LATVIJAS BANKA

BANK OF LATVIA: ANNUAL REPORT 2004

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Fragments of the painting *Alchemy* by Frančeska Kirke have been used in the design.
Photos by Gunta Andersone and Indriķis Stūrmanis.

Details may not add because of rounding-off.

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ABBREVIATIONS

BIS	Bank for International Settlements
CEBS	Committee of European Banking Supervisors
CIF	Cost, insurance and freight at the importer's border
CIS	Commonwealth of Independent States
CSBL	Central Statistical Bureau of Latvia
EC	European Commission
ECB	European Central Bank
EFC	Economic and Financial Committee
EKS	Electronic Clearing System
EMU	Economic and Monetary Union
ERM II	Exchange Rate Mechanism II
ESCB	European System of Central Banks
EU	European Union
EU15	EU countries prior to enlargement of May 1, 2004
FCMC	Financial and Capital Market Commission
FOB	Free on board at the exporter's border
FRS	Federal Reserve System
GDP	Gross Domestic Product
IBAN	International Bank Account Number
IMF	International Monetary Fund
ISO	International Organization for Standardization
JSC	Joint Stock Company
LCD	Latvian Central Depository
M0	Monetary base
M2D	Domestic money supply
M2X	Broad money
MFI	Monetary Financial Institution
NATO	North Atlantic Treaty Organisation
OECD	Organisation for Economic Cooperation and Development
Plc	Public limited company
RIGIBOR	Riga Interbank Offered Rate
SAMS	Interbank Automated Payment System
SDR	Special Drawing Rights
SJSC	State Joint Stock Company
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
US	United States of America
VAT	Value Added Tax

FOREWORD OF THE GOVERNOR

Year 2004 was a time when Latvia became a member of NATO and joined the European Union. These achievements created new stimuli for the growth of the Latvian economy and marked the beginning of the transition to the single European currency. As the Bank of Latvia joined the family of the EU central banks, its experts became full members of the respective ESCB committees and working groups, and as Governor of the Bank of Latvia I am now involved in the work of the ECB General Council.

In 2004, growth in the global economy moderated, the US dollar and the euro were highly volatile, and oil prices rose, triggering consumer price increases. The Federal Reserve System raised its federal fund rate, whereas the ECB maintained key interest rates at a historically low level.

GDP growth in Latvia was buoyant and supported by strong domestic demand and expansion of exports in 2004. The first half of the year was marked by a steep rise in consumer prices whose elevation was unprecedented for Latvia, with the annual average inflation standing at 6.2%. Banks substantially increased lending to financial institutions, non-financial corporations and households. The robust domestic demand and purchases of capital and investment goods triggered an increase in imports, which determined a pick-up in the current account deficit. On several occasions, the Bank of Latvia called on the Government to revise the budget deficit target downwards and it was accomplished via tighter fiscal policy pursued by the Government.

Monitoring possible financial risks, the Bank of Latvia engaged in financial stability assessments on a regular basis. In July, the international rating agencies *Fitch Ratings* and *Standard & Poor's* positively evaluated the stability of the Latvian economy and the favorable environment for investments, assigning a higher rating (raising it from BBB+ to A–) for Latvia's long-term liabilities in foreign currencies and maintaining an overall positive outlook.

The analysis of Latvia's macroeconomic indicators and development trends pointed to the need for the Council of the Bank of Latvia to make monetary policy decisions aimed at supporting a balanced long-term development of the economy and regulating the domestic demand. The Council raised the refinancing rate by 50 basis points on two occasions, in March and November, increased the reserve requirement for banks by 1.0 percentage point in July, and expanded the reserve base to include more bank liabilities in November.

For the purpose of providing the economic agents with better conditions for adjustment, the Bank of Latvia released information about the lats repeg from the SDR basket of currencies to the euro towards the close of 2003. On December 30, 2004, the peg rate (EUR 1 = LVL 0.702804) was set in accordance with the effective exchange rate formula of the SDR basket of currencies. This was another step towards Latvia's full-fledged participation in the Economic and Monetary Union.

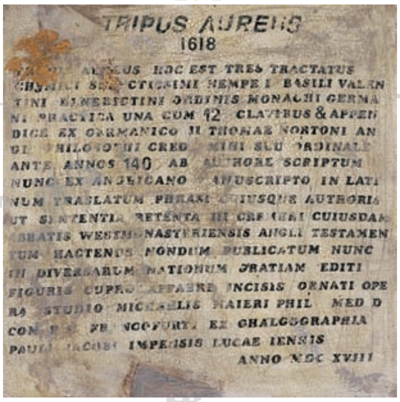
By the closing date of the competition for euro coin designs the Bank of Latvia, which organised the competition, received more than a thousand proposals. The winner of the competition was the proposal under the motto "Freedom – a European Value!" submitted by Ilze Kalniņa from Jēkabpils. The motifs of this proposal – the Freedom Monument, the Latvian maiden once featured on the silver 5 lats coin, and the coat of arms of the Republic of Latvia are representative of Latvia and its basic values. These laconic and explicit images will be displayed on Latvia's future coins and will help promote the recognisability of Latvia across the globe.

The Bank of Latvia took care of quality checking of the lats banknotes and coins, enabling banks to obtain high quality money notes from the Bank of Latvia branches. In 2004, the Bank of Latvia put into circulation three silver commemorative coins (*Vidzeme*, *Latgale* and *Latvia – EU. 2004*), the first bimetal (silver and niobium) commemorative coin of Latvia, *Coin of Time*, and two special 1 lats coins of limited circulation (*Mushroom* and *Sprīdītis*).

For the Bank of Latvia, the promotion of public awareness of the operational and decision-making activities of the central bank as well as the growth of the Latvian economy has always been of the utmost importance. In order to attain this goal, the Bank of Latvia used publications, the Internet, press, TV and radio as well as press conferences. A modern centre of financial education and information – the "Money World" has opened in the former vault area of the Bank of Latvia's central building. The main aim of the visitors' center is to help the public become better informed about the tasks and the operation of the central bank, its place within the ESCB, and the Bank of Latvia central building, which is a hundred-year old architectural monument of national significance. With the aim to promote research of topical financial and economic aspects by would-be economists, the Bank of Latvia announced, for the second consecutive year, a research paper competition for students of the Latvian universities. The conference "Latvian Economy within the European Union: Opportunities, Challenges and Perspectives" held by the Bank of Latvia in September 2004 addressed the issues of economic development trends and objectives for economic agents in the process of Latvia's integration with the EU and participation in the Economic and Monetary Union.

I would like to express my deepest gratitude to the Council and Board of the Bank of Latvia for a successful management of the Bank of Latvia's activities and to each and every employee for their contribution to the implementation of Bank's tasks. What has already been achieved forms a solid basis for progress in the future.

Ilmārs Rimšēvičs
Governor, Bank of Latvia
Riga, March 2005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THE NATIONAL ECONOMY AND THE BANK OF LATVIA'S MONETARY POLICY

GLOBAL ECONOMIC ENVIRONMENT

In 2004, the global economy developed successfully. Countries in Asia saw a particularly robust ongoing economic growth, and the US economy continued to strengthen at a rapid pace. Despite evident indications of progress, growth in the euro area economies remained moderate, while the Japanese economic growth rate was losing momentum.

With geopolitical imbalances in the world growing, uncertainties in the financial markets also aggravated. This was evidenced by more sizeable investments in less risk-exposed securities by market participants. Year 2004 was less successful for the global stock markets than 2003. The rising oil prices and uncertainties regarding the outlook for future economic development of the US and European countries had a negative influence on stock markets. The development of the US stock market was dampened by the US FRS raising the base rate. The US stock market index S&P 500 increased by 9%, the more liquid stock index DJIA went up by only 4%, and NASDAQ, the index for technology corporations, picked up 8%. The European stock market index Dow Jones EURO STOXX 50 increased by 6%. At the same time, stock exchanges in Asia recorded unstable developments, and considerable volatility was also typical for Russia's stock market.

In mid-2004, an increase in yields on fixed-income securities was recorded. The demand for fixed-income securities of European countries strengthened in the fourth quarter with shrinking yields on these securities as an indication of it. In 2004, the US and the German government 10-year bond yield rates declined from 4.3% to 4.2% and from 4.3% to 3.7%, respectively.

The substantial rise in oil prices on the global market was one of the central events in 2004. At the beginning of the year, oil prices rose slightly above 32 US dollars per barrel, but in spring they increased more markedly, by 30% on average, and remained at this level for some time. Uncertainties in the global oil market became more pronounced in the second half of the year when, due to a variety of factors, oil prices leaped to a historical high, exceeding 56 US dollars per barrel. The depreciation of the US dollar against several major world currencies was also significant; it was primarily associated with growing uncertainties regarding the large US current account deficit and potential global imbalances that were likely to increase under the pressure of sustained negative developments of the US current account. The most substantial depreciation of the US dollar was observed in the fourth quarter, and the appreciation of the euro against the US dollar was historically the strongest during the closing days of the year.

