 29
D-60311 Frankfurt am Main
Germany

c.c. Mr. González-Páramo

Dear Mr. Trichet,

Thank you for the prompt ECB's answer, signed by Mr. González-Páramo, to our letter of 27 October, 2008. In line with the request for further clarification of the current situation in the Latvian financial markets we would like to provide the following information:

Situation in the domestic financial market

While the latest data on the Latvian economy confirm that a gradual adjustment process is taking place, the situation in the domestic financial market is in a critical condition. As turmoil started to spread from the US financial markets to Europe in September of this year, serious tensions were observed in the Latvian financial market as well. Nervousness of both domestic and, in particular, international market participants, reflected itself in domestic FX market and spreads of Latvia's CDS and Eurobond spreads. Tensions were escalated by rumours that some of the local banks might face difficulties in refinancing their short term debt. Further uncertainty to the situation was added by the crash of financial markets in Iceland in October, followed by market unrest in Hungary at the end of October. These two events were catalysts for a substantial increase in risk premium in the non Euro-area EU member states. Additional risk premium was added to the Baltic countries due to the fixed currency regimes.

As a consequence of this negative external environment, the domestic interbank market has virtually stopped functioning. Money market and FX transactions are performed only on the very short term basis (O/N; SW; 1M). Domestic interest rates rose to the new highs during October. On 31 October O/N rate rose to 7.22%, 1M rate rose to 10.18%, and 12M rate rose to 13.12% as illustrated in the Chart 1. Counterparty limits between banks have been substantially diminished both in terms of volume and maturity, and in some cases even cut overall, particularly to domestically owned banks. This blockade of normal transaction pattern has left banks in a position of a substantial liquidity shortage.

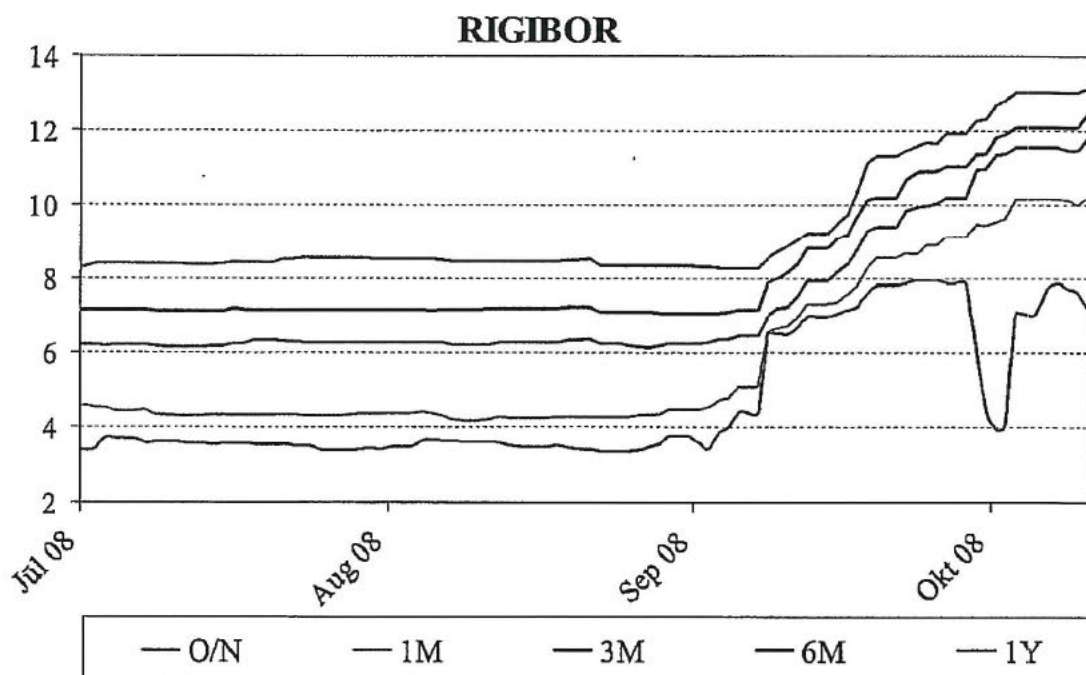


Chart 1. Domestic lending rates (RIGIBOR).

