LATVIJAS BANKA

BANK OF LATVIA: ANNUAL REPORT 2012

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

Details may not add because of rounding-off.

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

Photos: Aivars Liepiņš, Aleksandrs Kendenkovs, Indriķis Stūrmanis and Andris Tenass.

The cut-off date is 29 April 2013.

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ABBREVIATIONS

ATM	Automated Teller Machine
BIS	Bank for International Settlements
CSB	Central Statistical Bureau of Latvia
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EEA	European Economic Area
EFC	Economic and Financial Committee
EKS	Bank of Latvia's Electronic Clearing System
EMU	Economic and Monetary Union
ERM II	Exchange Rate Mechanism II
ESA 95	European System of Accounts 1995
ESA 2010	European System of Accounts 2010
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESRB	European Systemic Risk Board
EU	European Union
EU27	current EU countries
Eurostat	Statistical Bureau of the European Union
FCMC	Financial and Capital Market Commission
FRS	US Federal Reserve System
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
INTS	internet statistical database of the Bank of Latvia
IT	information technologies
JSC	joint stock company
LCD	Latvian Central Depository
Ltd.	limited liability company
M0	monetary base
M1	narrow monetary aggregate
M2	intermediate monetary aggregate
M2X	broad monetary aggregate calculated on the basis of the Bank of Latvia's methodology
M3	broad monetary aggregate
MFI	monetary financial institution
Ministry of Finance	Ministry of Finance of the Republic of Latvia
OECD	Organisation for Economic Co-operation and Development
OTC	over-the-counter trading
PPI	Producer Price Index
RIGIBID	Riga Interbank Bid Rate
RIGIBOR	Riga Interbank Offered Rate
SAMS	Bank of Latvia's Interbank Automated Payment System
SDR	Special Drawing Rights
SEA	State Employment Agency
SEPA	Single Euro Payments Area
SJSC	state joint stock company
UK	United Kingdom
UN	United Nations
US	United States of America
WTO	World Trade Organisation
VAT	Value Added Tax

FOREWORD OF THE GOVERNOR

In three years, Latvia has overcome the economic crisis, demonstrating that a decisive return to a responsible budget management helps stabilise the economy and state finances and renew growth. For two consecutive years, Latvia has posted the most rapid GDP growth rate in the EU; moreover, according to the EC forecast, a similar performance is expected in the next three years as well.

It is important that other factors are behind the economic growth than in the previous period of economic development when growth primarily resulted from domestic consumption and the real estate bubble triggered by easily obtained loans. The Latvian economy has regained its competitiveness with exports and investment as well as private consumption as the main drivers. Moreover, Latvia has managed to achieve stable growth in exports despite a substantial deterioration of the economic situation in its export partner countries.

Latvia has managed to resist the deterioration of external conditions caused by the sovereign debt crisis by modernising production, improving competitiveness and thus increasing exports without changing its exchange rate. Under the impact of sovereign debt crisis the rate of economic growth has dropped substantially in many EU countries, also reducing their demand for imports, while Latvian entrepreneurs have not only retained but even increased their market shares. The map of Latvia's exports is sufficiently extensive and varied, and that has allowed us to compensate, at least in part, for the decreasing demand in the EU, Latvia's largest export market, as exports to the trade partners outside the EU grew faster in the period at hand.

The most important factor behind the robust economic growth has been the regained confidence of investors and a substantial rise in investment; however, the total balance of loans granted by Latvian credit institutions, particularly loans to households, continued to deteriorate. Since the end of 2010, the inflows of foreign direct investment have posted stable growth, reaching 3.5% of GDP. If the investors see prospects for development in Latvia, it is primarily the result of the policies chosen for overcoming the crisis, i.e. decisively and quickly making expenditures commensurate with revenues and upholding the stability of the lats.

In the last couple of years, Latvia's economic activity has not been spurred by additional budget expenditure, and an ever growing part of the population is aware that a lack of budget discipline is a risky policy that scares off investors and endangers jobs. Even large countries, such as the UK and Japan, have learnt from recent experience that printing money does not ensure a quick recovery of the economy if the state finances are not in order. In Latvia, the opposite has taken place: growth has been supported not only by EU funding but also by income from exports and investment, while the state budget deficit has continued to shrink.

These developments, particularly the increased share of exports in the economy, have had a beneficial effect not only on exporting businesses and their employees but also on an increasing part of the general population. This is evident both in the rise in average salary and a gradual increase in employment. In the last few years, the necessary restructuring has taken place in the economy overall and particularly in the private sector, and the Latvian economy is now much better suited for maintaining sustainable economic growth.

In view of the fact that the risk of rising inflation is limited, the Bank of Latvia has cut interest rates on the main monetary operations as well as the minimum reserve requirement for credit institutions, so that credit resources, so vital for the economic growth, would become more easily available for businesses. As of mid-2012, lending to businesses in several sectors of the economy, including agriculture, transport and some sub-branches of manufacturing, has increased. The tension in the Latvian financial market, observed in the crisis years, has been basically overcome and the interbank market functions more efficiently, which has allowed us to lower the interest rates on the central bank's lending facility.

An important task at hand is to retain the recovered competitiveness of the economy and confidence in the economic policies of the state by continuing to gradually improve the structural balance of the budget. Both Latvia's fiscal discipline, which, having learnt the lesson from the crisis, we are determined to observe, and the EU-wide agreement, ratified by the Saeima of the Republic of Latvia by a large majority, will help in the formation of a growing budget reserve, thus improving the structural balance of the government budget as well.

Participants in the international financial markets and credit rating agencies have already given a positive evaluation to Latvia's achievements in stabilising the economy and growth: Latvia's credit ratings have been improved as has their assessment for the future. Investors have also offered low interest rates on Latvia's securities issued in the international financial markets. In a short time, Latvia has regained the GDP volume lost during the crisis, and it is expected that in 2013, the total real GDP per capita could reach the pre-crisis level. Economic growth is one of the ways of continuing to reduce unemployment and dropping purchasing power.

Looking back on the period under review, the responsible, economically sound actions by the government and Saeima of the Republic of Latvia deserve the highest praise for consistently moving toward conforming to the Maastricht criteria, which is the precondition to economic stability and increased economic activity and also opens the door for full participation of Latvia in the EMU. In the spring of 2013, Latvia asked its EU partners to evaluate country's compliance with the Maastricht criteria, so that it could introduce the euro as early as 2014. For Latvia it would mean greater financial gain than investment (higher credit ratings, lower interest rates both for the state and businesses, dissipation of the currency devaluation risk) and, at the same time, new opportunities for more rapid economic growth in the coming years.

If in the summer of 2013 the Council of Europe adopts a positive decision regarding Latvia's full participation in the Economic and Monetary Union as of 1 January 2014, the Latvian state institutions, including the Bank of Latvia, will have less than six months for practical preparations for smooth euro changeover. The work has already begun, including communication regarding the possible introduction of the euro, which is supported in Latvia by about one third of those surveyed. That is a lot, given the negative news background resulting from the sovereign debt crisis in the euro area, yet there is an equal number of sceptics for whom convincing information, explaining not only the procedure for exchanging the lats but also the long-term benefits of participation in the euro area by a small country like Latvia with an open economy and euro-pegged exchange rate, will be of utmost importance. After its transition to the euro, Latvia will no longer be punished by less favourable conditions in economic transactions for the mere fact that it is a small country with a currency, which, at times of global financial turmoil, invites questions about its stability and sustainability. The euro coins will feature symbols important to Latvia of the kind we are used to seeing on the lats coins. According to the annual public survey as to which of the collector coins struck in 2012 has been the most significant in terms of artistic approach, theme or emotional content, it was the *5-lats Silver Collector Coin* with the popular profile of a Latvian folk-maid originally created by Rihards Zariņš, which won the title of the coin of the year. This same design will adorn the national side of Latvian 1 and 2 euro coins.

I am very grateful to the employees of the Bank of Latvia for their work in the last year. In this very complicated period for the global economy, it has been an essential contribution to the stabilisation and further development of the Latvian economy. We face a period that is no less important. At the moment, Latvia is waiting with bated breath what the decision will be regarding its joining the euro area. May everyone have the strength and energy to help Latvia achieve this very important goal.

Ilmārs Rimšēvičs
Governor of the Bank of Latvia
Riga, 26 April 2013

THE BANK OF LATVIA VISION AND MISSION

VISION

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

MISSION

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

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

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

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

The Bank of Latvia is a reliable cooperation partner.

ECONOMIC ENVIRONMENT

GLOBAL ECONOMIC ENVIRONMENT

The global economic growth continued on a downward trend. In most developed countries, GDP grew only moderately, while some other economies recorded a decline. The euro area sovereign debt crisis, economic uncertainty in many countries and the resulting weakness of private consumption triggered negative effects on the economic growth. Although many countries were pursuing economic stimulus policies, inflation generally followed a downward trend. Due to market participants' anxiety about anticipated oil supply disruptions in the first quarter, the oil price remained elevated; nevertheless, in the remaining part of the year, decelerating economic progress in both developed and developing countries underpinned a substantial fall in the prices of energy resources. The re-election of US President Barack Obama to a second term figured as the most important event in 2012, suggesting continuation of the current US economic and political positions.

The overall global economic situation started to improve in the third quarter of 2012. It was primarily driven by growth acceleration in the developing world and also in the US. Meanwhile, the financial situation continued on a rise into the fourth quarter due to significant agreements reached to further resolve the crisis. However, many factors, e.g. economic uncertainty, continued to obstruct the global economic growth.

In 2012, a set of measures to mitigate the financial crisis were launched in the euro area, and its peripheral countries received a bulky support. The worries about an eventual collapse of the euro area generally abated, yet the implemented contractionary fiscal policy impeded economic recovery in the euro area. Despite some curbing of the euro area overall budget deficit, several major euro area countries failed to reduce their budgets to sustainable levels. The economic advance in the euro area differed across the countries. Germany recorded a slight GDP growth, while Spain and Italy plunged into recession but GDP in France posted a close-to-zero improvement.

In 2012 overall, the euro area recorded a GDP decline, with Greece and Portugal excelling in the steepest GDP drop and Slovakia and Estonia demonstrating the fastest GDP rise. Although GDP in Estonia expanded rather dynamically throughout 2012, the country's export growth decelerated in the second half of the year when the external demand weakened. Inflation stood at 4.2% in Estonia (5.1% in 2011), and its decline was primarily driven by lower energy and food prices in the world. Euro area's unemployment rose from 10.7% to 11.7% within the year.

GDP growth in Lithuania in 2012, which was also steep, was determined by the record-high expansion of manufacturing. Poland, by contrast, recorded the slowest growth in the last three years primarily on account of a weaker domestic demand.

In 2012, the US economy recorded a stronger growth (2.2%) than in the previous year (1.8%). The US accommodative monetary policy and expansionary fiscal policy supported private consumption; inflation, which in 2011 was basically caused by rising prices of resources, also moderated. The real estate market saw construction of new housing rise, and the unsold housing stock shrank. Unemployment declined from 8.5% to 7.8% in the course of the year. The end of the year was approaching in a tense situation due to several US economic stimulus programmes coming to a close; their abrupt closure threatened with recession in the US in 2013. In the concluding days of the year, however, the US legislators made several amendments to legislation thus averting an immediate growth deceleration in the US economy but jeopardising budget balancing in the US in a longer term.

At the end of 2011 and in early 2012, the economic growth in Japan was closely related to the disastrous earthquake of 2011 and liquidation of its negative effects; the economy fell into stagnation in the second half of the year again. Deflation continued, and Japan's trade balance was negative for the second year in the run. In addition, the situation took a turn for the worse in the second half of the year due to the conflict between Japan and China, which both lay claims to islands in the East China Sea. The UK economy was negatively impacted in 2012 by the moves approved in previous years with regard to cutting the country's fiscal deficit. Its GDP recorded some growth only in the third quarter primarily on account of the economic activity spurred by London hosting the summer Olympic Games.

Sweden's growth pace was relatively stable pace in 2012, while the economic recovery in Denmark remained very fragile. Even though the economic development in Sweden proceeded at a rather rapid rate, export growth decelerated notably towards the close of the year due to weaker external demand; the rise in domestic demand also started to slow down. In Denmark in the meantime, private consumption protractedly remained modest, with even the record-low interest rates failing to enhance it, as the private sector debt had been gradually contracting since the burst of the housing bubble.

The economic recovery in the UK was fragile in 2012. The largest drop in GDP, both year-on-year and quarter-on-quarter, was observed in the second quarter. Private consumption was impaired by tight lending standards, fiscal consolidation, and shrinking real income due to high inflation. Meanwhile, the Bank of England continued to pursue expansionary monetary policy, which supported private consumption to at least some extent. In general, the UK economy got positive impetus also from the Olympic Games hosted in 2012 in London.

In Russia in 2012, GDP increased by 3.4% (by 4.3% in 2011). In 2012, investment growth decelerated in particular, private consumption remained robust, and the negative contribution from net exports diminished considerably. In the breakdown by sector, agricultural output decreased significantly due to a seasonal heat wave and the subsequent drought.

The financial market developments in Europe and other related regions were significantly impacted by the sovereign debt crisis in some European countries. Credit risks augmented notably in some peripheral euro area countries in the first half of the year and gave rise to speculations about the euro area sustainability with the current country composition; as a consequence, the financial market participants refrained from investing in high-risk financial assets and opted for traditionally safer-deemed ones. In the second half of the year, the Member States managed to agree on further solutions to the crisis. As a result, the possibilities of euro area peripheral countries becoming insolvent were substantially reduced and financial market agents' fears about the economic growth sustainability in some countries of the euro area subdued. Consequently, the financial markets responded with gradually renewing investment in higher-risk assets in the second half of 2012, while investment in traditionally safer assets contracted accordingly.

Greece and the course of developments there were in the focus of financial markets and affected investment decisions of its participants throughout 2012. In the initial months of the year, when financial markets were clad in uncertainty whether Greece would be able to prevent insolvency, the euro area countries had to agree on a second support programme for the sovereign-debt-crisis-hardest-hit country in the euro area; in the meantime, in order to be entitled to such support, Greece had to solicit private investors for a write-off of a certain amount of Greek debt they held. In early March, when the nation's debt swap deal was reached, the financial market tensions abated temporarily. Soon after, driven by the Greek leading parties' declarations about the need to review the agreed international bail-out and backed by the newly elected (in May) parliament's failed attempts to form a coalition government, speculations of financial market participants about Greece's eventual departure from the euro area burst out with new force. The situation rebounded in June when, as a result of a second election, Greece succeeded in forming an effective government and taking responsible decisions on launching restrictive fiscal measures. The Eurogroup approved the next tranche of bail-out funding for Greece and a number of debt-alleviating measures as late as the end of November.

Participants of the European financial market put much of the focus on the problems of Spanish banks as well. In May, *Bankia*, one of the largest Spanish banks, requested financial support from the state. The resolution of problems at other credit institutions also required additional financing. In early June, Spain applied for the euro area funding to recapitalise its ailing banking sector. The Eurogroup made a decision on terms and conditions of the Spanish bail-out programme in July, and by December of 2012, a total of 40 billion euro had been paid out to the Spanish government.

The Cyprus support issue was not solved in 2012, while its credit institutions suffered heavy losses from investing in Greece. Despite clearly seen need for support, an agreement with international lenders was not actively discussed due to political reasons.

The ECB decisions and measures launched played an important part in resolving the European debt crisis. At the beginning of the year, the financial market strain was eased by the long-term liquidity-providing (refinancing) operations, which are used by the ECB to lend unlimited amounts of money at low interest rates to euro area banks. Furthermore, on 5 July the ECB decided to lower its key interest rates by 25 basis points. The announcement of Mario Draghi, President of the ECB, to do, within the ECB mandate, whatever it takes to preserve the euro was also crucial. In September, market participants' worries about the future of the euro area were dispelled by the ECB announcing the Outright Monetary Transactions (OMTs) Programme, under which the ECB undertook to purchase in secondary sovereign bond markets medium-term bonds of crisis-hit euro area countries under the condition that they receive the support from the European Financial Stability Facility or the European Stabilisation Mechanism and adhere to their commitments under support programmes. And even though by the end of 2012 no government bond-buying had taken place under this ECB programme, its existence induced confidence in market participants that, when necessary, the ECB would be able to reduce extra-high government bond yields.

Several political decisions taken by a number of euro area countries were no less important for finding the way out of the sovereign debt crisis. The European Stabilisation Mechanism started operation in October, and all the Member States managed to make the required capital payments according to accelerated schedule. Euro area countries agreed on the establishment of a single supervisory mechanism for all the credit institutions. Tighter fiscal policy requirements, also incorporating major austerity measures, were implemented in the EU.

In 2012 overall, the euro peripheral government bond yields tended to decline, while those of the so far traditionally safer-deemed countries rose. With market participants' risk appetites growing, East European government bond yields contracted. Following a protracted break, several countries, e.g. Ireland, successfully issued government bonds in the second half of the year. Other countries, e.g. Spain, likewise managed to effect their financing needs independently without using any international support.

The euro money market index EURIBOR decreased gradually in 2012 due to moderating risk aversion of financial market participants, rising confidence in euro area markets, and the ECB decision to lower the main refinancing operation rate. Liquidity operations, e.g. long-term liquidity operations with 36-month maturity offered by the ECB, also supported low money market indices.

At the beginning of the year, the euro depreciated against the US dollar, whereas in the second half of the year, along with the situation in the euro area financial market stabilising, it appreciated again. This move was supported by the accommodative monetary policy pursued by the FRS and market participants' worries about the US fiscal position. As was expected, the FRS increased the purchase of agency mortgage-backed securities in September at a pace 40 billion US dollars per month, and extended by one year (up to the middle of 2015) the period for keeping the target range of federal funds rate at 0%–0.25%. Meanwhile in December, the FRS defined the period of preserving the base rate at 0.25% against the US unemployment and inflation indicators. The FRS decided also to expand the third round of the quantitative easing programme by additionally purchasing long-term government securities at a pace of about 45 billion US dollars per month. Some other central banks across the world, e.g. the Bank of England and the Bank of Japan, also implemented accommodative monetary policies.

Following a slide-down in the spring of 2012, the global stock market indices started to go up again in the second half of the year. Despite volatility, oil prices did not change substantially during the year. *Brent* crude oil cost 108 US dollars per barrel at the close of 2011 and 111 US dollars per barrel a year later. The demand for oil remained weak, while its unstable supply was mainly dependent on the conflict situations in oil-producing Middle East regions.

Although towards the close of 2012 the sovereign debt crisis in the euro area had abated, aggravation of the situation in any of the euro area peripheral countries cannot be excluded. In order to attain the budget goals set by their fiscal policies, ensure higher competitiveness and economic growth, and implement and improve new solutions to the European debt crisis, the euro area countries will have to address complex problems in the medium term.

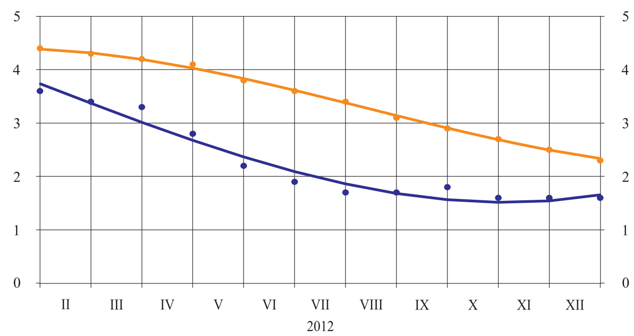
LATVIA'S ECONOMIC ENVIRONMENT

INFLATION AND PRICES

In 2012, inflation decreased notably from 3.6% in January to 1.6% in December (see Chart 1) due to both global developments and domestic factors.

Chart 1

ANNUAL CONSUMER PRICE INFLATION
(%)



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

Source: CSB.

Although global food and energy prices remained at a high level, they did not elevate as steeply as in 2011. For instance, the price of *Brent* crude oil in US dollars picked up 0.3% on average in 2012 (40.4% in 2011). The global energy prices got positive impetus from the domestic energy prices. The mid-year rise in the prices of natural gas and heat was on account of the surge in nine-month average heating oil price; in the second half of the year, natural gas sales price stabilised and positively affected prices of the related consumer goods, e.g. natural gas and heat.

The upward trend in global food prices had also subsided. According to the data of the Food and Agriculture Organisation of the United Nations, the price index for global food and agricultural goods decreased by 7% in 2012 (a rise of almost 23% was recorded in 2011). The harvest estimates of the new season, which became available in the middle of the year, had a negative impact on the cereal prices, which first rose rapidly, soon after stabilised, and in the fourth quarter were even on a downward trend. Speaking about the global market trends in the second half of the year in general, price hikes, driven by insufficient supplies, were recorded only for dairy products. Stabilisation of food prices in the world was reflected in the respective consumer prices in Latvia only gradually and with a certain delay.

In 2012, the contribution from indirect taxes to average inflation decreased. The base effect from the last-year-raised indirect tax rate faded in the course of the year, and, with the fiscal environment improving, it became possible to slightly lower the VAT rate set in the crisis period (by 1 percentage point, i.e. from 22% to 21%) and, in such a way, close the VAT rate gaps with the neighbouring countries.

Furthermore, an additional pressure on prices, which might have been expected to result from the accelerated economic growth, was not observed. The effects of demand on prices were set off by productivity and wages rising commensurately; thus, the average annual level of core inflation was low (0.7%) and in the second half of the year even negative (–0.2%). These developments were primarily driven by a decrease in prices of transport vehicles and wearing apparel, footwear and telecommunication services (the latter due to tighter competition).

In 2012, both the average annual inflation and HICP stood at 2.3% and did not exceed the estimated Maastricht criterion at the end of the year.

The average pace of increase in producer prices in 2012 decelerated to 3.7%, which was substantially lower than in 2011. Producer prices rose primarily on account of the global raw material price dynamics and were less impacted by increasing wages and salaries. It is seen from the gradually declining producer price index in manufacturing in the first half of the year and its faster upswing in the second half of the year when poor harvests triggered new pressures on grain prices; business sentiment indicators signal the same, with labour shortages as a factor limiting the production in most manufacturing branches receiving low assessment, while in the branches with higher assessment no substantial increases in producer prices were yet observed in the fourth quarter.

A slight transmission from producer prices to consumer prices testifies to the fact that in 2012 producer prices were not driven by wage and salary rises: consumer price index continued to shrink and, a somewhat accelerating annual resurge in producer prices notwithstanding, core inflation was even negative in the second half of the year.

The drivers of producer price rises together with the producer price index structure in 2012 were behind the substantial difference in producer price index growth between the output produced for domestic use and that for foreign market, which in annual terms on average were 5.2% and 1.8% respectively. Most notable differences were observed in energy production (primarily a domestic-market-oriented branch) as well as water supply and waste management, while with regard to manufacturing price increases were almost the same for both domestically-sold output and products for external markets.

Construction costs rose by 6.8% on average vis-á-vis 2.1% in 2011. The steepest rise was posted by labour remuneration (15.8%); with fuel prices continuously augmenting, maintenance and operational costs of machinery and mechanical appliances also grew (by 12.2%). At the same time, the building material costs increased only moderately (by 0.7%). The average annual growth of construction costs was mostly on account of hiking transport object (6.1% on average) and underground pipeline construction costs.

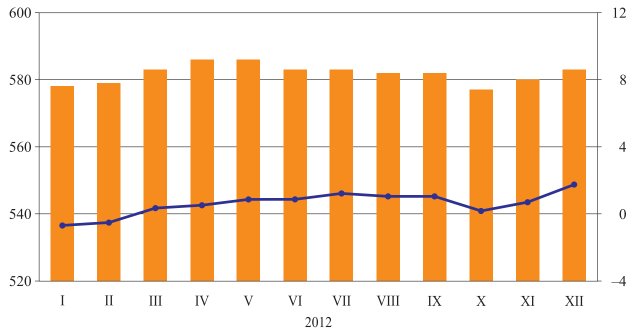
In 2012, the real estate market activity was moderately growing. In the year overall, the number of purchase agreements increased by 5.7% in comparison with 2011. Riga, Riga

District and Jūrmala contributed most to this increment. The demand from non-residents for real estate in these territories continued to soar, as the ownership of housing in Latvia entitles the buyer to a temporary residence permit.

In the housing market, prices of newly-built housing rose sharply on account of stronger demand from both residents and non-residents. Housing in new buildings was much sought-after due to its relatively acceptable quality promising smaller maintenance and accommodation costs as well as more favourable bank lending terms for such housing. In the meantime, the standard apartment market was stagnant, and the average apartment price fluctuated insignificantly, increasing by 1.6% year-on-year by the end of the year (data of *Latio Ltd*.; see Chart 2). Even though standard apartments account for a significant share of the housing market, their popularity is reduced by recurrent need to invest in renovation, projected future housing maintenance costs (e.g. to finance energy efficiency improvement), and relatively more cautious attitudes of credit institutions when financing the purchase of such apartments.

Chart 2

AVERAGE STANDARD APARTMENT PRICE AND ITS ANNUAL GROWTH RATE IN RIGA



Average price (euro per square meter)
Annual growth rate of average price (%; right-hand scale)

Source: Latio Ltd.

As household opportunities to purchase housing that would meet their wishes and correspond to their purchasing power were limited, the activity in the housing rental market became more buoyant. With demand exceeding supply, a gradual uplift of rent continued into 2012.

The commercial real estate rental market saw the activity to boost. Space available for rent contracted, and rent for trading premises started to grow. Meanwhile in the office space market, small office spaces were highly demanded.

GROSS DOMESTIC PRODUCT

In 2011, GDP in Latvia increased by 5.5%, which was the third best attainment in the EU; in 2012, the economy continued to develop buoyantly and its growth rate was the highest in the EU (5.6%). For the second year in the run, the Baltic economies were the most rapidly developing countries of the EU, while in the meantime, GDP in EU27 overall declined slightly (by 0.3%) in 2012.

Exports, investment and private consumption, with their dynamics changing in the course of the year, contributed equally to GDP growth in 2012. Investment played a major role at the beginning of the year, later private consumption dominated, but in the second half of the year, a significant positive contribution to GDP growth came from exports.

Latvia's exports continued to expand despite persisting negative developments in the global economy. However, as the economic progress moderated in major trade partner countries of Latvia and due to a higher base, the growth rate of real exports of goods and services fell almost two times behind the 2011 figure (7.1%). In general, export dynamics was spurred by regained competitiveness in manufacturing and also the steep rise in investment in the previous year.

Private consumption, the biggest component of domestic demand, picked up 5.4% in 2012 (more than in 2011). This rise was supported by growing disposable income and improving household confidence, as the anticipated negative external effect on exports and later also on the domestic demand did not materialise. The improvement in consumer confidence indicator was gradual until it reached the pre-crisis level. At the close of the year, surveys also demonstrated positive attitudes of the population regarding such previously negatively-valued areas as household financial position and country's economic outlook for the next 12 months.

A robust upswing in gross fixed capital formation (27.9%) was recorded already in 2011, and a very buoyant growth continued also in the first half of 2012. In the second half of the year, however, investment expansion decelerated on account of both higher base and uncertainty surrounding future external developments. In addition, as many enterprises had accomplished upgrading of their vehicle fleets and equipment postponed during the crisis, imports of capital goods decelerated. In 2012 overall, gross fixed capital formation increased by 12.3%. As to investment structure, productive investment grew most. Similar to 2011, investment in industry and the transport sector accounted for a half of non-financial investment also in 2012. Investment was mainly financed with own funds (better profit margins, previously accumulated savings, etc.), foreign direct investment and EU funds.

The trend of renewing inventory that plummeted during the economic downturn continued to moderate in 2012; hence a notable negative contribution of 3.2 percentage points to GDP growth was forming (positive contribution of 2.6 percentage points in 2011).

Imports of goods and services, which in 2011 grew by 22.7%, in 2012 increased only moderately (by 3.1%). The slowdown primarily depended on contracting imports of capital goods and replacing of imports with domestic output. The latter was spurred by investment and steeper-rising import unit value. In the course of the year, imports to GDP ratio decreased by around 2 percentage points.

As exports grew notably faster than imports, net export contribution was 2.0 percentage points in 2012.

Business surveys, tax collection data and other indicators testify that shadow economy is going down. It started to contract in 2011, with the trend continuing into 2012 as well.

Total value added increased by 5.2% in 2012. The rise was mainly determined by higher value added in trade (1.3 percentage point contribution to overall annual rise, 7.0% increase at constant prices), manufacturing (1.2 percentage points and 9.3% respectively), construction (0.8 percentage point and 14.6%), and information and communication services (0.4 percentage point and 8.9%). Meanwhile, a negative contribution to annual growth came from falling value added in public administration and defence (0.1 percentage point and 1.6%) as well as health and social care (0.1 percentage point and 2.7%).

In 2012, retail trade turnover expanded by 7.3%, while the growth in retail trade turnover (including motor vehicles) was slower, at 6.1%. The vehicle fleet having been upgraded, the demand for motor vehicles weakened. As in the previous year, the demand for furniture, household appliances and building materials contributed most to the growth in sales volumes.

In 2012, trade turnover was boosted not only by domestic demand but also by non-resident purchases. Although hotels and other spots of tourist accommodation did not register a steep rise in the number of served people (3.8%), visitors from Russia and Belorussia came in notably larger numbers. They generally stay on longer visits in Latvia and spend more money than tourists from other countries.

At constant prices, manufacturing output grew by 9.3% (working day adjusted data), with the increase at current prices standing at 11.9%. As previously, the expansion in manufacturing was basically driven by sales growth in export markets. Despite the sovereign debt crisis in the euro area, the branches with larger export market sales shares developed more buoyantly. In the domestic market, the turnover of manufacturing output at current prices picked up 5.9%, while exports expanded by18.2%.

As production capacity in manufacturing of basic metals was boosted by investment, the sector made the largest contribution to the overall manufacturing growth (2.4 percentage points). Manufacturing output likewise received significant positive impetus from the manufacture of wood and of products of wood and cork (1.6 percentage points), electric equipment (1.1 percentage points), fabricated metal products, except machinery and equipment (0.8 percentage point), non-metallic mineral products (0.8 percentage point), and chemicals and chemical products (0.7 percentage point). The contribution from repair and installation of machinery and equipment also was rather weighty (1.1 percentage points). It was determined by a number of investment projects implemented in the branches of electric energy, gas and heat supply, air conditioning, and transport and storage.

In transport and storage, the growth decelerated somewhat in 2012. The volume of cargoes loaded and unloaded at Latvian ports rose to 75.2 million tons, recording an overall 9.3% increase (5.9% at Riga port, 6.7% at Ventspils port, 53.0% at Liepāja port; small ports, on the other hand, posted a decrease of 6.5%). The growth in cargo volumes loaded and unloaded continued to be primarily driven by rising volumes of transported coal. By quarter, however, the growth decelerated towards the close of the year, when the global context became less favourable for coal transit, and part of oil product freights were shipped via Russian ports.

Railway accounted for transportation of a total of 60.6 million tons of freight (2.0% more than in 2011). The increase in transport volumes was driven by 2.7% higher imported freights, while a fall in exported freights and transit freights (by 0.9% and 5.5% respectively) had a limiting effect.

In 2012, the volume of freight transport was 53.4 million tons, i.e. 0.8% less than in 2011. Total freight traffic decreased on account of shrinking domestic freight transport (by 0.9%), while international traffic, even though having expanded by 3.3%, did not fully compensate for this contraction.

Non-financial investment in a number of sectors grew by 22.7% in 2012. The transport and storage sector accounted for the largest share of 7.5 percentage points and 57.4% at current prices of the overall annual increase in non-financial investment. Several investment projects were launched in this sector in 2012 (concerning port terminal expansion in particular). Investments grew notably in real estate (by 2.0 percentage points and 109.8%) and trade (by 1.7 percentage points and 27.9%), and of the latter, non-financial investment in retail trade accounted for the largest part (1.2 percentage points). The contribution of manufacturing to the annual growth in non-financial investment was negative (0.4 percentage point and 2.0%). With the production capacity utilisation almost at its historical high, further investing continues to be delayed by the absence of substantial development in export markets. Agriculture, forestry and fishing were also responsible for a notable effect on the rise in total non-financial investment (2.0 percentage points and 40.4%). The successfully concluded year in agriculture (with the best harvest record since Latvia regained independence) suggests that the volume of investment in agriculture is likely to remain substantial also in the future. The contribution of electric energy, gas and heat supply and air conditioning to non-financial investment growth was also very significant (4.3 percentage points and 57.4%), as several energy and water supply projects were under way.

LABOUR MARKET

In 2012, as unemployment rate was dynamically going down, the labour market situation improved further. In terms of new job creation, Latvia ranked in the first position in the EU, and the rising employment was mostly dependent on the private sector. Unemployment rate fell down by one third (from its high at the beginning of 2010) and was approaching the level recorded prior to the period of rapid growth following accession to the EU.

As all available statistical data sources confirmed increases in the number of employed in 2012, the labour market recovery could be assumed as strong and persisting. For instance, according to the data of CSB labour survey, the number of employed in 2012 increased by 24.0 thousand year-on-year; according to the CSB business survey, the number of jobs grew by 36.5 thousand. Meanwhile, the SRS's data on the number of social security contribution payers show that the number of employed increased by 26.3 thousand over the year. Employment increased in all major sectors of the economy. In the goods sector, employment rose in agriculture, manufacturing, and construction; in the services sector, more workers were hired in information and communication services sector as well as professional, scientific and technical activities.

Registered unemployment dropped 1.0 percentage point over the year and stood at 10.5% of economically active population at the end of the year. In April 2012, the figures for the registered unemployment rate were revised taking into account the 2011 census data. This adjustment pushed up the respective rate by 1.6 percentage points. Without it, the decrease in the registered unemployment rate would be 2.6 percentage points (close to the last year's level). Since its historical high in March 2010, the number of registered unemployed had decreased almost by half, i.e. to 104.1 thousand. Its regional disparities, however, remained very pronounced: at the end of the year, the rate of registered unemployed stood at 6.4% in Riga, while in Latgale it was 21.1%, which, at least in part, depended on the distinctive motivation of job seekers to register with the SEA, for the CSB's survey data provide more moderate regional disparities.

According to the CSB's labour survey data, job seekers constituted 14.9% of economically active population in 2012 (a year-on-year 1.3 percentage point drop). Differences in job seekers' rates by age group and education level still persisted: it was relatively more complicated for less educated and experienced inhabitants to find employment. For instance, in the fourth quarter when the average job seekers rate in the country was 13.8%, in the age group 15–24 years, it went up to 21.6%; moreover, for individuals with elementary education it several times exceeded the level of those with university education (24.7% and 5.8% respectively). Job vacancies in the economy increased only modestly, suggesting, on the one hand, better opportunities for finding job but, on the other, implying that only some professions and companies, instead of the entire economy, might be experiencing labour shortages. At the close of 2012, 3.1 thousand job vacancies were registered with the SEA, while the CSB's business survey recorded 3.5 thousand vacancies. The EC confidence survey data suggest that the number of businesses referring to labour shortages as the main obstacle to entrepreneurship became more stable towards the end of the year. Construction companies (10.4%) most widely referred to labour shortages as such an obstacle, while the indicators of manufacturing and services sector were lower both in general (8.0% and 6.4% respectively) and against 2004 and 2005.

Population losses due to migration declined to the level of 2008. The CSB data show that the number of emigrants exceeded that of immigrants by 10.0 thousand, which was considerably less than in the last three years.

Improvements in the labour market induced wages and salaries to rise again. In 2012, the average monthly wages and salaries amounted to 481 lats for full-time jobs, which was an increase of 3.7% over the year. Wages rose at a slightly faster pace (by 4.5%) in the public sector where they had been cut more during crisis years. Productivity gains were also broadly based in terms of both per hour worked and per person employed. They allowed for higher remuneration without a simultaneous increase in production costs: unit labour costs in real terms picked up a mere 0.7%. Consequently, currently on-going recovery of the labour market does not create inflation risks to the economy.

FOREIGN TRADE, BALANCE OF PAYMENTS AND EXTERNAL DEBT

Despite unstable global economic growth and low overall demand in foreign markets, Latvia's foreign trade activities were intensifying in 2012, with goods turnover amounting to 15.6 billion lats (14.1% more than in the previous year). For the second year in a row, exports of Latvian goods recorded one of the highest growth rates in the EU due to competitiveness gains of Latvian businesses in the previous three years of economic recovery. As the growth rate of exports of goods exceeded that of imports of goods, foreign trade deficit went down and stood at 11.7% of GDP at the end of 2012.

In 2012, real exports of goods picked up 11.0%, while the annual export growth in nominal terms reached 15.4% and was recorded for all groups of goods exports, except transport vehicles and their accessories, and products of the chemical and allied industries. The growth of goods exports across almost all commodity groups in 2012 was dominated by an increasing physical volume of goods, while the price effects minimised.

As the manufacturing performance was positive, all major exporting sectors continued to expand. Competition stiffened but Latvian exporters not only preserved the already existing markets but also continued to win new export market niches. Diversification of output and markets, productivity gains and higher producers' value added ensured improved export competitiveness and increased real volumes of goods exports in 2012.

Speaking about the structure of goods exports, the share of wood and of products of wood continued on a downward trend (from 16.8% in 2011 to 15.0% in 2012), whereas export shares of machinery and mechanical appliances, electrical equipment as well as agricultural and food products both increased from 12.7% to 13.7% and from 16.4% to 20.3% respectively. Overall, agricultural and food products with 10.0 percentage points, machinery and mechanical appliances, electrical equipment with 3.2 percentage points and base metals and articles of base metals with 1.6 percentage points were among the largest contributors to export growth in 2012.

According to the WTO and Eurostat data, Latvia's global export market shares were growing. The supply of the Latvian exporters to the common market is not voluminous, yet it is very flexible and easy-to-reorient. The diversified structure of Latvian exports together with the ability to compete enabled exporters to penetrate into so-far less explored markets, also outside the EU, this move serving to compensate for the declining demand in some EU countries and even to boost exports in a complex external environment.