In the year of the presidential election, US economic growth proceeded at a brisk pace, with GDP increasing by 4.4%. Private consumption and larger investments were the principal drivers behind this GDP growth; by contrast, the contribution of net exports to GDP was negative, as a result of robust expansion of imports. Growth in imports outpaced that in exports despite a sizable depreciation of the US dollar over the last several years, which should have promoted an expansion of US exports and enabled the US exporters to penetrate into new markets. With imports strengthening notably, the US current account deficit accounted for 6% of GDP. The resulting situation poses a downward risk for continued economic development not only in the US but also elsewhere in the world, on account of the former's significance in the global economy. The US labour market conditions improved, as new jobs were created, giving a certain momentum to private demand. A moderate deceleration of the economic activity took place during the summer season, with GDP growth rate slowing down to 3.3% in the second quarter, but picking up again in the second half of the year (4.0% and 3.8% in the third and fourth quarters, respectively).

Taking into account the ongoing economic development, the FRS raised the federal funds rate, which had been maintained at a historical low (1%) for a comparatively long time, by a total of 125 basis points (to 2.25% at the end of the year) in five successive 25 basis point steps.

Though the strengthening of economic activity in the euro area had been sustainable since the second half of 2003 and continued in 2004, GDP picked up but moderately (1.8%). At the beginning of the year, economic activity was supported by the favourable external environment, which triggered expansion of exports in the euro area. In the second quarter, oil price hikes gave rise to concern about a less positive outlook for further growth; nevertheless, export growth continued to drive GDP growth. In the second half of the year, economic activity in the euro area reversed again due to the high oil prices and a sizable appreciation of the euro. Despite some signs pointing to improvements in the private demand, year 2004 did not yet see a substantial upturn that could transform the domestic demand into a GDP driver. Of the three largest and major economies of the euro area, the economic performance was the strongest in France, with GDP growing by 2.1% (primarily as a result of an increase in private consumption). In Germany, GDP picked up 1.7%, which was a notable improvement over the previous year when a downward GDP trend was recorded. This upturn occurred thanks to a positive contribution of net exports with growth in exports outpacing that in imports. GDP increased by 1.2% in Italy.

In 2004, inflation in the euro area stood at the level of the previous year (2.1%). It was below the ECB reference value of 2% at the beginning of the year, but starting with the second quarter, it reversed primarily due to an increase in administratively regulated prices and indirect taxes. In the second quarter, inflation remained above the 2% level also due to the pick-up in the global oil prices. The ECB, nevertheless, left the main refinancing rate unchanged at the historically low level of 2%, as the domestic pressure on inflation was contained and the outlook for price stability in the medium term seemed favourable.

In the second half of 2004, Japan went through a period of decelerating economic growth; nevertheless, owing to robust growth in the first half of the year, GDP for 2004 as a whole recorded a 2.7% pick-up. The end-of-the-year deceleration was mainly a result of a less pronounced expansion of exports, formerly the most important contributor to growth, and a shrinking private demand due to a decrease in the income of households and negative effects of unfavorable weather conditions.

In the countries of Central and Eastern Europe, the strong increase in economic activity that had started in the previous year continued in 2004. The pace of GDP growth picked up in almost all countries except Lithuania. Economic activity was mainly driven by strengthening domestic demand and export growth. The Czech Republic, Hungary, Poland, Slovakia, Slovenia, Estonia, Lithuania and Latvia joined the EU on May 1. Accession to the EU facilitated the development in these countries, with growth rates in the Baltic States remaining above the region's average.

In line with sustained economic growth in Western Europe, industrial production strengthened also in the new EU Member States. Sectors producing goods for exports recorded the strongest growth. The shifting of resources (capital and labour) from the industrial production sector to the services sector became more pronounced. Poland recorded an annual 13.1% increase in industrial output, the best performance over last seven years. Inflows of foreign direct investment brought about a substantial expansion of production also in Hungary. Lithuania registered the most rapid increase in manufacturing, trade and repair of transport vehicles, whereas trade and construction were the most buoyant sectors in Estonia. The new EU Member States benefited from an ample inflow of foreign direct investment (Slovakia, Hungary and Lithuania in particular), with funds primarily channeled into the services sector, except in Lithuania where a substantial part of foreign direct investment went also to industry.

Export growth was strong in all Central and East European countries, particularly in Poland and the Czech Republic. Regarding Estonian exports, a better balance between export markets and commodity groups was achieved. In 2003, exports were mainly driven by goods that were produced by new and unconventional industries (manufacture of chemicals, chemical products and man-made fibers, and metals), whereas an increase in the share of traditional export commodities (wood and articles of wood, and dairy products) in total exports was characteristic of 2004. Despite substantial increases in exports, large current account deficits continued to weigh on the economies of the Baltic States and Hungary.

Following a consumer price rise in mid-2004 as a result of the accession of Central and East European countries to the EU and oil price hikes, inflation had stabilised by the end of the year, except in Lithuania and Estonia where in the fourth quarter it was higher than in the previous periods. The increase in inflation in the latter two countries was determined by prices in other Central and East European countries where they were higher previously as well, whereas convergence with the EU prices was more characteristic of the Baltic States. Nevertheless, inflation in Lithuania was still the lowest among the EU countries.

Although unemployment continued to shrink in all Central and East European countries, except Hungary, it remained at a relative high. The recovery of the economy was supported by a gradual emergence of new jobs, with shortages of highly-qualified labour force still figuring as a problem for several countries. Poland recorded the highest unemployment rate in the EU (19.1% at the end of the year).

In 2004, the minimum wage and salary was increased in Lithuania, Slovakia and Slovenia. Although in Lithuania this increase was the most substantial (16.0%), the minimum wage and salary there continued to rank among the lowest in Central and East European countries.

Price rises made several countries tighten their monetary policies. The Czech Republic and Poland resolved to increase interest rates, whereas in Slovakia the ongoing reduction of the latter was continued in order to prevent the appreciation of the national currency.

Lithuania, Estonia and Slovenia made the initial step towards full participation in the EMU and the introduction of the single European currency, the euro, and joined the ERM II in June 2004.

Higher-than-projected budget revenues in Central and East European countries notwithstanding, deficits in their budgets (except the Baltic States and Slovenia) increased compared with the previous year, exceeding 3% of GDP. Poland and Hungary recorded poorer fiscal positions; therefore the EU issued warnings to these countries concerning excessive budget deficits and inappropriate management of fiscal policies.

Lending in Central and East European countries developed buoyantly and was supported by both competition policies (banks lowered interest rates with the aim to capture larger market segments) and strengthening of the domestic market.

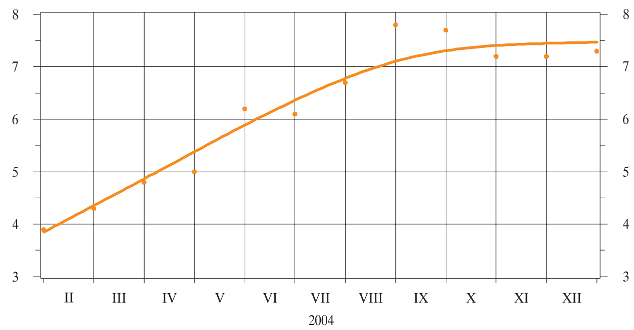
In Russia, GDP increased by 7.1% in 2004. The dynamic economic growth was mainly driven by an expansion of exports and rise in global oil prices, which considerably pushed up income from oil exports. Compared with 2003, Russia increased its crude oil exports (including oil transit) by 16.3%, and the income from these exports grew by 38.7%. With household consumption strengthening, the contribution of domestic demand to economic growth increased. Investment grew at a sufficiently high pace, yet compared with the steep acceleration of the previous year the pace slowed down due to increasing capital outflows, weakening corporate investment (mainly in fuel production) and contained financial sector's lending to the real sector. The annual average inflation continued to be high (11.6%). Opposite to earlier projections, the dynamics of a number of macroeconomic indicators became weaker towards the end of the year, political uncertainties strengthened and the pace of the ongoing reform process decelerated.

INFLATION AND PRICES

In 2004, the annual average inflation in Latvia was 6.2%, with prices for consumer goods rising at a faster pace (6.5%), but those for services increasing by 5.6% on average. Annual consumer price inflation was 7.3% (see Chart 1). Inflation was primarily affected by supply side factors, i.e. price rises associated with costs and structural adjustments, and a number of specific factors, e.g. poor harvests and unfavourable weather conditions. However, contrary to previous years, the demand side factors also slightly affected price volatility.

Chart 1

CHANGES IN THE CONSUMER PRICE INDEX
(year-on-year basis; %)



Source: CSBL.

Administratively regulated prices rose notably in January. They were primarily driven by higher electricity tariffs for households (by 15% on average). Tobacco product prices went up as a result of an increase in the excise tax. As Latvia joined the EU, legislative amendments establishing a broader basis for VAT, higher excise on fuel (which, combined with oil price hikes, caused an over 20% rise in fuel prices), and the exclusion of mandatory civil liability insurance of land vehicle owners from the basket of regulated prices became effective as of May 1. As a result, the overall contribution of insurance service prices to annual inflation reached 0.3 percentage point in some months.

