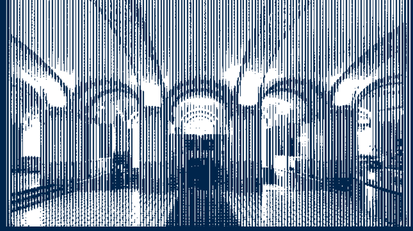


Laila Rūse

# BANK OF LATVIA IN TIMES OF CHANGE (1990–2004)

*Organisational developments for the re-establishment of the national central bank of Latvia*

Pursuant to the Latvian SSR Law "On Banks", on 2 March 1990 the Supreme Council of the Latvian SSR deemed it necessary to establish the central bank of the Latvian SSR, naming it the "Bank of Latvia"[1] and appointing Artūrs Graudiņš its Governor on 26 March 1990[2].

On 31 July 1990 amending the Law "On Banks", the Supreme Council stipulated that the Bank of Latvia was an independent state-owned bank regulated by the Law "On the Bank of Latvia".[3] At the same time the Supreme Council resolved to establish the Bank of Latvia, approve its temporary statutes "Regulation for the Bank of Latvia", and appoint Pāvils Sakss the Governor of the Bank of Latvia and Andris Bērziņš, Jānis Ozoliņš, Elmārs Siliņš and Elmārs Zelgalvis Members of the Bank of Latvia Council[4]; Andris Ruselis joined them on 20 November[5]. The Regulation stipulated that within a year of the Bank of Latvia's foundation day the state should grant the Bank of Latvia 30 million rubles as a share capital for performing its operations and securing its liabilities. At the same time it was established that the Bank of Latvia was a state-owned credit institution and the issuing centre of the national banknotes and coins, while the state should be responsible for its operations and security. The primary objective of the Bank of Latvia had not been defined yet, but the three main tasks had been set: the implementation of the national economic policy, ensuring currency circulation and credit resources, as well as supervision of credit institutions.

As a result of the events of August 1991, the independence of Latvia was irreversibly restored, and the Bank of Latvia became a fully-fledged national central bank. On 24 August 1991 the Supreme Council passed a Resolution "On Ensuring the Economic Basis for the Sovereignty of the Republic of Latvia"[6] and, in accordance with the above, a Resolution "On the Reorganisation of Banks in the Territory of the Republic of Latvia" was adopted on 3 September 1991. Pursuant to the latter and as per the balance sheet as at 1 August 1991, the Bank of Latvia took over and incorporated in its structure the Latvia Republican Bank of the State Bank of the USSR and its computer centre, Latvia Republican Collection Authority, Latvia Republican Bank of the Agro-Industrial Bank of the USSR, Latvia Republican Commercial Bank of the Industry and Construction Bank of the USSR and its computer centre, and Latvia State Social Development Bank (including all subordinate banking institutions of the above banks), as well as the Republican Commercial Bank for the USSR Foreign Economic Operations and Riga School of Accountancy and Crediting of the State Bank of the USSR.[7]

The Council of Ministers of the Republic of Latvia was assigned a task to immediately address and solve the issue of vacating the buildings where Latvian credit institutions had been located until 17 June 1940 and transferring them to the Bank of Latvia.

On 3 September 1991 the Supreme Council appointed Einars Repše the Governor and Alfrēds Bergs-Bergmanis the Deputy Governor of the Bank of Latvia[8], dismissing P. Sakss and Members of the Council of the Bank of Latvia[9]. By the time the Board and the Council of the Bank were established, meetings of the top managers of the Bank of Latvia were held once in two weeks. Top priority tasks included drafting the Law "On the Bank of Latvia" and proposals for revising the Law "On Banks", developing the basic principles of the monetary reform, and examination of the possibilities to recover Latvia's gold. The Law "On the Monetary Reform Committee of the Republic of Latvia"[10] regulated the establishment of the Monetary Reform Committee of the Republic of Latvia, its composition and operational principles, while the Supreme Council Resolution of 8 January 1992 assigned the Bank of Latvia the task of developing the possible options of the programme for introducing the national currency, providing for the economic and organisational mechanism of their implementation, by 1 March 1992[11]. On 4 March 1992 the Supreme Council acknowledged the Bank of Latvia, established on 31 July 1990, to be the sole successor to the rights of the Bank of Latvia that had been established in 1922 and operated until the Soviet occupation in 1940.[12] The re-established Bank of Latvia's prestige and powers were thereby strengthened, paving the way for recovering and taking over the deposits and other assets located abroad, as well as the gold and other assets owned by the Ministry of Finance of Latvia until 1940 and located abroad.

In spring 1992 the Supreme Council resolved to dismiss A. Bergs-Bergmanis from the position of Deputy Governor of the Bank of Latvia on the basis of his own letter of resignation; E. Repše, Governor of the Bank of Latvia, was asked to propose a new candidate for the above position to the Economic Commission of the Supreme Council by 28 May 1992.[13] Ilmārs Rimšēvičs[14] was appointed Deputy Governor of the Bank of Latvia (see Table 1).

On 19 May 1992 the Supreme Council passed the Laws "On the Bank of Latvia" and "On Banks".[15] When preparing for the re-establishment of the Bank of Latvia, it was decided that a two-tier banking system should be developed in Latvia, with the central bank issuing money and banks performing commercial operations. In order to implement the above, the Bank of Latvia first had to transfer the commercial functions which are not typical of a central bank. It was a new experience for Latvia: before World War II the Bank of Latvia had performed commercial operations as well. Moreover, it was more difficult to implement this task as there was no previous experience of how to develop a central bank and its functions in a transitional economy. The Law "On the Bank of Latvia" provided for establishing an independent central bank and stated that its main objective was to control the amount of currency in circulation by way of implementing monetary policy with the aim of maintaining price stability in Latvia. At the same time the Bank of Latvia was entitled to be the sole bearer of the right to issue the national currency and the right to hold reserves in foreign currency, gold and securities in order to ensure the stability of the national currency. According to the Law, the Bank of Latvia was not in the position to participate in any commercial activity, but it acted as a financial agent for the government. The Law stipulated the amount of the Bank's nominal capital and provisions for using the profit earned, as well as the monetary policy instruments.

Pursuant to the Law "On the Bank of Latvia", the Bank of Latvia is administered by the Council and the Board. The Governor of the Bank of Latvia chairs the Council of the Bank of Latvia and is responsible for the organisation of its work, approves the Bank of Latvia's organisational structure, has the power to hire and dismiss Bank of Latvia's employees, represents the Bank of Latvia in relations with international financial organisations, other banks, and public and local government institutions of Latvia.

After restoring the Bank of Latvia's operation and election of the Governor, the Council of the Bank of Latvia had to be established. The Council consisted of eight members, including the Governor and the Deputy Governor, who were appointed by the Saeima and held office for six years. The Council formulated monetary policy, inter alia the interest rates at the Bank of Latvia's operations, as well as made all decisions that were necessary to ensure the implementation of monetary policy in accordance with the Law "On the Bank of Latvia". The Council of the Bank of Latvia reviewed and approved the annual budget of the Bank of Latvia. The Members of the Council of the Bank of Latvia supervised particular areas of the operational activities of the central bank on a daily basis. The first five candidates were appointed Council Members pursuant to the Law in July 1992.[16]

The Bank of Latvia persistently revised the legislative acts pertaining to its operation. Their drafts were drawn up by the relevant structural units and reviewed by the Bank of Latvia Board who approved them or accepted and forwarded them for approval to the Council. Initially this process was very dynamic as many issues resolved by the national central banks of the developed countries over many years had to be accomplished in a very short period of time.

Table 1. COUNCIL OF THE BANK OF LATVIA (1991–2012)

| Position | Name, surname | Time period in office |
|---|---|---|
| Governor of the Bank of Latvia | | |
| | Einars Repše | 03.09.1991–20.12.2001 |
| | Ilmārs Rimšēvičs | 21.12.2001– |
| Deputy Governor of the Bank of Latvia | | |
| | Alfrēds Bergs-Bergmanis | 03.09.1991–13.05.1992 |
| | Ilmārs Rimšēvičs | 02.07.1992–20.12.2001 |
| | Andris Ruselis | 14.02.2002– |
| Member of the Council | | |
| | Gaļina Alijeva | 27.08.1992–05.03.1993 |
| | Harijs Bušs | 27.08.1992–01.07.2010 |
| | Valentīna Kolotova | 27.08.1992–01.07.2004 |
| | Bruno Reinholds Rubess | 27.08.1992–27.08.1998 |
| | Varis Zariņš | 27.08.1992–12.02.2004 |
| | Guntis Ulmanis | 31.03.1993–07.07.1993 |
| | Valentīna Zeile | 12.08.1993–11.08.2011 |
| | Vita Pilsuma | 31.03.1993– |
| | Arvils Sautiņš | 10.06.1998– |
| | Leonīds Gricenko | 02.07.2004– |
| | Aivars Skopiņš | 02.07.2004– |
| | Zoja Razmusa | 17.02.2011– |
| | Edvards Kušners | 31.05.2012– |

Table 2. BOARD OF THE BANK OF LATVIA (1992–2012)

| Position | Name, surname | Time period in office |
|---|---|---|
| Chairperson of the Board | | |
| | Ilmārs Rimšēvičs | 27.08.1992–20.01.2002 |
| | Māra Raubiško | 21.01.2002–15.07.2007 |
| | Māris Kālis | 16.07.2007– |
| Deputy Chairperson of the Board | | |
| | Māra Raubiško | 13.05.1994–20.01.2002 |
| | Helmūts Ancāns | 01.04.2002–17.01.2008 |
| | Reinis Jakovļevs | 01.04.2002– |
| Member of the Board | | |
| | Ēriks Blūms | 30.10.1992–16.09.1993 |
| | Māra Raubiško | 30.10.1992–13.05.1994 |
| | Silvija Lejniece | 30.10.1992–14.09.1995 |
| | Antonija Sileniece | 30.10.1992–12.09.2001 |
| | Guna Varslavāne | 16.09.1993–14.09.1995 |
| | Laila Rūse | 21.01.1993–11.07.1996 |
| | Reinis Jakovļevs | 16.11.1995–31.03.2002 |
| | Roberts Latvis Grava | 14.09.1995–14.07.2005 |
| | Helmūts Ancāns | 11.07.1996–31.03.2002 |
| | Māris Kālis | 13.09.2001–15.07.2007 |
| | Harijs Ozols | 01.04.2002– |
| | Andris Ņikitins | 14.07.2005– |
| | Ilze Posuma | 13.09.2007– |
| | Raivo Vanags | 22.04.2008– |

Prior to each regular meeting of the Bank of Latvia Council held on a bimonthly basis, the so-called day of discussion took place, with Members of the Bank of Latvia Council and Board and heads of the structural units participating in it and assessing the major strategic issues of the Bank of Latvia operation. The discussion day provided an opportunity to identify and summarise different opinions, seek and find the best solutions and draft higher quality documents. Bruno R. Rubess, a Member of the Bank of Latvia Council, had a significant role in initiating and holding the discussion days.