Deceleration in the EU economic activity notwithstanding, the expansion of market shares in total EU27 imports was going on, and growth was recorded also in those EU trade partner countries where the demand was weakening (Denmark and the UK). However, developments affecting exports of goods differed across major trade partner countries. Following a rise in the previous year, market shares in imports of Lithuania and Sweden contracted in 2012, while those in imports of Estonia were falling for the third year in the run. In Denmark, Finland, Poland, Germany and the UK, on the other hand, the respective market shares were expanding. Similar developments were observed for the Russian market and rapidly growing economies, e.g. India, China, and some Asian countries (United Arab Emirates, Azerbaijan, Kazakhstan, etc.). From among Latvia's major trade partners, exports to Denmark, the Netherlands and Russia displayed the highest growth rates (35.4%, 34.3% and 25.1% respectively).

In 2012 against 2011, Latvia's export structure did not change much in the breakdown by country and country group. Overall, the group of EU27 countries continued to be Latvia's major trade partner; however, Latvia's exports go to many other countries as well. The majority of Latvian exporters sell their output simultaneously in several countries, both in the east and west. This testifies to the ability of Latvian businesses to adjust their products to varying demand and markets. As previously, Lithuania with 16.1% of total exports, Estonia (13.0%), Russia (11.5%) and Germany (7.7%) ranked as Latvia's main partners in imports of goods.

When the growth in imports in 2012 is compared to that in exports, real imports of goods grew more moderately than exports (5.3%); on the other hand, the annual growth in imports of goods in nominal terms amounted to 13.1%. Import growth was spurred by a stronger demand for intermediate goods in manufacturing and a better domestic market situation. As manufacturing expanded, extra demand for imported goods, e.g. industrial raw materials, energy resources and capital goods, strengthened, from producers of goods for exports in particular. Although the income generated by exports furthermore boosted the domestic economic activity, moderation in the pace of import growth was also affected by weaker investment dynamics due to business uncertainty as to further external developments.

Most important commodity groups in Latvia's imports were machinery and mechanical appliances, electrical equipment (18.2% of total imports), mineral products (17.9%), agricultural and food products (15.4%), base metals and articles of base metals (10.4%), and transport vehicles (8.5%). Major trade partners in imports of goods were Lithuania (19.8% of total imports), Germany (11.5%), Russia (9.5%), Poland (8.6%) and Estonia (7.7%).

In 2012, the import price hikes were more dynamic than those of exports: over the year, export unit value increased by 3.7% and that of imports by 7.9%. Export prices rose most for food products (by 12.1%), plastics and products thereof (11.5%), and textiles and textile articles (10.6%). In imports, price hikes were most pronounced for mineral products (14.1%) and transport vehicles (11.6%).

The notably rising import prices underpinned the worsening of terms of trade (by 3.9%). By sector, the terms of trade deteriorated most for transport vehicles and accessories (by 13.4%), mineral products (by 9.1%) and wood (by 5.3%), meanwhile improving for building materials (by 3.8%), food products (by 3.7%), and vegetable products (by 2.1%).

In 2012, trade surplus was recorded only for wood and products of wood, agricultural and food products, and base metals and articles of base metals. The largest trade deficit was retained by mineral products and machinery and mechanical appliances, electrical equipment. Of major trade partners, Latvia's trade balance was positive with Estonia, the UK, Norway, Sweden and Denmark.

The dynamics of the real effective exchange rate of the lats suggests that market shares in several countries are likely to have expanded at the expense of gains in price and cost competitiveness (in the UK and Russia in particular); elsewhere market shares changed on account of other factors, because the real effective exchange rate of the lats, both CPI-deflated and PPI-deflated, depreciated also vis-á-vis almost all the other trade partners' currencies and most strongly against the Swedish krona, yet the latter reported no market share improvements. Relative price changes were favourable also vis-á-vis Estonia, nevertheless, Latvia did not expand its market share there but diversified its export markets instead. In general, cost and price dynamics over the year played into the hand of Latvian businesses: the CPI-based real effective exchange rate of the lats dropped 1.6%, while the PPI-based rate lost 1.7%. The four-quarter average real effective unit-labour-cost-deflated exchange rate of the lats declined as well.

Net inflows of foreign direct investment in 2012 amounted to 3.5% of GDP. The largest shares of foreign direct investment were injected in financial intermediation, real estate, trade, electric energy, water supply and manufacturing. Their largest flows, in turn, came from Sweden (119.1 million lats), Russia (118.9 million lats), Cyprus (68.9 million lats) and the Netherlands (43.3 million lats).

The goods and services trade balance improved year-on-year in 2012, with its deficit standing at 467.4 million lats or 3.0% of GDP. The improvement was mainly triggered by a notable expansion of exports of goods, while import growth remained moderate. The services balance was positive (1 056.2 million lats or 6.8% of GDP). Viewed from an overall annual perspective, services trade continued on an upward trend; in the fourth quarter, however, both services exports and services imports shrank. Around one half of total exports of services were transportation services, which albeit narrowed towards the close of the year because of both one-off factors (e.g. railway repair in Russia) and weakening demand for these services due to receding economic activity. By contrast, exports of information and computer, construction, and communication services gained momentum in 2012, yet speaking about non-residents, imports of transportation, construction and insurance services increased.

The current account of Latvia's balance of payments in 2012 was with a deficit of 259.9 million lats or 1.7% of GDP. This negative balance was financed with long-term capital in the form of foreign direct investment and long-term borrowing. The income account also was with a deficit in 2012 (239.1 million lats) due to dividends paid out to foreign investors and reinvested earnings. In the year overall, the income account deficit swelled as the economic situation improved.

The current transfers surplus recorded a slight year-on-year rise of 446.6 million lats. Financing from the EU funds accounted for the largest inflows into the current transfers and capital accounts. From the EU funds all in all, Latvia received 836.3 million lats (26.0% more than in the previous year) in 2012. Regarding the current transfers account, the inflows from the EU agricultural funds (239.5 million lats) and the European Social Fund (78.9 million lats) played a decisive role. Meanwhile, largest inflows into the capital account of the Latvian balance of payments came from the European Regional Development Fund (285.7 million lats) and the Cohesion Fund (167.1 million lats).

Latvia's gross external debt at the end of 2012 was 21.1 billion lats (a year-on-year increase of 0.4 billion lats). Its ratio to GDP fell to 136.2%. Net foreign debt, in turn, was 5.9 billion lats or 38.1% of GDP at the end of 2012.

FISCAL DEVELOPMENTS

On a cash flow basis, the consolidated general government budget posted a surplus of 19.1 million lats or 0.1% of GDP in 2012, whereas according to an accrual principle (ESA 95) used to evaluate compliance with the Maastricht criteria the budget ran a deficit of 187.2 million lats or 1.2% of GDP.

The surplus (here and further, on a cash flow basis) in 2012 was achieved on account of a 128.5 million lats surplus in the central government basic budget (a 300.7 million lats deficit in the previous year). The deficit of the central government social security budget contracted to 49.5 million lats from 124.9 million lats in the previous year, whereas the deficit of the consolidated local government budget increased to 62.5 million lats from 40.0 million lats in the previous year.

As a result of stronger-than-expected economic growth and continued pursuit of conservative government spending policies, the budget outcome in 2012 was better than initially planned. According to the agreement reached upon the expiry of the international loan programme, several revenue boosting and spending restriction measures were implemented in 2012 to ensure that the budget deficit did not exceed 2.5% of GDP on an accrual basis: freezing of wage bill, individual subsidy cuts and changes in VAT application. As tax collections were higher-than-planned, budgetary amendments could be introduced in the second half of the year and spending on priority measures could be increased. The VAT rate was cut down by 1 percentage point as of 1 July, with a view to smoothing the tax rate differences with the neighbouring countries. Despite the above measures having a negative effect on the budgetary balance, the deficit based on the accrual principle turned out to be considerably lower than agreed with the international donors.

Latvia was one of the first EU Member States to ratify the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union providing for strengthening of the fiscal discipline in national legislation. An important structural improvement of the fiscal policy is the Law on Fiscal Discipline adopted by the Saeima of the Republic of Latvia on 31 January 2013 to prevent any future potential return to pro-cyclical budgetary policies.

In 2012, the consolidated general government budget revenue amounted to 5 742.8 million lats or 37.2% of GDP. This represented an increase of 655.5 million lats or 12.9% in comparison with the previous year. The rise was primarily supported by the growing tax revenues; nevertheless, non-tax revenue and foreign financial assistance revenue also exceeded the level of 2011 considerably. Tax revenue expanded by 410.4 million lats or 10.6%, mainly as a result of higher collections of taxes on labour and VAT payments into the budget. The significant contribution of the VAT to the overall rise in tax revenue (157.9 million lats) was underpinned by the recovery in private consumption. Labour market developments resulted in a notable contribution (79.4 million lats and 94.4 million lats respectively) of the PIT and social insurance contributions to the overall revenue increase. Contrary to 2011, non-tax revenue expanded in 2012 (by 53.3 million lats or 16.2%). This expansion was primarily supported by the rise in unspent or recovered funding within the framework of the EU funds projects repaid to the central government basic budget. Foreign financial assistance inflows in the consolidated general government budget from the EU funds for the programming period 2007–2013 exceeded the 2011 inflows by 182.8 million lats or 27.6%. The rise was achieved mainly due to resuming EU funds payments which had been suspended at the turn of 2011 as well as larger inflows received towards the end of 2012 when Latvia introduced improvements to the EU funds monitoring system to comply with the the EC's requirements.

The expenditure of the consolidated general government budget amounted to 5 723.6 million lats or 37.1% of GDP in 2012, representing an annual increase of 191.4 million lats or 3.5%. The spending rise was mainly attributable to a 107.0 million lats increase in subsidies and grants implemented via amendments to the Law "On State Budget 2012" introduced in the second half of the year. With the government debt expanding, interest payments grew by 30.0 million lats.

On a cash flow basis, the general government debt totalled 5 652.0 million lats or 36.7% of GDP at the end of 2012, representing a year-on-year increase of 303.3 million lats. This masked an increase in the external debt of the central government by 348.9 million lats and a decline in its domestic debt by 37.3 million lats.

In 2012, the Latvian government launched two international bond issues. 5-year government bonds worth 1 billion US dollars were issued in February, whereas 7-year government bonds worth 1.25 billion US dollars were launched in December. Both succesful bond issues enabled Latvia to make an early repayment of the entire loan received from the IMF within the framework of the international stabilisation programme already in 2012.

As at the end of 2012, the government debt estimated based on the accrual principle totalled 6 309.2 million lats or 40.7% of GDP representing an annual increase of 334.8 million lats, whereas the government's debt service costs amounted to 204.5 million lats.

CREDIT INSTITUTION DEVELOPMENTS

At the end of 2012, 29 credit institutions (including nine branches of foreign credit institutions), 34 credit unions, six electronic money institutions and two money market funds were registered in the Republic of Latvia. The licences to engage in credit institution business were cancelled for the JSC *Latvijas Krājbanka* and the JSC *Parex banka* in 2012. Latvia Branch of *Pohjola Bank plc* and Latvia Branch of *DNB Bank ASA* started their operations in Latvia, whereas Latvia Branch of *Allied Irish Banks plc* wound up its business. The government's participating interest in the paid-up share capital of credit institutions decreased during the year to stand at 17.2% at the end of 2012.

Despite further economic growth observed in Latvia in 2012, the credit institution total assets continued to shrink, contracting by 3.3% in comparison with a 4.7% decline observed in 2011 (see Chart 3). This was primarily determined by the private sector deleveraging and the low lending activity. The portfolio of credit institution loans to resident and non-resident non-MFIs continued to shrink (by 10.9%; by 8.1% in 2011). Non-resident MFI financing also contracted by 18.3% (by 27.4% in 2011), accounting for 19.3% of the credit institution total assets at the year-end (including financing from parent banks amounted to 18.7%; see Chart 4). Conversely, resident deposits grew by 9.1%, whereas non-resident deposits increased by 16.8%.

Chart 3

DYNAMICS OF THE CREDIT INSTITUTION ASSET ITEMS
(%)

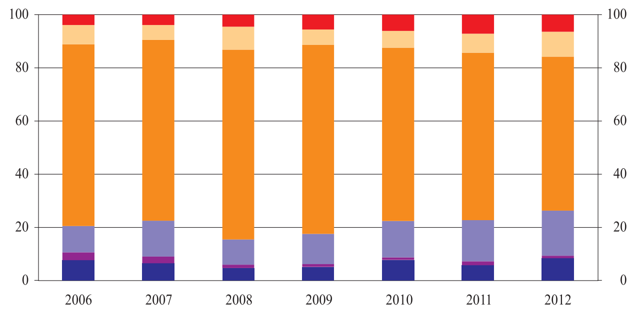
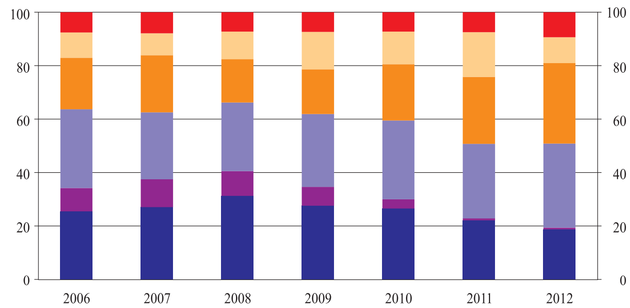


Chart 4

DYNAMICS OF THE CREDIT INSTITUTION LIABILITY ITEMS
(%)



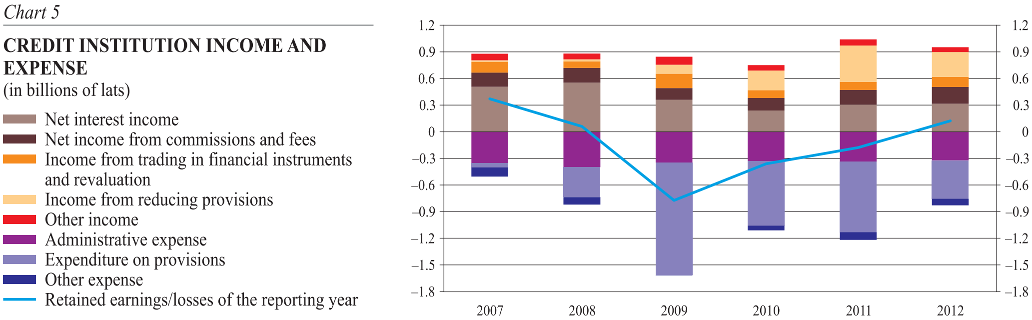
With the loan portfolio continuing to shrink, the share of liquid assets in total assets expanded to 32.3%.

As a result of the strong economic development, the loan portfolio quality of credit institutions improved, and the share of loans past due over 90 days in the aggregate loan portfolio of credit institutions contracted to 11.1%. The quality improvements in the portfolio of loans to non-financial corporations were again more substantial.

Most Latvia's credit institutions operated with profit in 2012, overall earning 122.3 million lats as opposed to the 178.7 million lats losses sustained in the previous year (see Chart 5). The operating income of credit institutions totalled 631.5 million lats in 2012,

Chart 5

CREDIT INSTITUTION INCOME AND EXPENSE
(in billions of lats)



representing a year-on-year increase of 10.6%. Net interest income remained the most sizeable component of the operating income and grew slightly year-on-year, accounting for half of the operating income. Although the interest income of credit institutions continued to shrink in comparison with 2011, the decline in interest expenditure was more pronounced, resulting in a year-on-year rise in net interest income by 3.5%. Net commissions and fees, the second most important income component, continued to expand growing by 14.7% (by 17.5% in 2011), still accounting for about 30% of the operating income. The operating costs of credit institutions remained at the level of the previous year.

The capital adequacy ratio of credit institutions remained high and stood at 17.6% at the end of the year (the minimum capital requirement set by the FCMC is 8%), whereas Tier I capital ratio was 15.2%. Credit institutions continued to boost their capital: within a year, nine credit institutions increased their capital by 75.0 million lats in total.

MONEY SUPPLY

The developments of the monetary aggregates in 2012 (see Appendix 1) mirrored the balanced growth of the Latvian economy and the large liquidity surplus accumulated by credit institutions. Following the financial sector turbulances observed at the turn of 2011, the situation stabilised quickly and the aggregate money supply started to expand gradually already from the first months of 2012. Although the cancelling of the credit institution licence of the JSC *Parex banka* in March and the respective licence of the JSC *Latvijas Krājbanka* in May had a downward effect on the monetary aggregates, the annual growth of the money supply was even faster than in the previous year. At the same time, the money supply was still concentrated primarily in currency and demand deposits, the most liquid components, reflecting the negative real deposit rates which discourage the economic agents from accumulating any longer-term savings.

Currency outside credit institutions expanded by merely 4.1% in 2012, representing the lowest growth rate in the last three years; nevertheless, currency in circulation reached an all-time-high at 1 082.4 million lats. Overnight deposits, the second most liquid component of the money supply, increased by 13.0% in 2012 (by 12.0% in 2011) and were accountable also for the rise in M1 (by 10.9%; by 15.6% in 2011). Due to lower remuneration offered on longer-term instruments, the growth of M2 and M3 was more sluggish than that of M1 (3.8% and 2.8% respectively; see Table 1 and Chart 6 for the annual changes in monetary aggregates). Nevertheless, the growth rates accelerated in comparison with 0.3% and 1.7% registered in 2011. The annual growth rate of M3 was volatile throughout the year, falling into a negative territory in some months. Nevertheless, with the money supply stabilising, from June onwards the annual growth of M3 was between 2% to 5%. The steepest monthly increase in M3 was registered in November (119.8 million lats or 1.8%) when deposits with MFIs (excluding the Bank of Latvia) expanded significantly. Conversely, the sharpest month-on-month fall was observed in March (133.0 million lats or 2.0%) due to the above-mentioned structural changes affecting the credit institutions.

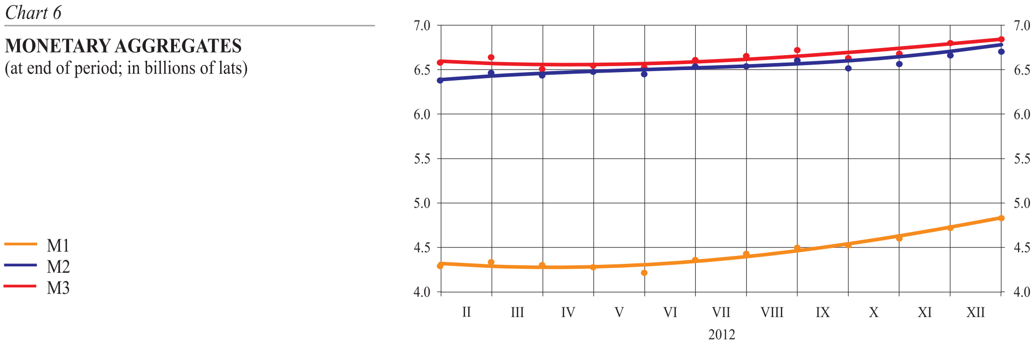
Table 1

ANNUAL CHANGES IN MONETARY AGGREGATES
(%)

	2012	2011
Currency outside MFIs	**4.1**	28.8
Overnight deposits	**13.0**	12.0
M1	**10.9**	15.6
Deposits with an agreed maturity of up to 2 years	**–12.0**	–22.4
Deposits redeemable at a notice of up to 3 months	**–1.7**	–10.2
M2	**3.8**	0.3
Money market fund shares and units and debt securities with a maturity of up to 2 years	**–29.2**	93.4
M3	**2.8**	1.7

Chart 6

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

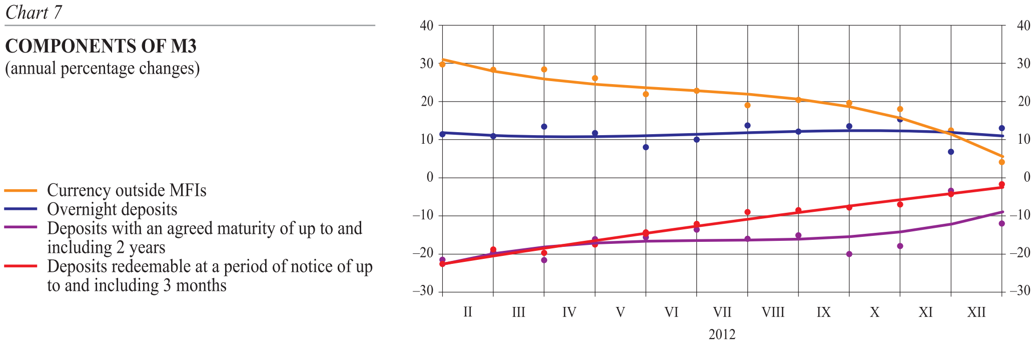


The growth of M3 was primarily supported by that of the demand deposits component, whereas the expansion of currency in circulation, with its contribution to M3 growing by merely 0.2 percentage point to 15.8%, was commensurate with the changes in the aggregate money supply (in 2011, the contribution grew by 3.3 percentage points). Although the continuously growing cash deposits with ATMs (a year-on-year increase of 23.1% in 2012) suggested potential activities in the grey economy, the stability of the financial sector and of the general economy facilitated the return of cash to credit institutions. A seasonally higher demand for cash was only observed in summer and in December; nevertheless, even then its rate of growth was lower than in the respective period of the previous year. At the end of the year, currency in circulation (the lats banknotes and coins issued by the Bank of Latvia less vault cash of other MFIs) exceeded the level at the end of 2011 by 42.4 million lats (currency in circulation increased by 232.7 million lats in 2011).

In 2012, deposits of resident financial institutions, non-financial corporations and households expanded by 4.5% in comparison with a decrease of 2.4% recorded in 2011. This overall rise masked an increase for all currency overnight deposits with MFIs and declines for all currency MFI deposits with an agreed maturity of up to two years and all currency deposits redeemable at a period of notice of up to 3 months. As a result, the share of overnight deposits in broad money grew from 49.8% at the end of 2011 to 54.8% at the end of 2012 (see Chart 7 for the developments in the components of M3).

Chart 7

COMPONENTS OF M3
(annual percentage changes)

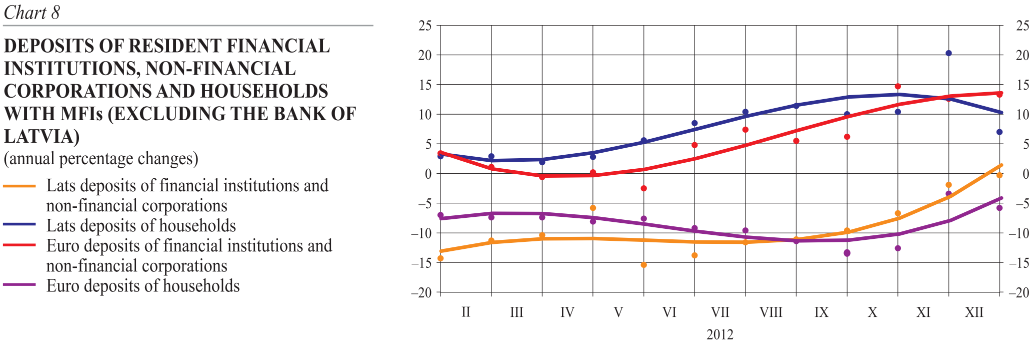


In the first half of 2012, deposits contracted, whereas in the second half of the year the annual rate of change in deposits with credit institutions returned to a positive territory, mainly as a result of an increase in deposits by non-financial corporations underpinned by industrial, export and retail growth. Financial institution and non-financial corporation deposits placed with credit institutions grew by 7.4% in 2012, whereas household deposits by a mere 2.1% suggesting that the income gains were used primarily for consumption. Thus the share of household deposits contracted to 52.5% of aggregate deposits in comparison with 53.8% at the end of 2011. Household deposits accounted for 60.7% of all time deposits and 47.7% of overnight deposits (63.6% and 46.4% at the end of 2011 respectively). Excluding the data of credit institutions with cancelled licences, resident deposits grew by 7.8% year-on-year, of which deposits made by financial institutions and non-financial corporations expanded by 12.0% and household deposits by 4.3% respectively.

The currency composition of deposits was characterised by a slight decrease in the shares of both lats and euro deposits in 2012, the decline being offset by an increase in other currencies group (mainly in the US dollars). In absolute terms, the deposits made in lats, euro and other currencies expanded by 3.2%, 2.3% and 23.3% respectively during the year (see Chart 8 for the annual developments in lats and euro deposits made by resident households as well as financial institutions and non-financial corporations). At the end of 2011, lats deposits accounted for 49.2% of resident non-MFI deposits, whereas at the end of 2012 the percentage had declined to 45.4%, whereas the share of the respective euro deposits had expanded from 42.9% to 45.6%. The share of the US dollar deposits increased from 6.5% at the end of 2011 to 6.9% at the end of 2012.

Chart 8

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



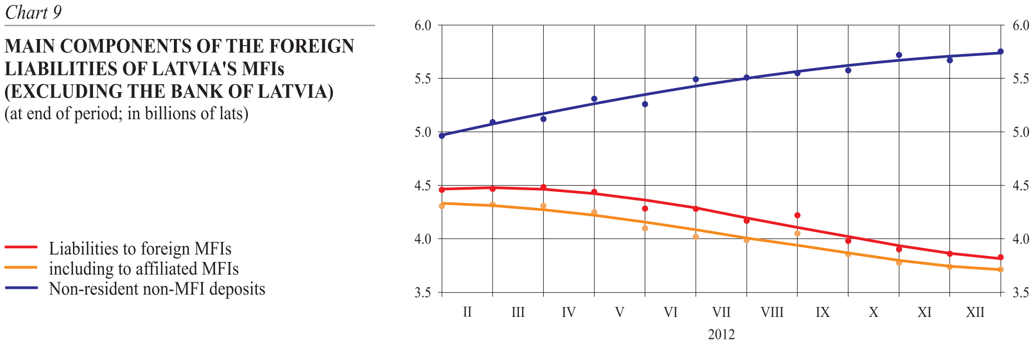
The contribution of additional components comprised in M3 remained relatively low. MFI debt securities with a maturity of up to 2 years shrank to zero as a result of cancelling a credit institution's licence in March; nevertheless, in the second half of the year some credit institutions issued new bonds amounting to 77.7 million lats at the end of the year and representing a decline of 41.6% in comparison with the end of the previous year. Money market fund shares and units totalled 62.0 million lats at the end of the year, representing a decrease of 3.4% over a year. So far, Latvian banks have concluded no repo agreements meeting the definition of M3.

The money multiplier decreased and was 2.57 in December 2012 in comparison with 3.07 in December 2011. As the level of macroeconomic risks remained relatively unchanged, the velocity of money was practically constant: it increased from 2.1 in 2011 to 2.3 in 2012.

The inflows of non-resident funds continued the previous years' tendency in 2012: non-resident non-bank deposits with Latvia's credit institutions grew by 16.9% during the year, almost at the same rate as in the previous year, signalling confidence in Latvia's credit institutions. Conversely, the inflows from foreign parent banks dried out as a result of persistently low lending activity: liabilities to foreign parent banks decreased by 18.0% in 2012, whereas overall liabilities to foreign MFIs contracted by 18.3% (see Chart 9). The previously negative net foreign assets of MFIs turned positive for the first

Chart 9

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



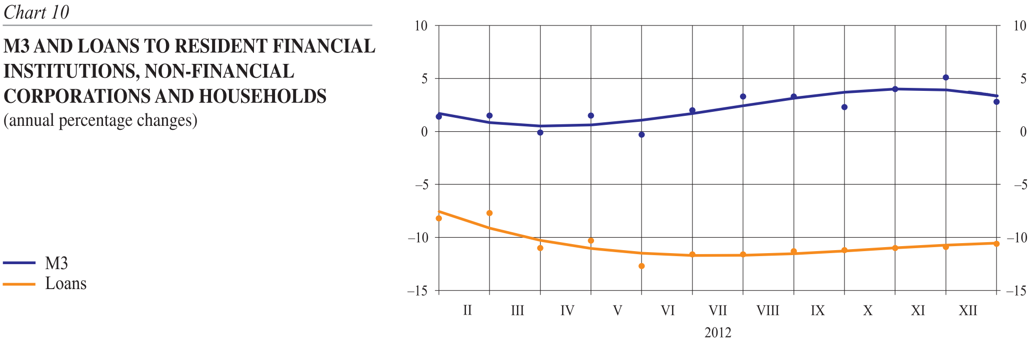
time since 2004 in 2012, with outflows exceeding inflows. In 2012, net foreign assets of MFIs grew by 838.5 million lats and totalled 613.7 million lats, with the net foreign assets of the Bank of Latvia expanding by 590.6 million lats and amounting to 4 025.8 million lats at the end of the year.

Foreign liabilities of MFIs (excluding the Bank of Latvia) remained broadly unchanged in 2012, whereas foreign assets expanded by 256.7 million lats, with claims on non-resident MFIs and the portfolio of foreign government securities growing by 273.1 million lats and 202.9 million lats respectively and loans to non-resident non-MFIs contracting by 186.3 million lats. Thus, the negative net foreign assets of MFIs (excluding the Bank of Latvia) had shrunk by 247.8 million lats year-on-year at the end of 2012 (in 2011, the negative net foreign assets of MFIs decreased by 1.6 billion lats year-on-year).

The decline in the MFI loans to private sector (see Chart 10) retained its downward effect on the monetary aggregates, with loans to resident financial institutions, non-financial corporations and households shrinking by 10.6% in the course of the year (by 8.3% in 2011). Nevertheless, the acceleration of this decline can be explained by the reduction in the number of credit institutions. Excluding the data of credit institutions with licences cancelled in 2012, the annual rate of decline in lending (4.2%) would have been much lower than in the previous year. Against the background of shrinking loan portfolio and GDP growth, the ratio of domestic loans to GDP shrank considerably: from 97.0% at the end of 2010 and 79.6% at the end of 2011 to 65.5% at the end of 2012. The shrinking of the loan portfolio was partly determined by the write-offs of lost loans (especially in December). Nevertheless, considering the impact of the volatile external environment, the situation in the lending market should be viewed as relatively favourable. Lending to non-financial corporations grew in six months of 2012, and the annual rate of decline in loans to those corporations in operating credit institutions was merely 1.0%. At the same time, loans past due contracted: excluding the data of credit institutions with licences cancelled in 2012, loans past due over 90 days amounted to 11.1% at the end of 2012, whereas at the end of 2011 the respective share had been 13.3%.

Chart 10

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



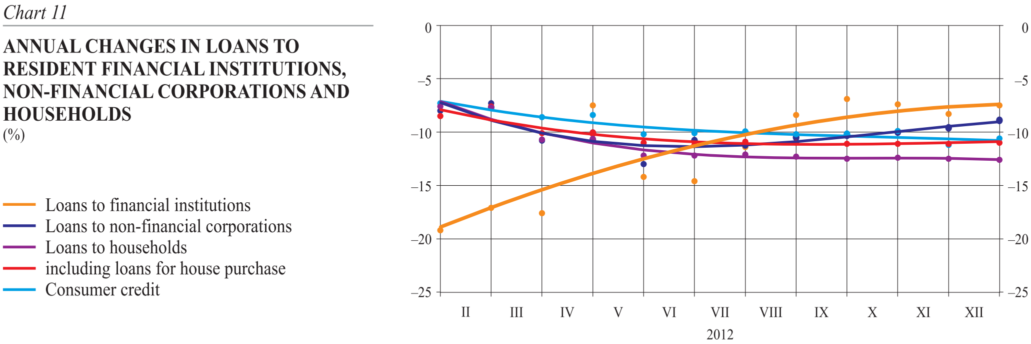
With loans continuing to contract, resident loans decreased to 51.0% of the aggregate balance sheet assets of MFIs (excluding the Bank of Latvia) at the end of 2012 (55.2% at the end of 2011). The stability of the financial sector was enhanced by the reduction of the loan to deposit ratio in 2012: resident deposits covered 56.0% of loans at the end of 2012 (47.9% at the end of 2011).

With the consolidated general government budget balance improving and government deposits with credit institutions increasing, net liabilities of MFIs to general government grew by 239.9 million lats in 2012.

Higher activity in commercial credit decelerated the decline in corporate lending (a contraction of 8.9% within a year), whereas the decrease in household lending reached 12.6% (see Chart 11 for changes in loans granted to resident financial institutions, non-financial corporations and households). Household lending continued to contract at an almost constant rate throughout 2012 (by 0.5%–1% each month) and resulted in a further reduction of the household indebtedness. The stable month-on-month drop was primarily backed by gradual repayments of household loans for house purchase.

Chart 11

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



Looking by economic sector, in 2012 lending for primarily infrastructural investment increased in energy sector (by 45.2%) and water supply (by 39.5%) as well as in agriculture (by 9.1%) and some sub-sectors of manufacturing and transport. Conversely, the steepest decline was still reported in construction (26.2%) and real estate activities (14.8%). Despite the overall reduction in loans in 2012, at the end of 2012 a large share of corporate loans was still concentrated in real estate activities (31.5%; 34.3% at the end of 2011), other major credit investment being made in manufacturing (13.5%; 13.7% in 2011), trade (10.7%; 10.9% in 2011), energy (7.7%; 4.9% in 2011) and construction (7.2%; 10.5% in 2011).

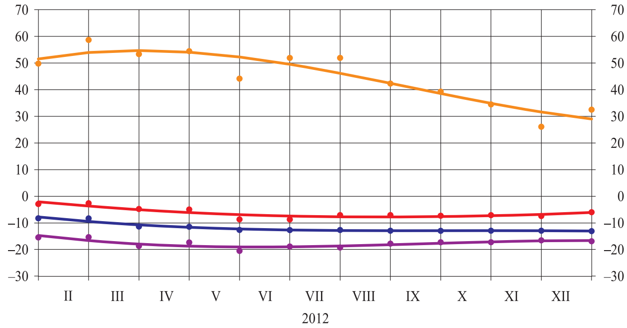
The most significant contraction during the year was observed for the mortgage loans granted to non-financial corporations as well as household loans for house purchase (by 18.3% and 11.0% respectively). The decrease in industrial credit and consumer credit granted to household was more moderate at 13.0% and 10.6% respectively, whereas commercial credit even posted a rise of 0.1% in 2012. At the end of December, loans for house purchase totalled 3.7 billion lats or 80.9% of all loans granted to households, representing a year-on-year decrease of 0.5 billion lats. Hence, industrial credit, commercial credit and loans for house purchase accounted for 16.9%, 15.9% and 36.9% of all loans at the end of the year respectively (17.8%, 14.6% and 37.0% at the end of 2011 respectively).

Lats and euro interest rate developments throughout the year resulted in further gradual changes of the currency composition of the loan portfolio. Lats loans expanded by 15.5% and amounted to 13.6% of the aggregate loans at the end of 2012 (10.5% at the end of 2011), whereas the share of euro loans shrank by 4.4 percentage points, to 81.4% (see Chart 12 for the annual developments in lats and euro loans granted to resident households as well as financial institutions and non-financial corporations). The share of other currency loans expanded to 5.0% of the aggregate loans. As at the end of 2012, 44.5% of those loans were granted in the US dollars, 31.5% in Swedish krona, 15.0% in Swiss francs and 8.5% in British pound sterling.

Chart 12

ANNUAL CHANGES IN LOANS 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 households



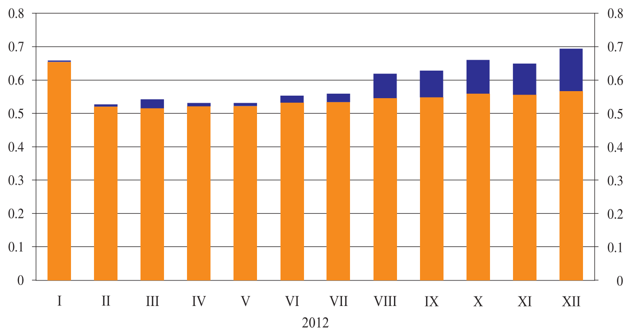
MONETARY BASE

The reduction of the minimum reserve ratio in January resulted in shrinking of the minimum reserves of credit institutions placed on accounts with the Bank of Latvia on an annual basis (see Chart 13), although starting from the second quarter the increase in liabilities of credit institutions subject to the minimum reserve requirements renewed the growth of minimum reserves placed on credit institution accounts with the Bank of Latvia. Nevertheless, overnight deposits by credit institutions and other financial institutions with the Bank of Latvia grew by 424.8 million lats or 42.1% during the year (by 23.4% in 2011) on account of a significant rise in foreign currency deposits of credit institutions (balances of TARGET2-Latvija accounts in euro) as the exceptionally low remuneration on interbank deposits encouraged some credit institutions to place their foreign currency liquidity with the central bank. At the same time, a moderate increase in recourse to the Bank of Latvia's deposit facilities had a compressing effect on the monetary base. With the demand for cash stabilising, currency in circulation increased by 74.0 million lats or 6.4% (by 23.7% in 2011). As a result, the monetary base M0 expanded by 23.0% and totalled 2 667.7 million lats at the end of 2012, whereas the cash component of the monetary base contracted to 46.3% in comparison with 53.5% at the end of 2011.

Chart 13

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

Minimum reserves on credit institution accounts with the Bank of Latvia
Excess reserves

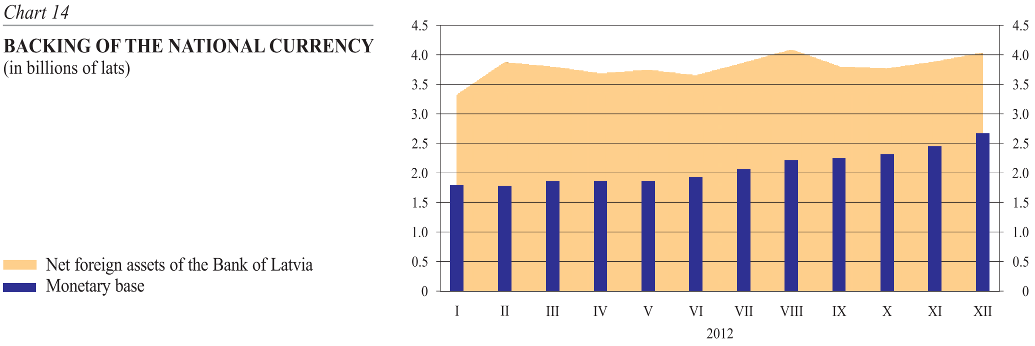


The shrinking of the Bank of Latvia's net domestic assets with their negative value increasing by 91.9 million lats had a downward effect on the monetary base. At the same time, net credit to general government decreased by 24.1 million lats with government deposits with the Bank of Latvia growing accordingly. As a result of higher recourse to deposit facilities, other items decreased in net terms. The same as in 2011, no loans to credit institutions were granted.