Prices for food products, dairy products and bread in particular, had already recorded a notable pick-up in the first quarter due to an increase in purchase and producer prices. Food prices continued on an upward trend also in the second and third quarters when poor fruit and vegetable yields, as well as unfavourable weather conditions during the harvesting season fueled the rise. As a result, seasonal price moderations were not observed in July and August, and the annual inflation strengthened substantially in August, reaching the highest level (7.8%) since 1997.

Under the impact of rising food prices and other costs, catering services became markedly more expensive in the second half of the year (at the end of 2004 gaining 10.6% year-on-year). Growing costs caused an increase in other services prices (primarily personal grooming services), education and tourism services.

The appreciation of the euro in 2004 was not as strong as in 2003, hence the pass-through of exchange rate changes to consumer prices became less pronounced.

In 2004, pressures on inflation from the demand side, which in the second quarter were stemming from the people's inflation expectations associated with the EU accession, gradually became apparent; however, the spillover effects of the growing private income were also felt.

In 2004, the average monthly gross wage and salary and the average monthly net wage and salary of persons employed in the national economy were LVL 211.06 and LVL 150.35, respectively. Compared with the previous year, the average gross wage and salary increased by 9.6%, and the average net wage and salary rose by 8.9%. The rise in wages and salaries exceeded the annual inflation rate; hence year-on-year, the real gross wage rose by 3.2% and the real net wage by 2.5%.

Consumer price core inflation in the year as a whole reached 5.9% on average and accounted for 4.2 percentage points of total inflation; the pick-up in administratively regulated prices and unprocessed food prices pushed total inflation up by 0.9 and 0.5 percentage points, respectively.

Fuel and metal price rises in the global market triggered an increase in producer prices. Compared with the previous year, the producer price index in production went up by 8.6% on average in 2004 (the strongest increase since 1996). The most sizable price rise was registered for manufacture of metals (27.9%), fabricated metal products, excluding machinery and equipment (14.6%), and electricity, gas, steam and hot water supply (9.6%). By contrast, producer prices in manufacture of chemicals, chemical products and man-made fibers dropped 2.4%.

Metal price rise and wage and salary growth also caused an increase in the construction cost index (by 6.4% on average as compared with the previous year).

The export unit value and the import unit value displayed strong increases in 2004. The former picked up 13.4% (7.9% in 2003), and the price rises for all commodities dominating exports were substantial (13.1% for wood and articles of wood, 28.5% for base metals and articles of base metals, 9.9% for textiles and textile articles, 7.4% for machinery and mechanical appliances, electrical equipment, and 18.9% for the output of food industry). Price rises and expanding volumes equally contributed to the strengthening of overall exports. The import unit value grew by 8.1% (by 6.9% in 2003). The increase was driven by the strong growth of prices for mineral products (24.0%), base metals and articles of base metals (20.1%), transport vehicles (8.8%) and agricultural products and foodstuffs. Prices dropped only for machinery and mechanical appliances, electrical equipment (1.2%). The expanding volume accounted for two thirds and the rising prices for one third of the overall import growth. With export unit value growing at a faster pace than the import unit value, terms of trade improved noticeably (by 5.0%), resulting in a more sizable income from exports.

GROSS DOMESTIC PRODUCT

In 2004, the robust economic growth of Latvia was supported by the strong domestic and rising foreign demand. In terms of current prices, GDP amounted to 7.4 billion lats, with real GDP exceeding last year's indicator by 8.5% (see Table 1).

Table 1

GROSS DOMESTIC PRODUCT AND GROSS VALUE ADDED
(at constant prices; year-on-year basis; %)

	2002	2003	**2004**
GDP	6.1	7.5	**8.5**
Goods-producing sector	7.0	8.4	**7.9**
Service sector	5.9	7.0	**8.7**

Source: CSBL.

The growth rate of the goods sector slightly fell behind that of the services sector. This was primarily determined by moderating growth in manufacturing in the second half of the year; nevertheless, the real growth in the sector's contribution to gross value added reached 7.9%. Construction, the second major branch of the goods sector, posted a notably more robust growth (13.0%), which was fostered by the extremely strong domestic demand for the output of this sector.

The upturn in construction, in turn, fueled the domestic demand for the output of a number of manufacturing sectors. Manufacture of non-metallic mineral products (a 12.4% rise), fabricated metal products (except machinery and equipment; a 5.0% rise), and rubber and plastic products (15.1%) accelerated. Growth in manufacturing of food products and beverages (6.5%) was also primarily driven by the domestic demand.

The external demand triggered the strengthening of real production output in such branches as manufacturing of wood and products of wood and cork (5.9%), fabricated metal products (except machinery and equipment; 8.1%), clothing (5.9%), radio, television and communication equipment and apparatus (18.3%), as well as some other branches.

The second half of the year saw growth increasing in a number of major branches, as a result of which an overall 8.7% increase in the services sector was recorded for 2004. Trade developed buoyantly, with retail trade turnover (including sale of motor vehicles and retail trade in automotive fuel) posting a 14.1% pick-up in 2004. This rapid growth was mainly a result of an increase in the volume of automotive fuel and food product sales. Retail trade turnover in automotive fuel increased by 24.1% and was driven by fuel price rises and an increase in the number of purchased cars in the first quarter. At the same time, the sales volume of food products, the largest commodity group, picked up 11.3%.

The development of a number of other branches – transport, storage and communication (12.9%), real estate, renting and business activities (7.4%), financial intermediation (8.3%), as well as several others – was significant. Regarding the transport, storage and communication sector, growth was observed in all freight transit sub-sectors. Transit cargoes transported by rail picked up 5.7% year-on-year, and a record high total freight volume was registered. Compared with the previous year, the volume of diesel oil transported via the oil product pipeline increased by 21.9%. In 2004, freight turnover at Latvian ports expanded by 4.8%.

Despite the buoyant economic activity in 2004, the number of the unemployed registered with the State Employment Agency increased slightly (to 8.8% of the total economically active population; 8.6% in 2003). The rise in the unemployment rate was mainly driven by a more active registration of the unemployed with the State Employment Agency and lay-offs by several fish processing companies associated with output sales problems in the first half of the year. Stronger activity of the unemployed was observed mainly due to an offer of more extensive wage labour and training opportunities. It particularly affected the unemployment rate in the summer season when, as a rule, registration rate is sluggish.

The dynamics of the unemployment/vacancy ratio (the number of the unemployed to job vacancies) reflects the more extensive employment opportunities. The average unemployment/vacancy ratio was 27.4 in 2003 and 19.9 in 2004, notwithstanding the increase in the monthly average number of the registered unemployed by 1.9 thousand (to 93.1 thousand). More positively, the share of the long-term unemployed in the total number of the unemployed was gradually contracting (to 25.9% on average; 26.5% on average in 2003).

FOREIGN TRADE AND THE BALANCE OF PAYMENTS

Latvia's foreign trade turnover reached 5 898.9 million lats in 2004. In comparison with 2003, exports of goods increased by 29.1% and imports of goods by 26.1%. Foreign trade deficit was 1 637.5 million lats (see Table 2).

Table 2

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

	2002	2003	**2004**
Exports	1 408.8	1 650.6	**2 130.7**
Imports	2 497.4	2 989.2	**3 768.2**
Balance	–1 088.6	–1 338.5	**–1 637.5**

Source: CSBL.

With the growth of exports exceeding that of the imports, the latter exceeded the former by 76.9% (81.1% in 2003). Expansion of demand for Latvia's commodities driven by the strengthening of economic activity in Europe alongside with improving competitiveness of the commodities contributed to the rapid increase of Latvia's exports. The growth of exports was affected also by improved terms of trade, with the export prices rising under the impact of the strong euro. The strengthening domestic demand and accumulation of stock of commodities prior to Latvia's accession to the EU as well as one-off purchases of large value investment goods fuelled a steep rise in imports.

The largest increase in the foreign trade deficit was registered for machinery and mechanical appliances, electrical equipment, mineral products, transport vehicles, and the chemical and allied industries, as imports of these products grew noticeably. The foreign trade surplus of wood and articles of wood increased slightly. Of the major trade partners, Latvia still maintained a foreign trade surplus with the United Kingdom (195.1 million lats).

In 2004, wood and articles of wood (30.5% of total exports), base metals and articles of base metals (14.2%), textiles and textile articles (10.7%), agricultural and food products (9.7%), and machinery and mechanical appliances, electrical equipment (7.9%) were the most important Latvia's export goods. The increase in exports of base metals and articles of base metals, mineral products, and wood and articles of wood was the most pronounced. The growth in exports of wood and articles of wood, textiles and textile articles was underpinned by their price increases and that of mineral products, machinery and mechanical appliances, electrical equipment and products of the chemical industry by their expanded volume, whereas exports of base metals and articles of base metals, and prepared foodstuffs benefited from the pickup in both factors. Exports of higher value-added goods (further processed wood, pharmaceutical products, machinery and mechanical appliances, electrical equipment) grew.