Pursuant to the Law "On the Bank of Latvia", to execute the practical work and ensure efficient management of the Bank of Latvia, the Council of the Bank of Latvia established a permanent Board consisting of six persons. The Chairperson of the Board was confirmed in office by the Council upon the recommendation of the Governor of the Bank; other Members of the Board were appointed upon the recommendation of the Chairperson of the Board. The Members of the Board were employees of the Bank of Latvia; they were appointed to and dismissed from their positions by a decision of the Council of the Bank of Latvia. The Board implemented the resolutions of the Bank of Latvia Council related to monetary policy, operation and oversight of the payment and settlement systems, currency circulation and other activities of the Bank, as well as drafted the legal acts to be approved by the Bank of Latvia Council.

Since the re-establishment of the Bank of Latvia the Board has been chaired by three Chairpersons; it has had three Vice Chairpersons, and all Board Members have simultaneously been holding the positions of heads of departments (see Table 2).

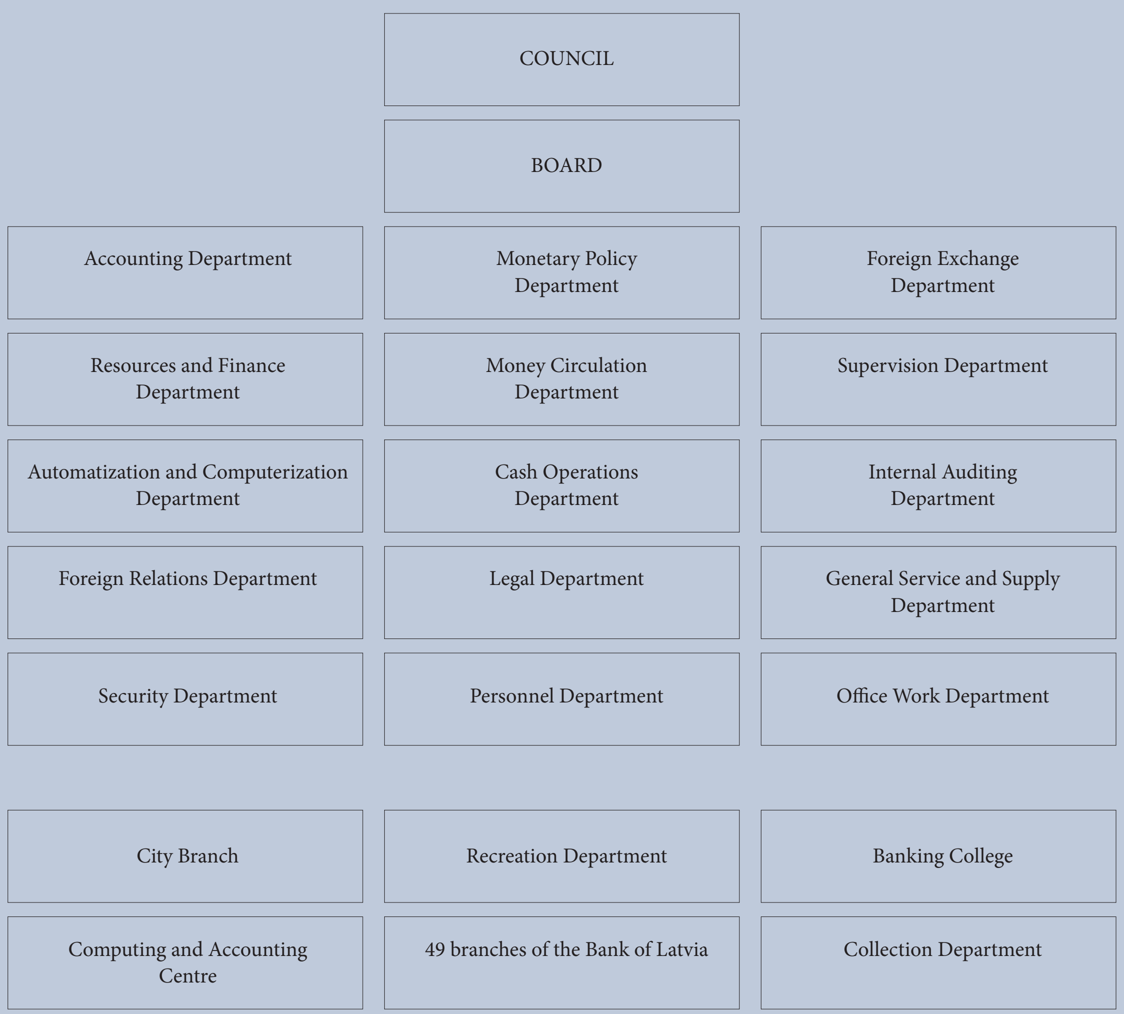
To proceed with the development of the Bank of Latvia and finalize the reorganisation of the banking system, the Supreme Council passed a resolution[17] whereby the Bank of Latvia Reorganisation and Privatisation Commission was approved, assigning it the task of examining and assessing the separation of the central bank functions, assigned to the Bank of Latvia, from commercial functions, establishing the Bank Privatisation Fund within a month, making decisions on the reorganisation or privatisation of the Bank of Latvia structural units, as well as provided for the procedure[18] for implementing the privatisation.

On 10 May 1993 the Bank of Latvia, the Bank Privatisation Fund of Latvia and the Bank of Latvia Reorganisation and Privatisation Commission signed a tripartite agreement on the transfer of 49 Bank of Latvia branches with all their movable and immovable assets, obligations and rights as at 1 May 1993 to the privatisation fund. The agreement stipulated that the immovable assets of the Daugavpils, Jelgava, Liepāja, Rēzekne, Valmiera and Ventspils Branches should remain in the possession of the Bank of Latvia for establishing branches. The Bank of Latvia Board approved the regulation for branches stipulating the tasks and functions of the Bank of Latvia branches as well as the duties of the heads of the branches.[19] After signing the above agreement, the transformation of the remaining branches of the Bank of Latvia was implemented via establishing a joint stock company and selling them at auction to the existing banks. On 28 September 1993 the JSC *Latvijas Universālā banka* was established, merging 21 non-privatised branches of the Bank of Latvia. In July 1994 it was transferred to the possession of the Privatisation Agency and registered as a private joint stock company in October 1995.[20]

### *The Bank of Latvia's organisational structure and staff*

With the operation of the Bank of Latvia evolving, assessing the experience of other countries, listening to the advice of the international cooperation partners and in view of the accession to the EU, the structure of the Bank of Latvia was persistently revised by creating new and merging or winding up the existing structural units (for the organisational structure of the Bank of Latvia at the end of 1992, see Chart 1).

Chart 1. ORGANISATIONAL STRUCTURE OF THE BANK OF LATVIA AT END OF 1992




*Source:* Bank of Latvia: Annual Report 1992. *Riga : Latvijas Banka, 1993, p. 31.*

Major changes in the structure of the Bank of Latvia were implemented in 1993 when several new departments were established, the existing departments were restructured, and five new Bank of Latvia branches were also created, their main task being prompt provision of cash to the credit institutions of the respective region (see Chart 3).

When preparations for taking over the compilation of the national balance sheet from the CSB began, the Statistics Department was restructured several times during 1996–2000. Likewise, the Monetary Policy Department experienced multiple structural changes as its functions were modified and expanded along with the financial market developments; monetary policy instruments were improved, statistical databases were developed and automated, and economic analysis and forecasting models were designed and revised. In order to optimise the implementation of the tasks of the Bank of Latvia related to payment systems, the Accounting and Settlements Department and Information Systems Department were reorganised, and the Payment Systems Department was established in 2000. In 2001 the construction of the new Riga Branch building at Bezdelīgu iela 3, Riga was accomplished, therefore the Riga Branch, General Service Department, Security Department and Construction Department saw structural changes. As of January 2002 part of the Bank of Latvia functions were performed at the Riga Branch building. Implementing legislative provisions, the Credit Institution Supervision Department was merged into the FCMC as of 1 July 2001.[21]

The development and improvement of the Bank of Latvia's functions and changes in its tasks defined the dynamics of the number of the Bank of Latvia staff. A notable increase in the number of Bank of Latvia employees was seen in 1992–1995 (see Chart 2).

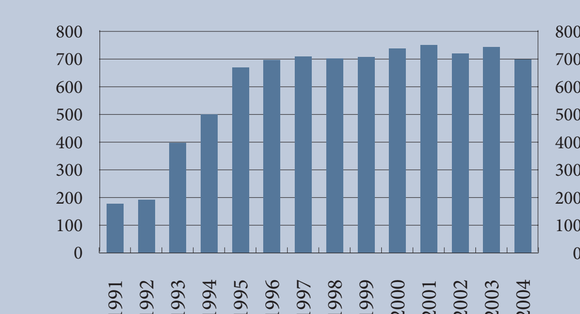
It was essential to improve the skills and competences of the staff, and the Bank of Latvia could use the support offered by foreign organisations as a result of their interest in the development of Latvia and its national central bank. As of November 1991 the Bank of Latvia was granted technical assistance by the IMF and governments and national central banks of foreign countries. The Bank of Latvia received diverse assistance: experts visited the Bank of Latvia and organised thematic training in various areas (accounting, statistics, use of monetary policy instruments, issues related to securities markets); various courses were offered on the spot, as well as the Bank of Latvia staff were invited to workshops and conferences abroad.

