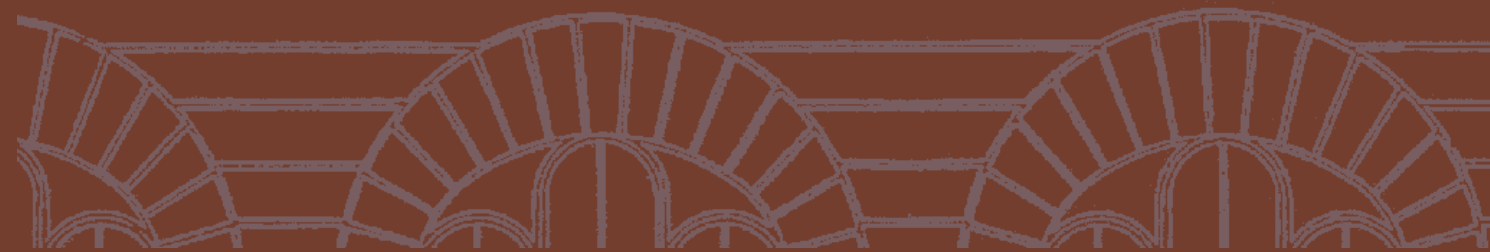
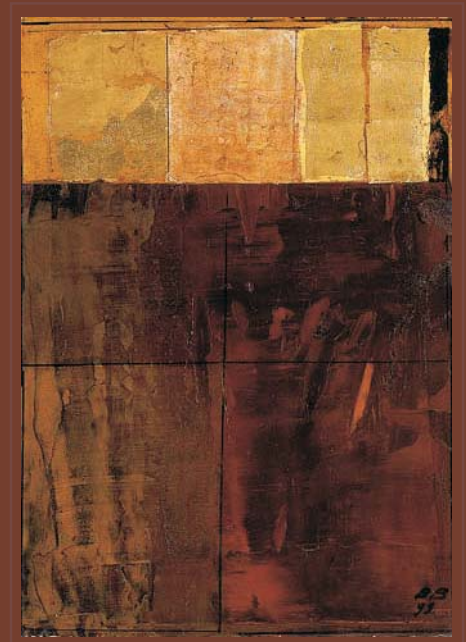
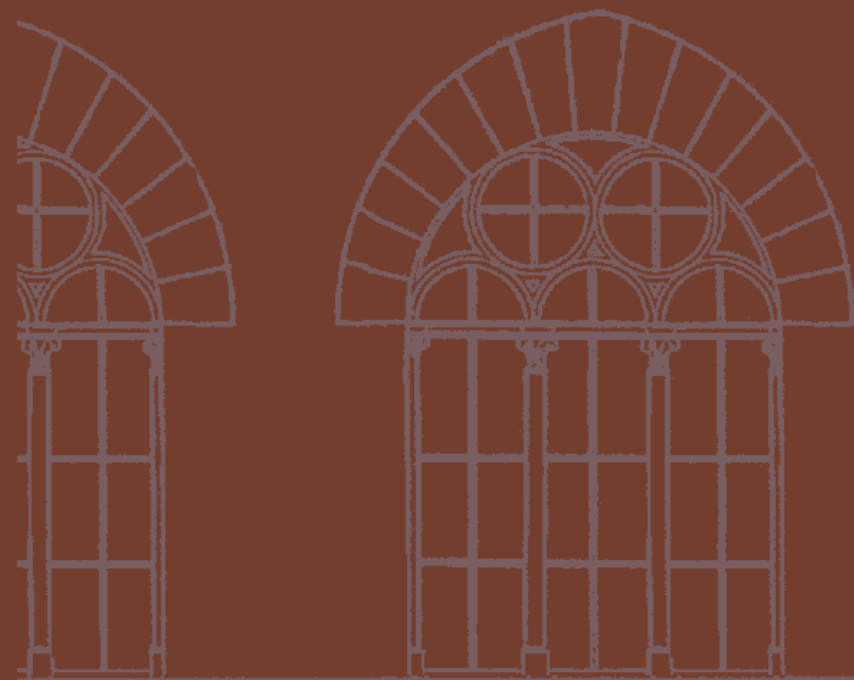


**BANK OF LATVIA: ANNUAL REPORT 2007**



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

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

*– no transactions or no outstanding amounts in the period.*

*x no data available or no computation of indicators possible.*

*0 the indicator is below 0.5 but over 0, or the result of the computation of the indicator is 0.*

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The cut-off date is 22 April 2008.

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## ABBREVIATIONS

|          |   |
|----------|---|
| BIS      | Bank for International Settlements  |
| CEBS     | Committee of European Banking Supervisors   |
| CIF      | cost, insurance and freight at the importer's border  |
| CIS      | Commonwealth of Independent States  |
| CSB      | Central Statistical Bureau of Latvia  |
| EBRD     | European Bank for Reconstruction and Development  |
| EC       | European Commission   |
| ECB      | European Central Bank   |
| EFC      | Economic and Financial Committee  |
| EKS      | Bank of Latvia's Electronic Clearing System   |
| EMU      | Economic and Monetary Union   |
| ERM II   | Exchange Rate Mechanism II  |
| ESCB     | European System of Central Banks  |
| EU       | European Union  |
| EU10     | countries which joined the EU on 1 May 2004   |
| EU12     | countries which joined the EU on 1 May 2004 and on 1 January 2007   |
| EU15     | EU countries before 1 May 2004  |
| Eurostat | Statistical Bureau of the European Community  |
| FCMC     | Financial and Capital Market Commission   |
| FM       | Ministry of Finance of the Republic of Latvia   |
| FOB      | free on board at the exporter's border  |
| FRS      | US Federal Reserve System   |
| GDP      | gross domestic product  |
| IMF      | International Monetary Fund   |
| ISO      | International Organization for Standardization  |
| JSC      | joint stock company   |
| LCD      | Latvian Central Depository  |
| M0       | monetary base   |
| M1       | narrow monetary aggregate   |
| M2       | intermediate monetary aggregate   |
| M2X      | broad money   |
| M3       | broad monetary aggregate  |
| MFI      | monetary financial institution  |
| NACE     | Statistical classification of economic activities within the Community<br>( <i>Nomenclature statistique des activités économiques dans la Communauté européenne</i> ) |
| OECD     | Organisation for Economic Co-operation and Development  |
| OFIs     | other financial intermediaries, except insurance corporations and pension funds   |
| OMXBGI   | Baltic equity index   |
| OMX Riga | capitalisation-based total return index including all company shares quoted on the RSE Main List and the RSE Secondary List   |
| Plc      | public limited company  |
| RIGIBID  | Riga Interbank Bid Rate; the index of Latvian interbank interest rates on deposits  |
| RIGIBOR  | Riga Interbank Offered Rate; the index of Latvian interbank lending interest rates  |
| RSE      | Riga Stock Exchange   |
| SAMS     | Bank of Latvia's Interbank Automated Payment System   |
| SEPA     | single euro payments area   |
| SDR      | Special Drawing Rights  |
| SJSC     | state joint stock company   |
| US       | United States of America  |
| VAT      | value added tax   |

## FOREWORD OF THE GOVERNOR



The year 2007 was a turning point in the macroeconomic development of Latvia. As a result of the measures under the inflation curbing plan adopted by the government, the growth that in the past few years was too vigorous is gradually moving towards more sustainable levels, whereas the already steep and still increasing inflation is mostly supported by excessive inflows of a variety of financing: credit resources from foreign parent banks, foreign direct investment, EU funding, workers' remittances from labour income abroad. With the pace of lending, excessively strong domestic demand and GDP growth gradually moderating, the first rebounding in inflation is to be expected in the second half of the year. The adoption of the euro, projected no earlier than 2012 or 2013, would then reward the Latvian economy for having reduced its inflation levels.

In its daily routine and communication with the financial market participants and the public at large, the central bank has focused on the factors that have fuelled buoyant economic growth in Latvia while helping to maintain an unchanged fixed exchange rate policy. Under a fixed exchange rate regime, the conventional monetary policy instruments of the central bank lose much of their impact and efficiency, necessitating the use of fiscal policy levers to achieve a surplus budget. According to the cash flow principle, the state budget balance has improved achieving 0.7% of GDP against the projected deficit (-1.4% of GDP); moreover, according to the accrual principle, the budget position was close to balance.

In 2007, the Bank of Latvia continued to pursue a tight monetary policy and on two occasions raised the refinancing rate by a total of 100 basis points (to 6.00%), thereby dampening the excessive domestic demand. In the second half of 2007, when the signs of economic overheating abated, the Bank of Latvia left its interest rates unchanged, but in the first half of 2008, given the slowdown in the growth of lending and the associated deterioration in the banks' role in fuelling the domestic demand, it lowered the minimum reserve requirement for bank liabilities with an agreed maturity of over 2 years by 2.0 percentage points (to 6.00%).

In line with the Bank of Latvia's forecasts and due to the deceleration in lending growth, import dynamics lost momentum, and the current account deficit of the balance of payments shrank to 17.7% of GDP in the fourth quarter (27.2% of GDP in the corresponding period of the previous year). The annual growth in domestic lending decelerated from 58.4% to 34.2% as a result of the steps taken

by the government and deliberate policy of Latvian banks. Their parent banks have thus validated their publicly declared intentions to do long-term business within the Latvian financial system, helping to set in place the preconditions for Latvia's economic stability. An additional encouraging trend has been observed: with mortgage lending decelerating, the growth in industrial credit is becoming more pronounced. The competitive capacity of exports is of equal importance: in 2007, Latvia's market share grew in the EU15 and EU12 and remained stable in Russia. The annual rate of growth in exports of goods amounted to 22.6% (14.0% in 2006), outpacing the growth in imports of goods in the fourth quarter and annually. Following the buoyant upsurge observed in the previous year, the annual growth in imports of goods decelerated to 21.4% (dropping from 36.2% annual growth in the first quarter to 4.5% in the fourth quarter).

Latvia continued its participation in the ERM II and improved the infrastructure necessary to achieve a fully-fledged participation in the EMU. The significant project of joining the Trans-European Automated Real-time Gross settlement Express Transfer system TARGET2 has been successfully completed. The Bank of Latvia's Credit Register, which is expected not only to serve as an instrument for financial stability analysis or depository of credit history but also contribute to curbing inflation, was launched on 1 January 2008.

Six new collector coins were minted in 2007. The coin *Fight for Freedom* placed first at the World Money Fair in Berlin in the Best Contemporary Event category. As a result of the annual public poll, the heptagonal *Coin of Digits* won the title *Latvia's Coin of the Year 2006*. Continuing to diversify the design of the Latvian money through limited issues of 1-lats coins, the Bank of Latvia released coins *Owl Fibula* and *Snowman*.

The Bank of Latvia strongly believes in promoting public awareness both of its operations and decision-making process and the economic development of the country as one of its most important missions. The issue of preconditions necessary for Latvia's convergence with the EU average prosperity levels, so vital for both the economic policy makers and public at large, was the focus of reports and discussions at the annual conference *Competitiveness: the Future Cornerstone of the Latvian Economy* hosted by the Bank of Latvia in October 2007.

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

The dynamic growth of the Latvian economy at the opening phases of the 21st century is likely to capture the minds of researchers and make corrections to some clichéd ideas; it provides a sound basis to my belief that the Bank of Latvia's Annual Report for 2007 will open new vistas to the reader already at this point in time.



Ilmārs Rimšēvičs  
Governor, Bank of Latvia  
Riga, 7 April 2008



# THE BANK OF LATVIA'S VISION AND MISSION

## VISION

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

## MISSION

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

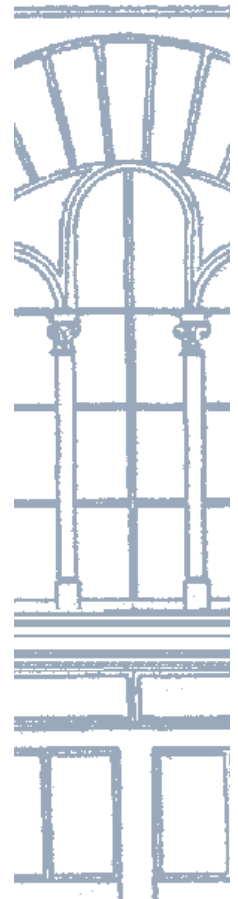
The Bank of Latvia is an active and responsible participant of the ESCB, promoting integration and stability of the financial systems of Latvia and other EU countries.

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

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

The Bank of Latvia is a reliable cooperation partner.

# NATIONAL ECONOMY DEVELOPMENTS AND MONETARY POLICY



## GLOBAL ECONOMIC ENVIRONMENT

In 2007, the overall pace of global economic growth was rather solid, though in the last quarter of the year some deceleration occurred in many regions in response to the impact of financial sector developments. Tighter financial sector conditions were primarily on account of the US sub-prime mortgage market problems. At the close of the year, the pace of economic growth slowed down in the US, Europe and Japan where indicators of consumer and producer confidence deteriorated. Despite the somewhat moderating export expansion, the developing countries experienced buoyant growth, including China and India where strong domestic demand was a driver behind it.

In 2007, GDP growth in the euro area fell only slightly behind the year-on-year trend (2.6%; 2.8% in 2006). Dynamic economic activity persisted in the first three quarters of the year due to strong domestic demand and growing foreign trade; in the fourth quarter signs of a slowdown surfaced through the lower levels of consumer and producer confidence mainly as a result of an impaired financial market situation and tighter credit conditions in Europe. As a result of high energy and food prices, euro area inflation started to pick up in the second half of the year, rising to 3.1% in November and December.

In Sweden and the UK, economic activity was quite vigorous, and GDP of these countries recorded increases of 3.1% and 3.4% respectively. Considering the impressive financial sector share in UK GDP and a downward growth trend in Swedish exports in the second half of the year, both economies displayed signs of decelerating growth towards the second half of the year.

The economic development in EU10 countries continued to be rather brisk but fell slightly behind the 2006 level. Differences across countries were relatively marked in this respect. The GDP growth in Lithuania, Poland, the Czech Republic and Slovakia remained vigorous, yet Poland and the Czech Republic recorded some weakening of activity in the final months of the year. Estonia entered a phase of slower growth with real estate prices falling and export and private consumption growth rates moderating. At the same time, GDP in Hungary posted a pickup of mere 1.4% due to a tighter fiscal policy, which improved the fiscal balance and decreased current account deficit yet had a dampening effect on growth.

In the US, GDP grew by 2.2% (by 2.9% in 2006). Contractions in the US housing market were more pronounced than the beginning of the year had suggested. Investment in this market was on a downward trend for the entire year, with no improvement at its close. Moreover, the credit market crisis had serious implications for the financial market impacting the global financial system and outlook for the future growth. Spillovers of this turmoil began to surface in the real economy only in the fourth quarter, with economic activity weakening in industrial production and the housing sector, and the employment situation and consumption deteriorating as well. It can be explained by a slow reaction of real estate prices to expanding supply in the housing market, hence it takes quite a time for consumers to perceive a fall in real estate value and to adjust their spending.

Russia's economic growth was extremely robust in 2007. GDP grew by 8.1% mainly owing to the steady upward trend of domestic demand (both private demand and investment increased steeply) and strengthening of the industrial production sector. Import expansion was exceptionally sharp (by more than 30%).

Since mid-2007, inflation had been on the rise in the developed countries and developing economies. Rapidly increasing oil prices were a primary driver of pro-

ducer and consumer price levels in the countries across the world in 2007. Oil prices went up from 59 US dollars per barrel at the beginning of January to 97 US dollars at the close of the year. Oil price rises were caused by intensifying mismatch between the demand for oil that was escalating and the supply of oil that remained restrained and volatile as well as speculative transactions on behalf of market participants. The demand for oil rose in the first half of the year due to a more buoyant growth of the global economy under the impact of seasonal factors and the US resolution to double its strategic oil reserve over 20 coming years. However, in the second half of the year, impacted by the financial market turmoil, the demand moderated somewhat. Oil extraction and processing capacity was restricted by various geopolitical factors. In 2007, a price rise was also observed for non-ferrous and precious metals.

To curb the risk of a new surge in inflation, the ECB raised the base rate in March and June by 25 basis points (to 4.0%) but left it unchanged in the second half of the year. The ECB's power to put a brake on the pace of stronger inflation pressures via higher base rates was hampered by the financial market turmoil in the second half of the year and projections regarding eventual slowdown in economic activity growth in the euro area countries. To dampen rising inflation, the Bank of England pursued a restrictive monetary policy in the first half of the year and raised its official base rate on three occasions, by 25 basis points each time (to 5.75%). However, when the second half of the year witnessed global financial market turmoil and the forecasts for the UK future economic development deteriorated, the Bank of England lowered the base rate by 25 basis points in December (to 5.50%). With the US sub-prime mortgage market situation aggravating, the FRS started to pursue an accommodative monetary policy in the second half of the year. As of September, the FRS lowered the base rate by 25–50 basis points at each of its regular meetings (reaching 4.25% at the end of the year). The Bank of Japan raised the base rate by 25 basis points (to 0.5%) in February.

The US dollar weakened versus several major world currencies in 2007. It depreciated against the euro from 1.32 to 1.47 (by 11.5%) at a particularly rapid pace from the beginning of the year to end-April, and from September to late November. The weakening of the US dollar was driven by deteriorating growth indicators of the US economy in the first half of the year and the restrictive monetary policy of the ECB, whereas in the second half of the year it was primarily on account of the US sub-prime mortgage crisis, the resulting financial market turmoil and market participants' projections regarding the narrowing of base rate spreads in US dollars and euro.

Investors' stances regarding equity securities were predominantly underpinned by the global economic perspective, projected future corporate income flows, interest rates, and US financial market turmoil. Despite a number of considerably sharp price falls in 2007 on the global stock market, stock prices grew over the year. The European stock market index Dow Jones EUROSTOXX 50 increased by 6.8%, whereas the US stock market indices S&P 500 and NASDAQ Composite rose by 3.5% and 9.8% respectively. The Chinese stock market index SSE A Share surged particularly steeply (by 96.1%), whereas the Russian stock market index RTS increased by 19.2%. At the same time, the Japanese stock market prices declined by 11.1%. The second half of the year was particularly strained when due to the US financial market turmoil a number of sharp stock price falls occurred (at end-July to the beginning of August, in November and end-December). At the end of July and beginning of August, the most pronounced decline of stock market prices was demonstrated by banks and other financial sector institutions that suffered losses and future income flow projection reversals related to the problems in US sub-

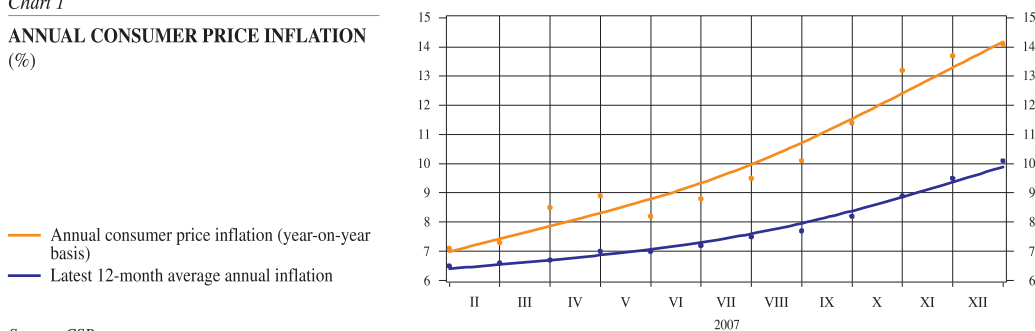
prime mortgage sector. When investing in other sectors' equities, investors were also precautionary and demanded higher risk premiums. In November and December, the stock price decline reoccurred in the situation of growing investors' concerns about US housing market developments and implications of financial market turmoil for further development of the global economy.

## INFLATION AND PRICES

In 2007, the annual consumer price inflation in Latvia gradually rose from 7.1% to 14.1%, reaching 10.1% on average (see Chart 1). Almost one third of the average annual inflation was on account of direct contribution of components on the supply side, of which administered prices pushed overall inflation up by 1.7 percentage points, those of unprocessed food contributed 1.1 percentage points, and fuel prices added 0.2 percentage point. With energy resources, labour and other costs rising and the domestic demand remaining solid, the contribution of costs and factors on the demand side to overall annual core inflation was stronger year-on-year. In the course of the year, the impact of factors on the supply side was rather stable but the contribution of core inflation components grew substantially.

Chart 1

### ANNUAL CONSUMER PRICE INFLATION (%)



Source: CSB.

Notwithstanding the downward pressure on inflation of lower VAT rates on household supplies of natural gas and electricity as well as on heat supplies in the first half of the year, with heating oil (mazout) quotations at the beginning of the year additionally supporting a minor effect of natural gas prices on inflation, a substantial price rise for housing maintenance related goods and services was recorded for the year overall in the group of administered prices. Heat prices were driven up (by 18.5%) by a new natural gas supply contract with Russia's company *Gazprom*. Public transport fares rose notably and so did regulated education services prices.

The contribution of unprocessed food prices to overall inflation was almost the same as in 2006 and mainly driven by rising costs.

Although at the beginning of the year the excise tax on fuel was raised somewhat, but the weakening of the US dollar offset oil price volatility to a large extent, the overall effect on fuel prices in Latvia was neutral in the first three quarters and strengthened only in the fourth quarter with oil prices surging in global markets.

In January and July, the excise tax on tobacco products was raised notably. As prices of these products are not administered and the producer sets the maximum price (for excise tax calculations), this factor substantially contributed to a rise in core inflation. Despite lower VAT rates on individual services, the overall service price level increased at a more rapid pace than in 2006. Thus non-administered service prices on average picked up 13.5% year-on-year and pushed the overall inflation rate up by 2.9 percentage points. Processed food ranked as the second

most important group (with 2.3 percentage point contribution), with prices within it driven by costs and the supply-demand balance, which had a marked effect on dairy and cereal product prices in the world economies and in the second half of the year also in Latvia. Changes in alcohol and tobacco product prices increased overall inflation by 0.9 percentage point, while the contribution of other non-regulated tradable goods was 1.0 percentage point. On average, the annual price rise for these goods was moderate due to technological advances, competition and a significant import content of consumption, because price rises in exporting countries were also subdued. Thus, for instance, household appliances, audio, video, photo and data processing equipment and telephones even recorded an essential price decline, whereas the rise in clothing and footwear prices was negligible (2%–3%).

Due to persisting inflation, the Latvian government approved an anti-inflation plan incorporating medium-term measures in the areas of fiscal accountability, tax policy (primarily relating to real estate market), lending restrictions and saving promotion as well as boosting labour productivity and competitiveness.

The overall producer price increase in industry (16.2%) in 2007 was underpinned by a sharp price rise of domestically sold output (18.6%), with a more moderate pickup observed for producer prices of exported goods (12.9%). Persisting upsurge in prices of durable consumer and intermediate goods as well as energy (25.6%, 24.5% and 20.9% respectively) was the driver of price rises in the domestic market. Of goods exports, the steepest rise was recorded for intermediate goods (15.3%).

The upward trend in construction costs was even more pronounced (an increase of 26.2% on average), primarily on account of 45.5% higher wages and salaries. Maintenance and operational costs of machinery and mechanical appliances grew by 33.2%, whereas construction material related costs went up by 12.4%.

In 2007, the export unit value continued on a steep upward trend (an increase of 13.3%), whereas the year-on-year pickup in import unit value was notably more moderate (5.7%). The recorded steeper rise in export prices supported the improvement of terms of trade (7.2%).

For goods dominating exports, a marked price rise was recorded. Prices of wood and articles of wood went up by 31.8%, those of base metals and articles of base metals rose by 12.4%, prepared foodstuff prices picked up 6.3%, and miscellaneous manufactured articles (furniture) became 10.6% more expensive. Price rises affected the export growth more than volume expansions.

Of the import unit value, the highest increases were recorded for products of the chemical and allied industries (11.4%), base metals and articles of base metals (8.7%), transport vehicles (7.1%), and agricultural and food products but some decrease was observed for machinery and mechanical appliances, electrical equipment (1.1%). Price rises accounted for almost one third and volume expansion for slightly over two thirds of import growth.

## GROSS DOMESTIC PRODUCT

After the buoyant economic growth in Latvia over recent years, a gradual decline in the domestic demand started in 2007 (11.3%, 11.0%, 10.9% and 8.1% GDP growth rate in the first, second, third and fourth quarter respectively, 10.3% in the year overall; 12.2% in 2006). This dynamics was determined by a slower pace

of private consumption and gross fixed capital formation growth, also on account of the anti-inflation plan adopted by the government. Still very robust in the first quarter (20.1%), the growth in domestic demand decelerated to 0.2% in the fourth quarter. At the close of 2007, consumer confidence deteriorated, primarily reflecting worsening assessment of the general economic situation and resulting in adversely changing overoptimistic public attitudes of the first half of the year about the income growth in the future. The decelerating pace of the domestic demand brought about a slowdown in import growth, with foreign demand remaining stable and high at the same time, reducing the negative contribution of net exports to GDP growth, which turned even positive at the end of the year.

Private consumption expanded by 13.9%, accounting for over a half of the growth in domestic demand in 2007. A boost in household expenditure was most substantially supported by an increase in disposable income which was determined by the rise in average real wages and salaries (19.4%). The situation regarding population saving and investment decisions was not uniform. On the one hand, household expenditure and saving growth decelerated due to negative real deposit rates and price rise expectations. On the other hand, a slowdown in the pace of economic development and deterioration in consumer confidence contributed to contained expenditure at the end of the year. In 2007, financial institutions were active in offering the population more diversified savings-related financial instruments, e.g. investment funds promising higher returns than deposits. Thus in 2007, an increase in household investment in financial instruments issued by non-residents was observed (primarily in investment fund investment certificates). The pension fund reserves also grew notably.

Gross fixed capital formation to GDP (in nominal terms) remained almost unchanged year-on-year (32.5% of GDP). In the wake of the buoyant growth of the previous years, the pace of gross fixed capital formation decelerated to 8.4% (16.4% in 2006). Good financial performance of the previous periods (reinvested earnings), the increase in foreign direct investment and funding from the EC as well as extensive crediting were the drivers behind investment in the first half of the year, whereas towards the end of the year investment growth slowed down.

In 2007, exports of goods and services (at constant prices) picked up 11.1% but imports grew by 15.0%. A slowdown in the growth of domestic demand in the second half of the year contributed to decelerating imports of goods and services (from 29.4% in the first quarter to -1.8% in the fourth quarter).

In 2007, GDP recorded an increase of 10.3% (see Table 1 for the growth of total value added), reaching 13 957.4 million lats at current prices.

Table 1

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

|                        | Growth (%) | Contribution to gross value added growth<br>(in percentage points) |
|------------------------|------------|--|
| GDP                    | 10.3       | x  |
| Gross value added      | 9.5        | x  |
| Goods-producing sector | 5.7        | 1.5  |
| Services sector        | 10.9       | 8.0  |

Source: CSB.

The growth in the first three quarters of 2007 was pushed by sustained robust domestic demand, hence the annual increase was primarily on account of trade (contribution of 2.8 percentage points to total annual growth; 12.7% growth), real estate, renting and business activities (1.6 percentage points; 10.1%), construction (1.1 percentage points; 14.4%), and financial intermediation (1.2 percentage points; 22.5%). With exports of transportation services on a strong upward trend, the contribution of transport, storage and communication to total growth was substantial (1.4 percentage points; 9.8%).

Retail trade turnover (including sales of motor vehicles and automotive fuel retailing) increased by 17.6% in 2007. With the growth in domestic demand weakening, a downward trend in retail trade turnover was observed (29.2%, 24.0%, 16.8% and 4.9% in the first, second, third and fourth quarter respectively). Turnover changes were primarily on account of the demand for motor vehicles, household goods and food products. The number of cars newly registered with the Road Traffic Safety Department posted a pickup of 9.9% in 2007 (from a 53.4% pickup in the first quarter to 17.6% decline in the fourth quarter on an annual basis).

In transport, storage and communication, all basic transportation groups recorded stable results. Primarily triggered by expansion in international carriage (24.1%), freight transportation by road grew by 20.2%. Freight transportation by rail picked up 7.1% mainly due to an 11.4% surge in oil product transportation. In general, freight transportation at Latvian ports expanded by 4.9% (by 6.8% at Ventspils port, 2.3% at Riga port, 0.9% at Liepāja port, and 32.4% at small ports).

A slowdown in the growth of goods sector was triggered by narrowing manufacture (the volume index of industrial output dropping 1.0% but value added shrinking by 0.3%), with no contribution of this sector to total value added growth. It was on account of several factors, e.g. noticeable structural changes in manufacture of wood and articles of wood, discontinuation of sugar production in the fourth quarter, and curtailed building material sales on the domestic market in the second half of the year.

Non-financial investment in the economy in 2007 amounted to 2.7 billion lats, 13% more year-on-year at constant prices. Largest investment went to manufacturing (434.6 million lats), yet the increase at constant prices was a mere 2%. At the same time, investment in transport, storage and communication was 326.8 million lats (a 5% rise), and 301.5 million lats in trade (a 2% drop). Investment growth was stronger in health and social care (3.3 times), public administration and defence (49%), electricity, gas and water supply (32%), and construction (29%).

## LABOUR MARKET

The labour market situation was tight in 2007. However, the deceleration in the pace of economic growth in the fourth quarter affected the labour market dynamics.

A decline in registered unemployment (4.9% of economically active population at the close of 2007; a fall of 1.6 percentage points within a year) was underpinned by the buoyant economic growth for the third year running. The fastest decline in registered unemployment was recorded for Latgale, yet structural unemployment in this region remained at a high level someplace (e.g. in Rēzekne district at 16.6% at the end of the year). At the end of 2007, the lowest unemployment rate was in Riga (3.1%), recording a drop of 0.7 percentage point over the year.

Impacted by the cyclical decline in unemployment, the number of long-term un-



employed persons shrank faster than in the previous year (by 41.0%). At the end of 2007, their number amounted to 9.4 thousand, with the respective share in total unemployment dropping to 18.0% (23.1% at the end of the previous year).

The State Employment Service registered the highest level of vacancies in August, which reduced substantially in the fourth quarter to be above the year-on-year indicator by only 13.1% at the year end. Over three quarters of all vacancies were in Riga and Riga district. The vacancy-unemployment ratio of the labour market (unemployed persons per vacancy) reached its low in September (2.3; 4.3 at the beginning of the year), but rose again to 2.9 in the fourth quarter. In Riga and Riga district, vacancy-unemployment ratio stood at 1.0, but in Latgale it was 35.0 at the end of 2007.

The situation in the labour market underpinned the rise in foreign labour particularly in such sectors as transport, storage and communication, construction and trade. The number of approved labour permits tripled in 2007 (3.1 thousand). More than a half of all foreign workers were employed in construction.

According to the CSB survey data, in 2007 the number of employed persons grew markedly, albeit slower than in the previous year. The economic activity in the age group from 15 to 74 strengthened over the year and stood at 67.3% at its end (plus 2.5 percentage points year-on-year). The rate of jobseekers to economically active population was 5.3% at the end of 2007 (0.8 percentage point less year-on-year).

In 2007, the average monthly gross wage and salary of persons employed in the national economy grew faster than in the previous year (by 31.5%) and reached LVL 397.64. The wage growth was slightly more dynamic in the public sector than in the private sector (35.2% and 30.4% respectively). All economic sectors (except construction where growth decelerated somewhat) recorded a faster wage growth than in 2006. As in the previous year, wage increases were mainly determined by the robust economic development and higher wages due to escalating inflation. However, at the closing months of the year, the upward movement in wages and salaries moderated on account of decelerating economic growth in the private sector and general government budget constraints at the end of the year in the public sector. Real gross wages and salaries in the economy increased by 19.4% (by 15.5% in 2006).

## FOREIGN TRADE AND THE BALANCE OF PAYMENTS

In 2007, Latvia's foreign trade developed vigorously, its turnover reaching 11.8 billion lats (see Table 2). The annual growth of exports of goods (22.6%) was stable throughout the year; moreover, it was higher than in the previous year, exceeding that of imports both in the fourth quarter and per annum. The growth rate of imports of goods, following the accelerated increase in the previous year,

Table 2

### LATVIA'S FOREIGN TRADE

(exports in FOB prices; imports in CIF prices;  
in millions of lats)

|         | 2007     | 2006     |
|---------|----------|----------|
| Exports | 4 038.7  | 3 293.2  |
| Imports | 7 746.3  | 6 378.5  |
| Balance | -3 707.6 | -3 085.3 |

Source: CSB.

moderated to 21.4% as a result of subdued domestic demand, falling from 36.2% of annual growth in the first quarter to 4.5% in the fourth quarter.

The highest foreign trade deficit was recorded for the groups of machinery and mechanical appliances, electrical equipment, transport vehicles and mineral products. Only wood and articles of wood posted a surplus. Of the major trade partners, Latvia retained a positive foreign trade balance with the UK and Norway in 2007. The foreign trade deficit with Germany, Lithuania, Italy and Russia widened considerably.

In 2007, wood and articles of wood (22.5% of total exports), base metals and articles of base metals (14.7%), agricultural and food products (14.4%), and machinery and mechanical appliances, electrical equipment (10.7%) were Latvia's major export goods. Wood and articles of wood, agricultural and food products, base metals and articles of base metals, and machinery and mechanical appliances, electrical equipment were the main contributors to the growth of exports of goods. Mineral products were the only group of exports to moderate (on account of declining volume). Exports of machinery and mechanical appliances, electrical equipment, products of the chemical and allied industries, as well as agricultural and food products increased as a result of the expanding volume while those of wood and articles of wood grew due to the price factor. The export growth of base metals and articles of base metals was underpinned by both factors, with the price factor having a slightly stronger impact.

In 2007, Latvia's major export market was the EU, with 76.1% of total exports going to this region. Export growth to EU countries expanded by 24.4%, dominated by that to EU12 countries (37.6%), with half of the export goods underlying the export growth going to Estonia, Lithuania and Poland. The moderate increase in exports to EU15 countries was underpinned by a rise in exports to Sweden, Finland, Germany and the UK. Wood and articles of wood (26.8% of total exports to the EU), base metals and articles of base metals (15.7%), agricultural and food products (13.4%), and machinery and mechanical appliances, electrical equipment (8.4%) were Latvia's major export goods to EU countries. Exports to CIS countries also posted a marked increase (27.1%, primarily to Russia), and were dominated by machinery and mechanical appliances, electrical equipment (22.5% of total exports to this group of countries), agricultural and food products (20.5%), products of the chemical and allied industries (14.3%), base metals and articles of base metals (8.9%) and textiles and textile articles (8.9%), whereas wood and articles of wood (19.4%), base metals and articles of base metals (16.7%), agricultural and food products (14.0%) and mineral products (11.9%) were major exports to other countries. Latvia's major export partners for goods were Lithuania (15.6% of total exports), Estonia (14.4%), Russia (9.6%), Germany (8.8%), Sweden (7.7%) and the UK (6.9%).

In 2007, Latvia's external competitiveness weakened as a result of a stronger rise in domestic prices and costs, as well as the nominal component (a total increase of 0.4% in the nominal effective exchange rate of the lats, inter alia relative to both groups of the major trade partners).

On the backdrop of a persistent consumer price rise the CPI-deflated real effective exchange rate of the lats posted a gradual increase. The rapid surge in costs in manufacturing, which had begun in the second half of 2006, continued also in early 2007; however, starting already with the second quarter, the increase in producer prices relative to the price dynamics in the major trade partners gradually levelled out and cost competitiveness did not post significant changes in the sec-

ond half of 2007 – it was more affected by fluctuations of the nominal effective exchange rate of the lats as a result of the depreciation of the US dollar.

In 2007, the average CPI-deflated real effective exchange rate of the lats was 7.4% higher year-on-year. The PPI-deflated real effective exchange rate of the lats also recorded a considerably stronger rise than in 2006, reaching 10.2%.

Machinery and mechanical appliances, electrical equipment (20.5% of total imports), transport vehicles (14.6%), mineral products (11.7%), agricultural and food products (11.2%), base metals and articles of base metals (9.7%), and products of the chemical and allied industries (8.1%) were the major import goods in 2007. The share of machinery and mechanical appliances, electrical equipment, transport vehicles, agricultural and food products, and base metals and articles of base metals in total imports expanded, thus contributing to two thirds of import growth. Imports of mineral products recorded a moderate increase, and their share in total imports contracted. Imports of machinery and mechanical appliances, electrical equipment grew as a result of higher volume; the increase in imports of transport vehicles, agricultural and food products and base metals and articles of base metals also predominantly resulted from the volume factor rather than from the price rise.

Imports from EU countries accounted for 77.8% of total imports, mostly machinery and mechanical appliances, electrical equipment (22.7% of total imports from the EU), transport vehicles (17.6%), agricultural and food products (12.7%), and products of the chemical and allied industries (8.1%). Imports from CIS countries were dominated by mineral products (43.5% of total imports from the CIS), base metals and articles of base metals (20.9%) and wood and articles of wood (13.5%) whereas major imports from other countries were machinery and mechanical appliances, electrical equipment (26.5% of total imports of this group of countries), products of the chemical and allied industries (14.8%), base metals and articles of base metals (11.0%), transport vehicles (7.8%) and agricultural and food products (7.7%). Latvia's principal import partners for goods were Germany (15.1%), Lithuania (13.9%), Russia (8.4%), Estonia (8.1%) and Poland (7.0%).

In 2007, the current account deficit of balance of payments amounted to 22.9% of GDP.