Latvia's principal export partners for goods were the EU countries to which exports climbed by 25.4%, although their export share declined from 79.3% in 2003 to 77.0% in 2004. Exports grew most notably to the new EU Member States (Lithuania, Estonia and Poland; 68.8%). Export growth to the EU15 group was dominated by Sweden and Denmark. Wood and articles of wood (35.2% of total exports to the EU), base metals and articles of base metals (14.1%), and textiles and textile articles (11.5%) were the most important of Latvia's exports to the EU countries. Exports to the CIS (mainly Russia and Belarus) and other countries (Switzerland, USA and Norway) also picked up significantly. Exports to the CIS countries were dominated by agricultural and food products (21.5% of total exports to this group of countries), machinery and mechanical appliances, electrical equipment (19.5%), products of the chemical and allied industries (13.5%), whereas exports to other countries by wood and articles of wood (24.6%), base metals and articles of base metals (21.1%), and mineral products (13.7%). Latvia's principal export partners were the United Kingdom (12.9% of total exports), Germany (12.4%), Sweden (10.3%), Lithuania (9.5%), Estonia (8.4%) and Russia (6.5%). Exports to a number of recently explored markets (Portugal, Iceland, Japan and Kazakhstan) continued to strengthen substantially.

In 2004, the index of the real effective exchange rate of the lats remained broadly unchanged, as the decline in the nominal effective exchange rate of the lats was offset by a rise in the value of the index of price changes. The small year-on-year increase in the index of the real effective exchange rate of the lats (0.2%) was determined by a more rapid growth of prices as compared with the major developed trade partners. The decline of the nominal effective exchange rate of the lats was primarily caused by the continuous appreciation of the euro throughout 2004. Although producer prices in Latvia, just like in many of its major trade partner countries, climbed rapidly as a result of increased oil and metal prices and other costs, the index of the real effective exchange rate of the lats based on producer prices remained broadly unchanged and recorded a mere 0.3% increase over the 2003 average. Consequently, no significant changes in competitiveness were observed. This small rise of the index was primarily caused by the increase in the price change ratio against the major trade partner countries (6.6%).

Machinery and mechanical appliances, electrical equipment (19.7% of total imports), mineral products (12.8%), agricultural and food products (11.8%), transport vehicles (10.7%), and base metals and articles of base metals (10.2%) were the most important of Latvia's import goods in 2004. The highest rise was recorded for imports of mineral products, machinery and mechanical appliances, electrical equipment, and base metals and articles of base metals. The overall rise in the mineral products group was driven by an increase in imports of oil products, natural gas imports decreased, whereas the electricity imports remained broadly unchanged. The impact of rising global oil prices was significant, although the expansion in the volume of imports for these products was even more notable. The rise in imports of base metals and articles of base metals was also underpinned by both factors, whereas the growth in the volume of imports significantly contributed to expansion of imports of machinery and mechanical appliances, electrical equipment, and transport vehicles.

Latvia's principal import partners were Germany (14.5%), Lithuania (12.6%), Russia (8.8%), Estonia (7.1%), Finland (6.5%) and Sweden (6.3%). 75.2% of total imports, mainly machinery and mechanical appliances, electrical equipment, agricultural and food products and transport vehicles, were from the EU countries (75.4% in 2003). Imports from Lithuania accounted for almost one fourth of the import growth. Imports from the CIS countries, predominantly mineral products, base metals and articles of base metals, and wood and articles of wood also expanded notably. Primarily machinery and mechanical appliances, electrical equipment, products of the chemical and allied industries, and agricultural and food products were exported from other countries.

The current account deficit of the balance of payments was 12.3% of GDP (8.2% of GDP in 2003). Although the growth of exports exceeded that of imports, the increase of the goods deficit by 345.3 million lats pushed up the current account deficit.

Services surplus shrank year-on-year, as a result of expanding volume of received transportation (especially freight) services as well as received business and communication services.

Income deficit grew significantly, with non-resident direct investment income in Latvia increasing; however, the current transfer surplus also expanded markedly. The surplus of services and current transfers covered 46.9% of the goods deficit.

In 2004, net inflow of foreign direct investment was 291.2 million lats and covered one third of the current account deficit. Direct investment abroad also grew, reaching 57.0 million lats.

Reserve assets increased by 214.7 million lats as the Treasury's account with the Bank of Latvia was credited with receipts from a eurobonds issue, and due to the Bank of Latvia's interventions on the foreign exchange market.

FISCAL POLICY

In 2004, the general government consolidated budget posted a fiscal deficit of 55.0 million lats or 0.7% of GDP based on the accrual principle used for evaluating compliance with the Maastricht criterion. According to the cash flow principle applied in central government budgeting, the general government consolidated budget recorded a fiscal deficit of 79.0 million lats or 1.1% of GDP, which was considerably lower than in 2003 (1.8% of GDP) and below the projections (2.2% of GDP); it was achieved on account of better revenue collections and moderate Government expenditure. Just as in 2003, the fiscal deficit accumulated only at the end of the year and for the first eleven months of the year the general government consolidated budget ran a surplus. The deficit was the result of traditionally high year-end current expenditure on wages and salaries and services as well as the budgetary amendments adopted in December, transferring part of 2005 expenditure to 2004. The overall year-on-year increase in the general consolidated budget revenue (420.3 million lats or 19.9%) in 2004 was steeper than that of the total expenditure (including net lending; 396.2 million lats or 17.9%).

The ratio of general consolidated budget revenue to GDP grew by 1.0 percentage point in 2004, reaching 34.4% of GDP. The pickup in revenue was underpinned by the significant inflows of foreign financial assistance and the notable increase in the direct tax and non-tax revenue. Tax revenue grew by 242.8 million lats or 13.6% year-on-year, with the most rapid increase recorded for the corporate income tax (33.9 million lats or 36.1%), personal income tax (68.3 million lats or 18.6%) and social insurance contributions (79.3 million lats or 14.1%) revenue. Personal income tax revenue and social insurance contributions increased on account of growing wages and salaries and the number of employed (especially in the private sector). The growth of the corporate income tax, in turn, was determined by higher than expected earnings of the previous year. Indirect tax revenue expanded at a more moderate rate: VAT revenue by 27.5 million lats or 6.0%, and excise tax revenue by 24.8 million lats or 11.7%. The rise in revenue from those two taxes related to amendments to the Latvian tax legislation governing the VAT and excise tax payment procedure, due to Latvia's accession to the EU. Revenue from customs duties decreased by 1.6 million lats or 8.7% year-on-year in 2004 as a result of changes to the customs duties payment regulations brought about by the EU accession. Starting from May 2004, Latvia as an EU Member State no longer has to pay customs duty on goods transported within the borders of the EU, whereas on goods imported from non-EU countries the EU customs tariffs are applied. The steep rise in foreign financial assistance (by 110.3 million lats or 3.2 times) was facilitated by Latvia's accession to the EU and the beginning of drawdown from the EU funds. Non-tax revenue increased by 51.5 million lats or 33.0%.

In 2004, the ratio of the general government consolidated budget expenditure to GDP grew by 0.5 percentage point year-on-year, reaching 35.5%. The general government consolidated budget expenditure rise was driven primarily by an increase in wages and salaries, intermediate consumption, and grants and subsidies (by 73.6 million lats or 16.1%, 48.7 million lats or 13.3% and 222.2 million lats or 22.4%, respectively). At the same time, investment expenditure remained broadly unchanged. Wages and salaries growth related to the reform affecting teaching staff salaries, rise of minimum wage and salary (from 70 to 80 lats) and other Government measures to raise the salaries of the public sector employees. The expansion of grants and subsidies was underpinned by several factors. Grants to the population grew on account of state pension indexation carried out twice in 2004, which was rather significant due to the high inflation and legislative amendments. Grants to institutions, organisations and commercial companies and other grants and subsidies expanded notably with the start of drawdown from the EU funds. Significant amounts were disbursed to farmers within the framework of the Guarantee Section of the European Agricultural Guidance and Guarantee Fund. Although investment remained unchanged in 2004, the EU funding channelled to the private sector will facilitate fixed capital formation and infrastructural development.

The fiscal deficit of the general government consolidated budget was comprised of the central government basic budget deficit amounting to 133.8 million lats or 1.8% of GDP and the surplus in the social insurance fund of 51.1 million lats or 0.7% of GDP. The execution of the social insurance budget remained very successful in 2004, pointing to positive results of the pension reform. The fiscal deficit of the local government consolidated budget was 7.3 million lats or 0.1% of GDP, slightly lower than in three previous years. In 2004, the local government consolidated budget revenue increased by 17.2% and expenditure (including net lending) by 13.9%.