Since 2002 job performance and development appraisal meetings were held at the Bank of Latvia[22], analysing the job performance of the particular employee in the previous period, tasks for the next period were considered, and the employee's

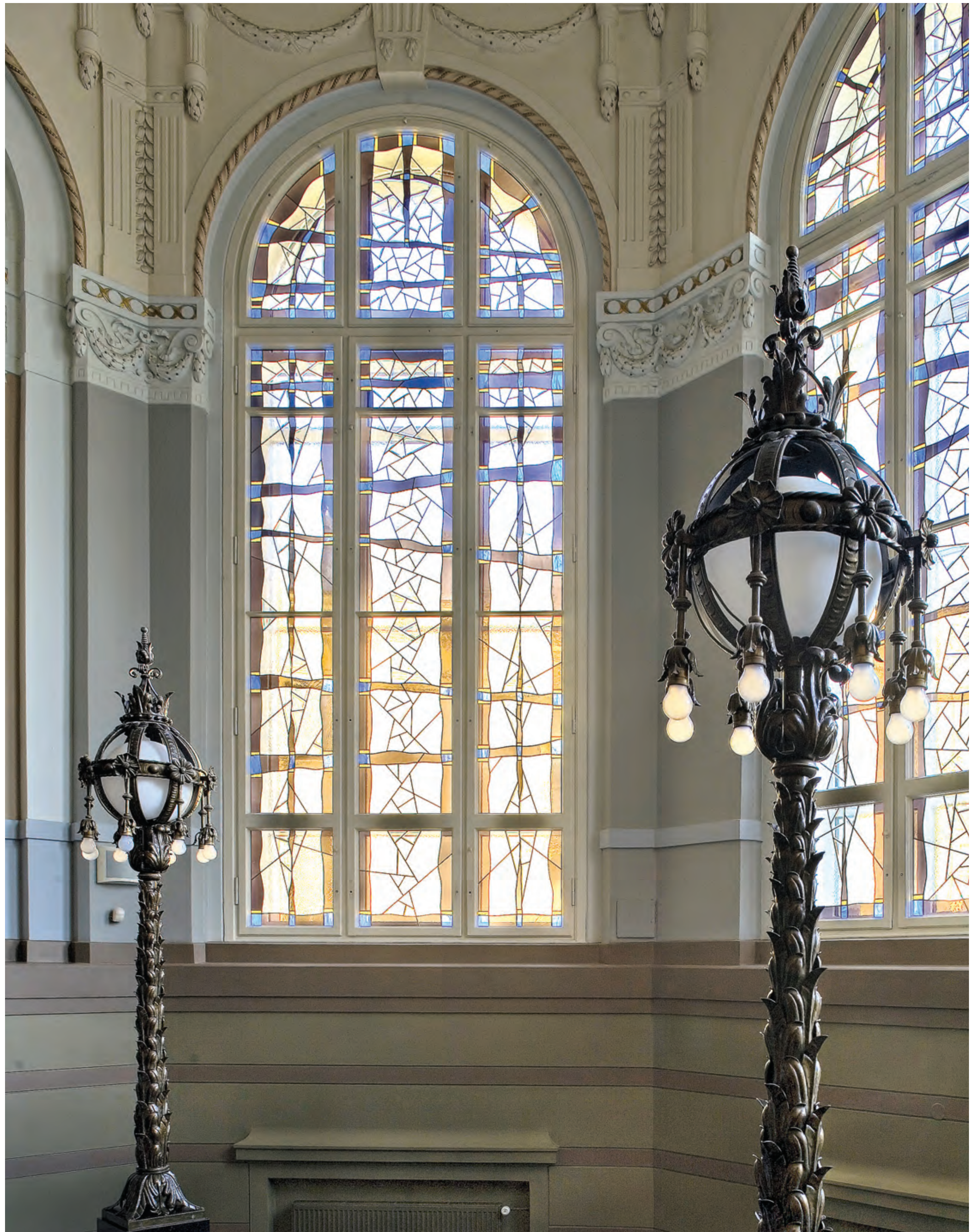
Table 3. CHANGES IN THE ORGANISATIONAL STRUCTURE OF THE BANK OF LATVIA (1993–2004)

| Year | Established structural units | Liquidated structural units |
|---|---|---|
| 1993 | Credit Institution Supervision Department, Cashier's and Money Operations Department, Accounting and Settlements Department, Statistics Department, Information Systems Department, Bank of Latvia Branches in Daugavpils, Jelgava, Liepāja, Rēzekne and Valmiera | Money Circulation Department, Cash Operations Department, Supervision Department, Automatization and Computerization Department |
| 1994 | Publications Division, Riga Branch | – |
| 1995 | – | Jelgava Branch |
| 1996 | Publications Department, Public Relations Department, Construction Department | Publications Division |
| 2000 | Accounting Department, Payment Systems Department | Accounting and Settlements Department |
| 2001 | – | Credit Institution Supervision Department |
| 2002 | Governor's Office, Communications Department | Publications Department, General Office |
| 2004 | Technical Support Department | General Service Department, Construction Department, Valmiera Branch |

Chart 2. NUMBER OF THE BANK OF LATVIA STAFF
(at end of year; 1991–2004)




*Source: Bank of Latvia Annual Report data for 1992–2004.*



wishes regarding his/her career and the ways of improving professional skills were discussed. Considerable attention was paid to the training issues. At the meeting with the direct manager or head of the department, the employee discussed and planned his/her further training. Training issues were discussed subject to the plans of the next year or next three years and taking into account the employees prospective tasks. The discussion process was improved on a continuous basis.

At the end of 2002 the Personnel Department started cooperation with the ECB's Directorate Human Resources in the field of personnel selection, enabling the Bank of Latvia's employees to apply for temporary or permanent employment vacancies at the ECB. In 2002–2004 a number of the Bank's employees successfully participated in international professional certification programmes.

***Establishment and development of the Monetary Policy Department***

Following the introduction of the national currency and Latvia's exit from the Russian ruble area, the Bank of Latvia was able to implement an independent monetary policy and required a structural unit to do so. To this end, the Monetary Policy Department was established on 15 July 1992, comprising Statistics Division, Analysing Division and Domestic Market Operations Division.[23] In September 1992, the Bank of Latvia announced a competition for the position of the Head of the Monetary Policy Department. Laila Rūse started working as the Head of the Monetary Policy Department on 2 November 1992. Initially, 19 people were employed at the Department.

First, the structure of the Department had to be improved. In February 1993, it was changed by adding the structural units of the Money Circulation Department and the Resources Division of the Resources and Finance Department and forming four Divisions: Analysis Division, Securities Division, Refinancing Division and Statistics and Data Processing Division.[24]

There was a discussion as to whether the Statistics and Data Processing Division should be incorporated in the Monetary Policy Department. Looking at the prospective volume of statistical data to be processed, it was decided to close this particular Division and create a Statistics Department.[25] In May 1993, the Board of the Bank of Latvia approved the Regulation of the Monetary Policy Department[26] stipulating its responsibility for the monetary policy area.

In a period of hyperinflation experienced by Latvia, the set of available monetary policy instruments and the legislative framework for their application were still fairly limited. Therefore, it was necessary to identify the potential monetary policy instruments, select the most needed ones as well as draft and implement the respective regulatory acts. The work was very challenging and interesting, yet it required extremely strong dedication, intensive learning and decisiveness.

The Monetary Policy Department participated in the undertakings relating to the preparation and implementation of the monetary reform. It developed all the key monetary policy instruments and their legal framework, organised repo and reverse repo auctions, granted Lombard loans, accepted time deposits from banks, conducted secondary market operations in government securities, analysed money supply and financial market developments on a regular basis as well as organised government securities auctions, carried out regular analysis of banking and economic statistics and the government's performance, prepared publications of regular statistical information and monetary policy reports and forecasted the income and expenditure of the Bank of Latvia from domestic banking operations.

In April 1996, Helmūts Ancāns, the Chief Expert for macroeconomic analysis of the Monetary Policy Department, became the Head of this Department. With a view to improving the financial market analysis and bank liquidity management, ensuring the accumulation and analysis of the database required for forecasting and improving the economic forecasting, the Department underwent restructuring. On 1 June 1996, the Analysis Division, Refinancing Division and Securities Division were liquidated and the Department now comprised four Divisions: Macroeconomic Analysis Division, Financial Markets Analysis Division, Open Market Operations Division and Monetary Research and Forecasting Division.[27] In August 2003, the Open Market Operations Division of the Monetary Policy Department was transformed into the Securities Settlement Division.[28]

The Monetary Policy Department continued with the improvements of regulatory acts, introduced additional monetary policy instruments, evaluated the development trends of macroeconomic fundamentals, prepared the development forecasts for selected economic sectors and proposals in the area of bank liquidity management as well as prepared and provided information about the consolidated indicators of the banking system to Latvian government and international financial institutions, started the preparations for Latvia joining the EU and harmonised the legal acts of the Bank of Latvia with the EU requirements.

***Evolution stages, objective and strategy of the Bank of Latvia's monetary policy***

The evolution of the Bank of Latvia's monetary policy prior to Latvia joining the EU could be divided into four periods characterised by different traits and monetary policy instruments applied.

The period 1991–1993 was a period of dynamic development and drafting of legislation. During that time, the monetary policy objective and strategy were selected, the available monetary policy instruments were identified and new monetary policy instruments were created as well as the first Treasury bills were issued by the Treasury.

The midpoint of the period 1994–1996 was the banking crisis. The set of available monetary policy instruments was further expanded: transactions in the secondary market of government securities started in 1994, whereas the first repo and reverse repo transactions were conducted in 1995. Due to the impact of the banking crisis 1995, the choice of the monetary policy instruments to be applied mostly depended on the money market developments. Significant amendments to the legislation governing banking activities were introduced.

In 1997–1999, the consequences of the banking crisis were gradually overcome and economic stabilisation was evident. The Russian financial crisis of 1998 affected some Latvian banks, while the overall stability of the financial sector survived. The Bank of Latvia increased the set of monetary policy instruments and extended the maturities of transactions.

2000–2004 was a period of economic stability and development, during which Latvia was preparing for the EU accession by harmonising its legislation with the EU requirements and the Bank of Latvia was further elaborating its monetary policy instruments.

The monetary policy which is the responsibility of the national central bank is a component of the national economic policy. It regulates the money supply by applying the monetary policy instruments. The set of the monetary policy instruments at the disposal of the Bank of Latvia was expanded gradually, along with the development of the government securities and interbank markets in Latvia and with the improvement of the opportunities to collect information from banks.

Most national central banks of the world have chosen low and stable inflation as their primary long-term goal, thereby shaping a stable and predictable business environment which ensures favourable macroeconomic conditions for the economic development. The primary objective of the Bank of Latvia (to maintain the price stability in Latvia) has also remained broadly unchanged since the adoption of the Law "On the Bank of Latvia". The amendments to this Law introduced in 2005 incorporated a more concentrated explanation of the monetary policy objective into the Law.[29] With a view to attaining the primary objective of a central bank, the operational objective of the monetary policy is identified: an objective that can be directly influenced by means of the monetary policy instruments at the particular central bank's disposal. Most often than not, central banks choose short-term interest rates or foreign exchange rates, monetary base, central bank loans, bank reserves with the central bank as their operational objectives and regulate the money supply by applying the monetary policy instruments in order to achieve the monetary policy objective.

In small and open transition economies, a fixed exchange rate strategy is one of the most effective monetary policy instruments helping to reduce inflation, stabilise the macroeconomic environment and strengthen the general public's confidence in the national economic policy. Foreign trade plays an extremely important role in small and open economies. Moreover, the higher the degree of openness of an economy, the more significant the influence of the foreign trade development on the overall growth of the economy. A smaller economy is more dependent on global financial and commodity market developments and it has a limited capability of influencing those developments, as even a single sizeable transaction (capital inflow or outflow) may cause considerable short-term exchange rate volatility, thereby increasing foreign exchange related expenditure and foreign exchange risk. Therefore, exchange rate stability is vitally important as it is required for successful development of foreign trade and ensuring foreign investment inflows. In Latvia's monetary policy transmission mechanism, exchange rate exerts a significant effect on consumer price developments, as imports are quite an important and necessary component of consumption and production. That was the reason why Latvia opted for a fixed exchange rate strategy already at the very start of the economic reforms by pegging the currency to the SDR basket of currencies and later to the euro.