The tensions in the global financial markets that escalated in September as well as the potential losses by the Scandinavian banks in the Baltic markets that were extensively covered by the Scandinavian media and rumors about financial positions of some banks caused increasing concerns among the general public about the strength of Latvia's banking sector. This background of uncertainty produced substantial deposit withdrawal from Latvian banks. In September 2008, resident deposits decreased by EUR 138.3 million, whereas non-resident deposits fell by EUR 228.7 million. Non-resident deposits have been somewhat more volatile than those of the residents also in the past, but the movements had been only marginal. Deposit outflows also continued in October. The decrease in deposit stock amounted to approximately EUR 500 million.

In addition to financing from deposits, domestically owned banks rely extensively on syndicated loans. As this market is virtually closed in the current situation, these banks are not able to refinance their debts and, as a consequence, this endangers the stability of the whole banking system in Latvia. There have been attempts from the banks to engage in talks with syndicated loan providers to roll the due debts over; however, these negotiations have not been successful due to the blockage of international financial markets. If certain banks would not be able to roll-over withstanding short-term debt, there are reasonable concerns that these banks would not be in a position to fulfill capital requirement criteria.

In the Bank of Latvia's view, the probability of adverse events taking place in the domestic market has increased substantially during the past couple of weeks, and this requires preemptive actions as markets show clear signs of disfunctioning.

Authorities' responses to the situation.

With lending growth converging to more sustainable levels and the economic activity slowing down over first two quarters of 2008, the inflationary pressures have started to ease. The fading inflationary pressures and the forecasts showing further decline in inflation allowed the Bank of Latvia to continue the gradual unwinding of the tight monetary policy conditions, which were in place since 2005. The Bank of Latvia has reduced the reserve ratio for bank liabilities with agreed maturity over two years by 1 percentage point to 5% and for other liabilities by 1 percentage point to 7%, while the reserve ratio for repo transactions remained 0%. These changes took effect from 24 October 2008.

Interest rates of the Bank of Latvia remain unchanged since 24 February 2008, and are as follows:

- refinancing - 6.0%;
- overnight deposit facility – 3.0%;
- overnight lending facility – 7.5%.

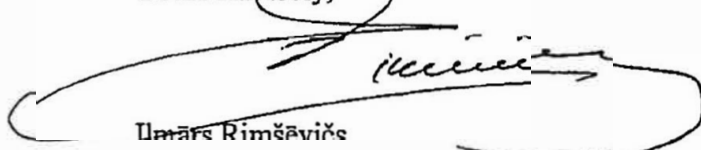
Additionally, the Bank of Latvia provides extra liquidity against eligible collateral in volumes which are compatible with the de facto currency board regime. We try to avoid a situation where monetary base is not covered by 100% of foreign reserves.

The Latvian government has also taken several measures with an aim to stabilize the situation. Namely, on 13 October the government agreed to increase the guaranteed limit for all depositors up to EUR 50,000 with no limit of duration of applicability. The government is currently working on the balanced state budget of 2009. To achieve this target, the government is determined to freeze the wage bill of public sector employees, to cut budget expenses even further and implement structural reforms to optimise the expenses side of the budget.

To sum up, the Bank of Latvia considers the situation as being very serious, in particular, for the domestically owned banks, and demanding decisive measures. However, as the lats is pegged to the euro, the central bank is not in a position to provide additional liquidity in the domestic currency to cover short term liquidity constraints. Euro-denominated short term liquidity provided to the domestic banks would be the best solution for the de facto currency board regime as it is in Latvia.

In the clear signs of domestic market disfunction, the Bank of Latvia asks for immediate assistance from the ECB. The Bank of Latvia would be ready to accept terms and conditions of aid similar to those announced in the ECB EUR 5 billion repurchase transaction agreement with the National Bank of Hungary. The Bank of Latvia asks for a EUR 1 billion facility.

Yours sincerely,



Ilmārs Rimševičs

Governor
Bank of Latvia

K. Krūmiņš
31.10.2008

U. Kol
31/10/2008