The Government's debt increased by 128.7 million lats (reaching 975.0 million lats or 13.2% of GDP). The overall expansion of the debt was determined by an issue of eurobonds in the amount of 400 million euro in spring 2004, partly used to redeem the eurobonds issued in 1999. Taking into account the new eurobonds issue and the euro exchange rate developments, the Government's external debt increased by 132.4 million lats in 2004 (to 552.0 million lats). The changes in the domestic debt of the Government were insignificant, with the debt declining by 3.7 million lats to stand at 423.0 million lats at the end of the year.

BANKING SECTOR AND FINANCIAL STABILITY

At the end of 2004, 22 banks, the Latvia Branch of *Nordea Bank Finland Plc* and 32 credit unions were registered in the Republic of Latvia, as well as representative offices of *Dresdner Bank AG* (Germany), *HSH Nordbank AG* (Germany), open JSC *AsiaUniversalBank* (Kyrgyzstan), *Nadra* (the Ukraine) and *East Bridge Bank* (Russia) operated in Riga.

At the end of 2004, the banks' paid-up share capital amounted to 383.8 million lats (an increase of 24.7% over the end of 2003). Nearly all banking industry, except one bank is in private hands in Latvia. At the end of the reporting year, the Government's stake in the banking sector's paid-up share capital was a mere 5.9%. The Latvian State is the sole owner of the JSC *Latvijas Hipotēku un zemes banka*. The share of foreign capital in the banks' total paid-up share capital increased slightly to 57.8% (53.9% at the end of 2003).

In 2004, all major bank performance indicators continued to improve rapidly, including assets (excluding trust assets), which expanded by 37.3% (to 7 850.4 million lats), loans (including transit credit) and deposits, which grew by 46.0% (to 4 380.7 million lats) and 36.6% (to 5 094.3 million lats), respectively. The banking sector's profit was 116.1 million lats (62.4% higher than in 2003). A rise of 30.6% (to 629.4 million lats) was recorded in the banks' equity.

In 2004, loans continued to gain importance in the structure of the banks' assets, reaching 55.8% (including a 17.0% rise in lending to households), and the share of claims on credit institutions also grew slightly (to 24.7%).

At the end of 2004, the banks' liquid assets (vault cash, claims on the Bank of Latvia and credit institutions, government securities) accounted for 33.7% of total assets, ensuring adequate liquidity to settle depositors' claims. Of liquid assets, 53.2% were claims on credit institutions of the OECD countries.

Compared to the end of 2003, the share of long-term loans granted to non-MFIs (with a maturity of over 5 years) increased from 41.6% to 47.3% of the loan portfolio, whereas the share of short-term loans (with a maturity of up to 1 year) declined from 20.3% to 16.5%.

In 2004, the share of non-MFI deposits in the banks' liabilities remained broadly unchanged (64.9% at the end of 2004), whereas liabilities to MFIs grew by 2.3 percentage points (to 21.1%).

Non-MFI deposits received by banks grew at a slower rate than loans granted to non-MFIs in 2004. With the share of short-term deposits in total deposits received by banks growing (from 20.1% to 22.5%), that of demand deposits decreased (by 1.0 percentage point, to 72.2%). The share of medium-term deposits (with a maturity of 1 to 5 years) shrank by 1.2 percentage points (to 4.8%).

In 2004, the assets of credit unions grew by 24.5% (to 4.9 million lats), loans and deposits increased by 27.7% (to 4.1 million lats) and 21.6% (to 3.2 million lats), respectively. Credit unions' profit was 78.8 thousand lats (a year-on-year increase of 34.5%). In 2004, their paid-up capital and equity expanded by 33.2% (to 0.9 million lats) and 31.8% (to 1.2 million lats), respectively. Although credit unions develop rather rapidly in Latvia, their impact in the financial sector is yet insignificant.

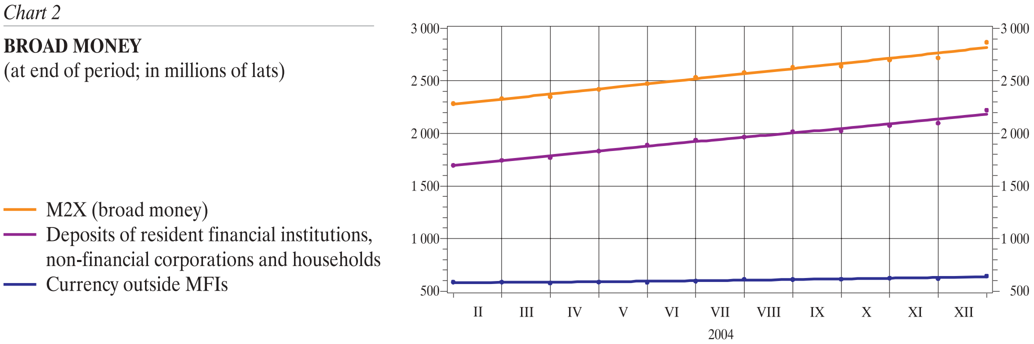
The Bank of Latvia, in close cooperation with the Financial and Capital Market Commission, published two issues of the *Financial Stability Report* in 2004. The report featured a macro-supervision analysis, provided a comparison of the key financial stability indicators of Latvia and the euro area as well as presented the results of quantitative estimates of banking risks. Stress test results of the Latvian banks' loan portfolios under several scenarios confirmed the resilience of the Latvian banking sector to potential shocks. Value-at-Risk method and stress tests were applied in measuring the foreign exchange risk. These estimates also suggested that even very significant exchange rate fluctuations had only a minimum effect on the Latvian banks' profitability. Two bank surveys (about the banks' outsourcing strategy and the key risks and developments in big banks during the year) were carried out within the framework of the stability analysis of the financial sector.

MONEY SUPPLY

The principal monetary aggregates of Latvia's MFIs and the Bank of Latvia are reflected in Appendix 1 of the Report. In 2004, money supply M2X increased by 27.0%, amounting to 2 867.9 million lats at the end of the year (see Chart 2). The robust growth of the Latvian economy resulted in acceleration of the money supply growth rate (M2X increase was 21.0% in 2002 and 21.1% in 2003). Broad money displayed rather buoyant growth over the year (12.2% in the first half of 2004, 13.1% in the second half of 2004), with an especially rapid expansion (148.7 million lats or 5.5%) in December alone, when deposits of resident financial institutions, non-financial corporations and households increased significantly and the seasonal factors pushed up the demand for cash.

Chart 2

BROAD MONEY
(at end of period; in millions of lats)



With the banking sector developing and banks introducing new services and improving the existing ones and Latvia preparing to become a full-fledged member of the EMU, the Bank of Latvia started publishing statistics compiled in line with the ECB methodology. This enables comparisons between the monetary aggregates of Latvia, the euro area and other EU countries.

The development dynamics of the broader aggregates M2X and M3 calculated based on the ECB's and the Bank of Latvia's methodology is almost identical and the difference is only about 30 million lats. The difference can be explained by the fact that M2X includes the component of about 100 million lats of deposits with an agreed maturity over two years, whereas M3 comprises about 70 million lats of local government deposits held with MFIs. M2 and M3 calculated based on the ECB's methodology are broadly the same, as the Latvian banks so far have not conducted any repos meeting the M3 definition and they have issued only small amounts of debt securities with an agreed maturity of up to two years.

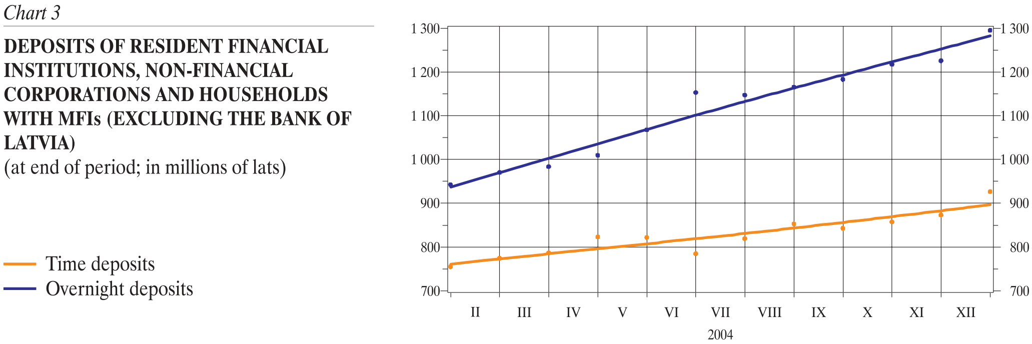
With lending expanding rapidly, the money multiplier continued to rise in 2004, reaching 3.00 in December (2.80 in December 2003). Economic stability and growing savings facilitated a decrease in the velocity of money circulation from 2.8 in 2003 to 2.7 in 2004.