The operational objective of the Bank of Latvia was to ensure the pegging of the lats to the SDR basket of currencies. A fixed exchange rate in combination with free movement of capital in a country means that the central bank is able to effectively ensure the stability of the fixed exchange rate, while the responsibility for achieving balanced national economic development by applying fiscal and economic policy instruments has to be undertaken by the government. In any country, a successful monetary policy is only possible if coordinated with the fiscal policy of the government and they are both heading in a direction supportive of economic growth.

The strategy selected by the Bank of Latvia, i.e. a stable national exchange rate, remained unchanged for 10 years starting from 12 February 1994 (SDR 1 = LVL 0.7997)[30] and was successful in implementing the function of an economic stabiliser. On 30 December 2004, the peg rate of the lats against the euro was fixed at EUR 1 = LVL 0.702804.



### *Monetary policy instruments (1991–1993)*

In 1992, the average inflation reached 951% in Latvia; therefore, the primary objective of the Bank of Latvia's monetary policy following the implementation of the Latvian ruble was to limit the inflation and achieve the stability of the currency and prices, hence securing also the macroeconomic stability. In a period of hyperinflation, the set of monetary policy instruments at the disposal of the Bank of Latvia was limited and the legislative framework just starting to get its shape. In an attempt to limit the money supply and taking into the account the recommendation of the IMF, the Bank of Latvia raised the reserve ratio applied to banks from 15% to 20% as of 1 July 1992.[31]

Juris Vīksniņš (USA), Advisor to the Bank of Latvia, admitted that the Bank of Latvia had hardly any money control instruments at its disposal, as, at that moment, the interbank money market and the securities market were non-existent, the lending rates were imposed administratively and one had to try using them as the only instrument for regulating the money stock.[32] Willy Friedmann, *Deutsche Bundesbank* expert, proposed that the Bank of Latvia should impose administratively liquidity quotas on banks, thereby limiting the amount of liquidity to be granted to each bank as well as try using the minimum reserve ratio. At the same time, he indicated that this could serve as an obstacle to the development of the interbank market and that banks could try to find some ways to avoid compliance with those ratios. When reporting on the monetary reform at the meeting of the Council of the Bank of Latvia, J. Vīksniņš also noted that only minimum money control instruments were available, one should not get carried away by administrative measures and foreign exchange market could not replace securities market, as foreign currency was required for stabilisation of the lats exchange rate.[33]

Knowledge about the most needed monetary policy instruments was required urgently as well as the necessary regulatory acts had to be drafted and approved. The monetary policy instruments available at the time for the purpose of limiting the currency issuance carried out by the Bank of Latvia, i.e. the monetary base M0, were loans, US dollar purchase and sales transactions, minimum reserve requirements and the refinancing rate. At the beginning of its operation, the Bank of Latvia chose the monetary base M0 (currency in circulation and bank deposits with the Bank of Latvia) as its target, as the amount of currency issued was the indicator to be managed.

In the first quarter of 1992, the Bank of Latvia granted liquidity to banks at the annual interest rate of 10%. With a view to reigning in the inflation and stabilising currency circulation, the Bank of Latvia annual refinancing rate was raised to 50% as of June. Later, following an agreement with the IMF, it was increased to 80% as of July and subsequently the Bank of Latvia Board raised the annual lending rate for banks to 120% in October 1992.[34]

During this period, Latvia experienced large inflows of foreign currency and the Bank of Latvia frequently had to resort to another monetary policy instrument available at that time: foreign currency purchasing. Thus, on the one hand, the foreign reserves of the Bank of Latvia expanded considerably, thereby providing the backing of the currency issued, while, on the other hand, the ample money supply resulting from foreign currency purchases posed an upward risk to the inflation. In 1992, M0 increased by 34% (by an average of 6.8% per month) and in 1993 already by 52.1%, reaching 224.9 million lats at the end of the year.[35]

Restrictions on the money supply had to be imposed also in accordance with the signed agreement with the IMF on threshold values for currency issuance. In June 1993, the Bank of Latvia Council defined several restrictions on additional currency issuance which, if complied with, should ensure the attainment of the monetary policy objective.[36] The exchange rates set by the Bank of Latvia for convertible currencies (translated into SDR) could not change by more than 2% in a single month. Additional currency could only be issued into circulation in the manners and amounts pre-set by the Bank of Latvia:

– unlimited purchases of convertible foreign currencies from banks and the government at the exchange rates set by the Bank of Latvia;

– additional short-term loans to banks in the amount of no more than 12 million lats (2.4 billion Latvian rubles);

– additional credit to the government pursuant to the agreement signed between the Bank of Latvia and the Ministry of Finance[37], in the total amount of no more than 20.5 million lats (4.1 billion Latvian rubles).

In his 26 January 1993 letter, the Governor of the Bank of Latvia urged the Council of Ministers to support the monetary policy pursued by the Bank of Latvia by an adequate economic policy through liquidating the state monopoly in food production and external trade as soon as possible, stepping up the privatisation of public companies, developing a fiscal policy that would stimulate production and providing statistical information about the production development indicators in the private sector.[38]

With the inflation and loan demand declining, the Board of the Bank of Latvia passed resolutions on lowering the refinancing rate on several occasions in 1993, decreasing it to 27% in October in an attempt to activate the interbank market development and loan inflows into the economy.[39] While continuing

to improve the credit terms and conditions with a view to ensure better control over money supply and limit the credit risk of banks, the Board of the Bank of Latvia took a decision to set refinancing limits for each credit institution.[40]

Mandated by the Council of the Bank of Latvia, the Credit Institution Supervision Department in cooperation with the Monetary Policy Department developed reserve ratios for banks for the first half of 1993[41], which were subsequently approved by the Board of the Bank of Latvia. The ratios were linked to the amount of funds received by the banks and their maturities: the longer the maturity, the lower the reserve ratio. The Bank of Latvia wanted to stimulate long-term lending, thereby attempting to provide indirect support to the economic stabilisation and development. Following an assessment of the impact of the proposed reserve ratio on money supply and in consultation with the central banks of developed European countries, the Bank of Latvia drafted a procedure for calculation of the reserve ratios.[42] The Council of the Bank of Latvia established that the reserve ratio was 8% of the total amount of funds received in all currencies, except liabilities to Latvia's credit institutions (including the Bank of Latvia) and the government budget.[43]

In order to enforce compliance with the Bank of Latvia's requirements and with the reserve ratios, sanctions applied in case of non-compliance were strengthened significantly as of December 1993. If previously a non-compliant credit institution had to pay the refinancing rate plus 10 percentage points, after the change it was 2.5 times the refinancing rate.[44]

At the turn of 1993, the Bank of Latvia expanded the set of the monetary policy instruments by offering banks an opportunity to make risk-free time deposits with the Bank of Latvia.[45] A temporary regulation for organising credit resource auctions was drafted. According to the regulation, the banks included on a list approved by the Board of the Bank of Latvia could draw additional liquidity-increasing credit resources within the refinancing limits and a 60-days maturity twice a month.[46] In order to ensure the liquidity of credit institutions in emergency situations when no refinancing loans from the central bank were available and it was impossible to wait until the next credit resource auction, the Bank of Latvia introduced Lombard loans, i.e. short-term loans (with a maturity of up to 2 weeks) at an increased interest rate.[47]

In support to the tight monetary policy implemented by the Bank of Latvia, the government tried to resort to the Bank of Latvia lending facilities as rarely as possible and sought other options for balancing out the budget: it raised the turnover and excise tax rates as of November 1993 as well as started issuing Treasury bills.[48] A working group comprising representatives from the Ministry of Finance and the Bank of Latvia and an auction commission were established in order to prepare for the issuing of the Treasury notes.[49] The first auction of Treasury bills was held in the Bank of Latvia on 15 December 1993. The Securities Division of the Monetary Policy Department and the Board of the Bank of Latvia approved a temporary regulation for keeping records of domestic Treasury bills.[50]

The overall economic environment at that particular development stage of the monetary policy in Latvia was complicated: output was decreasing practically in all sectors of the economy and unemployment was on a rise. The Bank of Latvia was in search of new monetary policy instruments and was further improving the existing ones. An interest rate "corridor" ranging from the lowest rate (on time deposits by banks) to the highest one (on Lombard loans) was established and it serves as an indication of the interest rate policy pursued by the central bank. Because of the foreign currency inflows, the main monetary policy instrument at the disposal of the Bank of Latvia for influencing money supply at that particular monetary policy development stage was foreign currency purchase and sales operations. The Bank of Latvia became increasingly more active in the foreign exchange market, buying more convertible foreign currency than it was selling. As a result, the lats appreciated considerably. The nation's trust in the lats strengthened in 1993. Other monetary policy instruments were also used: minimum reserves, refinancing rate, credit limits for banks, credit auctions were launched at the turn of the year. By pursuing a tight monetary policy, the Bank of Latvia was able to curb the excessive inflation and stabilise the Latvian ruble and lats. This was highly appreciated by the IMF and experts.

### *The beginning of bank supervision*

After Latvia regained independence, reforms were launched which included liberalisation of prices, revoking of subsidies, strengthening the financial discipline and establishing liberal trade and finance systems.

The minimum capital requirements for establishing commercial banks were low; therefore, the number of banks increased rapidly in Latvia. The Law "On Joint Stock Companies" adopted in 1990 stipulated that the minimum share capital to establish a commercial bank was 5 million rubles. The value of that amount, however, had decreased significantly as a result of inflation.[51] 14 licences were granted in 1991, 36 in 1992 and 16 in 1993. At the beginning of 1994, there were 62 banks in Latvia. In order to limit the sharp rise in the number of banks, the Council of the Bank of Latvia increased the share capital requirement for newly-established banks to 50 million Latvian rubles on 19 March 1993.[52] Conversely, the Law "On Joint Stock Companies" adopted on 18 May 1993 set the minimum threshold for share capital when establishing a bank at 100 thousand lats.[53]

Supervision of credit institutions by checking the compliance of their operations with the requirements set by the Bank of Latvia was an important task of the Bank of Latvia. The Credit Institution Supervision Department was set up in February 1993 by merging the Supervision Department and the Internal Auditing Department.[54] The merged Department was responsible for the licensing of credit institutions (Licensing Division), their supervision (Supervision Division) as well as participating in drafting of laws governing the operations of credit institutions and the Bank of Latvia regulatory acts (Methodology Division).[55]

In 1994, banking supervision related issues started to take up an increasingly bigger part of the meeting agenda of the Board of the Bank of Latvia, as check-ups detected various breeches of regulatory acts, financial problems in banks, unauthorised changes of bank owners and management, risky loans and even cases of false representation. The Bank of Latvia Board adopted resolutions on fines and on prohibition to accept household deposits, refused to approve the top management of banks and revoked licences. In June 1995, the Legal Division was set up within the Credit Institution Supervision Department, whereas the Methodology Division was transformed into the Methodology and Analysis Division with a view to improving the bank supervision, licensing and methodology work.