Net foreign assets of the Bank of Latvia grew by 590.6 million lats or 17.2% in 2012 on account of net purchases of euro by the Bank of Latvia as well as an increase in foreign currency deposits by the Latvian government and credit institutions. At the end of 2012, the Bank of Latvia's reserve assets covered the goods imports of 5.2 months (5.0 months at the end of 2010), whereas the backing of the monetary base with foreign currencies and gold (see Chart 14) was 150.9% (158.4% at the end of 2011).

Chart 14

BACKING OF THE NATIONAL CURRENCY
(in billions of lats)



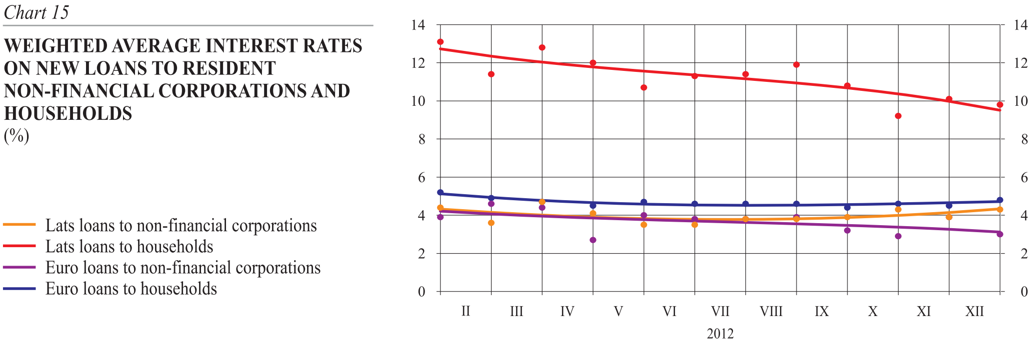
LENDING AND DEPOSIT RATES

Interest rates on new loans granted to resident households and non-financial corporations in 2012 were, on average, slightly lower than in the previous year. The weighted average interest rate on new MFI loans to resident households and non-financial corporations tended to decline slowly throughout the year and was 0.6 percentage point lower in 2012 in comparison with the previous year (4.2%). As a result of the downward trend in euro money market indices, the interest rate burden also eased on most of the resident households and non-financial corporations having taken either lats-denominated or euro-denominated loans in the preceding years. The drop in deposit rates was commensurate with that in the lending rates. This implies that the developments in lending and deposit rates had no significant effect on the profitability of the credit institutions operating in Latvia.

With relatively more active engagement of MFIs in lending to non-financial corporations, the weighted average interest rate on new loans to resident non-financial corporations declined to a slightly larger extent than that on the new household loans for house purchase. Against the background of strong economic development and declining credit risk of small and medium-sized businesses, MFIs reduced the risk premia on new small and medium-sized loans to non-financial corporations. Thus the spreads between the weighted average rate on new large-sized loans to resident to non-financial corporations (over 1 million euro or an equivalent in lats) which is traditionally lower and the weighted average rates on new small and medium-sized loans (up to 0.25 million euro or an equivalent in lats and 0.25–1 million euro or an equivalent in lats respectively) which are traditionally higher narrowed in 2012. Some credit institutions more actively engaged in lending to non-financial corporations slightly reduced their margins for new loans to non-financial corporations. Nevertheless, this was not the dominant interest rate policy. Overall, the margins on loans granted to resident non-financial corporations remained broadly unchanged in 2012. The interest rates on new lats loans granted to resident non-financial corporations remained close to the respective euro rates (see Chart 15); therefore, the share of the lats loans in aggregate loans continued to expand.

Chart 15

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



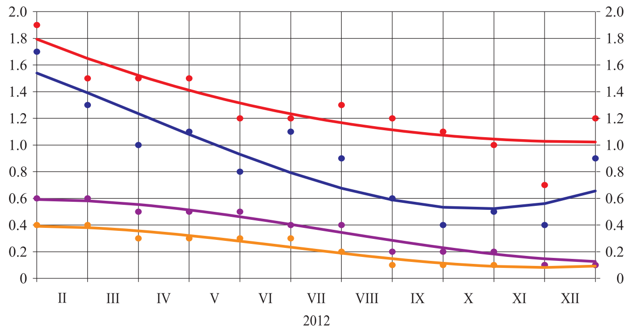
The interest rates on MFI loans to resident households declined as a result of the downward trend in the lats and the euro money market indices, with the weighted average rate going down from 4.0% in 2011 to 3.6% in 2012. The reduction in the lats and the euro money market indices had a significant effect on the floating interest rate and the interest rate with an initial rate fixation period of up to 1 year applied to MFI loans for house purchase granted to resident households. At the same time, the interest rates with longer initial rate fixation periods applied to resident household loans for house purchase remained almost unchanged. As the composition of consumer credit granted to households shifted in favour of lower interest rate loans (e.g. credit institutions granted relatively more loans for purchases of consumer durables), the weighted average interest rate on consumer credit granted to resident households edged down from 18.0% in 2011 to 16.0% in 2012. The interest rates on lats loans granted to resident households were close to those on the respective euro loans, with interest rates on lats loans for house purchase even sliding slightly below the level of the interest rates on the respective euro loans. The rate of expansion of the share of lats loans in all loans granted to resident households was lower than that in the loans granted to resident non-financial corporations.

The interest rates on new deposits by resident non-financial corporations and households also declined gradually (see Chart 16). It took a year for the rates on deposits by resident households to retreat gradually to the level observed prior to the rise reported at the end of 2011. In 2012, the interest rates on new deposits by resident households tended to increase during the most significant public holidays when credit institutions offered more favourable terms and conditions, as was the case in other years as well.

Chart 16

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



INTERBANK MARKET

The year 2012 was characterised by a decline of the interbank market rates to an all-time low. The low interest rate policies persistently pursued by the national central banks in combination with the ample liquidity of Latvia's credit institutions, convincing economic performance and regained access to international financial markets were reflected also in further shrinking of interest rates on interbank transactions in both the national currency and in foreign currencies. On the domestic interbank market, like in all previous years, dominated by uncollateralised overnight transactions, the weighted average interest rate on overnight lats transactions declined from 0.39% in January 2012 to 0.10% in December, with the weighted average interest rate on euro transactions decreasing from 0.23% to 0.08% respectively. Although domestic interbank loans in the national currency nearly doubled in 2012 reaching 7.4 billion lats, other currencies (mainly euro and US dollars) were still used more actively in interbank market (13.2 billion lats).

The average values of the money market index RIGIBOR to which the interest rates on non-MFI borrowing in lats are linked hit an all-time-low in 2012. 3-month RIGIBOR stood at 0.89% in 2012, whereas 6-month RIGIBOR was 1.42% (in 2011, 0.96% and 1.51% respectively). Once the financial market participants realised that the rumours circulating at the end of 2011 and the subsequent steep rise in shorter-term money market indices lacked justification, the interest rates resumed on a downward trend already at the beginning of 2012. In the circumstances of enormous liquidity surpluses accumulated by euro area credit institutions, EURIBOR, the euro money market index to which the interest rates on non-MFI borrowing in euro are linked, continued to decrease gradually mirroring the reductions in the key ECB interest rates as well as the minimum reserve ratio. 3-month EURIBOR stood at 0.57% in 2012, whereas 6-month EURIBOR was 0.83%.

The narrowing of the spreads between RIGIBOR and EURIBOR pointed to declining risk perception. The spread between 3-month RIGIBOR and EURIBOR decreased from 0.66 percentage point at the beginning of January 2012 to 0.34 percentage point at the end of December, whereas for the 6-month maturity it narrowed from 0.80 percentage point to 0.67 percentage point respectively.

FOREIGN EXCHANGE MARKET

In 2012, the most significant changes in the US dollar exchange rate were recorded vis-á-vis the Japanese yen (almost 13% appreciation), whereas the rate against the euro and the British pound sterling went down by 1.8% and 4.6% respectively.

The central banks of advanced economies pursued untraditional monetary policies aimed at providing maximum liquidity to the financial markets in 2012, although the set of the monetary instruments applied and scope of transactions differed across the countries. Thus the FRS set a monetary policy target for inflation in 2012, additionally targeting the US employment rate later in the year. With the help of several securities purchase programmes, the FRS continued massive capital injections into the US economy, thereby hoping to stimulate economic growth. The ECB reduced the interest rate on main refinancing operations by 0.25%, to an all-time-low at 0.75%. Under the leadership of the new President Mario Draghi the ECB provided liquidity to banks by way of collateralised loans with a three-year maturity. The ECB guaranteed the purchasing of euro area government securities (with a maturity of up to three years) on the secondary securities market should any of the euro area countries have liquidity problems. Thereby the ECB largely succeeded in suppressing the market speculations concerning the potential partial or full disintegration of the euro area. The Bank of England also increased liquidity injections into the financial system through its asset purchase programme. At the turn of the year, the new Japanese government announced a new policy priority: use all the means to fight deflation which is detrimental to the economy and achieve 2% inflation as soon as possible. The threat of price hikes and lower demand for Japanese financial assets resulted in a notable depreciation of the Japanese yen in the fourth quarter. Export-related Japanese businesses benefitted significantly from the above-mentioned exchange rate depreciation, fuelling an upsurge in the Japanese stock market. Accommodative monetary policies pursued by central banks and rising optimism with regard to the future prospects of the euro area supported stock market development in most advanced economies in 2012.

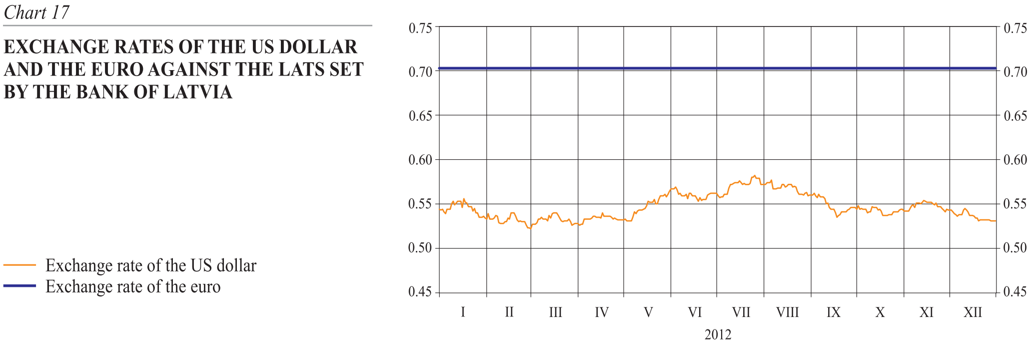
In 2012, the euro appreciated by 1.8% against the US dollar (from 1.2961 at the end of 2011 to 1.3193 at the end of 2012), peaking at 1.3487 on 24 February and reaching the low at 1.2043 on 24 July. In the first half of the year, the euro depreciated under the impact of the euro area sovereign debt crisis. Nevertheless, the economic stabilisation measures implemented by the ECB and the regained confidence in the euro area supported appreciation of the euro in the second half of the year. The probability that the US tax burden would be raised as of 2013 and the economic stimulation programmes would expire, uncertainty surrounding the results of the US Presidential elections at the turn of 2012, the unsolved problems with of the US federal deficit had a negative effect on the US dollar exchange rate. The US dollar depreciated against all major currencies (with the exception of the Japanese yen) in the second half of the year. It appreciated vis-á-vis the

Japanese yen from 76.91 at the end of 2011 to 86.75 at the end of 2012 (a rise of 12.8%), peaking at 86.79 on 31 December and hitting a low at 76.03 on 1 February. The sharpest depreciation of the Japanese yen was seen at the end of the year when the newly-elected Japanese Prime Minister Shinzo Abe announced the intention of the Bank of Japan to provide unlimited liquidity to the market, in order to achieve the government target of 2% inflation already in the near term. The market responded swiftly to the announcement of the Japanese government by selling off the Japanese assets, so far considered safe. Even despite the negative economic growth in the United Kingdom and the persistently high deficit, the British pound sterling appreciated by 4.6% against the US dollar in the course of the year (from 1.5543 at the end of 2011 to 1.6255 at the end of 2012), peaking at 1.6309 on 21 September and reaching the lowest point of 1.5235 on 13 January.

On the domestic foreign exchange market, the US dollar depreciated against the lats from 0.5401 at the end of 2011 to 0.5290 at the end of 2012, representing a 2.1% decrease. The US dollar reached its high at 0.5782 on 24 July and its low at 0.5178 on 27 February. The euro's volatility against the lats was low in 2012: the exchange rate fluctuated in a narrow range between 0.6960 and 0.7000 (0.6982 at the end of 2012). Moreover, almost half of the year, the euro exchange rate was close to the lower limit of the intervention band set by the Bank of Latvia (0.702804 ±1%; see Chart 17 for the changes in the US dollar and euro exchange rates set by the Bank of Latvia). In 2012, the Bank of Latvia sold lats for 330.1 million euro to the market participants and the Treasury in net interventions.

Chart 17

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



According to the monthly reporting data of credit institutions on foreign currency purchase and sales transactions, the overall turnover in exchange transactions continued to shrink in 2012 reaching 773.0 billion lats, with the turnover in all currencies contracting by 7.5% in the course of the year, roughly the same as in the previous year. At the same time, the turnover in foreign exchange transactions against the lats decreased to 82.6 billion lats. The overall decline in foreign exchange turnover was determined by a 7.6% decrease in non-cash foreign exchange transactions, while the cash foreign exchange transactions against the lats expanded by 2.9% during the year.

The largest contribution to the non-cash foreign exchange transaction turnover in 2012 was again made by transactions with non-residents, although this contribution shrank to 61.8%, with the contribution of transactions with residents expanding accordingly. A large share of the non-resident foreign exchange turnover was attributable to currency swaps with non-resident MFIs, exchanging the lats for the euro and vice versa.

The turnover of the cash foreign exchange transactions against the lats in credit institutions and currency exchange offices grew from 1.6 billion lats in 2011 to 1.7 billion lats in 2012. Moreover, the turnover of the cash foreign exchange transactions against the lats in credit institutions followed a downward path through recent years, while the respective turnover at the currency exchange offices increased further (for example, the turnover of the respective segment grew by 20.5% in 2011 and by 19.4% in 2012).

Mostly the euro was exchanged in cash for the lats, as usual; nevertheless, the share of this currency in foreign exchange transactions continued to contract: the share of euro exchange transactions against the lats decreased from 58.8% of the overall turnover in credit institutions and currency exchange offices to 55.7% in 2012. The share of the US dollar in the cash foreign exchange transactions against the lats increased slightly from 21.7% of the overall cash foreign exchange transactions against the lats in 2011 to 22.7% in 2012. The turnover of both British pound sterling and Russian ruble in foreign exchange transactions against the lats as well as their shares in the cash transactions expanded. In 2012, Russian ruble transactions amounted to 8.2% of the overall cash foreign exchange turnover. Moreover, most of those transactions were carried out at currency exchange offices. Conversely, in credit institutions cash transactions exchanging the British pound sterling for lats were more common often than the respective transactions in the Russian rubles, with the overall share of the British pound sterling in the cash foreign exchange transactions against the lats reaching 6.2%.

The euro and the US dollar remained the dominant currencies in all currency non-cash foreign exchange turnover, the same as in 2011. Their share in the overall foreign exchange turnover grew from 38.9% in 2011 to 51.8% in 2012. The turnover in other currency pairs tended to increase vis-á-vis the euro in 2012 (a rise of 55.0% in comparison with the previous year), declining against the US dollar (a drop of 33.0% in comparison with the previous year), although the US dollar remained the dominant currency in the market. The share of the Russian ruble exchange transactions against the US dollar in the overall turnover contracted considerably in 2012: from 18.1% in 2011 to 8.8% in 2012.

SECURITIES MARKET

In 2012, the consistent implementation of the macroeconomic stabilisation policy and successful economic development made a notable shift in investors' opinion about Latvia, and a relatively sharp decline in risk perception with interest rate drop was observed in Latvia's government bond market, also supported by the upgrading of Latvia's credit rating by the international credit rating agencies.

The value of government securities offered by the Treasury through primary market auctions was 253.0 million lats (down by 41.8% compared to last year). Lower amounts of new issues resulted from lower securities redemption amounts in 2012. Demand exceeded supply 3.5 times (2.9 times in 2011), and 96.4% of the supplied amount were sold (95.9% in 2011).

Six and eight competitive auctions of 10-year Treasury bonds were held in 2011 and 2012 respectively (particular attention will be paid to the interest rates of the latest issue in the secondary market as it will be the criterion for the assessment of Latvia's compliance with the Maastricht criterion of long-term interest rates in spring 2013). The above auctions can be considered successful: at the first competitive auction in April 2012 the weighted average yield stood at 5.30%, while at the last auction in October it had moved down to 3.20%, pointing to a substantial revision of Latvia's risk perception. Weighted average yields on short-term Treasury bills also fell, from 1.62% at the 12-month Treasury bill auction in January down to 0.67% at the November auction.

The amount of Latvian government securities outstanding contracted by 5.2%, to 675.1 million lats, on account of favourable developments in the external markets, and net borrowing in the domestic market moderated. As to the breakdown of government securities by holder, in 2012 the share of Latvian credit institutions' government securities holdings shrank from 54.8% to 54.0%, while those of other residents and non-residents increased from 42.8% to 43.0% and from 2.4% to 3.0% respectively.

In 2012, Latvia for the first time launched two bond issues in external markets in the same year. In February Latvia launched the second US dollar-denominated issue of euro bonds in the external market in the post-crisis period. It was a 5-year bond issue worth 1 billion US dollars with the average yield rate of 5.375%. Spread over the US government bonds of the same maturity was 455 basis points. In December, Latvia issued 7-year bonds worth 1.25 billion US dollars with the average yield of 2.889%, the latter being a historic low since Latvia has been making public borrowings in international markets. Spread over the US government bonds of the same maturity was 188 basis points. With the funds raised in the above bond issue Latvia made an early repayment of the entire IMF loan which was part of the international loan programme; this suggested that Latvia would also be able to refinance the expected major loan repayment of this programme in 2014 and 2015 on favourable terms.

The stock of publicly traded corporate debt securities registered with the LCD in all currencies expanded from 166.5 million lats to 263.5 million lats (the above stock posted a mere 5.7 million lats growth in 2011). Seven issues matured (inter alia, one issue was redeemed prior to the agreed maturity), and 13 new issues were launched. The stock of corporate debt securities denominated in lats decreased from 23.1 million lats to 14.2 million lats as two issues of the SJSC *Latvijas Hipotēku un zemes banka* matured, but no new issues of corporate debt securities denominated in lats were launched. All new issues were denominated in euro and US dollars, with *ABLV Bank* JSC (91.1 million lats; six issues), JSC *Latvenergo* (14.1 million lats; one issue) and JSC *Rietumu Banka* (12.9 million lats; three issues) being the major issuers. In 2012, an increase in debt securities was driven by the low interest rates in the euro and US dollar bond markets, making the bond offer of Latvian issuers look relatively more attractive, as well as by the improving macroeconomic results and credit ratings of Latvia.

On NASDAQ OMX Riga, the bid yield on Latvian government bonds maturing in February 2021 declined from 6.00% to 3.30% over 2012. At the beginning of the year, the bid rate on the government securities with the time to maturity approximately one month was 1.25%, moving down to 0.49% at the end of the year.

The quoted bid yield on Latvian government bonds denominated in US dollars and maturing in 2021 fell from 6.34% at the end of 2011 to 3.09% at the end of 2012. The spread between the above bid yield and that on US government bonds of the respective maturity shrank from 457 basis points to 165 basis points. A similar decline of over 200 basis points was also observed for the Lithuanian and Hungarian US dollar-denominated bonds of the same maturity. The yields also decreased due to the ECB refinancing operation with a maturity of three years performed at the end of February, and the September communication that the ECB could purchase unlimited amounts of euro area government securities subject to an appropriate economic reform plan in place in the respective country.

In 2012, the turnover of debt securities on NASDAQ OMX Riga was 25.1 million lats (considerably higher than in 2011). The sharp increase in the above turnover was driven by the new securities issues of Latvian credit institutions. The bonds of *ABLV Bank* JSC and those of Latvian government posted the largest turnover in the amount of 22.7 million lats and 2.2 million lats respectively.

The NASDAQ OMX Riga stock turnover decreased to 11.6 million lats in 2012, down from 26.1 million lats in 2011. The highest turnover was recorded for the shares of the JSC *Grindeks* (3.7 million lats), JSC *Olainfarm* (2.3 million lats) and JSC *Ventspils nafta* (1.6 million lats).

In 2012, OMXR, the NASDAQ OMX Riga index, rose by 6.7%, and the Baltic gross index OMXBGI grew by 23.4% (in 2011, OMXR fell by 5.7% and OMXBGI dropped 22.7%; thus OMXR performance was more balanced overall).

At the end of 2012, shares of 32 corporations were listed on NASDAQ OMX Riga (the same number as at the end of 2011). Five corporations were listed on the Baltic Main List and 27 corporations were included on the Baltic Secondary List.

The share price rise on NASDAQ OMX Riga was a result of the sound economic indicators of Latvia and the profits of Latvian businesses, as well as the developments on the major global stock exchanges where the stock market indices DJ EURO STOXX 50 and S & P 500 rose by 13%–14%. Gains in corporate profits favourably affected the global share prices; still, their increases notwithstanding, they had not reached the pre-crisis levels. Accommodative policies pursued by the central banks and the low interest rates also supported the rise in share prices. However, the fact that share prices posted a steeper increase than corporate profits makes one cautious.

BANK OF LATVIA OPERATIONS AND ACTIVITIES

LEGAL FRAMEWORK AND FUNCTIONS. THE BANK OF LATVIA IN THE EUROPEAN SYSTEM OF CENTRAL BANKS AND INSTITUTIONS OF THE EUROPEAN UNION

The Bank of Latvia is the central bank of the Republic of Latvia. The Bank of Latvia's tasks are set forth by the Law "On the Bank of Latvia". The primary objective of the Bank of Latvia is to maintain price stability in Latvia. Its main tasks are as follows:
– establishment and implementation of monetary policy;
– management of foreign currency and gold reserves;
– issue of the national currency, both banknotes and coins;
– promotion of a smooth operation of the payment systems in Latvia and organisation and provision of the operation of the interbank payment system;
– compiling and publishing financial statistics and Latvia's balance of payments as well as publishing the compiled statistics;
– issuing licences to legal persons listed in the Register of Enterprises of the Republic of Latvia, except credit institutions, for the purchase and sale of foreign currency as a commercial activity;
– representation of Latvia in foreign central banks and international financial institutions;
– acting as a financial agent for the Latvian government.

The Bank of Latvia is acting as a consultant of the Parliament (Saeima) and the Cabinet of Ministers of the Republic of Latvia in issues related to monetary policy and other issues concerning the Bank of Latvia's performance of its tasks. The Bank of Latvia also ensures the operation of the Credit Register.

The Bank of Latvia is not subject to decisions and instructions by the government or other institutions. The Bank of Latvia is independent in making and implementing decisions. The Bank of Latvia is supervised by the Parliament (Saeima) of the Republic of Latvia.

Like the national central banks of other EU countries, the Bank of Latvia is participating in the ESCB. In its activities, the Bank of Latvia complies with the Republic of Latvia and EU legislation as well as ECB legal acts in compliance with the Treaty on the Functioning of the European Union and the Statute of the European System of Central Banks and the European Central Bank (hereinafter, the "Statute of the ESCB and ECB").

In 2012, the Governor of the Bank of Latvia participated in the work of the ECB General Council. In compliance with the Statute of the ESCB and ECB, the ECB General Council discussed on its meetings reports on the macroeconomic situation and financial stability in the EU countries, reports on functioning of ERM II as well as addressed other issues concerning the national central banks of all EU countries.

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

The Bank of Latvia's experts also participated in committees and working groups of the Council of the EU and the EC. Sitting on the EFC and its subcommittees, the representatives of the Bank of Latvia regularly participated in the decision-making concerning the economic and financial development of the EU, assessed the convergence of the non-euro area countries which are getting ready to join the euro area in the future, discussed the relations with third countries and policies of international financial institutions as well as took part in drafting proposals addressing the economic policy strategy and instruments. In 2012, the EFC paid particular attention to the issues of the EU financial stability and the supervision of the financial sector as well the strengthening of the economic policy coordination and crisis management instruments. The Bank of Latvia's representatives participated in the EC and Eurostat working groups addressing issues related to euro coins, payment systems, economic forecasting and statistics.

In 2012, the Governor of the Bank of Latvia participated in the work of the ESRB, making decisions on recommendations towards preventing the systemic risks of the EU financial system as well as establishing the macro-prudential policy framework, and other related issues. The representatives of the Bank of Latvia participated in the Advisory Technical Committee of the ESRB and its working groups dealing with the issues related to financial stability.

The Bank of Latvia drafted amendments to the Law "On the Bank of Latvia" to ensure the consistency with the Treaty on the Functioning of the European Union and the Statute of the ESCB and ECB that ranks among the preconditions for the euro changeover. The Bank of Latvia updated the changeover plan of the euro implementation, inter alia, assessing the euro introduction experience gained by Estonia, and implemented several tasks provided for in this plan. The representatives of the Bank of Latvia participated in the Euro Team lecturer project delivering lectures to interested individuals and publishing analytical articles about the euro changeover and its importance.

In compliance with the requirements of the Statute of the ESCB and ECB, the Bank of Latvia ensured translation of the ECB Annual Report 2011, summaries of the ECB Convergence Report of May 2012 and the quarterly version of the ECB's Monetary Bulletin (published on the Internet).

DEVELOPMENT, ADOPTION AND IMPLEMENTATION OF MONETARY POLICY

ECONOMIC RESEARCH, ANALYSIS AND FORECASTING

Economic research and analysis are indispensable for a central bank to provide quantitative and scientifically sound accounts of economic processes, to develop econometric models for forecasting macroeconomic indicators and to estimate alternative scenarios. In 2012, the Bank of Latvia published six working papers and one discussion paper on its website; in addition, two more research papers were co-written together with researchers from other national central banks and published within the series of the ECB and *Suomen Pankki – Finlands Bank* working papers. Three articles written by Bank of Latvia specialists were published in international peer-reviewed journals.

One of the working papers published in 2012 deals with the equilibrium real exchange rate of the lats with the aim to find out whether the real exchange rate of the lats has remained close to its equilibrium after significant fluctuations of the previous years (see Working Paper 4/2012 on the Bank of Latvia website). Given that equilibrium exchange rate estimates are subject to substantial uncertainty and are sensitive to different assumptions, a broad set of methodologies and approaches that differ considerably in terms of the underlying theoretical background and macroeconomic time series have been employed. All in all, the results indicate that real effective exchange rate of the lats does not appear to be significantly misaligned at the current juncture and after the appreciation during boom years and the subsequent adjustment remains close to its equilibrium level.

The growing uncertainty about external developments underpins the need for more accurate and effective information regarding the economic development in the EU countries that are Latvia's major partners. The Bank of Latvia researchers have developed a new regularised direct filter approach as a tool for high-dimensional filtering and real-time signal extraction, applying the real-time filter methodology to the medium-to-long-run component of GDP growth of major EU countries. Although the findings of this research replicate the widely used EUROCOIN, the new methodology provides for obtaining, starting with mid-2009, of more timely, i.e. three months earlier, data (see Working Paper 2/2012 and 6/2012 on the Bank of Latvia website).

In order to record the changes in Latvia's financial system in a timely and effective manner, the Latvian financial stress index has been developed (see Discussion Paper 1/2012 on the Bank of Latvia website). This index signals the periods of elevated stress as well as those of excessively vigorous and imbalanced development of the financial system. The Bank of Latvia has been using the financial stress index as one of the elements of Latvia's financial system stability monitoring framework since 2009.

The recent financial and economic crisis has highlighted not only the need for financial system oversight but also the issue of economic competitiveness. In 2012, the ECBS *CompNet* (Competitiveness Research Network) was established to unite researchers from national central banks, international institutions and academic organisations. The Bank of Latvia actively participates in *CompNet* work, researching Latvia's competitiveness issues and developing new methodologies for assessing non-price competitiveness. In accordance with the detailed trade data analysis, Latvia's competitiveness in the global market has substantially improved in the course of last 10 years (see Working Paper 3/2012 on the Bank of Latvia website). It was spurred by increasing presence of Latvia's producers in already conquered markets, while the diminishing of Latvia's traditional market share in world trade is compensated by the expansion of Latvia's exporters into new markets. A weakness of conventional competitiveness assessment methods is the lack of due regard for non-price factors, e.g. physical product quality and consumer tastes. The methodology developed by the Bank of Latvia researchers allows for improving on these flaws (see Working Paper 1/2012 on the Bank of Latvia website). It shows that despite some elevation of the Latvian export prices vis-á-vis main rivals the relative quality of exports (or taste of consumers for Latvian goods) improved at a faster pace, fully offsetting price effects and enhancing overall competitiveness. Similar were the findings about the rest of the new EU countries, while the results with regard to other major industrial world countries differed: non-price factors had a positive effect on export competitiveness in Brazil, India, China and Turkey, whereas in Mexico the effect was negative (see Working Paper 19/2012 of *Suomen Pankki – Finlands Bank* Institute for Economies in Transition BOFIT).

The ECB Working Group on *Econometric Modelling* also focused on competitiveness studies. The ESCB research team, including also a Bank of Latvia employee, have concluded that there is no single factor explaining diverging external imbalances (see ECB Occasional Paper 139/2012). The study suggests impressive heterogeneity across euro area countries, with non-price factors basically contributing to trade surplus in some of them; trade deficit in South European countries, on the other hand, is also driven by price factors. An improvement in trade balance can be achieved by temporary reducing wages, enhancing productivity and product quality, and maintaining fiscal discipline.

Higher productivity is another aspect of national competitiveness; it is of particular importance in a long-term perspective as a driver of potential economic growth rate. Estimates of the Bank of Latvia researchers suggest that total factor productivity (TFP) has been a key determinant of long-run economic growth of a country for the last 15 years now (see Working Paper 5/2012 on the Bank of Latvia website). Moreover, Latvia was among the leaders of the new EU countries in terms of productivity growth which was relatively balanced across sectors, both goods and services, of the Latvian economy.

In 2012, the Bank of Latvia experts published three articles in international peer-reviewed journals. The research carried out in 2011 on consumer price formation mechanism appeared in the journal *Economic Modelling*. The study on export non-price competitiveness problems of countries in Central, East and Southeast Europe prepared by Bank of Latvia employees together with experts from *Oesterreichische Nationalbank* was published in the journal *Focus on European Economic Integration*. A research paper on Latvia's competitiveness has been published in the *Baltic Journal of Economics*.

MONETARY POLICY DECISIONS

In view of the contained risks to price stability, the Bank of Latvia cut the rates on the main refinancing operations as well as the credit institution minimum reserve ratio. Lower interest rates provide basis for enhanced availability of credit in the economy.

The year 2012 has been quite successful for Latvia, with robust economic growth, sound financial position and low inflation testifying to that. Like in the previous year, the impact of domestic factors on inflation was limited and risks to price stability remained low in the medium term. The Bank of Latvia forecasts suggest that inflation will remain sufficiently low also in 2013 and 2014. The financial market stabilised in Latvia. Despite the fact that a slight increase in risk perception was observed in the last months of 2011, related to the discontinuation of the JSC *Latvijas Krājbanka* operation and the cash run caused by rumours, it moderated again already in the first half of 2012, and a decline in 3-month RIGIBOR testified to that. In July, credit institutions started selling euro to the Bank of Latvia for lats.

In 2012, the Bank of Latvia reduced its refinancing rate and deposit facility rates on two occasions (in July and September). Overall, the refinancing rate was cut from 3.50% to 2.50%. The overnight deposit facility rate was reduced from 0.25% to 0.10% and from 0.10% to 0.05%, and the 7-day deposit facility rate was cut from 0.375% to 0.125% and from 0.125% to 0.075% respectively. The Bank of Latvia lowered the marginal lending facility rate in three steps (in March, July and September; see Chart 18 and Table 2). In January 2012, the Bank of Latvia set lower minimum reserve ratios for credit institutions. The minimum reserve ratios for deposits with an agreed maturity of over two years, deposits redeemable at notice of over two years and non-callable debt securities, issued by a credit institution, with an original maturity of over two years were cut from 3.00% to 2.00%; for repo transactions the reserve ratio remained unchanged at 0.00%; for other liabilities included in the reserve base it was lowered from 5.00% to 4.00%.

Chart 18

MONEY MARKET INTEREST RATES
(%)

- Bank of Latvia refinancing rate
- Bank of Latvia overnight deposit facility rate for credit institutions
- Bank of Latvia marginal lending facility rate, resorting to the facility no more than 5 working days within the previous 30 day period
- Bank of Latvia 7-day deposit facility rate for credit institutions
- 3-month RIGIBOR
- Overnight RIGIBOR

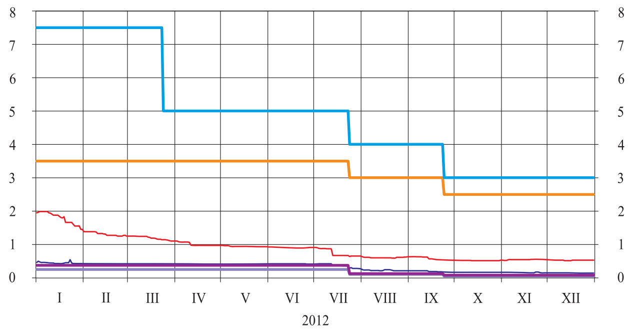


Table 2

INTEREST RATES SET BY THE BANK OF LATVIA
(% per annum)

Effective date	Bank of Latvia refinancing rate	Lending facility rate			Deposit facility rate with the Bank of Latvia		Reserve ratio (%)	
		If the lending facility has been used no more than 5 working days within the previous 30 day period	If the lending facility has been used 6–10 working days within the previous 30 day period	If the lending facility has been used more than 10 working days within the previous 30 day period	Overnight	7-day	Liabilities with a maturity of over 2 years	Other liabilities included in the reserve base
Status as at 01.01.2012	3.5	7.5	15.0	30.0	0.25	0.375	3.0	5.0
24.01.2012	–	–	–	–	–	–	2.0	4.0
24.03.2012	–	5.0	10.0	15.0	–	–	–	–
24.07.2012	3.0	4.0	7.0	10.0	0.10	0.125	–	–
24.09.2012	2.5	3.0	6.0	9.0	0.05	0.075	–	–

The global financial market participants and international credit rating agencies positively assessed Latvia's success achieved in the stabilisation and growth of the national economy; as a result, Latvia's credit ratings and their outlook were upgraded. Investors offered low interest rates on bonds issued by Latvia in the global financial markets.

USE OF MONETARY POLICY INSTRUMENTS

In July 2012, Latvian credit institutions resumed selling euro for lats to the Bank of Latvia: since the euro money market rates approached zero, demand for euro declined in comparison with that for lats. The amounts of euro held by credit institutions also increased on account of the Treasury converting euro to lats.

In 2012, Latvian credit institutions and the Treasury sold euro in exchange for lats in the net amount of 229.6 million lats to the Bank of Latvia (both as per transaction date and settlement date); the Bank of Latvia sold euro in the amount of 0.2 million lats at the Bank of Latvia Cashier's Office.

The end-of-day balance of the currency in circulation averaged 1 167.1 million lats in 2012 (a year-on-year increase of 17.9%). Currency in circulation remained broadly unchanged in the first half of the year, resuming an increase in summer. The average balance of credit institution minimum reserve requirements stood at 546.2 million lats (21.7% lower year-on-year on account of the reduced minimum reserve ratios). In 2012, the government lats deposit with the Bank of Latvia grew 1.1 times on average, to 378.2 million lats. In 2012, the overall impact of currency in circulation, the minimum reserve requirements for credit institutions and the government deposits contributed to a 224.4 million lats decrease in the lats liquidity. Credit institution liquidity was also affected by several other factors, e.g. a decrease in the lats deposits of other financial institutions with the Bank of Latvia. Nevertheless, excess liquidity persisted, and, like in the previous year, deposit facility was the major monetary policy instrument of the Bank of Latvia. The Bank of Latvia's overnight and 7-day deposit facility averaged 405.0 million lats (34.6% lower year-on-year).

In 2012, auctions of the main refinancing operations and currency swaps were conducted each business day; however, as a result of excess liquidity, there was no demand for these instruments. In January recourse to the marginal lending facility was used twice, in the total amount of 22.0 million lats, at the interest rate of 7.50% per year.

The Bank of Latvia continued to calculate RIGIBID (interbank deposit rates) and RIGIBOR (interbank lending rates) in accordance with the Bank of Latvia's "Regulation for the Calculation of RIGIBID and RIGIBOR", including those credit institutions in quotation list that were active on the interbank market and able to conduct market operations at their quoted money market rates on transactions in lats actively. At the end of 2012, the list of the credit institutions whose money market quotes were used in RIGIBID and RIGIBOR calculations in accordance with the Bank of Latvia's "Regulation for the Calculation of RIGIBID and RIGIBOR" included the JSC *Swedbank*, JSC *SEB banka*, JSC *UniCredit Bank*, Latvian Branch of *Nordea Bank Finland Plc*, JSC *DNB banka*, SJSC *Latvijas Hipotēku un zemes banka*, and JSC *Citadele banka*.