The expansion of deposits was supported by several factors, including higher real income of the population, trust in the banking sector, climbing interest rates and economic growth. Therefore, deposits of resident financial institutions, non-financial corporations and households received by the banking sector increased by 564.8 million lats or 34.1% in 2004 (see Chart 3; by 335.9 million lats or 25.4% in 2003). Currency outside MFIs posted an increase of 44.4 million lats or 7.4% (less than in 2003 – 10.7%). The seasonal rise in December (4.1%) was the most significant. The cash component of the broad money diminished to 22.5% at the end of 2004 (26.6% at the end of 2003). This was mainly driven by the development of the banking system as well as transition to broader application of electronic payment instruments, which, in turn, lead to expansion of the share of overnight deposits and time deposits in broad money (by 45.2% and 32.3%, respectively). The share of household deposits in resident deposits posted a slight increase, amounting to 57.9% (57.2% at the end of 2003). Household deposits accounted for 67.9% of time deposits and 50.8% of overnight deposits.

Chart 3

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

(at end of period; in millions of lats)



In the first half of 2004, the pattern of the previous years for higher yield rates to determine a more rapid increase in lats deposits persisted, with the lats deposits growing by 20.6% and the deposits made in foreign currencies by 10.8%. Following the EU accession and with the importance of the euro in Latvian foreign trade growing and the euro appreciating, the growth of deposits made in foreign currencies (especially in euro) accelerated significantly. In 2004, deposits in foreign currencies made by resident financial institutions, non-financial corporations and households expanded by 36.2%, whereas deposits in lats by 32.8%. The persistent depreciation of the US dollar significantly impaired the popularity of this currency among resident depositors. At the end of 2003, deposits in the US dollars accounted for 68.1% of resident non-MFI deposits made in foreign currencies, while at the end of 2004 for 42.0%. The share of deposits made in euro grew accordingly (from 29.7% to 55.8%). In 2004, resident non-MFI deposits made in the US dollars declined by 53.4 million lats, whereas deposits in euro increased by 314.3 million lats. At the end of 2004, deposits made in lats accounted for 61.8% of total deposits (62.4% at the end of 2003).

With the cash component and national currency component in money supply shrinking, the expansion of the domestic money supply M2D (23.4%) was slower than the overall rise. M1, the most liquid component of M2X, increased by 22.3%.

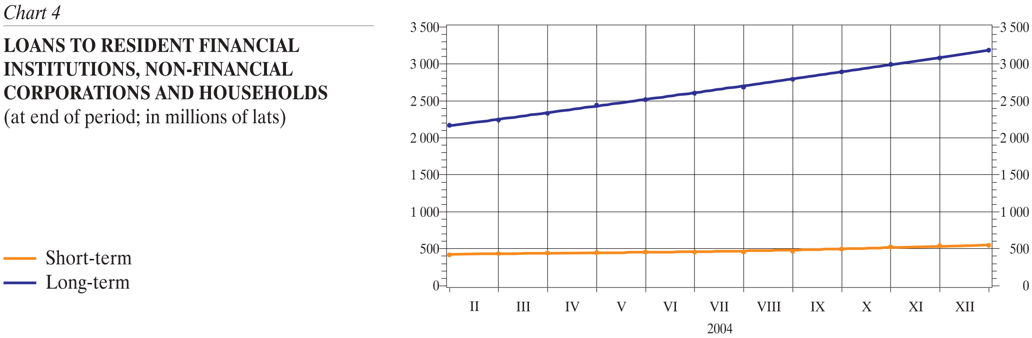
Although the Bank of Latvia's foreign reserves continued to increase, net foreign assets of the banking system declined by 306.4 million lats in 2004 and became negative. The decline in net foreign assets was determined by the fact that banks used non-resident (mainly parent bank) borrowing to lend to residents. In 2004, foreign liabilities of the banking sector grew by 1 320.3 million lats, including an increase of 539.5 million lats in liabilities to non-resident MFIs (of them, liabilities to associated and affiliated MFIs rose by 341.6 million lats) and a rise of 749.5 million lats in non-resident non-MFI deposits. The rise in the banking sector's foreign assets was lower (798.7 million lats), with claims on non-resident MFIs expanding by 571.3 million lats (including an increase of 325.0 million lats and 240.0 million lats in demand deposits and short-term deposits, respectively). Claims on non-resident non-MFIs increased by 226.4 million lats, with loans expanding rapidly (by 229.8 million lats), while investment in foreign government and corporate debt securities remained broadly unchanged. The net foreign assets of the banking sector posted a year-on-year decline of 521.7 million lats at the end of 2004.

For several successive years the growth in money supply has been driven by an increase in resident lending. In 2004, such loans expanded by 1 126.1 million lats or 39.9% (793.4 million lats or 39.1% in 2003), including loans granted to resident financial institutions, non-financial corporations and households increased by 1 194.5 million lats or 47.0% (by 693.1 million lats or 37.5% in 2003). At the end of 2004, exposure to resident financial institutions, non-financial corporations and households reached 47.6% of the MFI's aggregated balance sheet assets (44.4% at the end of 2003). The favourable fiscal situation in Latvia promoted a decline in the banking system's net claims on the Government by 30.7% (to 173.4 million lats).

The rise in resident loans to non-MFIs in 2004 was related to the increase in real money demand, macroeconomic stability and growing income of population against the background of relatively low interest rates on the global financial markets and stiff competition among MFIs trying to expand their market shares. Expansion of lending was also supported by banks' participation in providing co-financing for the EU funds projects, new services offered by MFIs and higher quality of customer service as well as a broader-based real estate market development outside the big cities. With the real estate market continuing to develop buoyantly, mortgage lending remained the most significant type of lending and the main determinant of the predominance of long-term loans in total loans. Long-term loans granted to resident financial institutions, non-financial corporations and households increased by 1 050.9 million lats or 49.2%, whereas the same short-term loans expanded by 143.5 million lats or 35.4% (for monthly amounts outstanding, see Chart 4). At the end of 2004, long-term loans accounted for 85.3% of total loans granted (84.1% at the end of 2003).

Chart 4

LOANS TO RESIDENT FINANCIAL INSTITUTIONS, NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS
(at end of period; in millions of lats)



Growth of mortgage lending reached 619.6 million lats or 80.2% in 2004, with the growth rate only slightly lower than that of the previous year, and the outstanding loans of this type amounted to 1 392.2 million lats or 37.3% of total loans granted. The growth rate of commercial credit and industrial credit was lower – 231.6 million lats or 30.1% and 191.7 million lats or 36.3%, respectively (14.7% and 21.2% in 2003). Overdraft also grew by 60.7 million lats or 66.3%, whereas the consumer credit expanded by 49.8 million lats or 34.7%.

The year 2004 was marked by a favourable economic trend – a year-on-year increase in the annual growth rate of loans granted to non-financial corporations (35.1%; 25.6% in 2003), whereas the corresponding figure for household lending declined from 76.3% to 74.8%. The rise in loans granted to non-financial corporations (625.0 million lats) was 55.5 million lats higher than that in loans granted to households. The high growth rate of lending to households was driven by a significant expansion of loans for house purchase (1.8 times). At the end of December those loans amounted to 889.0 million lats or 66.8% of total loans granted to households (64.0% at the end of 2003).

By sector of economy, the steepest rise of lending was posted in real estate, renting and business activities (by 171.2 million lats or 78.4%), financial intermediation (by 113.1 million lats or 40.2%), manufacturing (by 108.3 million lats or 41.0%), trade (by 78.4 million lats or 21.7%) and construction (by 70.6 million lats or 60.4%). These sectors displayed the fastest growth in 2004.

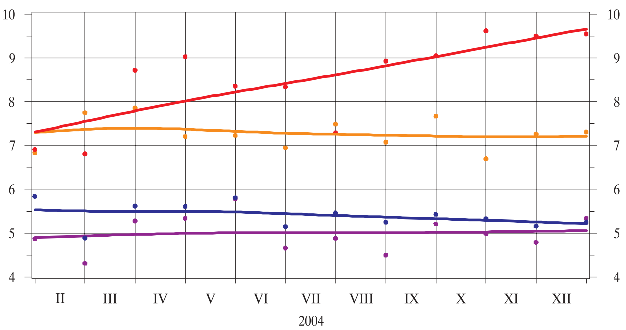
More favourable lending rates determined the dominance of foreign currency loans in total loans. In 2004, loans granted in lats increased by 325.9 million lats or 28.4% (35.8% in 2003), whereas loans granted in foreign currencies expanded by 868.6 million lats or 62.2% (38.9% in 2003). The share of loans granted in lats decreased by 5.7 percentage points (39.4% at the end of 2004). The share of the euro in resident non-MFI foreign currency loans expanded significantly, reaching 52.5% (33.9% at the end of 2003), whereas that of the US dollar declined to 46.9% (63.2% at the end of 2003).

LOAN AND DEPOSIT INTEREST RATES

In 2004, the interest rates on loans granted to resident non-financial corporations and households and deposits received from this group of customers were higher than in 2003, and it was recorded in loans and deposits of all maturity groups and currencies. After an all time low, the interest rates on deposits in lats again reached the high of 2002. The highest increase was registered for the interest rates on loans in lats (see Chart 5). The above rates are mostly pegged to longer term interbank market interest rates whose annual average was higher than before as a result of the Bank of Latvia raising its refinancing rate. Deposit rates were more stable and an upward inflationary pressure on them was insignificant (see Chart 6). In the first half of the year, the increase of interest rates was more pronounced, then it gradually declined and, though changes in interest rates were substantial, at the end of 2004 their level was close to that at the end of 2002.