On 1 January 1995, there were 32 staff positions in the Credit Institution Supervision Department.[56] In 1994, 65 regular and ad hoc audits were carried out (including 50 audits in banks, 2 in savings banks and 13 in pawnshops). In 1995, 96 audits were conducted (including 86 in banks), whereas in 1996 123 audits (only in banks) were completed.

### *Foreign currency and gold reserves management*

According to the Law "On the Bank of Latvia", the Bank of Latvia shall have its own foreign reserves comprising convertible foreign currency, gold, and securities in order to ensure the stability of the national currency. By March 1992 resolution of the Supreme Council, the Bank of Latvia was mandated to recognise on its balance sheet the gold and other valuable items abroad that until 1940 belonged to both the Bank of Latvia and the Ministry of Finance of Latvia.[57] On 17 June 1940 when Latvia was occupied by the USSR, there was 71.5 million lats worth of gold and 30.3 million lats worth of foreign currencies on the Bank of Latvia's balance sheet (almost 90% of those were kept in Western countries due to safety considerations).[58] The recovering of the gold continued for several years. On 22 November 1991, *Banque de France* handed over Latvia's gold deposited prior to the World War II to the Bank of Latvia in the presence of the Governor of the Bank of Latvia. Later the Bank of Latvia recovered the gold deposited with the Bank for International Settlements. On 17 November 1992, most of Latvia's gold deposited with the US Federal Reserve System was recovered. Part of the gold remained there frozen until May 1994 as it was not compliant with London Good Delivery standard.[59] In order to convert it according to the standard, it had to be recast into right size and weight bullions and stamped.[60] Negotiations with the Bank of England concerning the recovery of the gold continued for about a year, as all the potential mutual claims and consequences of the deal had to be weighed. In February 1967, as a result of an agreement between the UK and the USSR, Latvia's gold was sold, the proceeds were deposited, and the UK used them to compensate damages to its citizens caused by the USSR nationalising their property.[61] On 19 March 1993, an agreement was signed in the Ministry of Foreign Affairs of the Republic of Latvia on the government of the UK handing the gold belonging to Latvia over to the Bank of Latvia. The gold was transferred into the Bank of Latvia's account with the Bank of England on 31 March 1993.[62] At the end of 1993, the market value of the Bank of Latvia's gold stock totalled 56.3 million lats[63] and it accounted for 17.8% of the foreign reserves.

The Bank of Latvia estimated the value of the gold recovered in 1992 and 1993 from the USA, France and the UK on the basis of 300 USD per Troy ounce. In order to minimise the effect of the US dollar exchange rate movements on the estimate of the gold value, the Bank of Latvia reviewed the gold valuation policy in 1997. Thereafter the gold reserves were recorded on the Bank of Latvia balance sheet at their market value. The Council of the Bank of Latvia approved the guidelines for depositing of the gold reserves, establishing that the Bank of Latvia may only deposit the gold reserves with banks and financial institutions with the highest credit rating.[64]

Since 1994, the Bank of Latvia also uses the services of experienced foreign exchange reserves managers acting on the basis of the guidelines established by the Council of the Bank of Latvia.[65] The foreign exchange reserves are used to ensure the stability of the lats and intervene in the foreign exchange market, if required.

When approving the "Principles and Guidelines for Investing the Bank of Latvia's Foreign Exchange Reserves", the Bank of Latvia Council decided that the foreign exchange reserves investment strategy was based on three basic principles: safety of the reserves, i.e. the preservation of the value of the foreign reserves, liquidity of the reserves and earning profit.[66] It was prohibited to invest the foreign reserves in any kind of stocks.

The guidelines listed the issuer countries and international organisations for eligible securities as well as currencies in which investment could be made. It also listed the financial instruments into which the Bank of Latvia's foreign reserves could be invested. Without changing the primary reserve management principles, the guidelines were further improved in the years to follow, especially focussing on risk hedging which became possible after a new financial risk management and performance attribution system was introduced at the beginning of 2003.

The Bank of Latvia continuously developed and improved the information system of the Foreign Exchange Department, which provided for the input of all foreign currency related transactions and payments into the database, electronic data flows and transmission of the SWIFT messages. By promoting a more effective integration in the financial markets, the Bank of Latvia improved the availability of global economic and financial information significantly. The updated in-house information system enabled accurate processing of information and an in-depth analysis of the foreign currency reserves portfolio, thereby enhancing the quality of foreign reserves management and performance. The estimation of return indices for foreign reserve portfolios and duration was also further improved.

### *Improvement of the monetary policy instruments (1994–1996)*

The implementation of economic reforms continued in Latvia. The objective of the Bank of Latvia's monetary policy within this period remained unchanged: low inflation and stable currency.[67] The Bank of Latvia continued to implement tight control over money supply, in order to prevent price rises and push down inflation. In the period 1994–1996, inflation declined from 26.3%[68] to 13.1%[69].

The Bank of Latvia used foreign currency purchases and sales as the main money supply regulation instrument. As of 12 February 1994, the Bank of Latvia set a fixed exchange rate of the lats against the SDR basket of currencies (US dollar, Deutschmark, British pound sterling, French franc and Japanese yen). Thus the movements of the lats exchange rate became dependent on the co-movement of the SDR basket currencies. The Bank of Latvia ensured the stability and liquidity of the foreign exchange market by unlimited purchases and sales of the above-mentioned foreign currencies. The US dollar remained the dominant currency on Latvia's foreign exchange market. The Bank of Latvia set exchange rates for convertible currencies on a daily basis and for unconvertible currencies on a weekly basis. In 1994, the Bank of Latvia bought foreign currencies in the amount of 42.0 million lats from banks and the government[70]. Its net external assets totalled 252.7 million lats at the end of the year[71] and covered the goods imports of 4.4 months[72]. The banking crisis of 1995 and the fiscal problems faced by the government resulted in an exceptional demand for foreign currencies; therefore, the net external assets of the banking system contracted by 17.4%[73], while the Bank of Latvia's net external assets shrank by 10.1% and covered the goods imports of 3.0 months[74]. Nevertheless, the consistent monetary policy pursued by the Bank of Latvia safeguarded the stability of the national monetary system. In 1996, the net external assets of the Bank of Latvia expanded considerably, reaching 385 million lats at the end of the year, covering the goods imports of 3.4 months and backing 105.2% of the issued lats.[75] This can be explained by stabilisation of the macroeconomic situation and improvement of confidence in the national currency.

At the beginning of 1995, the government deficit increased. The Ministry of Finance had recourse to the Bank of Latvia's short-term lending facility in 1995 (at that time, the Law "On the Bank of Latvia" still allowed lending to the government). From March 1995 onwards, the amount of credit to the government on the Bank of Latvia's balance sheet expanded: the government resorted to the opened credit facility[76], the Prime Minister requested[77] an emergency loan in the amount of 20 million lats[78] as well as the Bank of Latvia purchased Treasury bills[79]. The Bank of Latvia agreed with the Ministry of Finance to impose restrictions on the credit facility. With a view to improving the government budget position and stabilise the securities market, the Bank of Latvia granted emergency short-term loans to the government on the condition that the government would submit a balanced draft budget to the Parliament for approval. To deal with a budgetary or a banking crisis alone would have been much easier; Latvia, however, had to face a combination of both and this resulted in a financial crisis. In the last months of the year, the prospects of covering the budgetary deficit by means of issuing Treasury bills improved. In order to compress the budgetary spending on domestic debt service, the Ministry of Finance started to reduce the maximum discount rates (most significantly, for the Treasury bills with the shortest maturities), at the same time also decreasing the allotment and thereby encouraging banks to purchase longer-term bills. With the fiscal position improving, the central bank's net credit to the government contracted sharply: from 56.9 million lats at the end of 1995[80] to 13.3 million lats at the end of 1996[81]. First, the emergency loan received during the financial crisis of 1995 was repaid and the government also increased its deposit with the central bank.

Securities market operations became the second most important monetary policy instrument of the Bank of Latvia. The Bank of Latvia still organised launching of government securities on the primary market by means of auctions (these serve fiscal instead of monetary purposes), yet, from April 1994 onwards, it started to participate also on the secondary market of government securities. Initially, pursuant to a resolution of the Bank of Latvia's Council the government securities portfolio could not exceed 5 million lats.[82]

The Bank of Latvia was the authorised agent of the government in the field of organising government securities auctions and keeping records thereof. In 1994, the securities market had just started to develop, as the first issue of the Treasury bills and their auction in the Bank of Latvia was held at the turn of 1993. In addition to the original 28-day Treasury bills, 91-day Treasury bills were also issued starting from the second quarter of 1994[83] and 182-day Treasury bills starting from March 1995[84]. These changes enabled a transition to collateralised bank lending only. Starting from 1 October 1995, the Bank of Latvia only granted loans to banks in exchange for collateral (government securities), and the short-term credit resource auctions were replaced by repo auctions[85].

Using the monetary policy to increase the liquidity of government securities, the Bank of Latvia set the discount rates of the government securities and operated on the secondary market starting from April 1994, becoming even more active in 1995 and 1996. With the budgetary deficit on a rise, the Ministry of Finance introduced new maturities for the securities and also reduced their nominal values, involving more market participants and allowing private persons to purchase government securities on the secondary market. From February 1996, foreign banks were also allowed to participate in primary market auctions of securities.

The Bank of Latvia operated a government securities recording system and drafted a temporary regulation for keeping records and circulation of Treasury bills in 1994. With the government securities market developing, the Bank of Latvia developed and approved an updated regulation for keeping records and circulation of government securities in October 1995[86]. From May 1996, the Latvian Central Depository started to keep the records of a part of the secondary market transactions in government securities.

The Bank of Latvia's refinancing rate serves as a barometer for the participants of Latvia's money market, signalling the preferred interest rate development trends. As the inflation continued to decrease, the Bank of Latvia lowered the refinancing rate in several steps to 25% in December 1994[87]. The change of the refinancing rate enabled a faster decline in the short-term interest rates on bank loans.

In order to activate the development of the interbank market once the financial system stabilised following the banking crisis and the inflation was on a downward trend, the Bank of Latvia cut the annual refinancing rate from 24% to 9.5% in 1996.[88] Bank of Latvia loans granted to banks shrank from 24.6 million lats at the beginning of the year to 10.0 million lats at the end of the year.[89] The Bank of Latvia intervened in the interbank money market by transacting in government securities in the secondary market as well as concluding repo agreements and granting demand (up to 14 days) and automatic (overnight) Lombard loans to banks in exchange for government securities collateral. As the government tightened its fiscal policy, the Bank of Latvia's credit to the government shrank considerably in 1996.