FOREIGN CURRENCY AND GOLD RESERVES MANAGEMENT

The Bank of Latvia's foreign reserves, which include gold, convertible foreign currencies and SDR, amounted to 3 994.8 million lats at the end of 2012 (3 472.9 million lats at the end of 2011). An increase in foreign reserves resulted from income gained from investing foreign reserves in foreign financial markets and interventions on the foreign exchange market. The Bank of Latvia manages its foreign reserves in compliance with the guidelines adopted by the Council of the Bank of Latvia. The benchmark currency is the euro and the benchmark assets are composed of 40% of euro-denominated assets, 40% of US dollar-denominated assets, 10% of Japanese yen-denominated assets, 8% of Canadian dollar-denominated assets and 2% Singapore dollar-denominated assets. In order to further diversify the financial assets, on 1 June 2012 the benchmark composition was supplemented by Canadian dollar-denominated assets and Singapore dollar-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 EU countries and the US and international organisations, as well as in highly rated bank and corporate debt securities, asset-backed securities and callable bonds. Interest rate futures are used to manage the duration of the reserves. For the purpose of implementing yield curve strategies on the interest rate market, interest rate swaps are used, whereas foreign exchange futures and forwards are applied to ensure the optimal currency composition of the foreign reserves.

Foreign currency reserves of the Bank of Latvia are managed relative to the 1–3 year government bond indices of the US, euro area countries, Japan, Canada and Singapore; hence investments are made primarily in securities with maturity of 1–3 years. Particular attention is paid to the interest rates of 2-year bonds which declined (from 0.14% to –0.02% in the euro area and from 0.14% to 0.10% in Japan) and rose (from 0.24% to 0.25% in the US, from 0.88% to 1.14% in Canada[1] and from 0.19% to 0.25% in Singapore[1]) over 2012. In view of the historically very low levels of interest rates, it is quite difficult for the central bank as a conservative investor with a low risk tolerance level to generate high returns. Nevertheless, investments in the private sector securities and the decline in interest rates positively affected the Bank of Latvia income in 2012.

The Bank of Latvia stored its gold reserves with the Bank of England. The Bank of Latvia hedged the risk related to fluctuations in gold reserves market value by entering into forward exchange rate and currency future contracts and currency swap arrangements.

The Bank of Latvia uses the services of four external reserve managers. They manage a small portion of the Bank of Latvia's foreign reserves pursuant to the guidelines adopted 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 risk allocation is managed in line with various investment decisions.

PROVISION OF CURRENCY IN CIRCULATION

At the end of 2012 currency in circulation posted a 6.4% year-on-year increase (from 1 160.2 million lats to 1 234.1 million lats; for the lats banknotes and coins in circulation by face value as at year-end, see Tables 3 and 4).

The cash received from credit institutions was checked for wear and tear and authenticity by automated cash processing systems. The amount of cash processed in 2012 (2 989.6 million lats) exceeded the amount of currency in circulation 2.4 times (2.8 times in 2011). As a result, the total value of cash withdrawn from circulation was 300.4 million lats or 10.0% of all processed currency (249.9 million lats or 7.7% in 2011).

The nominal value of detected counterfeits (17.5 thousand lats) accounted only for 0.0014% of the currency in circulation (0.0032% in 2011).

To mark significant cultural, historic and sports events, in 2012 the Bank of Latvia issued silver collector coins *100 Years in Olympic Games* (in circulation as of 16 April 2012), *Riga Zoo* (in circulation as of 7 June 2012), *Riga Technical University* (in circulation as of 4 October 2012), and *Kārlis Zāle* (in circulation as of 7 November 2012). The

[1] As of 1 June 2012 for Canada and Singapore.

Table 3

BANKNOTES IN CIRCULATION AT THE END OF THE YEAR

Nominal	Amount (in thousands of lats)		Number (in thousands of units)		Percentage (%)	
	2012	2011	**2012**	2011	**2012**	2011
LVL 5	**78.7**	71.6	**15.7**	14.3	**6.8**	6.5
LVL 10	**75.0**	76.7	**7.5**	7.7	**6.5**	7.0
LVL 20	**636.9**	584.6	**31.8**	29.2	**54.9**	53.5
LVL 50	**94.5**	94.2	**1.9**	1.9	**8.1**	8.6
LVL 100	**188.5**	171.4	**1.9**	1.7	**16.2**	15.7
LVL 500	**87.0**	94.8	**0.2**	0.2	**7.5**	8.7
Total	**1 160.6**	1 093.3	**x**	x	**100.0**	100.0

Table 4

COINS IN CIRCULATION AT THE END OF THE YEAR

Nominal	Amount (in thousands of lats)		Number (in thousands of units)		Percentage (%)	
	2012	2011	**2012**	2011	**2012**	2011
LVL 2	**9.0**	8.6	**4.5**	4.3	**12.2**	12.9
LVL 1	**39.7**	35.3	**39.7**	35.3	**54.0**	52.8
50 s	**9.1**	8.3	**18.1**	16.6	**12.4**	12.4
20 s	**5.2**	4.8	26.1	23.8	**7.1**	7.2
10 s	**3.1**	2.9	**31.4**	29.0	**4.2**	4.3
5 s	**2.4**	2.2	**47.2**	43.8	**3.3**	3.3
2 s	**2.6**	2.4	**129.8**	120.8	**3.5**	3.6
1 s	**1.9**	1.8	**191.2**	180.4	**2.6**	2.7
LVL 100 and LVL 10 collector coins	**0.5**	0.5	**0**	0	**0.7**	0.8
Total	**73.5**	66.9	**x**	x	**100.0**	100.0

5-Lats Silver Collector Coin, created by Rihards Zariņš in 1929, was issued anew as a dedication to the 90th anniversary of the Bank of Latvia and the Latvian national currency (in circulation as of 1 November 2012). With the help of a unique minting technology, developed by *Rahapaja Oy* (Finland), a silver and granite collector coin *Stone Coin* with the Lielvārde belt ornamental elements was struck (in circulation as of 10 January 2012).

Hedgehog (in circulation as of 7 June 2012) and *Christmas Bells* (in circulation as of 4 December 2012), two new 1-lats special circulation coins, were added to the circulation coin collection.

BANK OF LATVIA COINS STRUCK IN 2012

SPECIAL 1 LATS CIRCULATION COINS OF LIMITED MINTAGE

HEDGEHOG

Weight: 4.80 g, diameter: 21.75 mm
Metal: cupro-nickel
Struck by *Staatliche Münzen Baden-Württemberg* (Germany)
Artists: Andris Vītoliņš (graphic design),
Laura Medne (plaster model)

CHRISTMAS BELLS

Weight: 4.80 g, diameter: 21.75 mm
Metal: cupro-nickel
Struck by *Staatliche Münzen Baden-Württemberg* (Germany)
Artists: Holgers Elers (graphic design),
Laura Medne (plaster model)

COLLECTOR COINS

100 YEARS IN OLYMPIC GAMES

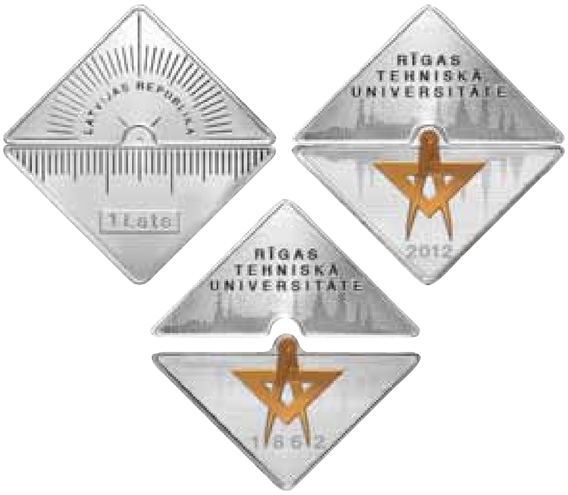
Face value: 1 lats
Weight: 22.00 g; diameter: 35.00 mm
Metal: silver of .925 fineness,
quality: proof
Struck by *Koninklijke Nederlandse Munt* (the Netherlands)
Artist: Aigars Bikše

RIGA ZOO

Face value: 1 lats
Weight: 27.00 g, diameter: 35.00 mm
Metal: silver of .925 fineness,
quality: proof
Struck by *Rahapaja Oy* (Finland)
Artists: Ivars Mailītis (graphic design);
Ligita Franckeviča and Ivars Mailītis (plaster model)

RIGA TECHNICAL UNIVERSITY

Face value: 1 lats
Weight: 26.00 g, shape: a square formed of two detachable triangles; area measurement: 32.00 × 32.00 mm
Metal: silver of .925 fineness,
quality: proof, with gilded elements and latent image
Struck by *Rahapaja Oy* (Finland)
Artist: Kristaps Ģelzis



5-LATS SILVER COLLECTOR COIN

Face value: 5 lats
Weight: 25.00 g, diameter: 37.00 mm
Metal: silver of .925 fineness,
quality: tamped back
Struck by The Royal Mint (the UK)
Artist: Rihards Zariņš (1869–1939)

KĀRLIS ZĀLE

Face value: 1 lats
Weight: 22.00 g, diameter: 35.00 mm
Metal: silver of .925 fineness,
quality: proof
Struck by *Koninklijke Nederlandse Munt* (the Netherlands)
Artists: Krišs Salmanis (graphic design),
Ligita Franckeviča (plaster model)

PAYMENT AND SETTLEMENT SYSTEMS

OPERATION OF THE BANK OF LATVIA PAYMENT AND SETTLEMENT SYSTEMS

The Bank of Latvia maintains the operation of the interbank payment systems, thus ensuring the implementation of monetary policy operations, secure, rapid and efficient settlement between credit institutions as well as final settlement of other payment and securities settlement systems. Hence efficient payment infrastructure is available to credit institutions providing payment services to their customers. Operation of other payment and securities settlement systems in Latvia is ensured by the private sector.

The Bank of Latvia organised and provided the operation of three payment systems: the SAMS, the EKS and TARGET2-Latvija in the Republic of Latvia. The daily average of payments processed by the Bank of Latvia via all systems totalled 138.1 thousand payments in the value of 1.0 billion lats (for the monthly data of payments processed through the Bank of Latvia's interbank payment systems see Charts 19 and 20).

Chart 19

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

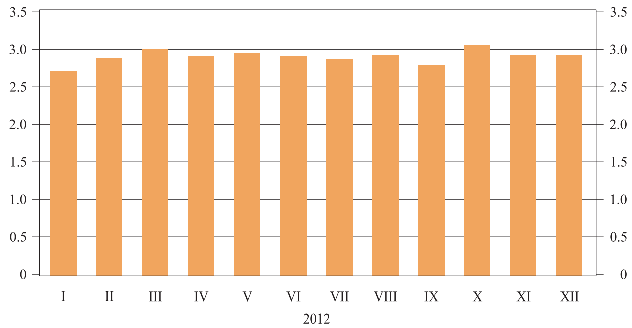
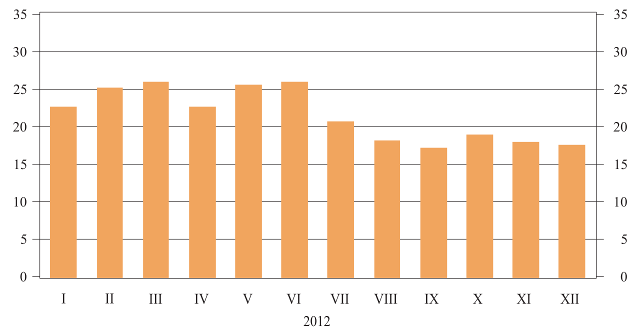


Chart 20

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



The SAMS is a real-time gross settlement system processing payments in lats. The SAMS enabled the following: the settlement of the Bank of Latvia's monetary policy operations, interbank settlement of large-value payments and final settlement in lats for the securities settlement system of the LCD, the card payment systems, such as *First Data Latvia Ltd*., *MasterCard Europe Sprl* and *Visa Europe Services Inc*., and final settlement in lats for the Bank of Latvia's settlement system EKS. At the end of 2012, 26 credit institutions (including five branches of foreign banks), the Treasury and the Bank of Latvia were the participants in the SAMS. The SAMS processed 229.7 thousand payments (value – 111.2 billion lats; see Table 5). The SAMS provided 100% availability to its participants.

The EKS is the Bank of Latvia's net settlement system used for the processing of retail payments in lats and euro. The EKS is an ACH (Automated Clearing House) system where payment processing is fully automated and only electronic payment documents are accepted and processed. The EKS final settlement in lats is effected in the participants' accounts opened with the Bank of Latvia in the SAMS, while that in euro is executed in the participants' accounts opened with the Bank of Latvia in TARGET2-Latvija. The EKS, as a SEPA compliant payment system, also contributes to establishing the uniform SEPA

Table 5

PAYMENTS PROCESSED IN THE SAMS

	Volume (in thousands)			Value (in billions of lats)		
	Interbank and ancillary system	Customer		Interbank and ancillary system	Customer	
2012	**110.9**	**118.8**	**229.7**	**99.3**	**11.9**	**111.2**
2011	106.9	109.6	216.4	126.2	11.6	137.8
2010	96.8	96.3	193.0	157.5	8.8	166.3
2009	101.6	98.6	200.2	156.5	11.0	167.5
2008	107.7	140.7	248.4	169.0	12.9	181.9

requirements for the credit institution-to-customer domain in Latvia. The euro payments executed via the EKS were processed in four clearing cycles and lats payments were handled in two clearing cycles. At the end of 2012, 25 credit institutions (including five branches of foreign credit institutions), the Treasury and the Bank of Latvia were the participants in the EKS lats settlement and 17 credit institutions (including one branch of a foreign credit institutions), the Treasury and the Bank of Latvia participated in the euro settlements respectively. The EKS processed 34.2 million payments, with their value amounting to 16.6 billion lats (see Table 6). The EKS provided 99.80% availability of the system to its participants, i.e. over the year, the settlement of EKS clearing cycle was delayed on three occasions.

Table 6

PAYMENTS PROCESSED IN THE EKS

	Volume (in thousands)			Value (in billions of lats)		
	Lats	Euro		Lats	Euro	
2012	**33 544.8**	**703.8**	**34 248.6**	**12.2**	**4.4**	**16.6**
2011	34 597.9	464.0	35 061.9	12.0	2.0	14.0
2010	32 796.8	310.1	33 107.0	10.5	1.1	11.6
2009	31 796.8	252.5	32 049.2	10.2	0.9	11.1
2008	33 227.1	223.8	33 451.0	13.1	1.1	14.1

The Bank of Latvia, along with other participants of the ESCB, ensured the operation of TARGET2, the Trans-European Automated Real-time Gross Settlement Express Transfer system. The Bank of Latvia maintained the operation of its component system, TARGET2-Latvija, providing for the mutual payment settlement by the system's participants in euro and final settlement of the EKS in euro. At the end of 2012, 24 credit institutions (including four branches of foreign credit institutions), the Treasury and the Bank of Latvia were the participants in TARGET2-Latvija. In 2012, 328.1 thousand payments in the value of 186.0 billion euro were processed in TARGET2-Latvija (see Table 7).

Table 7

PAYMENTS PROCESSED IN TARGET2-LATVIJA

	Volume (in thousands)			Value (in billions of euro)		
	Interbank	Customer		Interbank	Customer	
2012	**35.7**	**292.4**	**328.1**	**173.1**	**12.9**	**186.0**
2011	35.2	272.2	307.4	215.2	12.6	227.8
2010	39.5	247.6	287.1	190.7	9.3	200.0
2009	43.4	126.5	169.9	194.7	5.7	200.5
2008	31.1	118.7	149.8	63.5	6.6	70.1

OVERSIGHT OF PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

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

In 2012, upon conducting the oversight of the securities settlement system of the LCD, the Bank of Latvia, in cooperation with the FCMC and LCD, performed the compliance assessment of the securities settlement system of the LCD against the recommendations for the securities settlement systems issued by the ESCB and the European Securities and Markets Authority (ESMA).

The Bank of Latvia headed the Latvian User Group of the Eurosystem's TARGET2-Securities Project along with the LCD in order to facilitate the integration of Latvia's securities market into the single European securities market. The Bank of Latvia conducted the feasibility assessment for the Bank's participation in TARGET2-Securities and concluded that the Bank of Latvia had no obstacles for migration. The Bank of Latvia drafted a high-level adaptation plan for TARGET2-Securities. Pursuant to the decision taken by the Governing Council of the ECB in 2011, TARGET2-Securities is planned to be launched in June 2015.

The Bank of Latvia compiled data on the payment instruments used in Latvia (see Table 8). Of all payment instruments used in 2012, customer credit transfers amounted to 130.3 million payments or 49.4% and payments with payment cards comprised 128.0 million payments or 48.5%. The value of such payments stood at 343.6 billion lats and 1.9 billion lats respectively. Other payment instruments (direct debit, cheques and e-money) were relatively seldom used.

Table 8

PAYMENT INSTRUMENTS USED IN LATVIA

	Volume (in millions)				Value (in billions of lats)			
	Customer credit transfers	Card payments	Direct debits, cheques and e-money payments		Customer credit transfers	Card payments	Direct debits, cheques and e-money payments	
2012	**130.3**	**128.0**	**5.7**	**264.0**	**343.6**	**1.9**	**0.2**	**345.7**
2011	119.3	114.0	5.3	238.6	297.1	1.7	0.1	298.9
2010	115.7	101.9	5.3	222.9	260.7	1.4	0.2	262.3
2009	114.3	97.8	5.2	217.2	242.7	1.4	0.2	244.3
2008	121.9	95.1	5.3	222.3	364.5	1.7	0.3	366.5

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

In 2012, the Bank of Latvia, in cooperation with the FCMC, participated in the European Forum on the Security of Retail Payments established by the ECB and was involved in developing draft recommendations for card payments via Internet and electronic payment services of credit institutions.

Pursuant to the updated risk-based assessment methodology developed by the ECB, in 2012 the Bank of Latvia assessed, within the oversight framework, the payment systems operating in Latvia. According to the above, the assessment of payment systems has to be performed in three phases. During the first phase payment systems are mutually compared by determining their significance and oversight status. The assessment resulting from the mutual comparison of the payment systems is used for defining a further priority for the payment system oversight. In the second phase, the major payment systems are assessed against the risk categories, analysing the impact of a specific risk, its probability and the risk mitigation measures implemented in order to set an oversight priority for the components of a particular payment system. The ECB will implement the third phase upon comparing the second phase assessments of the above systems in a number of countries for the purpose of obtaining a consolidated overview of the risk categories common to the majority of the EU payment systems. In the first assessment phase, the Bank of Latvia assessed all payment systems of Latvia: the systems maintained by the Bank (the SAMS, EKS and TARGET2-Latvija), the local lats clearing and settlement system of *First Data Latvia Ltd.*, automated payment system of the JSC *Itella Information* and Postal settlement system of the SJSC *Latvijas Pasts*. The relevance of focussing primarily on the SAMS, including its day-to-day oversight, was supported by the above assessment. Based on the results obtained during the first phase of risk-based assessment, the Bank of Latvia carried out the second phase of the risk-based assessment, assessing in detail the effect and probability of risks and the measures of risk containment in the SAMS. The oversight priorities regarding the system's exposure and components were established. It follows from the assessment that upon performing the SAMS oversight the focus should mainly be on the operational risk. The assessment supported the relevance of the day-to-day oversight performed by analysing the technical and operational functions of the systems and stipulated by "The Bank of Latvia's Payment and Securities Settlement System Policy".

In 2012, the Bank of Latvia finalised the review of social costs of retail payment instruments in Latvia, elaborated as a result of the Bank's participation in the study of the social costs of retail payment instruments in the EU in 2009 and coordinated by the ECB. The goal of the review is to promote the public awareness and understanding of the costs of the most widely used retail payment instruments (cash and non-cash payments), directly associated with the production of payment instruments for the general public, mostly individuals, in order to ensure the possibility to make payments in the retail and services sectors. According to the Review data, the total social costs of payment instruments in Latvia amounted to 121.5 million lats or 0.93% of GDP in 2009. The largest of them (67.1 million lats) were incurred by credit institutions and the Bank of Latvia. The company social costs amounted to 45.1 million lats, while the costs of cash-in-transit and processing companies and interbank payment infrastructure operators were 9.3 million lats. Comparison of the social costs of different payment instruments shows that cash payments posted the highest costs (65.8 million lats). The social costs of credit transfers and card payments were similar (28.5 million lats and 26.1 million lats respectively), while the social costs of direct debits were the lowest, standing at 1.1 million lats. Credit transfers incurred the largest unit social costs (47.1 santims), with cash payments having the smallest ones (9.0 santims). The unit social costs of card payments and direct debits were similar (27.8 santims and 25.1 santims).

FINANCIAL STABILITY

In 2012, the Bank of Latvia continued to develop and enhance the risk assessment instruments of financial system. The methodology of the financial stress index was published. The Latvian financial stress index combines various financial indicators (primarily characterising the credit institution balance sheets as well as the money and securities market) whose developments reflect the major symptoms signalling heightened stress in the credit institution sector. At the same time, a risk panel was developed to ensure consistent and uniform representation of the major current risks to financial stability and their change dynamics.

Taking into account the fact that credit institutions are the major participants in Latvia's financial system, their perception of current and potential risks which might affect the stability of the financial system is essential for the Bank of Latvia. Hence the Bank of Latvia conducted a risk survey of credit institutions in 2012, for the first time in order to gain a better understanding of the key risk sources and significance of the risks. The results of the survey indicated that such survey was a useful source of information, and it was decided to conduct the risk survey on a semi-annual basis.

Close cooperation among the Nordic and Baltic countries continued in the area of financial stability in 2012. The Monitoring Working Group of the Nordic-Baltic Financial Stability Group summarised the risks to financial stability in the Nordic and Baltic region for the first time to gain a better understanding of common and specific risks in the region. In the future, such stock-taking of risks in the region will be done on a regular basis.

The Nordic-Baltic Macro-prudential Forum decided to establish two working groups in preparation for the implementation of Basel III requirements: one for dealing with the issues of counter-cyclical capital reserves and the other for addressing the issue of the risk weights for mortgage loans. The main task of the first working group is to reach a common understanding about the decision-making processes of determining the capital buyers in the countries of the region and based on it, debate about the reciprocity of capital buyer requirements in cases when the buyer requirement exceeds 2.5% of the risk weighted assets. The second working group is assigned the task of examining the differences in practices of determining the risk weights that are currently applied to mortgage loans by credit institutions in the countries of the region, where such differences arise from the credit institution internal rating models used for calculating the capital adequacy, and as a result, a consistent solution to the issue of harmonising the risk weights, focussing on the details of the calculation, has to be reached.

A model for the assessment of the financial position of households was developed, based on the results of the first survey of household borrowers conducted in 2011, and the impact of diverse financial shocks on the household borrowers' solvency was modelled.

The exchange-of-experience programme launched for the staff of the Bank of Latvia and the FCMC continued in 2012, with the involvement of a representative of the FCMC in the Bank of Latvia's macro-prudential analysis of credit institution risks and development of the methodology for the risk panel. At the same time, the Bank of Latvia's representative took part in the activities of the FCMC aimed at the introduction of the new liquidity ratio under Basel III Framework.

OPERATION OF THE CREDIT REGISTER

In the Credit Register, the Bank of Latvia collects, accumulates and stores the data of the Credit Register participants (such as credit institutions providing financial services associated with credit risks, companies having close links with credit institutions and providing financial services associated with credit risks, credit unions and insurers; hereinafter, the participants) on customers and customer guarantors, obligations of the customers and customer guarantors and the performance thereof and default, pursuant to the amount and procedure stipulated by the Bank of Latvia.

On 1 December 2012, the Law "On Credit Register" governing the operation of the Credit Register came into effect. The Law "On Credit Register" was required to consolidate, harmonise and update the regulatory framework provisions for the Credit Register, stipulated previously in the Law "On Credit Institutions", "On Insurance Companies and Supervision Thereof", "On Credit Unions" and in several laws stipulating the general provisions for the area of the Credit Register operation.

The Law "On Credit Register" also stipulates the terms of data storage regarding the customer obligations and customer guarantor's obligations, the scope of data provided to a customer, customer's guarantor, participants, consumer's creditor, public institutions, the FCMC and the Bank of Latvia. Moreover, the status of a restricted Register participant has been introduced to ensure that the participant who has lost the Register participant's status continues to update the data submitted to the Credit Register on its customers' obligations and customer guarantors' obligations until the expiry of the respective obligations. The system of the Credit Register has been improved in line with the above changes.

The goal of the Credit Register has changed along with the implementation of a uniform regulation so as to enable the participants and restricted Register participants to assess the credit worthiness of the customers and customer guarantors more accurately, manage credit risks more efficiently, provide the FCMC with additional opportunities of receiving data necessary for performing supervision, enable the consumer creditors of the EU Member States and EEA countries to assess the consumers' creditworthiness, and furnish data to the Bank of Latvia and the FCMC necessary for macroeconomic analysis and required for the compilation of the financial statistics of the Bank of Latvia, and contribute to the promotion of fulfilling the tasks of public administration, providing the public institutions with additional opportunities of receiving data necessary for performing the analysis required by the tasks stipulated by laws and regulations, and provide additional opportunities to enhance the performance of the obligations of a customer and customer's guarantor facing financial difficulties.

At the end of 2012, the Credit Register comprised 100 participants (including four restricted Credit Register participants) who authorised 800 users to work with the Credit Register. The Credit Register contained data on 989.6 thousand persons and 3.0 million obligations (at the end of 2011, on 965.4 thousand persons and 2.8 million obligations), of which 1.1 million were outstanding obligations. The total outstanding obligations of the participants and restricted Credit Register participants were 14.5 billion lats (at the end of 2011, 1.3 million obligations with the total outstanding obligations amounting to 14.0 billion lats). In 2012, the participants and restricted Credit Register participants submitted 15.6 million requests to the Credit Register (a decrease of 3.7% in comparison with the end of 2011). The Bank of Latvia provided the Credit Register data to 4.5 thousand natural and legal persons (a 31.0% increase year-on-year).

STATISTICS

The Bank of Latvia collects and compiles financial and monetary statistics and balance of payments statistics as well as prepares quarterly financial account statistics and government finance statistics. Pursuant to the ECB's request, the Bank of Latvia has also been involved in addressing issues related to the methodology of some fields of economic statistics and compiling specific aggregates. The Bank of Latvia uses statistical data to implement its monetary policy, perform analysis of finance and macroeconomics as well as raise public awareness of the developments in the financial sector and the economy.

In March 2012, the Bank of Latvia launched internet statistical database INTS for the purpose of providing users with modern, user friendly and adaptable means for data access and analysis of data using graphic tools. Balance of payments and international investment position statistics as well as the data on foreign direct investment, external debt and effective exchange rate of the lats were first available in the database. Over the year the Bank of Latvia expanded the range of the data available in the internet statistical database INTS by initiating the release of monthly MFI balance sheet data and data on loans granted by MFIs. A number of standard tables were prepared to provide data users with user friendly and easy access to the required data. The Bank of Latvia also proceeded with the dissemination of MFI data on the Bank of Latvia's website ("Statistics/Data room/Main indicators"), and expanded the above range of data by compiling the monthly balance sheet statistics of investment funds.

The Bank of Latvia continued the regular transmission of statistical data to the ECB, BIS and IMF and transmitted statistical information to other domestic and foreign data users. To furnish a wide range of data users with timely information, the Bank of Latvia disseminated financial and monetary statistics and balance of payments statistics of

Latvia via its regular publications and the Bank of Latvia website and compiled data for publishing in the ECB publications and the ECB Statistical Data Warehouse as well as the IMF publications and within the framework of the IMF Special Data Dissemination Standard. The Bank of Latvia continued to transmit data to the BIS as well as compiled and transmitted financial soundness indicators to the IMF. Moreover, in 2012, the Bank of Latvia participated in the IMF's *Financial Access Survey*, reporting data on the access to and scope of the services provided to households by Latvia's financial institutions.

FINANCIAL AND MONETARY STATISTICS

In 2012, significant methodological work was performed in the field of financial and monetary statistics to prepare for amendments of the ECB's legal framework because of the forthcoming changes in ESA 95 which relate to the breakdowns applied to sectors of an economy and financial instruments, and to examine possibilities of establishing new reporting requirements for insurance corporations with the aim of providing information for the performance of the tasks of the ESCB and the ESRB.

The Bank of Latvia, subject to the ECB's assignment, conducted several significant fact-finding surveys, involving the following reporting agents: credit institutions, insurance corporations, investment management corporations and other participants in the financial sector. Taking into account the results of the surveys, the Bank of Latvia provided the ECB with the opinion of the financial sector players on the feasibility of incorporating the ESA 95 changes and new requirements into the effective legal acts of the ECB, which stipulate the requirements for the MFI balance sheet statistics and interest rate statistics, statistics on the assets and liabilities of investment funds and payment statistics, and also on the feasibility of reporting data in accordance with the new legal act in the area of insurance corporation statistics. Fact-finding exercises were followed by cost surveys. The ECB used cost information obtained during these surveys to estimate the total costs that EU Member States would incur due to the introduction of new requirements and regular reporting of data and to match these costs against merits associated with the introduction of the new requirements. Such procedure for establishing and assessing costs and merits ensures effective and commensurate utilisation of the resources of central banks and reporting agents.

BALANCE OF PAYMENTS STATISTICS

In August 2012, the securities issues and holders database launched at the Bank of Latvia and providing data for the compilation of the balance of payments statistics and other statistics as well as for the supervision of financial market participants was presented at the annual meeting of *Nordstat*, where statistics experts from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden debated about topical issues. Following the ECB's new data request, the Bank of Latvia initiated the reporting of securities holdings data to the ECB on the basis of the above database.

In 2012, the new requirements stipulated by the ECB, Eurostat and IMF for the compilation of the balance of payments statistics were further examined and the process of drafting amendments to the effective regulations for statistical reports and their compilation was commenced. The compilation of data on foreign direct investment is subject to the most significant changes, since net foreign assets and liabilities associated with the foreign sister companies will be reported separately as of 2014, and the reporting agent will have to provide data on the main parent company while the reporting agents compiling consolidated reports will have to report consolidated data.

GENERAL ECONOMIC AND GOVERNMENT FINANCE STATISTICS

Pursuant to the ECB's request regarding the economic statistics, the Bank of Latvia's experts commenced the preparation of data on the housing transaction value.

As regards the quarterly financial account statistics, the methodological study of the compliance with the requirements of the new ECB Guideline taking effect as of September 2014 and incorporating the provisions of ESA 2010 has been initiated in 2012. Within the above framework, the Bank of Latvia's experts harmonised further the methodology for the compilation of the quarterly financial accounts statistics and the annual financial accounts statistics which is under the CSB's responsibility. The Bank of Latvia, in cooperation with the CSB, developed a common macroeconomic statistics revision policy for the financial statistics, quarterly and annual financial accounts statistics, balance of payments and international investment position statistics.

PROVIDING FINANCIAL SERVICES TO THE GOVERNMENT

Pursuant to the requirements of the Law "On the Bank of Latvia", the Bank of Latvia renders several services to the Treasury, ensuring current account management, acceptance of time deposits, foreign exchange transactions and other transactions. The Treasury uses the Bank of Latvia services for effecting settlement and also takes part in the Bank of Latvia payment and settlement systems as a direct participant in the system.

In 2012, the Treasury had settlement accounts in nine foreign currencies with the Bank of Latvia. Over the year, the Bank of Latvia settled 1.5 thousand payments made by the Treasury in foreign currencies in the total value of 8.4 billion lats. The Treasury also placed 261 time deposits in foreign currencies with the Bank of Latvia. In view of the interest rate developments in the financial markets, the Treasury discontinued placing time deposits with the Bank of Latvia in the last few months of 2012.

In 2012, the Treasury conducted 21 foreign exchange transactions in the Bank of Latvia in the total amount of 56.3 million lats.

ADVISORY ACTIVITIES AND INFORMATION TO THE PUBLIC

ADVISORY SERVICES TO THE GOVERNMENT AND OTHER INSTITUTIONS

One of the tasks of the Bank of Latvia is to advise the Saeima and the Cabinet of Ministers of the Republic of Latvia on monetary policy and other issues related to the performance of the Bank of Latvia's tasks.

In 2012, the Bank of Latvia staff members participated in drafting the Law "On Credit Bureaus" and revising the Law "On Credit Register".

The Governor of the Bank of Latvia, other officials of the Bank and its employees held meetings with the representatives of the Republic of Latvia government on a regular basis, including participation in the meetings of the Cabinet of Ministers of the Republic of Latvia and the work of different committees established both by the Republic of Latvia Ministries and pursuant to the Prime Minister's Order.

The employees of the Bank of Latvia contributed to Latvia's economic development by participating in different working groups and professional organisations and providing them advice.

In the working group of Financial Sector Development Strategy, chaired by the Ministry of Finance, experts from the Bank of Latvia participated in identifying the course of action and tasks to be included in the financial sector development strategy (also on the basis of the recommendations of the Financial Sector Assessment Program of the World Bank).

The Bank of Latvia experts continued to participate in the SEPA Project in Latvia by steering the National SEPA Working Group. The SEPA Working Group developed and approved the draft Version 4.0 of Latvia's National SEPA Plan and proceeded with the implementation of SEPA requirements in Latvia. In various project sub-groups the Bank of Latvia staff members provided recommendations and comments both in drafting the Green Paper "Towards an integrated European market for card, internet and mobile payments" and on the European SEPA communication plan. The representative of the Bank of Latvia in cooperation with an FCMC expert took part in drafting recommendations for the European Forum on the Security of Retail Payments as well as prepared proposals on SEPA issues for the European institutions.

Representatives of the Bank of Latvia took part in the Latvian National User Group of the TARGET2-Securities Project in order to promote further integration of the securities market in the EU single market.

In preparation for the adoption of the euro, the Bank of Latvia submitted proposals for the draft Law on the Procedure for Introducing the Euro regarding the euro changeover in cash and non-cash settlement. The Bank of Latvia coordinated preparations of the institutions and organisations represented in the Money and Payment Systems Working Group for the euro changeover, submitted proposals for the National Euro Changeover Plan regarding the aspects of the introduction of the euro in cash and non-cash settlement, addressed issues related to the euro coin and banknote acquisition, participated in drafting the Plan of Security Measures for the euro changeover project, and submitted to the Steering Committee the euro changeover cost estimate by government authorities represented in the Money and Payment Systems Working Group.

The Bank of Latvia helped to address issues concerning the accessibility of financial services in peripheral regions of Latvia. Its experts delivered presentations on euro changeover issues at the Book Festival organised by the Rural Library Support Association as well as at the seminars on euro changeover issues organised for various stakeholders by the Ministry of Finance.

The Bank of Latvia participated actively in building stronger cooperation with international credit rating agencies, drafting of reports on Latvia's sovereign credit rating and the underlying factors as well as ensured information exchange when preparing for the current visits of representatives from international credit rating agencies.

The Bank of Latvia employees, in the capacity of experts, took part in the preparation of the Tables of the general government budget deficit and debt notification (for spring and autumn 2012) and dealt with the above methodology-related issues.

In February, the Bank of Latvia staff participated in Eurostat's Excessive Deficit Procedure dialogue visit to Latvia. The visit focussed on government deficit and government debt notification issues (transactions of general government sector concerning the global financial crisis, accrued taxes and social contributions, accrued interest, guarantees issued by the central government, capital injections, financial derivatives, financial flows of EU funds etc.).

The Bank of Latvia participated in the inter-institutional working group on changes in the Classification of Institutional Sectors according to the new ESA 2010 methodology as well as in the CSB's inter-institutional working group on implementation of a harmonised national revision policy for macroeconomic statistics.

The Bank of Latvia shared its experience in IT system security management issues at the meetings held by the National Council for the Security of Information Technologies, thereby supporting improvements in the above area of public administration.

The Bank of Latvia staff organised training for the Special Tasks Unit and Military Police staff and received high appreciation from the Ministry of Defence of the Republic of Latvia.

OPERATION OF THE VISITORS CENTRE

In 2012, the Bank of Latvia's Visitors Centre "Money World" offering modern displays for obtaining financial education and information had 8 106 visitors. The number of visitors equals that of the previous years and is close to maximum possibilities to receive visitors since the operation of the Centre is organised as group visits of particular amount and number.

Secondary school seniors and university students majoring in social sciences are the primary target audience of the Visitors Centre: they accounted for almost 80% of total audience. The overwhelming presence of youth among the visitors is of importance also because the information communicated by the Centre helps them master educational programmes; likewise, dialogue arouses interest in macroeconomic and financial topics also stirring up discussions by public at large.

Topics about the planned euro changeover in Latvia, stability of the euro area, the general government debt, lats stability and recovery of the economic competitiveness were among the most discussed in 2012. They gave rise to the updating of displays that tackle the essence of value added in an interactive way; at the same time, the information about the planned designs of the Latvian euro coins is provided in a more streamlined way. A multi-media programme has been also developed in order to inform about the history and buildings of the Bank of Latvia.

INFORMATION TO THE PUBLIC

In 2012, the central bank of Latvia celebrated its 90th anniversary. In 2011 and 2012, eight economists and historians provided analysis of the history of the Bank of Latvia, its monetary policy, the lats and the Latvian national economy. The results of the analysis are summarized in the book "The Bank of Latvia XC", which has been issued in Latvian and English and handed over to Latvia's public and academic libraries as well as published on the Bank of Latvia's website www.bank.lv. Based on the study, the Bank of Latvia organised a series of discussions in autumn 2012 to inform the general public about the history of the central bank of Latvia and its monetary policy in the economic and historical context. The series of discussions "Transformation of Latvia's Money. Lessons from the Past, Future Perspectives" was organised with the launch of the book on 1 November, and it continued in four regional universities of Latvia – Liepāja University, Vidzeme University of Applied Sciences, Latvia University of Agriculture and Daugavpils University.