### **FISCAL POLICY**

On the cash flow basis, the consolidated general government budget posted a surplus of 94.0 million lats or 0.7% of GDP in 2007. However, on the accrual basis used to evaluate compliance with the Maastricht criteria, the consolidated general government budget ran a slight deficit of 5.7 million lats or 0.04% of GDP. The financial surplus estimated on the cash flow basis showed an improvement in comparison with the financial deficit in the amount of 98.6 million lats or 0.9% of GDP recorded in 2006 and also exceeded the financial surplus target set in the Law "On State Budget 2007" at 54.5 million lats or 0.4% of GDP.

Robustly growing tax revenue (2.2% above the annual target) and tightened expenditure policy helped to achieve better outturn for the consolidated general government budget.

In 2007, the consolidated general government budget revenue amounted to 5.4 billion lats or 38.5% of GDP, representing a year-on-year increase of 1.3 billion

lats or 33.5%. Tax revenue increased by 1 063.9 million lats or 32.2% in comparison with 2006. With the raise of the minimum wage from 90 lats to 120 lats and growing employment and wages, personal income tax revenue and social security contributions increased by 35.1% and 32.0% respectively. Corporate income tax revenue rose by 57.5% on account of surging corporate profits. With private consumption remaining high, value added tax revenue also increased significantly by 29.3%. Nevertheless, the growth of the VAT collections decelerated in comparison with 2006 (37.4%) as a result of the high base and reduction of the VAT rate from 18% to 5% for electricity, gas, firewood and fuel wood supplies to the population as well as on hairdresser services and housing renovation services. Excise tax revenue grew by 22.4% on account of higher tax rates imposed on tobacco products, oil products as well as alcoholic beverages and beer.

Non-tax revenue increased by 43.4 million lats or 17.2% year-on-year in 2007. Larger inflows from the EU funds boosted the foreign financial assistance receipts by 201.9 million lats or 77.8% year-on-year.

In 2007, the consolidated general government budget expenditure totalled 5.3 billion lats or 37.9% of GDP. The annual increase of expenditure was 1.2 billion lats or 28.0%. Steadily growing wages and salaries in the public sector and significant old-age pension indexation resulted in a considerable increase of spending on wages and salaries and social security contributions by 269.9 million lats or 34.2%. Capital investment expenditure also expanded further by 234.2 million lats or 43.9%.

The financial surplus of the general government consolidated budget was the result of a surplus in the central government social security budget amounting to 379.6 million lats and a deficit in both the central government basic budget and local government consolidated budget of 263.4 million lats and 33.0 million lats respectively.

At the end of 2007, the general government debt totalled 1 158.6 million lats or 8.3% of GDP on the cash flow basis, representing an increase of 43.4 million lats year-on-year. The debt expanded mainly on account of central government borrowing from the European Investment Bank for co-financing of Cohesion Fund and structural funds projects. By contrast, the domestic debt of the central government shrank by 22.5 million lats during 2007.

## **BANKING DEVELOPMENTS**

At the end of 2007, 21 banks, four branches of foreign banks (two branches were opened in 2007 and one closed due to a change in type of business), 35 credit unions, six electronic money institutions (three of them launched operations in 2007) and two money market funds were registered in the Republic of Latvia. All Latvian banks, except one (the Latvian government is the sole owner of the *SJSC Latvijas Hipotēku un zemes banka*), are private in Latvia, and the government's participating interest in their paid-up share capital contracted to 5.5% at the end of 2007.

The year 2007 marked a turning point in Latvia's economic development, which started to decelerate after several years of buoyant growth. First signs of a slowdown of the economic growth became apparent in the second half of the year, when the implementation of the anti-inflation plan produced by the government, moderation of funding from parent bank and tightening of the banks' lending policies resulted in a rather abrupt deceleration of the domestic lending growth.

Nevertheless, the activity of Latvia's financial sector remained high; therefore, bank assets increased by 37.8% during the year. Assets still expanded on account of loans granted to residents, with their growth rate declining to 34.0% at the end of 2007. The overall loan expansion was dampened by lower growth of mortgage lending: at the end of 2007, the annual increase of mortgage loans amounted to merely 38.6% in comparison with 89.2% at the end of 2006. Looking at the composition of bank funding sources, borrowing from MFIs continued to increase and amounted to 40.1% of the total liabilities at the end of year, including 27.0% from affiliated credit institutions. Deposits by both domestic and foreign non-MFIs continued to grow.

Bank profitability deteriorated slightly during the year. As in 2006, it was affected by the growth of interest expense outpacing that of interest income. Nevertheless, bank profitability remained high: ROE was 24.2% at the end of the year, whereas ROA stood at 2.0%. Cost efficiency of banks improved and they earned profit totalling 371.3 million lats. The overall margin on new business continued to shrink, as the growth of deposit rates outpaced that of the lending rates due to the persistently growing competition in domestic lending and higher bank activity in attracting domestic funds, particularly in lats. In the second half of the year, banks started to promote savings products more actively.

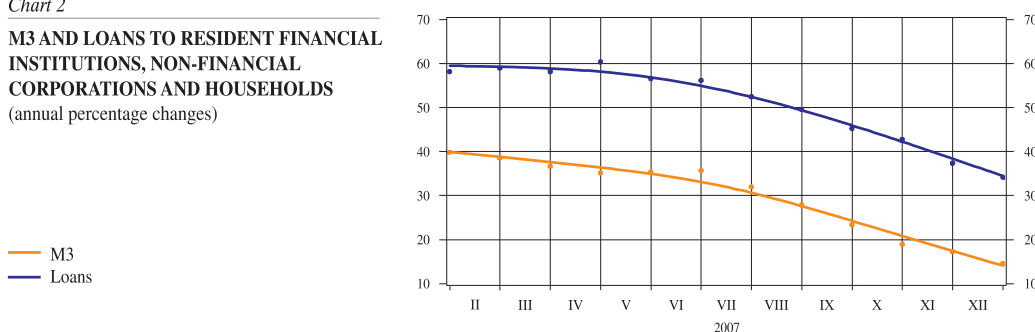
The quality of bank assets remained high, whereas the capital adequacy ratio improved, strengthening the banks' ability to absorb any potential shocks.

## MONEY SUPPLY

Annex 1 provides an overview of the principal monetary aggregates of MFIs. In 2007, the development of the monetary aggregates reflected the stabilisation of the rapid and rather unbalanced economic growth as well as the impact of the anti-inflation measures implemented by the government on money supply. M3 increased by 14.6%, representing a decline by 25.7 percentage points in comparison with 2006 (see Chart 2), and amounted to 6 311.6 million lats at the end of 2007 (see Chart 3). The strength of the economic development witnessed in the first half of 2007 underlay robust growth of the money supply and M3 expanded by 11.6%, yet in the second half of the year, with the anti-inflation plan of the government starting to materialise (particularly in the area of lending), it grew by merely 2.7%. The highest growth rate of M3 at 39.9% was reported in January, whereas the biggest monthly increase of 246.6 million lats or 4.2% in June, when deposits with MFIs (except the Bank of Latvia) increased significantly.

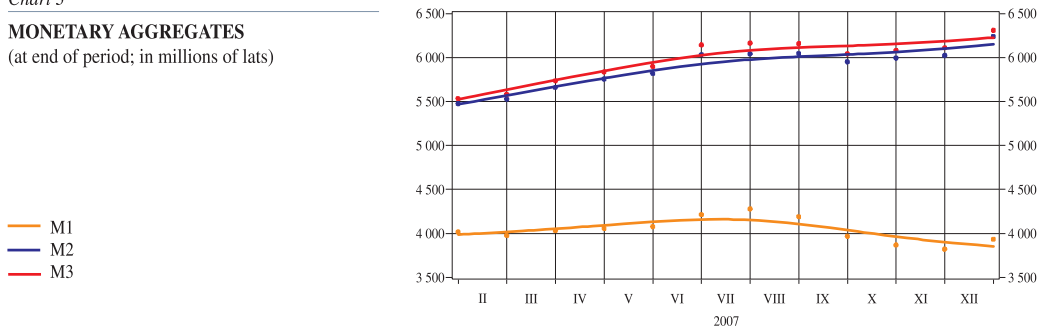
Chart 2

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



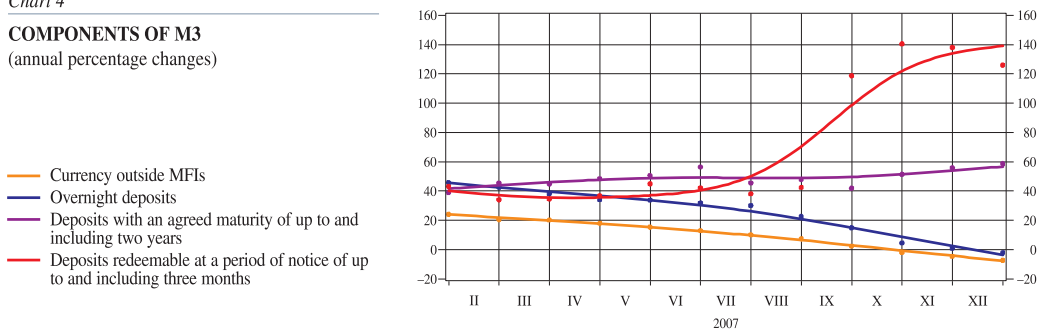
The overall slowdown of the growth of M3 was mostly affected by the most liquid components of the narrow monetary aggregate M1. Rising interest rates supported shifts into time deposits and savings deposits, opportunity costs of holding cash

Chart 3

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


increased and cashless payments were used more often. As a result, the advantages of cash liquidity diminished, and M1 shrank by 3.2% in comparison with a 41.7% increase in 2006, including overnight deposits with MFIs in all currencies contracted by 2.0% and currency outside MFIs by 7.1% (see Chart 4). Thus time deposits with banks remained the main contributors to the overall monetary expansion, and the cash component of the broad money continued to shrink, declining from 17.6% at the end of 2006 to 14.3% at the end of 2007 (overnight deposit component decreased from 56.2% to 48.1% respectively).

Chart 4

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


M2 increased by 14.4% in comparison with 39.7% in 2006, with all currency deposits redeemable at notice of up to and including three months growing 2.3 times, yet remaining insignificant, whereas all currency deposits with an agreed maturity of up to and including two years held with MFIs expanded by 58.8%. The growth rates of both types of deposits were significantly higher than in 2006. Other components of M3 remained modest, with money market fund shares/units totalling 41.3 million lats at the end of the year and MFI debt securities with a maturity of up to two years amounting to 28.2 million lats, representing a 10.4% annual decline and a 5.9 times annual increase respectively. So far, Latvian banks have concluded no repo agreements included in M3.

Monetary expansion decelerated mainly on account of a more moderate growth of MFI loans to domestic businesses and households. The money multiplier increased only slightly and was 2.55 in December 2007 in comparison with 2.45 in December 2006. Aggravating macroeconomic risks and a rather modest increase of savings supported acceleration of the velocity of money to stand at 2.2 in comparison with 2.0 in 2006.

Resident financial institution, non-financial corporation and household deposits with MFIs increased by 760.6 million lats or 16.9% in 2007 in comparison with 41.0% in 2006. Growth of deposits decelerated against the background of mounting economic instability and inflation expectations in Latvia as well as deepening concerns about the sustainability of the economic growth.

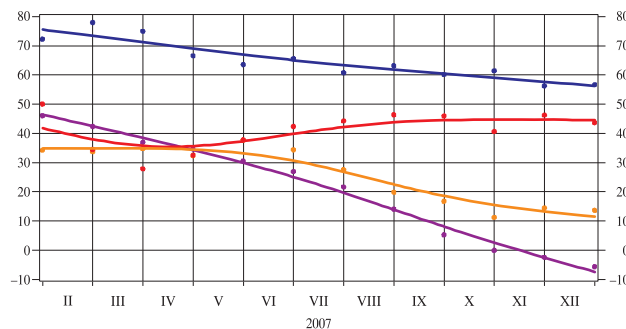
Although the remuneration of lats deposits was more attractive, foreign currency deposits expanded at a significantly higher rate under the impact of the above factors, with the annual increase of deposits in lats and foreign currencies amounting to 3.0% and 36.6% in 2007 respectively. The growing significance of the euro in the Latvian economy, its dominance in lending and the fixed exchange rate against the lats contributed to a notable increase in deposits made in this currency, and deposits by resident non-MFIs made in euro grew by 51.1% in 2007 (see Chart 5 for developments in lats and euro deposits by resident financial institutions, non-financial corporations and households). Depreciation of the US dollar and persistently narrowing use of this currency in domestic business underlay an annual decrease in the US dollar deposits by 7.2%. At the end of 2006, lats deposits amounted to 59.7% of resident non-MFI deposits and at the end of 2007 to 53.2%, whereas the respective US dollar deposits shrank from 9.7% to 7.7%. The share of the euro in total deposits increased from 29.7% at the end of 2006 to 38.3% at the end of 2007.

Chart 5

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

(annual percentage changes)

- Lats deposits of financial institutions and non-financial corporations
- Lats deposits of households
- Euro deposits of financial institutions and non-financial corporations
- Euro deposits of households



As the rates on deposits with an agreed maturity and deposits redeemable at notice gradually increased, resident financial institutions, non-financial corporations and households compressed their overnight deposit share in the total deposits from 65.9% at the end of 2006 to 54.4% at the end of 2007, with the share of deposits with an agreed maturity expanding accordingly. Household deposits contracted slightly and amounted to 59.0% of all the above-mentioned deposits in comparison with 59.9% at the end of 2006, and their annual growth at 15.1% was also marginally lower than that of deposits by financial institutions and non-financial corporations at 19.6%. Household deposits accounted for 71.7% of all time deposits and 48.3% of overnight deposits (74.9% and 52.1% at the end of 2006 respectively).

The increase of the monetary aggregate M2X calculated based on the Bank of Latvia's methodology (12.6%; 37.5% in 2006) was slightly lower than the overall growth of money supply.

Monetary developments were still driven by strong capital inflows. Negative net foreign assets of MFIs grew 1.7 times in 2007 amounting to 4 482.8 million lats, although the Bank of Latvia's net foreign assets increased by 15.0% and totalled 2 776.0 million lats at the end of the year. Nevertheless, the negative net foreign assets grew less rapidly than the previous year, when they expanded two-fold. This was mainly achieved by more prudence on behalf of non-resident banks (primarily parent banks) in granting funds for domestic lending. Foreign liabilities of MFIs (excluding the Bank of Latvia) grew by 4.1 billion lats or 46.8%, including an increase of 2.5 billion lats or 46.7% in liabilities to foreign MFIs (of which, liabilities to associated and affiliated MFIs rose by 1.8 billion lats or 43.9%) and non-resident non-MFI deposits by 1.5 billion lats or 49.6%. Foreign assets of banks

increased by a smaller amount (1.8 billion lats), with claims on foreign MFIs growing by 1.4 billion lats and claims on non-resident non-MFIs by 0.4 billion lats, including an increase of 382.7 million lats in loans outstanding. Thus the negative net foreign assets of MFIs (excluding the Bank of Latvia) grew by 2.2 billion lats at the end of 2007 year-on-year.

The significant dampening of lending growth supported economic stabilisation and easing of the private consumption pressure. With the introduction of the government anti-inflation plan and banks tightening their lending policies, the annual growth of MFI loans granted to the private sector decelerated considerably in the second half of the year. In 2007, loans granted to resident financial institutions, non-financial corporations and households expanded by 3.3 billion lats or 34.2% in comparison with 3.6 billion lats or 58.4% in 2006. The annual growth rate of lending remained at the high level of 56%–60% in the first half of the year, with outstanding loans increasing by 2.0 billion lats. In the second half of the year, loans increased by 1.3 billion lats, but the annual growth rate dropped by 22.0 percentage points. At the end of 2007, exposure to domestic loans decreased to 60.7% of the aggregate balance sheet assets of MFIs (excluding the Bank of Latvia) in comparison with 61.3% at the end of 2006.

Restrictions on lending within the framework of the anti-inflation plan implemented by the government, amendments to income tax legislation, prudent lending policies of banks, rising lending rates, growing supply of housing as a result of properties purchased for speculative purposes being released on the market, shrinking demand due to the potential buyers deciding to wait out, as well as the price hike reaching the maximum in 2006 caused significant changes on the real estate market. According to the data of company *Latio*, prices of housing in standard apartment blocks continued to follow on an upward trend until April and increased by about 13%, but in May they started to decline and dropped by approximately 18% by December. Prices on new housing grew moderately by about 10% in 2007, mainly on account of increased costs. Private house and land market was also more sluggish, whereas the market for office premises and trading sites displayed no signs of lower activity in 2007.

With a surplus accumulating in the consolidated general government budget, net MFI claims on the government contracted by 187.8 million lats in course of the year and turned negative (87.3 million lats).

As in 2006, the growth of MFI loans to the private sector was similar in both major money holding sectors: loans to both non-financial corporations and households increased by 1.7 billion lats in 2007. Nevertheless, their growth dynamics was significantly different throughout the year. Loans to non-financial corporations expanded robustly all the year, increasing by 823.6 million lats in the first half of the year and 835.0 million lats in the second half of the year. The annual growth of these loans decelerated from 52.5% in 2006 to 36.3% in 2007. Household loans, in turn, recorded higher growth in the first half of 2007 when they expanded by 1 079.0 million lats, yet in the second half of the year, with the government starting to implement the anti-inflation measures the growth decelerated and amounted to a mere 606.6 million lats. Consequently, the decline of the annual growth rates was also steeper for loans granted to the household sector: from 75.5% in 2006 to 39.2% in 2007 (see Chart 6 for developments concerning the developments in lats and euro loans granted to resident financial institutions, non-financial corporations and households). The overall decline was primarily the result of deceleration of the annual growth of loans for house purchase from 86.4% to 44.5% (see Chart 7 for developments concerning the main types of lending). At the end of



Chart 6

**CHANGES IN THE ANNUAL GROWTH OF LOANS GRANTED TO RESIDENT FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS (%)**

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

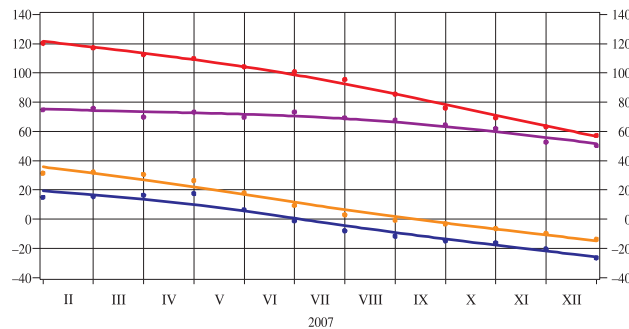
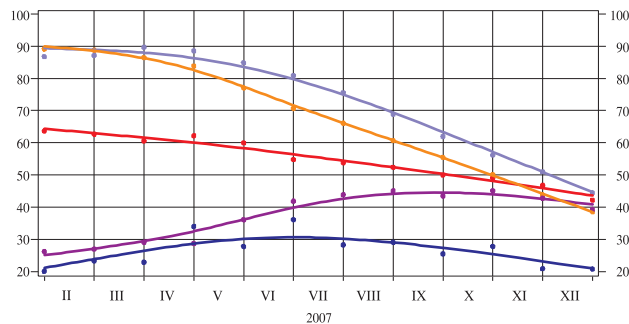


Chart 7

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

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



December, loans for house purchase amounted to 4.7 billion lats or 78.7% of all household loans. At the end of 2006, the percentage was slightly lower: 75.8%. The growth of consumer credit was more sluggish at 21.5%, and its share in total household loans declined by 1.8 percentage points to 12.0%.

Loans for house purchase remained the main determinants of the dominance of mortgage loans in loan stock, as the annual growth of mortgage loans granted to financial institutions and non-financial corporations decelerated more dramatically from 94.0% in 2006 to 29.2% in 2007. Overall, mortgage loans expanded by 38.6% as opposed to 89.2% in the previous year and amounted to 56.4% of all loans at the end of the year (54.6% at the end of 2006). Lower, yet stable or even accelerating annual growth was reported for other major types of corporate loans, with commercial credit increasing by 20.8% in comparison with 22.6% in 2006 and industrial credit by 39.3% over 23.6% and amounting to 18.4% and 13.2% of total loans at the end of 2007 respectively (20.4% and 12.7% at the end of the previous year).

The rise in corporate loans was dominated by lending to real estate, renting and business activities which expanded by 693.8 million lats or 43.2%. Thus the share of this sector in the corporate loan portfolio was 32.5% at the end of the year. Significant increase was recorded for loans granted to manufacturing (296.0 million lats or 43.2%; 13.9% of the loan portfolio), trade (212.3 million lats or 32.2%; 12.3% of the loan portfolio) and construction (115.3 million lats or 21.2%; 9.3% of the total loan portfolio). Of the sectors of manufacturing, the highest lending growth was reported in production of food products and beverages (56.4 million lats or 29.7%), and wood and products of wood (94.9 million lats or 54.1%).

Rapidly climbing lats interest rates against the background of significantly lower, yet also growing euro interest rates accounted for an increasingly larger dominance of euro loans in lending to non-financial corporations and households. Resident non-MFI loans in the national currency decreased by 471.7 million lats or 20.8% in comparison with a rise of 21.0% in 2006, whereas loans granted in euro

expanded by 3.8 billion lats or 1.5 times in comparison with 2.0 times in 2006. The US dollar loans contracted by 46.6 million lats or 13.1% in 2007. Thus the share of resident non-MFI loans granted in lats declined by 9.4 percentage points in course of the year and amounted to 13.7% at the end of 2007, those granted in the US dollars by 1.2 percentage points to 2.4%, whereas the share of loans granted in euro increased by 10.4 percentage points and accounted for 83.4% of all loans.

## LENDING AND DEPOSIT RATES

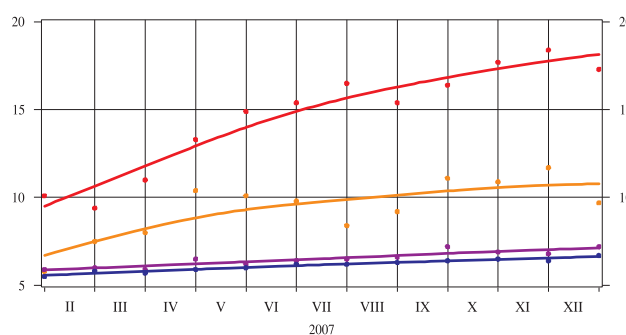
Overall, interest rates on lats loans granted to resident non-financial corporations and households and on lats deposits received from this particular customer group were higher in 2007 than in 2006. Lats lending and deposit rates rose steeply in February–May and August–November, mainly mirroring the lats money market fluctuations.

Euro lending and deposits rates were also mainly on an upward trend; nevertheless, their rise was slower and smoother than that of the lats lending rates (see Chart 8). The US dollar lending and deposit rates, in turn, declined. The rates on foreign currency loans granted to resident non-financial corporations and households and their deposit rates mainly reflected the movements of the respective money market interest rates. The monetary policy pursued by the ECB in the first half of the year and the global financial market turmoil in the second half pushed up the euro money market rates and, consequently, also the rates on euro lending and deposits. The FRS cut down the US dollar base rates, thereby causing a drop in the US dollar money market rates as well as the US dollar lending and deposit rates.

Chart 8

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

— Lats loans to non-financial corporations  
— Lats loans to households  
— Euro loans to non-financial corporations  
— Euro loans to households



Bank margins on lats loans granted in 2007 fluctuated. In periods of rising lats money market rates, banks imposed lower margins on lending rates to non-financial corporations and households, whereas when the lats money market rates declined, increased the margins. Consequently, the rates on the lats lending to non-financial corporations and households were less volatile in comparison with the lats money market rates. Bank margins on euro loans either slightly increased or remained broadly unchanged depending on the type of loan on account of higher risk premiums on bank lending.

Weighted average interest rates on new lats loans granted to resident non-financial corporations and households increased: by 2.9 percentage points in the case of non-financial corporations (from 6.8% in December 2006 to 9.7% in December 2007) and by 7.4 percentage points in the case of households (from 9.9% to 17.3% respectively).

Weighted average interest rates on new foreign currency loans were only 1.1–1.3 percentage points higher year-on-year in December 2007. The rates on loans to

non-financial corporations grew from 5.9% to 7.2%, whereas those on household loans from 5.7% to 6.8% respectively. This reflected a rise in interest rates on euro loans and a decrease in US dollar lending rates.

In 2007, the majority of new loans (almost 80%) were again granted with a floating interest rate and initial interest rate fixation period of up to one year. Yet against the background of a narrowing spread between lending rates with a longer initial interest rate fixation period and short-term interest rates as well as increased volatility of the floating rates on lats lending, the proportion of these loans in new loans continued to shrink on account of loans with a longer initial interest rate fixation period. In 2007, on average 14.6% of the new loans were with the initial interest rate fixation period of 1–5 years.

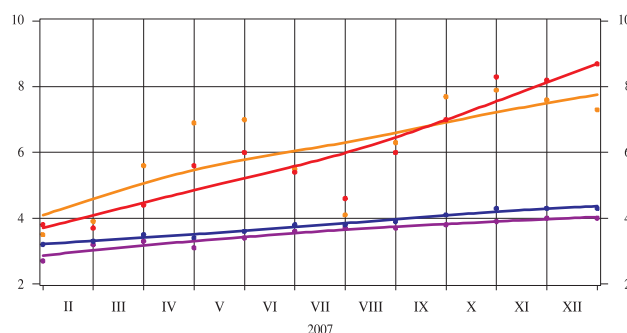
With the interest rates on lats loans granted to non-financial corporations and households increasing more rapidly than those on euro loans, the share of the euro loans in new loans expanded to 85.8% in December 2007 in comparison with 73.1% in December 2006 and the share of the lats loans shrank accordingly.

The rates on lats time deposits by resident non-financial corporations climbed by 3.8 percentage points in 2007 to 7.3%, whereas those on time deposits by resident households by 4.9 percentage points to stand at 8.7% (see Chart 9).

Chart 9

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

- Lats deposits of non-financial corporations
- Lats deposits of households
- Euro deposits of non-financial corporations
- Euro deposits of households



Weighted average interest rates on foreign currency time deposits increased by 0.6–0.8 percentage point in 2007: to 4.1% on deposits from non-financial corporations and to 4.4% on household deposits. Looking at the currency breakdown, the rates on euro time deposits by non-financial corporations grew by 1.2 percentage points to 4.0% in 2007, whereas those on euro time deposits by households by 1.0 percentage point to stand at 4.3%. The rates on the US dollar time deposits by non-financial corporations and households declined by 0.1 percentage point and 0.3 percentage point respectively.

Most new time deposits of resident non-financial corporations and households (about 98.1% on average) were with a maturity of up to one year. The share of lats time deposits in new household deposits contracted in 2007: to 20.9% from an average of 30.5% in 2006. The share of the lats deposits in new time deposits from non-financial corporations remained broadly unchanged: 57.1% on average in 2007.

With the inflation growing, the real interest rates on lats loans granted with a floating rate and initial interest rate fixation period of up to one year declined in course of the year and turned negative at –1.5% in December. The real interest rate on loans with an initial interest rate fixation period over one year also decreased in the second half of the year to stand at 2.1%. The real interest rates on time deposits in lats remained negative and followed on a downward trend in 2007, reaching –6.3% in December.

## INTERBANK MARKET

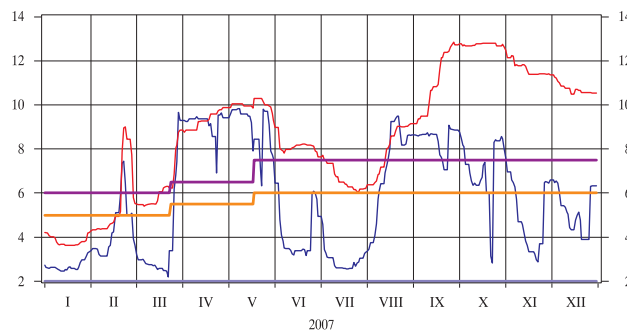
In 2007, RIGIBOR for transactions with a maturity over 3 months reached the highest peak since the end of 1998. The rise was mainly the result of Latvia's macroeconomic imbalances against the backdrop of fundamental changes in the attitude towards risk caused by global financial market turmoil. The assumption that the global economic instability would mostly affect countries with large current account deficits and persistently growing inflation fuelled speculations among financial market participants concerning the stability of the lats. Nevertheless, the shortage of longer-term lats liquidity on the interbank market prevented any significant pressure on the lats stability and mainly resulted in higher lats interest rates. Stabilisation of the lats money market towards the end of the year was supported by the government anti-inflation measures dampening the growth of lending, achieving of a fiscal surplus in 2007 and planning of a balanced budget for 2008 as well as the fact that the Parliament of the Republic of Latvia re-elected the Governor of the Bank of Latvia for the second term, thus doing away with any potential uncertainties concerning the future monetary policy of the Bank of Latvia.

The average 3-month RIGIBOR was 8.63% in 2007, representing a 4.25 percentage point increase over the previous year. 6- and 12-months RIGIBOR grew by 4.49 percentage points and 4.53 percentage points respectively, to 8.98% and 9.11% (see Chart 10 for interest rates of the Bank of Latvia and selected maturity RIGIBOR).

Chart 10

### MONEY MARKET INTEREST RATES (%)

- The Bank of Latvia's refinancing rate
- Interest rate on deposit facility with the Bank of Latvia<sup>1</sup>
- Interest rate on marginal lending facility of the Bank of Latvia<sup>2</sup>
- 3-months RIGIBOR
- RIGIBOR on overnight loans



<sup>1</sup> Until 23 March, interest rate on 7-day time deposits of banks with the Bank of Latvia.

<sup>2</sup> Until 23 March, interest rate on the Bank of Latvia Lombard loans of up to 10 days.

In the wake of the financial market developments of 2007, the lats money market uncertainty increased, resulting in a widening spread between the interest rates that the banks were willing to pay for liquidity and the rates at which they were willing to lend lats. In 2006, the spread between 3-month RIGIBOR and RIGIBID was 0.51 percentage point, whereas in 2007 it increased to already 1.80 percentage points. Nevertheless, despite the widening interest rate spread, the activity of the longer-term segment of the lats money market grew more actively (turnover for transactions with a maturity of 3–6 months grew three-fold, whereas for transactions with a maturity of 6–12 months two-fold) in comparison with the shorter-term segment (overnight transactions grew by 63.0%), yet the share of longer-term transactions in overall turnover remained at a traditionally low level for the lats money market: below 1% of all transactions.

The weighted average interest rate of overnight transactions, the most active part of the lats money market, was 1.77 percentage points higher year-on-year in 2007 and stood at 4.97%.

Overall, the amount of domestic interbank market loans continued to grow rapidly in 2007, reaching 29.0 billion lats (one third more year-on-year), including transactions in lats expanded to 13.9 billion lats or by 44.8%. The share of transactions with a maturity of over one day increased from 27.0% in 2006 to 30.5% in 2007.

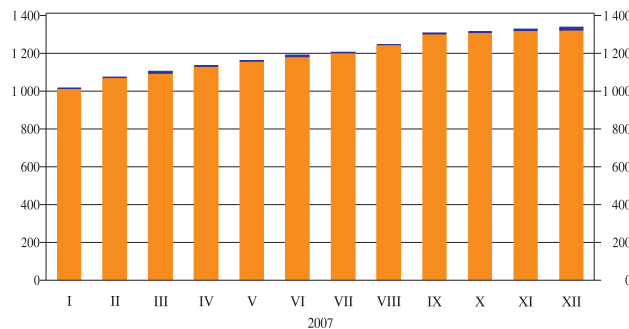
### MONETARY BASE

Although the reserve base remained unchanged, as a result of deposits with banks growing, minimum reserves held by banks on cash accounts with the Bank of Latvia continued to increase (see Chart 11). Thus deposits from credit institutions and other financial institutions held by the Bank of Latvia grew by 246.8 million lats or 21.0% in 2007 as opposed to 2.5 times in 2006. For the first year, the demand for cash decreased, and currency in circulation shrank by 24.4 million lats or 2.3% (a 22.4% increase in 2006). As a result, the central bank's money supply or monetary base M0 increased only by 9.9% in 2007, considerably less than in 2006, and totalled 2 471.2 million lats at the end of the period, whereas the cash component of the monetary base decreased to 42.5% in comparison with 47.8% at the end of 2006.

Chart 11

#### BANK RESERVES WITH THE BANK OF LATVIA (in millions of lats)

Minimum reserves with the Bank of Latvia  
Excess reserves

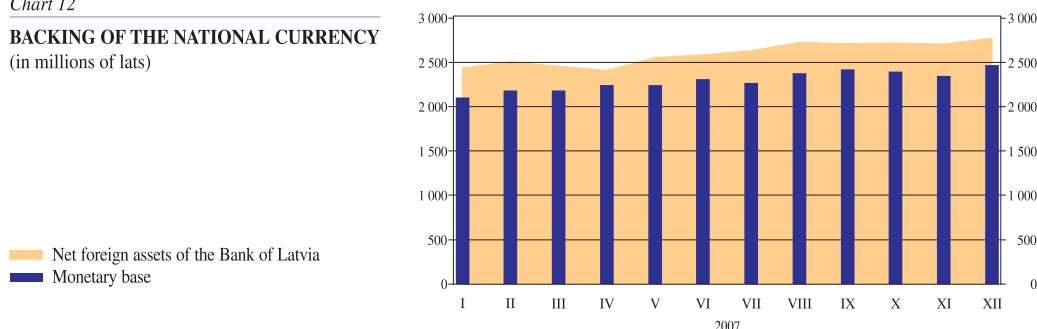


The growth in the monetary base was mainly underpinned by an increase in net foreign assets of the Bank of Latvia by 361.6 million lats or 15.0%, with the Bank of Latvia purchasing foreign currency in the net amount of 158.6 million lats and conducting foreign exchange swaps. Large amounts of foreign currency were sold to the Bank of Latvia due to the continued rapid growth of euro loans subsequently converted into lats and by the expansion of the minimum reserves, which created an additional demand for the lats liquidity. More foreign currency was sold to the Bank of Latvia also because of inflows of foreign investment and foreign financial assistance funding in the economy. Foreign assets of the central bank expanded also on account of the government's foreign currency deposits. At the end of 2007, the Bank of Latvia's reserve assets covered the goods imports of 4.4 months (of 4.6 months at the end of 2006), whereas the backing of the national currency with the Bank's net foreign assets was 112.3% (107.4% at the end of 2006; see Chart 12).

Overall, the changes in the Bank of Latvia's net domestic assets were less pronounced (the negative value of the net domestic assets increased by 139.2 million lats). Lending to banks expanded slightly by 6.9 million lats, whereas the government deposits with the Bank of Latvia recorded a significant increase of 121.4 million lats.

Mainly as a result of actively resorting to the marginal lending facility in some months, new loans granted by the Bank of Latvia to banks amounted to 4.8 billion

Chart 12

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

lats, which is 6.1 times more than in 2006. At auctions of the main refinancing operations, demand was even slightly lower than that for repo loans in 2006 (see Table 3 for the monthly average amounts outstanding).

Table 3

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

|           | 2007 | 2006 |
|-----------|------|------|
| January   | 0    | 66.0 |
| February  | 16.9 | 18.0 |
| March     | 6.1  | 1.4  |
| April     | 89.1 | 12.2 |
| May       | 81.3 | 12.5 |
| June      | 3.6  | 7.7  |
| July      | 0    | 17.3 |
| August    | 36.4 | 28.4 |
| September | 66.8 | 2.0  |
| October   | 31.7 | 10.7 |
| November  | 13.7 | 0    |
| December  | 10.4 | 0    |

**THE FOREIGN EXCHANGE MARKET AND LATVIA'S EXTERNAL DEBT**

In 2007, the global foreign exchange market saw depreciation of the US dollar against the euro, the British pound sterling and the Japanese yen on account of a slowdown of the US economic growth, falling interest rates in the US and concerns about the status of the US dollar as the global reserve currency. Problems in the US housing market, a slowdown in the US economic growth and the declining stock market in the second half of the year underpinned a marked drop in the US interest rates.

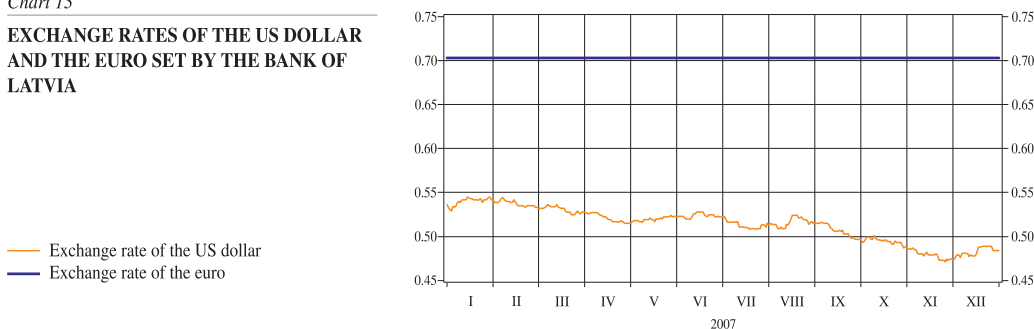
In 2007, the euro appreciated against the US dollar by 10.5% (from 1.3199 at the end of 2006 to 1.4590 at the end of 2007), reaching its high on 23 November (1.4967). The US dollar depreciated against the Japanese yen from 119.07 at the end of 2006 to 111.71 at the end of 2007 (a decrease of 6.2%), in 2007 reaching a high (124.14) on 22 June and a low (107.23) on 26 November. Over the year, the British pound sterling appreciated vis-à-vis the US dollar by 1.3% (from 1.9589 at the end of 2006 to 1.9849 at the end of 2007), reaching its high (2.1162) on 9 November.