Chart 5

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



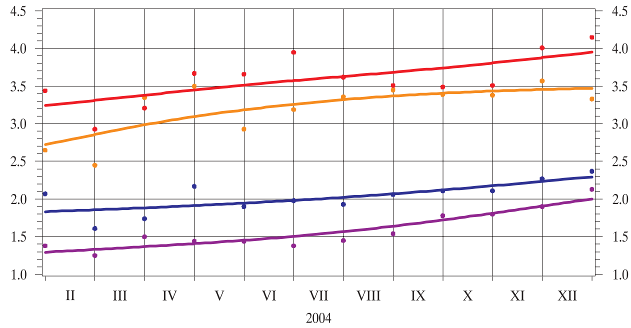
The weighted average interest rates on loans granted to resident non-financial corporations and households in lats fluctuated considerably (between 6.6% and 7.9% for short-term loans and between 7.4% and 11.3% for long-term loans). In December 2004, the weighted average interest rate on short-term loans in lats

Chart 6

WEIGHTED AVERAGE INTEREST RATES ON TIME DEPOSITS OF RESIDENT NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS

(%)

- Deposits in lats of non-financial corporations
- Deposits in lats of households
- Deposits in foreign currency of non-financial corporations
- Deposits in foreign currency of households



reached 7.6% (a year-on-year increase of 1.8 percentage points). The weighted average interest rate on long-term loans in lats grew by 2.8 percentage points (to 10.2%), with money market indices for longer-term lats transactions increasing.

In December 2004, the weighted average lending rates in foreign currencies were lower than those on loans granted in lats of the same maturity (by 2.4 percentage points on short-term loans and 3.9 percentage points on long-term loans). This was mostly due to the lower main refinancing rates of the euro and the US dollar. The weighted average interest rate on short-term and long-term loans in foreign currencies rose by 0.7 percentage point (to 5.2%) and by 2.2 percentage points (to 6.3%), respectively.

In 2004, the weighted average interest rates on deposits attracted from resident non-financial corporations and households remained the same as in the second half of 2003. Also in terms of any particular month, the weighted average interest rate fluctuations were relatively modest (from 2.5% to 3.6% on short-term loans and from 4.4% to 5.3% on long-term loans). In December, the weighted average interest rate on short-term deposits in lats grew by only 0.2 percentage point year-on-year, whereas that on long-term deposits rose by 0.7 percentage point.

Interest rates on deposits in lats, similar to lending rates in lats, were higher than those on deposits in foreign currencies of the same maturity, which facilitated a more pronounced growth in deposits received from resident non-financial corporations and households over the rise in foreign currency deposits. In December 2004, interest rates on both short- and long-term deposits in foreign currencies increased year-on-year by 0.6 percentage point (to 2.2%) and 0.7 percentage point (to 3.5%), respectively.

With inflation rising at a relatively more rapid pace, the real interest rates on short-term loans in lats shrank by 1.9 percentage points (to 0.3%) and those on long-term loans fell by 0.9 percentage point (to 2.9%), in the course of the year. The real interest rates on deposits in lats were negative in 2004.

INTERBANK MARKET

In 2004, the amount of interbank loans granted to domestic banks grew by 28.9% (to 12.5 billion lats). The share of transactions with agreed maturity of over one day increased.

The amount of interbank loans granted to domestic banks for transactions in foreign currencies grew more rapidly (by 32.6%; by 25.9% for transactions in lats). The amount of transactions in lats reached 6.8 billion lats. On the domestic interbank market, 54.4% transactions were conducted in lats, 30.4% in US dollars and 12.0% in euro.

The amount of non-resident MFI loans grew by 33.9% (to 140.7 billion lats). These transactions were mostly executed in US dollars (76.3%) and in a smaller amount in euro (17.7%) and in British pound sterling (3.4%).

The weighted average interest rate on lats transactions on the domestic interbank market amounted to 3.27% (a year-on-year increase of 0.4 percentage point). As transactions with maturity of up to one month dominated on the interbank market, the changes in bank short-term liquidity had a considerable effect on the interest rates on lats transactions and their overall fluctuation ranged from 2.18% to 4.46%.

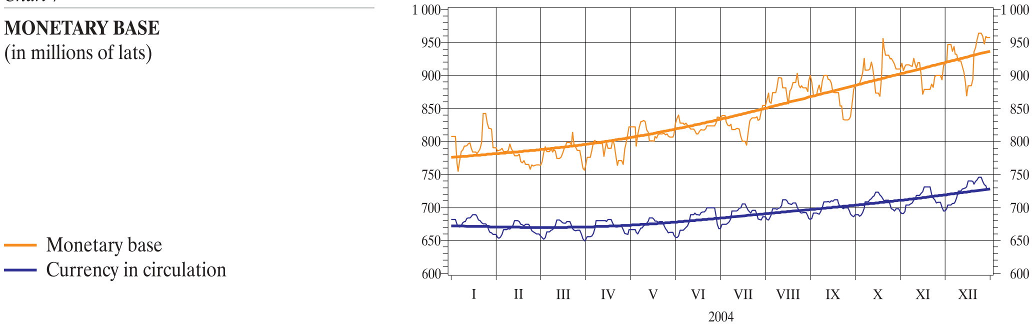
At the end of 2004, the money market index RIGIBOR (interest rates on loans to non-MFIs are often pegged to this index) amounted to 4.40% on loans with a 3-month maturity (24 basis points higher year-on-year), whereas that on loans with a 6-month maturity remained unchanged (4.28%).

MONETARY BASE

With the Bank of Latvia raising the reserve requirement and the balance of deposits attracted by banks growing, the money supply of the central bank or monetary base M0 increased by 18.7% during 2004 (considerably faster than in 2003), reaching 957.2 million lats at the end of the year (see Chart 7). The demand for cash grew moderately (in 2004, currency in circulation increased by 45.2 million lats or 6.6%; by 9.6% in 2003), whereas the pickup in deposits of MFIs and other financial institutions with the Bank of Latvia was rather substantial (105.3 million lats – an increase of 1.8 times; in 2003 such deposits slightly shrank). Thus, the cash component of the monetary base diminished to 76.0% (84.5% at the end of 2003).

Chart 7

MONETARY BASE
(in millions of lats)



Growth in M0 was mainly effected by an increase in net foreign assets of the Bank of Latvia (215.3 million lats or 26.1%), with the Bank of Latvia purchasing foreign currency as well as transferring receipts from the Government eurobond issue and EC funds into the central bank's foreign assets. Although the central bank also offered currency swaps, their amount decreased by 60.7 million lats over the year. Thus at the end of 2004, the Bank of Latvia's net foreign assets reached an all time high – 1 039.3 million lats (see Chart 8) and, as at the end of 2003, covered goods imports of about 3.3 months, while the backing of the national currency with the Bank of Latvia's net foreign assets (see Chart 9) stood at 108.6% (102.1% at the end of 2003).

The Bank of Latvia's net domestic assets posted a minor decrease of 64.9 million lats as the balance of domestic credit shrank. The Bank of Latvia's lending to banks declined substantially (by 46.4 million lats), whereas net lending to the Government remained broadly unchanged – an increase in the central government's

Chart 8

NET FOREIGN ASSETS OF THE BANK OF LATVIA
(in millions of lats)

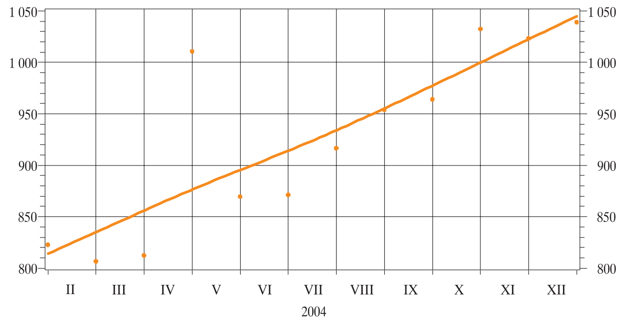
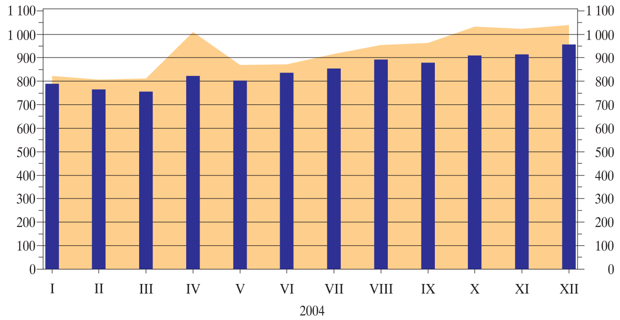


Chart 9

BACKING OF THE NATIONAL CURRENCY
(in millions of lats)

Net foreign assets of the Bank of Latvia
Monetary base



deposit with the Bank of Latvia (26.9 million lats) was offset by an increase in the central government's securities portfolio held by the Bank of Latvia (30.9 million lats).