To raise public awareness, the Bank of Latvia continued to prepare a wide range of regular publications. Incorporating the data provided by the Bank of Latvia, CSB, Ministry of Finance, and FCMC, the quarterly Macroeconomic Developments Report discussed the developments of external sector, financial markets, domestic demand and supply, costs and prices, and balance of payments, and presented economic growth forecasts and inflation projections. The Bank of Latvia compiled and published Latvia's Balance of Payments, providing information and analysing financial statistics for 2011. The publication Financial Stability Report assessed major financial stability risks, while Payment and Securities Settlement System Oversight Carried Out by the Bank of Latvia in 2011 described the payment system oversight carried out to promote the smooth operation of Latvia's payment system. Six studies by the Bank of Latvia's experts and one discussion paper were published (all these publications are available on the Bank of Latvia's website at macroeconomics.lv and bank.lv). Moreover, the Bank of Latvia economists also published their working papers in international peer-reviewed journals in economics, including the analytical periodical *Baltic Journal of Economics* providing analysis of the economic developments in the Baltic States.

The Bank of Latvia macroeconomic research and financial market analysis that is used in consulting the government and required by economic agents for understanding current circumstances and further decision-making trends was widely discussed. After each regular Bank of Latvia's Council meeting, the Governor presented an account of macroeconomic developments to mass media on a bimonthly basis.

In order to promote a deeper understanding of economists and stakeholders about the analysis of and developments in the national economy and future perspectives to entice them into debate, the Bank of Latvia organised two conferences. High-level international conference "Against the Odds: Lessons from the Recovery in the Baltics" organised by the Bank of Latvia and the IMF" took place in Riga in June. This one day conference brought together prominent policymakers and representatives of academia and the public to discuss policy that helped Latvia, Lithuania and Estonia to overcome the crisis, to resume economic growth and to get closer to (to achieve in case of Estonia) the euro changeover target date. The conference also gave an opportunity to discuss further complicated tasks of the region and to gather experience to be used in other European countries.

On 2 November, the Bank of Latvia organised the international conference "Economic Adjustment under Sovereign Debt Crisis: Can Experience of the Baltics be Applied to Others?". The first part of the conference addressed the issues raised already at the closure of the June conference on how to apply the lessons learnt by another country: to what extent this experience can be taken on board and to what extent each country has to find its own solution. The question of whether the contribution of policy makers and international institutions as well as the private sector in overcoming the economic crisis in individual countries and solving the problems of the global economy has been timely and adequate was discussed in the second part of the conference.

In 2012, after macroeconomic stabilisation and the completion of the international loan programme an active discussion on the anticipated impact of the introduction of the euro on the Latvian economy was on the agenda. To ensure that the discussion takes place in a quality manner, the Bank of Latvia, performing the advisory role of the central bank, assessed the macroeconomic impact of the euro introduction from the perspective of the general budget, economic activity and price developments. In September, the analysis conducted by the Bank of Latvia was communicated to stakeholders and the general public at the roundtable discussions of the central bank's experts, where other important aspects of the euro introduction – the impact of the euro introduction on finances of the export-oriented companies, the price policy of trade companies etc. were discussed. To facilitate public awareness, the Bank of Latvia held a series of wide discussions in the regions of Latvia, by meeting the businesses, local government managers and employees, and representatives of local government institutions. The Bank of Latvia's analysis and estimates were explained in the publications series on its websites and reflected in the most popular Internet sites.

Public perception and sentiment are important factors for overcoming an economic crisis and achieving future growth, and they are largely dependent on the understanding of macroeconomic processes and decisions. This is why communicating the macroeconomic and financial developments to the general public and to specific target groups is one of the key communication areas for the Bank of Latvia. In cooperation with the Bank of Latvia and using its staff expertise and analysis, explanatory graphic arts drawings "Banknotes and Coins. The ABC of Economics" were transmitted by Latvia's Television and placed on several Internet sites, as well as a radio broadcast *Lata spogulī* by Latvia's Radio, both attracting a vast audience. The Bank of Latvia's experts prepared weekly publications on the economic developments in Latvia and worldwide for mass media and public at large.

The results of the "TNS Latvia" survey conducted in autumn of 2012 showed that the issue regarding the level of economic education is topical. The Bank of Latvia made the economic educational opportunities more accessible to the general public and provided new opportunities for students and teachers, by developing the website "Money School" (www.naudasskola.lv). This will help to understand economic regularities, to debate about important economic events, to test knowledge in games and competitions as well as to engage in educational events. The materials are easily understandable by students and the general public and useful for teachers for the purpose of work performance. In 2012, a competition for students' research papers was organised already for the 10th time with a view to promoting interest about researching topical macroeconomical subjects, with five papers (out of 18 submitted) awarded in it.

In order to test the public assessment of work done in the field of collector coins and to identify the most attractive topics and artistic solutions, the Bank of Latvia held the traditional public survey on the most popular collector coin and welcomed everyone to vote for Latvia's Coin of the Year 2011. The survey was supported by the network of public libraries and project *Trešais tēva dēls* of the State Agency "Cultural Information Systems"; 2 106 of the total of 8 552 votes cast and the title Latvia's Coin of the Year 2011 went to the collector coin *Fog Mists the Pane* struck by *Rahapaja Oy* (Finland); artists: Ilmārs Blumbergs (graphic design), Ligita Franckeviča (plaster model).

COOPERATION WITH INTERNATIONAL ORGANISATIONS AND FOREIGN CENTRAL BANKS

The Bank of Latvia is the representative of the Republic of Latvia in foreign central banks and international financial institutions. The Bank of Latvia may participate in the operations of other international financial and credit organisations consistent with its objectives and tasks.

In 2012, the Bank of Latvia continued to represent Latvia's interests at the meetings of the IMF Board of Governors as well as in the coordination of operational issues. Latvia's interests in the IMF were represented in the Nordic-Baltic Constituency that includes Denmark, Estonia, Iceland, Latvia, Lithuania, Norway, Finland and Sweden. One Executive Director represented this constituency on the IMF Executive Board, with a total of 3.41% votes.

The 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. The priority policy issues on the IMF agenda in 2012 were mainly related to the implementation of the decisions already taken to address spillovers from the global financial crisis and develop a stronger international financial system as well as to the process of the implementation of the IMF governance and quota formula reform to facilitate the IMF legitimacy in the area of the global economic development and solution of its problems.

The cooperation with the IMF, based on consultations under Article IV of the IMF Articles of Agreement, continued in 2012. On 16 July 2012, the IMF Executive Board reviewed the first post-programme monitoring report on the implementation of the Latvian economic, monetary and financial policy.

In 2012, the Bank of Latvia continued its membership in the BIS.

In 2012, the Bank of Latvia continued its cooperation with the central banks of other countries, sharing expertise and information. The Bank of Latvia organised several international meetings and seminars. The Bank of Latvia organised together with the EC a seminar "EU Balance-of-Payments Assistance for Latvia: Foundations of Success" in March in Brussels, while in cooperation with the IMF a conference "Against the Odds: Lessons from the Recovery in the Baltics" in June. In June, the Bank of Latvia organised a meeting of the Steering Committee of CashSSP (the cash transaction support system, which is available in the ESCB by voluntarily joining the cooperation agreement), while in August – the meeting of Nordic-Baltic statisticians *(Nordstat)*. In September, ECBS training seminar on risk management, while in November – ESCB training seminar "Economics for Non-Economists" were held. In October, the Bank of Latvia's staff advised the experts of *Eesti Pank* on issues related to the implementation of CashSSP system. In November, the Bank of Latvia organised the international conference "Economic Adjustment under Sovereign Debt Crisis: Can Experience of the Baltics be Applied to Others?".

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

In 2012, the Bank of Latvia's employees participated in courses held by the ECB, the IMF Institute, the Joint Vienna Institute, Study Center Gerzensee and *Deutsche Bundesbank*, and also in seminars organised by the central banks of Austria, Belgium, Bulgaria, Check Republic, Italy, the UK, the Netherlands, Norway, Poland, Finland, Spain, Hungary and Sweden and those held by the World Bank.

The Bank of Latvia's employees went on experience exchange visits to the central banks of Belgium, Estonia, Luxemburg and Sweden and the IMF as well as received consultations from the experts of the central bank of Malta.

BANK OF LATVIA ORGANISATIONAL STRUCTURE

THE COUNCIL OF THE BANK OF LATVIA

The Council of the Bank of Latvia takes decisions on behalf of the Bank of Latvia. The Council of the Bank of Latvia comprises the Governor, Deputy Governor and six members whose term in office is six years. The composition of the Council of the Bank of Latvia, as at the end of 2012, was as follows.

– Governor **Ilmārs Rimšēvičs**;

– Deputy Governor **Andris Ruselis**;

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

On 31 May 2012, the Saeima of the Republic of Latvia appointed Mr. Edvards Kušners Member of the Council of the Bank of Latvia.

The Bank of Latvia's Council meetings are held as appropriate, but at least once a quarter. Nine Bank of Latvia's Council meetings were held in 2012. To establish and implement monetary policy, the Council of the Bank of Latvia conducted an in-depth assessment of monetary and economic developments and adopted six legal acts related to the implementation of monetary policy and the use of monetary policy instruments.

When performing other tasks set forth by the Law "On the Bank of Latvia", the Council of the Bank of Latvia adopted 82 legal acts overall in 2012 (including six legal acts in the area of the operation and oversight of the payment and securities settlement system, four in the area of the Credit Register operation, six in the area of the foreign reserves management, seven in the area related to currency in circulation and five in the area of licensing and supervising the purchase and sales of cash foreign currency).

THE BOARD OF THE BANK OF LATVIA

To conduct and manage day-to-day activities, the Council of the Bank of Latvia has established the Board of the Bank of Latvia that is comprised of six members and performs activities on a continuous basis. In 2012, the composition of the Board of the Bank of Latvia was as follows:

– Chairman of the Board	**Māris Kālis**;
– Deputy Chairman of the Board:	**Reinis Jakovļevs**;
– Members of the Board:	**Andris Ņikitins**, **Harijs Ozols**, **Ilze Posuma**, **Raivo Vanags**.

The Board of the Bank of Latvia conducted the daily activities of the Bank in compliance with the requirements of the Law "On the Bank of Latvia" and other legal acts, as well as the Bank of Latvia's Council decisions on monetary policy and other areas of the operational activities of the central bank. The Board of the Bank of Latvia adopted 125 legal acts in the areas of conducting daily activities of the central bank. The Board of the Bank of Latvia drafted 33 legal acts for the Council of the Bank of Latvia and submitted to it 24 reports concerning the operation of the central bank.

EMPLOYEES OF THE BANK OF LATVIA

At the end of 2012, the Bank of Latvia's staff numbered 561, of which 17 had temporary job contract for a limited period (556 and 15 employees at the end of 2011 respectively). As at the end of 2012, the Bank of Latvia's staff was 57% male and 43% female.

To ensure exchange of information between the Bank of Latvia and the EU institutions, Counsellor of the Bank of Latvia at the Permanent Representation of Latvia to the EU continued her work in 2012.

COMMISSIONS AND COMMITTEES OF THE BANK OF LATVIA

The Bank of Latvia Audit Committee	The Bank of Latvia Information Systems Management Committee
The Bank of Latvia Budget Commission	The Bank of Latvia Investment Committee
The Bank of Latvia Coin Design Commission	The Bank of Latvia Licensing Committee
The Bank of Latvia Commission for Assessing the Quality of Lats Banknotes	The Bank of Latvia Operational Risk Management Committee
The Bank of Latvia Commission for Examination of Lats Banknotes and Coins	The Bank of Latvia RIGIBID and RIGIBOR Commission
The Bank of Latvia Document and Archives Management Expert Commission	The Bank of Latvia Security Oversight Commission
The Bank of Latvia Ethics Committee	

In order to ensure successful and secure performance of the Bank of Latvia's tasks, several committees, commissions and working groups approved by the Council of the Bank of Latvia, the Governor of the Bank of Latvia and the Board of the Bank of Latvia continued to work in 2012. The following committees and commissions related to the central bank principal activities have been established at the Bank of Latvia.

The Euro Settlements Implementation Working Group of the Bank of Latvia has made a significant contribution to the preparation for the euro changeover (its task is to ensure successful introduction of euro cash and non-cash settlements in the Republic of Latvia), but the Bank of Latvia working group for the cooperation with the ESCB coordinated the work and ensured exchange of information.

The Bank of Latvia Audit Committee for and on behalf of the Council of the Bank of Latvia conducted the oversight of the internal auditing function, the activities of the Bank of Latvia's external auditors and the drafting of financial statements, as well as enhanced the operation of the Bank of Latvia's internal control system. A wide range of issues related to security were addressed by the Bank of Latvia Security Oversight Commission. The Bank of Latvia Information Systems Management Committee monitored and coordinated the issues related to the operation of the Bank of Latvia's information systems, the security and development, as well as the processing of personal data. At the same time, the Bank of Latvia Operational Risk Management Committee supervised the operational risk management at the Bank of Latvia.

The Bank of Latvia Commission for Assessing the Quality of Lats Banknotes monitored the degree of wear-and-tear, cleanliness and damage of the Bank of Latvia banknotes, while the Commission examining the Bank of Latvia's banknotes identified the counterfeits of lats banknotes and established the procedure for identifying the damaged lats banknotes as legal tender and replacing the damaged banknotes with valid ones. To ensure that the requirements set out for purchasing and selling cash foreign currency in a way of a financial service are met, the Bank of Latvia Licensing Committee granted licenses for purchasing and selling cash foreign currency to capital companies as a commercial activity.

The Bank of Latvia Budget Commission whose aim is to submit the draft budget of the Bank of Latvia to the Bank of Latvia's Council for approval, provided that the Bank of Latvia's financial resources are balanced and used in alignment with the envisaged purposes, and to follow the process of monitoring the utilisation of the financial resources, contributed to the management of the Bank of Latvia's operational activity.

The Bank of Latvia Investment Committee developed and defined the strategy and approach for foreign reserves management according to the Bank of Latvia Council Regulation "Guidelines for Managing the Bank of Latvia's Foreign Reserves". The Bank of Latvia RIGIBID and RIGIBOR Commission coordinated all the measures related to the calculation of RIGIBID and RIGIBOR.

At the same time, the Bank of Latvia Document and Archives Management Expert Commission whose aim is to examine the value of documents, to prepare the document nomenclature, to establish the terms of document storage and to address other issues related to the document management, ensured the fulfilment of the requirements of "The Procedure for the Document Management at the Bank of Latvia" and the Law "On Archives" within the context of the Bank of Latvia's archive activities. The Bank of Latvia Ethics Committee monitored the compliance with the "Bank of Latvia's Code of Conduct".

MANAGEMENT PRINCIPLES AND DEVELOPMENT

The Bank of Latvia's management must ensure excellent implementation of the tasks stipulated in the Law "On the Bank of Latvia" on a sustainable basis. The Bank of Latvia's management applies the "Plan-Do-Check-Act" cycle which also serves as the basis for the Common Assessment Framework used by the Bank of Latvia for streamlining its managerial processes. It enables detection of any management gaps in areas such as strategies, resources, staff, processes and leadership, as well as provides an opportunity to measure the results achieved vis-á-vis customers, staff and general public.

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

The fulfilment of the Bank of Latvia's daily tasks and duties is ensured by its staff; therefore, motivation, creative approach and responsibility are essential for the Bank to operate successfully. The Bank of Latvia's basic values include orientation towards the quality and outcomes of services, use of modern technologies and corporate governance principles, teamwork, maintaining favourable working environment, professionalism, ethical attitude towards work and colleagues and civic qualities.

Every year, the progress towards achieving the set objectives is measured. The execution of functions and processes is monitored daily, implementation of work plans is reviewed on a biannual basis and customer satisfaction surveys are conducted biennially asking customers to assess the quality of the Bank of Latvia's services, the level of their accessibility and convenience, competence and responsiveness of the staff. The Board of the Bank of Latvia evaluates the overall performance of the Bank of Latvia and submits an annual report to the Council of the Bank of Latvia on the achievement of the strategic goals, functional goals, results of the customer satisfaction survey and the employee survey, employee and customer complaints and suggestions, results of operational risk and business continuity management.

In the customer survey, highest scores in 2012 were attributed to the payment system and settlement services and the services provided by the Bank of Latvia when acting as the financial agent of the Latvian government.

The employee survey provided a quality evaluation of the implementation of support functions. Highest scores in 2012 were attributed to the accounting and settlement, and the physical security provision services, the personnel administration process, library, archives and transportation services. Areas with lower scores were analysed on their merits, identifying the improvements required regarding the execution of functions and processes.

Improvements were introduced in 2012 on the basis of the previous year results of customer and personnel surveys and continued improvement of the Bank of Latvia's business processes, including the publishing of the data of financial intermediaries was launched on the Bank of Latvia's website; the operation of the Credit Register was improved pursuant to the requirements of the new Credit Register Law including the legislative framework was changed; the website for economic education was developed for public benefit; a new version of the SAMS was introduced; the infrastructure of the local computer network was modernised; in-depth survey of employee satisfaction was performed, recommendations for improving the human resources management functions were made to the management; an employee performance assessment system was introduced; a project aimed at streamlining the Accident and Incident Register was launched; the staff members have improved their knowledge in the area of information security; the procedure for replying to customer inquiries by phone was improved; the operational risk management process and the Risk Register were improved.

RESOURCE MANAGEMENT

HUMAN RESOURCES

In 2012, the Bank of Latvia continued to pursue its key principles of human resource policy: it hired well-qualified and professional staff members as a result of effective recruitment selection process and established long-term working relationships, creating a motivating work environment and providing professional development opportunities.

Similar to the previous years, for the purposes of personnel development the Bank of Latvia used internal and external rotation. Within the framework of the internal rotation programme, one employee was promoted to other business area of the Bank of Latvia and 19 employees were promoted within the same business area in 2012. Six staff members were on short-term secondment with the ECB and complemented their knowledge in the area of economics, financial stability and internal audit, while one staff member undertook secondment at *Banca d'Italia*, one attained work experience with the IMF and one with the EC. Within the framework of the exchange-of-experience programme launched for the staff of the Bank of Latvia and FCMC, one Bank of Latvia's staff member extended knowledge about the supervision of financial market participants.

Following a careful and well-considered implementation process involving several stages of the pilot project, a new performance management system which ensures that objectives and tasks of each staff member are based on the Bank of Latvia's strategic, functional and procedural goals and the staff performance is aimed at performing specific objectives and tasks of the Bank of Latvia was introduced by the Bank of Latvia in 2012. The planning and implementation of the personnel development is based on the annual job performance appraisal when the need to improve the professional and social competencies of the staff member is determined at the meeting with the head of the department. The professional development plan worked out for the staff member within the framework of the newly introduced performance management system provides an opportunity to plan the Bank of Latvia budgetary resources and training programmes more effectively. The Bank of Latvia staff training costs amounted to 1.8% of the total expenses on remuneration (1.4% in 2011).

The Bank of Latvia staff members continued to broaden their expertise in the fields of monetary policy, financial stability, macroeconomics, econometrics, financial markets, statistics, bank accounting, financial instruments accounting, audit, human resources management, law, translation, risk management and information technologies. A number of the Bank's employees successfully participated in international professional certification programmes and acquired internationally recognised certificates.

A long-term training project designated for the heads of the structural units of the Bank of Latvia was completed in 2012. In 2007–2012, the heads of 62 structural units of the Bank of Latvia improved their leadership skills, acquiring the skills necessary to increase the work effectiveness of management and employees, the personality development elements, skills to enhance communication skills and development and motivation of subordinates. Four seminars were organised in 2012, where the employees of the Bank of Latvia developed communication and information sharing skills, problem solving skills as well as skills to enhance the work effectiveness and quality. To facilitate the unity and cooperation among employees, one of the structural units of the Bank of Latvia was involved in a teambuilding exercise.

In 2012, seminars delivered by the Bank of Latvia experts on the EU management and crisis management instruments as well as the process of forecasting macroeconomic indicators at the Bank of Latvia in order to extend the staff members' knowledge of the Bank of Latvia's functions and keep them up-to-date on the current issues were organised.

FINANCIAL RESOURCES

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

The Bank of Latvia's operation is mainly financed from the income received from foreign currency and gold reserves management. The Bank of Latvia does not receive financing from the state budget. Instead, it transfers 65% of its profit of the reporting year to the state budget. The Bank of Latvia's profit for 2012 was 34.0 million lats of which 22.1 million lats will be transferred to the state budget. The Bank of Latvia has contributed to the state budget a total of 134.8 million lats from its profits earned between 2007 and 2011.

Major financial transactions of the Bank of Latvia are related to the management of foreign reserves and implementation of monetary policy. Foreign reserves are managed in compliance with the basic principles set out in the "Guidelines for Managing the Bank of Latvia's Foreign Reserves" as approved by the Council of the Bank of Latvia, inter alia, preserving the value of foreign reserves, ensuring their liquidity and earning income within the framework of acceptable risk, and without prejudice to the monetary policy pursued by the Bank of Latvia. The Bank of Latvia performs operations related to the implementation of monetary policy in line with the "Regulation for the Use of the Bank of Latvia's Monetary Policy Instruments" as adopted by the Council of the Bank of Latvia.

In order to ensure comprehensive and transparent information about the Bank of Latvia's financial transactions, financial risks and their management as well as the Bank of Latvia's operational results, the Bank of Latvia prepares and publishes annual financial statements. They are prepared in accordance with the "Financial Accounting Policy of the Bank of Latvia", approved by the Bank of Latvia's Council, organising accounting in line with the "Bank of Latvia Financial Accounting Regulation", approved by the Board of the Bank of Latvia, and other regulations of the Bank, in compliance with the Law "On the Bank of Latvia" and other laws and regulations of the Republic of Latvia binding on the Bank of Latvia. "Financial Accounting Policy of the Bank of Latvia" stipulates that events and financial transactions of the Bank of Latvia related to the implementation of the monetary policy, management of foreign reserves, as well as participating interest in the ECB are reported in accordance with the legal framework for accounting and financial reporting in the ESCB, at the same time taking into consideration that the Bank of Latvia is not a member of the Eurosystem. This Policy also sets forth requirements regarding notes to annual financial statements.

The Bank of Latvia publishes a monthly closing balance sheet and notes to it, as well as other financial information, also available on the Bank of Latvia's website. The Bank's integrated information system ensures a standardised, automated, safe and efficient execution of the Bank of Latvia's financial transactions and uniform accounting for and financial reporting on them. The management of the Bank of Latvia and other employees also receive information about the Bank of Latvia's financial position, performance results and budget implementation on a daily basis. Within the framework of the internal financial control system, the Bank of Latvia's top management assesses, on a regular basis, changes in the Bank of Latvia's assets and liabilities as well as income and expenses, paying particular attention both to the results from managing foreign reserves as well as to the consistency of operating costs and long-term investment with the Bank's approved budget. The Council of the Bank of Latvia approves the Bank of Latvia's annual budget; the management of the budget is carried out in compliance with the "Regulation for Managing the Bank of Latvia's Budget" approved by the Council of the Bank of Latvia and aimed at ensuring spending efficiency. The Regulation provides for the procedure of drafting, approving and monitoring the execution of the Bank's budget. Within the budget management framework, the Bank of Latvia assesses the effectiveness, costs and human resources of each project on a continuous basis in order to ensure efficient use of funds. To ensure the independence of internal audit, the Bank of Latvia's Council approves a special expenditure plan for the Internal Audit Department.

The Bank of Latvia's Council has set up a Budget Commission, comprising at least five members of the Bank of Latvia's Council. The main tasks of the Bank of Latvia Budget Commission are evaluation of the draft budget prepared by the Board of the Bank of Latvia and oversight of the budget execution. The key budget management tasks of the

Bank of Latvia's Board are to prepare the draft budget in collaboration with the heads of relevant structural units and to submit it to the Bank of Latvia Budget Commission and the Council as well as to report on budget execution on a regular basis.

INFRASTRUCTURE RESOURCES

Engineering and technical infrastructure resources

The Bank of Latvia maintains the infrastructure necessary for its operation in good condition. In preparation for the euro changeover and taking into account the need to service customers in comfortable and safe conditions in several cashier's offices simultaneously, in 2012 the restoration and reconstruction works of the Bank of Latvia building at K. Valdemāra iela 1B, in Riga, were completed in compliance with the construction works contract awarded to *Skonto Būve Ltd*. in the amount of 4.2 million lats as a result of public procurement procedure. The Statistics Department, Payment Systems Department and Cash Department have their work premises in the renovated and reconstructed building. Conference, workshop and meeting premises, as well as premises for servicing recipients of Credit Register data and the cashier's offices are also housed in the above building.

Minor construction works required for building maintenance were also performed at the main building of the Bank of Latvia at K. Valdemāra iela 2A, in Riga, and the buildings of Riga Branch, Daugavpils Branch, Liepāja Branch, and the Training Centre in Jūrmala.

In 2012 the security alarm system of the Daugavpils Branch cash vault was renovated and the reconstruction of the Bank of Latvia video surveillance and video recording systems was completed.

Resources of information technologies

In 2012, the Bank of Latvia's local computer network modernisation project was completed in order to ensure successful functioning of the Bank of Latvia computer network by means of an advanced functionality, high-speed, secure solution which is cost efficient regarding its overall implementation and maintenance, thus not requiring any substantial additional investments in the coming years.

In 2012, the remote access infrastructure was upgraded, enhancing the level of security and making the solution more user-friendly.

In 2012, the Bank of Latvia took part in the current round of a periodic survey conducted by the Information Security Forum to assess the compliance and security of the information systems environment of the Forum's members, and received a high appraisal.

RISK MANAGEMENT

The Bank of Latvia manages strategic, financial and operational risks in compliance with "The Bank of Latvia Risk Management Policy", "The Bank of Latvia Business Continuity Policy", "The Bank of Latvia Information and Information Systems Security Policy", and "The Bank of Latvia Physical Security Policy" adopted by the Council of the Bank of Latvia. A comprehensive and uniform oversight of the policies is carried out by the Bank of Latvia's Security Supervision Commission.

The Bank of Latvia manages financial risks related to its foreign reserves in accordance with "The Guidelines for Managing the Bank of Latvia's Foreign Reserves".

The Bank of Latvia manages its operational risks related to processes and projects in compliance with "The Regulation for the Management of the Bank of Latvia Operational Risks" adopted by the Board of the Bank of Latvia. Risks are identified, analysed and assessed, opting for the most appropriate risk mitigation measures. Operational risk management is carried out by the Bank of Latvia structural units, project managers and other Bank of Latvia experts and is supervised by the Bank of Latvia Operational Risk Management Committee, appointed by the Board of the Bank of Latvia, ensuring the coordination of the daily activities of the risk management process and provides support to the Board of the Bank of Latvia in the area of operational risk management.

The Bank of Latvia business continuity management is aimed at ensuring continuity of the processes critical to the performance of the Bank of Latvia core functions or achievement of its objectives or, in case a critical process is interrupted, its re-establishment at an appropriate level and in acceptable timeframe, as well as efficient management of the incident and crisis. In 2012, within the framework of Bank of Latvia business continuity management, the main focus was on the updating and improving, and testing the action plans for ensuring business continuity of the Bank of Latvia.

Based on the information system risk management methodology, the risk analysis of the Bank of Latvia's critical and top-importance information systems was carried on in 2012. Such analysis is also performed as part of any information system development or upgrading project, and information system infrastructure modification project.

In April 2012, the Board of the Bank of Latvia reviewed and approved the Bank of Latvia risk report and submitted to the Council of the Bank of Latvia a statement about the situation in the area of risk management in 2011, providing information on the essential risks to the Bank of Latvia and their management, performance of risk mitigation plans and the essential incidents.

In 2012, the Bank of Latvia was not exposed to such risks that would have substantially interfered with its business. The staff members received training in the areas of information and information system security, business continuity and operational risk management.

INTERNAL AND EXTERNAL AUDIT

By an unbiased examination of the Bank of Latvia functions and processes, the internal audit provides the management of the Bank of Latvia with an independent evaluation of the effectiveness of risk management, control systems and processes and gives recommendations for their improvement. At the Bank of Latvia, the internal audit is conducted by the Internal Audit Department. The Audit Committee of the Bank of Latvia supervises the internal audit process and supports its improvement. The internal audit is organised and conducted in accordance with "The Internal Audit Policy of the Bank of Latvia" approved by the Council of the Bank of Latvia. In its conduct, the Institute of Internal Auditors' "International Standards for the Professional Practice of Internal Auditing" and the "Code of Ethics", as well as CobiT (Control Objectives for Information and Related Technology) and the ISACA (Information System Audit and Control Association) standards are applied.

The compliance of internal audit activities with the "International Standards for the Professional Practice of Internal Auditing" and the "Code of Ethics" has been attested by the external assessment of the internal audit quality in 2010 and the periodic internal assessment of the internal audit quality in 2012.

The internal audit covers all business areas of the Bank of Latvia operation. Internal audits are planned and conducted on a risk assessment basis. The outcome of each internal audit is reported to the Bank of Latvia Governor and the Audit Committee by the Head of Internal Audit Department. The Bank of Latvia Audit Committee jointly with the Head of the Internal Audit Department review the internal audit findings and recommendations and their implementation on a quarterly basis. The results of internal audit activities are reported to the Council of the Bank of Latvia on an annual basis.

The Internal Audit Department carries out internal auditing at the Bank of Latvia also in accordance with the audit plan approved by the ESCB Internal Auditors Committee (IAC); three such audits were conducted in 2012.

In compliance with the Law "On the Bank of Latvia", the central bank's business activities and financial statements of the reporting year are audited by the Audit Commission whose composition is approved by the State Audit Office of the Republic of Latvia. In 2012, the Audit Commission for auditing business activities and financial statements of the Bank of Latvia comprised auditors from the State Audit Office of the Republic of Latvia and *Ernst & Young Baltic* SIA.

FINANCIAL STATEMENTS OF THE BANK OF LATVIA
FOR THE YEAR ENDED 31 DECEMBER 2012

BALANCE SHEET

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

ASSETS	Notes[1]	**2012**	2011
FOREIGN ASSETS		**4 053 478**	3 507 542
Gold	6	218 750	210 066
Special Drawing Rights	7	83 367	79 069
Convertible foreign currencies	8	3 692 653	3 184 920
Participating interest in the European Central Bank	9	750	750
Participating interest in the Bank for International Settlements	10	19 991	18 997
Other foreign assets	11	37 967	13 740
DOMESTIC ASSETS		**32 857**	31 683
Fixed assets	12, 13	31 963	30 675
Other domestic assets	14, 15	894	1 008
TOTAL ASSETS		**4 086 335**	3 539 225

[1] The accompanying notes set out on pages 78 to 112 are an integral part of these financial statements.

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

LIABILITIES, CAPITAL AND RESERVES	Notes	**2012**	2011
FOREIGN LIABILITIES		**27 680**	72 372
Convertible foreign currencies	16	18 775	9 560
International Monetary Fund	7	305	313
Other international institution deposits in lats	17	3 341	18 271
Foreign bank deposits in lats		2 332	712
Other foreign liabilities	18	2 927	43 516
LATS IN CIRCULATION	19	**1 234 147**	1 160 183
DOMESTIC LIABILITIES		**2 462 505**	1 979 508
Balances due to credit institutions	20	1 688 349	1 197 740
Balances due to the government	21	761 152	737 088
Balances due to other financial institutions	22	10 814	42 715
Other domestic liabilities	23, 24	2 190	1 965
CAPITAL AND RESERVES		**362 003**	327 162
Nominal capital	25	25 000	25 000
Reserve capital	25	159 797	148 587
Valuation account	25	143 245	121 547
Profit of the reporting year	25	33 961	32 028
TOTAL LIABILITIES, CAPITAL AND RESERVES		**4 086 335**	3 539 225

The financial statements, which are set out on pages 72 to 112, were authorised by the Board of the Bank of Latvia on 13 March 2013.

BOARD OF THE BANK OF LATVIA

M. Kālis

R. Jakovļevs

A. Ņikitins

H. Ozols

R. Vanags

PROFIT AND LOSS STATEMENT

(in thousands of lats)

	Notes	**2012**	2011
INTEREST INCOME			
Foreign operations	35	**47 555**	73 265
Interest on securities		45 579	58 813
Interest on deposits with foreign credit institutions and other foreign financial institutions		995	5 832
Interest on derivative financial instruments		981	8 620
Domestic operations	35	**8**	13
Interest on loans to credit institutions		8	1
Interest on derivative financial instruments		–	12
INTEREST EXPENSE			
Foreign operations	35	**–5 521**	–494
Interest on deposits		–8	–7
Interest on derivative financial instruments		–5 513	–487
Domestic operations	35	**–4 410**	–11 475
Interest on deposits of credit institutions		–2 063	–4 057
Interest on government deposits		–2 273	–7 125
Interest on deposits of other financial institutions		–74	–293
NET INTEREST INCOME	35	**37 632**	61 309

(cont.) (in thousands of lats)

	Notes	**2012**	2011
REALISED GAINS/LOSSES (–) FROM FINANCIAL OPERATIONS	36	**17 518**	5 942
Foreign operations		**15 944**	–3 505
Debt securities		25 892	11 836
Derivative financial instruments		–9 948	–15 341
Foreign currency exchange transactions		**1 574**	9 447
WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS	25, 37	**–1 585**	–16 556
Foreign operations		**–1 482**	–14 905
Debt securities		–1 482	–14 905
Foreign currency position		**–103**	–1 651
INCOME FROM PARTICIPATING INTEREST	38	**278**	245
OTHER OPERATING INCOME	39	**1 482**	1 261
BANKNOTE PRODUCTION AND COINAGE COSTS	40	**–797**	–582
OTHER OPERATING EXPENSES		**–20 567**	–19 591
Remuneration	41	–10 243	–9 902
Social security costs	41	–2 430	–2 373
Depreciation and amortisation charges	12, 15	–2 887	–2 948
Maintenance and operation of information systems		–1 993	–1 670
Other operating expenses	42	–3 014	–2 698
PROFIT OF THE REPORTING YEAR		**33 961**	32 028

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

(in thousands of lats)

	Notes	**2012**	2011
REVALUATION	25	**34 815**	27 871
Equity instruments		995	17 233
Foreign currency and gold		6 253	6 068
OTC interest rate swap arrangements		–	25
Debt securities		27 567	4 545
REALISATION OF ACCUMULATED REVALUATION RESULT	25	**–14 702**	–30 493
Foreign currency and gold		–145	–13 761
OTC interest rate swap arrangements		–25	–
Debt securities		–14 532	–16 732
WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS	25, 37	**1 585**	16 556
PROFIT OF THE REPORTING YEAR		**33 961**	32 028
TOTAL		**55 659**	45 962

CASH FLOW STATEMENT

(in thousands of lats)

	Notes	2012	2011
CASH FLOW FROM OPERATING ACTIVITIES			
Profit of the reporting year		**33 961**	32 028
Non-cash transaction adjustments	43 (1)	**4 462**	19 506
Net movements in balance sheet positions	43 (1)	**398 298**	6 178
Net cash and cash equivalents inflow from operating activities		**436 721**	57 712
CASH FLOW FROM INVESTING ACTIVITIES			
Dividends on shares of the Bank for International Settlements	38	**278**	245
Acquisition of fixed assets	12	**–3 925**	–2 345
Disposal of fixed assets	12	**13**	–
Acquisition of intangible assets	15	**–218**	–92
Net cash and cash equivalents outflow from investing activities		**–3 852**	–2 192
CASH FLOW FROM FINANCING ACTIVITIES			
Profit appropriated to the state budget	25	**–20 818**	–15 440
Net cash and cash equivalents outflow from financing activities		**–20 818**	–15 440
NET CASH AND CASH EQUIVALENTS INFLOW		**412 051**	40 080
Cash and cash equivalents at the beginning of the year	43 (2)	**596 730**	556 650
Cash and cash equivalents at the end of the year	43 (2)	**1 008 781**	596 730

NOTES TO THE FINANCIAL STATEMENTS

1. PRINCIPAL ACTIVITIES

The Bank of Latvia is the central bank of Latvia. It was established on 19 September 1922 (re-established in 1990) and operates under the Law of the Republic of Latvia "On the Bank of Latvia" and other legislative provisions.

The primary goal of the Bank of Latvia is to maintain price stability in Latvia. Pursuant to the Law "On the Bank of Latvia", its primary tasks are as follows:
– establishment and implementation of monetary policy;
– management of foreign currency and gold reserves;
– issue of the national currency, both banknotes and coins;
– promotion of a smooth operation of the payment systems in Latvia and organisation and management of the interbank payment system;
– collecting, compiling and publishing financial statistics and Latvia's balance of payments;
– representation of Latvia in foreign central banks and international financial institutions;
– acting as a financial agent for the Latvian government.

The Bank of Latvia also ensures the operation of the Credit Register as of 1 January 2008. The Bank of Latvia issues licences to legal persons listed in the Republic of Latvia's Register of Enterprises, except credit institutions, for the purchase and sale of foreign currency cash as a commercial activity, and controls compliance with the procedure it has established for effecting foreign currency cash purchase and sales transactions.

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

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

The Head Office of the Bank of Latvia is situated in K. Valdemāra iela 2A, Riga. The Bank of Latvia manages the storage, processing and circulation of cash through its Riga Branch and the regional branches in Daugavpils and Liepāja. Since 2012 the Bank of Latvia's building at K. Valdemāra iela 1B, Riga, is used to ensure the operation of the interbank payment systems, compilation and publishing of statistics, operation of the Credit Register and customer service for cash transactions.

2. 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.

2.1. BASIS OF PRESENTATION

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

The "Financial Accounting Policy of the Bank of Latvia" requires that events and financial transactions of the Bank of Latvia relating to the implementation of monetary policy and management of foreign reserves as well as participating interest in the ECB are reported in accordance with the legal framework for accounting and financial reporting in the ESCB.

2.2. BASIS OF MEASUREMENT

These financial statements have been prepared in accordance with the historical cost basis of accounting except for gold, debt securities, participating interest (except the participating interest in the ECB), currency future contracts and interest rate derivatives, which are accounted for at fair value. Forward exchange rate contracts and currency swap arrangements are valued according to the principles described in Note 2.15. The reconciliation of the book value and fair value of these instruments is provided in Note 26.

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

Fair value of financial instruments is determined by the Bank of Latvia using quoted prices in active markets, other financial market information sources or discounted cash flows. The discounted cash flows are modelled using quoted market prices of financial instruments and money market interest rates. The breakdown of assets and liabilities measured at fair value, taking into account the hierarchy of fair value determination, is provided in Note 5.