On the domestic foreign exchange market, the US dollar depreciated against the lats from 0.5283 at the end of 2006 to 0.4778 at the end of 2007, recording a 9.6% decrease. The US dollar reached its high (0.5424) on 12 January and a low (0.4671)

on 23 November. At the end of 2006 and 2007, the euro exchange rate against the lats was the same (0.6971), recording a high (0.7096) on 19 March and a low (0.6958) on 23 May. The British pound sterling against the lats depreciated from 1.0350 at the end of 2006 to 0.9487 at the end of 2007, standing at its high (1.0645) on 22 January and a low (0.9455) on 28 December (for the exchange rate developments of the major currencies as set by the Bank of Latvia, see Chart 13 and Annex 5).

Chart 13

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



According to the international investment position data, Latvia's gross external debt increased by 6.0 billion lats in 2007, totalling 18.7 billion lats (134.2% of GDP) at the end of the year, with net external debt amounting to 7.3 billion lats (52.1% of GDP). The government and the central bank's liabilities to non-residents grew by 0.1 billion lats, the banking sector and other sectors' liabilities posted increases of 4.0 billion lats and 1.6 billion lats respectively, and debt-related direct investment expanded by 0.3 billion lats. Consequently, the external debt composition by sector changed: the share of other sectors' liabilities increased to 20.8% (17.9% in 2006), while the share of the government and the central bank's debt, banks' debt and the debt-related direct investment shrank to 4.0% (5.2% in 2006), 68.1% (68.7% in 2006) and 7.0% (8.2% in 2006) respectively.

The breakdown of the external debt by instrument slightly changed in 2007: the share of other debt instruments shrank as other investment expanded from 86.5% to 89.5%. At the end of 2007, debt-related direct investment, debt securities, currency and deposits, and borrowing amounted to 7.0%, 3.5%, 21.7% and 62.3% of the external debt respectively. At the end of 2007, long-term debt stood at 10.7 billion lats, and short-term debt amounted to 8.1 billion lats.

At the end of 2007, MFI (excluding the Bank of Latvia) external debt amounted to 12.8 billion lats. In 2007, the maturity profile of banks' foreign liabilities remained broadly unchanged: the received long-term funds accounted for 46.3% of the banks' external debt at the end of 2007 (46.4% at the end of 2006). Although loans from parent corporations expanded 1.4 times (to 5.8 billion lats), their share in the breakdown by creditor shrank to 45.3% (45.9% at the end of 2006). In 2007, currency and deposits grew by 1.5 billion lats, with their share in the banks' liabilities increasing to 31.7% (29.5% in 2006). At the end of 2007, the banks' net external debt amounted to 7.4 billion lats.

At the end of 2007, the external debt of other sectors was 3.9 billion lats, including long-term liabilities in the amount of 2.7 billion lats. In 2007, foreign liabilities grew by 70.9%, with the share of loans increasing to 75.8% (68.0% at the end of 2006) and that of trade credit shrinking to 22.4% (29.9% at the end of 2006) in other sectors' debt. Other sectors and banks' debt liabilities to direct investors increased gradually as well. In 2007, they amounted to 1.3 billion lats.

According to the Treasury data, the government external debt in foreign curren-

cies increased by 54.0 million lats over 2007, standing at 634.3 million lats (4.5% of GDP) at the end of the year. In 2007, the government received foreign financing in the amount of 70.0 million lats. 40.2 million lats (including 13.6 million lats for repayment of the principal amount of loans) equalling 0.7% of annual exports of goods and services, were used to service foreign debt. The share of euro-denominated liabilities of the government continued to grow (from 94.5% to 95.9%), whereas those in US dollars shrank from 5.4% to 4.0%.

## SECURITIES MARKET

In 2007, the amount of securities offered by the Treasury in the primary market auctions of government securities was smaller than in the previous year due to the growing uncertainty and borrowing costs on the financial markets. In February, the focus was mostly on the economic imbalances on the domestic market; and since August the situation on the global financial markets has aggravated considerably, thus further increasing the borrowing costs. The Latvian macroeconomic environment was also not favourable: the growing inflation subdued the interest in fixed income securities. Banks started to offer their customers time deposits in lats with 8%–10% interest rates on transactions with 3–12 month maturity, and 3-month RIGIBOR was also high. The Treasury was not in the position to compete with such levels of short-term interest rates; nevertheless, market participants retained certain interest about government short-term securities as they could be used in transactions with the Bank of Latvia.

In 2007, the fiscal situation was satisfactory, and there was no substantial need for new issues of government securities, and the amount of government securities outstanding decreased by 8.5% (to 383.3 million lats).

In 2007, the amount of government securities offered at primary auctions was 165.0 million lats (33.5% less than in the previous year), the demand was 238.8 million lats (5.4% less year-on-year), and the amount sold stood at 63.9 million lats (a drop of 50.8% year-on-year), of that transactions in the amount of 61.8 million lats were concluded in the first quarter. So for most of the year banks' interest in government securities was either minimal or the bid rates at auctions exceeded the level of interest rates acceptable for the Treasury.

In 2007, the Treasury issued 11-year bonds for the first time, and their yield will be used for measuring the compliance with the Maastricht convergence criterion. At the first auction in August, the average yield was 5.65%, remaining at the same level also at the next auction in October.

The government securities holdings of Latvian banks shrank from 57.1% of the total at the end of 2006 to 43.4% at the end of 2007, and the share of those held by other residents decreased from 36.0% to 31.7% while that of securities held by non-residents increased from 6.9% to 24.9%.

As the lending terms and conditions both globally and in Latvia became tighter and the outlook for the future borrowing costs was uncertain, companies became more interested in attracting funds with the help of debt securities. In 2007, the stock of publicly traded corporate debt securities, denominated in euro and registered with the LCD, grew rapidly while those denominated in lats and US dollars posted a minor increase. The pickup in euro-denominated securities relative to those denominated in other currencies reflected the significant role of the euro which tends to strengthen further both in Latvia's financial sector and economy in general. Publicly traded corporate debt securities denominated in euro and regis-



tered with the LCD surged by 74.3% (to 134.9 million euro) in 2007. One issue of securities matured, and 16 new issues were launched and registered. Of the new issues, the largest one was the JSC *Akciju komercbanka "Baltikums"* bond issue in the amount of 10 million euro and with maturity of three years with the estimated coupon rate of 3-month EURIOBOR + 3%. The JSC *PrivatBank* and the SJSC *Latvijas Hipotēku un zemes banka* issued debt securities in the amount of 9 million euro each, with maturity of three years and a floating interest rate and maturity of one year and a fixed interest rate respectively. Publicly traded corporate debt securities, denominated in lats and registered with the LCD, grew by 5.4% (to 52.5 million lats) in 2007. Six issues matured, and new securities in the amount of 13.3 million lats were issued; the sales of securities issued and registered in the previous years also increased (by 11.0 million lats net). *DnB NOR Bank ASA* (Norwegian bank) recorded the largest issue (12.0 million lats), registered at the end of 2006 and traded in 2007 (with three-year maturity). The SJSC *Latvijas Hipotēku un zemes banka* also launched a substantial issue in the amount of 10.0 million lats and with maturity of one year.

At the beginning of 2007, the bid rate quoted on the RSE for Treasury bonds maturing in December 2015 stood at 5.00%, rising in the next months and reaching a high of 6.50% at the beginning of September before falling back again, to 5.41%, at the end of the year. At the beginning of 2007, the bid rate of the government securities with the time to maturity less than one month was 3.76%, reaching 8.25% at the end of the year.

At the end of 2006, the bid rate of the SJSC *Latvijas Hipotēku un zemes banka* bonds (maturing in 2013; the corporate debt security with the longest maturity on the RSE) was 5.18%, standing at 6.10% a year later and reaching a high of 8.00% over the year.

The increase in the interest rates of debt securities was underpinned by the tensions on the foreign exchange market at the beginning of the year and a lower sovereign rating assigned to Latvia – in April and May interest rates reached a high and remained at that level for a longer period. The global financial market turmoil affected the interest rates of debt securities for a shorter period.

The bid rate quoted for Latvian Eurobonds (maturing in 2014) rose from 4.15% at the end of 2006 to 4.77% in 2007. The interest rate spread between the Latvian Eurobonds and the same maturity German government Eurobonds widened from 20 basis points to 56 basis points. Foreign investors became more cautious with respect to Latvian securities, and interest rates on euro-denominated securities rose on account of increasing inflation in Europe and the upward pressure on interest rates.

In 2007, the turnover of debt securities on the RSE was 31.3 million lats (1.1 million lats in the previous year). Government securities (28.8 million lats) dominated the trading, with the first government 10-year bond issue (maturing in 2013) posting the largest amount (the turnover was 17.4 million lats). In the corporate securities sector, the SJSC *Latvijas Hipotēku un zemes banka* mortgage bonds recorded the largest turnover (2.0 million lats). October and November saw the highest trading turnover when part of investors chose to reduce their investment in the securities of the transition economies as the risks on the global financial markets increased.

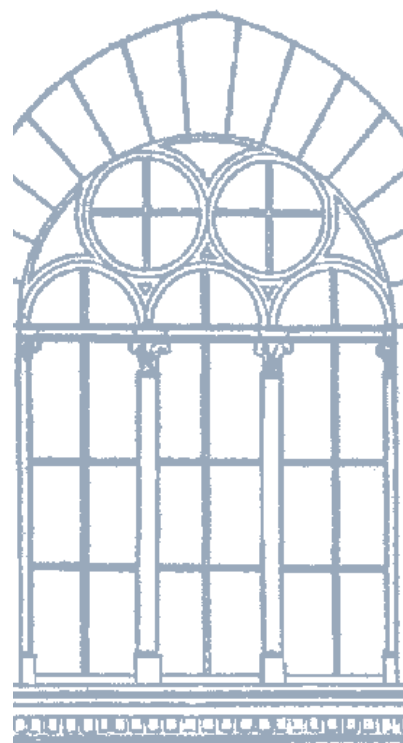
In 2007, the RSE stock turnover was 71.7 million lats (16.4% higher year-on-year), and shares of the Main List accounted for 79.6% of the turnover.

The RSE capitalisation index OMX Riga fell by 9.2% (to 595.3 points) and the Baltic equity index OMXBGI dropped 6.8% (to 515.4 points). By early October, the RSE capitalisation index had reached a 15.3% increase in comparison with the end of 2006 as the Latvian corporate profit indicators were good: despite the considerable increase in costs there were no signs of economic growth moderation. However, in view of the developments on the global stock markets, in October a wave of share selling began on the Latvian corporate stock market as well and the year 2007 ended with a lower price level than at the beginning of the year. Non-residents actively engaged in selling securities, as they expected a fall in emerging market stock prices. The capitalisation of the stock quoted on the RSE increased by 33.1% (to 1.9 billion lats), but this increase in stock capitalisation was mostly related to the fact that the Secondary List and the Free List were combined.

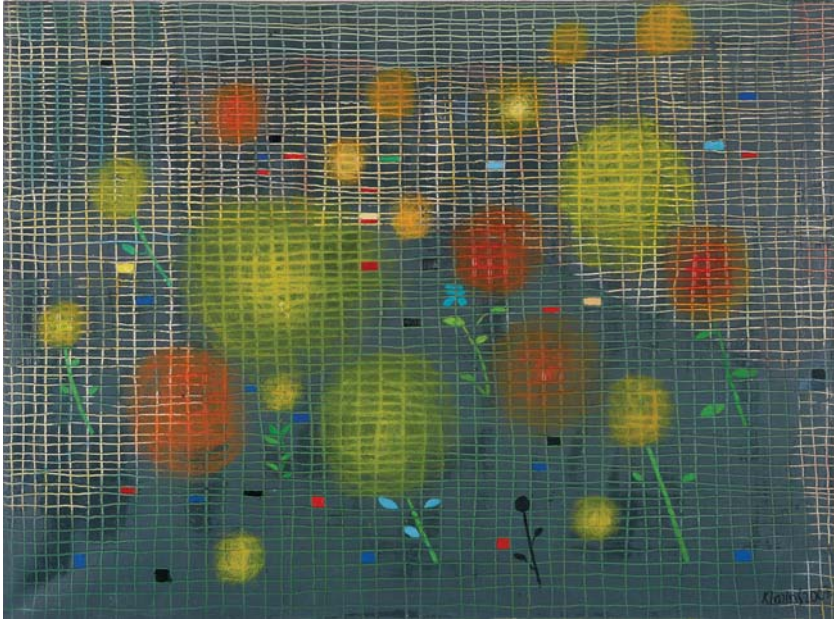
The highest turnover on the RSE was recorded for the shares of the JSC *Latvijas kuģniecība* (21 million lats; 13 million lats in the previous year) and the JSC *Grindeks* (15 million lats; 16 million lats in the previous year).

At the end of 2007, shares of 42 corporations were listed on the RSE (40 corporations at the end of 2006): six corporations were listed on the Main List and 36 corporations were included on the Secondary List. To avoid fragmentation of lists in the Baltics, the Free List was dissolved. On 1 June, *First North*, an alternative marketplace for trading in shares was launched as part of the OMX Nordic alternative market bearing the same name. The alternative market has fewer admission and information disclosure requirements, and a certified adviser helps companies to meet the stock exchange requirements.

On 31 August, trading with futures linked with the Baltic equity index *OMX Baltic 10* (comprising the shares of the 10 most liquid companies quoted on the Baltic stock exchanges) was launched on the OMX Derivatives Stock Exchange. This is the first stock exchange-traded instrument that will provide hedging opportunities against stock price movements in the Baltics.



CENTRAL BANK OPERATIONS AND ACTIVITIES



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

In 2007, the Bank of Latvia continued to operate within the ESCB. The Governor of the Bank of Latvia participated in the ECB General Council meetings on a regular basis. In compliance with the Statute of the ESCB and ECB, at the meetings the ECB General Council discussed macroeconomic, monetary and financial developments in the EU and reports on functioning of the ERM II, as well as addressed other issues concerning the central banks of all EU Member States. In May, the ECB General Council approved the ECB Convergence Report on the readiness of Malta and Cyprus for the introduction of the euro.

The Bank of Latvia's representatives continued to participate in 12 ESCB committees and the Human Resources Conference (see Appendix 8), as well as more than 30 working groups, dealing with issues related to monetary policy, banking supervision, euro banknotes, statistics, accounting, market operations, payment systems, international relations etc. Moreover, in May 2007, the Bank of Latvia hosted the meeting of the Information Systems Security Working Group of the ESCB Information Technology Committee in Riga where the Bank of Latvia and representatives of other EU countries discussed the common vulnerabilities of the ESCB information systems and measures for their prevention.

The Bank of Latvia's experts also participated in several committees and working groups of the Council of the EU and the EC. Sitting on the EFC and its subcommittees, the representatives of the Bank of Latvia regularly participated in the decision-making concerning the economic and financial development of the EU, discussed the preparation of countries for the introduction of the euro, relations with third countries and policies of international financial institutions as well as took part in drafting proposals addressing the economic policy strategy and instruments.

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

In compliance with the provisions of the Statute of the ESCB and ECB, the Bank of Latvia ensured preparation for publishing in Latvian of the ECB Annual Report 2006 and the Convergence Report of May 2007, as well as translation of the quarterly version of the ECB's Monthly Bulletin (published on the Internet).

### STRATEGIC PLANNING

The Bank of Latvia's strategic management process has been improved since the beginning of 2006, taking into account the best practices of corporate management. In September 2007, the Council of the Bank of Latvia approved the Bank of Latvia's strategic guidelines for the next four years. The Bank of Latvia's priority goals and goals of diverse bank's functions are stated in these guidelines. The Bank's priorities are the following:

- price stability and promotion of stability of the financial system. The Bank of Latvia promotes in-depth studies of the economic environment to use the resulting information in its monetary policy decisions;
- preparation for a full-fledged membership of Latvia in the EMU. In cooperation with the government and other institutions, the Bank of Latvia facilitates the implementation of the Maastricht criteria as well as ensures the financial sector

settlement infrastructure, the cash changeover, the necessary amendments to the laws and regulations and full-fledged participation in the ESCB;

– promotion of public awareness of the Bank of Latvia's operation, and the decisions it has taken as well as Latvia's economic development. It is essential for the Bank of Latvia to provide transparent and detailed information on the Bank of Latvia's actions and reasons behind them;

– enhancement of the Bank of Latvia's management processes. The Bank of Latvia proceeds with the improvement of management processes, taking into account the best practices of corporate management;

– improvement of the Bank of Latvia's operational efficiency. The Bank of Latvia balances the timing, quality and costs depending on priority set in each task;

– development of the Bank of Latvia as a learning organisation. It is important for the Bank of Latvia that its employees possess a positive attitude towards work, persist in improving their skills to attain the necessary results, collaborate and share their know-how with colleagues;

– increased staff motivation. The Bank of Latvia wishes to attract, engage and retain highly proficient and creative personnel.

In 2007, the Bank of Latvia fulfilled its main tasks and planned the activities consistently seeking to reach the objectives stated in its strategic guidelines. The accomplished goals have been described in other parts of this Section.

#### **FOREIGN EXCHANGE POLICY AND FOREIGN RESERVES**

Latvia continued to participate in the ERM II to become a full-fledged member of the EMU and introduce the euro. The Maastricht criteria specify that for at least two years prior to the euro changeover the lats is to be pegged to the euro, with the fluctuation of the lats exchange rate against the euro not exceeding  $\pm 15\%$  against the central parity rate of the lats vis-à-vis the euro. The Bank of Latvia has unilaterally ensured the lats exchange rate fluctuations against the euro within  $\pm 1\%$  of the central parity rate. In 2007, the euro exchange rate against the lats fluctuated within the limits of the currency intervention band set by the Bank of Latvia (EUR 1 = LVL 0.6958/0.7098). In March, the exchange rate of the lats was close to the upper limit of the currency intervention band set by the Bank of Latvia and the Bank sold foreign currency, whereas in May and June, the exchange rate of the lats was close to the lower limit of the intervention band set by the Bank of Latvia and the Bank purchased foreign currency.

The Bank of Latvia's foreign reserves, which include gold, convertible foreign currencies and SDR, amounted to 2 786.9 million lats at the end of 2007 (2 417.0 million lats at the end of 2006). The Bank of Latvia generated income by conducting interventions on the foreign exchange market and investing its foreign reserves on the financial markets in compliance with the guidelines approved by the Council of the Bank of Latvia. The guidelines stipulate that the base currency of the benchmark portfolio is the euro and the benchmark currency structure is composed of 50% of euro-denominated assets, 40% of US dollar-denominated assets and 10% of Japanese yen-denominated assets.

The Bank of Latvia invests its foreign reserves in safe and liquid financial instruments, primarily in debt securities issued by governments and government agencies of the euro area countries and the US and international organisations, as well as in highly rated bank and corporate debt securities, asset-backed debt securities and callable bonds. Interest rate futures are used to manage the duration of the reserves. For the purpose of implementing yield curve strategies on the interest

rate market, interest rate swaps are used, whereas foreign exchange forwards are applied to ensure the optimal currency composition of the foreign reserves.

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

The Bank of Latvia used the services of two external reserve managers. They managed a minor portion of the foreign reserves pursuant to the guidelines set by the Council of the Bank of Latvia.

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

### MONETARY POLICY INSTRUMENTS

In 2007, the Bank of Latvia continued to pursue a tight monetary policy. The consequences of the economic imbalances became more pronounced and the external environment was also more complex, both contributing to the changes in the monetary policy measures.

The Bank of Latvia raised the refinancing rate on two occasions in 2007 (by 100 basis points overall). In the second half of February, the concerns about the lats stability arouse and, as a result, a substantial amount of lats was converted to foreign currencies. At the same time, the rate of lending remained high and inflation was on the rise, while risks of a rapid downturn of the economic growth in Latvia or so-called hard landing increased. As of 24 March, the refinancing rate was raised from 5.00% to 5.50% and as of 18 May, to 6.00%. The objectives of raising the refinancing rate were twofold: to safeguard the lats with a more expensive lending facility so as to increase the costs for speculators, as well as to persist in containing the excessive total demand by increasing bank lending costs. On these dates the marginal lending facility rate (previously, the Lombard loan) was raised from 6.00% to 6.50% and 7.50% respectively. The rate of deposit facility (previously, the bank time deposits) remained unchanged (2.0%). The widening of interest rate corridor points to a rise in macroeconomic risks in Latvia. The ECB raised the base rate on two occasions in the course of the year (each time by 25 basis points; from 3.50% to 4.00%). Given the significant role of the euro in the financial sector of Latvia, the lending costs in Latvia are also substantially affected by the euro base rate.

In contrast to 2005 and 2006, when the Bank of Latvia raised the minimum reserve ratio or increased the minimum reserve base of banks, in 2007, the Bank did not change these ratios and hence they remained relatively high. At the end of 2007, 21 banks and four branches of EU Member State banks were subject to the minimum reserve requirements.

The growth rate of currency in circulation was more subdued than in the previous years, whereas the government lats deposits with the Bank of Latvia increased. The average end-of-day balance of the currency in circulation was 1 053.7 million lats in 2007, 11.2% higher year-on-year (the annual growth rate of the average end-of-day balance of the currency in circulation amounted to 21.0% in 2006). The government lats deposits averaged 152.8 million lats in 2007 (2.0 times higher year-on-year).

In 2007, the net amount of euro sold to the Bank of Latvia in foreign exchange transactions was 158.6 million lats, lower than the respective indicator in the previous three years. The amount allotted in the Bank of Latvia's main refinancing operations was 1 810.0 million lats (2.1 times lower than in the previous year). At the same time, the banks' bids in the main refinancing operations increased by 39.4%, reaching 1 453.0 million lats. The average balance of the main refinancing operations stood at 12.3 million lats (15.0% lower year-on-year). The average weighted interest rate on the main refinancing operations (previously, repo transactions with a 7-day maturity) amounted to 6.48% (218 basis points higher year-on-year).

The volume of foreign exchange swaps offered by the Bank of Latvia was 8.5 times higher year-on-year. The allotment amount was 3 237.0 million lats and the bid amount stood at 3 356.0 million lats. The end-of-day balance on foreign exchange swaps averaged 57.7 million lats (0.3 million lats in 2006), while the weighted average interest rate on the euro transactions with a 7-day maturity was 7.68% (4.46% in 2006). The Bank of Latvia increased the volume of foreign exchange swaps to provide the lats liquidity to the banks, at the same time retaining an adequate backing of the lats with foreign currency.

In 2007, the average recourse to the deposit facility amounted to 21.7 million lats, whereas the average recourse to the marginal lending facility rose to 17.3 million lats, with the weighted average interest rate expanding to 6.94%. Thus, considering the changes in the use of standing facilities, liquidity was, on average, lower year-on-year.

As of 24 March 2007, the Bank of Latvia introduced changes in the monetary policy instruments in order to align them with the ECB monetary policy instruments. The Bank of Latvia did not change the name of the key rate, still referred to as the refinancing rate. Lombard loans previously granted with the maturity of up to 1 month were replaced by a marginal lending facility (the loan is issued at the end of the settlement day and repaid in the morning of the next settlement day). The Bank of Latvia introduced a deposit facility instead of the previous bank time deposits with 7- and 14-day maturities. Hence, the transition to only one deposit facility rate and one marginal lending facility rate took place. The new system encouraged the market participants to react rapidly to the liquidity fluctuations. The Bank of Latvia has maintained the bank time deposits as a non-regular monetary policy instrument used in some cases by way of auctions when the absorption of lats liquidity is required on the interbank market. However, bank time deposit auctions were not held in 2007.

As of 24 March, the name of the Bank of Latvia's main refinancing operations has been changed: the main refinancing operations with a 7-day maturity are conducted instead of the previous repos with a maturity of 7- and 28-days. As in the case of the marginal lending facility, shortening the term ensured higher flexibility both to the central bank as a supplier of reserves and the banks borrowing reserves. The Bank of Latvia introduced longer-term refinancing operations with a 3-month maturity, whereas in 2007 these operations were not conducted due to an adequate amount of the structural liquidity of banks. As of 24 March 2007, foreign exchange swaps with 28- and 91-day maturities were suspended, maintaining only transactions with a 7-day maturity. As of the above date, the Bank of Latvia only uses the euro in foreign exchange swaps.

The Bank of Latvia decided to use the refinancing rate as the minimum bid rate at the lats liquidity-providing auctions (the main refinancing operations, longer-term



refinancing operations and foreign exchange swaps when selling the lats with repurchase) and as the maximum bid rate at the lats liquidity-absorbing auctions (time deposit transactions and foreign exchange swaps when purchasing the lats with reselling), thereby strengthening the role of refinancing rate in the monetary policy pursued by the Bank of Latvia.

The frequency of organising auctions remained unchanged. Auctions of main refinancing operations and foreign exchange swaps were conducted on a business day basis, and both of them were liquidity-providing operations, hence no substantial changes in the bank liquidity management process resulted.

As of 24 March, the Bank of Latvia has opened one collateral securities account (the pooling system) for each participant in the monetary policy operations. Previously, collateralised securities were earmarked for each transaction and the collateral value was not recalculated upon effecting the transaction with the Bank of Latvia, while as of 24 March, the total value of liabilities against the Bank of Latvia is calculated for each participant in the monetary policy operations and has been guaranteed by the total collateral securities held in the collateral securities account of the participant. The value of the collateralised securities is recalculated daily in line with the Stock Exchange prices, and only where the total value of collateral falls below the total value of liabilities a margin call is required.

The Bank of Latvia continued to quote RIGIBID (deposit rates on the interbank market) and RIGIBOR (lending rates on the interbank market) in accordance with the Bank of Latvia's "Regulation for the Calculation of RIGIBID and RIGIBOR", including those banks in quotation list that were active on the interbank market and able to conduct market operations at the quoted money market rates on transactions in lats. At the end of 2007, the list of the banks whose money market quotes are used in RIGIBID and RIGIBOR calculations in accordance with the Bank of Latvia's "Regulation for the Calculation of RIGIBID and RIGIBOR" include the JSC *Hansabanka*, the JSC *Latvijas Krājbanka*, the JSC *SEB Latvijas Unibanka*, the JSC *Parex banka*, the JSC *UniCredit Bank*, the Latvian Branch of *Nordea Bank Finland Plc* and the JSC *DnB NORD Banka*.

## ECONOMIC RESEARCH, ANALYSIS AND FORECASTING

A modern central bank cannot effectively pursue monetary policy without focussing on an in-depth analysis of the macroeconomic indicator development trends and their interaction, which in turn is inconceivable without using statistical, mathematical and econometric methods. Economic research and analysis are needed to provide quantitative and scientifically grounded explanations of economic processes, develop econometric models for forecasting macroeconomic indicators and evaluate alternative scenarios.

At the Bank of Latvia, topical issues of the economic research are the following: the analysis of monetary policy transmission, the studying of the causes of inflation, an interaction of the financial and real sector indicators, the competitiveness of Latvia's economy, the medium and short-term forecasting.

In 2007, a number of working papers prepared by the Bank of Latvia's staff and encompassing the most topical issues of Latvia's economy were published on the Bank of Latvia's website (see Appendix 9). On the basis of the results of the consumer survey, inflation expectations in Latvia were quantified and their impact on the actual inflation was assessed in the working paper outlining inflation expectations. Price formation mechanism has been studied by analysing the operation

of enterprises in Latvia. Inflation uncertainty has been described in an individual working paper. The working paper on market for apartments in standard apartment blocks focuses on the correlation among the prices for housing, lending and household purchasing power.

The Bank of Latvia assessed the strategically significant competitiveness of Latvia's exports, disseminating the results of the project at the experts' round-table and the Bank of Latvia's annual conference.

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

### CASH MANAGEMENT

At the end of 2007, currency in circulation diminished by 2.3% as compared with the end of 2006 (from 1 073.9 million lats to 1 049.5 million lats). The declining indicator evidences a reversal of the previous trend. Over the last five years, the currency in circulation has grown 1.7 times.

Banknotes and coins received from banks were checked for authenticity and fitness for circulation by using automated cash processing systems. In 2007, the amount of processed cash (3 340.1 million lats) exceeded that of currency in circulation 3.2 times (2.5 times in 2006). Of the amount of cash processed, 517.0 million lats or 15.5% was withdrawn from circulation (319.1 million lats or 12.0% in 2006).

The total nominal value of counterfeits detected in 2007 (28.1 thousand lats) accounted for only 0.003% of the currency in circulation.

The Bank of Latvia released a new issue of 1-, 2-, 5-, 20- and 50-santims and 1-lats circulation coins and 5-, 20-lats banknotes, as well as 100-lats banknotes with improved security features in 2007.

In 2007, by issuing 1-lats silver collector coins *Foreign Rulers* (in circulation as of 20 March 2007) and *Rebirth of the State* (in circulation as of 7 November 2007), the Bank of Latvia completed the fourth series State of the national collector coin programme *Latvia. Times and Values*. In response to the proposal by Sigulda Region Council and to commemorate the 800th Anniversary of the Sigulda Castle, the 1-lats silver coin *Sigulda* was issued (in circulation as of 25 July 2007), dedicated to one of the most picturesque regions of Latvia. The golden coin *The Golden Apple Tree* (gold of .9999 fineness; in circulation as of 2 October 2007) with the denomination of 1 lats was issued within the international collector coin programme *Treasures of the World*. The logo of the publishing house *Zelta ābele* featured on the coin is a dedication to the Latvian intellectual heritage. To continue the theme of time commenced in 2004, a second 1-lats silver and niobium coin the *Coin of Time II* (in circulation as of 29 November 2007) was issued in 2007. At the end of the year, a special coin featuring creative or original design is traditionally put into circulation. In 2007, the *Coin of Life* with the denomination of 1 lats (in circulation as of 10 December 2007) was issued. Gold plating technique was applied to the minting of the coin.

New special 1-lats coins *Owl Fibula* (in circulation as of 12 June 2007) and *Snowman* (in circulation as of 5 December 2007) replenished the stock of circulation coins.

## BANK OF LATVIA'S BANKNOTES AND COINS PRINTED AND STRUCK IN 2007

## 5 LATS

Face value: 5 lats  
 Size: 130 x 65 mm  
 Colour: green  
 Printed by *Giesecke & Devrient GmbH* (Germany)  
 Artists: Imants Žodžīks,  
 Valdis Ošiņš

*Obverse*

An oak-tree and a stylised oak-leaf (a see-through register) are superimposed on a motif of ornamental suns. Two relief inscriptions of the numeral 5 are imprinted above the oak-leaf. Across the top of the banknote, there is a two-coloured inscription LATVIJAS BANKAS NAUDAS ZĪME (money note of the Bank of Latvia) with the serial number of the banknote inscribed in red below. Across the bottom of the banknote, there are the inscriptions PIECI LATI (five lats) in two-coloured print, LATVIJAS BANKA (Bank of Latvia), the facsimile signature of the Governor of the Bank of Latvia, and the serial number of the banknote in black print. On the right side of the banknote, there is a vertical ornamental band composed of the motif of Lielvārde belt and topped by the numeral 5. The nominal value superimposed on the vertical band is visible when viewed at an angle against light. In the left upper part of the banknote, there is a green relief dot (Braille) and a watermark on a white background. Beneath the watermark, there is a horizontal band incorporating fine green lines in a blend of colours and the numeral 5, under which a band with the text "LATVIJAS BANKA" in micro-lettering is superimposed. The numeral is printed with a special paint creating a colour-changing optical effect depending on the angle of viewing. To the left of the numeral 5, there is a vertical relief band with the relief numeral 5 repeated four times in different shades of colour depending on the angle of viewing.

*Reverse*

A design of an ornamental sun cut in wood is superimposed on a distaff motif. On the left of it, a vertical metallic hologram with the inscriptions of the nominal value is worked into the paper; on the right, there is a stylised oak-leaf. Across the top of the banknote, there is the two-coloured inscription PIECI LATI (five lats) and the numeral 5. At the bottom of the banknote, there is the numeral 5 and the two-coloured inscription LATVIJAS BANKAS NAUDAS ZĪME (money note of the Bank of Latvia). A vertical band with numerals 5 set slantwise and diagonal stripes that shade into one another is on the left of the distaff motif. Along the edge of the band, there is a vertical inscription © LATVIJAS BANKA 1992 (© Bank of Latvia 1992) on a white background. A design of the large coat of arms of the Republic of Latvia with the year 2007 inscribed beneath it is depicted on a white background in the right lower corner of the banknote. Above the coat of arms, the paper is watermarked (a profile of a Latvian folk maid).

## 20 LATS



Face value: 20 lats  
 Size: 130 x 65 mm  
 Colour: brown  
 Printed by Giesecke & Devrient GmbH (Germany)  
 Artists: Imants Žodžiks,  
 Valdis Ošiņš

*Obverse*

An ancient Latvian homestead and a stylised oak-leaf (a see-through register) are superimposed on an ornamental background, with two relief inscriptions of the numeral 20 embedded above. Across the top of the banknote, there is a two-coloured inscription LATVIJAS BANKAS NAUDAS ZĪME (money note of the Bank of Latvia) with the serial number of the banknote inscribed in red below. Across the bottom of the banknote, there are the inscriptions DIVDESMIT LATU (twenty lats) in two-coloured print, LATVIJAS BANKA (Bank of Latvia), the facsimile signature of the Governor of the Bank of Latvia, and the serial number of the banknote in black print. On the right side of the banknote, there is a vertical ornamental band composed of the motif of Lielvārde belt and topped by the numeral 20. The nominal value superimposed on the vertical band is visible when viewed at an angle against light. In the left upper part of the banknote, there are two brown relief dots (Braille) arranged horizontally on a white background, which is watermarked. Beneath the watermark, there is a horizontal band incorporating fine brown lines in a blend of colours and the numeral 20, under which a band with the text "LATVIJAS BANKA" in micro-lettering is superimposed. The numeral is printed with a special paint creating a colour-changing optical effect depending on the angle of viewing. To the left of the numeral 20, there is a vertical relief band with the relief numeral 20 repeated four times in different shades of colour depending on the angle of viewing.

*Reverse*

It depicts a motif of traditional Latvian ornaments. On the left of it, a vertical metallic hologram with the inscriptions of the nominal value is worked into the paper; on the right, there is a stylised oak-leaf. Across the top of the banknote, there is the two-coloured inscription DIVDESMIT LATU (twenty lats) and the numeral 20. At the bottom of the banknote, there is the numeral 20 and the two-coloured inscription LATVIJAS BANKAS NAUDAS ZĪME (money note of the Bank of Latvia). A vertical band with the numerals 20 set slantwise and diagonal stripes that shade into one another is on the left of the ornamental motif. Along the edge of the band, there is a vertical inscription © LATVIJAS BANKA 1992 (© Bank of Latvia 1992) on a white background. A design of the large coat of arms of the Republic of Latvia with the year 2007 inscribed beneath it is depicted on the white background in the right lower corner of the banknote. Above the coat of arms, the paper is watermarked (a profile of a Latvian folk maid).

## 100 LATS



Face value: 100 lats  
 Size: 130 x 65 mm  
 Colour: red  
 Printed by Giesecke & Devrient GmbH (Germany)  
 Artists: Imants Žodžiks,  
 Valdis Ošiņš

*Obverse*

A portrait of Krišjānis Barons and a stylised oak-leaf (a see-through register) are superimposed on a motif of traditional Latvian ornaments. On the left of the portrait, there is a vertical translucent band, which covers the see-through register, and the transparent window above it featuring a red semicircle of the sun on a light background and the letterings "Ls" in four displaced lines on a dark background. There is a silver semicircle of the sun between the transparent window and the see-through register. Across the top of the banknote, there is the inscription LATVIJAS BANKAS NAUDAS ZĪME (money note of the Bank of Latvia). Across the bottom of the banknote, there are the inscriptions SIMT LATU (one hundred lats) in two-coloured print, LATVIJAS BANKA (Bank of Latvia), the facsimile signature of the Governor of the Bank of Latvia, and the serial number of the banknote in black print. On the right side of the banknote, there is a vertical ornamental band composed of the motif of Lielvārde belt and topped by the numeral 100. On the left side of the banknote, there are two relief dots (Braille) in red print arranged diagonally on a white background; there is the serial number in red print on the left of the relief dots, with a watermark incorporated beneath. Below the watermark, there is a horizontal band with the numerals 100 in greyish brown print and the numeral 100 in a larger reddish brown print, which changes to greyish green or brown when the banknote is tilted, and acquires a different shade under the impact of heat.

*Reverse*

It depicts a variety of Lielvārde belt ornaments. A vertical metallic holographic band with the lettering "Ls" and the inscriptions of the nominal value "Ls 100" (a see-through register) on the left of the ornaments and a stylised oak-leaf on the right are worked into the paper. At the top of the banknote, there is the inscription SIMT LATU (one hundred lats) in two-coloured print and the numeral 100. The numeral 100 and the inscription LATVIJAS BANKAS NAUDAS ZĪME (money note of the Bank of Latvia) in two-coloured print are at the bottom of the banknote. A vertical band with the numerals 100 arranged slantwise and diagonal stripes that shade into one another is on the left of the ornaments. Along the edge of the band, there is a vertical inscription © LATVIJAS BANKA 1992 (© Bank of Latvia 1992) on a white background. A design of the large coat of arms of the Republic of Latvia with the year 2007 inscribed beneath it is depicted on a white background in the right lower corner of the banknote. Above the coat of arms, the paper is watermarked (a profile of a Latvian folk maid).



The transparent window on a light and dark background on the obverse (on the left) and reverse (on the right) of the banknote.

## 1 SANTIMS



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

### Obverse

The small coat of arms of the Republic of Latvia, encircled by the inscription LATVIJAS REPUBLIKA • 2007 (Republic of Latvia 2007), is placed in the centre.