The Bank of Latvia's Board approved the "Regulations Governing Reverse Repo Auctions of Treasury Bills" in 1996.[90] No recourse to the new monetary policy instrument was made in 1996, as the Bank of Latvia and the banks licensed by it made cashless purchases and sales of foreign convertible currencies in exchange for the lats; moreover, the banks and the government could place their free liquidity on time deposits with the central bank.

In 1996, the Bank of Latvia retained the reserve ratio at 8% of the average balances of the funds attracted by the respective bank[91]; nevertheless, as these funds increased the overall reserves to be kept on the bank accounts with the Bank of Latvia expanded, whereas the cash component in the reserve requirement decreased.

The accomplishments of the Bank of Latvia in the area of regulating money supply ensured the stabilisation of inflation and the lats stability even in crisis circumstances, while a lot remained to be done in the fields of the bank liquidity provision and management: liquidity had deteriorated in the wake of the banking crisis and the monetary policy instruments available at that time were not sufficiently flexible. Moreover, they were rather limited in scope and designated for maintaining the short-term bank liquidity. It was time to further improve the set of monetary policy instruments at the Bank of Latvia's disposal.

### *Contribution of the central bank to easing the impact of the Russian financial crisis of 1998*

The Russian financial crisis caused changes in the global financial markets in the third quarter of 1998. As a result of Russia's default on its obligations, the Russian ruble was devalued. Following the above developments, investors' attitude towards investing in the emerging markets also changed. A decline in the exports of Latvian goods caused problems for those manufacturers whose major export markets were Russia and the Eastern markets. At the same time it encouraged businesses to seek new markets and improve competitiveness.

The Russian financial crisis of 1998 had a minor effect on the Latvian banks with a small share of their assets in Russia. Overall, it posed no threat to the banking system and the stability of the lats; nevertheless, for some banks considerable investments in Russian securities resulted in liquidity problems, further deepened by the cautiousness of investors and depositors who withdrew their deposits from banks following the Russian ruble devaluation. With the situation gradually stabilising, the share of foreign assets in the bank balance sheets shrank while that of loans granted to private persons and domestic companies expanded; the decrease in the available liquidity for some banks notwithstanding, bank lending in Latvia continued and the bank willingness to attract additional funds pushed up interest rates on deposits, as well as on loans granted in lats. In November 1998 the negative impact of the Russian financial crisis on Latvian banks had already eased notably and the population's trust in the Latvian banking system had stabilised.

Situation with the JSC *Rīgas Komercbanka* was more complicated as its investment in bonds (39.7 million lats, mostly in Russian Treasury bonds) and other debt securities accounted for a substantial share (43.5%) of the bank's assets. The major problem of the JSC *Rīgas Komercbanka* was insufficient liquidity: following a run on the bank, a large outflow of funds was observed.

To reduce the funds outflow, the Bank of Latvia applied the procedure of intensified supervision to the bank.[92] To maintain liquidity, the Bank of Latvia granted the JSC *Rīgas Komercbanka* 23 million lats against collateral at the refinancing rate.[93] The situation regarding deposits saw a gradual stabilisation and the Bank of Latvia resolved to participate in the rehabilitation of the JSC *Rīgas Komercbanka* and capitalize part of the granted loan, investing the above funds in the bank's share capital.[94] The Bank of Latvia approved the rehabilitation plan for the JSC *Rīgas Komercbanka*.[95] On 4 August 1999 the Bank of Latvia resolved to establish a Bank of Latvia's non-profit organisation *Rīgas Komercbankas rehabilitācijas aģentūra,* Ltd.[96] On 13 October 1999, in view of the recovery of the bank's solvency, the Riga Regional Court ruled to terminate the initiated insolvency proceedings of the JSC *Rīgas Komercbanka*; on 26 October the latter resumed its operation under the name of the JSC *Pirmā Latvijas Komercbanka*; thus the restructuring of the bank was completed.[97] The bank's shareholders were the Bank of Latvia (holding a majority shareholding), the Latvian government, the European Bank for Reconstruction and Development, two international bank syndicates, and over 1 000 depositors of the bank who participated in the rehabilitation process of the bank. A new management of the bank was appointed as well.

In May 2000 the shareholders of the JSC *Pirmā Latvijas Komercbanka* entered into a share purchase and sale agreement with *Norddeutsche Landesbank Girozentrale* (NORD/LB) on the sale of all the shares owned by them in the bank to NORD/LB.[98] As a result, the JSC *Pirmā Latvijas Komercbanka* had a strategic investor and the bank's rehabilitation was completed. After the operational objective – rehabilitation and restructuring of the JSC *Rīgas Komercbanka* as defined in the Statute of the *Rīgas Komercbankas rehabilitācijas aģentūra,* Ltd. – had been achieved, the existence of the latter was no longer necessary, and it was wound up.[99]

The credit institution supervision carried out by the Bank of Latvia enabled localisation of the banking crisis effects and facilitated further development of the banks operating in line with the effective legislation and complying with the regulatory provisions.

In order to harmonise the regulatory provisions governing credit institution operation with the EU Directives and International Accounting Standards, the Bank of Latvia set forth stricter regulations: it improved the procedure for credit institution licensing, as well as introducing essential changes in their operation, organisational structure or composition of owners; specified more accurately and elaborated the requirements for identifying the founders and owners of credit institutions; improved the procedure for assessing credit liabilities and off-balance sheet liabilities and loan loss provisioning; made amendments to the procedure for calculating capital adequacy, restrictions on exposures and open foreign currency positions, as well as set new liquidity requirements. Banks were required to develop liquidity management policy and maintain liquid assets in the amount of no less than 30% of total current liabilities.

In order to make the management of banks identify and assess operational risks on a more regular basis, the Bank of Latvia Council approved "Recommendations for Developing an Internal Control System for Credit Institutions"[100] as well as provided for establishing and documenting an adequate and effective internal control system in each credit institution by 1 April 1998. The Bank of Latvia's recommendations comprised effective credit risk management guidelines that any credit institution had to comply with when developing a credit risk management system appropriate for the operation of the respective credit institution. The recommendations emphasized the role of the management of a credit institution in managing the credit risk as well as the importance of clearly defined lending criteria in making reasonable decisions. They also stipulated the need for continuous loan administration, assessment and supervision and principles for developing the above.

On 21 May 1998, with the Saeima adopting the Law "Amendments to the Law on Credit Institutions"[101], the procedure for credit institution supervision was established, from then on it was based on consolidated financial accounts. By adopting this law, the legal preconditions for the Bank of Latvia's cooperation with other supervisory institutions in Latvia and abroad were stipulated; the legal basis for developing the register of debtors of credit institutions was established; essential amendments were made to the provisions stipulating the procedure for credit institution liquidation, insolvency, rehabilitation and bankruptcy and activities of the receiver in the above processes; as well as the rights to control the activities of liquidators were granted to the national central bank. In view of the consolidated supervision stipulated by law, the Council of the Bank of Latvia approved the revised "Regulation for Granting Credit Institution Operating Licences and Permits" with additional requirements to identify the financial position of the founders and owners of the credit institutions and their qualifying holdings in other companies.[102]

Pursuant to the Bank of Latvia "Regulation for the Bank Consolidated Supervision"[103] and Council Directive 92/121/EEC on the monitoring and control of large exposures of credit institutions[104], the Bank of Latvia Council approved amendments to the "Regulation for Calculating Indicators Characterising the Operation of Credit Institutions"[105], imposing no limits to exposures of a credit institution to its subsidiaries: credit institutions, financial institutions (excluding insurance corporations) or auxiliary enterprises where the financial accounts were consolidated for supervisory purposes.

In order to ensure sustainable development of banks in the future, the Bank of Latvia continued to harmonise the regulatory requirements in line with the EU banking directives and Basel Core Principles for Effective Banking Supervision.

The Saeima passed several essential laws for improving the Latvian financial system. The purpose of the Law "On the Prevention of Laundering of Proceeds Derived from Criminal Activity"[106] was to prevent the use of the public financial system for money laundering. The Law "On Natural Person Deposit Guarantees", adopted to protect the interests of depositors, provided for the banks to make payments into the Deposit Guarantee Fund wherefrom the depositors – natural persons – would receive guaranteed compensations in the event of bank bankruptcy. The "Law on Mortgage Bonds"[107] supported further development of mortgage lending, legally regulating the issue and circulation of the public mortgage bonds.

To ensure compliance with the provisions of the Law "On the Prevention of Laundering of Proceeds Derived from Criminal Activity", the Bank of Latvia approved core principles to be observed by credit institutions in order to identify and avoid suspicious financial transactions and stipulated that credit institutions should approve adequate internal control procedures by 1 January 2001.[108]

Following a request by the Bank of Latvia, the IMF Technical Assistance Mission assessed the compliance of the Bank of Latvia's supervisory practice and Latvian banking regulations with the Basel Core Principles for Effective Banking Supervision and expressed a positive evaluation.[109] Latvia was one of the first countries where an independent assessment of supervision had been conducted, providing specific recommendations for improving credit institution regulations and supervisory practices in the future.

Implementing Council Directive 93/6/EEC on the capital adequacy of investments firms and credit institutions[110] whereby capital requirements for market risks were defined, the Bank of Latvia Council approved the "Regulation for Calculating Capital Adequacy"[111] on 16 March 2000, replacing the existing procedure established by the Bank of Latvia for calculating the capital adequacy ratio on the basis of credit risk assessment. To achieve maximum compliance with the EU requirements, apart from the capital requirement for credit risk, capital requirements to cover market risks were stipulated, including capital requirements with regard to foreign exchange risk, which is inherent in all activities of a credit institution, and position, commodities, settlement and counterparty risks, which are inherent in a credit institution's trading book.[112] The regulation was complicated, therefore the Bank of Latvia prepared examples for capital adequacy calculations and organised training for bank employees.

In 2000 the Bank of Latvia conducted self-assessment on the compliance of the Latvian banking regulations and its supervisory practices with the Basel Core Principles for Effective Banking Supervision on the basis of the Core Principles assessment methodology. Upon the Bank of Latvia's request, experts from the IMF conducted an independent evaluation of the self-assessment. The evaluation confirmed that the information provided in the Bank of Latvia's self-assessment was accurate and met the stipulated criteria.[113]

As of 1 July 2001 the Bank of Latvia's rights, duties and obligations in the area of credit institution supervision were taken over by the FCMC and the Bank of Latvia no longer performed the credit institution supervision.

### *Curbing inflation and ensuring the lats stability (1997–2004)*

After the banking crisis of 1995 the Latvian banking system had grown stronger and the macroeconomic situation stabilised. The impact of the Russian financial crisis of 1998 on the Latvian national economy could be still felt a year later as the GDP dynamics suggested (3.6% growth in 1998[114] as compared to a mere 0.1% increase in 1999[115]). Beginning with the year 2000 the national economy saw GDP growth of 6%–7%, with the services sector posting a more accelerated increase, thus promoting demand for loans.