Fair value of the Bank of Latvia's financial assets and financial liabilities does not differ materially from the reported book value of the respective assets and liabilities.

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

Transactions in foreign currencies are included in the calculation of net foreign currency position of the respective currency. The transactions in foreign currencies reducing the respective currency position result in realised gains or losses. Any gain or loss arising from revaluation of transactions in foreign currencies and currency positions are credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 2.25. The principles referred to herein and in Note 2.25 for valuation and recording of transactions denominated in foreign currencies shall be applicable also to gold reserves and transactions in gold.

The exchange rates of major foreign currencies set by the Bank of Latvia and used in the preparation of the balance sheet for the year ended 31 December 2012 and the year ended 31 December 2011 are as follows:

(at the end of the year)

	2012	2011	Changes (%)
Euro (EUR)	**0.702804**	0.702804	0
US dollar (USD)	**0.531**	0.544	–2.4
Japanese yen (JPY)	**0.00619**	0.007	–11.6
Gold (XAU)	**879.554**	844.634	4.1
Special Drawing Rights (XDR)	**0.818**	0.839	–2.5

2.5. RECOGNITION AND DERECOGNITION OF FINANCIAL ASSETS AND LIABILITIES

Financial assets and financial liabilities are recognised in the balance sheet when the Bank of Latvia becomes a contractual party in the respective financial transaction.

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

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

2.6. 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.

2.7. USE OF ESTIMATES AND ASSUMPTIONS

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.

The major estimates and assumptions in the preparation of the financial statements have been made with respect to the following: impairment of assets (see Note 2.19), the method for establishing the fair value of the BIS shares (see Note 10), the useful life of fixed assets and intangible assets (see Notes 2.17 and 2.18), the repurchasing probability of collector coins (see Note 2.22), as well as the court proceedings of the bankrupt JSC *Banka Baltija* (see Note 47).

2.8. GOLD

Gold reserves are stated at market value in the balance sheet in accordance with the principles described in Note 2.4.

Any gain or loss arising from transactions in gold and revaluation of gold reserves is credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles described in Note 2.25.

2.9. DEBT SECURITIES

Debt securities are stated at fair value in the balance sheet.

Interest on securities, including premium and discount, is recognised in the profit and loss statement as interest income. Gain or loss arising from transactions in debt securities and revaluation are credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 2.25.

2.10. 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.

2.11. 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.

2.12. SECURITIES LENDING

Securities lent under automatic securities lending programme agreements are retained in the Bank of Latvia's balance sheet caption "Convertible foreign currencies" along with other securities that are not involved in these transactions. Only cash collateral placed on the account of the Bank of Latvia is recognised in the balance sheet.

Income from securities lending transactions is recognised as interest income in the profit and loss statement.

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

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

2.14. PARTICIPATING INTEREST

Participating interest includes long-term investments of the Bank of Latvia in equity instruments. The Bank of Latvia has no control or significant influence in any institution, therefore participating interest is not accounted for as an investment in a subsidiary or an associate. Equity instruments are reported at fair value in the balance sheet, except participating interest in the ECB, which is reported at cost in the balance sheet in accordance with the legal framework for accounting and financial reporting in the ESCB.

The change in fair value of participating interest is reported in the balance sheet caption "Valuation account".

2.15. DERIVATIVE FINANCIAL INSTRUMENTS

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

Interest on derivative financial instruments, including the spot and forward interest rate spread of forward exchange rate contracts and currency swap arrangements, is recognised in the profit and loss statement as interest income or interest expense. Any gain or loss arising from a change in fair value of interest rate and currency future contracts is included in the profit and loss statement. Any gain or loss arising from a change in fair value of other derivative financial instruments is credited or charged to the profit and loss statement or the balance sheet caption "Valuation account" in accordance with the principles referred to in Note 2.25.

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

2.17. FIXED ASSETS
Fixed assets are tangible long-term investments with the useful life over one year. Capitalisation limit of fixed assets is 100 lats, except the costs related to real estate improvements and replacement of fixed asset parts for which the Board of the Bank of Latvia has set a higher capitalisation limit depending on their significance. These assets are used in the provision of services as well as in the maintenance of other fixed assets and to ensure the Bank of Latvia's operation.

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

Depreciation is recognised using the straight-line method over the estimated useful life of the asset. Assets under construction or development, land and works of art are not depreciated. Buildings and structures are accounted by separate components, with individual useful life set for each such component.

In 2012 and 2011, the useful life set for fixed assets was as follows:

(years)

	2012	2011
Buildings and their components, improvement of territory	**5–100**	5–100
Transport vehicles	**10–15**	10
Office equipment and inventories	**5–25**	5–25
Cash processing and verifying equipment	**5–15**	5–15
Computer and telecommunication equipment	**2–7**	2–7
Other fixed assets	**5–15**	5–15

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

2.18. INTANGIBLE ASSETS
Intangible assets are long-term investments without physical substance with a useful life of over one year. Capitalisation limit of intangible assets is 100 lats. Intangible assets include software application rights and other rights.

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

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

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

2.19. IMPAIRMENT OF ASSETS
An asset is impaired when its carrying amount exceeds its recoverable amount. Upon detecting any indications of impairment of an asset, the recoverable amount of the respective asset is estimated. If the recoverable amount is less than the carrying amount of the respective asset, adequate allowances for the relevant asset are made. Such

allowances are recognised in the profit and loss statement with a respective reduction in the asset's carrying amount.

No impairment of assets was detected in 2012 and 2011.

2.20. LATS IN CIRCULATION

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

2.21. GOLD CIRCULATION COINS

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

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

2.22. COLLECTOR COINS

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

2.23. PROVISIONS

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

2.24. CASH AND CASH EQUIVALENTS

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

2.25. RECOGNITION OF GAINS OR LOSSES ON FINANCIAL INSTRUMENTS

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

(a) realised gains and losses shall be recognised in the profit and loss statement;

(b) unrealised gains shall be recognised in the balance sheet caption "Valuation account";

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

(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 position in the subsequent years;

(e) there shall be no netting of unrealised losses in a financial instrument, foreign currency or gold position against unrealised gains in other financial instrument, foreign currency or gold position.

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

2.26. INTEREST INCOME AND EXPENSE

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

Interest income includes interest on securities, securities lending, deposits, loans granted, forward exchange rate contracts, and currency and interest rate swap arrangements. Interest on securities also includes premium and discount, which is amortised over the remaining life of the respective securities using the straight-line method.

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

2.27. REALISED GAINS OR LOSSES FROM FINANCIAL OPERATIONS

Realised gains or losses from financial operations are recognised in the profit and loss statement at the time of disposal of financial instrument or at the time of settlement.

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

2.28. INCOME FROM PARTICIPATING INTEREST

The change in fair value of participating interest is reported in the balance sheet caption "Valuation account".

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

2.29. BANKNOTE PRODUCTION AND COINAGE COSTS

Banknote and coin acquisition costs, except gold circulation coin acquisition costs, are charged to the profit and loss statement at the time of banknote and coin acquisition.

2.30. OTHER EXPENSE AND INCOME

Bank's other operating expense and income is recognised in the profit and loss statement on an accrual basis. The amount of accrued expense and income for the reporting period is calculated in accordance with the volume of services received or rendered in the reporting period. Lease payments are recognised in the profit and loss statement proportionally over the term of the respective agreement.

3. SUMMARY OF THE BANK OF LATVIA'S FINANCIAL POSITION AND FINANCIAL PERFORMANCE

3.1. FINANCIAL POSITION

In 2012, the Bank of Latvia assets grew by 547.1 million lats mainly on account of an increase in foreign assets.

Assets in convertible foreign currencies posted 507.7 million lats growth, mostly as a result of increases of 423.5 million lats in credit institution deposits in foreign currencies and 195.6 million lats[1] in the Bank of Latvia foreign exchange transactions with credit institutions, while a 181.7 million lats reduction in the Latvian government's foreign currency deposits with the Bank of Latvia had a decreasing effect.

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[1] On a settlement date basis.

As a result of persistent excess liquidity in lats held by credit institutions, the Bank of Latvia had granted no loans to credit institutions at the end of 2012. Credit institution deposits in lats grew by 67.1 million lats in 2012.

With the demand for cash growing, the amount of cash in circulation expanded in 2012, hence the Bank of Latvia balance sheet caption "Lats in circulation" increased by 74.0 million lats.

Capital and reserves of the Bank of Latvia grew by 34.8 million lats on account of profits earned in 2012 (34.0 million lats) and net changes in valuation of financial instruments (21.7 million lats), whereas profits remitted to the state budget revenue in the amount of 20.8 million lats had a decreasing effect.

3.2. FINANCIAL PERFORMANCE

In 2012 the Bank of Latvia profit amounted to 34.0 million lats (32.0 million lats in 2011).

In 2012 net interest income decreased by 23.7 million lats in comparison with 2011. Interest income on securities shrank by 13.2 million lats, with the adverse impact of the mostly low interest rates in the US and euro area in 2012 persisting. However, such adverse impact from the low interest rates was partly offset by an increase in the Bank of Latvia's foreign reserves and investment decisions, which ensured a higher return on foreign reserves in comparison with that on the benchmark.

In 2012 the short-term interest rates on the US dollar exceeded those on the euro, reducing interest income from and increasing interest expense on financial derivatives used for hedging currency and gold price risk (hereinafter, currency risk).

Given the excess lats liquidity of credit institutions, the Bank of Latvia issued loans to credit institutions in minimum amounts in 2012 and the respective interest income was 8 thousand lats (1 thousand lats in 2011).

With average credit institution deposits in lats with the Bank of Latvia decreasing and due to lower average interest rates on these deposits than in 2011, the interest expense on credit institution deposits contracted by 2.0 million lats. Lower interest rates on government deposits in foreign currencies and a smaller amount of funds in foreign currencies received from the Latvian government as deposits accounted for a 5.6 million lats fall in interest expense on the above deposits, while interest expense on the government deposits in lats grew by 0.7 million lats.

Realised gains from financial operations increased by 11.6 million lats, while write-downs of the negative revaluation result on financial assets and positions decreased by 15.0 million lats in comparison with 2011, mostly on account of a fall in interest rates in the euro area and the US in 2012, which in turn positively affected the market value of the respective securities, as well as the realisation of the positive revaluation result accumulated in the previous periods. The realised gains from financial operations were also affected by the result of currency future contracts concluded for the purpose of hedging the currency risk and realised gains on foreign exchange transactions. The positive revaluation result of the hedged balance sheet items is reported in the balance sheet caption "Valuation account".

The uncertainty of the Bank of Latvia's further financial performance is mostly related to interest rate developments in the euro area and US financial markets since the Bank of Latvia is exposed to the interest rate risk. In view of the very low levels of interest rates, a further interest rate fall is potentially negligible in comparison with a potential rise; thus, the expected pickup in interest rates in foreign financial markets may negatively affect the income on foreign fixed income securities.

4. INVESTMENT POLICY

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

Foreign reserves include the assets reported under "Gold", "Special Drawing Rights" and "Convertible foreign currencies" as well as derivative financial instruments and spot exchange rate contracts whose book value is reported under relevant balance sheet captions of other assets or other liabilities.

Foreign reserves are managed by classifying them into different investment portfolios by investment strategy and source of funding. Portfolios of borrowed funds include foreign reserves which correspond to the Bank of Latvia's liabilities in foreign currencies to other institutions, mainly foreign reserves arising from the Treasury deposits and foreign exchange swaps conducted in pursuit of monetary policy. Foreign reserves that are not included in the portfolios of borrowed funds (net reserves) are included in the portfolios of gold reserves, portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark. A part of foreign currency reserves included in the portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark are managed by external foreign reserves managers.

The parameters for a benchmark reflecting the acceptable level of financial risks and return target are set out for each portfolio type in the Guidelines.

The breakdown of foreign reserves by type of investment portfolio at the end of 2012 and 2011 was as follows:

	Portfolio value (in thousands of lats)		Percentage (%)	
	2012	2011	**2012**	2011
Portfolios managed against multi-currency fixed income securities benchmark	**2 703 967**	2 388 804	**79.9**	72.7
Portfolios of borrowed funds	**274 931**	507 330	**8.1**	15.4
Gold reserves portfolio	**225 862**	215 374	**6.7**	6.5
Portfolios managed against asset-backed securities benchmark	**181 438**	175 883	**5.3**	5.4
Total	**3 386 198**	3 287 391	**100.0**	100.0

In 2012 the Bank of Latvia increased diversification of foreign reserves by pledging the government securities of Canada and Singapore to its multi-currency fixed income securities benchmark; consequently, now it is pledged to the weighted 1–3 year government securities index of the euro area countries, US, Japan, Canada and Singapore (merely the euro area countries, the US and Japan in 2011).

The benchmark for borrowed funds portfolios is formed in compliance with the parameters of respective liabilities.

The benchmark of gold reserves portfolio is pledged to the euro money market short-term index.

The benchmark of portfolios managed against asset-backed securities benchmark is pledged to the US mortgage-backed securities index.

According to the exchange rate policy of the Bank of Latvia, the Guidelines provide that, except for portfolios of borrowed funds, the currency of the foreign reserves benchmark is the euro, limiting the currency risk. For portfolios of borrowed funds, the benchmark currency structure is formed in compliance with the parameters of respective liabilities.

The description of the main methods used in financial risk management is provided in Note 27.1.

BALANCE SHEET NOTES

5. ASSETS AND LIABILITIES AT FAIR VALUE

Fair value of Bank of Latvia's assets and liabilities is determined using the following hierarchy (see also Note 2.3):
– quoted market price. Fair value is determined using quoted prices for identical financial instruments in active markets;
– observable data. Fair value is determined using quoted prices for similar financial instruments in active markets, quoted prices for similar or identical financial instruments in inactive markets or using models where all significant inputs are observable;
– non-observable data. Fair value is determined using models where significant inputs are not observable.

At the end of 2012 and 2011, Bank of Latvia's assets and liabilities carried at fair value were generally valued on the basis of quoted market price.

At the end of 2012 and 2011, participating interest in the BIS was assessed using non-observable data. The assessment was conducted using the 70% net asset value model (see also Note 10).

At the end of 2012 and 2011, the breakdown of assets and liabilities carried at fair value according to the fair value hierarchy was as follows:

(in thousands of lats)

	Quoted market price	Observable data	Non-observable data	Total
As at 31 December 2012				
FOREIGN ASSETS				
Gold	218 750	–	–	218 750
Convertible foreign currencies				
Debt securities	2 418 964	264 908	–	2 683 872
Participating interest in the Bank for International Settlements	–	–	19 991	19 991
Other foreign assets				
Forward transactions in securities	158	–	–	158
Total foreign assets at fair value	**2 637 872**	**264 908**	**19 991**	**2 922 771**
FOREIGN LIABILITIES				
Other foreign liabilities				
Forward transactions in securities	121	–	–	121
Total foreign liabilities at fair value	**121**	**–**	**–**	**121**

(cont.) (in thousands of lats)

	Quoted market price	Observable data	Non-observable data	Total
As at 31 December 2011				
FOREIGN ASSETS				
Gold	210 066	–	–	210 066
Convertible foreign currencies				
Debt securities	2 227 982	214 727	–	2 442 709
Participating interest in the Bank for International Settlements	–	–	18 997	18 997
Other foreign assets				
Forward transactions in securities	560	–	–	560
OTC interest rate swap arrangements	–	25	–	25
Total foreign assets at fair value	2 438 608	214 752	18 997	2 672 357
FOREIGN LIABILITIES				
Other foreign liabilities				
Forward transactions in securities	147	–	–	147
Total foreign liabilities at fair value	147	–	–	147

The average market prices on the last trading day of the reporting year are obtained from the electronic information systems *Bloomberg* and *Interactive Data*. Where the above price for a financial instrument is absent in the electronic information systems, the price provided by a market participant (broker) or the price determined by applying the discounted cash flow approach is used for evaluating the financial instrument.

6. GOLD

	Troy ounces	In thousands of lats
As at 31 December 2010	248 706	187 179
During 2011		
Increase in gold market value	x	22 887
As at 31 December 2011	248 706	210 066
During 2012		
Increase in gold market value	x	8 684
As at 31 December 2012	**248 706**	**218 750**

The Bank of Latvia hedges the risk related to fluctuations in gold reserves market value by entering into forward exchange rate contracts, currency swap arrangements, and currency future contracts (see also Notes 2.8, 2.15 and 28). Revaluation of gold reserves, forward exchange rate contracts, and currency swap arrangements is recognised in the balance sheet caption "Valuation account", whereas revaluation of currency future contracts, taking into account settlement, is recognised in the profit and loss statement caption "Realised gains/losses from financial operations".

7. SPECIAL DRAWING RIGHTS, INTERNATIONAL MONETARY FUND

Pursuant to the Law "On the Republic of Latvia Joining the International Monetary Fund" the Bank of Latvia serves as a depository for the IMF and services the IMF accounts in the member state currency without compensation. The IMF holdings in lats comprise promissory notes issued by the Latvian government, Account No. 1 used for financial transactions with the IMF, and Account No. 2 used for the IMF administrative expenditure and receipts.

Latvia's claims on the IMF include SDR and Latvia's quota in the IMF. SDR is an international reserve asset created by the IMF and used in transactions between the IMF and its members. The quota in the IMF reflects the subscription in the IMF of respective members. Latvia's quota in the IMF is secured by the Latvian government promissory note issued to the IMF and is recorded as an asset denominated in SDR.

Latvia's liabilities to the IMF are made up of the IMF holdings in lats and IMF allocations. In 2012 liabilities to the IMF decreased, with the Latvian government repaying the IMF loan in the amount of 982 240 SDR and thus redeeming the promissory notes of the same amount issued by the government of Latvia.

At the end of 2012, the claims on the IMF in SDR as recorded on the Bank of Latvia's balance sheet were equivalent to 83 367 thousand lats (at the end of 2011 – 79 069 thousand lats), whereas the liabilities to the IMF are made up of funds at the disposal of the IMF in the amount of 305 thousand lats (at the end of 2011 – 313 thousand lats) held on its Accounts No. 1 and No. 2.

At the end of 2012 and 2011, Latvia's net liabilities to the IMF were as follows:

	(in thousands of lats)		(in thousands of SDR)	
	2012	2011	**2012**	2011
Latvia's quota in the IMF	**116 238**	119 222	**142 100**	142 100
IMF holdings in lats	**–116 207**	–943 290	**–142 062**	–1 124 302
Promissory notes of the Latvian government	–115 902	–942 977	–141 690	–1 123 930
Account No. 1	–291	–298	–355	–355
Account No. 2	–14	–15	–17	–17
Stand-by Arrangement for Latvia	–	824 099	–	982 240
Reserve position in IMF	**45**	46	**55**	55
SDR	**83 367**	79 069	**101 916**	94 242
General allocation	**–76 890**	–78 864	**–93 998**	–93 998
Special allocation	**–21 942**	–22 505	**–26 824**	–26 824
Latvia's net liabilities to the IMF	**–15 420**	–22 254	**–18 851**	–26 525

The reserve position in the IMF is the difference between the Latvia's quota in the IMF and the IMF holdings in lats, excluding the balance on Account No. 2 and adding the amount of the Stand-by Arrangement for Latvia.

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

8. CONVERTIBLE FOREIGN CURRENCIES

Bank of Latvia's foreign assets in convertible foreign currencies are invested primarily in debt securities of high liquidity and short-term deposits.

The carrying amount of interest bearing debt securities includes accrued interest income (18 724 thousand lats at the end of 2012 and 19 604 thousand lats at the end of 2011).

At the end of 2012 and 2011, the balance sheet asset caption "Convertible foreign currencies" was comprised of the following assets:

(in thousands of lats)

	2012	2011
Debt securities of foreign governments, financial institutions and non-financial corporations	**2 683 872**	2 442 709
Demand deposits with foreign central banks, credit institutions and international institutions	**991 831**	519 867
Time deposits with foreign credit institutions and other foreign financial institutions	**3 611**	208 733
Foreign currency in cash	**13 339**	13 611
Total	**3 692 653**	3 184 920

For pledged assets in convertible foreign currencies see Note 45.

9. PARTICIPATING INTEREST IN THE EUROPEAN CENTRAL BANK

With Latvia's accession to the EU, the Bank of Latvia became a subscriber of the capital of the ECB. In accordance with the Statute of the ESCB and of the ECB, the share of the Bank of Latvia in the ECB's capital was calculated on the basis of the EU states' population and gross domestic product data and is adjusted every five years or at shorter intervals depending on changes in the number of the EU Member States.

At the end of 2012 and 2011, the Bank of Latvia's percentage share in the ECB's capital was 0.2837% equivalent to 30 528 thousand euro (21 455 thousand lats). As Latvia does not participate in the euro area, pursuant to the transitional provisions of the Statute of the ESCB and of the ECB and Decision of the ECB's General Council, the Bank of Latvia has paid up a 3.75% minimum contribution of its total subscribed capital in the ECB amounting to 1 145 thousand euro or 750 thousand lats (1 145 thousand euro or 750 thousand lats at the end of 2011; see also Note 47).

In accordance with the legal framework for accounting and financial reporting in the ESCB participating interest in the ECB's capital has been reported at cost in the balance sheet of the Bank of Latvia. ECB's capital shares are not traded in the public securities market, and the share of the Bank of Latvia in the ECB's capital can be increased or decreased only in the cases referred to in this Note (see also Note 2.14).

10. PARTICIPATING INTEREST IN THE BANK FOR INTERNATIONAL SETTLEMENTS

At the end of 2012 and 2011, the Bank of Latvia owned 1 070 shares in the BIS, which correspond to 0.19% of the total subscribed and paid-up BIS capital.

The nominal value of the Bank of Latvia's shareholding in the BIS is 5 350 thousand SDR (the nominal value per share is 5 thousand SDR), paid up in the amount of 1 338 thousand SDR or 25% (see also Note 47). At the end of 2012 and 2011, the BIS shareholding is reported in the Bank of Latvia balance sheet at fair value. BIS shares are not traded in the public securities market. In the opinion of the Bank of Latvia's management, the most appropriate method for establishing the fair value of the BIS shares is 70% of the BIS net assets based on the latest audited financial statements of the BIS. The BIS applied this valuation method for calculating the price of its shares; the International Court at the Hague has also recognised it as appropriate for the valuation of shares when repurchasing them from former private shareholders of the BIS. Pursuant to the Statutes of the BIS, only central banks can be shareholders in the BIS. At the end of 2012, the fair value of BIS shares was 19 991 thousand lats (18 997 thousand lats at the end of 2011) (see also Note 2.14).

11. OTHER FOREIGN ASSETS

(in thousands of lats)

	2012	2011
OTC financial derivative and spot exchange rate contracts with non-residents	**37 001**	13 143
Prepaid expense	**740**	461
Interest accrued on deposits	**1**	59
Other	**225**	77
Total	**37 967**	13 740

12. FIXED ASSETS

(in thousands of lats)

	Buildings, improvement of territory, and land	Furniture and office equipment	Cash processing equipment	Transport vehicles	Other fixed assets	Total
As at 31 December 2010						
Cost	37 000	6 368	4 580	1 235	5 133	54 316
Accumulated depreciation	–11 041	–4 878	–2 488	–743	–4 163	–23 313
Net book value	25 959	1 490	2 092	492	970	31 003
During 2011						
Additions	1 566	306	30	–	443	2 345
Change in classification	–	88	–37	–	–51	–
Disposals and write-offs	–	–64	–3	–24	–169	–260
Net change in cost	1 566	330	–10	–24	223	2 085
Depreciation charge	–1 694	–372	–238	–102	–265	–2 671
Change in classification	–	–39	36	–	3	–
Accumulated depreciation on disposals and write-offs	–	63	3	24	168	258
Net change in accumulated depreciation	–1 694	–348	–199	–78	–94	–2 413
As at 31 December 2011						
Cost	38 566	6 698	4 570	1 211	5 356	56 401
Accumulated depreciation	–12 735	–5 226	–2 687	–821	–4 257	–25 726
Net book value	25 831	1 472	1 883	390	1 099	30 675
During 2012						
Additions	2 872	552	25	–	476	3 925
Change in classification	–8	–	–	–	–27	–35
Disposals and write-offs	–1	–455	–12	–38	–38	–544
Net change in cost	2 863	97	13	–38	411	3 346
Depreciation charge	–1 715	–320	–240	–43	–281	–2 599
Accumulated depreciation on disposals and write-offs	1	452	12	38	38	541
Net change in accumulated depreciation	–1 714	132	–228	–5	–243	–2 058
As at 31 December 2012						
Cost	41 429	6 795	4 583	1 173	5 767	59 747
Accumulated depreciation	–14 449	–5 094	–2 915	–826	–4 500	–27 784
Net book value	**26 980**	**1 701**	**1 668**	**347**	**1 267**	**31 963**

At the end of 2012, the total cadastral value of land under the ownership and possession of the Bank of Latvia was 1 771 thousand lats (1 811 thousand lats at the end of 2011; the change is related to a revision in the cadastral value of land). Land is reported in the balance sheet of the Bank of Latvia at cost (1 669 thousand lats at the end of 2012 and 2011).

At the end of 2012, the Bank of Latvia's contractual commitments related to acquisition of fixed assets were 165 thousand lats (3 338 thousand lats at the end of 2011); their reduction is mostly related to the completion of the reconstruction of the building at K. Valdemāra iela 1B, Riga.

13. LEASING

The Bank of Latvia's assets subject to leases are premises, land, and equipment. In the balance sheet they are reported as fixed assets. Asset lease agreements where the Bank of Latvia acts as a lessor are operating leases. Lease payments, except those that are directly transferred to the state budget, are recognised in the profit and loss statement proportionally over the term of the respective agreement. The depreciation of the assets given on lease is calculated on the basis of the depreciation policy described in Note 2.17 and reported in the profit and loss statement as depreciation charges.

Carrying amount of assets given on lease at the end of 2012 and 2011 was as follows:

(in thousands of lats)

As at 31 December 2011	
Cost	1 146
Accumulated depreciation	–538
Net book value	608
As at 31 December 2012	
Cost	1 163
Accumulated depreciation	–580
Net book value	**583**

14. OTHER DOMESTIC ASSETS

(in thousands of lats)

	2012	2011
Intangible assets	**405**	440
Prepaid expense	**161**	108
Spot exchange rate contracts with residents	**73**	–
Other	**255**	460
Total	**894**	1 008

15. INTANGIBLE ASSETS

(in thousands of lats)

As at 31 December 2010	
Cost	3 878
Accumulated amortisation	–3 253
Net book value	625
During 2011	
Additions	92
Net change in cost	92
Amortisation charge	–277
Net change in accumulated amortisation	–277
As at 31 December 2011	
Cost	3 970
Accumulated amortisation	–3 530
Net book value	440
During 2012	
Additions	218
Change in classification	35
Net change in cost	253
Amortisation charge	–288
Net change in accumulated amortisation	–288
As at 31 December 2012	
Cost	4 223
Accumulated amortisation	–3 818
Net book value	**405**

16. CONVERTIBLE FOREIGN CURRENCIES

At the end of 2012 convertible foreign currency liabilities mostly consisted of the cash collateral received by the Bank of Latvia for securing transactions in derivative financial instruments, as well as funds on the EC account for settlements in euro. The EC account is used by the EC for the distribution of EU budgetary funds (see also Note 17).

(in thousands of lats)

	2012	2011
Cash collateral received	**15 279**	3 580
EC demand deposits	**1 488**	5 681
Other liabilities	**2 008**	299
Total	**18 775**	9 560

17. OTHER INTERNATIONAL INSTITUTION DEPOSITS IN LATS

Other international institution deposits in lats mostly consist of funds on the EC account for settlements in lats, which is used for effecting Latvian government payments to the EU budget (see also Note 16).

(in thousands of lats)

	2012	2011
EC demand deposits	**2 965**	18 024
Other deposits	**376**	247
Total	**3 341**	18 271

18. OTHER FOREIGN LIABILITIES

(in thousands of lats)

	2012	2011
OTC financial derivative contracts and spot exchange rate contracts with non-residents	**1 977**	43 210
Payments due	**607**	–
Accrued expense	**309**	272
Other	**34**	34
Total	**2 927**	43 516

19. LATS IN CIRCULATION

Banknotes and coins with the total nominal value of 1 160 654 thousand lats and 73 493 thousand lats respectively were in circulation at the end of 2012 (1 093 313 thousand lats and 66 870 thousand lats respectively at the end of 2011).

At the end of 2012, the total nominal value of the issued gold circulation coins (fineness .999), with the denomination of 100 lats, and collector coins was 1 989 thousand lats and 1 613 thousand lats respectively (1 989 thousand lats and 1 556 thousand lats at the end of 2011 respectively). The respective coins in circulation are not included in the balance sheet caption "Lats in circulation" (see also principles described in Notes 2.21 and 2.22).

20. BALANCES DUE TO CREDIT INSTITUTIONS

Balances due to credit institutions include balances on the settlement accounts of domestic credit institutions opened with the Bank of Latvia, as well as overnight and 7-day deposits (deposit facility) received from them. The respective credit institutions place their funds with the Bank of Latvia in order to comply with its minimum reserve requirement, as well as to effect interbank and customer payments, and settlements related to the Bank of Latvia's monetary policy operations. At the end of 2012, the overnight deposit facility rate and 7-day deposit facility rate as set by the Bank of Latvia were 0.05% and 0.075% respectively (at the end of 2011, the overnight deposit facility rate and 7-day deposit facility rate were 0.25% and 0.375% respectively).

(in thousands of lats)

	2012	2011
Current account balances in lats	**857 728**	824 840
Current account balances in euro	**567 191**	143 680
Overnight deposit facility in lats	**11 930**	2 220
7-day deposit facility in lats	**251 500**	227 000
Total	**1 688 349**	1 197 740

21. BALANCES DUE TO THE GOVERNMENT

Balances due to the government 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.

(in thousands of lats)

	2012	2011
Demand deposits in lats	**441 218**	235 441
Demand deposits in foreign currencies	**319 934**	242 523
Time deposits in foreign currencies	–	259 124
Total	**761 152**	737 088

22. BALANCES DUE TO OTHER FINANCIAL INSTITUTIONS

Balances due to other financial institutions mostly include the funds of the FCMC and the Deposit Guarantee Fund and Fund for the Protection of the Insured, both managed by the FCMC, in the amount of 9 080 thousand lats (41 027 thousand lats at the end of 2011).

23. OTHER DOMESTIC LIABILITIES

(in thousands of lats)

	2012	2011
Accrued expense and similar liabilities	**1 669**	1 571
Tax liabilities	**96**	69
Accrued interest expense	**9**	63
Other	**416**	262
Total	**2 190**	1 965

24. TAX

(in thousands of lats)

	Personal income tax	Compulsory social security contributions (by employer)	Compulsory social security contributions (by employee)	Tax on real estate	Value added tax	Other taxes and duties	Total
Liabilities as at 31 December 2010	0	0	0	0	80	0	80
During 2011							
Calculated	2 044	2 373	1 086	92	427	1	6 023
Increase in deferred liabilities	0	5	0	0	0	0	5
Paid	–2 044	–2 378	–1 086	–92	–438	–1	–6 039
Liabilities as at 31 December 2011	0	0	0	0	69	0	69
During 2012							
Calculated	2 074	2 430	1 097	89	505	1	6 196
Decrease in deferred liabilities	0	–27	0	0	0	0	–27
Paid	–2 074	–2 403	–1 097	–89	–478	–1	–6 142
Liabilities as at 31 December 2012	**0**	**0**	**0**	**0**	**96**	**0**	**96**

In addition to the tax payments indicated herein, the Bank of Latvia transfers 65% of the profit for the reporting year, including the payment for the usage of state capital (20 818 thousand lats in 2012; 15 440 thousand lats in 2011; see also Notes 25 and 44) to the state budget. The Bank of Latvia is not subject to corporate income tax.

25. CAPITAL AND RESERVES

(in thousands of lats)

	Nominal capital	Reserve capital	Valuation account	Profit of the reporting year	Capital and reserves
As at 31 December 2010	25 000	140 273	107 613	23 754	296 640
During 2011					
Revaluation, realisation, and write-downs	x	x	13 934	x	13 934
Profit appropriated to the state budget	x	x	x	–15 440	–15 440
Profit transferred to the reserve capital	x	8 314	x	–8 314	0
Profit of the reporting year	x	x	x	32 028	32 028
As at 31 December 2011	25 000	148 587	121 547	32 028	327 162
During 2012					
Revaluation, realisation, and write-downs	x	x	21 698	x	21 698
Profit appropriated to the state budget	x	x	x	–20 818	–20 818
Profit transferred to the reserve capital	x	11 210	x	–11 210	0
Profit of the reporting year	x	x	x	33 961	33 961
As at 31 December 2012	**25 000**	**159 797**	**143 245**	**33 961**	**362 003**

The capital of the Bank of Latvia is comprised of the nominal capital, reserve capital and the balance sheet item "Valuation account", as well as the undistributed profit of the reporting year. The Bank of Latvia does not take decisions affecting the formation of the nominal capital, reserve capital, and the profit distribution as they are provided for by the Law "On the Bank of Latvia". The balance sheet item "Valuation account" comprises the positive result on revaluation of the financial instruments and gold. The accounting policy, harmonised with the principal accounting policies established by the legal framework for accounting and financial reporting in the ESCB and described in Note 2, stipulates that the realised gains are recognised in the profit and loss statement only after the disposal of a financial instrument or settlement while unrealised gains are recorded under the balance sheet item "Valuation account", thus facilitating the preservation of the capital under the impact of financial instrument price, interest rate and exchange rate fluctuations.

The legislation does not provide for any capital adequacy requirements for the central bank; nevertheless, the amount of the Bank of Latvia's capital should be adequate to promote credibility of the monetary policy implemented by the Bank of Latvia, and to ensure implementation of its operations and financial independence when performing the tasks set forth by the Law "On the Bank of Latvia". The Bank of Latvia does not hedge interest rate risk related to domestic financial assets to avoid a conflict with the monetary policy pursued by it. The implementation of the monetary policy as well as exposure to other financial and operational risks may adversely affect the Bank of Latvia income or cause losses to be covered from the capital and reserves of the Bank of Latvia.

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

The Law "On the Bank of Latvia" establishes that a part of the Bank of Latvia's profit of the reporting year, calculated by applying the same percentage as the tax rate set for resident corporate entities of Latvia by the Law "On Corporate Income Tax", together with a payment in the amount of 50% of the profit of the reporting year for the usage of state capital shall be transferred to the state budget. At the end of 2012 and 2011, the corporate income tax rate applicable to residents of Latvia was 15%. Therefore, 65% of the Bank of Latvia's profit of the reporting year shall be transferred to the state budget within 15 days following the approval of the Annual Report of 2012 by the Council of the Bank of Latvia. In 2013, the Bank of Latvia will transfer 22 075 thousand lats from its profit earned in 2012 to the state budget.

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

In 2012 and 2011, changes in the balance sheet caption "Valuation account" were as follows:

(in thousands of lats)

	2012	Write-downs	Revaluation	Realisation	2011	Write-downs	Revaluation	Realisation	2010
Initial valuation account	**24 018**	x	x	–	24 018	x	x	–75	24 093
Deferred result on revaluation of foreign currencies and gold	24 018	x	x	–	24 018	x	x	–	24 018
Deferred result on revaluation of debt securities	–	x	x	–	–	x	x	–75	75
Revaluation reserve for equity instruments	**18 228**	–	995	–	17 233	–	17 233	–	–
Result on revaluation of foreign currencies and gold	**55 793**	103	6 253	–145	49 582	1 651	6 068	–13 761	55 624
Result on revaluation of OTC interest rate swap arrangements	**–**	–	–	–25	25	–	25	–	–
Result on revaluation of debt securities	**45 206**	1 482	27 567	–14 532	30 689	14 905	4 545	–16 657	27 896
Total	**143 245**	1 585	34 815	–14 702	121 547	16 556	27 871	–30 493	107 613

The initial valuation account was established by transferring thereto the result on revaluation prior to the change in the accounting policy on 1 January 2007, whereas the revaluation reserve for equity instruments has been established to account for the result on revaluation of the BIS shares.

26. DERIVATIVE FINANCIAL INSTRUMENTS AND SPOT EXCHANGE RATE CONTRACTS

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

(in thousands of lats)

	Contract or notional amount		Book value			
			Assets		Liabilities	
	2012	2011	**2012**	2011	**2012**	2011
OTC financial derivative and spot exchange rate contracts with non-residents						
Forward exchange rate contracts and currency swap arrangements	**2 462 085**	1 775 002	**36 805**	12 211	**1 660**	43 026
Spot exchange rate contracts	**66 645**	114 643	**38**	347	**196**	37
Forward transactions in securities	**249 195**	152 949	**158**	560	**121**	147
Interest rate swap arrangements	**–**	870	**–**	25	**–**	–
Total	**x**	x	**37 001**	13 143	**1 977**	43 210
Spot exchange rate contracts with residents						
Spot exchange rate contracts	**22 229**	–	**73**	–	**–**	–
Total	**x**	x	**73**	–	**–**	–
Traded financial derivative contracts with non-residents						
Interest rate future contracts	**957 105**	1 189 194	**x**	x	**x**	x
Currency future contracts	**154 718**	151 365	**x**	x	**x**	x

The book value of the OTC financial derivative contracts and spot exchange rate contracts is reported in the respective balance sheet captions of other assets or other liabilities (see also Notes 11, 14 and 18). Since settlement has been made for the change in the fair value of future contracts, it is reported as demand deposits in the balance sheet asset caption "Convertible foreign currencies".