### Reverse

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

Edge: plain.

## 2 SANTIMS

Weight: 1.90 g; diameter: 17.00 mm  
 Metal: copper-clad steel  
 Struck by *Koninklijke Nederlandse Munt*  
 (the Netherlands)  
 Artists: Gunārs Lūsis (graphic design),  
 Jānis Strupulis (plaster model)



### Obverse

The small coat of arms of the Republic of Latvia encircled by the inscription LATVIJAS REPUBLIKA • 2007 (Republic of Latvia 2007) is placed in the centre.

### Reverse

The numeral 2 is centred on the coin, with the inscription SANTĪMI arranged in a semicircle beneath it. Two diamond-shaped suns are located on either side of the numeral. At the top of the coin, five arcs (representing the work cycle) join the two diamond-shaped suns.

Edge: plain.

## 5 SANTIMS



Weight: 2.50 g; diameter: 18.50 mm  
 Metal: alloy of copper, nickel and zinc  
 Struck by *Münze Österreich* (Austria)  
 Artists: Gunārs Lūsis (graphic design),  
 Jānis Strupulis (plaster model)

### Obverse

The small coat of the Republic of Latvia encircled by the inscription LATVIJAS REPUBLIKA • 2007 (Republic of Latvia 2007) is placed in the centre.

### Reverse

The numeral 5 is centred on the coin, with the inscription SANTĪMI arranged in a semicircle beneath it. Two diamond-shaped suns are located on either side of the numeral. At the top of the coin, five arcs (representing the work cycle) join the two diamond-shaped suns.

Edge: plain.

## 20 SANTIMS

Weight: 4.00 g; diameter: 21.50 mm  
 Metal: alloy of copper, nickel and zinc  
 Struck by *Real Casa de la Moneda* (Spain)  
 Artists: Gunārs Lūsis (graphic design),  
 Jānis Strupulis (plaster model)



### Obverse

The small coat of the Republic of Latvia encircled by the inscription LATVIJAS REPUBLIKA • 2007 (Republic of Latvia 2007) is placed in the centre.

### Reverse

The numeral 20 is centred on the coin, with the inscription SANTĪMU arranged in a semicircle beneath it. Two diamond-shaped suns are located on either side of the numeral. At the top of the coin, five arcs (representing the work cycle) join the two diamond-shaped suns.

Edge: plain.

## 50 SANTIMS



Weight: 3.50 g; diameter: 18.80 mm  
 Metal: cupro-nickel  
 Struck by *Staatliche Münzen Baden-Württemberg* (Germany)  
 Artists: Gunārs Lūsis (graphic design), Jānis Strupulis (plaster model)

*Obverse*

The small coat of the Republic of Latvia encircled by the inscription LATVIJAS REPUBLIKA • 2007 (Republic of Latvia 2007) is placed in the centre.

*Reverse*

A pine tree seedling, the symbol of bountiful Latvian timber resources, is depicted in the upper part of the coin. A horizontal line separates it from the numeral 50, under which the inscription SANTĪMU is placed in a semicircle.

*Edge:* reeded.

## 1 LATS



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

*Obverse*

The large coat of arms of the Republic of Latvia with the year 2007 inscribed below is placed in the centre. The inscriptions LATVIJAS and REPUBLIKA, each arranged in a semicircle, are above and beneath the central motif respectively.

*Reverse*

A salmon, the symbol of Latvia's abundant water resources, is shown jumping out of the water from left to right. The numeral 1 with the inscription LATS in a semicircle beneath it is centred in the lower part of the coin.

*Edge*

Two inscriptions LATVIJAS BANKA (Bank of Latvia), separated by rhombic dots.

## SPECIAL CIRCULATION COINS OF LIMITED MINTAGE

## OWL FIBULA

Face value: 1 lats  
 Weight: 4.80 g; diameter: 21.75 mm  
 Metal: cupro-nickel  
 Struck by *Münze Österreich* (Austria)  
 Artists: Arvīds Priedīte (graphic design), Jānis Strupulis (plaster model)



## SNOWMAN

Face value: 1 lats  
 Weight: 4.80 g; diameter: 21.75 mm  
 Metal: cupro-nickel  
 Struck by *Münze Österreich* (Austria)  
 Artists: Daina Lapiņa (graphic design), Ligita Franckeviča (plaster model)



## COLLECTOR COINS



## SIGULDA

Face value: 1 lats  
 Weight: 31.47 g; diameter: 38.61 mm  
 Metal: silver of .925 fineness  
 Quality: proof  
 Struck by *Koninklijke Nederlandse Munt* (the Netherlands)  
 Artists: Arvīds Priedīte (graphic design), Jānis Strupulis (plaster model)



### COIN OF LIFE

Face value: 1 lats  
 Weight: 31.47 g; diameter: 38.61 mm  
 Metal: silver of .925 fineness  
 Quality: proof  
 Struck by *Monnaie de Paris* (France)  
 Artists: Ilmārs Blumbergs (graphic design), Ligita Franckeviča (plaster model)



### COIN OF TIME II

Face value: 1 lats  
 Weight: 17.15 g (weight of the central circle – 7.15 g, weight of the outer ring – 10.00 g);  
 diameter: 34.00 mm  
 Metal: the central circle – niobium;  
 the outer ring – silver of .900 fineness  
 Quality: UNC  
 Struck by *Münze Österreich* (Austria)  
 Artists: Laimonis Šēnbergs (graphic design), Jānis Strupulis (plaster model)

## COINS ISSUED WITHIN THE SERIES *STATE OF THE NATIONAL COLLECTOR COIN PROGRAMME LATVIA. TIMES AND VALUES*

### FOREIGN RULERS

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



### REBIRTH OF THE STATE

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



## COIN ISSUED WITHIN THE INTERNATIONAL COLLECTOR COIN PROGRAMME *TREASURES OF THE WORLD*



### THE GOLDEN APPLE TREE

Face value: 1 lats  
 Weight: 1.2442 g; diameter: 13.92 mm  
 Metal: gold of .9999 fineness  
 Quality: proof  
 Struck by *Staatliche Münze Berlin* (Germany)  
 Artists: Laimonis Šēnbergs (graphic design after V. Krastiņš's graphic mark for the publishing house *Zelta ābele*), Jānis Strupulis (plaster model)



## STATISTICS

In 2007, new statistical requirements of the ECB were introduced in the field of financial market and monetary statistics, the methodological work regarding the amendments to the ECB legislation and drafting new legislation continued as well as the statistical information was compiled on a regular basis in accordance with the requirements of the ECB and other data users.

Pursuant to the new Regulation (EC) No 1027/2006 (ECB/2006/8) of the European Central Bank of 14 June 2006 on statistical reporting requirements in respect of post office giro institutions that receive deposits from non-monetary financial institution euro area residents, the ECB had stipulated the data requirements applicable in Latvia to the SJSC *Latvijas Pasts*, hence the Bank of Latvia drafted requirements in 2007 for compiling statistics of financial services provided by the postal institution.

The Bank of Latvia finalised the identification of the new data collection options commenced at the end of 2006 in relation to the amendments to the Regulation (EC) No 2423/2001 (ECB/2001/13) concerning the consolidated balance sheet of the monetary financial institutions sector and Regulation (EC) No 63/2002 (ECB/2001/18) concerning statistics on interest rates applied by monetary financial institutions to deposits and loans vis-à-vis households and non-financial corporations, and collated the results as well as conducted the MFI survey to identify one-off and regular costs of implementing the potential new data requirements in the MFI balance sheet and interest rate statistics. Issues regarding the electronic money institutions were also studied.

Significant methodological work was performed in relation to the drafting of the Regulation (EC) No 958/2007 (ECB/2007/8) of the ECB of 27 July 2007 concerning statistics on the assets and liabilities of investment funds as well as the ECB Guideline (ECB/2003/2) of 6 February 2003 concerning certain statistical reporting requirements of the ECB and the procedures for reporting by the national central banks of statistical information in the field of money and banking statistics. The above Guideline became invalid when the revised ECB Guideline (ECB/2007/9) of 1 August 2007 on monetary, financial institutions and market statistics took effect.

In 2007, the Bank of Latvia finalised the identification of the financial vehicle corporations in accordance with the ECB's OFI statistics project, thereby ascertaining that such corporations have not been established in Latvia so far.

To learn about the methodology for compiling financial and monetary statistics in Latvia, as well as to assess the compliance of the compiled statistics with the ECB requirements, the management of the Monetary, Financial Institutions and Market Statistics Working Group of the ECB's Directorate General Statistics visited the Bank of Latvia in April 2007. The representatives of the ECB gave a positive report specifying some recommendations for the Bank of Latvia regarding further cooperation with other institutions of Latvia collecting and compiling statistical data.

On the ECB initiative the Bank focussed on the activities ensuring continuous preparation and transmission of the statistical data to the users. The Bank of Latvia also paid attention to the issues of compliance with the principle of statistical data confidentiality. To implement the data release plans encompassing changes in on-line publication and establishment of feed-back between the data providers and the central bank in 2008, the Bank of Latvia conducted a survey of MFIs. All MFIs supported both the publishing of the MFIs' detailed balance

sheet data on the Bank's website and transmission of the consolidated data to the data providers.

Although the IMF project for the preparation of financial stability data was finalised in 2006, an ongoing analysis of the project's results was conducted and experience summarised both on the initiative of the IMF and the ECB and within the Nordic-Baltic Constituency.

In 2007, the methodological work in the area of preparing Latvia's balance of payments statistics continued, with the main attention being focussed on improving the securities data collection.

In order to fulfil the requirement of the ECB to use the data on individual securities for the compilation of the balance of payments and provide information to the Centralised Securities Database (CSDB) of the ECB, the Council of the Bank of Latvia approved the "Regulation for Compiling the 'Monthly Report of Holders of Securities' ", according to which credit institutions, excluding the electronic money institutions, and investment brokerage companies will provide information on securities in the breakdown by individual securities held by them and their customers. The Bank of Latvia continued to participate in improving the data quality of the ECB's CSDB, thereby monitoring the data of the securities issued in Latvia and stored in the database as well as verifying the investment certificates issued by the investment funds of Latvia and the list of the ISIN codes of the investment portfolio securities.

The compilation of two new sets of data for transmission to the ECB and IMF has commenced. In accordance with the requirement of the ECB for the compilation of the securities data, the preparation of the Stock Exchange statistics was commenced in 2007, including the data on the number of market participants and detailed information about each list. The data on Latvia's investment shown in the breakdown by country were submitted for the first time to the IMF under the Coordinated Portfolio Investment Survey.

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

For the purpose of harmonising the annual financial accounts statistics compiled by the CSB and the quarterly financial accounts statistics of the EMU prepared by the Bank of Latvia, the aligning of the methodology of the annual financial accounts statistics with the quarterly financial accounts statistics of the EMU was commenced jointly with the CSB on the initiative of the Bank of Latvia in 2007.

The Bank of Latvia continued the regular transmission of statistical data to the BIS and MFI and transmitted statistical information to other domestic and foreign data users. The data transmission to the BIS was improved by expanding the range of Latvia's data in the BIS database.

To furnish timely information to a wide range of data users, the Bank of Latvia changed the term for releasing the financial and monetary statistics as well as the quarterly balance of payments statistics on the Bank of Latvia's website, and now the data on financial and monetary statistics are available within a month after

the end of the reporting period, while the quarterly balance of payments statistics – on the 85th day after the end of the reporting period. The Bank of Latvia disseminated the Latvian financial and balance of payments statistics via its regular publications and the Bank's website, IMF publications *International Financial Statistics* and *Balance of Payments Statistics Yearbook* and within the IMF Special Data Dissemination standard. The Bank of Latvia compiled the data on the Latvian securities market for inclusion in the ECB publication *Bond markets and long-term interest rates in non-euro area Member States of the European Union*. The Bank of Latvia continued to provide regular information on payment system statistics for the ECB publication *Blue Book*, specific macroeconomic indicators for the ECB publication *Orange Book* and structural statistics data for the ECB's Report *EU Banking Structures*.

#### PAYMENT AND SETTLEMENT SYSTEMS

The Bank of Latvia continued to ensure the operation of two payment systems (the SAMS – real-time gross settlement system for interbank and urgent payments and the EKS – clearing and settlement of net positions of batch retail payments). On 19 November 2007, a new payment system TARGET2-Latvija mostly used for large value payments in euro in central bank money commenced its operation.

At the end of 2007, 21 banks, one branch of a foreign bank and the Bank of Latvia were the participants in the Bank of Latvia's payment systems. In 2007, 95.9% of all interbank payments initiated in Latvia in lats were made via the SAMS and their share of value accounted for 98.6% (80.7% and 74.8% in 2006 respectively). The total volume of payments processed in the SAMS increased by 17.8% year-on-year, reaching 234.0 thousand, while their total value rose by 86.6%, amounting to 96.2 billion lats. The SAMS processed both interbank and customer payments and their share of volume accounted for 38.4% and 61.6% respectively, while that of value was 88.5% and 11.5% respectively. In 2007, the average value of a single payment processed in the SAMS rose by 58.4% (to 411.2 thousand lats). The volume concentration ratio of the payments made by the five largest banks in the SAMS was 70.2%, while the payment value concentration ratio stood at 76.8% (67.3% and 73.5% in 2006 respectively). The SAMS ensured 99.69% availability of the system to its participants in 2007 (99.98% in 2006).

In 2007, 74.4% of all customer payments executed by banks in Latvia in lats were processed in the EKS and their share of value accounted for 67.4% (76.0% and 69.9% in 2006 respectively). The total volume of payments processed in the EKS increased by 10.2% (to 30.2 million) and their total value grew by 19.7% (to 12.4 billion lats). The payments made in the EKS were processed in two clearing cycles. The participants in the system mostly used the first clearing cycle, executing 65.4% and 56.0% of all payments in the EKS in terms of volume and value. In 2007, the average value of a single payment in the EKS rose by 8.7% (to LVL 409.93). The volume concentration ratio of the payments made by the five largest banks in the EKS was 76.8% and the payment value concentration ratio stood at 75.2%.

The entire development and testing activities of the new EKS were conducted in 2007 to ensure that pursuant to the strategy for implementation of the euro settlements in the EKS as of 1 January 2008, the Bank of Latvia may commence the processing of euro payments made by the banks in Latvia. In order to ensure the euro settlements in the EKS, the Board of the Bank of Latvia approved the amendments to the "Regulation for Interbank Settlements Effected by the Bank of Latvia" on 13 December 2007.

On 19 November 2007, when the Bank of Latvia along with other seven national central banks of the EU countries joined the European Automated Real-time Gross Settlement Express Transfer System TARGET2, a new interbank euro payment system TARGET2-Latvija commenced its operation. As of that date, Latvia's financial institutions became direct participants in TARGET2, one of the largest payment systems in the world. TARGET2-Latvija is one of the 21 components of TARGET2. Its operation is ensured by the Bank of Latvia in conjunction with other central banks of the ESCB. The Bank of Latvia along with other central banks of the EU countries incorporated TARGET2 Guidelines in the Latvian legislation to ensure uniform requirements for the participation conditions and processing of payments in all components of TARGET2. At the end of 2007, 21 banks, one branch of a foreign bank, the Treasury, the LCD and the Bank of Latvia were direct participants in TARGET2-Latvija. In 2007, 9.6 thousand payments in the total value of 4.3 billion euro were executed in TARGET2-Latvija.

#### PAYMENT SYSTEM OVERSIGHT

The Bank of Latvia continued to oversee the payment system of Latvia. Within the framework of oversight, the Bank of Latvia assessed the efficiency of liquidity usage in the SAMS. The minimum liquidity needs of some banks were analysed, given the current payment value, and the lowest liquidity level required for ensuring efficient settlement of daily payments was forecast. The period from 25 June 2007 to 21 September 2007 was studied and it was concluded that to ensure timely payment settlements, the bank liquidity needs only averaged 10.6% of the current liquidity in the SAMS, or 4.5% for settling payments by the end of the settlement day, thereby applying current procedures of the payment processing and settlement optimisation in the SAMS (payment unblocking, changing priority payments). In addition, the impact of an individual participant in the SAMS on other participants was assessed in the cases where the above participant was unable to send payments for technical or any other reason, thereby accumulating the system's liquidity on its account in the SAMS. It has been concluded that, given the current levels of liquidity, the probability of systemic risk is minimal, whereas if the participants' liquidity is absorbed, other participants in the system would be mostly affected by the participant having the highest node risk.

Pursuant to the Bank of Latvia's Payment System Policy concerning the oversight of retail payment and clearing systems of the Republic of Latvia, the Bank of Latvia has assessed the significance of the SJSC *Latvijas Pasts* Postal payment system and the related infrastructure in accordance with the ECB *Oversight Standards for Euro Retail Payment Systems*. In accordance with the oversight standards, the Postal payment system was not deemed to be a systemically prominent retail payment system as the share of transactions in terms of volume and value (cash transactions 24.8% and 4.2% and customer credit transfers 21.4% and 0.8% respectively) did not amount to that of the prominent system (25%) stipulated by the oversight standards, and the value of payments was minor (only 2.4%) compared with the real-time gross settlement system SAMS. Hence the Postal payment system was not deemed to be a source of financial risks. It may be concluded from the assessment that the Postal payment system is a significant component of the national payment system and due to its ample infrastructure (60.6% of customer payment servicing places in Latvia) the payment services of the SJSC *Latvijas Pasts* can be deemed to be almost irreplaceable. Moreover, 23.0 million payments with the total value of 1.0 billion lats were processed via the SJSC *Latvijas Pasts* in 2007. Therefore, the Bank of Latvia invited the SJSC *Latvijas*

*Pasts* to make self assessment in compliance with the BIS *Core Principles for Systemically Important Payment Systems*.

Nine electronic money institutions that may commence their operation in line with the requirements of the Law "On Credit Institutions" without being granted a licence, had notified the Bank of Latvia by the end of 2007 on the commencement of the operation.

Within the framework of payment system oversight, the Bank of Latvia also collated data on the payment instruments used. As in previous years, customer credit transfers (120.0 million payments or 59.6%) and payments by cards (76.6 million payments or 38.1%) accounted for the majority of all payment instruments used in Latvia in 2007. The value of these payments was 430.3 billion lats and 1.4 billion lats respectively. The value and share of other payment instruments (direct debits, cheques and electronic money) was relatively minor.

Following the request from the ECB, the Bank of Latvia collated data on payments executed in euro through correspondent banks. In order to assess the overall payment flows in Latvia more accurately, the Bank of Latvia, in addition to the above information, also collated data on payments made in lats and other foreign currencies through correspondent banks. The total daily volume of all payments made in loro accounts (accounts opened by a bank for its correspondent banks) by all Latvian banks averaged 1 634 and their total value accounted for 133.0 million lats. In loro accounts, 34.1%, 33.9% and 32.0% of the total volume and 49.2%, 28.3% and 22.5% of the total value of payments were made in lats, euro and other currencies respectively.

For the purpose of harmonising the payment statistics in Latvia with the methodology of the payment statistics outlined in the ECB publication *Payment and Securities Settlement Systems in the European Union (Blue Book)*, the Council of the Bank of Latvia approved the amendments to the "Regulation for Compiling 'Credit Institution Payment Statistics Report' " on 15 March 2007. The updated report provides information on the payments executed both in the national currency and the euro, as well as the cross-border payments made. As of 1 July 2007, banks commenced the data aggregation in line with the new methodology.

## FINANCIAL STABILITY

In 2007, representatives of the Bank of Latvia participated on CEBS, the ESCB's Banking Supervision Committee as well as working groups established by the above committees. These institutions continued working on implementing the capital requirements directive, defining the concept of equity capital, issues related to harmonization of deposit guarantee schemes, developing a common understanding of crisis management, as well as monitoring of structural and conjuncture developments, assessment of the impact of legislation and supervision requirements on the financial stability, and improvement of cooperation between the central banks and supervisory authorities.

Against the backdrop of the mounting instability and tensions on the global financial markets, concerted and coordinated action in potential crisis situations became increasingly important for EU countries. The EU reached an agreement on common practical guidelines for the potential cross-border crisis management and a common analytical framework for assessing the systemic implications of a crisis.

In autumn 2007, the Bank of Latvia participated in the common exercise of the

Nordic-Baltic central banks to assess the practical usage of the mutually concluded memoranda of understanding and those concluded on the EU level.

The year 2007 marked a turning point in Latvia's economic development as along with the implementation of the government anti-inflation plan and with banks tightening their lending policies, the annual growth of bank loans granted to the national economy decelerated considerably in the second half of the year. It resulted in a drop of the activity and prices on the real estate market; a considerable decline was observed in construction and retail trade, and imports shrank. In the situation of economic growth moderation, when income of economic agents and borrowers starts to decrease, credit risk in the financial sector tends to build up. In view of the above, the Bank of Latvia, closely monitoring the processes in the domestic financial sector in cooperation with the FCMC, paid particular attention to the assessment of those macroeconomic developments which could pose potential threats to the banks' stability in due course as the banks persistently retained the major role in financial intermediation.

In autumn 2007, the Bank of Latvia, being aware of the particular importance of lending to the Latvian economic development and their implications to financial stability and monetary policy decision-making, conducted a survey of the major banks granting loans in order to identify changes in the guidelines for granting loans. In the future, the Bank of Latvia will conduct such surveys twice a year by the time Latvia joins the euro area.

#### **OPERATION OF THE REGISTER OF DEBTORS AND ESTABLISHMENT OF THE CREDIT REGISTER**

In 2007, the Bank of Latvia continued to operate the Register of Debtors. The Register of Debtors ensured collection, centralised accumulation and permanent storage of data on the debtors of banks and their subsidiaries registered in the Republic of Latvia and providing financial services associated with credit risk, branches of foreign banks, as well as insurance corporations registered in the Republic of Latvia (hereinafter, the participant) and their obligations in order to make this information available to the participants of the Register, the FCMC and debtors themselves.

Participants submitted information to the Register of Debtors only on those debtors (borrowers or borrower guarantors) who had delayed the payments stipulated in the agreement for more than 60 days and the amount of the entire arrears was at least 100 lats, or had violated any other provision, viewed as significant by the participant, of the loan agreement, guarantee agreement or agreement on execution of the subrogation action, or where the borrowers or borrower guarantors had violated the provisions of Article 73 of the Law "On Credit Institutions".

At the end of 2007, 60 participants had registered with the Register of Debtors and submitted data on 68.8 thousand debtors and 97.6 thousand obligations. From the moment the Register of Debtors was launched on 2 June 2003 until the end of 2007, participants had made 2.76 million requests, and the Bank of Latvia, upon request from natural and legal persons, had provided data from the Register of Debtors in 3 188 cases.

In 2007, the Credit Register of the Bank of Latvia was developed to be launched on 1 January 2008, its task being to collect data not only about debtors but also about borrowers, borrower guarantors and their obligations and thus ensure the development of data base of borrowers' credit history in Latvia.

The Credit Register participants are banks and bank subsidiaries registered in the Republic of Latvia and providing financial services associated with credit risks, branches of foreign banks, insurance corporations and credit unions registered in the Republic of Latvia, as well as the association "Latvian Office of Vehicle Insurance". The Credit Register started its operation, comprising 98 participants. The Credit Register will enable the participants to assess borrowers' credit worthiness more accurately, manage credit risks more efficiently, provide additional opportunities for performing supervisory functions and secure the Bank of Latvia and FCMC's needs for macroeconomic analysis.

The Credit Register contains data on the borrower and borrower's guarantor, detailed information about their obligations (type of obligations, collateral and its value, sector of the economy, type of interest rate, etc.) and performance thereof, as well as about the outstanding obligations at the end of the calendar quarter, the modified and cancelled data, data requests and debtor information. Credit Register information will be available not only to the participants but also to the FCMC, the Bank of Latvia and the borrowers themselves (natural and legal persons).

#### **INFORMATION SYSTEMS**

In 2007, all arrangements were in place to prepare the Bank of Latvia's information system environment for joining TARGET2, the real-time gross settlement system for the euro. On 19 November 2007 Latvia joined the system seamlessly. To support settlements in euro, a new release of electronic clearing system was developed and integrated into TARGET2 in 2007.

The Credit Register, an information system for safe storing of data on borrowers and their liabilities, was developed.

In addition, a new universal auction system for monetary instruments was developed to replace several existing autonomous auction systems, also involving the pooling of the respective transaction-related collaterals and their valuation at market prices.

In 2007, the MFI statistical information system was upgraded to handle the new payment statistics report by credit institutions and investment fund statistics.

The system for preparing the national balance of payments for posting information on the Bank of Latvia's website has been enhanced, allowing a dynamic data selection by various criteria, thus providing the users more convenient and up-to-date methods for viewing and analysing information.

A new statistics system for securities was developed in compliance with the ECB requirements for aggregating the portfolio investments in breakdown by individual security, also including MFI- and brokerage-provided information regarding securities, their issuers and holders. The enhancement of the Bank of Latvia's electronic document management system eDPS was continued, adding a feature for electronic processing of procurement documents.

An in-depth risk analysis of all essential information systems of the Bank of Latvia was conducted on the basis of adapted Information Security Forum methodology. The Bank of Latvia took part in a survey conducted by the Information Security Forum, every two years to assess the compliance and security of the information systems environment of the Forum's members, and received a very positive evaluation.

## INFORMATION TO THE PUBLIC

Inflation and anti-inflation measures, along with the restoration of macro-economic balance, were among the key economy-related topics in 2007. Opinion polls as well as over two thousand publications and stories in the mass media are evidence that inflation is the number one concern of the Latvian population. The Bank of Latvia's communications focused on promoting the awareness of the destructive impact of inflation on sustainable development. The Bank of Latvia undertook a number of actions to help the general public, public administration bodies and financial market participants develop an enhanced understanding of the essence of anti-inflation measures and further steps to be taken by the economic policy-makers.

The Bank of Latvia provided information to and entered into dialogue with the economic policy-makers and theoreticians. The central bank communicated its activities to general public via its publications, website, printed media, TV and radio broadcasts.

The Bank of Latvia's Council monetary policy decisions and the considerations of the Bank's economists form the core of the information that needs to be disseminated quickly, clearly and as widely as possible. The Governor of the Bank of Latvia used to brief the audience at press conferences run immediately after the close of the Bank of Latvia's Council meetings, on the Council's monetary policy decisions and the economic aspects behind them, to offer national macroeconomic development forecasts, and to answer questions from media representatives. Press releases contained information on the Bank of Latvia's monetary and other decisions. The address and the statements by the Governor of the Bank of Latvia were immediately posted on the website to make them accessible to any market participant and other interested parties on the very same day.

The Bank of Latvia's website was improved both in terms of graphic design and the layout of contents; state-of-the-art technological solutions were applied. The upgraded website now features supplementary information to media representatives, researchers and other interested parties on Latvian money and financial topicalities, and provides for searching, receiving and personalising the required information in a more user-friendly manner. In 2007, the first statistical database for posting the national balance of payments on the website was developed, allowing the users to select own criteria for sorting, thus facilitating the viewing and analysis of the data. Webcasts of the conferences on Latvia's economic development and experts' round-table discussions, the most significant events organised by the Bank of Latvia, were also provided. In the autumn of 2007 the webpage section allotted to the Bank's Visitors Centre "Money World" was updated.

The Bank of Latvia's regular publications provided comprehensive information on Latvia's financial sector and the national economy. At the beginning of 2007, the Bank of Latvia published its Annual Report 2006 to provide information on its operations and financial results for that year. Latvia's economic development has been analysed in the context of developments in global economy. The Bank of Latvia's quarterly publications *Monetārais Apskats*. *Monetary Review*, *Latvijas Maksājumu Bilance*. *Latvia's Balance of Payments*, monthly publications *Monetary Bulletin* and *Latvia's Balance of Payments (Key Items)* as well as *Financial Stability Report* play an important role in information dissemination.

The Bank of Latvia organised several analytical discussions focusing on Latvia's economic development. The annual conference *Competitiveness: the Future Corner-*



*stone of the Latvian Economy* was the central event, where academics, experts from public institutions, businessmen and financial experts discussed the potential of Latvia's competitiveness and export growth, including the ways of using the experience and research of other countries. One of the participants, Christian Noyer, Governor of *Banque de France*, gave a speech on the topic of the euro area achievements.

In 2007, the Bank of Latvia established a tradition to call an experts' roundtable several times a year, inviting the participation of economists, sector professionals and media representatives. The objective is to discuss, on the basis of the research done by the Bank of Latvia's staff, the topical and complex issues of the Latvian national economy. Webcasts of the discussions are provided on the Bank of Latvia's website. A total of four experts' roundtables were held in 2007: on developments in real estate market; on relationship between inflation, economic growth and inflation expectations; on development of Latvia's exports; and on the Credit Register as a support to Latvian economy, financial market and borrowers.

The persistent interest in the Bank of Latvia's Visitors Centre "Money World" was largely promoted by its updated section on the Bank of Latvia's website. The Centre had about 8 thousand visitors in 2007. At the end of the year, a survey of school teachers and students was conducted, and 97% of the respondents gave a positive evaluation to the Centre's performance.

In the annual competition of student research papers organised by the Bank of Latvia, the winning authors tackled topics crucial to the national economy, analysing the issues pertaining to productivity, inflation curbing measures and the real estate market. A new competition was announced in the autumn of 2007, enabling the students to combine their academic assignments with the participation in the competition as well as to pick a research topic of importance to the economic policy.

The target audience of the quarterly bulletin *Averss un Reverss* is researchers and financial analysts: the publication analyses the current macroeconomic trends in Latvia and worldwide, e.g. financial markets (including interest rate developments), export growth potential, the components of countering inflation and stabilising economy, the crisis in the USA sub-prime lending market etc.

The said topics have also been discussed in *Naudas zīmes*, a series of broadcasts on the national TV channel (prepared in cooperation with the Bank of Latvia), as well as in *Lata spoguļi*, a sequence of radio broadcasts on financial topics, addressing a vast audience.

## ORGANISATIONAL DEVELOPMENT

The composition of the Council of the Bank of Latvia, as at the end of 2007, was as follows:

- |                           |  |
|---------------------------|--|
| – Governor                | <b>Ilmārs Rimšēvičs;</b>   |
| – Deputy Governor         | <b>Andris Ruselis;</b>   |
| – Members of the Council: | <b>Harijs Bušs,<br/>Leonīds Gricenko,<br/>Vīta Pilsuma,<br/>Arvils Sautiņš,<br/>Aivars Skopiņš,<br/>Valentīna Zeile.</b> |

On 1 November 2007 the Saeima of the Republic of Latvia re-elected Ilmārs Rimšēvičs Governor of the Bank of Latvia for another six-year term starting 21 December 2007.

The Board of the Bank of Latvia, as at the end of 2007, was as follows:

- |                                 |  |
|---------------------------------|--|
| – Chairman of the Board         | <b>Māris Kālis;</b>  |
| – Deputy Chairmen of the Board: | <b>Reinis Jakovļevs,<br/>Helmūts Ancāns<sup>1</sup>;</b>   |
| – Members of the Board:         | <b>Ilze Posuma,<br/>Andris Ņikitins,<br/>Harijs Ozols.</b> |

On 17 May 2007 the Bank of Latvia Council appointed Māris Kālis, a member of the Bank of Latvia's Board, Chairman of the Board as of 16 July 2007.

On 13 September 2007 the Bank of Latvia's Council appointed Ilze Posuma, Head of the Legal Department, to the Bank of Latvia's Board.

At the end of 2007, the Bank of Latvia's staff numbered 643, of which 19 had job contract for a limited period (635 and 33 employees at the end of 2006 respectively). As at the end of 2007, the Bank's staff was 56% male and 44% female.

To ensure exchange of information between the Bank of Latvia and the EU institutions, the Bank of Latvia's special attaché at the Latvia's Mission to the EU continued his work in 2007.

Structural improvements continued at the Bank of Latvia in 2007. The Monetary Policy Department underwent structural changes following the launching of new monetary policy instruments and the streamlining and automating of securities settlement systems. The Securities Settlement Division was closed and its entire functions were transferred to the Market Operations Department. The operational organisation was enhanced simultaneously.

With the growth of cash handling volumes in Riga Branch, the number of cash handlers has been increased. The Personnel Department opened a new position of the Personnel Development Manager with the aim to promote development, motivation and evaluation of the employees. The technical support and security staff numbers have been increased in line with the enhancement of security systems and the changes introduced in operational organisation.

## **PERSONNEL DEVELOPMENT**

For the purposes of personnel development, the Bank of Latvia uses internal and external rotation and personnel training.

Internal rotation allows the employees to enhance their professional skills and build their careers within the Bank of Latvia. As a result of internal recruitment, in 2007 nine employees were promoted and three were appointed replacements for colleagues in longer-term absence.

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<sup>1</sup> Until 17 January 2008.

As a part of the ECB's external work experience scheme, in 2007 two employees were on secondment to the ECB for an up to ten-month period.

Constant improvement of the staff's skills and competencies continues to be a guiding principle of the Bank of Latvia's personnel strategy. The Bank of Latvia and its employees share the responsibility of improving staff qualifications in the pursuit of a consistently high level of professional know-how of the personnel as the ultimate goal.

In 2007, 2.7% of the total expenses on wages, salaries and other personnel costs was spent on personnel training (3.0% in 2006).

The Bank of Latvia employees continued with their academic studies and advanced professional training, participating in seminars, workshops, courses and conferences in Latvia and abroad to keep up with the latest developments in the fields of monetary policy, financial stability, macroeconomics, econometrics, foreign exchange operations, payment systems, statistics, bank accounting and information technologies.

A number of the Bank's employees successfully participated in international professional certification programmes.

The focus of the training continued to be on developing skills that are necessary for successful cooperation of the Bank's personnel with the ECB and the national central banks of other EU countries. As in previous years, employees had the opportunity to take part in workshops organised by the ESCB. They participated in two ESCB workshops on the enhancement of leadership skills and in the ESCB Intro seminar.

The translators and editors of the Bank of Latvia who prepare the Latvian-language editions of the ECB publications participated in a four-day seminar (jointly held by the ECB and the Business and Financial Research Centre of the BA School of Business and Finance) on banking system, monetary policy, risk management and analysis, and financial markets, instruments and analysis.

In-depth studies in the fields of business presentations, corporate communication, business correspondence, lateral thinking continued as did computer skills and foreign language (English, French, German) training.

Special seminars were held for recently hired employees, attended by 70 newcomers to learn about the Bank's tasks and the functions of its structural units. Presenting the key areas of operations of their respective units the speakers in one-day seminars were experts from the Departments of Monetary Policy, Market Operations, Payment Systems, Statistics and Accounting.

The Personnel Department conducted an evaluation of the management competencies as a part of the voluntary annual performance appraisal interviews. A multi-source feedback was applied for this purpose, with direct supervisors, subordinates and colleagues evaluating the managerial competencies of the heads of structural units. The results helped to outline the areas for further improvement. A long-term training project designated for the Bank of Latvia's managers was launched in 2007. The first group comprised 16 new managers with human resource management experience of less than five years. The key topics were increasing the labour efficiency and effectiveness of management, personality development, enhancement of communication skills and development and motivation of subordinates. Considering the positive feedback from the trainees and assessing the training

results, the Bank of Latvia is going to proceed with the training programme for managers in 2008–2010, involving in this project remaining structural unit heads, their deputies and heads of divisions.

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

The Training and Recreation Centre of the Bank of Latvia also hosted the second part of the ESCB seminar "Heading for Leadership" (the first part was run in Dublin). The audience was comprised of the heads of structural units of the central banks of 17 EU Member States.

### **RISK AND QUALITY MANAGEMENT**

In 2007, the Bank of Latvia's Board continued to develop risk management in line with the core principles stipulated in the "The Security Policy of the Bank of Latvia", taking into consideration the development of the financial market and the Bank of Latvia's operation. "The Security Policy of the Bank of Latvia" describes also its oversight. It is the function of the Bank of Latvia's Security Supervision Commission comprising four members of the Bank of Latvia's Council.

The Bank of Latvia's financial risks are managed in line with the "Guidelines for Managing the Bank of Latvia's Foreign Reserves", which the Council of the Bank of Latvia reviews and, if necessary, amends at least once a year.

An analysis of all essential Bank of Latvia's information systems risks was carried out. An analysis of this type will also become part of any information system development or upgrading.

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

In April 2007, the Board reviewed and approved the Bank's risk report as well as reported to the Bank of Latvia's Council on the situation in the area of risk management. Personnel training in the field of information and information system security, operations continuity and risk management also took place.

In 2007, the Bank of Latvia proceeded with the enhancement of its business continuity measures. The main focus was on the documents and routines governing business continuity management; on the business continuity plans for individual structural units, their testing and updating; on incident management and elaboration of the registration details thereof; and on improvements regarding the monitoring the implementation of the Bank of Latvia's business continuity measures. The business continuity plan was upgraded with the view of the changes in the procedures for monetary operations, the launch of TARGET2-Latvija and the Credit Register.

Quality management system is in place in the Bank of Latvia. The Bank of Latvia continued to maintain its quality management system compliant with the ISO 9001:2000 standard.

## INTERNAL AND EXTERNAL AUDIT

After carrying out an unbiased examination of the Bank's functions and processes, the internal audit provides the Bank of Latvia's management with an independent evaluation of the efficiency of risk management, control systems and processes and gives recommendations as to the necessary improvements. The internal audit of the Bank of Latvia is conducted by the Internal Audit Department. An Audit Committee operates in the Bank of Latvia, supervising and helping to improve internal audit.

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

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

In line with "International Standards for the Professional Practice of Internal Auditing" and "Internal Audit Policy of the Bank of Latvia", the internal audit quality assessment has been made in the Internal Audit Department. The quality assessment exercise showed the Internal Audit Department operations to be broadly compliant with the "International Standards for the Professional Practice of Internal Auditing", though there is still room for improvement as far as meeting some of the standards is concerned.