With the economy expanding, companies increasingly required long-term loans; however, the capital market was underdeveloped and longer-term financing from banks was scarce. As a result, the Bank of Latvia's monetary policy, apart from its basic task to maintain price stability in Latvia, was focused on establishing an interest rate structure allowing for the development of interbank market and expanding lending.

The Council of the Bank of Latvia adopted several resolutions with the aim of supporting attraction of longer-term funds, further decrease of interest rates and development of long-term financial instruments. To stimulate availability of longer-term financing to banks and develop the money market, in 1997 the Bank of Latvia extended the maturity for Treasury bonds sold at repo auctions, setting three maturities for government securities: 7 days, 28 days and 91 days[116] and revising the regulations for repo transactions[117] and reverse repo transactions.[118] Repo agreements and Lombard loans were the most often used monetary policy instruments. The Bank of Latvia granted a demand Lombard loan under an agreement upon request of a bank for a loan for an agreed period not exceeding 14 consecutive days, whereas an automatic Lombard loan was granted for one day in the amount of an overdraft on the bank's account with the Bank of Latvia. To implement the monetary policy more effectively, a new monetary policy instrument was introduced: in April 1997 the Board of the Bank of Latvia approved the "Regulation for Short-Term Currency Swap Tenders"[119]; in July the Bank of Latvia launched currency swaps once a week, eventually extending their organisation to three times a week. Bank demand for this instrument was high; they actively used the opportunity to temporarily borrow funds in lats without currency exchange. At first US dollars and later also euro were used in the transactions. In March 2000, proceeding with the improvement of the above instrument, the Council of the Bank of Latvia approved Regulations[120] and resolved to launch long-term currency swaps of 2-year maturity using all four currencies of the SDR currency basket.[121]

In view of the market trends, the Bank of Latvia lowered its interest rates and increased the supply of long-term currency swaps, but as of December 2001 ceased holding long-term currency swap tenders.[122] The Bank of Latvia's long-term currency swaps were fully repaid in 2003.[123] The sustainable decrease in the annual inflation rate, discount rates on the government securities and interbank market rates enabled the Bank of Latvia to consistently reduce the refinancing rate to 3.0%, down from 9.5% during 1997–2002.[124] The introduction of longer-term monetary policy instruments facilitated the interbank market development, expanded lending and helped to reduce bank short-term liquidity fluctuations. During the Russian financial crisis of 1998 bank demand for borrowing from the Bank of Latvia saw accelerated growth. In the periods of ample excess liquidity (e.g. in 1998 and 2001) banks were more active in placing time deposits with the Bank of Latvia.

In late 1999 the Bank of Latvia started a gradual harmonisation of the reserve requirement with that of the ECB, reducing the credit institution reserve ratio from 8.0% to 7.0%[125], down to 6%[126] as of 1 December 2000, and further to 5%[127] as of 1 January 2001. The Council of the Bank of Latvia resolved to cut the bank reserve ratio to 3% as of November 2002, excluding the cash component (its share had been gradually narrowed, starting with 50% in late 1999).[128] With the Bank of Latvia gradually harmonising its monetary policy instruments with those of the ECB (the ECB's core instrument – the main refinancing operations – was similar to the repo agreements of the Bank of Latvia), the role of currency swaps weakened in 2004.

In order to reduce the upper limit of the interbank market rates and in view of the interest rate trends in the money market, the Bank of Latvia lowered the interest rates on Lombard loans in 1999 and 2000.

To promote the money market development, the Bank of Latvia launched the money market rate indices RIGIBID and RIGIBOR on 12 January 1998. The money market rates on transactions in lats, quoted by the most active banks in the interbank money market, were used to calculate them.[129]

In 1997 and 1998, implementing a tight fiscal policy, the government placed its available funds with the Bank of Latvia. Opening a single account for the Treasury with the Bank of Latvia enabled to improve the management of the public funds and facilitated an increase in the government deposit. As of 20 February 1998 the government funds could be deposited as demand deposits and also time deposits.[130] To offset the impact of the government deposit on money supply, the Bank of Latvia was more active in the secondary market of government securities and expanded its portfolio of government securities by purchasing securities in the secondary market. The Bank of Latvia mostly bought 5-year Treasury bonds as they were more liquid.

In 2004 Latvia became a member of NATO and joined the EU, thus facilitating Latvia's economic development. Accelerated GDP growth persisted, reaching a high among EU countries. Nevertheless, the rising inflation, widening external imbalances, as well as the structure of the growth sectors of the economy, and the steep rise in lending driving the domestic demand – they all caused concern.

In order to reduce the macroeconomic risks – mostly inflation and the growing balance of payments' deficit – the Bank of Latvia Council raised the refinancing rate and bank reserve ratio, as well as expanded the minimum reserve base to include more bank liabilities. The Bank of Latvia analysed the risks of the Latvian financial system on a regular basis, looking at various scenarios and providing the assessment of the economic situation.

***Further improvement of the Bank of Latvia's operation (1998–2004)***

With Latvia getting ready for the EU accession, intensive work on the basis of Agenda 2000[131] adopted by the EC in mid-1997 continued in 1998–2004. The document contained the EC's judgement on Latvia's readiness to join the EU and identified the short-term and medium-term priorities for the EU integration.

Latvia's EU integration process was governed by the Europe Agreement[132] providing for the harmonisation of Latvia's legal acts and institutional practice with the EU legislation and practical operation aspects, Treaty of Rome outlining the need to remove the barriers for free movement of capital and to improve the EU legal framework for the provision of financial services and establishment of the single market, as well as the EU Maastricht Treaty.[133] According to this Treaty, the EU Member States were expected to be ready to meet the conditions for joining the EMU, including to fulfil the convergence criteria, ensure central bank independence, comply with the prohibition of direct government financing, set price stability as the main monetary policy objective as well as improve the payment systems and statistics by developing and implementing real time settlement systems and taking measures to ensure credibility of statistics.

Analysing the above EU requirements and the EC's judgement of Latvia provided in Agenda 2000, the Bank of Latvia identified the problems directly or indirectly concerning the Bank of Latvia and asking for improvements of the financial system. An action plan for the period up to 2000 was drafted and approved, confirming the core tasks for each Department of the Bank of Latvia and additional tasks involving several Departments as well as providing specific guidance as to the regulatory acts which needed to be drafted or updated in compliance with the requirements of the EU legislation and the conceptual issues which needed to the resolved within the specified timeframe.

In 1998, the Board of the Bank of Latvia approved the principal regulations governing interbank settlements, security of bank information technologies and the use of the interbank data transmission network. The Bank of Latvia started to exchange information with banks electronically on 17 November 1998, ensuring its encryption and digital signature. Information exchange was governed by the "Regulation for Encrypting and Digitally Signing Information"[134] passed by the Board of the Bank of Latvia as well as the contracts signed with banks. The objective of the project was to improve the information exchange significantly by a transition from paper-based information exchange and processing to electronic information exchange. This increased the efficiency, speed and security of information processing considerably and minimised direct human involvement in this process. With the number of payment documents to be processed by the electronic clearing system (EKS) of the Bank of Latvia on a daily basis increasing, it was no longer possible to ensure quality processing of this information without using secure and user-friendly electronic information exchange.

Based on the established infrastructure, the Bank of Latvia started to collect information required for the preparation of Latvia's balance of payments from banks electronically at the end of 1998. Starting from 1999, banks also reported the monthly statistics electronically, and from November 1999 the above information exchange and safeguarding technologies were also used in processing the budget payments of the Treasury. For each of these areas, Bank of Latvia Regulations were developed and approved.

According to international practice, a policy for the payment system area has to be formulated and published, as facilitating smooth operation of the payment system is one of the core tasks of any central bank. The central bank implements payment system oversight with a view to ensuring the stability of the financial system and improving the customer confidence in non-cash payment instruments. On 13 September 2001, the Council of the Bank of Latvia approved "The Bank of Latvia's Payment System Policy" outlining the role of the central bank and its tasks with regard to Latvia's payment system.[135]

The Bank of Latvia focuses primarily on large value interbank payment systems that are the core mechanism for monetary policy transmission and can be the largest source of risk to the operation of the national payment system due to the fact that such systems handle significant cash flows. Nevertheless, smooth and efficient functioning of retail payment systems is just as important. Errors in such systems can affect a large number of users and thus degrade confidence in the entire payment system.

In June 2002, the ECB, in cooperation with the central banks of the EU Member States, conducted an assessment of the infrastructure of payment and securities settlement systems and the related oversight function of the EU accession countries. It was recognised that in the EU enlargement context Latvia's payment and securities settlement systems would pose no additional risks to the single EU payment system. At the same time, recommendations for improvements of the payment system performance were provided, and the Bank of Latvia started to implement those recommendations.

In addition to the assessment of the payment system infrastructure conducted by the ECB, the Bank of Latvia evaluated the compliance of its interbank payment systems with the Core Principles for Systemically Important Payment Systems, as formulated by the BIS, judging compliance with each of the ten principles separately. The assessment covered the legal aspects of the system, the inherent financial risks and their management, operational aspects, including operation in crisis situations, as well as issues relating to the efficiency and management of the systems.[136] The assessment identified that both the interbank automated payment system (SAMS) and the EKS of the Bank of Latvia were compliant with international standards. It was proposed to change the business hours for the EKS to meet market requirements. Several proposals for improvements to the systems' legal framework and risk management procedures in emergencies were also made.

On 11 July 2002, the Council of the Bank of Latvia passed a resolution "On Approving the 'Regulation for Credit Transfers'"[137] (in effect as of 1 January 2003). That ensured full compatibility of credit transfers in Latvia with the Directive 97/5/EC of the European Parliament and of the Council on cross-border credit transfers.[138]

On 14 November 2002, the Bank of Latvia's Council adopted a new version of the "Strategic Development Plan for the Bank of Latvia's Information Systems", laying down the guidelines for further development of the Bank's information systems in the period from 2003 to 2005. It was planned, inter alia, to significantly enhance the payment and settlement systems, the Bank of Latvia's securities settlement system and the technical facilities for compiling the balance of payments as well as to ensure the compatibility of the Bank of Latvia's information systems with the ESCB common information systems.[139]

In order to ensure the compliance of the securities settlement system operated by the Bank of Latvia with the EU requirements, the Bank of Latvia's Council approved a new version of the "Regulation on the Securities Settlement System Organised by the Bank of Latvia" on 13 November 2003.[140] It is important to note that thereafter credit institutions of the EU and the European Economic Area could also become participants of the securities settlement system.