At the end of 2012 and 2011, the book value and the fair value of OTC contracts concluded by the Bank of Latvia and not reported at their fair value, were not materially different. The reconciliation of the book value and net fair value of these instruments at the end of 2012 and 2011 was as follows:

(in thousands of lats)

	Net fair value		Net book value		Difference	
	2012	2011	**2012**	2011	**2012**	2011
OTC financial derivative and spot exchange rate contracts with non-residents						
Forward exchange rate contracts and currency swap arrangements	**34 899**	–31 290	**35 145**	–30 815	**–246**	–475
Spot exchange rate contracts	**–158**	311	**–158**	310	**–**	1
Total	**34 741**	–30 979	**34 987**	–30 505	**–246**	–474
Spot exchange rate contracts with residents						
Spot exchange rate contracts	**73**	–	**73**	–	**–**	–
Total	**73**	–	**73**	–	**–**	–

MAJOR RISKS AND PRINCIPLES FOR THEIR MANAGEMENT

27. RISK MANAGEMENT

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

27.1. FINANCIAL RISKS

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

The Bank of Latvia manages financial risks related to foreign reserves in accordance with the Guidelines. The basic principles of investment policy set out in the Guidelines are provided in Note 4. Foreign reserves are managed by classifying them into different investment portfolios. Parameters for a benchmark reflecting the acceptable level of financial risks and return target are set out for each portfolio type in the Guidelines. On a business day basis, the Risk Management Division of the Market Operations Department monitors the compliance of foreign reserves with the requirements set out in the Guidelines.

In 2012 parameters of the multi-currency fixed income securities portfolio benchmark have been changed in order to increase the diversification of the benchmark and reduce credit risk.

For the purpose of foreign reserves management, including management of related financial risks, the Investment Committee of the Bank of Latvia develops the investment management strategy, approves tactical decisions and sets detailed limits for financial risks within the framework of the Guidelines as well as oversees the operation of external foreign reserve managers. The Investment Committee of the Bank of Latvia reviews the investment strategy once a quarter, and on a weekly basis receives and reviews reports and forecasts for developments in financial markets, which are prepared by foreign reserves investment portfolio managers, reviews the reports by financial risk managers and approves the investment management tactical decisions for the forthcoming week. Once every two months the Market Operations Department informs the Council of the Bank of Latvia about the results of management of foreign reserves.

27.1.1. Market Risk

Market risk is exposure to losses due to adverse changes in financial markets (for example, movements in interest rates or exchange rates).

The Bank of Latvia is exposed to interest rate risk primarily due to investing in foreign debt securities and interest rate derivatives that are subject to interest rate fluctuations and used within the course of foreign reserve management. The Bank of Latvia manages the interest rate risk by using a modified duration limit set individually for each investment portfolio.

The Bank of Latvia's exposure to currency risk is determined by the structure of its foreign reserves, which cannot be formed in compliance with the Bank of Latvia's liability parameters. The Bank of Latvia manages the currency risk by determining open currency position limits and using tracking error. Tracking error is calculated as the expected annualised standard deviation of the difference in return between the investment portfolio and the respective benchmark. The aggregate market and credit risk of portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark (see also Note 4) is managed by determining the tracking error limit. Tracking error in 2012 and 2011 is provided in Note 30.

For investment portfolios, except for portfolios of borrowed funds, the benchmark currency is the euro. For portfolios of borrowed funds, the benchmark currency structure is formed in compliance with the parameters of respective liabilities. Deviations from the benchmark currency structure give rise to the open currency position. In order to achieve the compliance of open foreign currency positions with the limits, the Bank of Latvia hedges the currency risk by using forward exchange rate contracts, currency swap arrangements, and currency future contracts.

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

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

The Bank of Latvia's exposure to market risk (as at the end of 2012 and 2011) is disclosed in Notes 28–30.

27.1.2. Credit Risk

Credit risk is exposure to losses resulting from counterparty default. The Bank of Latvia's exposure to credit risk results mainly from investments in foreign financial instruments and short-term lending to domestic credit institutions.

The Bank of Latvia manages exposure to credit risk related to investments made in foreign financial instruments by establishing limits on investments of different credit quality in the Guidelines. Credit quality is evaluated on the basis of ratings assigned by the international credit rating agencies Fitch Ratings, Moody's Investors Service and Standard & Poor's. The Bank of Latvia is allowed to invest in financial instruments of certain credit quality of the OECD countries. Limits are set also on the maximum investment in financial instruments of the same class and counterparty, as well as in financial instruments of one issuer. To hedge the credit risk associated with OTC derivative counterparties, the Bank of Latvia enters with them into International Swaps and Derivatives Association, Inc. Master Agreements and Credit Support Annexes. In order to monitor the Bank of Latvia's credit risk exposure associated with its foreign operations, the Risk Management Division of the Market Operations Department is involved in monitoring of the Bank of Latvia's compliance with the Guidelines on a business day basis.

Short-term loans granted to domestic credit institutions are secured by collateral of Latvian government securities and such private sector debt securities, according to the requirements established by the Council of the Bank of Latvia. The Market Operations Department reviews the compliance of credit ratings assigned to issuers of these securities with the requirements of the Council of the Bank of Latvia and monitors the adequacy of collateral on a regular basis.

The Bank of Latvia's exposure to credit risk (as at the end of 2012 and 2011) is disclosed in Notes 32 to 34.

27.1.3. Liquidity Risk

Liquidity risk is associated with a failure to meet liabilities timely. The Bank of Latvia's exposure to liquidity risk arises mainly from the need to ensure foreign currency for conducting foreign exchange transactions with credit institutions and repaying deposits of the Latvian government and other institutions. The Bank of Latvia manages liquidity risk by investing foreign reserves in liquid debt securities issued by international institutions, foreign governments and the corporate sector, short-term deposits with foreign financial institutions and other financial instruments. Investments are made so as to ensure timely settlement of the Bank of Latvia's liabilities. The structure of the Bank of Latvia's cash and its equivalents is provided in Note 43. The liquidity profile of the Bank of Latvia's assets and liabilities as at the end of 2012 and 2011 is disclosed in Note 31.

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.

27.2. OPERATIONAL RISKS

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

The basic principles of the Bank of Latvia's operational risk management are determined by the Council of the Bank of Latvia. The Bank of Latvia's operational risk management is implemented by the Board of the Bank of Latvia, which has established the Committee for Managing the Bank of Latvia's Operational Risks to coordinate, on a day-to-day basis, the activities under the operational risk management process and to provide support to the Board of the Bank of Latvia on operational risk management issues. The Committee is presided by a Member of the Board of the Bank of Latvia and includes the Operational Risk Manager, Business Continuity Manager, Information Security Manager, Information Systems Security Manager, and the Head of Security Department.

In 2012 the regulation for the management of the Bank of Latvia operational risks was amended, highlighting risk revision after the event (an incident, audit recommendation, changes in the internal or external environment, etc.) and providing for risk revision at least once in four years. Development of the Bank of Latvia register of operational risks improves the registration of information on risks and expands its availability for all registered users of the register.

In order to ensure confidentiality, authorised access to and integrity of information, the Bank of Latvia information systems are classified into levels depending on their significance; the owners of the Bank of Latvia information systems in cooperation with the Information Systems Department have established the rules for the usage and access rights of the information system, as well as ensure the implementation of the risk analysis of the respective information system, coordinated by the information systems security manager of the Bank of Latvia who also oversees the introduction of measures aimed at minimising the identified risks. The Head of Information Systems Department ensures the compliance of the functionality and performance of the Bank of Latvia information system infrastructure with the requirements stipulated for the information systems, as well as its safe and continuous operation. The Bank of Latvia conducts, on a regular basis, the analysis of information systems security risks and improves security measures and tools.

The management of Bank of Latvia business continuity is organised and conducted in accordance with the "Bank of Latvia Business Continuity Policy", approved by the Council, abiding by the internationally recognised standards and taking into account the ECB recommendations regarding business continuity management. The Bank of Latvia on a regular basis conducts educational sessions for employees on information and information systems security, operational risk management and management of business continuity.

In order to limit the implications of operational risks, the Bank of Latvia is insured against a possible impact of certain types of operational risks.

In 2012, the Bank of Latvia was not exposed to the risks that could substantially affect or hamper its operation.

28. CURRENCY PROFILE[1]

(in thousands of lats)

	LVL	EUR	USD	JPY	Gold	Other	Total
As at 31 December 2012							
Assets							
Foreign assets	37 735	1 935 478	1 315 386	263 702	218 750	282 427	4 053 478
Domestic assets	32 829	28	–	–	–	–	32 857
TOTAL ASSETS	**70 564**	**1 935 506**	**1 315 386**	**263 702**	**218 750**	**282 427**	**4 086 335**
Liabilities							
Foreign liabilities	7 144	14 270	5 986	44	–	236	27 680
Lats in circulation	1 234 147	–	–	–	–	–	1 234 147
Domestic liabilities	1 575 364	801 144	61 489	8 197	–	16 311	2 462 505
TOTAL LIABILITIES	**2 816 655**	**815 414**	**67 475**	**8 241**	**–**	**16 547**	**3 724 332**
Net position on balance sheet	–2 746 091	1 120 092	1 247 911	255 461	218 750	265 880	362 003
Net position on financial instruments' off-balance sheet accounts	–	2 004 323	–1 234 596	–254 185	–219 009	–261 436	35 097
Net position on balance sheet and off-balance sheet accounts	–2 746 091	3 124 415	13 315	1 276	–259	4 444	397 100
Profile of the net position on balance sheet and off-balance sheet accounts (%)	**x**	**99.5**	**0.4**	**0**	**0**	**0.1**	**100.0**
Benchmark currency structure (%)	x	100.0	0	0	0	0	100.0
As at 31 December 2011							
TOTAL ASSETS	44 960	1 851 528	1 176 038	238 913	210 066	17 720	3 539 225
TOTAL LIABILITIES	2 556 172	596 849	39 585	8 164	–	11 293	3 212 063
Net position on balance sheet	–2 511 212	1 254 679	1 136 453	230 749	210 066	6 427	327 162
Net position on financial instruments' off-balance sheet accounts	–	1 542 642	–1 131 368	–227 796	–210 314	–3 231	–30 067
Net position on balance sheet and off-balance sheet accounts	–2 511 212	2 797 321	5 085	2 953	–248	3 196	297 095
Profile of the net position on balance sheet and off-balance sheet accounts (%)	x	99.6	0.2	0.1	0	0.1	100.0
Benchmark currency structure (%)	x	100.0	0	0	0	0	100.0

29. REPRICING MATURITY

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

[1] The assets and liabilities, denominated in SDR and exposed to the SDR currency risk, including liabilities to the IMF, are reported as per the SDR basket of currencies.

(in thousands of lats)

	Up to 3 months	3–6 months	6–12 months	1–3 years	Over 3 years	Total
As at 31 December 2012						
Foreign assets						
Special Drawing Rights	83 367	–	–	–	–	83 367
Convertible foreign currencies	1 548 759	80 324	108 887	1 268 329	662 429	3 668 728
Total interest-sensitive assets	**1 632 126**	**80 324**	**108 887**	**1 268 329**	**662 429**	**3 752 095**
Foreign liabilities						
Convertible foreign currencies	15 280	–	–	–	–	15 280
Domestic liabilities						
Balances due to credit institutions	1 120 326	–	–	–	–	1 120 326
Balances due to the government	631 136	–	–	–	–	631 136
Balances due to other financial institutions	2 396	–	–	–	–	2 396
Other domestic liabilities	2	–	–	–	–	2
Total interest-sensitive liabilities	**1 769 140**	**–**	**–**	**–**	**–**	**1 769 140**
Net position on balance sheet	–137 014	80 324	108 887	1 268 329	662 429	1 982 955
Assets on financial instrument off-balance sheet accounts	3 080 862	–	–	692 492	173 291	3 946 645
Liabilities on financial instrument off-balance sheet accounts	3 571 031	398	–	4 909	335 210	3 911 548
Net position on balance sheet and off-balance sheet accounts	**–627 183**	**79 926**	**108 887**	**1 955 912**	**500 510**	**2 018 052**
As at 31 December 2011						
Total interest-sensitive assets	1 351 339	12 221	84 090	1 089 024	710 297	3 246 971
Total interest-sensitive liabilities	1 730 258	–	–	–	–	1 730 258
Net position on balance sheet	–378 919	12 221	84 090	1 089 024	710 297	1 516 713
Assets on financial instrument off-balance sheet accounts	2 637 476	1 088	3 264	566 165	146 078	3 354 071
Liabilities on financial instrument off-balance sheet accounts	2 753 163	865	3 264	376 752	250 094	3 384 138
Net position on balance sheet and off-balance sheet accounts	–494 606	12 444	84 090	1 278 437	606 281	1 486 646

30. TRACKING ERROR

The exposure to aggregate market risk and credit risk of foreign reserves, included in portfolios managed against multi-currency fixed income securities benchmark and asset-backed securities benchmark is characterised by the tracking error, which is measured as the expected annualised standard deviation of the difference in return between the investment portfolio and the respective benchmark (see also risk management principles described in Note 27.1). At the end of 2012 and 2011, the actual (ex-post) tracking errors of the portfolios managed against multi-currency fixed income securities benchmark were 27 basis points and 54 basis points respectively, whereas the tracking errors of the portfolios managed against asset-backed securities benchmark were 69 basis points and 84 basis points respectively.

The expected (ex-ante) tracking error lay within the following basis point intervals during the year:

	Book value (at the end of the year; in thousands of lats)	Expected tracking error (number of business days)			
		10–39	40–69	70–99	100–110
During 2012					
Portfolios managed against multi-currency fixed income securities benchmark	2 703 967	2	242	8	–
Portfolios managed against asset-backed securities benchmark	181 438	–	13	212	27
During 2011					
Portfolios managed against multi-currency fixed income securities benchmark	2 388 804	–	253	–	–
Portfolios managed against asset-backed securities benchmark	175 883	–	171	76	6

31. LIQUIDITY PROFILE

(in thousands of lats)

			2012			2011
	Up to 3 months	No fixed maturity	**Total**	Up to 3 months	No fixed maturity	Total
Assets						
Foreign assets	4 031 772	21 706	**4 053 478**	3 487 257	20 285	3 507 542
Domestic assets	241	32 616	**32 857**	376	31 307	31 683
TOTAL ASSETS	4 032 013	54 322	**4 086 335**	3 487 633	51 592	3 539 225
Liabilities						
Foreign liabilities	27 646	34	**27 680**	72 339	33	72 372
Lats in circulation	–	1 234 147	**1 234 147**	–	1 160 183	1 160 183
Domestic liabilities	2 462 505	–	**2 462 505**	1 979 508	–	1 979 508
TOTAL LIABILITIES	2 490 151	1 234 181	**3 724 332**	2 051 847	1 160 216	3 212 063
Net position on balance sheet	1 541 862	–1 179 859	**x**	1 435 786	–1 108 624	x

In the liquidity profile, asset items are reported on the basis of the Bank of Latvia's capability to convert them into cash. Liabilities items are reported by their expected settlement date.

32. SECTORAL PROFILE OF ASSETS

	Amount (in thousands of lats)		Percentage (%)	
	2012	2011	**2012**	2011
Foreign central governments and other governmental institutions	**1 284 308**	1 104 267	**31.4**	31.2
Foreign local governments	**31 626**	51 437	**0.8**	1.5
Foreign central banks and credit institutions	**1 690 083**	1 493 624	**41.4**	42.2
Other foreign financial institutions	**879 987**	668 356	**21.5**	18.9
Foreign non-financial corporations	**31 372**	78 127	**0.8**	2.2
International institutions	**135 141**	110 837	**3.3**	3.1
Unclassified assets	**33 818**	32 577	**0.8**	0.9
Total	**4 086 335**	3 539 225	**100.0**	100.0

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

	Amount (in thousands of lats)		Percentage (%)	
	2012	2011	**2012**	2011
Euro area countries	**1 464 393**	1 526 724	**36.1**	43.5
Other EU countries	**621 690**	725 868	**15.3**	20.7
US	**494 259**	519 974	**12.2**	14.8
Canada	**275 222**	103 468	**6.8**	3.0
Japan	**261 529**	231 590	**6.5**	6.6
Other countries and international institutions	**936 385**	399 918	**23.1**	11.4
Total	**4 053 478**	3 507 542	**100.0**	100.0

Assets under "Other countries and international institutions" also comprise claims on the ECB corresponding to the balances on the settlement accounts of the direct participants in TARGET2-Latvija, standing at 616 232 thousand lats at the end of 2012 (143 425 thousand lats at the end of 2011).

34. ASSETS BY CREDIT RATING ASSIGNED TO THE COUNTERPARTY

	Credit rating	Amount (in thousands of lats)		Percentage (%)	
		2012	2011	**2012**	2011
FOREIGN ASSETS					
Gold	AAA	**218 750**	210 066	**5.4**	5.9
Special Drawing Rights	AAA	**83 367**	79 069	**2.0**	2.2
Foreign debt securities	AAA	**1 255 817**	838 391	**30.8**	23.8
	AA+	**631 139**	361 359	**15.4**	10.2
	AA	**50 227**	149 536	**1.2**	4.2
	AA–	**454 599**	475 843	**11.1**	13.5
	A+	**182 817**	238 576	**4.5**	6.8
	A	**71 599**	350 477	**1.8**	9.9
	A–	**7 403**	6 662	**0.2**	0.2
	BBB+	**6 058**	806	**0.1**	0
	BBB	**956**	–	**0**	–
	BBB–	**355**	373	**0**	0
	BB+	**22 902**	20 686	**0.6**	0.6
Deposits with foreign financial institutions	AAA	**818 704**	438 969	**20.1**	12.4
	AA+	**110 355**	31 985	**2.7**	0.9
	AA	**27 092**	25 867	**0.7**	0.7
	AA–	**–**	45 396	**–**	1.3
	A+	**35 579**	129 163	**0.9**	3.7
	A	**3 638**	57 220	**0.1**	1.6
	A–	**74**	–	**0**	–
Foreign currency in cash	AAA	**13 332**	13 607	**0.3**	0.4
	AA+	**7**	4	**0**	0

(cont.)

	Credit rating	Amount (in thousands of lats)		Percentage (%)	
		2012	2011	**2012**	2011
Participating interest in the European Central Bank	AAA	**750**	750	**0**	0
Participating interest in the Bank for International Settlements	AAA	**19 991**	18 997	**0.5**	0.5
Derivative financial instruments	AAA	**1 917**	560	**0**	0
	AA–	**4 844**	82	**0.1**	0
	A+	**3 189**	7 791	**0.1**	0.2
	A	**16 847**	4 609	**0.4**	0.1
	A–	**7 670**	101	**0.2**	0
	BBB+	**1 982**	–	**0**	–
	BBB	**552**	–	**0**	–
Accrued interest income	Different	**1**	59	**0**	0
Other foreign assets	Different	**965**	538	**0**	0
DOMESTIC ASSETS	Different	**32 857**	31 683	**0.8**	0.9
TOTAL		**4 086 335**	3 539 225	**100.0**	100.0

The amount in the rating group "BB+" consisted of securities issued by an agency partially owned by an OECD country government; these securities were disposed of in February 2013.

At the end of 2012 and 2011, the Bank of Latvia's foreign assets broken down by major categories of credit ratings assigned to the counterparty were as follows:

	Credit rating category	Amount (in thousands of lats)		Percentage (%)	
		2012	2011	**2012**	2011
Foreign assets	AAA	**2 412 628**	1 600 409	**59.6**	45.6
	AA	**1 278 263**	1 090 072	**31.5**	31.1
	A	**328 816**	794 599	**8.1**	22.7
	BBB	**9 903**	1 179	**0.2**	0
	BB	**22 902**	20 686	**0.6**	0.6
	Different	**966**	597	**0**	0
Total		**4 053 478**	3 507 542	**100.0**	100.0

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

PROFIT AND LOSS NOTES

35. NET INTEREST INCOME

The Bank of Latvia net interest income was mainly derived from investing foreign currency reserves. In 2012 net interest income decreased by 23 677 million lats in comparison with 2011.

In 2012, interest income from foreign operations shrank by 25 710 thousand lats in comparison with 2011, and interest expense grew by 5 027 thousand lats year-on-year. Lower interest rates in 2012 resulted in a 13 234 thousand lats fall in interest income from securities.

Higher short-term interest rates on the US dollar in comparison with those on the euro in 2012 in their turn mostly accounted for a 7 639 thousand lats drop in the net interest income from financial derivatives and a 5 026 thousand lats increase in the net interest expense on them.

Interest income from domestic operations was a mere 8 thousand lats (13 thousand lats in 2011) as the demand for loans granted by the Bank of Latvia was low due to the excess lats liquidity of credit institutions.

Interest expense on domestic operations was largely comprised of interest on deposits of domestic credit institutions and the Latvian government. Interest expense on credit institution deposits contracted by 1 994 thousand lats, as interest paid on these deposits decreased in 2012, including the remuneration for holding the minimum reserves. In 2012 the average amount of Latvian government funds, placed as deposits with the Bank of Latvia, remained broadly unchanged in comparison with 2011; however, interest rates on deposits in foreign currencies declined, therefore interest expense on government deposits shrank by 4 852 thousand lats.

36. REALISED GAINS/LOSSES FROM FINANCIAL OPERATIONS

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

Gains from the disposal of debt securities increased by 14 056 thousand lats in comparison with 2011. A larger amount of the positive debt securities revaluation result, accumulated on the valuation account in previous reporting years, was realised in comparison with 2011.

The realised gains or losses from financial operations were negatively affected by the negative result on derivative financial instruments, despite the fact that it decreased by 5 393 thousand lats in comparison with 2011, mostly on account of the result of interest rate future contracts as well as the result of currency future contracts concluded for the purpose of hedging currency risks. The negative result of the currency future contracts concluded for the purpose of hedging currency risk exposure is offset in equal value by the positive revaluation result of the hedged balance sheet items reported in the balance sheet caption "Valuation account" as well as the realised gains on foreign exchange transactions recognised in the profit and loss statement.

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

The revaluation result of several debt securities and foreign currency positions at the end of 2012 and 2011 was negative, and it has been recognised in the profit and loss statement while the positive result on the revaluation of debt securities and foreign currency positions has been reported in the balance sheet caption "Valuation account" (see also Note 25).

38. INCOME FROM PARTICIPATING INTEREST

Income from participating interest comprises the dividends received from the participating interest in the BIS (see also Note 10).

39. OTHER OPERATING INCOME

(in thousands of lats)

	2012	2011
Income from sale of collector coins	**773**	581
Income from payment and securities settlement services	**368**	379
Other	**341**	301
Total	**1 482**	1 261

40. BANKNOTE PRODUCTION AND COINAGE COSTS

(in thousands of lats)

	2012	2011
Coinage of collector coins	**–715**	–481
Coinage of circulation coins	**–82**	–101
Total	**–797**	–582

41. REMUNERATION AND SOCIAL SECURITY COSTS

(in thousands of lats)

	2012	2011
Remuneration		
Remuneration of Members of the Council and the Board	**–880**	–895
Remuneration of other personnel	**–9 363**	–9 007
Total remuneration	**–10 243**	–9 902
Social security costs	**–2 430**	–2 373
Total remuneration and social security costs	**–12 673**	–12 275

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 these duties.

The number of employees in 2012 and 2011 was as follows:

	2012	2011
Number of employees at the end of the year		
Members of the Council and the Board	**14**	13
Other personnel	**547**	543
Total at the end of the year	**561**	556
Average number of employees per period	**561**	563

42. OTHER OPERATING EXPENSES

(in thousands of lats)

	2012	2011
Municipal services	**–671**	–553
Information and public relations	**–366**	–214
Maintenance of buildings, territory and equipment	**–348**	–398
Business travel	**–269**	–209
Risk insurance	**–263**	–267
Telecommunications services and system maintenance	**–197**	–167
Personnel training	**–181**	–139
Acquisition of low value office supplies	**–175**	–227
Transport provision	**–114**	–109
Tax on real estate	**–89**	–91
Audit, advisory and legal services	**–38**	–27
Other	**–303**	–297
Total	**–3 014**	–2 698

The audit, advisory and legal services expenses also comprise the remuneration in the amount of 24 thousand lats paid to Ernst & Young Baltic SIA for the audit of 2012 financial statements (23 thousand lats to Deloitte Audits Latvia SIA in 2011) and 8 thousand lats for the audit of tax calculations.

NOTE TO THE CASH FLOW STATEMENT

43. CASH FLOW STATEMENT

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

(in thousands of lats)

	2012	2011
Profit before appropriation	**33 961**	32 028
Non-cash transaction adjustments		
Depreciation of fixed assets and amortisation of intangible assets	2 887	2 948
Profit (–)/loss on disposal of fixed assets	–10	2
Write-downs of revaluation result on financial assets and positions	1 585	16 556
Net non-cash transaction adjustments	**4 462**	19 506
Change in balance sheet items		
Net increase (–)/decrease in Special Drawing Rights	–6 277	22 589
Net increase (–)/decrease in foreign debt securities and other foreign investments	–148 718	606 426
Net decrease in other assets	–217	–32
Net increase/decrease (–) in foreign convertible currency liabilities	9 215	–4 122
Net increase/decrease (–) in foreign bank and other international institution deposits in lats	–13 310	9 752
Net increase in lats in circulation	73 964	222 279
Net increase/decrease (–) in deposits of domestic credit institutions	490 609	–492 490
Net increase/decrease (–) in Latvian government deposits	24 064	–343 922
Net decrease in deposits of other financial institutions	–31 901	–14 023
Net increase/decrease (–) in other liabilities	869	–279
Net change in balance sheet items	**398 298**	6 178
Net cash and cash equivalents inflow arising from operating activities	**436 721**	57 712

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

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

	2012	Change	2011	Change	2010
Convertible foreign currencies in cash	**13 339**	–272	13 611	–2 102	15 713
Demand deposits with foreign credit institutions and other foreign financial institutions	**991 831**	471 964	519 867	–11 868	531 735
Time deposits with foreign credit institutions and other foreign financial institutions with original maturity up to 5 business days	**3 611**	–59 641	63 252	54 050	9 202
Total cash and cash equivalents	**1 008 781**	412 051	596 730	40 080	556 650

OTHER NOTES

44. TRANSACTIONS WITH THE LATVIAN GOVERNMENT

The Bank of Latvia, whose capital is wholly owned by the Republic of Latvia, 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 currencies, 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 2012 and 2011 the Bank of Latvia did not perform such transactions). The Bank of Latvia is independent in making its own decisions on entering into the above transactions.

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 2012 and 2011, the breakdown of the Bank of Latvia claims on and liabilities to the Latvian government and the respective interest rates were as follows:

	Amount (in thousands of lats)		Interest rate (%)	
	2012	2011	2012	2011
Liabilities/claims (–)				
Demand deposits in lats	**441 218**	235 441	**0.31**	0.57
Demand deposits in foreign currencies	**319 934**	242 523	**0.00–0.30**	0.00–0.22
Time deposits in foreign currencies	**–**	259 124	**–**	0.32–0.51
Spot exchange rate contracts	**–73**	–	**x**	x
Accrued interest expense	**–**	20	**x**	x
Tax liabilities	**96**	69	**x**	x
Total net liabilities	**761 175**	737 177	**x**	x

In 2012 and 2011, the breakdown of the Bank of Latvia's income and expense related to the Latvian government, as well as the Bank of Latvia's profit of the previous reporting year appropriated to the state budget was as follows (see also Notes 24, 25, and 35):

(in thousands of lats)

	2012	2011
Expense and the Bank of Latvia's profit appropriated to the state budget		
Interest on government deposits	**2 273**	7 125
Taxes	**6 196**	6 023
Profit appropriated to the state budget	**20 818**	15 440
Total expense and the Bank of Latvia's profit appropriated to the state budget	**29 287**	28 588

45. PLEDGED ASSETS

Securities and other financial instruments with the market value of 15 464 thousand lats, as at the end of 2012 (23 720 thousand lats at the end of 2011), have been pledged to provide collateral for forward exchange contracts and interest rate and currency future contracts. These financial instruments are included in the balance sheet asset caption "Convertible foreign currencies".

46. SECURITIES LENDING

On behalf of the Bank of Latvia its agents conclude securities lending transactions, as part of an automatic securities lending programme, where Bank of Latvia's securities are lent against cash or other securities collateral. Securities lending transactions provide additional income without any material impact on foreign currency reserve liquidity as the securities lent are readily available to the Bank of Latvia. The Bank of Latvia's agent administers the securities lending programme and monitors the securities lending and related collateral.

At the end of 2012, the fair value of Bank of Latvia's securities lent was 262 087 thousand lats (278 577 thousand lats at the end of 2011).

At the end of 2012 and 2011, the fair value of collateral provided in securities lending transactions was as follows:

(in thousands of lats)

	2012	2011
Foreign currency cash	**243 203**	241 602
Debt securities of foreign governments, financial institutions and non-financial corporations	**23 355**	41 987
Total	**266 558**	283 589

Foreign currency cash or securities provided as collateral in securities lending transactions is not recognised in the Bank of Latvia's balance sheet (see also principles described in Note 2.12).

47. CONTINGENT LIABILITIES AND COMMITMENTS

In 2005, the liquidator of the bankrupt JSC *Banka Baltija* filed a claim against the Bank of Latvia on behalf of the creditors of JSC *Banka Baltija* in the Riga Regional Court for the recovery of losses. In February 2010, the amount of the claim was increased from 185.6 million lats to 238.3 million lats. The claimant alleges that the Bank of Latvia, as the institution in charge of banking supervision at that time, is responsible for losses arising from the bankruptcy of JSC *Banka Baltija* in 1995. On 12 October 2010, the Civil Court Collegium of Riga District Court as the court of first instance ruled to satisfy the claim against the Bank of Latvia in part, collecting 60 million lats from the Bank of

Latvia for the benefit of the JSC *Banka Baltija* undergoing liquidation for the purpose of reimbursing losses, and 32 thousand lats as stamp duty for the benefit of the State. The Bank of Latvia appealed the judgement of the court of first instance, thus the judgement did not take effect. On 21 February 2012, the Chamber of Civil Court of the Supreme Court announced a judgement whereby the court ruled that the claim against the Bank of Latvia be completely rejected and court expenses in the amount of 16 thousand lats and legal services in the amount of 150 thousand lats be collected from the JSC *Banka Baltija* undergoing liquidation. On 12 April 2012 the claimant appealed the judgement under cassation procedure to the Senate of the Supreme Court. The Bank of Latvia is confident that the claim is without merits and therefore no provisions are recognised in the financial statements. Should the Senate of the Supreme Court refuse to initiate the cassation proceedings, the judgement of the Chamber of Civil Court of the Supreme Court of 21 February 2012 whereby the claim against the Bank of Latvia was completely rejected will take effect. Should the Senate of the Supreme Court initiate the cassation proceedings, the final judgement in this case could be expected no earlier than in 2015.

The Bank of Latvia has not paid up 96.25% of the Bank of Latvia's share in the ECB subscribed capital, which is payable following the decision of the General Council of the ECB. At the end of 2012 and 2010, the Bank of Latvia's unpaid share in the ECB subscribed capital was 29 383 thousand euro (20 651 thousand lats; see also Note 9).

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 2012, the uncalled portion of the BIS share holding was 4 013 thousand SDR (3 367 thousand lats; 4 013 thousand SDR or 3 291 thousand lats at the end of 2011; see also Note 10).

At the end of 2012, the Bank of Latvia had issued collector coins in the nominal value of 1 613 thousand lats (1 556 thousand lats at the end of 2011) and gold circulation coins with a nominal value of 1 989 thousand lats (1 989 thousand lats at the end of 2011). These coins may be represented to the Bank of Latvia in exchange for lats at a nominal value. In the opinion of management of the Bank of Latvia, the probability that the Bank of Latvia will be required to repurchase these coins from their holders is considered low and no provisions have been made.

INDEPENDENT AUDITORS' REPORT

TO THE COUNCIL OF THE BANK OF LATVIA

We have audited the accompanying financial statements of the Bank of Latvia ("the Bank") set out on pages 72 to 112, which comprise the balance sheet as at 31 December 2012, and the related statements of profit and loss, total recognised gains and losses and cash flows for the year then ended, and a summary of principal accounting policies and other explanatory notes.

Board's Responsibility for the Financial Statements
The Board of the Bank is responsible for the preparation and fair presentation of these financial statements in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Council of the Bank, and the Law "On the Bank of Latvia", and for such internal control as the Board of the Bank determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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

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

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

Opinion
In our opinion, the financial statements of the Bank give a true and fair view of the financial position of the Bank as at 31 December 2012, and of its financial performance and its cash flows for the year then ended in accordance with the "Financial Accounting Policy of the Bank of Latvia" approved by the Council of the Bank, and the Law "On the Bank of Latvia".

Ernst & Young Baltic SIA Licence No. 17	The State Audit Office of the Republic of Latvia
Iveta Vimba Member of the Board	Elita Krūmiņa Auditor General
Riga, Latvia 13 March 2013	Riga, Latvia 13 March 2013

APPENDICES

Appendix 1

MONETARY INDICATORS IN 2012

(at end of period; in millions of lats)

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	**XII**
BANK OF LATVIA												
M0	1 793.0	1 777.1	1 865.7	1 854.2	1 852.3	1 919.9	2 060.0	2 206.6	2 255.3	2 310.7	2 443.6	**2 667.7**
Currency in circulation	1 132.4	1 127.6	1 133.6	1 146.8	1 117.3	1 136.2	1 158.1	1 167.6	1 173.5	1 167.7	1 179.0	**1 234.1**
Demand deposits with the Bank of Latvia	660.6	649.5	732.0	707.4	735.0	783.7	901.9	1 038.9	1 081.8	1 143.0	1 264.6	**1 433.5**
Currency vs monetary base (%)	63.2	63.5	60.8	61.8	60.3	59.2	56.2	52.9	52.0	50.5	48.2	**46.3**
Net foreign assets	3 316.3	3 865.2	3 789.6	3 675.0	3 736.4	3 643.5	3 856.1	4 081.0	3 793.5	3 759.8	3 874.9	**4 025.8**
Net domestic assets	–1 523.3	–2 088.0	–1 923.9	–1 820.8	–1 884.1	–1 723.5	–1 796.1	–1 874.4	–1 538.2	–1 449.1	–1 431.2	**–1 358.1**
Credit	–793.0	–1 240.6	–1 104.4	–1 066.7	–1 124.8	–1 064.8	–1 145.0	–1 161.1	–873.9	–766.7	–792.7	**–761.2**
To MFIs	0	0	0	0	0	0	0	0	0	0	0	**0**
To government (net)	–793.0	–1 240.6	–1 104.4	–1 066.7	–1 124.8	–1 064.8	–1 145.0	–1 161.1	–873.9	–766.7	–792.7	**–761.2**
Other assets (net)	–730.3	–847.4	–819.5	–754.1	–759.3	–658.8	–651.2	–713.3	–664.4	–682.4	–638.5	**–597.0**
MFI												
M1	4 292.0	4 336.5	4 303.9	4 279.3	4 216.6	4 361.2	4 431.0	4 498.7	4 525.6	4 602.5	4 721.7	**4 831.7**
M2	6 382.1	6 467.0	6 438.0	6 479.7	6 452.4	6 539.5	6 541.1	6 607.2	6 518.1	6 566.7	6 663.7	**6 706.1**
M3	6 582.7	6 642.8	6 509.9	6 549.2	6 526.9	6 611.9	6 656.6	6 723.2	6 633.4	6 682.8	6 802.7	**6 845.7**
M2X	6 400.9	6 488.9	6 423.4	6 456.3	6 382.8	6 480.4	6 479.9	6 544.9	6 471.8	6 563.2	6 684.2	**6 775.4**
Currency outside MFIs	1 024.6	1 020.8	1 021.2	1 028.2	997.2	1 029.3	1 042.8	1 051.9	1 062.8	1 053.4	1 058.2	**1 082.4**
Deposits of resident financial institutions, non-financial corporations and households	5 376.2	5 468.1	5 402.1	5 428.1	5 385.5	5 451.1	5 437.2	5 493.0	5 409.0	5 509.8	5 626.0	**5 693.0**
In foreign currencies	2 835.4	2 892.5	2 876.0	2 867.9	2 876.4	2 948.7	2 946.9	2 987.5	2 908.5	2 949.9	3 007.9	**2 980.0**
Net foreign assets	–183.2	270.1	–131.4	–121.9	64.2	54.2	249.9	378.6	155.0	202.8	378.0	**613.7**
Net domestic assets	6 584.1	6 218.7	6 554.7	6 578.3	6 318.6	6 426.2	6 230.1	6 166.3	6 316.8	6 360.4	6 306.3	**6 161.7**
Loans to resident financial institutions, non-financial corporations and households	11 314.9	11 249.1	10 747.3	10 726.9	10 418.2	10 439.3	10 424.3	10 447.4	10 420.9	10 408.8	10 367.1	**10 165.4**
INTEREST RATES												
Bank of Latvia refinancing rate (at end of period; %)	3.5	3.5	3.5	3.5	3.5	3.5	3.0	3.0	2.5	2.5	2.5	**2.5**
Weighted average interest rates on transactions in lats (%)												
Interbank loans	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.2	0.1	0.1	0.1	**0.1**
Loans to non-financial corporations and households with a floating interest rate and an initial rate fixation of up to 1 year (new business)	5.2	5.2	6.4	6.4	6.2	4.2	5.0	5.5	5.1	5.4	5.5	**6.2**
Time deposits of non-financial corporations and households (new business)	0.7	0.5	0.5	0.5	0.4	0.5	0.3	0.2	0.2	0.2	0.2	**0.4**