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

## ACCOUNTING AND BUDGET MANAGEMENT

The Bank of Latvia's accounting system has been established and managed in line with the "Financial Accounting Policy of the Bank of Latvia" approved by the Bank of Latvia's Council, "Bank of Latvia Accounting Manual" approved by the Board of the Bank of Latvia and the other regulations of the Bank, in compliance with the Law "On the Bank of Latvia" and other laws and regulations binding on the Bank of Latvia. "Financial Accounting Policy of the Bank of Latvia" was approved in January 2007. The document stipulates that events and financial transactions of the Bank of Latvia relating to the implementation of monetary policy and management of foreign reserves are accounted for in accordance with the principal accounting policies established by the ECB Guideline of 10 November 2006 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2006/16). The Bank of Latvia is not currently a participant of the Eurosystem, but has elected to adopt these principles.

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

The Council of the Bank of Latvia approves the Bank of Latvia's budget; management of the budget proceeds in compliance with the "Regulation for Managing the Bank of Latvia's Budget" approved by the Council of the Bank of Latvia and aimed at ensuring spending efficiency. The Regulation provides for the procedure of drafting, approving and monitoring the execution of the Bank's budget. To support a sovereign functioning of the internal audit, the Bank of Latvia's Council now, starting with 2007, approves a separate expenditure plan for the Bank of Latvia's Internal Audit Department.

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

#### **COOPERATION WITH INTERNATIONAL ORGANISATIONS**

The Bank of Latvia continued to represent Latvia's interests at the meetings of the IMF Board of Governors as well as on a day to day basis.

Latvia's interests in the IMF were represented in the Nordic-Baltic Constituency that includes Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden. One Executive Director represented this constituency on the IMF Executive Board, with a total of 3.52% votes.

Representatives of the Bank of Latvia continued to participate in the work of the Nordic-Baltic Monetary and Financial Committee established for developing strategies and guidelines and preparing a joint opinion on operational issues of the IMF.

Cooperation with the IMF, based on consultations under Article IV of the IMF Articles of Agreement, continued.

In 2007, Latvia continued its activities as a member of the International Bank for Reconstruction and Development, the International Development Association, the International Finance Corporation and the EBRD. The Bank of Latvia continued its membership in the BIS.

## COOPERATION WITH FOREIGN CENTRAL BANKS AND TECHNICAL ASSISTANCE

In 2007, the Bank of Latvia continued its cooperation with the central banks of other countries, sharing expertise and information.

Within the framework of the World Bank technical assistance, in February a staff member of the Accounting Department advised the specialists of the Central Bank of Trinidad and Tobago on issues of accounting practices, financial reporting and information systems. In December, staff members of the Market Operations Department extended their know-how in using information systems for foreign reserve management to the Central Bank of Egypt.

In July, staff members of the Statistics Department shared their expertise with the specialists from the Central Bank of Armenia in the areas of balance of payments, banking and monetary statistics, as well as drafting the report "International Reserves and Foreign Currency Liquidity".

In September, the Market Operations Department organised a seminar for the experts from the National Bank of Georgia on employing information systems for foreign reserve management purposes.

In December, staff members of the Public Relations Department presented the key exhibition design principles and the work methodology practiced by the Bank of Latvia's Visitors Centre "Money World" to the experts from the Central Bank of Armenia.

The Bank of Latvia organised several international meetings. As part of the ongoing pan-Baltic cooperation project of the central banks, the Bank of Latvia organised its regular March seminar for the Baltic central bank experts on the issues of monetary policy, statistics and document management; the focus in its October seminar was on the issues of international cooperation.

In May, the Bank of Latvia hosted the meeting of the Information Systems Security Working Group of the ESCB Information Technology Committee in Riga, attended by experts from the EU countries and the ECB.

In June, the Bank of Latvia organised a meeting for the ESCB IS Network Experts Group on the issues of upgrading and optimisation of the ESCB information systems infrastructure.

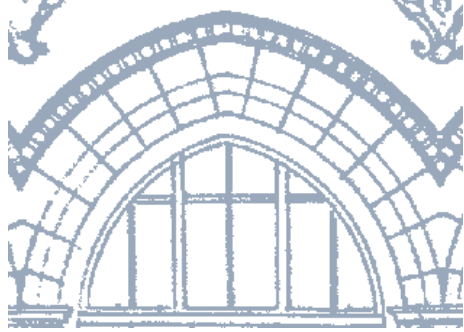
International financial institutions and foreign central banks extended support to the Bank of Latvia, providing opportunities to participate in the workshops and courses hosted by these institutions as well as to obtain consultations on the issues related to the central bank operations.

The Bank of Latvia's employees participated in a number of courses held by the ECB, the IMF Institute and the Joint Vienna Institute as well as seminars organised by the ECB, central banks of the Czech Republic, France, Italy, the UK, the Netherlands, Spain, Switzerland and Germany.

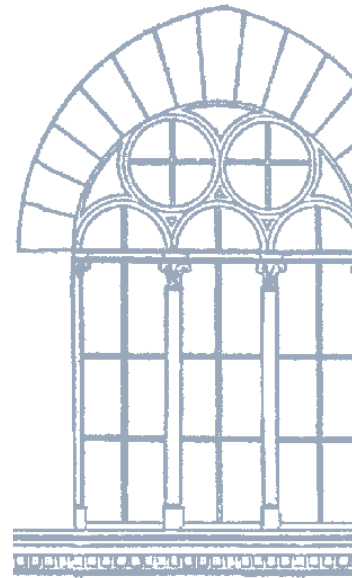
Following the initiative by the Bank of Latvia, the Centre for Central Banking Studies of the Bank of England jointly with experts from Banque de France and De Nederlandsche Bank conducted an international seminar "Monetary Policy Strategies on the Road to the Euro" at the premises of the Training and Recreation

Centre of the Bank of Latvia in June 2007. The seminar was attended by monetary policy experts from the central banks of the Czech Republic, Latvia, Lithuania, Poland, Romania and Ukraine.





**FINANCIAL STATEMENTS OF THE BANK OF LATVIA  
FOR THE YEAR ENDED 31 DECEMBER 2007**



## BALANCE SHEET

66

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

| ASSETS   | Notes <sup>1</sup> | 2007             | 2006 <sup>2</sup> |
|--|--------------------|------------------|-------------------|
| <b>FOREIGN ASSETS</b>  |                    | <b>2 902 787</b> | 2 553 022         |
| Gold   | 4                  | 99 130           | 83 668            |
| Special Drawing Rights   | 6                  | 83               | 85                |
| Convertible foreign currencies                                   | 5                  | 2 687 707        | 2 333 279         |
| International Monetary Fund                                      | 6                  | 95 997           | 101 815           |
| Participating interest in the European Central Bank              | 7                  | 743              | 760               |
| Participating interest in the Bank for International Settlements | 8                  | 1 763            | 1 763             |
| Other foreign assets   | 9                  | 17 364           | 31 652            |
| <b>DOMESTIC ASSETS</b>   |                    | <b>41 172</b>    | 34 873            |
| Loans to credit institutions                                     | 10                 | 6 850            | –                 |
| Fixed assets   | 11                 | 32 646           | 32 763            |
| Other domestic assets  | 12, 13             | 1 676            | 2 110             |
| <b>TOTAL ASSETS</b>  |                    | <b>2 943 959</b> | 2 587 895         |

<sup>1</sup> The accompanying notes set out on pages 72 to 107 are an integral part of these financial statements.

<sup>2</sup> The reconciliation of the Bank of Latvia's balance sheet items for the year ended 31 December 2006 and their recalculations, had the accounting policies referred to in Note 3 been applied in preparing the financial statements for 2006, is provided in Note 41.

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

| LIABILITIES,<br>CAPITAL AND RESERVES                | Notes  | 2007             | 2006      |
|---|--------|------------------|-----------|
| <b>FOREIGN LIABILITIES</b>                          |        | <b>126 783</b>   | 138 656   |
| Convertible foreign currencies                      | 14     | 5 330            | 21 158    |
| International Monetary Fund                         | 6      | 96 212           | 102 044   |
| Other international institution<br>deposits in lats | 15     | 6 049            | 1 348     |
| Foreign bank deposits in lats                       |        | 35               | 448       |
| Other foreign liabilities                           | 16     | 19 157           | 13 658    |
| <b>LATS IN CIRCULATION</b>                          | 17     | <b>1 049 473</b> | 1 073 851 |
| <b>DOMESTIC LIABILITIES</b>                         |        | <b>1 597 218</b> | 1 271 929 |
| Balances due to credit institutions                 | 18     | 1 416 802        | 1 212 263 |
| Balances due to the Government                      | 19     | 171 241          | 49 818    |
| Balances due to other financial<br>institutions     |        | 4 876            | 6 308     |
| Other domestic liabilities                          | 20, 21 | 4 299            | 3 540     |
| <b>CAPITAL AND RESERVES</b>                         |        | <b>170 485</b>   | 103 459   |
| Nominal capital                                     | 22     | 25 000           | 25 000    |
| Reserve capital                                     | 22     | 59 508           | 54 898    |
| Valuation account                                   | 22     | 34 513           | 16 442    |
| Profit of the reporting year                        | 22     | 51 464           | 6 586     |
| European Union grant                                | 22     | –                | 533       |
| <b>TOTAL LIABILITIES,<br/>CAPITAL AND RESERVES</b>  |        | <b>2 943 959</b> | 2 587 895 |
| <b>OFF-BALANCE SHEET ACCOUNTS</b>                   | 33     |                  |           |

The financial statements, which are set out on pages 66 to 107, were authorised by the Board of the Bank of Latvia on 26 February 2008.

#### BOARD OF THE BANK OF LATVIA

M. Kālis

R. Jakovļevs

A. Ņikitins

H. Ozols

I. Posuma

## PROFIT AND LOSS STATEMENT

(in thousands of lats)

|  | Notes | 2007           | 2006 <sup>1</sup>   |
|--|-------|----------------|---------------------|
| <b>INTEREST AND SIMILAR INCOME</b>   |       |                |                     |
| Foreign operations   |       | <b>137 655</b> | 51 268              |
| Gain on investment in debt securities  |       | 90 760         | 46 870              |
| Interest on deposits with foreign credit institutions and other foreign financial institutions |       | 10 625         | 5 268               |
| Gains/losses from derivative financial instruments   |       | 36 054         | -1 081 <sup>2</sup> |
| Dividends on shares in the Bank for International Settlements                                  |       | 216            | 211                 |
| Domestic Operations  |       | <b>3 278</b>   | -3 167              |
| Interest on loans to credit institutions   |       | 2 026          | 644                 |
| Gain on investment in debt securities  |       | -              | -3 811              |
| Interest on derivative financial instruments   |       | 1 252          | -                   |
| <b>INTEREST EXPENSE</b>  |       |                |                     |
| Foreign operations   |       | <b>24 255</b>  | 8                   |
| Interest on deposits   |       | 5              | 8                   |
| Interest on derivative financial instruments   |       | 24 250         | -                   |
| Domestic operations  |       | <b>36 122</b>  | 20 188              |
| Interest on deposits of credit institutions  |       | 24 830         | 16 103              |
| Interest on government deposits  |       | 11 198         | 4 017               |
| Interest on deposits of other financial institutions   |       | 94             | 68                  |
| <b>NET INTEREST AND SIMILAR INCOME</b>   | 23    | <b>80 556</b>  | 27 905              |
| <b>REALISED GAIN ON FOREIGN CURRENCY EXCHANGE TRANSACTIONS</b>                                 | 24    | <b>2 700</b>   | -                   |
| <b>WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS</b>   | 25    | <b>5 862</b>   | -                   |

<sup>1</sup> The reconciliation of the Bank of Latvia's profit and loss statement items for the year ended 31 December 2006 and their recalculations, had the accounting policies referred to in Note 3 been applied in preparing the financial statements for 2006, is provided in Note 41.

<sup>2</sup> Restated to include result on interest rate future contracts, which in the financial statements of 2006 was recorded under the profit and loss statement caption "Gain on investments in debt securities".

| <i>(cont.)</i>   |        | (in thousands of lats) |        |
|--|--------|------------------------|--------|
|  | Notes  | <b>2007</b>            | 2006   |
| <b>OTHER OPERATING INCOME</b>                                  | 26     | <b>1 190</b>           | 712    |
| <b>OTHER OPERATING EXPENSE</b>                                 |        | <b>27 120</b>          | 22 031 |
| Remuneration   | 27     | 12 587                 | 10 207 |
| Social security costs  | 27     | 2 284                  | 1 943  |
| Banknote production and coinage costs                          | 28     | 3 772                  | 1 071  |
| Depreciation and amortisation charges                          | 11, 13 | 3 628                  | 4 077  |
| Maintenance and operation of information systems               |        | 1 548                  | 1 086  |
| Costs of financing the Financial and Capital Market Commission |        | –                      | 240    |
| Other operating expense  | 29     | 3 301                  | 3 407  |
| <b>PROFIT OF THE REPORTING YEAR</b>                            |        | <b>51 464</b>          | 6 586  |

## STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

(in thousands of lats)

|   | Notes | 2007          | 2006   |
|---|-------|---------------|--------|
| <b>RESULT ON REVALUATION</b>                          |       |               |        |
| Result on revaluation of foreign currency and gold    |       | 3 813         | -4 085 |
| Result on revaluation of interest rate swap contracts |       | -98           | -1 074 |
| Result on revaluation of securities                   |       | 8 494         | 8 268  |
| Write-downs on financial assets and positions         |       | 5 862         | -      |
| <b>NET RESULT ON REVALUATION</b>                      | 22    | <b>18 071</b> | 3 109  |
| <b>PROFIT OF THE REPORTING YEAR</b>                   |       | <b>51 464</b> | 6 586  |
| <b>TOTAL</b>  |       | <b>69 535</b> | 9 695  |

## CASH FLOW STATEMENT

(in thousands of lats)

|   | Notes  | 2007           | 2006    |
|---|--------|----------------|---------|
| <b>CASH FLOW FROM OPERATING ACTIVITIES</b>                      |        |                |         |
| Profit of the reporting year                                    |        | <b>51 464</b>  | 6 586   |
| Non-cash transaction adjustments                                | 30 (1) | <b>9 492</b>   | 4 078   |
| Net movements in balance sheet positions                        | 30 (1) | <b>60 740</b>  | 49 710  |
| Net cash and cash equivalents inflow from operating activities  |        | <b>121 696</b> | 60 374  |
| <b>CASH FLOW FROM INVESTING ACTIVITIES</b>                      |        |                |         |
| Decrease of participating interest in the European Central Bank |        | <b>17</b>      | –       |
| Dividends on shares of the Bank for International Settlements   |        | <b>216</b>     | 211     |
| Acquisition of fixed assets                                     |        | <b>–3 038</b>  | –1 192  |
| Acquisition of intangible assets                                |        | <b>–54</b>     | –360    |
| Net cash and cash equivalents outflow from investing activities |        | <b>–2 859</b>  | –1 341  |
| <b>CASH FLOW FROM FINANCING ACTIVITIES</b>                      |        |                |         |
| Profit appropriated to the state budget                         |        | <b>–1 976</b>  | –2 918  |
| Net cash and cash equivalents outflow from financing activities |        | <b>–1 976</b>  | –2 918  |
| <b>NET CASH AND CASH EQUIVALENTS INFLOW</b>                     |        |                |         |
| Cash and cash equivalents at the beginning of the year          | 30 (2) | <b>123 946</b> | 67 831  |
| Cash and cash equivalents at the end of the year                | 30 (2) | <b>240 807</b> | 123 946 |



## 1. PRINCIPAL ACTIVITIES

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

The primary goal of the Bank of Latvia is to maintain price stability in Latvia. Pursuant to the Law "On the Bank of Latvia", its primary tasks are as follows:

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

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

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

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

## 2. RISK MANAGEMENT

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

### FINANCIAL RISKS

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

The Bank of Latvia manages financial risks related to foreign currency and gold reserves (hereinafter, foreign reserves) in accordance with the "Guidelines for Managing the Bank of Latvia's Foreign Reserves" (hereinafter, the Guidelines), as approved by the Council of the Bank of Latvia. Managing of foreign reserves is conducted in compliance with the basic principles set out in the Guidelines,

including preserving the value of foreign reserves, ensuring their liquidity and earning income within the framework of acceptable risk without contradicting to the Bank of Latvia's monetary policy objectives.

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

Parameters for a benchmark portfolio reflecting the return target and acceptable level of financial risks, as well as the target structure of investments are set out for each portfolio type in the Guidelines. On a business day basis, the Risk Management Division of the Market Operations Department monitors the compliance of foreign reserves with the requirements set out in the Guidelines.

For the purpose of financial risk management, the Investment Committee of the Bank of Latvia that develops the investment management strategy, approves the investment tactics and sets detailed limits for financial risks in accordance with the Guidelines has been established. The Investment Committee of the Bank of Latvia reviews the investment strategy once a quarter, and on a weekly basis receives and reviews reports and forecasts for developments in financial markets, which are prepared by foreign reserves investment portfolio managers, and approves the investment management tactics for the forthcoming week.

#### *MARKET RISK*

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

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

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

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

The Bank of Latvia manages interest rate risk arising from foreign reserves by

investing only in financial instruments denominated in the currencies of the OECD countries which have been assigned a definite credit rating.

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

Exposure of the Bank of Latvia to market risk (as at the end of 2007 and 2006) is provided in Notes 35 and 36.

#### *CREDIT RISK*

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

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

Short-term loans granted to domestic credit institutions are secured by collateral of Latvian Government securities (hereinafter, government securities) and such private sector debt securities, which are tradable, have been included on the list of securities according to the requirements established by the Council of the Bank of Latvia. The Market Operations Department reviews the compliance of ratings assigned to issuers of securities on the list referred above with the requirements of the Council of the Bank of Latvia and monitors the adequacy of collateral on a regular basis. Exposure of the Bank of Latvia to credit risk (as at the end of 2007 and 2006) is provided in Notes 38 to 40.

#### *LIQUIDITY RISK*

Liquidity risk is associated with a failure to meet liabilities timely and to dispose of assets close to fair value. The Bank of Latvia manages liquidity risk by investing foreign exchange reserves in liquid debt securities and other financial instruments issued by international institutions, foreign governments and the corporate sector, while investing its gold reserves in short-term deposits with foreign financial institutions. Investments are made so as to ensure timely meeting of the Bank of Latvia's liabilities. The structure of the Bank of Latvia's cash and its equivalents is provided in Note 30. The liquidity profile of the Bank of Latvia's assets and liabilities as at the end of 2007 and 2006 is provided in Note 37.

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

#### *OPERATIONAL RISK*

Operational risk is exposure to financial and non-financial losses resulting from an unexpected interruption of operation, unauthorised use of information or

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

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

The Board of the Bank of Latvia determines the procedure for Bank of Latvia's risk management. "The Regulation for Managing the Bank of Latvia's Risks" covers the procedure for identifying, documenting, assessing and minimising risks. The management of the Bank of Latvia's operational risk is coordinated by the Head of Risk Management.

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

In order to ensure confidentiality, accessibility and integrity, information and relevant technical resources are classified under the internal control system. The Bank of Latvia has appointed owners of information and information systems who are responsible for classification, risk analysis and protection of relevant information or information systems, as well as determination of access rights and their application procedure.

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

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

In order to improve the organisation of the Bank of Latvia's operational activities and to mitigate operational risk, the Bank of Latvia has designed and is continu-

ously developing a quality management system in compliance with the quality management system standard ISO 9001:2000.

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

### 3. PRINCIPAL ACCOUNTING POLICIES

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

#### CHANGES IN ACCOUNTING POLICIES

In January 2007, the Bank of Latvia's Council approved the "Financial Accounting Policy of the Bank of Latvia", which stipulates that events and financial transactions of the Bank of Latvia relating to the implementation of monetary policy and management of foreign reserves are accounted for in accordance with the principal accounting policies established by the ECB Guideline of 10 November 2006 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2006/16). The Bank of Latvia is not currently a participant of the Eurosystem, but has elected to adopt these principles.

These accounting principles have been applied prospectively as of 1 January 2007.

The nature of the principle changes in accounting policies is as follows:

- (a) the amortised discount or premium on securities is reported in the profit and loss statement as interest income. In the financial statements for 2006, the discount or premium on securities is included in the result on revaluation of these securities and is reported under the balance sheet caption "Valuation account" until disposal of these securities;
- (b) forward exchange rate contracts and foreign exchange swaps are valued by applying the exchange rate of the respective foreign currency set by the Bank of Latvia at the end of the reporting period to the spot equivalent of each leg of transaction. In the financial statements for 2006, these transactions were recorded at fair value by applying the exchange rate of the respective foreign currency set by the Bank of Latvia at the end of the reporting period to the discounted cash flows;
- (c) the difference between the spot and forward rates of forward exchange rate contracts and currency swap arrangements is recognised in the profit and loss statement as interest income or interest expense. In 2006, the exchange rate difference was recorded under the balance sheet caption "Valuation account" within the framework of the overall fair value valuation of the respective transactions;
- (d) interest on interest rate swap arrangements is recognised in the profit and loss statement as interest income or interest expense. In the financial statements for 2006, this interest was recorded under the balance sheet caption "Valuation account" within the framework of overall fair value valuation of the respective transactions;
- (e) realised gains and losses on foreign exchange transactions are recognised in the profit and loss statement. In the financial statements for 2006, the total result on foreign exchange transactions is recorded under the balance sheet caption "Valuation account";
- (f) unrealised losses on securities, interest rate swap arrangements and the net foreign currency position are recognised in the profit and loss statement at the end of the year, if they exceed previously recorded revaluation gains of the respective financial instrument or currency position, while unrealised gains are

recorded under the balance sheet caption "Valuation account". In the financial statements for 2006, unrealised losses on the above instruments are recorded under the balance sheet caption "Valuation account".

To preserve a consistent recognition of gains or losses arising from the Bank of Latvia's financial instruments outstanding as at 31 December 2006, the following transitional provisions are applied:

- (a) valuation differences on financial derivative instruments resulting from the first-time application of the "Financial Accounting Policy of the Bank of Latvia" are recorded in the balance sheet caption "Valuation account";
- (b) upon recognition of the gains and losses on the financial derivative instruments in the profit and loss statement or the balance sheet caption "Valuation account", such gains and losses are offset with the revaluation result accumulated by 31 December 2006 for the respective financial instruments in the balance sheet caption "Valuation account";
- (c) the securities revaluation result accumulated by 31 December 2006 in the balance sheet caption "Valuation account" is recognised in the profit and loss statement taking into account the amount of the securities disposed of;
- (d) market prices and foreign exchange rates effective at the time of the change in accounting policy are considered as the average cost of financial assets and financial liabilities.

The accounting policy of collector coins was changed in November 2007, stipulating that the nominal value of the issued collector coins is not included in the balance sheet liabilities. Proceeds from sales of collector coins are recognised in the profit and loss statement when incurred. The accounting principle has been applied prospectively as of 1 January 2007.

The reconciliation of financial statement items for 2006 with the respective items restated due to the change in accounting policies is provided in Note 41.

#### BASIS OF PRESENTATION

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

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

Details of accounting policies are set out in Note 3 to these financial statements.

#### BASIS OF MEASUREMENT

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

#### USE OF ESTIMATES

Estimates and assumptions have been made in the preparation of the financial statements that affect the amounts of certain assets, liabilities and contingent liabilities reported in the financial statements. Future events may affect the above mentioned estimates and assumptions. The effect of a change in such estimates

and assumptions is reported in the financial statements of the reporting period and each particular future period to which it refers.

#### FOREIGN CURRENCY TRANSLATION

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

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

The principal exchange rates of foreign currencies and gold set by the Bank of Latvia and used in the preparation of the balance sheet for the year ended 31 December 2007 and the year ended 31 December 2006 are as follows:

|                              | (at the end of the year) |          |             |
|------------------------------|--------------------------|----------|-------------|
|                              | 2007                     | 2006     | Changes (%) |
| Euro (EUR)                   | <b>0.702804</b>          | 0.702804 | –           |
| US dollar (USD)              | <b>0.484</b>             | 0.536    | –9.7        |
| Japanese yen (JPY)           | <b>0.00424</b>           | 0.00451  | –6.0        |
| Gold (XAU)                   | <b>398.591</b>           | 336.421  | 18.5        |
| Special Drawing Rights (XDR) | <b>0.759</b>             | 0.805    | –5.7        |

#### RECOGNITION AND DERECOGNITION OF FINANCIAL ASSETS AND LIABILITIES

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

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

#### FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

Fair value of the Bank of Latvia's financial assets and financial liabilities at the end of 2007 and 2006 did not differ materially from the reported book value of the respective assets and liabilities.

#### OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

#### GOLD

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

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

#### SECURITIES

Debt securities of foreign issuers and Latvian government securities are stated at fair value in the balance sheet.

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

#### REVERSE REPURCHASE AGREEMENTS

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

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

#### REPURCHASE AGREEMENTS

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

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



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

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

## PARTICIPATING INTEREST

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

## FINANCIAL DERIVATIVES

The Bank of Latvia enters into commitments involving forward exchange rate contracts, currency and interest rate swap arrangements, and interest rate future contracts, which are reported in off-balance sheet accounts at their contract or notional amount. Forward exchange rate contracts and currency swap arrangements are included in the net position of the respective currency on transaction day at the spot rate of the transaction and are recorded in the balance sheet in lats at the exchange rate of the respective currency set by the Bank of Latvia at the end of the reporting period. Other financial derivatives are reported in the balance sheet at fair value.

Interest on financial derivatives, including the spot and forward interest rate spread of forward exchange rate contracts and currency swap arrangements, are recognised in the profit and loss statement as interest income or interest expense. Any gain or loss arising from a change in fair value of interest rate future contracts is included in the profit and loss statement upon settlement. Any gain or loss arising from a change in fair value of other financial derivatives is credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 3 under "Recognition of profit or loss on the financial instruments".

## ACCRUED INTEREST INCOME AND EXPENSE

Accrued interest income on debt securities of foreign issuers and Latvian government securities are reported under the balance sheet caption "Convertible foreign currencies" or "Government securities", respectively. Accrued interest income and expense on other financial instruments are reported under relevant balance sheet captions of other assets or other liabilities.

## FIXED ASSETS

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

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

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

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

|                              | (%)   |       |
|------------------------------|-------|-------|
|                              | 2007  | 2006  |
| Buildings                    |       |       |
| – structures                 | 1     | 1     |
| – outer finishing            | 5     | 5     |
| – interior decorations       | 5–20  | 5–20  |
| – engineering communications | 5     | 5     |
| – other components           | 10–20 | 10–20 |
| Improvement of territory     | 10    | 10    |
| Transport vehicles           | 10    | 10–20 |
| Office furniture             | 10    | 10    |
| Computer equipment           | 20–33 | 20–33 |
| Other office equipment       | 20    | 20    |
| Cash processing equipment    | 10–20 | 10–20 |
| Tools                        | 50    | 50    |
| Other fixed assets           | 7–20  | 10–20 |

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

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

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

#### INTANGIBLE ASSETS

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

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

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

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

#### IMPAIRMENT OF ASSETS

With a view to detecting any indications of impairment of an asset, the Bank of Latvia's organisational units assess the quality of the Bank of Latvia's assets that have not been recognised at their fair value on a regular basis. Upon detecting

any indications of impairment of an asset, the recoverable amount of the respective asset is estimated. If the recoverable amount is less than the carrying amount of the respective asset, adequate allowances for the relevant asset are made. Such allowances are recognised in the profit and loss statement with a respective reduction in the asset's carrying amount.

#### LATS IN CIRCULATION

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

#### GOLD CIRCULATION COINS

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

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

#### COLLECTOR COINS

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

#### PROVISIONS

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

#### CASH AND CASH EQUIVALENTS

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

#### RECOGNITION OF PROFIT OR LOSS ON FINANCIAL INSTRUMENTS

Gain or loss on financial instruments shall be recognised in accordance with the following principles:

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

reporting year shall not be reversed and offset by unrealised gains of the respective financial instrument, foreign currency or gold holding in the subsequent years; (e) there shall be no netting of unrealised losses in a financial instrument, foreign currency or gold holding against unrealised gains in other financial instrument, foreign currency or gold holding.

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

#### INTEREST AND SIMILAR INCOME AND EXPENSE

Interest income and expense are recognised in the profit and loss statement on an accrual basis. Dividends on participating interest are recognised in the profit and loss statement when received.

Interest and similar income includes interest on acquired securities, deposits, loans granted as a result of monetary operations, forward exchange rate contracts, currency and interest rate swap arrangements, as well as the result on disposal of debt securities, the result on changes in the fair value of interest rate future contracts, and dividends on BIS shares. Interest on acquired securities also includes premium and discount, which is amortised over the remaining life of the respective securities using the straight-line method.

Interest expense includes interest on deposits received from the Latvian Government, domestic credit institutions and other financial institutions, as well as forward exchange rate contracts, and currency and interest rate swap arrangements.

#### BANKNOTE PRODUCTION AND COINAGE COSTS

Banknote production and coinage costs are charged to the profit and loss statement when incurred.

#### OTHER EXPENSE AND INCOME

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

### 4. GOLD

Movements in gold reserves in 2007 and 2006 were as follows:

|                               | Troy ounces    | Amount in thousands of lats |
|-------------------------------|----------------|-----------------------------|
| As at 31 December 2005        | 248 701        | 76 170                      |
| Increase in gold market value | x              | 7 498                       |
| As at 31 December 2006        | 248 701        | 83 668                      |
| Increase in gold market value | x              | 15 462                      |
| <b>As at 31 December 2007</b> | <b>248 701</b> | <b>99 130</b>               |

The Bank of Latvia hedges the risk related to fluctuations in gold reserves market value by entering into forward exchange rate contracts (see also Note 35).

## 5. CONVERTIBLE FOREIGN CURRENCIES

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

The carrying amount of interest bearing debt securities includes both interest income purchased at the date of acquisition and interest income accrued subsequent to the date of acquisition of securities (24 658 thousand lats at the end of 2007 and 22 972 thousand lats at the end of 2006).

At the end of 2007 and 2006, the balance sheet asset caption "Convertible foreign currencies" was comprised of the following assets:

|  | (in thousands of lats) |           |
|--|------------------------|-----------|
|  | 2007                   | 2006      |
| Debt securities of foreign governments, financial institutions and non-financial corporations  | <b>2 398 148</b>       | 2 209 333 |
| Demand deposits with foreign central banks, credit institutions and international institutions | <b>223 530</b>         | 116 298   |
| Time deposits with foreign credit institutions and other foreign financial institutions        | <b>63 564</b>          | 7 504     |
| Foreign currency in cash   | <b>2 465</b>           | 144       |
| <b>Total</b>   | <b>2 687 707</b>       | 2 333 279 |

## 6. INTERNATIONAL MONETARY FUND

Claims on the IMF include SDR and Latvia's quota in the IMF. SDR is an international reserve asset created by the IMF and used in transactions between the IMF and its members. The quota in the IMF reflects the subscription in the IMF of respective members. Latvia's quota in the IMF is secured by the Latvian Government promissory note issued to the IMF and is recorded as an asset denominated in SDR. The total Latvian quota in the IMF is 126 800 thousand SDR. The Latvian Government has paid up share of Latvia's quota in the IMF in the amount of 322 thousand SDR. The unpaid share of Latvia's quota in the IMF is recognised in the balance sheet in the amount of 126 478 thousand SDR (95 997 thousand lats).

Liabilities to the IMF consist of the IMF holdings in lats, which are the resources at the disposal of the IMF held on its accounts with the Bank of Latvia and used in the IMF transactions.

At the end of 2007 and 2006, net claims on the IMF were as follows:

|                                | (in thousands of lats) |          | (in thousands of SDR) |          |
|--------------------------------|------------------------|----------|-----------------------|----------|
|                                | 2007                   | 2006     | 2007                  | 2006     |
| Total Latvian quota in the IMF | <b>96 241</b>          | 102 074  | <b>126 800</b>        | 126 800  |
| IMF holdings in lats           | <b>-96 212</b>         | -102 044 | <b>-126 762</b>       | -126 762 |
| incl. No. 2 Account            | <b>13</b>              | 14       | <b>17</b>             | 17       |
| Reserve position in IMF        | <b>42</b>              | 44       | <b>55</b>             | 55       |
| Special Drawing Rights         | <b>83</b>              | 85       | <b>109</b>            | 105      |
| <b>Net claims on IMF</b>       | <b>125</b>             | 129      | <b>164</b>            | 160      |

The reserve position in the IMF is a difference between the total Latvian quota in the IMF and the IMF holdings in lats, excluding the balance of No. 2 Account, which is used for the IMF administrative expenditure and receipts.

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

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

With Latvia's accession to the EU, the Bank of Latvia became a subscriber of the capital of the ECB. In accordance with the Statute of the ESCB and the ECB, the share of the Bank of Latvia in the ECB's capital was calculated on the basis of the EU states' population and GDP data and is adjusted every five years or at shorter intervals depending on changes in the number of the EU Member States. The share of the Bank of Latvia in the ECB's capital by 1 January 2007 was 0.2978%, which corresponds to 16 572 thousand euro (11 647 thousand lats).

On 1 January 2007, Bulgaria and Romania joined the EU; consequently, the share of the Bank of Latvia in the ECB's capital shrank to 0.2813% which corresponds to 16 205 thousand euro (11 389 thousand lats). As Latvia does not participate in the euro area, pursuant to the transitional provisions of the Statute of the ESCB and the ECB, the Bank of Latvia has paid up a minimal 7% contribution of its total subscribed capital in the ECB amounting to 1 134 thousand euro or 743 thousand lats (see also Note 34).

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

At the end of 2007 and 2006, the Bank of Latvia owned 1 070 shares in the BIS, which corresponds to 0.20% of the total subscribed and paid-up BIS capital.

The nominal value of the Bank of Latvia's shareholding in the BIS is 5 350 thousand SDR (the nominal value per share is 5 thousand SDR), paid up in the amount of 25% or 1 338 thousand SDR (see also Note 34). The deemed cost of this holding as at 31 December 2007 and 31 December 2006 is reported in the Bank of Latvia's balance sheet in the amount of 1 763 thousand lats.

#### 9. OTHER FOREIGN ASSETS

At the end of 2007 and 2006, other foreign assets consisted of the following items:

|  | (in thousands of lats) |               |
|--|------------------------|---------------|
|  | 2007                   | 2006          |
| Non-traded financial derivative contracts and spot exchange rate contracts with foreign financial institutions | 16 523                 | 31 087        |
| Interest accrued on deposits   | 217                    | 6             |
| Prepaid expense  | 250                    | 268           |
| Advance payment for delivered goods  | 325                    | 269           |
| Other  | 49                     | 22            |
| <b>Total</b>   | <b>17 364</b>          | <b>31 652</b> |

## 10. LOANS TO CREDIT INSTITUTIONS

At the end of 2007, loans to domestic credit institutions included the main refinancing operations totalling 6 850 thousand lats. No loans had been granted to credit institutions as at the end of 2006.

## 11. FIXED ASSETS

The following changes in fixed assets took place in 2007 and 2006:

|  | (in thousands of lats)                                |                                      |                                 |                       |                          |               |
|--|---|--------------------------------------|---------------------------------|-----------------------|--------------------------|---------------|
|  | Buildings<br>improvement<br>of territory,<br>and land | Furniture<br>and office<br>equipment | Cash<br>processing<br>equipment | Transport<br>vehicles | Other<br>fixed<br>assets | Total         |
| <b>As at 31 December 2005</b>          |   |                                      |                                 |                       |                          |               |
| Cost                                   | 31 124  | 6 249                                | 4 100                           | 1 210                 | 4 516                    | 47 199        |
| Accumulated depreciation               | -2 084  | -4 151                               | -2 145                          | -761                  | -3 180                   | -12 321       |
| Net book value                         | 29 040  | 2 098                                | 1 955                           | 449                   | 1 336                    | 34 878        |
| <b>During 2006</b>                     |   |                                      |                                 |                       |                          |               |
| Additions                              | 359   | 398                                  | 140                             | 26                    | 269                      | 1 192         |
| Change in classification               | -238  | 373                                  | -                               | -                     | -135                     | -             |
| Disposals                              | -   | -135                                 | -                               | -123                  | -                        | -258          |
| Net change in cost                     | 121   | 636                                  | 140                             | -97                   | 134                      | 934           |
| Depreciation charge                    | -1 708  | -679                                 | -248                            | -93                   | -578                     | -3 306        |
| Change in classification               | -10   | -15                                  | -                               | -                     | 25                       | -             |
| Accumulated depreciation on disposals  | -   | 134                                  | -                               | 123                   | -                        | 257           |
| Net change in accumulated depreciation | -1 718  | -560                                 | -248                            | 30                    | -553                     | -3 049        |
| <b>As at 31 December 2006</b>          |   |                                      |                                 |                       |                          |               |
| Cost                                   | 31 245  | 6 885                                | 4 240                           | 1 113                 | 4 650                    | 48 133        |
| Accumulated depreciation               | -3 802  | -4 711                               | -2 393                          | -731                  | -3 733                   | -15 370       |
| Net book value                         | 27 443  | 2 174                                | 1 847                           | 382                   | 917                      | 32 763        |
| <b>During 2007</b>                     |   |                                      |                                 |                       |                          |               |
| Additions                              | 971   | 478                                  | 1 225                           | 47                    | 317                      | 3 038         |
| Disposals                              | -   | -514                                 | -24                             | -128                  | -182                     | -848          |
| Net change in cost                     | 971   | -36                                  | 1 201                           | -81                   | 135                      | 2 190         |
| Depreciation charge                    | -1 766  | -658                                 | -247                            | -72                   | -410                     | -3 153        |
| Accumulated depreciation on disposals  | -   | 513                                  | 24                              | 128                   | 181                      | 846           |
| Net change in accumulated depreciation | -1 766  | -145                                 | -223                            | 56                    | -229                     | -2 307        |
| <b>As at 31 December 2007</b>          |   |                                      |                                 |                       |                          |               |
| Cost                                   | 32 216  | 6 849                                | 5 441                           | 1 032                 | 4 785                    | 50 323        |
| Accumulated depreciation               | -5 568  | -4 856                               | -2 616                          | -675                  | -3 962                   | -17 677       |
| <b>Net book value</b>                  | <b>26 648</b>   | <b>1 993</b>                         | <b>2 825</b>                    | <b>357</b>            | <b>823</b>               | <b>32 646</b> |

## 12. OTHER DOMESTIC ASSETS

At the end of 2007 and 2006, other domestic assets consisted of the following items:

|                   | (in thousands of lats) |       |
|-------------------|------------------------|-------|
|                   | 2007                   | 2006  |
| Intangible assets | 1 371                  | 1 832 |
| Prepaid expense   | 135                    | 134   |
| Other             | 170                    | 144   |
| Total             | 1 676                  | 2 110 |

## 13. INTANGIBLE ASSETS

Intangible assets include the rights to use software acquired by the Bank of Latvia and other rights.