On 14 November 2002, the Bank of Latvia's Council approved the "Regulation for Issuance and Maintaining of Electronic Money".[141] The Regulation was prepared in order to implement the provisions of the Directive 2000/46/EC of the European Parliament and of the Council on the taking up, pursuit of and prudential supervision of the business of electronic money institutions concerning the issuance redemption of electronic money[142]. The Regulation also includes the minimum requirements for electronic money issuers developed by the ESCB.[143]

In 2002, the Bank of Latvia intensified its cooperation with the ECB, with a view to gradually joining the common information systems of the ESCB. The first cooperation project of this kind was successfully implemented at the turn of 2002 when the Bank of Latvia was linked to the ECB information exchange system CebaMail.

On 16 January 2003, the Council of the Bank of Latvia passed the "Regulation for the Register of Debtors".[144] According to this Regulation, the operation of the Bank of Latvia Register of Debtors was launched on the premises of Riga Branch of the Bank of Latvia (see Box) on 2 June 2003. The Board of the Bank of Latvia approved the "Procedure for Maintaining the Register of Debtors" on 6 November 2003. The establishment of the Register of Debtors was stipulated by Article 106 of the Law "On Credit Institutions". That was required to enhance the stability of Latvia's financial system, improve the capability of the FCMC and banks to assess the borrowers' credit risk, facilitate and speed up the process of receiving bank loans, increase the borrowers' discipline in repaying the loans as well as collect the information required for the compilation of the financial statistics of the Bank of Latvia and macroeconomic analysis.

The Register of Debtors was an information system of the Bank of Latvia for collection, centralised accumulation and permanent storage of the information provided by banks about their debtors and the loans issued to those debtors. The participants of the Register were banks and branches of foreign banks registered in Latvia. The Bank of Latvia was well-experienced in implementing technologically complex information systems in cooperation with banks (electronic clearing system, interbank automated payment system etc.); therefore, the Bank of Latvia was capable both in terms of technology as well as organisational capacity to ensure the safekeeping and confidentiality of the information. The information stored in the Register of Debtors was available to its participants, the FCMC and the debtors themselves. Information about the negative credit history of debtors was stored starting from mid-2003.

*Box*

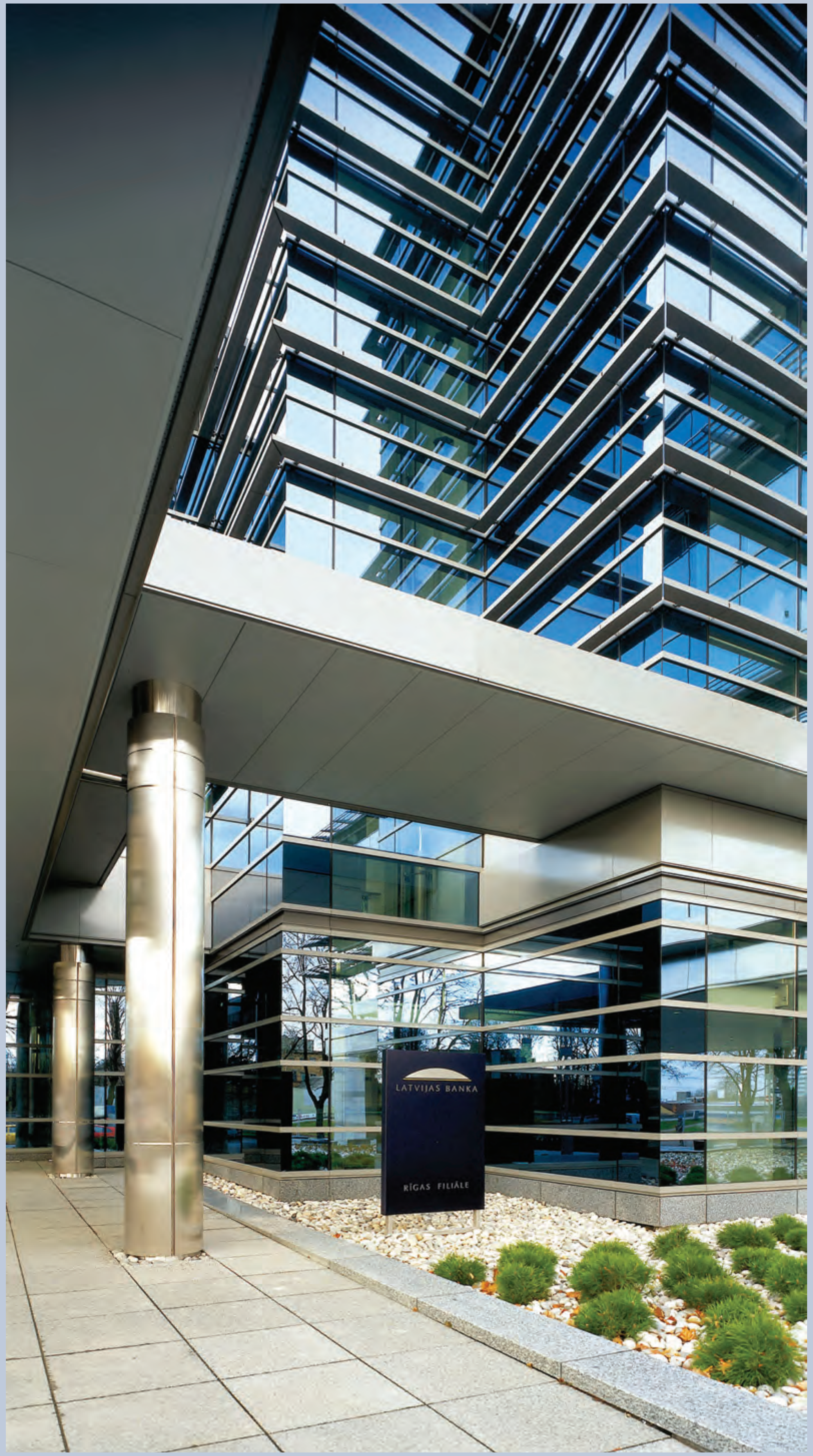
## THE PREMISES OF RIGA BRANCH OF THE BANK OF LATVIA

The Council of the Bank of Latvia passed a resolution on construction of a new Riga Branch building on 12 May 1994. Preparatory work included development of the concept, purchase of the land plot, getting the required authorisations, development of the financing schedule and construction design. This stage took longer than the construction itself because, thanks to favourable weather conditions and the use of modern technologies, the selected contractors managed to finish the works in a couple of years. The foundation stone of the building was laid on 23 July 1999. The crucial decision to build a new cash vault for the Bank of Latvia was prompted by both the domestic conditions as well as the developments in Europe. Until then, the cash reserves of Latvia's national currency (the lats and santims) were kept in the cash vault of the *Deutsche Bundesbank*. With Germany joining the single European currency and the start of the dual circulation period after the euro cash changeover on 1 January 2002, the *Deutsche Bundesbank* needed larger cash vault premises to store the money.

Various functions were carried out in the new building of Riga Branch of the Bank of Latvia that were previously discharged in the main building, as well as several new tasks were implemented. The cash vault built in the Branch building is well-suited for the needs of an issuant bank, it is sufficiently spacious and secure. It is used for cash processing, admission and release to banks. The EKS and the SAMS are located in Riga Branch building.

The building of Riga Branch of the Bank of Latvia was officially opened on 16 November 2001. This building has become one the architectural landmarks of modern Riga.

*Sources: BLA, BLF, descr. 1, f. 7, p. 120;* Latvijas Banka būvē jaunu filiāles ēku. *Averss un Reverss, Nr. 4, 1999, 3. un 4. lpp.*



### *Information to the public*

The Bank of Latvia ensured communication with the general public through its publications and via the press, television and radio. It also supplied information to the IMF, BIS and other international organisations.

Starting from 1992, the performance of the Bank of Latvia and its financial results are analysed in the Annual Reports of the Bank of Latvia. The Bank of Latvia released publications providing information about economic indicators and monetary developments (Monetary Bulletin and Monetary Review) regularly and published *Averss un Reverss* bulletin to inform the general public about the resolutions of the Council and the Board of the Bank of Latvia as well as the economic developments in Latvia and abroad. The Bank of Latvia published the Annual Reports 1999 and 2000 of the Credit Institution Supervision Department which supplemented the information featured in the Annual Reports of the Bank of Latvia and provided an insight into the work performed by the Department and the development of Latvian credit institutions. It also provided an overview of the changes implemented in the regulatory acts governing the operation of credit institutions. As of the first quarter of 2000, the Bank of Latvia took over the publishing of the bulletin on Latvia's balance of payments from the CSB as well as started to release special publications for statistical reporting agents.[145] Since 2001, the Bank of Latvia publishes working papers developed by its experts regularly.[146] The Bank of Latvia has also produced other publications providing information about banknotes and coins, payment systems, accounting and other issues. All Bank of Latvia's publications are available on the Bank of Latvia's website.

The Bank of Latvia organised many press conferences for the representatives of mass media, briefing them about the economic and banking system developments as well as issued press releases featuring information about the resolutions of the Bank of Latvia's Council and Board and about the Bank of Latvia's performance.

The Bank of Latvia's experts prepared materials for Latvian and foreign magazines and newspapers as well as delivered lectures on the monetary and banking system and on topical financial issues to university and secondary school students and teachers of economics.

In 2000, the development of an interactive teaching aid, a multi-media CD "Money and financial institutions", was completed. It was presented to all higher and vocational education institutions, secondary schools, regional centres of the educational system and central libraries of Latvia.[147]

The Bank of Latvia participated in the production of the TV series "Kā bankā". The series reflected the banking activities and financial developments in Latvia and in the world as well as provided information which is useful for solving financial problems. In 2000, selected videos of the TV series "Kā bankā" (1997–2000) were released as a teaching aid in economics for secondary and primary schools.[148] Latest financial information with the participation of the Bank of Latvia is provided by radio series "Lata spogulī".

The information on the central bank performance disseminated by the Bank of Latvia increased the general public's confidence in Latvia's national currency, banking system and the operation of the payments system as well as improved the knowledge and understanding of the international institutions, foreign investors and other interested parties about Latvia's economic and financial market development.

### *Transformation of Latvia Banking College*

As of 1 August 1992, Riga School of Accountancy and Crediting was transformed into Latvia Banking College. The study programme for the "Banking" speciality was developed in co-operation with Swedish experts. In May 1994, the College received a licence issued by the Ministry of Education and Science granting it the right and accreditation to teach for a period of five years.[149] The new Regulation of Latvia Banking College was approved in April 1995.[150]

In 1995 and 1996, Latvia Banking College delivered banking and finance programmes and trained banking specialists and tax inspectors for the State Revenue Service. Commissioned by Latvian School of Public Administration, the College also organised training for civil servants.

On 3 January 1996, Latvia Banking College was granted a Ministry of Education licence for the establishment of the Banking Academy. By 30 December 1997 Order No. 675 of the Cabinet of Ministers, the BA School of Business and Economics was established which is the successor to the rights, responsibilities and liabilities of Latvia Banking College and which took over its archives, movable and intellectual property.[151]





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