Appendix 2

THE BANK OF LATVIA MONTH-END BALANCE SHEETS FOR 2012

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

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	**XII**
FOREIGN ASSETS	3 350 671	3 891 736	3 813 851	3 709 079	3 817 952	3 685 204	3 965 180	4 114 991	3 818 340	3 786 498	3 892 948	4 053 478
Gold	229 780	230 375	217 929	217 671	217 017	219 971	230 602	230 925	238 216	231 369	232 229	**218 750**
SDR	77 844	71 539	71 981	72 540	70 578	70 167	71 323	65 894	69 342	82 338	78 723	**83 367**
Convertible foreign currencies	2 993 003	3 536 659	3 488 948	3 391 612	3 502 265	3 363 915	3 638 816	3 773 763	3 472 155	3 438 442	3 540 694	**3 692 653**
Participating interest in the ECB	750	750	750	750	750	750	750	750	750	750	750	**750**
Participating interest in the BIS	18 997	18 997	18 997	18 997	18 997	18 997	18 997	18 997	18 997	18 997	18 997	**19 991**
Other foreign assets	30 297	33 416	15 246	7 509	8 345	11 404	4 692	24 662	18 880	14 602	21 555	**37 967**
DOMESTIC ASSETS	31 542	31 594	31 484	32 034	32 093	32 230	32 530	32 426	32 383	32 956	32 837	**32 857**
Fixed assets	30 464	30 472	30 401	30 816	30 935	31 186	31 685	31 496	31 466	32 231	32 081	**31 963**
Other domestic assets	1 078	1 122	1 083	1 218	1 158	1 044	845	930	917	725	756	**894**
TOTAL ASSETS	3 382 213	3 923 330	3 845 335	3 741 113	3 850 045	3 717 434	3 997 710	4 147 417	3 850 723	3 819 454	3 925 785	**4 086 335**
FOREIGN LIABILITIES	34 347	26 587	24 281	34 062	81 566	41 741	109 093	34 040	24 818	26 695	18 080	**27 680**
Convertible foreign currencies	11 776	18 780	13 667	7 789	3 506	12 816	69 589	16 554	7 389	10 535	9 685	**18 775**
IMF	308	302	304	306	319	317	322	318	313	311	310	**305**
Other international institution deposits in lats	13 898	3 400	6 000	17 440	12 574	18 745	1 923	11 863	1 861	5 090	3 913	**3 341**
Foreign bank deposits in lats	1 187	1 538	1 021	572	729	954	12 540	1 081	1 770	1 844	1 982	**2 332**
Other foreign liabilities	7 178	2 567	3 289	7 955	64 438	8 909	24 719	4 224	13 485	8 915	2 190	**2 927**
LATS IN CIRCULATION	1 132 402	1 127 580	1 133 645	1 146 843	1 117 269	1 136 248	1 158 092	1 167 642	1 173 502	1 167 682	1 179 008	**1 234 147**
DOMESTIC LIABILITIES	1 871 136	2 418 646	2 332 921	2 225 678	2 314 377	2 198 881	2 378 900	2 589 695	2 294 451	2 263 711	2 366 387	**2 462 505**
Balances due to credit institutions	1 044 383	1 150 485	1 183 094	1 134 571	1 120 994	1 065 368	1 160 725	1 355 501	1 345 711	1 461 982	1 560 316	**1 688 349**
Balances due to the government	792 954	1 240 617	1 104 409	1 066 697	1 124 777	1 064 785	1 144 968	1 161 072	873 862	766 694	792 728	**761 152**
Balances due to other financial institutions	30 969	24 916	21 360	22 333	65 944	66 722	70 221	71 325	72 457	32 528	11 432	**10 814**
Other domestic liabilities	2 830	2 628	24 058	2 077	2 662	2 006	2 986	1 797	2 421	2 507	1 911	**2 190**
CAPITAL AND RESERVES	344 328	350 517	354 488	334 530	336 833	340 564	351 625	356 040	357 952	361 366	362 310	**362 003**
TOTAL LIABILITIES, CAPITAL AND RESERVES	3 382 213	3 923 330	3 845 335	3 741 113	3 850 045	3 717 434	3 997 710	4 147 417	3 850 723	3 819 454	3 925 785	**4 086 335**

Appendix 3

THE BANK OF LATVIA YEAR-END BALANCE SHEETS FOR THE YEARS 2008–2012

(at end of year; in thousands of lats)

	2008	2009	2010	2011	**2012**
FOREIGN ASSETS	2 734 395	3 384 585	4 074 611	3 507 542	**4 053 478**
Gold	108 998	134 365	187 179	210 066	**218 750**
SDR	187	91 237	99 356	79 069	**83 367**
Convertible foreign currencies	2 488 693	3 150 992	3 782 167	3 184 920	**3 692 653**
Participating interest in the ECB	743	750	750	750	**750**
Participating interest in the BIS[1]	1 763	1 763	1 763	18 997	**19 991**
Other foreign assets	134 011	5 478	3 396	13 740	**37 967**
DOMESTIC ASSETS	679 200	175 719	32 722	31 683	**32 857**
Loans to credit institutions	639 263	140 449	–	–	**–**
Fixed assets	34 626	33 232	31 003	30 675	**31 963**
Other domestic assets	5 311	2 038	1 719	1 008	**894**
TOTAL ASSETS	3 413 595	3 560 304	4 107 333	3 539 225	**4 086 335**
FOREIGN LIABILITIES	402 145	71 469	42 556	72 372	**27 680**
Convertible foreign currencies	131 252	19 006	13 682	9 560	**18 775**
IMF	256	256	274	313	**305**
Other international institution deposits in lats	6 503	32 502	8 505	18 271	**3 341**
Foreign bank deposits in lats	247 001	499	726	712	**2 332**
Other foreign liabilities	17 133	19 206	19 369	43 516	**2 927**
LATS IN CIRCULATION	1 018 092	788 155	937 904	1 160 183	**1 234 147**
DOMESTIC LIABILITIES	1 751 384	2 412 922	2 830 233	1 979 508	**2 462 505**
Balances due to credit institutions	1 094 295	1 115 677	1 690 230	1 197 740	**1 688 349**
Balances due to the government	638 056	1 291 942	1 081 010	737 088	**761 152**
Balances due to other financial institutions	1 705	1 948	56 738	42 715	**10 814**
Other domestic liabilities	17 328	3 355	2 255	1 965	**2 190**
CAPITAL AND RESERVES	241 974	287 758	296 640	327 162	**362 003**
Nominal capital	25 000	25 000	25 000	25 000	**25 000**
Reserve capital	95 533	114 236	140 273	148 587	**159 797**
Valuation account	68 004	74 129	107 613	121 547	**143 245**
Profit of the reporting year	53 437	74 393	23 754	32 028	**33 961**
TOTAL LIABILITIES, CAPITAL AND RESERVES	3 413 595	3 560 304	4 107 333	3 539 225	**4 086 335**

[1] Starting with 2011, equity instruments are reported at fair value in the balance sheet and the change in fair value is reported in the balance sheet caption "Valuation account" (for the description of changes in the accounting policies see Note 3.1 to the financial statements for 2011).

Appendix 4

THE BANK OF LATVIA PROFIT AND LOSS STATEMENTS FOR THE YEARS 2008–2012

(at end of period; in thousands of lats)

	2008	2009	2010	2011	**2012**
INTEREST INCOME					
Foreign operations	143 646	59 245	57 055	73 265	**47 555**
Domestic operations	7 264	26 925	3 618	13	**8**
INTEREST EXPENSE					
Foreign operations	–11 923	–1 662	–967	–494	**–5 521**
Domestic operations	–54 461	–18 515	–13 362	–11 475	**–4 410**
NET INTEREST INCOME	84 526	65 993	46 344	61 309	**37 632**
REALISED GAINS OR LOSSES FROM FINANCIAL OPERATIONS (–)	34 886	36 959	9 147	5 942	**17 518**
WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS	–38 087	–5 474	–12 995	–16 556	**–1 585**
INCOME FROM PARTICIPATING INTEREST	206	221	611	245	**278**
OTHER OPERATING INCOME	3 433	4 683	1 278	1 261	**1 482**
BANKNOTE PRODUCTION AND COINAGE COSTS	–4 046	–4 695	–541	–582	**–797**
OTHER OPERATING EXPENSES	–27 481	–23 294	–20 090	–19 591	**–20 567**
PROFIT OF THE REPORTING YEAR	53 437	74 393	23 754	32 028	**33 961**
Profit transferrable to the reserve capital	18 703	26 038	8 314	11 210	**11 886**
Profit transferrable to the state budget	34 734	48 355	15 440	20 818	**22 075**

Appendix 5

THE BANK OF LATVIA YEAR-END STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES FOR THE YEARS 2008–2012

(in thousands of lats)

	2008	2009	2010	2011	**2012**
REVALUATION	–833	27 907	35 482	27 871	**34 815**
Equity instruments[1]	–	–	–	17 233	**995**
Foreign currency and gold	733	18 812	36 680	6 068	**6 253**
Non-traded interest rate swap arrangements	–3 145	–	–	25	**–**
Debt securities	1 579	9 095	–1 198	4 545	**27 567**
REALISATION OF ACCUMULATED REVALUATION RESULT	–3 763	–27 256	–14 993	–30 493	**–14 702**
Foreign currency and gold	–831	–1 238	–3 889	–13 761	**–145**
Non-traded interest rate swap arrangements	364	–3 263	–	–	**–25**
Debt securities	–3 296	–22 755	–11 104	–16 732	**–14 532**
WRITE-DOWNS OF REVALUATION RESULT ON FINANCIAL ASSETS AND POSITIONS	38 087	5 474	12 995	16 556	**1 585**
PROFIT OF THE REPORTING YEAR	53 437	74 393	23 754	32 028	**33 961**
TOTAL	86 928	80 518	57 238	45 962	**55 659**

[1] Starting with 2011, equity instruments are reported at fair value in the balance sheet and the change in fair value is reported in the balance sheet caption "Valuation account" (for the description of changes in the accounting policies see Note 3.1 to the financial statements for 2011).

Appendix 6

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

(LVL vs foreign currency)

2012	GBP				100 JPY				USD			
	Maximum	Average	Minimum	At end of period	Maximum	Average	Minimum	At end of period	Maximum	Average	Minimum	At end of period
I	0.8530	0.8446	0.8370	0.8380	0.7230	0.7076	0.6900	0.6960	0.5560	0.5449	0.5340	0.5340
II	0.8480	0.8397	0.8270	0.8280	0.7070	0.6808	0.6440	0.6480	0.5400	0.5320	0.5230	0.5230
III	0.8450	0.8412	0.8310	0.8400	0.6620	0.6453	0.6320	0.6390	0.5400	0.5319	0.5220	0.5280
IV	0.8610	0.8525	0.8400	0.8600	0.6690	0.6534	0.6340	0.6550	0.5400	0.5334	0.5260	0.5320
V	0.8830	0.8732	0.8600	0.8800	0.7090	0.6841	0.6550	0.7090	0.5640	0.5468	0.5310	0.5640
VI	0.8790	0.8710	0.8640	0.8760	0.7250	0.7069	0.6960	0.7070	0.5690	0.5603	0.5530	0.5620
VII	0.9040	0.8893	0.8720	0.8990	0.7450	0.7218	0.6990	0.7300	0.5820	0.5707	0.5570	0.5720
VIII	0.9000	0.8916	0.8840	0.8870	0.7370	0.7218	0.7110	0.7130	0.5770	0.5679	0.5590	0.5600
IX	0.8900	0.8809	0.8680	0.8830	0.7170	0.7013	0.6790	0.7020	0.5620	0.5484	0.5350	0.5460
X	0.8840	0.8717	0.8620	0.8730	0.7040	0.6875	0.6730	0.6850	0.5480	0.5421	0.5370	0.5440
XI	0.8800	0.8748	0.8680	0.8690	0.6990	0.6783	0.6580	0.6610	0.5540	0.5478	0.5410	0.5430
XII	0.8730	0.8652	0.8570	0.8570	0.6610	0.6421	0.6190	0.6190	0.5450	0.5361	0.5310	0.5310

Appendix 7

THE BANK OF LATVIA ORGANISATIONAL UNITS AT THE END OF 2012

1. ACCOUNTING DEPARTMENT
(Head of Department, Chief Accountant of the Bank of Latvia – Jānis Caune; Deputy Head of Department, Deputy Chief Accountant of the Bank of Latvia – Iveta Medne)
1.1 Financial Statements and Accounting Policy Division (Head of Division – Gatis Gersons)
1.2 Internal Banking Operations Division (Head of Division – Anita Jakāne)

2. CASH DEPARTMENT
(Head of Department – Jānis Blūms; Deputy Heads of Department – Veneranda Kausa, Vilnis Kepe)
2.1 Cash Operations Division (Acting Head of Division – Veneranda Kausa)
2.2 Coin Division (Head of Division – Maruta Brūkle)
2.3 Cash Technology Division (Head of Division – Andris Tauriņš)
2.4 Riga Branch (Branch Manager – Jānis Strēlnieks)
2.5 Liepāja Branch (Branch Manager – Gundars Lazdāns)
2.6 Daugavpils Branch (Branch Manager – Ināra Brauna)

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

4. INFORMATION SYSTEMS DEPARTMENT
(Head of Department – Harijs Ozols)
4.1 System Design and Programming Division (Head of Division – Ilgvars Apinis)
4.2 Computer Network and Server Systems Division (Head of Division – Uldis Kristapsons)
4.3 Bank Information System Maintenance and Development Division (Head of Division, Deputy Head of Department – Valdis Spūlis)
4.4 Information Systems Security Division (Head of Division – Ilona Etmane)
4.5 Information Systems Quality Assurance Division (Head of Division – Askolds Kālis)
4.6 Systems Maintenance Division (Head of Division – Valērijs Kondratjevs)

5. INTERNAL AUDIT DEPARTMENT
(Head of Department – Leo Ašmanis; Deputy Head of Department – Juris Ziediņš)

6. INTERNATIONAL RELATIONS AND COMMUNICATION DEPARTMENT
(Head of Department – Juris Kravalis)
6.1 Document Management and Library Division (Head of Division – Ineta Strade)
6.2 Publications Division (Head of Division, Deputy Head of Department – Aina Raņķe)
6.3 Public Relations Division (Head of Division, Deputy Head of Department – Kristaps Otersons)
6.4 International Relations and Protocol Division (Head of Division, Deputy Head of Department – Aleksandra Bambale)

7. LEGAL DEPARTMENT
(Head of Department – Ilze Posuma; Deputy Heads of Department – Maija Āboliņa, Iveta Krastiņa)

8. MARKET OPERATIONS DEPARTMENT
(Head of Department – Raivo Vanags)
8.1 Trading and Investment Division (Head of Division – Vadims Zaicevs)
8.2 Risk Management Division (Head of Division, Deputy Head of Department – Daira Brunere)
8.3 Payments Division (Head of Division – Una Ruka)

Appendix 7 (cont.)

9. MONETARY POLICY DEPARTMENT
(Head of Department – Uldis Rutkaste; Deputy Heads of Department – Mārtiņš Bitāns, Elmārs Zakulis)
9.1 Macroeconomic Analysis Division (Head of Division – Santa Bērziņa)
9.2 Financial Market Analysis Division (Head of Division – Gunārs Bērziņš)
9.3 Monetary Research and Forecasting Division (Head of Division – Konstantīns Beņkovskis)
9.4 Financial Stability Division (Head of Division – Nataļja Beņkovska)

10. PAYMENT SYSTEMS DEPARTMENT
(Head of Department – Egons Gailītis; Deputy Heads of Department – Agnija Jēkabsone, Irēna Krūmane)
10.1 Payment Systems Policy Division (Head of Division – Anda Zalmane)
10.2 Payment Systems Operations Division (Head of Division – Natālija Popova)
10.3 Account Service and Maintenance Division (Head of Division – Andra Gailīte)
10.4 Credit Register Division (Head of Division – Laura Ausekle)

11. PERSONNEL DEPARTMENT
(Head of Department – Liene Glāzniece; Deputy Head of Department – Vineta Veikmane)

12. SECURITY DEPARTMENT
(Head of Department – Romualds Namnieks; Deputy Heads of Department – Imants Kravals, Sandis Mackēvičs)
12.1 Analytical Unit (Head of Unit – Māris Dzelme)
12.2 Armament Unit (Head of Unit – Juris Kušķis)
12.3 Central Division (Head of Division – Guntars Ezeriņš)
12.4 Riga Division (Head of Division – Igo Peičs)
12.5 Daugavpils Division (Head of Division – Ilmārs Suhockis)
12.6 Liepāja Division (Head of Division – Gints Liepiņš)

13. STATISTICS DEPARTMENT
(Head of Department – Agris Caune; Deputy Head of Department – Ilmārs Skarbnieks)
13.1 Financial Market and Monetary Statistics Division (Head of Division – Zigrīda Aušta)
13.2 Balance-of-Payments Statistics Division (Head of Division – Daiga Gaigala-Ližbovska)
13.3 General Economic and Financial Statistics Division (Head of Division – Iveta Salmiņa)

14. TECHNICAL SUPPORT DEPARTMENT
(Head of Department – Andris Ņikitins)
14.1 General Service Division (Head of Division – Einārs Cišs)
14.2 Building Systems Division (Head of Division, Deputy Head of Department – Jānis Kreicbergs)
14.3 Security Systems Division (Head of Division – Viesturs Balodis)

15. TRAINING CENTRE
(Head of Centre – Zaiga Blūma)

Appendix 8

REPRESENTATION OF THE BANK OF LATVIA IN INTERNATIONAL ORGANISATIONS

EUROPEAN UNION

ESRB
Ilmārs Rimšēvičs, Governor of the Bank of Latvia (Banking Supervisory Institution is represented by Kristaps Zakulis, Chairman of the FCMC)

Advisory Technical Committee of the ESRB
Zoja Razmusa, Member of the Bank of Latvia's Council (Banking Supervisory Institution is represented by Ludmila Vojevoda, Member of the Council of the FCMC)

EFC
Uldis Rutkaste, Head of Monetary Policy Department
Juris Kravalis, Head of International Relations and Communication Department (Alternate)

EFC's Euro Coin Sub-Committee (ECSC)
Maruta Brūkle, Head of Coin Division, Cash Department

EFC's Sub-Committee on IMF and Related Issues (SCIMF)
Aleksandra Bambale, Deputy Head of International Relations and Communication Department, Head of International Relations and Protocol Division

EBA
Vita Pilsuma, Member of the Bank of Latvia's Council (Banking Supervisory Institution is represented by Kristaps Zakulis, Chairman of the FCMC)

Committee on Monetary, Financial and Balance of Payments Statistics (CMFB)
Agris Caune, Head of Statistics Department
Ilmārs Skarbnieks, Deputy Head of Statistics Department

Eurostat Balance of Payments Committee
Agris Caune, Head of Statistics Department
Ilmārs Skarbnieks, Deputy Head of Statistics Department

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

Public Administration Network (PAN II)
Antra Trenko, Senior Economist of International Relations and Protocol Division, International Relations and Communication Department

EUROPEAN SYSTEM OF CENTRAL BANKS

General Council of the ECB
Ilmārs Rimšēvičs, Governor of the Bank of Latvia

Accounting and Monetary Income Committee (AMICO)
Jānis Caune, Head of Accounting Department, Chief Accountant of the Bank of Latvia
Gatis Gersons, Head of Financial Statements and Accounting Policy Division, Accounting Department

Banknote Committee (BANCO)
Jānis Blūms, Head of Cash Department
Veneranda Kausa, Deputy Head of Cash Department

Financial Stability Committee
Elmārs Zakulis, Deputy Head of Monetary Policy Department
Nataļja Beņkovska, Head of Financial Stability Division, Monetary Policy Department

Appendix 8 (cont.)

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

Human Resources Conference (HRC)
Liene Glāzniece, Head of Personnel Department

Information Technology Committee (ITC)
Harijs Ozols, Member of the Bank of Latvia's Board, Head of Information Systems Department
Valdis Spūlis, Deputy Head of Information Systems Department, Head of Bank Information System Maintenance and Development Division

Internal Auditors Committee (IAC)
Leo Ašmanis, Head of Internal Audit Department
Juris Ziediņš, Deputy Head of Internal Audit Department

International Relations Committee (IRC)
Andris Ruselis, Deputy Governor of the Bank of Latvia
Juris Kravalis, Head of International Relations and Communication Department

Legal Committee (LEGCO)
Ilze Posuma, Member of the Bank of Latvia's Board, Head of Legal Department
Iveta Krastiņa, Deputy Head of Legal Department

Market Operations Committee (MOC)
Raivo Vanags, Member of the Bank of Latvia's Board, Head of Market Operations Department
Harijs Zuļģis, Chief Analyst of Financial Market Operations, Market Operations Department

Monetary Policy Committee (MPC)
Uldis Rutkaste, Head of Monetary Policy Department
Mārtiņš Bitāns, Deputy Head of Monetary Policy Department

Payment and Settlement Systems Committee (PSSC)
Egons Gailītis, Head of Payment Systems Department
Agnija Jēkabsone, Deputy Head of Payment Systems Department

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

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

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

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

Nordic-Baltic IMF Office in Washington
Gundars Dāvidsons, Senior Advisor to the Executive Director of the Nordic-Baltic Constituency of the IMF, Latvia's representative in IMF

Appendix 9

THE BANK OF LATVIA PUBLICATIONS AND MAJOR PUBLICATIONS BY THE BANK OF LATVIA EXPERTS IN 2012

The following Bank of Latvia's publications are available on the Bank of Latvia's website (www.bank.lv). Those prepared in print are available free of charge both at the Bank of Latvia and by mail (unless indicated otherwise and if sufficient number of copies are available) sending a request to the address indicated on the last page of this publication or by e-mailing to: info@bank.lv.

REGULAR PUBLICATIONS

Bank of Latvia: Annual Report 2011
Financial Stability Report (2011)
Latvijas Maksājumu Bilance. Latvia's Balance of Payments. 2011
Macroeconomic Developments Report (January, April, July and October (No. 9–12) 2012)
Payment and Securities Settlement System Oversight Carried out by the Bank of Latvia in 2011

WORKING PAPERS

BEŅKOVSKIS, Konstantīns, WÖRZ, Julia (2012) – *Evaluation of Non-Price Competitiveness of Exports from Central, Eastern and Southeastern European Countries in the EU Market. Latvijas Banka* Working Paper, No. 1.
BUŠS, Ginters (2012) – *A New Real-Time Indicator for the Euro Area GDP. Latvijas Banka* Working Paper, No. 2.
BEŅKOVSKIS, Konstantīns (2012) – *Competitiveness of Latvia's Exporters. Latvijas Banka* Working Paper, No. 3.
AJEVSKIS, Viktors, RIMGAILAITE, Ramune, RUTKASTE, Uldis, TKAČEVS, Oļegs (2012) – *The Assessment of Equilibrium Real Exchange Rate of Latvia. Latvijas Banka* Working Paper, No. 4.
BEŅKOVSKIS, Konstantīns, FADEJEVA, Ludmila, STEHRER, Robert, WÖRZ, Julia (2012) – *How Important is Total Factor Productivity for Growth in Central, Eastern and Southeastern European Countries? Latvijas Banka* Working Paper, No. 5.
BUŠS, Ginters (2012) – *Forecasting and Signal Extraction with Regularised Multivariate Direct Filter Approach. Latvijas Banka* Working Paper, No. 6.

DISCUSSION PAPER

SIŅENKO, Nadežda, TITARENKO, Deniss, ĀRIŅŠ, Mikus (2012) – *Latvian Financial Stress Index. Latvijas Banka* Discussion Paper, No. 1.

PUBLICATIONS

BEŅKOVSKIS, Konstantīns. Competitiveness of Latvia's Exporters (2012) – *Baltic Journal of Economics*, Autumn, pp. 17–29.
BENKOVSKIS, Konstantins, WÖRZ, Julia (2012) – Non-Price Competitiveness Gains of Central, Eastern and Southeastern European Countries in the EU Market. *Focus on European Economic Integration*, Q3, pp. 27–47.
BENKOVSKIS, Konstantins, FADEJEVA, Ludmila, KALNBERZINA, Krista (2012) – Price Setting Behaviour in Latvia: Econometric Evidence from CPI Micro Data. *Economic Modelling*, vol. 29, issue 6, November, pp. 2115–2124.

Appendix 10

2012 HIGHLIGHTS OF RESOLUTIONS AND REGULATIONS ADOPTED IN PURSUIT OF THE BANK OF LATVIA'S MAIN TASKS

Regulatory document	No.	Date of adoption (effective date)	Title of the regulatory document adopted by the Bank of Latvia's Council
Regulation	84	19.01.2012 (24.01.2012)	"Minimum Reserve Ratio"
Regulation	85	15.03.2012 (24.03.2012)	"Interest Rates on Transactions"
Regulation	86	15.03.2012 (24.04.2012)	"Regulation for Calculating and Fulfilling the Minimum Reserve Requirements for Credit Institutions"
Regulation	87	25.05.2012 (07.06.2012)	"Amendment to the Bank of Latvia Regulation No. 38 'Description of Lats Banknotes and Coins' of 13 May 2009"
Regulation	88	25.05.2012 (01.06.2012)	"Amendments to the Bank of Latvia Regulation No. 36 'Regulation for Purchasing and Selling Cash Foreign Currency' of 13 May 2009"
Recommendations	89	25.05.2012 (01.06.2012)	"Amendments to the Bank of Latvia Recommendations No. 37 'Recommendations to Capital Companies that Have Received a Licence Issued by the Bank of Latvia for Purchasing and Selling Cash Foreign Currencies for Developing an Internal Control System for the Prevention of Laundering the Proceeds from Criminal Activity (Money Laundering) and of Terrorist Financing' of 13 May 2009"
Regulation	203/3	25.05.2012 (29.05.2012)	"Amendment to the Bank of Latvia's Council Regulation No. 183/3 'Regulation for the Participation Procedure in the Bank of Latvia's Electronic Clearing System' of 9 September 2010"
Regulation	203/4	25.05.2012 (01.06.2012)	"Amendments to the Bank of Latvia's Council Regulation No. 195/10 'Regulation for the Participation Procedure in the Lats Cash Transactions at the Bank of Latvia' of 13 July 2011"
Regulation	90	12.07.2012 (24.07.2012)	"Interest Rates on Transactions"
Regulation	91	12.07.2012 (18.07.2012)	"Amendments to the Bank of Latvia Regulation No. 66 'The Amount of and the Payment Procedure for the Fees to be Paid for the Use of the Credit Register' of 4 November 2010"
Regulation	92	13.09.2012 (24.09.2012)	"Interest Rates on Transactions"
Regulation	93	13.09.2012 (01.12.2012)	"Regulation for the Credit Register of the Bank of Latvia"
Regulation	94	13.09.2012 (01.12.2012)	"Regulation for Electronic Exchange of Information with the Bank of Latvia"
Regulation	95	13.11.2012 (04.12.2012)	"Amendment to the Bank of Latvia Regulation No. 38 'Description of Lats Banknotes and Coins' of 13 May 2009"
Regulation	207/1	13.12.2012 (01.01.2013)	"On Amendments to the Bank of Latvia's Council Regulation No. 186/4 'Regulation for the Participation Procedure in TARGET2-Latvija' of 4 November 2010"

Appendix 11

GLOSSARY

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

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

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

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

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

Central government: public institutions, including ministries, embassies, representative offices, agencies, councils, educational, healthcare, law enforcement, cultural and other public institutions whose competence covers the whole economic territory of the country. The list of the institutional units of the Latvian central government is prepared in accordance with the requirements of ESA 95 by the CSB.

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

Concentration ratio: market share of the five largest senders of payment messages in each payment system in terms of the total volume and value of transactions. The five largest senders in terms of the volume of payment transactions may be different from the five largest senders in terms of the value of payment transactions. The concentration ratio of the Bank of Latvia's payment systems includes also the Bank of Latvia's transactions.

Credit institutions: capital companies whose business is to receive deposits or other repayable funds from the public and to grant credits on its own account and provide other financial services. Latvian credit institutions are included in the List of Monetary Financial Institutions of the Republic of Latvia (see the Bank of Latvia's website (www.bank.lv), section *Statistics*).

Credit risk: a risk to incur losses as a result of a counterparty default.

Debt securities: securities representing an obligation and a promise on the part of the issuer to make one or more payment(s) to the holder of the securities at a specified future date or dates (e.g. bonds, notes). Such securities usually carry a specific rate of interest (the coupon) or are sold at a discount to the amount that will be repaid at maturity. Short-term debt securities are debt securities issued with an original maturity of up to one year (inclusive). Long-term debt securities are debt securities issued with an original maturity of over one year.

Appendix 11 (cont.)

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

Deposit facility: a standing facility enabling credit institutions registered in the Republic of Latvia to make overnight deposits and 7-day deposits with the Bank of Latvia on their own initiative.

Deposits redeemable at notice: cash assets deposited with an MFI without any specified maturity, with the possibility of withdrawing on demand either subject to notifying the MFI within an agreed period of notice or subject to payment of a substantial penalty.

Deposits with an agreed maturity: cash assets deposited with an MFI that cannot be withdrawn prior to maturity or can be withdrawn only subject to payment of a small penalty. This category also encompasses some non-marketable debt instruments, such as non-marketable (retail) certificates of deposit.

Direct investment: investment (net transactions and outstanding amounts) made by a foreign investor (direct investor) in order to obtain a lasting interest (ownership of at least 10% of the ordinary shares or voting power) in a Latvian commercial company (direct investment 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. Direct investment implies long-term relationship between a direct investor and direct investment company. Direct investor can be either natural or legal person.

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 process that led to the introduction of the single currency, the euro, and the single monetary policy in the euro area, as well as to the coordination of the economic policies of the EU Member States. This process, as laid down in the Treaty on the Functioning of the European Union, took place in three stages. Stage Three, the final stage, 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 of setting up the EMU.

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

Euro area: EU countries which have adopted the euro as their single currency in accordance with the Treaty on the Functioning of the European Union and in which a single monetary policy is conducted under the responsibility of the Governing Council of the ECB. As at the end of 2012, the euro area comprised Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

European Banking Authority (EBA): an EU body with legal personality which is a part of the EFSF. The objective of the EBA is to protect the public interest by contributing to the short-, medium- and long-term stability and effectiveness of the financial system, for the EU economy, its citizens and businesses. The EBA comprises a Board of Supervisors, a Management Board, a Chairperson, an Executive Director and a Board of Appeal.

European Central Bank (ECB): the central institution of the ESCB and the Eurosystem having a legal personality under the EU law. The ECB implements the tasks conferred upon the Eurosystem and the ESCB pursuant to the Statute of the ESCB and ECB in cooperation with the central banks of the EU Member States. The ECB is governed by the Governing Council and the Executive Board, and, until all EU Member States adopt the euro, by a third decision-making body, the General Council.

European System of Central Banks (ESCB): includes the ECB and the national central banks of the EU Member States. The national central banks of those EU Member States that have not yet adopted the euro implement an independent monetary policy according to their national law and are thus not involved in the conduct of the monetary policy of the Eurosystem.

European Systemic Risk Board (ESRB): an independent body of the EU which forms part of the ESFS. The ESRB is responsible for the macro-prudential oversight of the financial system within the EU in order to contribute to the prevention or mitigation of systemic risks to financial stability in the EU that arise within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress. It contributes to the smooth functioning of the internal market and thereby ensures a sustainable contribution of the financial sector to economic growth. The ESRB has a General Board, a Steering Committee, a Secretariat, an Advisory Scientific Committee and an Advisory Technical Committee.

European System of Financial Supervision (ESFS): comprises ESRB, EBA, European Insurance and Occupational Pensions Authority, European Securities and Markets Authority, Joint Committee of the European Supervisory Authorities and the supervisory authorities in the EU Member States. The main objective of the ESFS is to ensure that the rules applicable to the financial sector are adequately implemented to preserve financial stability and to ensure confidence in the financial system as a whole and sufficient protection for the customers of financial services.

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

Exchange rate mechanism II (ERM II): the exchange rate mechanism that ensures the framework for exchange rate policy cooperation between the euro area countries and the non-euro-area EU Member States. ERM II is a multilateral agreement on fixed, albeit adjustable central rates with a standard fluctuation band of ±15%. The decisions on the central rates and, potentially, on narrower fluctuation bands are taken by an agreement between the respective EU Member State, euro area Member States, ECB and other EU Member States participating in the mechanism. Participation in the ERM II is a pre-condition for an EU Member State to become a fully-fledged member of the EMU and implement the euro. As at the end of 2012, Denmark, Latvia and Lithuania were members of the 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 corporations and the financial market. The FCMC, NASDAQ OMX Riga, the LCD, insurance brokerage companies, capital companies engage in cash buying and selling of foreign currencies as well as investment management corporations are regarded as financial auxiliaries.

Appendix 11 (cont.)

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

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

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

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

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

General government: public institutions engaged in production of non-market goods or provision of services intended for individual or collective consumption, or public institutions engaged in redistribution of national income or wealth. General government in the Republic of Latvia includes central government and local government. The list of the institutional units of the Latvian central government is prepared in accordance with the requirements of ESA 95 by the CSB.

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

Households: natural persons or groups of natural persons as consumers and producers of goods and non-financial services exclusively for their own final consumption. Sole proprietors are also regarded as households in Latvia provided that they have not registered their activity with the Commercial Register of the Enterprise Register of the Republic of Latvia.

International investment position: a statistical statement reflecting the value and composition of Latvia's financial claims ("Assets") on and financial obligations ("Liabilities") to the rest of the world respectively, at a specified date, as well as reasons for changes in the outstanding amounts in the respective time period. Changes in the outstanding amounts may occur as a result of net flows (balance of payments data), exchange rate changes, price changes, and other adjustments (mainly due to various reclassifications in the system of information provider, debt capitalisation, etc). Investment under international investment position is classified into assets and liabilities. Both assets and liabilities include direct investment, portfolio investment, financial derivatives, and other investment, while assets include also reserve assets.

Appendix 11 (cont.)

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

Liquidity risk: a risk of finding it difficult to fulfil obligations arising from financial liabilities settled in cash or using another financial asset.

Local government: public institutions, whose competence covers only a local economic territory. The list of the institutional units of the Latvian central government is prepared in accordance with the requirements of ESA 95 by the CSB.

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

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

M1: narrow monetary aggregate calculated on the basis of the ECB methodology and comprising the lats banknotes and coins issued by the Bank of Latvia (less vault cash of MFIs) and overnight deposits in lats and foreign currencies held with MFIs by resident financial institutions, non-financial corporations, households, 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 monetary 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 financial institutions, non-financial corporations, households and non-profit institutions serving households. M2X incorporates deposits made by local governments as a net item on the demand side.

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

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

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

Appendix 11 (cont.)

Market operations: financial market operations initiated by the central bank. The Bank of Latvia's market operations fall into four categories used by the Eurosystem: main refinancing operations, longer-term refinancing operations, structural operations and fine-tuning operations. The main instruments of the Bank of Latvia's market operations are reverse transactions. Outright transactions are available for the conduct of structural operations, whereas outright transactions, foreign exchange swaps and time deposits are available for the conduct of fine-tuning operations.

Market risk: the risk to incur losses as a result of adverse changes in financial market factors (e.g. interest rates or exchange rates).

Minimum reserve requirements: requirements for credit institutions registered in the Republic of Latvia to hold an amount of reserves compliant with the reserve ratio with the Bank of Latvia.

Monetary financial institutions (MFIs): credit institutions, credit unions, electronic money institutions, money market funds and other financial corporations whose business is to receive deposits or close substitutes for deposits from customers other than MFIs and, on their own account, to grant credits and invest in securities, as well as the national central bank. The Bank of Latvia compiles, maintains and regularly updates the List of Monetary Financial Institutions of the Republic of Latvia (see the Bank of Latvia's website (www.bank.lv), section *Statistics*). The list is also available on the ECB website where the ECB publishes the "List of MFIs of the EU Member States" on a regular basis. At the end of 2012, Latvia's MFIs were: the Bank of Latvia, 29 credit institutions, two money market funds and 40 other MFIs (including 34 credit unions and six electronic money institutions).

Non-financial corporations: economic entities producing goods or providing non-financial services with the aim of gaining profit or other yield. In the Republic of Latvia, sole proprietorships registered with the Commercial Register of the Enterprise Register of the Republic of Latvia are also regarded as non-financial corporations. Non-financial corporations may be both public and private. Public non-financial corporations are non-financial corporations where the government owns more than 50% of the capital or voting rights, or where they exercise direct or indirect control.

Non-profit institutions serving households: non-profit institutions that provide goods and services to natural persons or groups of natural persons and that derive resources mainly from voluntary contributions in cash or kind, from payments made by general governments and from property income. Such institutions are, for instance, trade unions, professional or educational associations, consumer associations, political parties, churches, religious communities as well as culture, recreation and sports clubs, charity, support and aid organisations.

Operational risk: the risk of incurring financial and non-financial losses as a result of inadequate or failed business processes, people's actions, information or operation of a technical system, or the impact of external circumstances.

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

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

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

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

Portfolio investment: investment (net transactions and positions) made by residents of Latvia in securities issued by residents of other countries ("Assets") and by residents of other countries in securities issued by residents of Latvia ("Liabilities"). Portfolio investment is made with the purpose of increasing the investment value or earning dividends or interest, without directly influencing the management of the company. Portfolio investment includes the short-term and long-term financial instruments. Financial instruments included under portfolio investment are freely tradable on securities market. In the balance of payments, portfolio investment is classified based on the type of financial instrument: into equities and debt securities (bonds and notes, money market instruments).

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

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

Reserve holdings: money holdings of credit institutions registered in the Republic of Latvia with the Bank of Latvia serving to fulfil reserve requirements.

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

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

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

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

Appendix 11 (cont.)

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

SEPA (Single Euro Payments Area): a project to harmonise the way retail payments in euro are made, making payments in euro across European countries as fast, secure and effective as domestic payments. SEPA enables consumers, businesses and other economic agents to make both domestic and cross-border payments in euro on the same main terms and conditions, with the same rights and obligations, regardless of their location. As at the end of 2012, SEPA encompassed all EU Member States, Iceland, Liechtenstein, Monaco, Norway and Switzerland.

Standing facility: a central bank facility available to counterparties on demand. The Bank of Latvia offers two standing facilities to credit institutions registered in the Republic of Latvia: marginal lending facility and deposit facility.

TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system): the Eurosystem's real-time gross settlement system for the euro. The first generation TARGET system was replaced by TARGET2 in May 2008.

TARGET2: the second-generation TARGET system. It settles payments in euro in central bank money and functions on the basis of a single IT platform, to which all payment orders are submitted for processing.

TARGET2-Latvija: a component system of TARGET2 in Latvia. Its operation is ensured by the Bank of Latvia in conjunction with other central banks of the ESCB.

TARGET2-Securities: the Eurosystem's single technical platform enabling central securities depositories and national central banks to provide core, borderless and neutral securities settlement services in the central bank money in Europe.

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

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