The following changes in intangible assets took place in 2007 and 2006:

|   | (in thousands of lats) |              |
|---|------------------------|--------------|
| As at 31 December 2005                          |                        |              |
| Cost  |                        | 4 118        |
| Accumulated amortisation                        |                        | -1 875       |
| Net book value                                  |                        | 2 243        |
| During 2006                                     |                        |              |
| Additions                                       |                        | 360          |
| Disposals                                       |                        | -167         |
| Net change in cost                              |                        | 193          |
| Amortisation charge                             |                        | -771         |
| Accumulated amortisation on disposals           |                        | 167          |
| Net change in accumulated amortisation          |                        | -604         |
| As at 31 December 2006                          |                        |              |
| Cost  |                        | 4 311        |
| Accumulated amortisation                        |                        | -2 479       |
| Net book value                                  |                        | 1 832        |
| <b>During 2007</b>                              |                        |              |
| Additions                                       |                        | 54           |
| Derecognised assets                             |                        | -615         |
| Net change in cost                              |                        | -561         |
| Amortisation charge                             |                        | -475         |
| Accumulated amortisation on derecognised assets |                        | 575          |
| Net change in accumulated amortisation          |                        | 100          |
| <b>As at 31 December 2007</b>                   |                        |              |
| Cost  |                        | 3 750        |
| Accumulated amortisation                        |                        | -2 379       |
| <b>Net book value</b>                           |                        | <b>1 371</b> |



#### 14. CONVERTIBLE FOREIGN CURRENCIES

Convertible foreign currency liabilities consist of funds on the EC account for settlements in euro as well as liabilities to other foreign institutions; the respective account is used by the EC for the distribution of EU budgetary funds (see also Note 15).

At the end of 2007, the balance sheet liability caption "Convertible foreign currencies" included demand deposits of the EC in the amount of 5 330 thousand lats (21 158 thousand lats at the end of 2006).

#### 15. OTHER INTERNATIONAL INSTITUTION DEPOSITS IN LATS

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

At the end of 2007 and 2006, the breakdown of deposits of other international institutions in lats was as follows:

|                                     | (in thousands of lats) |       |
|-------------------------------------|------------------------|-------|
|                                     | 2007                   | 2006  |
| European Commission demand deposits | 5 819                  | 1 051 |
| Other deposits                      | 230                    | 297   |
| <b>Total</b>                        | <b>6 049</b>           | 1 348 |

#### 16. OTHER FOREIGN LIABILITIES

At the end of 2007 and 2006, other foreign liabilities consisted of the following items:

|  | (in thousands of lats) |        |
|--|------------------------|--------|
|  | 2007                   | 2006   |
| Non-traded financial derivative contracts and spot exchange rate contracts with foreign financial institutions | 18 874                 | 13 436 |
| Accrued expense  | 244                    | 182    |
| Other  | 39                     | 40     |
| <b>Total</b>   | <b>19 157</b>          | 13 658 |

## 17. LATS IN CIRCULATION

At the end of 2007 and 2006, the following units of lats (LVL) and santims (s) were in circulation:

| Nominal                   | Amount<br>(in thousands<br>of lats) |           | Number<br>(in thousands<br>of units) |         | Percentage<br>(%) |       |
|---------------------------|-------------------------------------|-----------|--------------------------------------|---------|-------------------|-------|
|                           | 2007                                | 2006      | 2007                                 | 2006    | 2007              | 2006  |
| <b>Banknotes</b>          |                                     |           |                                      |         |                   |       |
| LVL 500                   | <b>143 413</b>                      | 179 559   | <b>287</b>                           | 359     | <b>13.7</b>       | 16.7  |
| LVL 100                   | <b>170 275</b>                      | 201 953   | <b>1 703</b>                         | 2 020   | <b>16.2</b>       | 18.8  |
| LVL 50                    | <b>68 481</b>                       | 70 500    | <b>1 370</b>                         | 1 410   | <b>6.5</b>        | 6.6   |
| LVL 20                    | <b>458 353</b>                      | 429 028   | <b>22 918</b>                        | 21 451  | <b>43.9</b>       | 40.0  |
| LVL 10                    | <b>79 128</b>                       | 76 298    | <b>7 913</b>                         | 7 630   | <b>7.5</b>        | 7.1   |
| LVL 5                     | <b>73 922</b>                       | 68 473    | <b>14 784</b>                        | 13 695  | <b>7.0</b>        | 6.4   |
| Total banknotes           | <b>993 572</b>                      | 1 025 811 | <b>x</b>                             | x       | <b>94.8</b>       | 95.6  |
| <b>Coins</b>              |                                     |           |                                      |         |                   |       |
| LVL 100                   | <b>404</b>                          | 404       | <b>4</b>                             | 4       | <b>0</b>          | 0     |
| LVL 10                    | <b>145</b>                          | 145       | <b>14</b>                            | 14      | <b>0</b>          | 0     |
| LVL 5                     | <b>-</b>                            | 98        | <b>-</b>                             | 20      | <b>0</b>          | 0     |
| LVL 2                     | <b>8 811</b>                        | 8 027     | <b>4 405</b>                         | 4 013   | <b>0.8</b>        | 0.7   |
| LVL 1                     | <b>26 997</b>                       | 22 207    | <b>26 997</b>                        | 22 207  | <b>2.6</b>        | 2.1   |
| 50 s                      | <b>7 374</b>                        | 6 648     | <b>14 747</b>                        | 13 296  | <b>0.7</b>        | 0.6   |
| 20 s                      | <b>4 168</b>                        | 3 632     | <b>20 842</b>                        | 18 159  | <b>0.4</b>        | 0.3   |
| 10 s                      | <b>2 596</b>                        | 2 264     | <b>25 961</b>                        | 22 643  | <b>0.2</b>        | 0.2   |
| 5 s                       | <b>1 966</b>                        | 1 713     | <b>39 329</b>                        | 34 265  | <b>0.2</b>        | 0.2   |
| 2 s                       | <b>1 940</b>                        | 1 642     | <b>97 001</b>                        | 82 125  | <b>0.2</b>        | 0.2   |
| 1 s                       | <b>1 500</b>                        | 1 260     | <b>149 985</b>                       | 126 046 | <b>0.1</b>        | 0.1   |
| Total coins               | <b>55 901</b>                       | 48 040    | <b>x</b>                             | x       | <b>5.2</b>        | 4.4   |
| Total lats in circulation | <b>1 049 473</b>                    | 1 073 851 | <b>x</b>                             | x       | <b>100.0</b>      | 100.0 |

At the end of 2007, the total nominal value of gold circulation coins (fineness .999) issued, with the denomination of LVL 100, was 1 988 thousand lats (1 987 thousand lats at the end of 2006). The respective coins in circulation are not included in the balance sheet caption "Lats in circulation", since their nominal value is directly supported by their content of gold.

As at the end of 2007, collector coins with the total nominal value of 1 346 thousand lats had been issued (1 283 thousand lats at the end of 2006). These coins are not included in the balance sheet caption "Lats in circulation" at the end of 2007. (At the end of 2006 the collector coins with a nominal value of 219 thousand lats were included in the balance sheet caption "Lats in circulation").

## 18. BALANCES DUE TO CREDIT INSTITUTIONS

Balances due to credit institutions include balances on the settlement accounts of domestic credit institutions opened with the Bank of Latvia, as well as deposit facility and time deposits in lats received from the above financial institutions.

The respective credit institutions place their funds with the Bank of Latvia in order to comply with its minimum reserve requirement, as well as to effect interbank and customer payments, the Bank of Latvia's monetary policy operations and other settlements in the Bank of Latvia's payment systems.

At the end of 2007 and 2006, balances due to domestic credit institutions consisted of the following items:

|                                  | (in thousands of lats) |           |
|----------------------------------|------------------------|-----------|
|                                  | 2007                   | 2006      |
| Current account balances in lats | <b>1 407 539</b>       | 1 168 763 |
| Current account balances in euro | <b>9 263</b>           | –         |
| Time deposits in lats            | –                      | 43 500    |
| <b>Total</b>                     | <b>1 416 802</b>       | 1 212 263 |

#### 19. BALANCES DUE TO THE GOVERNMENT

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

At the end of 2007 and 2006, the breakdown of Latvian Government deposits was as follows:

|                                       | (in thousands of lats) |        |
|---------------------------------------|------------------------|--------|
|                                       | 2007                   | 2006   |
| Demand deposits in foreign currencies | <b>43 744</b>          | 18 120 |
| Time deposits in lats                 | <b>75 646</b>          | 23 405 |
| Time deposits in foreign currencies   | <b>51 851</b>          | 8 293  |
| <b>Total</b>                          | <b>171 241</b>         | 49 818 |

#### 20. OTHER DOMESTIC LIABILITIES

At the end of 2007 and 2006, other domestic liabilities consisted of the following items:

|   | (in thousands of lats) |       |
|---|------------------------|-------|
|   | 2007                   | 2006  |
| Accrued expense and similar liabilities                                 | <b>2 192</b>           | 2 305 |
| Accrued interest expense  | <b>728</b>             | 513   |
| Money in transit  | <b>498</b>             | –     |
| Tax liabilities   | <b>170</b>             | 45    |
| Non-traded currency swap arrangements with domestic credit institutions | <b>101</b>             | –     |
| Other   | <b>610</b>             | 677   |
| <b>Total</b>  | <b>4 299</b>           | 3 540 |

**21. TAX**

In 2007 and 2006, the Bank of Latvia calculated and paid the following taxes:

|   | (in thousands of lats)    |   |   |                       |                    |                           |            |
|---|---------------------------|---|---|-----------------------|--------------------|---------------------------|------------|
|   | Personal<br>income<br>tax | Compulsory<br>social security<br>contributions<br>(by employer) | Compulsory<br>social security<br>contributions<br>(by employee) | Tax on real<br>estate | Value<br>added tax | Other taxes<br>and duties | Total      |
| Liabilities as at 31 December 2005        | –                         | 6   | 2   | –                     | 51                 | –                         | 59         |
| <b>During 2006</b>                        |                           |   |   |                       |                    |                           |            |
| Calculated                                | 2 136                     | 1 943   | 723   | 426                   | 246                | 1                         | 5 475      |
| Increase in deferred liabilities          | –                         | 20  | –   | –                     | –                  | –                         | 20         |
| Paid                                      | –2 136                    | –1 922  | –722  | –426                  | –262               | –1                        | –5 469     |
| Liabilities as at 31 December 2006        |                           | 7   | 3   |                       | 35                 | 0                         | 45         |
| <b>During 2007</b>                        |                           |   |   |                       |                    |                           |            |
| Calculated                                | 2 631                     | 2 285   | 886   | 144                   | 437                | 2                         | 6 385      |
| Decrease in deferred liabilities          |                           | 70  |   |                       |                    |                           | 70         |
| Paid                                      | –2 631                    | –2 356  | –887  | –144                  | –310               | –2                        | –6 330     |
| <b>Liabilities as at 31 December 2007</b> | <b>0</b>                  | <b>6</b>  | <b>2</b>  | <b>0</b>              | <b>162</b>         | <b>0</b>                  | <b>170</b> |

In addition to the tax payments indicated herein, the Bank of Latvia transfers 30% of the profit for the reporting year, including the payment for the usage of state capital (1 976 thousand lats in 2007; 2 918 thousand lats in 2006; see also Notes 22 and 31) to the state budget. The Bank of Latvia is not subject to corporate income tax.

**22. CAPITAL AND RESERVES**

In 2007 and 2006, changes in the Bank of Latvia's capital and reserves were as follows:

|   | (in thousands of lats) |                    |                      |                                    |          |                            |
|---|------------------------|--------------------|----------------------|------------------------------------|----------|----------------------------|
|   | Nominal<br>capital     | Reserve<br>capital | Valuation<br>account | Profit of the<br>reporting<br>year | EU grant | Capital<br>and<br>reserves |
| As at 31 December 2005                    | 25 000                 | 48 090             | 13 333               | 9 726                              | 533      | 96 682                     |
| <b>During 2006</b>                        |                        |                    |                      |                                    |          |                            |
| Net result on revaluation                 | x                      | x                  | 3 109                | x                                  | x        | 3 109                      |
| Profit appropriated to the state budget   | x                      | x                  | x                    | –2 918                             | x        | –2 918                     |
| Profit transferred to the reserve capital | x                      | 6 808              | x                    | –6 808                             | x        | –                          |
| Profit of the reporting year              | x                      | x                  | x                    | 6 586                              | x        | 6 586                      |
| As at 31 December 2006                    | 25 000                 | 54 898             | 16 442               | 6 586                              | 533      | 103 459                    |
| <b>During 2007</b>                        |                        |                    |                      |                                    |          |                            |
| Net result on revaluation                 | x                      | x                  | 18 071               | x                                  | x        | 18 071                     |
| Profit appropriated to the state budget   | x                      | x                  | x                    | –1 976                             | x        | –1 976                     |
| Profit transferred to the reserve capital | x                      | 4 610              | x                    | –4 610                             | x        | –                          |
| Decrease in EU grant                      | x                      | x                  | x                    | x                                  | –533     | –533                       |
| Profit of the reporting year              | x                      | x                  | x                    | 51 464                             | x        | 51 464                     |
| <b>As at 31 December 2007</b>             | <b>25 000</b>          | <b>59 508</b>      | <b>34 513</b>        | <b>51 464</b>                      | <b>–</b> | <b>170 485</b>             |

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

The Law "On the Bank of Latvia" establishes that a part of the Bank of Latvia's profit of the reporting year, calculated by applying the same percentage as the tax rate set for residents of Latvia by the Law "On Corporate Income Tax", together with a payment in the amount of 15% of the profit of the reporting year for the usage of state capital shall be transferred to the state budget. At the end of 2007 and 2006, the corporate income tax rate applicable to residents of Latvia was 15%. Therefore, 30% of the Bank of Latvia's profit of the reporting year shall be transferred to the state budget within 15 days following the approval of the annual report by the Council of the Bank of Latvia.

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

In 2007, the Bank of Latvia agreed to transfer the outstanding amount (533 thousand lats) of the EU grant to the Ministry of Finance and the EC for further use in compliance with the EC instructions.

In 2007 and 2006, changes in the balance sheet caption "Valuation account" were as follows:

|  | 2007          | Change | Write-offs<br>difference | Valuation<br>sification | Reclas- | 2006   | Change | 2005    |
|--|---------------|--------|--------------------------|-------------------------|---------|--------|--------|---------|
| Initial valuation account  | <b>20 715</b> | –      | 4 070                    | 203                     | 16 442  | x      | x      | x       |
| Deferred result on revaluation<br>of foreign currencies and gold                   | 24 018        | 717    | –                        | 203                     | 23 098  | x      | x      | x       |
| Deferred result on revaluation<br>of non-traded interest rate<br>swap arrangements | –545          | –557   | 278                      | x                       | –266    | x      | x      | x       |
| Deferred result on revaluation<br>of securities                                    | –2 758        | –160   | 3 792                    | x                       | –6 390  | x      | x      | x       |
| Result on revaluation of foreign<br>currencies and gold                            | <b>3 251</b>  | 2 893  | 358                      | x                       | –23 098 | 23 098 | –4 085 | 27 183  |
| Result on revaluation of non-traded<br>interest rate swap arrangements             | <b>181</b>    | 181    | –                        | x                       | 266     | –266   | –1 074 | 808     |
| Result on revaluation of securities  | <b>10 366</b> | 4 862  | 5 504                    | x                       | 6 390   | –6 390 | 8 268  | –14 658 |
| <b>Total</b>   | <b>34 513</b> | 7 936  | 9 932                    | 203                     | 0       | 16 442 | 3 109  | 13 333  |

The initial valuation account was established by transferring thereto the result on revaluation in the amount of 16 442 thousand lats accrued by the end of 2006 prior to the change in the accounting policies. The change in the balance of the initial valuation account in 2007 is related to the recognition of the profit or loss or result on revaluation of the financial instruments of the Bank of Latvia (4 070 thousand lats) outstanding at the end of 2006 and the recognition of the valuation difference of the financial instruments (203 thousand lats), pursuant to the transitional provisions for applying the changed accounting policies (see Note 3). At the end of 2007, balances of other items comprise the positive result on revaluation of the respective financial instruments, calculated from the beginning of 2007 (the negative result on revaluation at the end of 2007 has been recognised

in the caption "Write-downs on financial assets and positions" of the profit and loss statement.

### **23. NET INTEREST AND SIMILAR INCOME**

In 2007, the Bank of Latvia's net interest and similar income amounted to 80 556 thousand lats (27 905 thousand lats in 2006). The income was mainly derived from investing foreign currency reserves.

Interest and similar income from foreign operations increased by 62 140 thousand lats in comparison with 2006. The increase in net interest and similar income primarily resulted from the interest rate drop in financial markets of the US and euro area in the second half of 2007, as well as the Bank of Latvia's significant interventions in foreign currency markets (as a result of the latter, the Bank of Latvia's foreign reserves grew by 1 009 million lats in 2006).

In comparison with 2006, interest income from domestic operations increased by 2 634 thousand lats in 2007 on account of larger amounts of loans granted to domestic credit institutions and non-traded currency swap arrangements with domestic credit institutions resulting from the implementation of monetary policy.

Interest and similar income (36 054 thousand lats) and expense (24 250 thousand lats) from foreign operations for financial derivatives were mostly comprised of interest on forward exchange rate contracts and currency swap arrangements concluded by the Bank of Latvia for the purpose of hedging currency risk exposure, as well as of the result on the interest rate future contracts. Due to the change in the accounting policies, implemented in 2007, the interest on forward exchange rate contracts and currency swap arrangements have been reported only in the profit and loss statement for the year ended 31 December 2007, and the comparative amounts are presented in Note 41.

Interest expense on domestic operations (36 122 thousand lats; 20 188 thousand lats in 2006) was largely comprised of interest on deposits of domestic credit institutions and the Latvian Government. The increase in interest expense on credit institution deposits by 8 727 thousand lats was mainly caused by the significant growth in minimum reserves deposited with the Bank of Latvia. The Bank of Latvia received a larger amount of Latvian Government funds as deposits than in 2006; moreover, interest paid on these deposits rose considerably, therefore interest expense on Government deposits increased by 7 181 thousand lats in 2007.

### **24. REALISED PROFIT AND LOSS ON EXCHANGE RATE CONTRACTS**

Realised profit and loss on exchange rate contracts comprises the result on the sale of foreign currency conducted for the purpose of interventions in the foreign exchange market and foreign reserves management. In 2007, the Bank of Latvia conducted interventions on the foreign exchange market by purchasing foreign currency in the amount of 395.7 million lats; nevertheless, the increase in the profit on exchange rate contracts primarily was due to foreign currency sales in the amount of 235.7 million lats during March 2007.

### **25. WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS**

The unrealised result on the revaluation of several securities positions as well as other financial instruments was negative at the end of 2007. According to the new accounting policies, it has been recognised as a write-down on financial instruments

in the profit and loss statement, with a compensating adjustment to the balance sheet caption "Valuation account" (see also Note 22).

## 26. OTHER OPERATING INCOME

Other operating income in 2007 and 2006 was as follows:

|  | (in thousands of lats) |      |
|--|------------------------|------|
|  | 2007                   | 2006 |
| Income from sale of collector coins                    | 776                    | 330  |
| Income from payment and securities settlement services | 205                    | 185  |
| Other  | 209                    | 197  |
| Total  | 1 190                  | 712  |

## 27. REMUNERATION AND SOCIAL SECURITY COSTS

Remuneration and social security costs in 2007 and 2006 were as follows:

|  | (in thousands of lats) |        |
|--|------------------------|--------|
|  | 2007                   | 2006   |
| Remuneration   |                        |        |
| Remuneration of members of the Council and the Board | 1 261                  | 995    |
| Remuneration of other personnel                      | 11 326                 | 9 212  |
| Total remuneration                                   | 12 587                 | 10 207 |
| Social security costs                                | 2 284                  | 1 943  |
| Total remuneration and social security costs         | 14 871                 | 12 150 |

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

The number of employees in 2007 and 2006 was as follows:

|  | 2007 | 2006 |
|--|------|------|
| Number of employees at the end of the year |      |      |
| Members of the Council and the Board       | 14   | 14   |
| Other personnel                            | 629  | 621  |
| Total at the end of the year               | 643  | 635  |
| Average number of employees per period     | 635  | 637  |

## 28. BANKNOTE PRODUCTION AND COINAGE COSTS

The breakdown of banknote production and coinage costs in 2007 and 2006 was as follows:

|                              | (in thousands of lats) |       |
|------------------------------|------------------------|-------|
|                              | 2007                   | 2006  |
| Banknote production          | 2 191                  | 601   |
| Coinage of circulation coins | 1 214                  | 228   |
| Coinage of collector coins   | 367                    | 242   |
| Total                        | 3 772                  | 1 071 |

**29. OTHER OPERATING EXPENSE**

Other operating expense in 2007 and 2006 was as follows:

|  | (in thousands of lats) |              |
|--|------------------------|--------------|
|  | 2007                   | 2006         |
| Maintenance of buildings, territory and equipment  | 447                    | 394          |
| Municipal services                                 | 414                    | 337          |
| Business travel                                    | 317                    | 305          |
| Personnel training                                 | 314                    | 273          |
| Information and public relations                   | 303                    | 238          |
| Telecommunications services and system maintenance | 279                    | 281          |
| Risk insurance                                     | 266                    | 304          |
| Acquisition of low value office supplies           | 178                    | 166          |
| Transport provision                                | 149                    | 122          |
| Tax on real estate                                 | 138                    | 426          |
| Audit, advisory and legal services                 | 49                     | 51           |
| Other  | 447                    | 510          |
| <b>Total</b>                                       | <b>3 301</b>           | <b>3 407</b> |

**30. CASH FLOW STATEMENT**

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

|   | (in thousands of lats) |          |
|---|------------------------|----------|
|   | 2007                   | 2006     |
| Profit before appropriation   | 51 464                 | 6 586    |
| Non-cash transaction adjustments  |                        |          |
| Depreciation of fixed assets and amortisation of intangible assets                | 3 628                  | 4 077    |
| Losses on disposal of fixed assets  | 2                      | 1        |
| Write-downs on financial assets and positions                                     | 5 862                  | –        |
| Net change in balance sheet items   |                        |          |
| Net increase in gold  | –                      | –        |
| Net increase in Special Drawing Rights  | –3                     | –5       |
| Net increase in foreign debt securities and other foreign investments             | –220 942               | –983 757 |
| Net increase (–)/decrease in loans to domestic credit institutions                | –6 850                 | 23 300   |
| Net decrease in Latvian government securities                                     | –                      | 99 759   |
| Net increase in other assets  | –263                   | –379     |
| Net increase/decrease (–) in foreign convertible currencies                       | –15 828                | 17 863   |
| Net increase in foreign bank and other international institution deposits in lats | 4 288                  | 205      |
| Net increase/decrease (–) in lats in circulation                                  | –24 378                | 196 577  |
| Net increase in time deposits of domestic credit institutions                     | 204 539                | 709 594  |
| Net increase/decrease (–) in Latvian Government time deposits                     | 121 423                | –18 571  |



| <i>(cont.)</i>   | <i>(in thousands of lats)</i> |        |
|--|-------------------------------|--------|
|  | 2007                          | 2006   |
| Net increase/decrease (-) in time deposits of other financial institutions | <b>-1 432</b>                 | 4 304  |
| Net increase in other liabilities  | <b>186</b>                    | 820    |
| Net cash and cash equivalents inflow arising from operating activities     | <b>121 696</b>                | 60 374 |

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

|  | <i>(at the end of year; in thousands of lats)</i> |         |         |        |        |
|--|---|---------|---------|--------|--------|
|  | 2007  | Change  | 2006    | Change | 2005   |
| Convertible foreign currencies in cash   | <b>2 465</b>                                      | 2 321   | 144     | -55    | 199    |
| Demand deposits with foreign credit institutions and other foreign financial institutions  | <b>223 530</b>                                    | 107 232 | 116 298 | 48 666 | 67 632 |
| Time deposits with foreign credit institutions and other foreign financial institutions with original maturity up to 5 business days | <b>14 812</b>                                     | 7 308   | 7 504   | 7 504  | -      |
| Total cash and cash equivalents  | <b>240 807</b>                                    | 116 861 | 123 946 | 56 115 | 67 831 |

### 31. TRANSACTIONS WITH THE LATVIAN GOVERNMENT

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

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

At the end of 2007 and 2006, the breakdown of the Bank of Latvia claims on and liabilities to the Latvian Government and the respective interest rates were as follows:

|                          | Amount<br><i>(in thousands of lats)</i> |        | Yield (%)        |           |
|--------------------------|---|--------|------------------|-----------|
|                          | 2007                                    | 2006   | 2007             | 2006      |
| Liabilities              |   |        |                  |           |
| Demand deposits          | <b>43 744</b>                           | 18 120 | <b>3.22-3.89</b> | 3.00-5.00 |
| Time deposits            | <b>127 497</b>                          | 31 698 | <b>3.99-5.81</b> | 2.49-3.57 |
| Tax liabilities          | <b>190</b>                              | 45     | x                | x         |
| Accrued interest expense | <b>114</b>                              | 17     | x                | x         |
| Total liabilities        | <b>171 545</b>                          | 49 880 | x                | x         |

In 2007 and 2006, the breakdown of the Bank of Latvia's income and expense related to the Latvian Government, as well as the Bank of Latvia's profit

appropriated to the state budget in 2007 and 2006 was as follows (see also Note 23):

|   | (in thousands of lats) |               |
|---|------------------------|---------------|
|   | 2007                   | 2006          |
| <b>Income</b>   |                        |               |
| Result on investment in government securities   | -                      | -3 811        |
| <b>Total income</b>   | <b>-</b>               | <b>-3 811</b> |
| <b>Expense and the Bank of Latvia's profit appropriated to the state budget</b>       |                        |               |
| Interest on government deposits   | <b>11 198</b>          | 4 017         |
| Taxes   | <b>6 385</b>           | 5 475         |
| Bank of Latvia's profit appropriated to the state budget                              | <b>1 976</b>           | 2 918         |
| <b>Total expense and the Bank of Latvia's profit appropriated to the state budget</b> | <b>19 559</b>          | 12 410        |

### 32. PLEDGED ASSETS

Securities with the market value of 7 395 thousand lats as at the end of 2007 (5 323 thousand lats at the end of 2006) have been pledged to provide collateral for interest rate future contract transactions. These securities are included in the balance sheet asset caption "Convertible foreign currencies".

### 33. OFF-BALANCE SHEET ACCOUNTS

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

At the end of 2007 and 2006, the Bank of Latvia's off-balance sheet account profile was as follows:

|   | (in thousands of lats)      |           |               |        |               |        |
|---|-----------------------------|-----------|---------------|--------|---------------|--------|
|   | Contract or notional amount |           | Book value    |        |               |        |
|   | 2007                        | 2006      | Assets        |        | Liabilities   |        |
|   | 2007                        | 2006      | 2007          | 2006   | 2007          | 2006   |
| Non-traded financial derivative contracts with foreign financial institutions |                             |           |               |        |               |        |
| Forward exchange rate contracts and currency swap arrangements                | <b>1 814 172</b>            | 1 461 493 | <b>15 332</b> | 28 554 | <b>17 782</b> | 10 637 |
| Gold interest rate swap arrangements  | <b>25 510</b>               | 21 531    | <b>317</b>    | 539    | <b>8</b>      | 2      |
| Other interest rate swap arrangements   | <b>70 280</b>               | 601 992   | <b>874</b>    | 1 994  | <b>1 084</b>  | 2 797  |
| <b>Total</b>  | <b>x</b>                    | <b>x</b>  | <b>16 523</b> | 31 087 | <b>18 874</b> | 13 436 |

|  | Contract or notional amount |           | Book value    |      |             |       |
|--|-----------------------------|-----------|---------------|------|-------------|-------|
|  | 2007                        | 2006      | Assets        |      | Liabilities |       |
|  |                             |           | 2007          | 2006 | 2007        | 2006  |
| Traded financial derivative contracts with foreign financial institutions    |                             |           |               |      |             |       |
| Interest rate future contracts   | <b>1 710 251</b>            | 1 030 233 | <b>-6 014</b> | 941  | <b>188</b>  | 2 512 |
| Non-traded financial derivative contracts with domestic credit institutions  |                             |           |               |      |             |       |
| Currency swap arrangements   | <b>10 101</b>               | -         | <b>2</b>      | -    | <b>101</b>  | -     |
| Total  | <b>x</b>                    | x         | <b>2</b>      | -    | <b>101</b>  | -     |
| Other transactions   |                             |           |               |      |             |       |
| Agreements concluded on a regular way placement and receipt of time deposits | <b>4 920</b>                | -         | <b>x</b>      | x    | <b>x</b>    | x     |
| Contracted commitments related to acquisition and rent of fixed assets       | <b>174</b>                  | 483       | <b>x</b>      | x    | <b>x</b>    | x     |

As at the end of 2007 and 2006, the book value and the fair value of non-traded contracts concluded by the Bank of Latvia were not materially different. At the end of 2007 and 2006, the comparison of the book value of the off-balance sheet instruments and their net fair value was as follows:

(in thousands of lats)

|  | Net fair value |        | Net book value |        | Difference  |      |
|--|----------------|--------|----------------|--------|-------------|------|
|  | 2007           | 2006   | 2007           | 2006   | 2007        | 2006 |
|  |                |        |                |        |             |      |
| Non-traded financial derivative contracts with foreign financial institutions                                |                |        |                |        |             |      |
| Forward exchange rate contracts and currency swap arrangements   | <b>-2 900</b>  | 17 917 | <b>-2 450</b>  | 17 917 | <b>-450</b> | 0    |
| Gold interest rate swap arrangements   | <b>309</b>     | 537    | <b>309</b>     | 537    | <b>0</b>    | 0    |
| Other interest rate swap arrangements  | <b>-210</b>    | -803   | <b>-210</b>    | -803   | <b>0</b>    | 0    |
| Total  | <b>-2 801</b>  | 17 651 | <b>-2 351</b>  | 17 651 | <b>-450</b> | 0    |
| Traded financial derivative contracts with foreign financial institutions                                    |                |        |                |        |             |      |
| Interest rate future contracts   | <b>-6 202</b>  | -1 571 | <b>-6 202</b>  | -1 571 | <b>0</b>    | 0    |
| Non-traded financial derivative contracts and spot exchange rate contracts with domestic credit institutions |                |        |                |        |             |      |
| Currency swap arrangements   | <b>-98</b>     | -      | <b>-99</b>     | -      | <b>1</b>    | -    |
| Total  | <b>-98</b>     | -      | <b>-99</b>     | -      | <b>1</b>    | -    |

#### 34. CONTINGENT LIABILITIES AND COMMITMENTS

In May 2005, JSC *BDO Invest Rīga* being the liquidator of the bankrupt JSC *Banka Baltija* filed a claim against the Bank of Latvia on behalf of the creditors of JSC *Banka Baltija* in the Riga Regional Court for the recovery of losses in the amount of 185.6 million lats. The claimant alleges that the Bank of Latvia, as the institution in charge of banking supervision at that time, is responsible for losses arising from

the bankruptcy of JSC *Banka Baltija* in 1995. The Bank of Latvia is confident that the claim is without merits; therefore no provision is recognised in the financial statements. The final ruling on the case is expected no earlier than in 2009.

The Bank of Latvia has not paid up 93% of the Bank of Latvia's share in the ECB subscribed capital, which is payable following the decision of the ECB. At the end of 2007, the Bank of Latvia's unpaid share in the ECB subscribed capital was 15 070 thousand euro (10 592 thousand lats).

The Bank of Latvia's uncalled portion of the BIS shares is 75% of their nominal value. These shares are callable following the decision of the BIS Board. At the end of 2007, the uncalled portion of the BIS share holding was 4 013 thousand SDR (3 230 thousand lats).

At the end of 2007, the Bank of Latvia had issued collector coins in the nominal value of 1 346 thousand lats (1 283 thousand lats at the end of 2006) and gold circulation coins with a nominal value of 1 988 thousand lats (1 987 thousand lats at the end of 2006). The potential possibility of repurchase of these coins from their holders by the Bank of Latvia is considered minimal.

### 35. CURRENCY PROFILE

At the end of 2007 and 2006, the currency profile of the Bank of Latvia's assets, liabilities and off-balance sheet accounts was as follows:

|  | (in thousands of lats) |                    |                  |                  |                |               |               |                  |
|--|------------------------|--------------------|------------------|------------------|----------------|---------------|---------------|------------------|
|  | LVL                    | XDR                | USD              | EUR              | JPY            | Gold          | Other         | Total            |
| <b>As at 31 December 2007</b>                                    |                        |                    |                  |                  |                |               |               |                  |
| Foreign assets   |                        |                    |                  |                  |                |               |               |                  |
| Gold   | –                      | –                  | –                | –                | –              | 99 130        | –             | 99 130           |
| Special Drawing Rights   | –                      | 83                 | –                | –                | –              | –             | –             | 83               |
| Convertible foreign currencies                                   | –                      | –                  | 1 287 148        | 1 143 663        | 237 476        | –             | 19 420        | 2 687 707        |
| International Monetary Fund                                      | –                      | 95 997             | –                | –                | –              | –             | –             | 95 997           |
| Participating interest in the European Central Bank              | –                      | –                  | –                | 743 <sup>1</sup> | –              | –             | –             | 743              |
| Participating interest in the Bank for International Settlements | –                      | 1 763 <sup>1</sup> | –                | –                | –              | –             | –             | 1 763            |
| Other foreign assets   | 13 285                 | –                  | 1 025            | 1 381            | 1 628          | 35            | 10            | 17 364           |
| Domestic assets  | –                      | –                  | –                | –                | –              | –             | –             | –                |
| Loans to credit institutions                                     | 6 850                  | –                  | –                | –                | –              | –             | –             | 6 850            |
| Fixed assets   | 32 646                 | –                  | –                | –                | –              | –             | –             | 32 646           |
| Other domestic assets  | 1 626                  | –                  | –                | 11               | –              | –             | 39            | 1 676            |
| <b>TOTAL ASSETS</b>  | <b>54 407</b>          | <b>97 843</b>      | <b>1 288 173</b> | <b>1 145 798</b> | <b>239 104</b> | <b>99 165</b> | <b>19 469</b> | <b>2 943 959</b> |

<sup>1</sup> The respective assets are recorded in the balance sheet at cost and the Bank of Latvia is not exposed to currency risk related to these assets.

|   | (in thousands of lats) |                   |                  |                  |                |               |              |                  |
|---|------------------------|-------------------|------------------|------------------|----------------|---------------|--------------|------------------|
|   | LVL                    | XDR               | USD              | EUR              | JPY            | Gold          | Other        | Total            |
| <i>(cont.)</i>  |                        |                   |                  |                  |                |               |              |                  |
| <b>Foreign liabilities</b>  |                        |                   |                  |                  |                |               |              |                  |
| Convertible foreign currencies  | -                      | -                 | -                | 5 330            | -              | -             | -            | 5 330            |
| International Monetary Fund   | 96 212 <sup>1</sup>    | -                 | -                | -                | -              | -             | -            | 96 212           |
| Other international institution deposits in lats  | 6 049                  | -                 | -                | -                | -              | -             | -            | 6 049            |
| Foreign bank deposits in lats   | 35                     | -                 | -                | -                | -              | -             | -            | 35               |
| Other foreign liabilities   | 17 589                 | -                 | 921              | 587              | -              | 8             | 52           | 19 157           |
| Lats in circulation   | 1 049 473              | -                 | -                | -                | -              | -             | -            | 1 049 473        |
| <b>Domestic liabilities</b>   |                        |                   |                  |                  |                |               |              |                  |
| Balances due to credit institutions   | 1 407 539              | -                 | -                | 9 263            | -              | -             | -            | 1 416 802        |
| Balances due to the Government  | 75 646                 | 83                | 2 359            | 93 147           | 6              | -             | -            | 171 241          |
| Balances due to other financial institutions  | 4 856                  | -                 | 18               | 2                | -              | -             | -            | 4 876            |
| Other domestic liabilities  | 3 726                  | -                 | 1                | 571              | -              | -             | 1            | 4 299            |
| <b>TOTAL LIABILITIES</b>  | <b>2 661 125</b>       | <b>83</b>         | <b>3 299</b>     | <b>108 900</b>   | <b>6</b>       | <b>8</b>      | <b>53</b>    | <b>2 773 474</b> |
| Net position on balance sheet   | -2 606 718             | 97 760            | 1 284 874        | 1 036 898        | 239 098        | 99 157        | 19 416       | 170 485          |
| Net position on financial instruments' off-balance sheet accounts   | 10 002                 | -                 | -1 284 008       | 1 622 463        | -236 783       | -98 893       | -15 231      | -2 450           |
| Net position on balance sheet and off-balance sheet accounts  | -2 596 716             | 97 760            | 866              | 2 659 361        | 2 315          | 264           | 4 185        | 168 035          |
| Net position on balance sheet and off-balance sheet accounts exposed to currency risk                                     | x                      | -215 <sup>2</sup> | 866              | 2 658 618        | 2 315          | 264           | 4 185        | 2 666 033        |
| Foreign currency profile of the net position on balance sheet and off-balance sheet accounts exposed to currency risk (%) | x                      | -0.01             | 0.03             | 99.72            | 0.09           | 0.01          | 0.16         | 100.00           |
| Benchmark currency structure (%)  | x                      | 0                 | 0                | 100.00           | 0              | 0             | 0            | 100.00           |
| As at 31 December 2006  |                        |                   |                  |                  |                |               |              |                  |
| <b>TOTAL ASSETS</b>   | <b>65 159</b>          | <b>103 663</b>    | <b>1 026 060</b> | <b>1 083 914</b> | <b>222 824</b> | <b>83 668</b> | <b>2 607</b> | <b>2 587 895</b> |
| <b>TOTAL LIABILITIES</b>  | <b>2 435 642</b>       | <b>85</b>         | <b>1 813</b>     | <b>46 796</b>    | <b>58</b>      | <b>-</b>      | <b>42</b>    | <b>2 484 436</b> |
| Net position on balance sheet   | -2 370 483             | 103 578           | 1 024 247        | 1 037 118        | 222 766        | 83 668        | 2 565        | 103 459          |
| Net position on financial instruments' off-balance sheet accounts   | -                      | -                 | -1 023 095       | 1 350 021        | -221 952       | -83 462       | -3 861       | 17 651           |
| Net position on balance sheet and off-balance sheet accounts  | -2 370 483             | 103 578           | 1 152            | 2 387 139        | 814            | 206           | -1 296       | 121 110          |
| Net position on balance sheet and off-balance sheet accounts exposed to currency risk                                     | x                      | -229 <sup>2</sup> | 1 152            | 2 386 379        | 814            | 206           | -1 296       | 2 387 026        |
| Foreign currency profile of the net position on balance sheet and off-balance sheet accounts exposed to currency risk (%) | x                      | -0.01             | 0.05             | 99.97            | 0.03           | 0.01          | -0.05        | 100.00           |
| Benchmark currency structure (%)  | x                      | 0                 | 0                | 100.00           | 0              | 0             | 0            | 100.00           |

<sup>1</sup> The Bank of Latvia is exposed to the SDR currency risk related to IMF holdings in lats based on changes in the underlying SDR balances determined in accordance with the exchange rate set by the IMF.

<sup>2</sup> Net XDR position on balance sheet and off-balance sheet accounts exposed to currency risk comprises liabilities to the IMF (96 212 thousand lats) and does not include participating interest in BIS (1 763 thousand lats).

## 36. REPRICING MATURITY AND TRACKING ERROR

The table below reflects the sensitivity of the Bank of Latvia's assets, liabilities off-balance sheet accounts to a change in interest rates. Items reported in this table are stated at carrying amounts, except for traded interest rate future contracts that are stated at notional amounts and included in off-balance sheet accounts. A nearest contractual interest repricing or residual maturity date to 31 December of the reporting year is used for categorising items reported in this table.

|  | Interest bearing |               |                |                |                | Non-interest bearing | Total            |
|--|------------------|---------------|----------------|----------------|----------------|----------------------|------------------|
|  | Up to 3 months   | 3-6 months    | 6-12 months    | 1-3 years      | Over 3 years   |                      |                  |
| (in thousands of lats)   |                  |               |                |                |                |                      |                  |
| <b>As at 31 December 2007</b>                                    |                  |               |                |                |                |                      |                  |
| Foreign assets   |                  |               |                |                |                |                      |                  |
| Gold   | 47 394           | –             | –              | –              | –              | 51 736               | 99 130           |
| Special Drawing Rights   | 83               | –             | –              | –              | –              | –                    | 83               |
| Convertible foreign currencies                                   | 971 883          | 76 252        | 318 624        | 726 027        | 592 211        | 2 710                | 2 687 707        |
| International Monetary Fund                                      | –                | –             | –              | –              | –              | 95 997               | 95 997           |
| Participating interest in the European Central Bank              | –                | –             | –              | –              | –              | 743                  | 743              |
| Participating interest in the Bank for International Settlements | –                | –             | –              | –              | –              | 1 763                | 1 763            |
| Other foreign assets   | 82               | –             | –              | –              | –              | 17 282               | 17 364           |
| Domestic assets  |                  |               |                |                |                |                      |                  |
| Loans to credit institutions                                     | 6 850            | –             | –              | –              | –              | –                    | 6 850            |
| Fixed assets   | –                | –             | –              | –              | –              | 32 646               | 32 646           |
| Other domestic assets  | 5                | –             | –              | –              | –              | 1 671                | 1 676            |
| <b>TOTAL ASSETS</b>  | <b>1 026 297</b> | <b>76 252</b> | <b>318 624</b> | <b>726 027</b> | <b>592 211</b> | <b>204 548</b>       | <b>2 943 959</b> |
| Foreign liabilities  |                  |               |                |                |                |                      |                  |
| Convertible foreign currencies                                   | –                | –             | –              | –              | –              | 5 330                | 5 330            |
| International Monetary Fund                                      | –                | –             | –              | –              | –              | 96 212               | 96 212           |
| Other international institution deposits in lats                 | –                | –             | –              | –              | –              | 6 049                | 6 049            |
| Foreign bank deposits in lats                                    | –                | –             | –              | –              | –              | 35                   | 35               |
| Other foreign liabilities  | –                | –             | –              | –              | –              | 19 157               | 19 157           |
| Lats in circulation  | –                | –             | –              | –              | –              | 1 049 473            | 1 049 473        |
| Domestic liabilities   |                  |               |                |                |                |                      |                  |
| Balances due to credit institutions                              | 1 407 539        | –             | –              | –              | –              | 9 263                | 1 416 802        |
| Balances due to the Government                                   | 171 241          | –             | –              | –              | –              | –                    | 171 241          |
| Balances due to other financial institutions                     | 3 785            | –             | –              | –              | –              | 1 091                | 4 876            |
| Other domestic liabilities                                       | 728              | –             | –              | –              | –              | 3 571                | 4 299            |
| <b>TOTAL LIABILITIES</b>   | <b>1 583 293</b> | <b>–</b>      | <b>–</b>       | <b>–</b>       | <b>–</b>       | <b>1 190 181</b>     | <b>2 773 474</b> |

|  | Interest bearing |            |             |           |              | Non-interest bearing | Total     |
|--|------------------|------------|-------------|-----------|--------------|----------------------|-----------|
|  | Up to 3 months   | 3–6 months | 6–12 months | 1–3 years | Over 3 years |                      |           |
| Net position on balance sheet                                    | -556 996         | 76 252     | 318 624     | 726 027   | 592 211      | x                    | x         |
| Assets on financial instruments' off-balance sheet accounts      | 2 009 520        |            | 75 315      | 1 533 964 | 10 828       | x                    | x         |
| Liabilities on financial instruments' off-balance sheet accounts | 3 445 667        | 59 165     | 38 159      | 19 844    | 69 242       | x                    | x         |
| Net position on balance sheet and off-balance sheet accounts     | -1 993 143       | 17 087     | 355 780     | 2 240 147 | 533 797      | x                    | x         |
| As at 31 December 2006   |                  |            |             |           |              |                      |           |
| TOTAL ASSETS   | 671 128          | 92 070     | 418 752     | 879 522   | 289 799      | 236 624              | 2 587 895 |
| TOTAL LIABILITIES  | 1 264 269        | -          | -           | -         | -            | 1 220 167            | 2 484 436 |
| Net position on balance sheet                                    | -593 141         | 92 070     | 418 752     | 879 522   | 289 799      | x                    | x         |
| Assets on financial instruments' off-balance sheet accounts      | 1 507 956        | -          | 112 750     | 1 472 618 | 5 538        | x                    | x         |
| Liabilities on financial instruments' off-balance sheet accounts | 2 517 120        | 20 175     | 407 676     | 9 367     | 126 872      | x                    | x         |
| Net position on balance sheet and off-balance sheet accounts     | -1 602 305       | 71 895     | 123 826     | 2 342 773 | 168 465      | x                    | x         |

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

In 2007 and 2006, the average weighted tracking error of the Bank of Latvia's foreign reserves portfolios, except for the gold portfolio and portfolios of borrowed funds, was 28 and 38 basis points respectively, and it lay within the following basis points intervals during the year:

| Tracking error (in basis points) | Number of business days |      |
|----------------------------------|-------------------------|------|
|                                  | 2007                    | 2006 |
| 10–20                            | 48                      | 30   |
| 20–30                            | 91                      | 113  |
| 30–40                            | 79                      | 94   |
| 40–55                            | 30                      | 13   |
| Total                            | 248                     | 250  |

### 37. LIQUIDITY PROFILE

At the end of 2007 and 2006, the liquidity profile of the Bank of Latvia's assets and liabilities was as follows:

|                               | (in thousands of lats) |                      |                  |                   |                      |                  |
|-------------------------------|------------------------|----------------------|------------------|-------------------|----------------------|------------------|
|                               | 2007                   |                      |                  | 2006              |                      |                  |
|                               | Up to<br>3 months      | No fixed<br>maturity | Total            | Up to<br>3 months | No fixed<br>maturity | Total            |
| <b>Assets</b>                 |                        |                      |                  |                   |                      |                  |
| Foreign assets                | 2 803 659              | 99 128               | <b>2 902 787</b> | 2 448 119         | 104 903              | 2 553 022        |
| Domestic assets               | 6 980                  | 34 192               | <b>41 172</b>    | –                 | 34 873               | 34 873           |
| <b>TOTAL ASSETS</b>           | <b>2 810 639</b>       | <b>133 320</b>       | <b>2 943 959</b> | <b>2 448 119</b>  | <b>139 776</b>       | <b>2 587 895</b> |
| <b>Liabilities</b>            |                        |                      |                  |                   |                      |                  |
| Foreign liabilities           | 126 744                | 39                   | <b>126 783</b>   | 138 616           | 40                   | 138 656          |
| Lats in circulation           | –                      | 1 049 473            | <b>1 049 473</b> | –                 | 1 073 851            | 1 073 851        |
| Domestic liabilities          | 1 597 218              | –                    | <b>1 597 218</b> | 1 271 929         | –                    | 1 271 929        |
| <b>TOTAL LIABILITIES</b>      | <b>1 723 962</b>       | <b>1 049 512</b>     | <b>2 773 474</b> | <b>1 410 545</b>  | <b>1 073 891</b>     | <b>2 484 436</b> |
| Net position on balance sheet | 1 086 677              | –916 192             | <b>x</b>         | 1 037 574         | –934 115             | <b>x</b>         |

### 38. SECTORAL PROFILE OF ASSETS

The sectoral profile of the Bank of Latvia's assets at the end of 2007 and 2006 was as follows:

|   | Amount<br>(in thousands of lats) |                  | Percentage<br>(%) |              |
|---|----------------------------------|------------------|-------------------|--------------|
|   | 2007                             | 2006             | 2007              | 2006         |
| <b>Claims</b>   |                                  |                  |                   |              |
| Foreign central governments and other governmental institutions | <b>1 318 772</b>                 | 1 250 360        | <b>44.8</b>       | 48.3         |
| Foreign local governments                                       | <b>19 992</b>                    | 31 632           | <b>0.7</b>        | 1.2          |
| Foreign central banks and credit institutions                   | <b>882 651</b>                   | 449 194          | <b>30.0</b>       | 17.4         |
| Other foreign financial institutions                            | <b>517 398</b>                   | 655 507          | <b>17.6</b>       | 25.3         |
| Foreign non-financial corporations                              | <b>33 683</b>                    | 41 379           | <b>1.1</b>        | 1.6          |
| IMF and other international institutions                        | <b>130 276</b>                   | 124 852          | <b>4.4</b>        | 4.8          |
| Latvian central government                                      | <b>6 855</b>                     | –                | <b>0.2</b>        | 0            |
| Domestic credit institutions                                    | <b>40</b>                        | 29               | <b>0</b>          | 0            |
| Unclassified assets   | <b>34 292</b>                    | 34 942           | <b>1.2</b>        | 1.4          |
| <b>Total</b>  | <b>2 943 959</b>                 | <b>2 587 895</b> | <b>100.0</b>      | <b>100.0</b> |

For the purposes of credit risk analysis, loans issued to domestic credit institutions and secured by pledged securities are classified herein according to the issuer of the security. As a result, loans issued to domestic credit institutions are reported as exposure to the Latvian central government.



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

At the end of 2007 and 2006, the Bank of Latvia's foreign assets broken down by their location or the counterparty's domicile were as follows:

|  | Amount<br>(in thousands of lats) |           | Percentage<br>(%) |       |
|--|----------------------------------|-----------|-------------------|-------|
|  | 2007                             | 2006      | 2007              | 2006  |
| Euro area                                | <b>1 027 351</b>                 | 1 094 291 | <b>35.4</b>       | 42.9  |
| US                                       | <b>849 142</b>                   | 738 291   | <b>29.3</b>       | 28.9  |
| Japan                                    | <b>256 734</b>                   | 247 115   | <b>8.8</b>        | 9.7   |
| Other countries                          | <b>639 284</b>                   | 348 473   | <b>22.0</b>       | 13.6  |
| IMF and other international institutions | <b>130 276</b>                   | 124 852   | <b>4.5</b>        | 4.9   |
| <b>Total</b>                             | <b>2 902 787</b>                 | 2 553 022 | <b>100.0</b>      | 100.0 |

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

At the end of 2007 and 2006, the Bank of Latvia's assets broken down by categories of credit ratings assigned to the counterparty were as follows:

|  | Credit rating | Amount<br>(in thousands of lats) |           | Percentage<br>(%) |      |
|--|---------------|----------------------------------|-----------|-------------------|------|
|  |               | 2007                             | 2006      | 2007              | 2006 |
| <b>FOREIGN ASSETS</b>                        |               |                                  |           |                   |      |
| Gold   | AAA           | <b>25 754</b>                    | 43 225    | <b>0.9</b>        | 1.7  |
|  | AA            | <b>73 376</b>                    | 40 443    | <b>2.5</b>        | 1.6  |
| Special Drawing Rights                       | AAA           | <b>83</b>                        | 85        | <b>0</b>          | 0    |
| Foreign debt securities                      | AAA           | <b>1 526 129</b>                 | 1 599 278 | <b>51.8</b>       | 61.8 |
|  | AA+           | <b>115 141</b>                   | 87 772    | <b>3.9</b>        | 3.4  |
|  | AA            | <b>208 368</b>                   | 55 102    | <b>7.1</b>        | 2.1  |
|  | AA-           | <b>183 680</b>                   | 185 937   | <b>6.2</b>        | 7.2  |
|  | A+            | <b>304 369</b>                   | 29 782    | <b>10.3</b>       | 1.2  |
|  | A             | <b>57 656</b>                    | 248 918   | <b>2.0</b>        | 9.6  |
|  | A-            | <b>2 169</b>                     | 2 544     | <b>0.1</b>        | 0.1  |
|  | BBB-          | <b>316</b>                       | -         | <b>0</b>          | 0    |
| Deposits with foreign financial institutions | B             | <b>320</b>                       | -         | <b>0</b>          | 0    |
|  | AAA           | <b>183 401</b>                   | 106 990   | <b>6.2</b>        | 4.1  |
|  | AA+           | <b>1 586</b>                     | 2 253     | <b>0.1</b>        | 0.1  |
|  | AA            | <b>26 009</b>                    | 4 953     | <b>0.9</b>        | 0.2  |
|  | AA-           | <b>11 995</b>                    | 5 149     | <b>0.4</b>        | 0.2  |
|  | A+            | <b>53 208</b>                    | 4 025     | <b>1.8</b>        | 0.2  |
|  | A             | <b>3 669</b>                     | 379       | <b>0.1</b>        | 0    |
| Foreign currency in cash                     | A-            | <b>7 226</b>                     | 53        | <b>0.2</b>        | 0    |
|  | AAA           | <b>2 465</b>                     | 144       | <b>0.1</b>        | 0    |
| International Monetary Fund                  | AAA           | <b>95 997</b>                    | 101 815   | <b>3.3</b>        | 3.9  |

(cont.)

|  | Credit rating | Amount<br>(in thousands of lats) |                  | Percentage<br>(%) |              |
|--|---------------|----------------------------------|------------------|-------------------|--------------|
|  |               | 2007                             | 2006             | 2007              | 2006         |
| Participating interest in the European Central Bank              | AAA           | 743                              | 760              | 0                 | 0            |
| Participating interest in the Bank for International Settlements | AAA           | 1 763                            | 1 763            | 0.1               | 0.1          |
| Derivative financial instruments                                 | AAA           | 591                              | 1 742            | 0                 | 0.1          |
|  | AA+           | –                                | 1 145            | 0                 | 0            |
|  | AA            | 3 345                            | 5 987            | 0.1               | 0.2          |
|  | AA–           | 7 969                            | 14 562           | 0.3               | 0.6          |
|  | A+            | 3 921                            | 4 902            | 0.2               | 0.2          |
|  | A             | 697                              | 2 593            | 0                 | 0.1          |
|  | A–            | –                                | 156              | 0                 | 0            |
| Accrued interest income  | Different     | 217                              | 6                | 0                 | 0            |
| Other foreign assets   | Different     | 624                              | 559              | 0                 | 0            |
| <b>DOMESTIC ASSETS</b>   |               |                                  |                  |                   |              |
| Loans to credit institutions                                     | Different     | 6 850                            | –                | 0.2               | 0            |
| Other  | Different     | 34 322                           | 34 873           | 1.2               | 1.3          |
| <b>TOTAL</b>   |               | <b>2 943 959</b>                 | <b>2 587 895</b> | <b>100.0</b>      | <b>100.0</b> |

At the end of 2007 and 2006, the Bank of Latvia's foreign assets broken down by major categories of credit ratings assigned to the counterparty were as follows:

|                | Credit rating category | Amount<br>(in thousands of lats) |                  | Percentage<br>(%) |              |
|----------------|------------------------|----------------------------------|------------------|-------------------|--------------|
|                |                        | 2007                             | 2006             | 2007              | 2006         |
| Foreign assets | AAA                    | 1 836 926                        | 1 855 802        | 63.3              | 72.7         |
|                | AA                     | 631 469                          | 403 303          | 21.8              | 15.8         |
|                | A                      | 432 915                          | 293 352          | 14.9              | 11.5         |
|                | BBB–                   | 316                              | –                | 0                 | –            |
|                | B                      | 320                              | –                | 0                 | –            |
|                | Different              | 841                              | 565              | 0                 | 0            |
| <b>Total</b>   |                        | <b>2 902 787</b>                 | <b>2 553 022</b> | <b>100.0</b>      | <b>100.0</b> |

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

#### 41. RECONCILIATION OF FINANCIAL STATEMENT COMPARATIVE AMOUNTS

This note presents the reconciliation of the 2006 financial statement balance sheet and profit and loss items published in 2006 to restate these 2006 figures as if the accounting policies referred to in Note 3 had been applied in preparing the financial statements for 2006.

The comparison of specific balance sheet items is as follows:

|  | Notes | 2006<br>(published) | 2006<br>(restated) | Difference |
|--|-------|---------------------|--------------------|------------|
| (at the end of the year; in thousands of lats) |       |                     |                    |            |
| FOREIGN ASSETS                                 |       | 2 553 022           | 2 555 983          | 2 961      |
| Other foreign assets                           | (a)   | 31 652              | 34 613             | 2 961      |
| FOREIGN LIABILITIES                            |       | 138 656             | 141 413            | 2 757      |
| Other foreign liabilities                      | (b)   | 13 658              | 16 415             | 2 757      |
| LATS IN CIRCULATION                            | (c)   | 1 073 851           | 1 073 632          | -219       |
| CAPITAL AND RESERVES                           | (d)   | 103 459             | -103 881           | 422        |

(a) Change in the valuation of the non-traded forward exchange rate contracts and currency swap arrangements, applying the respective exchange rate set by the Bank of Latvia at the end of 2006 to the spot equivalent of each leg of transaction. In the published financial statements for 2006, these transactions have been valued at their fair value, applying the respective exchange rate set by the Bank of Latvia at the end of 2006 to the discounted cashflows. The accrued interest reported within the fair value of the above transactions in the published financial statements for 2006 also contribute to the difference in the indicators.

(b) Change in the valuation of the non-traded forward exchange rate contracts and currency swap arrangements, applying the respective exchange rate set by the Bank of Latvia at the end of 2006 to the spot equivalent of each leg of transaction. In the published financial statements for 2006, these transactions have been valued at their fair value, applying the respective exchange rate set by the Bank of Latvia at the end of 2006 to the discounted cashflows. The accrued interest reported at the fair value of the above transactions in the published financial statements for 2006 also contribute to the difference in the indicators.

(c) The decrease in lats in circulation comprises the nominal value of collector coins sold which is not recognised now.

(d) Total valuation difference of the non-traded forward exchange rate contracts and currency swap arrangements and the decrease in lats in circulation (see also Notes (a), (b) and (c)).

The comparison of specific profit and loss statement items is as follows:

|  | Notes | 2006<br>(published) | 2006<br>(restated) | Difference |
|--|-------|---------------------|--------------------|------------|
| (in thousands of lats)                               |       |                     |                    |            |
| <b>INTEREST AND SIMILAR INCOME</b>                   |       |                     |                    |            |
| Foreign operations                                   |       | 51 268              | 61 315             | 10 047     |
| Gain on investments in debt securities               | (e)   | 46 870              | 49 189             | 2 319      |
| Gains/losses from derivative financial instruments   | (f)   | -1 081              | 6 647              | 7 728      |
| Domestic operations                                  |       | -3 167              | -3 164             | 3          |
| Interest on derivative financial instruments         | (f)   | -                   | 3                  | 3          |
| <b>INTEREST EXPENSE</b>                              |       |                     |                    |            |
| Foreign operations                                   |       | 8                   | 20 748             | 20 740     |
| Interest on derivative financial instruments         | (f)   | -                   | 20 740             | 20 740     |
| Domestic operations                                  |       | 20 188              | 20 189             | 1          |
| Interest on derivative financial instruments         | (f)   | -                   | 1                  | 1          |
| <b>NET INTEREST AND SIMILAR INCOME</b>               |       | 27 905              | 17 214             | -10 691    |
| <b>WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS</b> | (g)   | -                   | 8 889              | 8 889      |
| <b>OTHER OPERATING INCOME</b>                        | (h)   | -                   | 219                | 219        |

(e) Additional result on securities disposal, had the cost of the respective securities been regarded as equal to their market value on 31 December 2005.

(f) Interest on non-traded forward exchange rate contracts and currency and interest rate swap arrangements which in the financial statements for 2006 had not been reported separately but were reported in the balance sheet caption "Valuation account" within the framework of the overall fair value valuation of the respective transactions. In addition, the result on the non-traded interest rate swap arrangement disposal, reported in the balance sheet caption "Valuation account" in the financial statements for 2006, was included.

(g) Unrealised losses of securities and non-traded interest rate swap arrangements which had been recognised in the profit and loss statement at the end of the reporting period where they exceed the previously calculated revaluation gains.

(h) The increase in other operating income comprises the nominal value of collector coins issued.

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

## REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying financial statements of the Bank of Latvia ("the Bank"), which comprise the balance sheet as at 31 December 2007, and the related statements of profit and loss, total recognised gains and losses and cash flow for the year then ended, and a summary of principal accounting policies and other explanatory notes to the financial statements, as set out on pages 66 to 107.

### *Management's Responsibility for the Financial Statements*

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

### *Auditors' Responsibility*

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

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

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

### *Opinion*

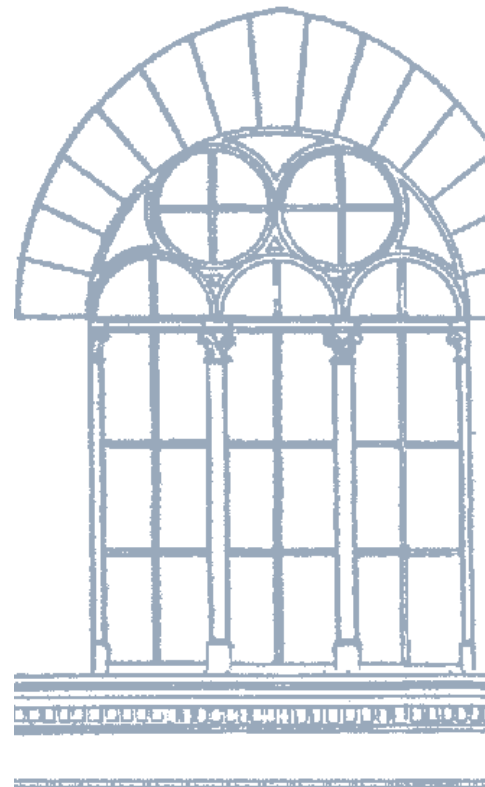
In our opinion, the financial statements give a true and fair view of the financial position of the Bank as at 31 December 2007, and of its financial performance and its cash flows for the year then ended in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Bank of Latvia's Council, and the law "On the Bank of Latvia".

Stephen Young  
KPMG Baltics SIA  
Licence No 55

Inguna Sudraba  
The State Audit Office  
of the Republic of Latvia

Riga, Latvia  
26 February 2008

## APPENDICES



## MONETARY INDICATORS IN 2007

(at end of period; in millions of lats)

|  | I        | II       | III      | IV       | V        | VI       | VII      | VIII     | IX       | X        | XI       | XII             |
|--|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|-----------------|
| <b>BANK OF LATVIA</b>  |          |          |          |          |          |          |          |          |          |          |          |                 |
| M0   | 2 101.9  | 2 185.5  | 2 180.8  | 2 244.8  | 2 245.0  | 2 311.8  | 2 268.9  | 2 376.6  | 2 422.4  | 2 394.1  | 2 348.1  | <b>2 471.2</b>  |
| Currency in circulation  | 1 047.6  | 1 031.0  | 1 030.0  | 1 049.6  | 1 034.1  | 1 056.1  | 1 054.7  | 1 057.5  | 1 029.4  | 996.9    | 999.8    | <b>1 049.5</b>  |
| Demand deposits with the Bank of Latvia  | 1 054.3  | 1 154.5  | 1 150.8  | 1 195.2  | 1 210.8  | 1 255.7  | 1 214.2  | 1 319.1  | 1 393.0  | 1 397.1  | 1 348.3  | <b>1 421.7</b>  |
| Currency vs monetary base (%)  | 49.8     | 47.2     | 47.2     | 46.8     | 46.1     | 45.7     | 46.5     | 44.5     | 42.5     | 41.6     | 42.6     | <b>42.5</b>     |
| Net foreign assets   | 2 439.0  | 2 507.8  | 2 455.8  | 2 409.6  | 2 554.0  | 2 582.3  | 2 636.1  | 2 725.6  | 2 715.1  | 2 720.9  | 2 708.4  | <b>2 776.0</b>  |
| Net domestic assets  | -337.1   | -322.3   | -275.0   | -164.8   | -309.0   | -270.5   | -367.2   | -349.1   | -292.7   | -326.8   | -360.4   | <b>-304.9</b>   |
| Credit   | -231.6   | -234.9   | -183.6   | -77.8    | -224.5   | -186.0   | -248.1   | -241.2   | -177.8   | -201.8   | -219.6   | <b>-164.4</b>   |
| To MFIs  | 0        | 2.7      | 41.9     | 140.6    | 23.0     | 0        | 0        | 46.8     | 121.8    | 54.3     | 25.0     | <b>6.9</b>      |
| To central government (net)  | -231.6   | -237.6   | -225.5   | -218.4   | -247.5   | -186.0   | -248.1   | -288.0   | -299.6   | -256.0   | -244.6   | <b>-171.2</b>   |
| Other assets (net)   | -105.6   | -87.4    | -91.5    | -86.9    | -84.6    | -84.6    | -119.1   | -107.9   | -114.9   | -125.1   | -140.8   | <b>-140.5</b>   |
| <b>MFI</b>   |          |          |          |          |          |          |          |          |          |          |          |                 |
| M1   | 4 017.5  | 3 977.6  | 4 032.7  | 4 058.9  | 4 079.1  | 4 214.3  | 4 280.7  | 4 191.1  | 3 969.4  | 3 870.4  | 3 823.3  | <b>3 935.2</b>  |
| M2   | 5 477.8  | 5 528.4  | 5 663.2  | 5 757.3  | 5 821.2  | 6 035.3  | 6 044.5  | 6 047.2  | 5 953.5  | 5 996.4  | 6 027.0  | <b>6 242.0</b>  |
| M3   | 5 534.7  | 5 582.6  | 5 736.9  | 5 838.1  | 5 900.0  | 6 146.6  | 6 167.0  | 6 161.2  | 6 044.6  | 6 083.6  | 6 113.0  | <b>6 311.6</b>  |
| M2X  | 5 477.3  | 5 511.3  | 5 625.6  | 5 706.9  | 5 744.6  | 5 939.4  | 5 949.2  | 5 946.1  | 5 839.8  | 5 885.5  | 5 905.6  | <b>6 171.3</b>  |
| Currency outside MFIs  | 954.3    | 935.7    | 933.6    | 940.6    | 932.3    | 948.6    | 946.8    | 940.6    | 914.7    | 888.4    | 880.3    | <b>900.0</b>    |
| Deposits of resident financial institutions, non-financial corporations and households   | 4 523.0  | 4 575.7  | 4 692.1  | 4 766.3  | 4 812.2  | 4 990.8  | 5 002.4  | 5 005.5  | 4 925.1  | 4 997.1  | 5 025.2  | <b>5 271.2</b>  |
| In foreign currencies  | 1 877.5  | 1 935.1  | 1 999.8  | 2 083.6  | 2 133.4  | 2 247.6  | 2 316.6  | 2 380.3  | 2 402.0  | 2 433.5  | 2 434.6  | <b>2 541.2</b>  |
| Net foreign assets   | -2 812.4 | -3 032.8 | -3 293.6 | -3 387.4 | -3 508.2 | -3 675.5 | -3 744.3 | -3 995.7 | -4 175.8 | -4 400.0 | -4 492.6 | <b>-4 482.8</b> |
| Net domestic assets  | 8 289.7  | 8 544.1  | 8 919.3  | 9 094.3  | 9 252.7  | 9 614.9  | 9 693.5  | 9 941.8  | 10 015.7 | 10 285.5 | 10 398.2 | <b>10 654.0</b> |
| Loans to resident financial institutions, non-financial corporations and households  | 9 994.3  | 10 340.2 | 10 767.2 | 11 113.8 | 11 384.9 | 11 754.6 | 11 980.5 | 12 265.3 | 12 406.6 | 12 670.2 | 12 807.1 | <b>13 050.6</b> |
| <b>INTEREST RATES</b>  |          |          |          |          |          |          |          |          |          |          |          |                 |
| Bank of Latvia refinancing rate  | 5.0      | 5.0      | 5.5      | 5.5      | 6.0      | 6.0      | 6.0      | 6.0      | 6.0      | 6.0      | 6.0      | <b>6.0</b>      |
| Weighted average interest rates on transactions in lats  |          |          |          |          |          |          |          |          |          |          |          |                 |
| Interbank loans  | 2.6      | 3.7      | 3.4      | 7.7      | 7.6      | 3.6      | 2.7      | 6.7      | 8.0      | 6.9      | 4.6      | <b>5.1</b>      |
| Loans to non-financial corporations and households with a floating interest rate and an initial rate fixation of up to 1 year (new business) | 6.7      | 7.8      | 8.5      | 11.1     | 11.4     | 11.3     | 10.9     | 11.1     | 12.8     | 13.2     | 13.7     | <b>12.6</b>     |
| Time deposits of non-financial corporations and households (new business)  | 3.7      | 3.9      | 5.2      | 6.5      | 6.7      | 5.5      | 4.3      | 6.2      | 7.5      | 8.0      | 7.8      | <b>7.8</b>      |

## THE BANK OF LATVIA'S MONTH-END BALANCE SHEETS FOR 2007

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

|  | I                | II               | III              | IV               | V                | VI               | VII              | VIII             | IX               | X                | XI               | XII              |
|--|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| <b>FOREIGN ASSETS</b>                            | 2 566 885        | 2 633 012        | 2 580 310        | 2 526 064        | 2 674 218        | 2 695 736        | 2 752 331        | 2 848 802        | 2 843 361        | 2 839 819        | 2 831 910        | <b>2 902 787</b> |
| Gold   | 86 719           | 90 953           | 87 286           | 87 881           | 85 444           | 83 690           | 84 818           | 85 247           | 90 048           | 95 208           | 95 150           | <b>99 130</b>    |
| SDR  | 85               | 85               | 85               | 84               | 85               | 85               | 84               | 85               | 84               | 83               | 83               | <b>83</b>        |
| Convertible foreign currencies                   | 2 361 342        | 2 419 760        | 2 364 782        | 2 300 428        | 2 463 957        | 2 488 845        | 2 546 330        | 2 641 000        | 2 605 263        | 2 584 569        | 2 576 857        | <b>2 687 707</b> |
| IMF  | 102 194          | 101 309          | 100 929          | 99 538           | 100 171          | 99 918           | 99 665           | 99 791           | 97 641           | 96 882           | 95 364           | <b>95 997</b>    |
| Participating interest in the ECB                | 743              | 743              | 743              | 743              | 743              | 743              | 743              | 743              | 743              | 743              | 743              | <b>743</b>       |
| Participating interest in the BIS                | 1 763            | 1 763            | 1 763            | 1 763            | 1 763            | 1 763            | 1 763            | 1 763            | 1 763            | 1 763            | 1 763            | <b>1 763</b>     |
| Other foreign assets                             | 14 039           | 18 399           | 24 722           | 35 627           | 22 055           | 20 692           | 18 928           | 20 173           | 47 819           | 60 571           | 61 950           | <b>17 364</b>    |
| <b>DOMESTIC ASSETS</b>                           | 34 651           | 37 659           | 77 243           | 176 775          | 58 417           | 34 187           | 33 837           | 80 691           | 155 585          | 87 762           | 58 271           | <b>41 172</b>    |
| Loans to credit institutions                     | –                | 2 700            | 41 900           | 140 600          | 23 000           | –                | –                | 46 810           | 121 820          | 54 270           | 25 000           | <b>6 850</b>     |
| Fixed assets                                     | 32 507           | 32 354           | 32 377           | 32 458           | 32 276           | 31 878           | 31 714           | 31 604           | 31 517           | 31 417           | 31 307           | <b>32 646</b>    |
| Other domestic assets                            | 2 144            | 2 605            | 2 966            | 3 717            | 3 141            | 2 309            | 2 123            | 2 277            | 2 248            | 2 075            | 1 964            | <b>1 676</b>     |
| <b>TOTAL ASSETS</b>                              | <b>2 601 536</b> | <b>2 670 671</b> | <b>2 657 553</b> | <b>2 702 839</b> | <b>2 732 635</b> | <b>2 729 923</b> | <b>2 786 168</b> | <b>2 929 493</b> | <b>2 998 946</b> | <b>2 927 581</b> | <b>2 890 181</b> | <b>2 943 959</b> |
| <b>FOREIGN LIABILITIES</b>                       | 127 873          | 125 256          | 124 475          | 116 511          | 120 197          | 113 423          | 116 200          | 123 157          | 128 247          | 118 914          | 123 465          | <b>126 783</b>   |
| Convertible foreign currencies                   | 3 076            | 2 186            | 1 963            | 1 379            | 2 241            | 5 158            | 1 395            | 584              | 10 703           | 2 101            | 12 872           | <b>5 330</b>     |
| IMF  | 102 424          | 101 536          | 101 156          | 99 762           | 100 396          | 100 142          | 99 889           | 100 015          | 97 860           | 97 100           | 95 579           | <b>96 212</b>    |
| Other international institution deposits in lats | 1 604            | 6 455            | 8 006            | 7 841            | 4 081            | 1 076            | 1 854            | 2 067            | 1 459            | 2 926            | 2 142            | <b>6 049</b>     |
| Foreign bank deposits in lats                    | 513              | 445              | 493              | 846              | 471              | 490              | 461              | 80               | 42               | 33               | 122              | <b>35</b>        |
| Other foreign liabilities                        | 20 256           | 14 634           | 12 857           | 6 683            | 13 008           | 6 557            | 12 601           | 20 411           | 18 183           | 16 754           | 12 750           | <b>19 157</b>    |
| <b>LATS IN CIRCULATION</b>                       | <b>1 047 575</b> | <b>1 030 989</b> | <b>1 030 009</b> | <b>1 049 610</b> | <b>1 034 142</b> | <b>1 056 064</b> | <b>1 054 740</b> | <b>1 057 499</b> | <b>1 029 433</b> | <b>996 932</b>   | <b>999 824</b>   | <b>1 049 473</b> |
| <b>DOMESTIC LIABILITIES</b>                      | <b>1 323 615</b> | <b>1 397 896</b> | <b>1 383 287</b> | <b>1 420 111</b> | <b>1 465 287</b> | <b>1 447 436</b> | <b>1 489 326</b> | <b>1 612 267</b> | <b>1 696 300</b> | <b>1 656 697</b> | <b>1 595 614</b> | <b>1 597 218</b> |
| Balances due to credit institutions              | 1 086 598        | 1 154 559        | 1 151 234        | 1 195 139        | 1 210 788        | 1 255 583        | 1 229 044        | 1 312 231        | 1 384 671        | 1 393 154        | 1 340 480        | <b>1 416 802</b> |
| Balances due to the Government                   | 231 589          | 237 555          | 225 458          | 218 416          | 247 496          | 185 958          | 248 105          | 288 026          | 299 573          | 256 028          | 244 581          | <b>171 241</b>   |
| Balances due to other financial institutions     | 2 841            | 2 796            | 2 353            | 2 843            | 2 944            | 3 029            | 8 954            | 8 738            | 8 339            | 3 987            | 7 775            | <b>4 876</b>     |
| Other domestic liabilities                       | 2 587            | 2 986            | 4 242            | 3 713            | 4 059            | 2 866            | 3 223            | 3 272            | 3 717            | 3 528            | 2 778            | <b>4 299</b>     |
| <b>CAPITAL AND RESERVES</b>                      | <b>102 473</b>   | <b>116 530</b>   | <b>119 782</b>   | <b>116 607</b>   | <b>113 009</b>   | <b>113 000</b>   | <b>125 902</b>   | <b>136 570</b>   | <b>144 966</b>   | <b>155 038</b>   | <b>171 278</b>   | <b>170 485</b>   |
| <b>TOTAL LIABILITIES, CAPITAL AND RESERVES</b>   | <b>2 601 536</b> | <b>2 670 671</b> | <b>2 657 553</b> | <b>2 702 839</b> | <b>2 732 635</b> | <b>2 729 923</b> | <b>2 786 168</b> | <b>2 929 493</b> | <b>2 998 946</b> | <b>2 927 581</b> | <b>2 890 181</b> | <b>2 943 959</b> |



## THE BANK OF LATVIA'S YEAR-END BALANCE SHEETS FOR THE YEARS 2003–2007

(at end of year; in thousands of lats)

|   | 2003             | 2004             | 2005             | 2006             | 2007             |
|---|------------------|------------------|------------------|------------------|------------------|
| <b>FOREIGN ASSETS</b>   | 937 526          | 1 170 605        | 1 513 427        | 2 553 022        | <b>2 902 787</b> |
| Gold  | 55 543           | 56 901           | 76 170           | 83 668           | <b>99 130</b>    |
| SDR   | 75               | 77               | 85               | 85               | <b>83</b>        |
| Convertible foreign currencies                                | 774 834          | 986 458          | 1 323 520        | 2 333 279        | <b>2 687 707</b> |
| IMF   | 101 144          | 101 144          | 107 633          | 101 815          | <b>95 997</b>    |
| Participating interest in the ECB                             | –                | 760              | 760              | 760              | <b>743</b>       |
| Participating interest in the BIS                             | 1 000            | 1 000            | 1 763            | 1 763            | <b>1 763</b>     |
| Other foreign assets  | 4 930            | 24 265           | 3 496            | 31 652           | <b>17 364</b>    |
| <b>DOMESTIC ASSETS</b>  | 162 716          | 145 283          | 159 487          | 34 873           | <b>41 172</b>    |
| Loans to credit institutions                                  | 59 320           | 12 880           | 23 300           | –                | <b>6 850</b>     |
| Transit credits   | 3 018            | –                | –                | –                | <b>–</b>         |
| Government securities   | 62 273           | 93 208           | 98 817           | –                | <b>–</b>         |
| Fixed assets  | 34 200           | 35 931           | 34 878           | 32 763           | <b>32 646</b>    |
| Other domestic assets   | 3 905            | 3 264            | 2 492            | 2 110            | <b>1 676</b>     |
| <b>TOTAL ASSETS</b>   | <b>1 100 242</b> | <b>1 315 888</b> | <b>1 672 914</b> | <b>2 587 895</b> | <b>2 943 959</b> |
| <b>FOREIGN LIABILITIES</b>                                    | 113 545          | 131 291          | 123 196          | 138 656          | <b>126 783</b>   |
| Convertible foreign currencies                                | 149              | 2 445            | 3 295            | 21 158           | <b>5 330</b>     |
| IMF   | 104 423          | 101 773          | 107 875          | 102 044          | <b>96 212</b>    |
| Other international institution deposits in lats <sup>1</sup> | 268              | 21 515           | 1 105            | 1 348            | <b>6 049</b>     |
| Foreign bank deposits in lats <sup>1</sup>                    | 409              | 396              | 486              | 448              | <b>35</b>        |
| Other foreign liabilities <sup>2</sup>                        | 8 296            | 5 162            | 10 435           | 13 658           | <b>19 157</b>    |
| <b>LATS IN CIRCULATION</b>                                    | 682 145          | 727 354          | 877 274          | 1 073 851        | <b>1 049 473</b> |
| <b>DOMESTIC LIABILITIES</b>                                   | 209 472          | 361 513          | 575 762          | 1 271 929        | <b>1 597 218</b> |
| Balances due to credit institutions                           | 123 810          | 228 872          | 502 669          | 1 212 263        | <b>1 416 802</b> |
| Balances due to the Government                                | 80 254           | 107 156          | 68 389           | 49 818           | <b>171 241</b>   |
| Balances due to other financial institutions                  | 1 670            | 1 300            | 2 004            | 6 308            | <b>4 876</b>     |
| Other domestic liabilities                                    | 3 738            | 24 185           | 2 700            | 3 540            | <b>4 299</b>     |
| <b>CAPITAL AND RESERVES</b>                                   | 95 080           | 95 730           | 96 682           | 103 459          | <b>170 485</b>   |
| Nominal capital   | 25 000           | 25 000           | 25 000           | 25 000           | <b>25 000</b>    |
| Reserve capital <sup>3</sup>                                  | 37 928           | 45 787           | 48 090           | 54 898           | <b>59 508</b>    |
| Valuation account   | 19 712           | 21 121           | 13 333           | 16 442           | <b>34 513</b>    |
| Undistributed profit <sup>3</sup>                             | 11 908           | 3 289            | 9 726            | 6 586            | <b>51 464</b>    |
| EU grant  | 532              | 533              | 533              | 533              | <b>–</b>         |
| <b>TOTAL LIABILITIES, CAPITAL AND RESERVES</b>                | <b>1 100 242</b> | <b>1 315 888</b> | <b>1 672 914</b> | <b>2 587 895</b> | <b>2 943 959</b> |

<sup>1</sup> Other international institution deposits in lats were reported under the caption "Foreign bank deposits in lats" in the financial statements for the years 2003.

<sup>2</sup> Liabilities in non-convertible currencies that were reported under the caption "Non-convertible currencies" in the financial statements for the years 2003–2005 are also included.

<sup>3</sup> In the financial statements for years 2003–2005, profit was divided across several captions: profit appropriated to the state budget was reported under the caption "Other domestic liabilities", and increase in reserve capital was reported under the caption "Reserve capital".

## Appendix 4

## THE BANK OF LATVIA'S PROFIT AND LOSS STATEMENTS FOR THE YEARS 2003–2007

(in thousands of lats)

|   | 2003          | 2004          | 2005          | 2006          | 2007 <sup>1</sup> |
|---|---------------|---------------|---------------|---------------|-------------------|
| <b>INTEREST AND SIMILAR INCOME</b>                |               |               |               |               |                   |
| Foreign operations                                | 27 327        | 21 760        | 33 673        | 51 268        | 137 655           |
| Domestic operations                               | 5 984         | 7 005         | 5 080         | -3 167        | 3 278             |
| <b>INTEREST EXPENSE</b>                           |               |               |               |               |                   |
| Foreign operations                                | 8             | 8             | 9             | 8             | 24 255            |
| Domestic operations                               | 2 651         | 5 282         | 10 018        | 20 188        | 36 122            |
| <b>NET INTEREST AND SIMILAR INCOME</b>            | <b>30 652</b> | <b>23 475</b> | <b>28 726</b> | <b>27 905</b> | <b>80 556</b>     |
| REALISED PROFIT OF FOREIGN EXCHANGE TRANSACTIONS  | -             | -             | -             | -             | 2 700             |
| IMPAIRMENT OF FINANCIAL ASSETS AND POSITION VALUE | -             | -             | -             | -             | 5 862             |
| OTHER OPERATING INCOME                            | 994           | 447           | 577           | 712           | 1 195             |
| OTHER OPERATING EXPENSE                           | 19 738        | 20 633        | 19 577        | 22 031        | 27 125            |
| <b>PROFIT BEFORE APPROPRIATION</b>                | <b>11 908</b> | <b>3 289</b>  | <b>9 726</b>  | <b>6 586</b>  | <b>51 464</b>     |

## Appendix 5

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

(LVL vs foreign currency)

| 2007 | GBP     |         |         |                  | 100 JPY |         |         |                  | USD     |         |         |                  |
|------|---------|---------|---------|------------------|---------|---------|---------|------------------|---------|---------|---------|------------------|
|      | Maximum | Average | Minimum | At end of period | Maximum | Average | Minimum | At end of period | Maximum | Average | Minimum | At end of period |
| I    | 1.0740  | 1.0574  | 1.0410  | 1.0640           | 0.4570  | 0.4494  | 0.4440  | 0.4450           | 0.5450  | 0.5400  | 0.5290  | 0.5420           |
| II   | 1.0670  | 1.0544  | 1.0420  | 1.0470           | 0.4520  | 0.4457  | 0.4410  | 0.4440           | 0.5440  | 0.5377  | 0.5330  | 0.5330           |
| III  | 1.0440  | 1.0336  | 1.0250  | 1.0360           | 0.4620  | 0.4521  | 0.4460  | 0.4500           | 0.5360  | 0.5308  | 0.5250  | 0.5280           |
| IV   | 1.0400  | 1.0351  | 1.0310  | 1.0320           | 0.4500  | 0.4392  | 0.4340  | 0.4340           | 0.5280  | 0.5212  | 0.5150  | 0.5150           |
| V    | 1.0400  | 1.0323  | 1.0260  | 1.0360           | 0.4350  | 0.4310  | 0.4290  | 0.4300           | 0.5240  | 0.5196  | 0.5150  | 0.5230           |
| VI   | 1.0460  | 1.0396  | 1.0340  | 1.0440           | 0.4330  | 0.4276  | 0.4210  | 0.4250           | 0.5280  | 0.5238  | 0.5200  | 0.5220           |
| VII  | 1.0510  | 1.0429  | 1.0350  | 1.0430           | 0.4350  | 0.4211  | 0.4160  | 0.4350           | 0.5230  | 0.5130  | 0.5080  | 0.5150           |
| VIII | 1.0450  | 1.0381  | 1.0320  | 1.0370           | 0.4660  | 0.4412  | 0.4260  | 0.4460           | 0.5240  | 0.5161  | 0.5090  | 0.5150           |
| IX   | 1.0420  | 1.0224  | 1.0020  | 1.0020           | 0.4510  | 0.4404  | 0.4300  | 0.4300           | 0.5170  | 0.5071  | 0.4970  | 0.4970           |
| X    | 1.0190  | 1.0095  | 1.0020  | 1.0060           | 0.4320  | 0.4270  | 0.4210  | 0.4260           | 0.5010  | 0.4947  | 0.4870  | 0.4880           |
| XI   | 1.0130  | 0.9939  | 0.9750  | 0.9830           | 0.4380  | 0.4298  | 0.4210  | 0.4310           | 0.4870  | 0.4791  | 0.4710  | 0.4740           |
| XII  | 0.9890  | 0.9767  | 0.9630  | 0.9630           | 0.4350  | 0.4301  | 0.4240  | 0.4240           | 0.4890  | 0.4824  | 0.4740  | 0.4840           |

<sup>1</sup> Data for year 2007 have been prepared in line with the accounting principles applied as of 1 January 2007 (for the description of changes in the accounting policies see Note 3 to the Bank of Latvia's financial statements for 2007).

*Appendix 6***THE BANK OF LATVIA'S ORGANISATIONAL UNITS AT THE END OF 2007****1. ACCOUNTING DEPARTMENT**

(Head of Department, Chief Accountant – Jānis Caune; Deputy Chief Accountants – Leo Ašmanis, Iveta Čavare)

1.1 Financial Statements and Accounting Policy Division (Head of Division – Gatis Gersons)

1.2 Internal Banking Operations Division (Head of Division – Anita Jakāne)

**2. CASHIER'S AND MONEY OPERATIONS DEPARTMENT**

(Head of Department – Veneranda Kausa; Deputy Head of Department – Vilnis Kepe)

2.1 Cash Operations Division (Head of Division – Oskars Zaltans)

2.2 Money Operations Division (Head of Division – Ruta Strēle)

2.3 Coin Division (Head of Division – Maruta Brūkle)

2.4 Money Expertise and Equipment Maintenance Division (Head of Division – Andris Tauriņš)

**3. COMMUNICATIONS DEPARTMENT**

(Head of Department – Aina Raņķe)

3.1 Publications Division (Head of Division, Deputy Head of Department – Aija Grīnfelde)

3.2 Library (Manager of Library – Anita Zariņa)

3.3 Archive (Manager of Archive – Baiba Blese)

3.4 Clerical Office (Head of Clerical Office, Deputy Head of Department – Svetlana Petrovska)

3.5 Protocol Division (Head of Division – Gundega Vizule)

**4. GOVERNOR'S OFFICE**

(Head of Office – Guntis Valujevs)

**5. INFORMATION SYSTEMS DEPARTMENT**

(Head of Department – Harijs Ozols; Deputy Head of Department – Ivo Oditis)

5.1 System Design and Programming Division (Head of Division – Ilgvars Apinis)

5.2 Computer Network and Server Systems Division (Head of Division, Deputy Head of Department – Egons Bušs)

5.3 Bank Information System Maintenance and Development Division (Head of Division – Valdis Spūlis)

5.4 Information Systems Security Division (Head of Division – Ilona Etmane)

5.5 Information Systems Quality Assurance Division (Head of Division – Askolds Kālis)

5.6 Systems Maintenance Division (Head of Division – Edvīns Mauriņš)

**6. INTERNAL AUDIT DEPARTMENT**

(Head of Department – Modris Briedis)

6.1 Operational Audit Division (Head of Division, Deputy Head of Department – Anita Hāznere)

6.2 Information System Audit Division (Head of Division – Juris Ziediņš)

**7. INTERNATIONAL DEPARTMENT**

(Acting Head of Department – Juris Kravalis; Deputy Head of Department – Aleksandra Bambale)

*Appendix 6*  
(cont.)

8. LEGAL DEPARTMENT

(Acting Head of Department – Ilze Posuma; Deputy Heads of Department – Iveta Krastiņa, Edvards Kušners)

9. MARKET OPERATIONS DEPARTMENT

(Head of Department – Raivo Vanags)

9.1 Trading and Investment Division (Head of Division, Deputy Head of Department – Kārlis Bauze<sup>1</sup>)

9.2 External Debt Management Division (Head of Division – Agita Birka)

9.3 Risk Management Division (Head of Division – Daira Brunere)

9.4 Analysis Division (Head of Division, Deputy Head of Department – Aigars Egle)

9.5 Payments and Settlements Division (Head of Division – Una Ruka)

10. MONETARY POLICY DEPARTMENT

(Head of Department – Helmūts Ancāns<sup>2</sup>; Deputy Heads of Department – Ēriks Āboliņš<sup>3</sup>, Zoja Rasmusa)

10.1 Macroeconomic Analysis Division (Head of Division – Vilnis Purviņš)

10.2 Financial Market Analysis Division (Head of Division – Elmārs Zakulis)

10.3 Monetary Research and Forecasting Division (Head of Division – Konstantīns Beņkovskis)

10.4 Financial Stability Division (Head of Division – Jeļena Zubkova)

11. PAYMENT SYSTEMS DEPARTMENT

(Head of Department – Egons Gailītis; Deputy Head of Department – Agnija Jēkabsons)

11.1 Payment Systems Policy Division (Head of Division – Anda Zalmane)

11.2 Payment Systems Operations Division (Head of Division – Natālija Popova)

11.3 Account Service and Maintenance Division (Head of Division – Andra Gailīte)

11.4 Register of Debtors Division<sup>4</sup> (Head of Division – Laura Ausekle)

12. PERSONNEL DEPARTMENT

(Head of Department – Inta Lovnika; Deputy Head of Department – Vineta Veikmane)

13. PUBLIC RELATIONS DEPARTMENT

(Head of Department, Press Secretary – Mārtiņš Grāvītis; Deputy Head of Department – Kristaps Otersons)

13.1 Visitors Centre (Head of Centre – Jānis Motivāns)

14. SECURITY DEPARTMENT

(Head of Department – Romualds Namnieks; Deputy Heads of Department – Imants Kravals, Sandis Mackēvičs)

14.1 Analytical Unit (Head of Unit – Māris Dzelme)

14.2 Armament Unit (Head of Unit – Juris Kušķis)

14.3 Central Division (Head of Division – Guntars Ezeriņš)

14.4 Riga Division (Head of Division – Normunds Puzulis)

<sup>1</sup> As of 18 January 2008, vacancy.

<sup>2</sup> As of 18 January 2008, Mr. Kārlis Bauze.

<sup>3</sup> As of 10 March 2008, Mr. Uldis Rutkaste.

<sup>4</sup> As of 1 January 2008 – Credit Register Division.

*Appendix 6*  
(cont.)

14.5 Daugavpils Division (Head of Division – Ilmārs Suhockis)

14.6 Liepāja Division (Head of Division – Gints Liepiņš)

14.7 Rēzekne Division (Head of Division – Andrejs Gugāns)

15. STATISTICS DEPARTMENT

(Head of Department – Agris Caune; Deputy Head of Department – Ilmārs Skarbnieks)

15.1 Financial Market and Monetary Statistics Division (Head of Division – Zigrīda Aušta)

15.2 Balance-of-Payments Statistics Division (Head of Division – Daiga Gaigala-Ližbovska)

15.3 General Economic and Financial Statistics Division (Head of Division – Iveta Salmiņa)

16. TECHNICAL SUPPORT DEPARTMENT

(Head of Department – Andris Nīkitins)

16.1 General Service Division (Head of Division, Deputy Head of Department – Einārs Čiņš)

16.2 Building Systems Division (Head of Division – Jānis Kreicbergs)

16.3 Security Systems Division (Head of Division – Viesturs Balodis)

17. RIGA BRANCH

(Branch Manager – Jānis Strēlnieks; Deputy Branch Manager – Gunārs Viksne)

18. DAUGAVPILS BRANCH

(Branch Manager – Jolanda Mateša<sup>1</sup>; Deputy Branch Manager – Bernarda Kezika)

19. LIEPĀJA BRANCH

(Branch Manager – Gundars Lazdāns; Deputy Branch Manager – Ieva Ratniece)

20. RĒZEKNE BRANCH

(Branch Manager – Anna Matisāne; Deputy Branch Manager – Gintauts Senkans)

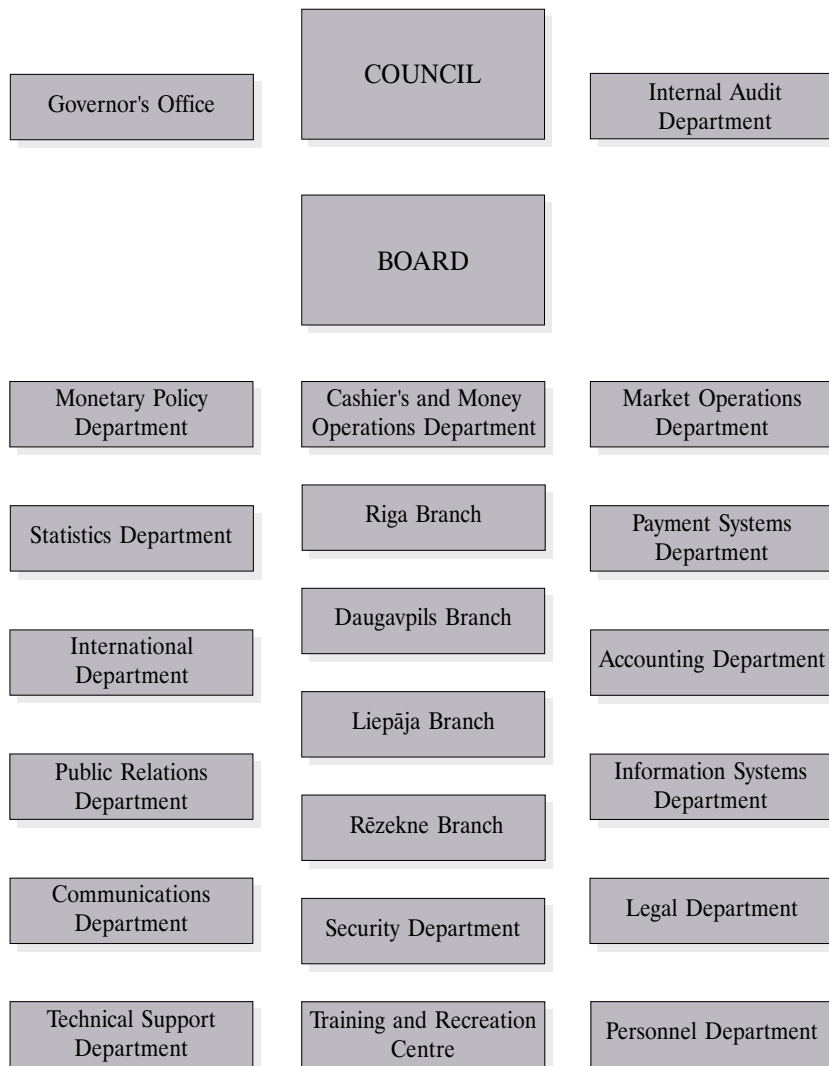
21. TRAINING AND RECREATION CENTRE

(Head of Centre – Zaiga Blūma; Deputy Head of Centre – Dace Miķilpa)

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<sup>1</sup> As of 18 January 2008, vacancy; as of 10 March 2008, Ms. Ināra Brauna.

## THE BANK OF LATVIA'S STRUCTURE AT THE END OF 2007



*Appendix 8***REPRESENTATION OF THE BANK OF LATVIA IN INTERNATIONAL ORGANISATIONS****EUROPEAN UNION****EFC**

Helmūts Ancāns, Deputy Chairman of the Bank of Latvia's Board, Head of Monetary Policy Department<sup>1</sup>

Jeļena Zubkova, Head of Financial Stability Division, Monetary Policy Department<sup>2</sup>

**EFC's Euro Coin Sub-Committee (ECSC)**

Maruta Brūkle, Head of Coin Division, Cashier's and Money Operations Department

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

Juris Kravalis, Head of International Department

**Committee of European Banking Supervisors (CEBS)**

Vita Pilsuma, Member of the Bank of Latvia's Council (Banking Supervisory Institution is represented by Jānis Placis, Member of the Council of the FCMC)

**Committee on Monetary, Financial and Balance of Payments Statistics (CMFB)**

Agris Caune, Head of Statistics Department

Ilmārs Skarbnieks, Deputy Head of Statistics Department

**Eurostat Balance of Payments Committee**

Daiga Gaigala-Ližbovska, Head of Balance of Payments Statistics Division, Statistics Department

Valters Zile, Deputy Head of Balance of Payments Statistics Division, Statistics Department

**Public Administration Network (PAN II)**

Vilnis Kepe, Deputy Head of Cashier's and Money Operations Department

**Republic of Latvia Mission to the EU**

Aldis Austers, Special Attaché of the Bank of Latvia

**EUROPEAN SYSTEM OF CENTRAL BANKS****General Council of the ECB**

Ilmārs Rimšēvičs, Governor of the Bank of Latvia

**Accounting and Monetary Income Committee (AMICO)**

Jānis Caune, Chief Accountant of the Bank of Latvia

Leo Ašmanis, Deputy Chief Accountant of the Bank of Latvia

**Banking Supervision Committee (BSC)**

Zoja Razmusa, Deputy Head of Monetary Policy Department (Banking Supervisory Institution is represented by Uldis Cērps, Chairman of the FCMC)

**Banknote Committee (BANCO)**

Veneranda Kausa, Head of Cashier's and Money Operations Department

Vilnis Kepe, Deputy Head of Cashier's and Money Operations Department

<sup>1</sup> As of 21 January 2008, Mr. Kārlis Bauze, Head of Monetary Policy Department.

<sup>2</sup> As of 21 January 2008, Mr. Juris Kravalis, Head of International Department.

*Appendix 8*  
(cont.)

**Eurosystem/ESCB Communications Committee (ECCO)**

Mārtiņš Grāvītis, Head of Public Relations Department

Aina Raņķe, Head of Communications Department

**Human Resources Conference (HRC)**

Inta Lovnika, Head of Personnel Department

**Information Technology Committee (ITC)**

Harijs Ozols, Member of the Bank of Latvia's Board, Head of Information Systems Department

Ivo Odītis, Deputy Head of Information Systems Department

**Internal Auditors Committee (IAC)**

Modris Briedis, Head of Internal Audit Department

Anita Hāznere, Deputy Head of Internal Audit Department, Head of Operational Audit Division

**International Relations Committee (IRC)**

Andris Ruselis, Deputy Governor of the Bank of Latvia

Juris Kravalis, Head of International Department

**Legal Committee (LEGCO)**

Ilze Posuma, Head of Legal Department

Iveta Krastiņa, Deputy Head of Legal Department

**Market Operations Committee (MOC)**

Raivo Vanags, Head of Market Operations Department

Aigars Egle, Deputy Head of Market Operations Department, Head of Analysis Division

**Monetary Policy Committee (MPC)**

Helmūts Ancāns, Deputy Chairman of the Bank of Latvia's Board, Head of Monetary Policy Department<sup>1</sup>

Uldis Rutkaste, Chief Economist of Macroeconomic Analysis Division, Monetary Policy Department<sup>2</sup>

**Payment and Settlement Systems Committee (PSSC)**

Egons Gailītis, Head of Payment Systems Department

Ēriks Āboliņš, Deputy Head of Monetary Policy Department<sup>3</sup>

**Statistics Committee (STC)**

Agris Caune, Head of Statistics Department

Ilmārs Skarbnieks, Deputy Head of Statistics Department

**INTERNATIONAL MONETARY FUND**

**Board of Governors**

Ilmārs Rimšēvičs, Governor of the Bank of Latvia

**Nordic-Baltic Monetary and Financial Committee (NBMFC)**

Andris Ruselis, Deputy Governor of the Bank of Latvia

<sup>1</sup> As of 21 January 2008, Mr. Kārlis Bauze, Head of Monetary Policy Department.

<sup>2</sup> As of 10 March 2008, Deputy Head of Monetary Policy Department.

<sup>3</sup> As of 20 March 2008, Mr. Elmārs Zakulis, Head of Financial Market Analysis Division of Monetary Policy Department.



*Appendix 8*  
*(cont.)*

**Nordic-Baltic Monetary and Financial Committee, Group of Alternates (NBMFC Alternates)**

Juris Kravalis, Head of International Department

**Nordic-Baltic IMF Office in Washington**

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

*Appendix 9***THE BANK OF LATVIA'S 2007 PUBLICATIONS**

*This list contains publications prepared and issued by the Bank of Latvia in 2007. These publications are available on the Bank of Latvia's website ([www.bank.lv](http://www.bank.lv)). Those prepared in print are available free of charge both at the Bank of Latvia and by mail (if not indicated otherwise and a sufficient number of copies are available) sending a request to the address indicated on the last page of this publication or by e-mailing to: [info@bank.lv](mailto:info@bank.lv).*

**REGULAR PUBLICATIONS**

Bank of Latvia: Annual Report 2006  
Monetārais Apskats. Monetary Review (3, 4/2006 and 1, 2/2007)  
Monetary Bulletin (11, 12/2006 and 1–10/2007)  
Financial Stability Report (2/2006)  
Latvijas Maksājumu Bilance. Latvia's Balance of Payments (3, 4/2006 and 1, 2/2007)  
Latvia's Balance of Payments (Key Items) (11, 12/2006 and 1–10/2006)

**WORKING PAPERS**

1. *Beņkovskis K., Paula D.* Inflation and Inflation Uncertainty in Latvia
2. *Meļihovs A., Zasova A.* Estimation of the Phillips Curve for Latvia
3. *Ajevskis V.* Inflation Expectations in Latvia: Consumer Survey Based Results

*Appendix 10***2007 HIGHLIGHTS OF RESOLUTIONS AND REGULATIONS ADOPTED IN PURSUIT OF THE BANK OF LATVIA'S MAIN TASKS****15 March**

The Council of the Bank of Latvia approved the Regulation No. 1 "Transaction Interest Rates", increasing the refinancing rate by 0.5 percentage point, to 5.50% (in effect as of 24 March 2007). The Bank of Latvia's marginal lending facility rate was also set at 6.50% and deposit facility rate – at 2.00%.

The Council of the Bank of Latvia approved the Regulation No. 2 "Regulation Governing Transactions" stipulating the procedure for setting transaction interest rates, prices, amounts and maturities (in effect as of 24 March 2007).

The Council of the Bank of Latvia approved the Regulation No. 3 "Regulation for Compiling 'Credit Institution Payment Statistics Report' " (in effect as of 1 July 2007).

**17 May**

The Council of the Bank of Latvia approved the Regulation No. 4 "Transaction Interest Rates", increasing the refinancing rate by 0.5 percentage point, to 6.00% and the marginal lending facility rate by 1.0 percentage point, to 7.50%, and leaving the bank deposit facility rate unchanged at 2.00% (in effect as of 18 May 2007).

The Council of the Bank of Latvia approved the Regulation No. 5 "Regulation for the Use of the Bank of Latvia's Monetary Policy Instruments" outlining the procedure for the use of the monetary policy instruments by the Bank of Latvia and participation by banks in the monetary policy operations of the Bank of Latvia (in effect as of 1 June 2007).

**12 July**

The Council of the Bank of Latvia approved Regulation No. 6 "The Monthly Report of Holders of Securities" (in effect as of 1 January 2008).

The Council of the Bank of Latvia approved Regulation No. 7 "The Description of the Lats Banknotes" (in effect as of 13 July 2007).

**13 September**

The Council of the Bank of Latvia approved Regulation No. 8 "Regulation for the Credit Register" (in effect as of 1 January 2008).

The Council of the Bank of Latvia approved Regulation No. 9 "Regulation for the Amount of and the Payment Procedure for the Fees to Be Paid for the Use of the Credit Register by Its Participants" (in effect as of 1 January 2008).

**2 November**

The Council of the Bank of Latvia passed a resolution "On Participation in the Trans-European Automated Real-time Gross Settlement Express Transfer System TARGET2", deciding to join the Trans-European Automated Real-time Gross Settlement Express Transfer System TARGET2 on 19 November 2007 and commence TARGET2-Latvija operation.

**15 November**

The Council of the Bank of Latvia approved the Regulation No. 10 "Technical Regulation for the Credit Register" (in effect as of 1 January 2008).

*Appendix 10*  
*(cont.)*

The Council of the Bank of Latvia approved the Regulation No. 11 "Amendments to the Bank of Latvia Regulation No. 8 of 13 September 2007, the 'Regulation for the Credit Register' " (in effect as of 1 January 2008).

The Council of the Bank of Latvia approved the Regulation No. 12 "Amendments to the Bank of Latvia Regulation No. 9 of 13 September 2007, the 'Regulation for the Amount of and the Payment Procedure for the Fees to Be Paid for the Use of the Credit Register by Its Participants' " (in effect as of 1 January 2008).

The Council of the Bank of Latvia approved the Regulation No. 13 "Amendment to the Bank of Latvia Regulation No. 7 of 12 July 2007, 'The Description of the Lats Banknotes' " (in effect as of 5 December 2007).

*Appendix 11***GLOSSARY**

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

**Automatic Lombard loan:** see *automatic loan*.

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

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

**Central government:** public institutions, including ministries, embassies, representative offices, agencies, councils, educational, healthcare, law enforcement, cultural and other public institutions whose competence covers the whole economic territory of a country. Central government includes state non-profit institutions managed and financed by the central government.

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

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

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

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

**Debt securities:** securities representing an obligation and promise on the part of the issuer (i.e. the borrower) to make one or more payment(s) to the holder (the lender) of the securities at a specified future date or dates (e.g. bonds, notes, money market instruments). Such securities usually carry a specific rate of inter-

*Appendix 11*  
(cont.)

est (the coupon) or are sold at a discount to the amount that will be repaid at maturity. Debt securities issued with an original maturity of more than one year are classified as long-term debt securities.

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

**Demand Lombard loan:** see *demand loan*.

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

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

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

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

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

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

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

**Equities:** securities representing ownership of a stake in a commercial company.

*Appendix 11  
(cont.)*

They comprise listed and unlisted equities (e.g. quoted shares, unquoted shares and other forms of equity) and usually produce income in the form of dividends.

**Euro area:** EU countries which have adopted the euro as their single currency in accordance with the Treaty establishing the European Community and in which a single monetary policy is conducted under the responsibility of the Governing Council of the ECB. As at the end of 2007, the euro area comprised Austria, Belgium, Finland, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Slovenia, Spain and Germany (Cyprus and Malta also joined the euro area on 1 January 2008).

**European Central Bank (ECB):** the central institution of the ESCB and the Eurosystem having a legal personality under the Community law. The ECB implements the tasks conferred upon the Eurosystem and the ESCB pursuant to the Statute of the ESCB and ECB in cooperation with the national central banks. The ECB is governed by the Governing Council and the Executive Board, and, until all EU Member States introduce the euro, by a third decision-making body, the General Council.

**European System of Central Banks (ESCB):** includes the ECB and the national central banks of the EU Member States. The national central banks of those EU Member States which have not adopted the euro implement an independent monetary policy according to national law and are thus not involved in the conduct of the monetary policy of the Eurosystem.

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

**Exchange rate mechanism II (ERM II):** the exchange rate arrangement that ensures the framework for exchange rate policy cooperation between the euro area countries and the EU Member States not participating in Stage Three of EMU. As at the end of 2007, Denmark, Estonia, Cyprus, Latvia, Lithuania, Malta and Slovakia were members of the ERM II. (With the introduction of the euro on 1 January 2008, Cyprus and Malta ceased to participate in ERM II).

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

**Financial institutions:** OFIs, financial auxiliaries, insurance corporations and pension funds.

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

**Floating rate instrument:** a financial instrument for which the coupon is periodically reset relative to a reference index to reflect changes in short-term or medium-term market interest rates. Floating rate instruments may have a coupon

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(cont.)

determined either on the basis of the reference index at a certain date before the start of the coupon accrual period or during the coupon accrual period.

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

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

**General government:** public institutions engaged in production of non-market goods and services intended for individual and collective consumption or public institutions engaged in redistribution of national income or wealth. General government in the Republic of Latvia includes central government and local government.

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

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

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

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

**International Monetary Fund (IMF):** an international organisation, founded in July 1944, to facilitate international monetary cooperation, exchange rate stability, national economic growth and employment growth, and ensure short-term financial assistance, should any of the IMF Member States need to solve balance-of-payments related problems.



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

**Local government:** public institutions, whose competence covers only a local economic territory. Local government includes state non-profit institutions managed and financed by the local government. In the Republic of Latvia, the local government level is comprised of the local authorities.

**Lombard loan:** see *marginal lending facility*.

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

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

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

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

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

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

**Main refinancing operations:** market operations of the Bank of Latvia organised in the form of auctions of reverse transactions, whereby banks registered in the Republic of Latvia are granted collateralised loans. The minimum bid rate at the

*Appendix 11*  
*(cont.)*

auction equals the Bank of Latvia's refinancing rate. The Bank of Latvia sets the total allotment amount for each auction. The maturity of the loan is 7 days. These operations replaced auctions of repurchase agreements on short-term securities.

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

**Market operations:** operations executed on the initiative of the central bank in the financial market. The Bank of Latvia's market operations fall into four categories used by the Eurosystem: main refinancing operations, longer-term refinancing operations, structural operations and fine-tuning operations. The main instruments of the Bank of Latvia's market operations are reverse transactions. Outright transactions are available for the conduct of structural operations, whereas outright transactions, foreign exchange swaps and time deposits are available for the conduct of fine-tuning operations.

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

**Monetary financial institutions (MFIs):** institutions forming the money-issuing sector. The Bank of Latvia maintains the "List of Monetary Financial Institutions of the Republic of Latvia" (see Statistical Reporting Forms under Legal section on the Bank of Latvia's website at [www.bank.lv](http://www.bank.lv)) which comprised the Bank of Latvia, 31 credit institutions, two money market funds and 35 other MFIs (credit unions) as at the end of 2007. The ECB regularly publishes the "List of MFIs of the EU Member States" on its website (see Links on the Bank of Latvia's website at [www.bank.lv](http://www.bank.lv)).

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

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

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

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

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(cont.)*

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

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

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

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

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

**Reserve base:** the sum of the balance sheet items which constitute the basis for calculating the reserve requirements of banks registered in the Republic of Latvia.

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

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

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

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

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

*Appendix 11*  
*(cont.)*

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

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

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

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

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

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

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

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

**Bank of Latvia: Annual Report 2007**

Latvijas Banka (Bank of Latvia)

K. Valdemāra ielā 2A, Rīga, LV-1050, Latvia

Tēl.: +371 6702 2300 Fax: +371 6702 2420

<http://www.bank.lv>

[info@bank.lv](mailto:info@bank.lv)

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