The Bank of Latvia's total loans to MFIs (2 167.1 million lats) were 17.9% less than in 2003, with the demand for repo loans diminishing and the amount of Lombard loans growing.

Of the Bank of Latvia's loans to MFIs, repo loans accounted for 94.7% (98.8% in 2003), demand Lombard loans and automatic Lombard loans for 4.2% and 1.1%, respectively (for the monthly average amounts outstanding, see Table 3).

Table 3

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

	2002	2003	**2004**
January	22.5	23.7	**55.9**
February	11.3	28.9	**39.7**
March	7.5	33.9	**61.3**
April	6.0	55.9	**50.4**
May	13.9	69.9	**19.2**
June	13.1	65.9	**10.0**
July	22.4	56.9	**23.2**
August	33.0	84.5	**71.7**
September	32.1	79.3	**67.6**
October	36.1	41.5	**96.3**
November	31.0	95.8	**38.6**
December	34.6	51.7	**28.1**

Repo loans of 7-day and 28-day maturities were granted in the amount of 1 947.5 million lats and 105.7 million lats, respectively. The amount of repo loans dropped 21.3% year-on-year; demand Lombard loans and automatic Lombard loans grew

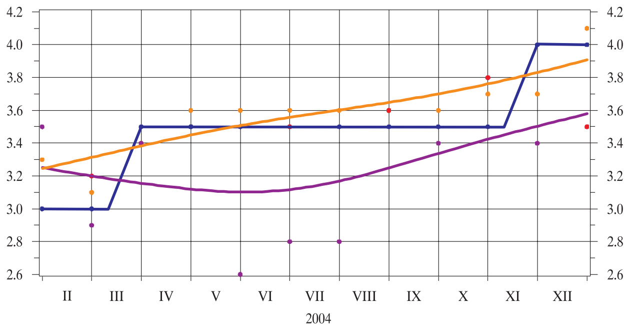
3.2 times (90.3 million lats) and 11.3 times (23.7 million lats) year-on-year, respectively.

In 2004, the Bank of Latvia raised its refinancing rate twice by 50 basis points (from 3.0% to 3.5% as of March 11, and from 3.5% to 4.0% as of November 12; see Chart 10). The average weighted interest rate on repo loans changed in line with the central bank and interbank market interest rates, generally being considerably higher than in the previous year. It was the lowest (3.1%) in February and the highest (4.2%) in December.

Chart 10

MONEY MARKET INTEREST RATES
(%)

The Bank of Latvia's refinancing rate
Weighted average repo rate
Weighted average yield on 6-month Treasury bills
Weighted average interest rate on domestic interbank loans in lats



FOREIGN EXCHANGE MARKET AND LATVIA'S EXTERNAL DEBT

Considerable volatility was observed on the global foreign exchange market, with the appreciation of the euro and depreciation of the US dollar against other SDR basket currencies being its main features in 2004. The increasing budget deficit and foreign trade deficit in the US, as well as the slow growth in the national economies of the EU countries and failure to overcome economic stagnation were the major factors behind the exchange rate fluctuations of the SDR basket currencies. Following the prolonged economic crisis, the first signs of positive economic change were witnessed in Japan, yet it was too early to talk about an overall recovery of Japan's economy. The UK economy demonstrated robust growth, however, the first signs indicating a slowdown appeared in the second half of the year.

The euro appreciated against the US dollar by 7.6% (from 1.2595 at the end of 2003 to 1.3554 by the end of 2004), reaching its high on December 30, 2004 (1.3666). In 2004, most US economic growth indicators were better year-on-year. The labour market also improved and, after a long interval, the US FRS started to increase base rates in the second half of the year. The pickup in the US stock market was not as pronounced as in the previous year, yet the key indices grew. The US dollar depreciated against the Japanese yen by 4.3% (from 107.22 at the end of 2003 to 102.63 by the end of 2004), reaching its low on December 2, 2004 (101.84). The US dollar depreciation against the Japanese yen was the slightest compared with its decline against other SDR basket currencies. That had a favourable impact on the Japanese producers' competitiveness on world markets. The British pound sterling appreciated against the US dollar by 7.4% (from 1.7858 at the end of 2003 to 1.9181 by the end of 2004), reaching its high on December 16, 2004 (1.9552). In 2004, the UK economy demonstrated robust growth, although in the second half of the year the growth rate slowed down, which was also confirmed by a fall of a previously steep rise in housing prices.

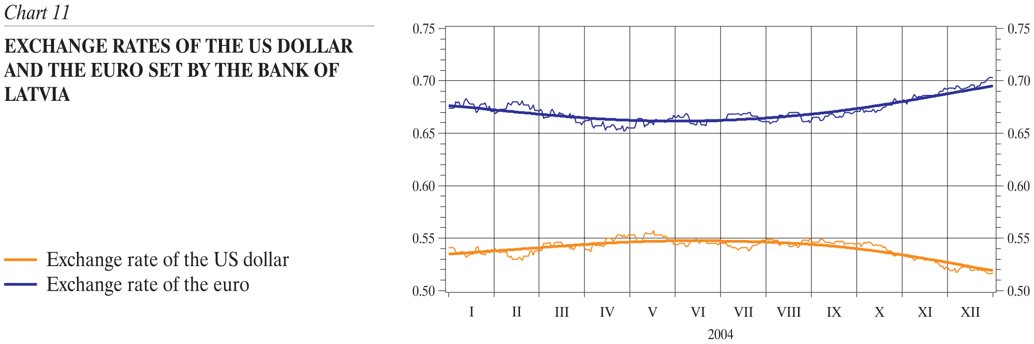
As the euro strengthened against all other SDR basket currencies, it also appreciated against the lats by 3.9% on the domestic foreign exchange market (from 0.6714 at the end of 2003 to 0.6975 by the end of 2004). The euro exchange rate was the lowest on April 26, 2004 (0.6468); it was the highest on December 30, 2004 (0.6980).

The US dollar depreciated against all other SDR basket currencies. The US dollar shrank against the lats by 3.3% (from 0.5335 at the end of 2003 to 0.5155 by the end of 2004). The US dollar exchange rate reached its high on May 13, 2004 (0.5535) and was the lowest on December 27, 2004 (0.5105; for the dynamics of the exchange rates of the US dollar and the euro as set by the Bank of Latvia, see Chart 11).

As of January 1, 2005, the lats has been pegged to the euro. On December 30, 2004, the peg rate of the lats against the euro was fixed at EUR 1 = LVL 0.702804. As of January 2005, the Bank of Latvia has been unilaterally ensuring the lats exchange rate fluctuations against the euro within ±1% of the central or peg rate.

Chart 11

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



According to the international investment position, Latvia's external debt to non-residents increased by 1 799.4 million lats, reaching 6 857.8 million lats (93.2% of GDP) at the end of 2004. Foreign assets totalled 4 705.9 million lats and net external debt amounted to 2 151.9 million lats (29.2% of GDP). In 2004, the Government and the central bank's liabilities to non-residents increased by 149.9 million lats, the banking sectors' liabilities grew by 1 320.4 million lats, those of the other sectors by 182.7 million lats and debt-related direct investment – by 146.4 million lats. Compared to 2003, the share of banks' liabilities in total external debt increased (to 61.9%; 57.8% in 2003) and that of other sectors diminished (to 19.1%; 22.3% in 2003). No substantial changes were observed in the breakdown of the external debt by instrument. At the end of 2004, debt-related direct investment, debt securities and other investment amounted to 10.1%, 6.7% and 83.2% of the external debt, respectively. At the end of the year, long-term and short-term debt totalled 2 914.7 million lats and 3 943.1 million lats, respectively.

At the end of 2004, the banking sector's external debt amounted to 4 246.2 million lats. Banks increased (by 147.5%) the attracted long-term foreign financial funds considerably, and by the end of 2004 they amounted to 1 010.7 million lats or 23.8% of the banks' external debt (14.0% at the end of 2003). Non-resident deposits received by banks accounted for 56.7% of the banks' debt (65.0% at the end of 2003). Net external debt of the banking sector amounted to 1 286.2 million lats at the end of 2004.

At the end of 2004, other sectors' external debt was 1 312.9 million lats (including long-term liabilities of 631.1 million lats and short-term liabilities of 681.7 million lats). Although foreign liabilities increased by 16.2% in 2004, their structure remained broadly unchanged. The other sectors attracted foreign financial funds primarily through loans (57.9% of other sectors' external debt) and trade credit (39.2%). Other sectors' liabilities to direct investors have been gradually increasing as well. In 2004, they amounted to 636.4 million lats.

According to the Treasury data, the Government external debt in foreign currencies rose by 132.4 million lats over the year and reached 552.0 million lats (7.5% of GDP) at the end of the year. In 2004, the Government attracted foreign financial funds in the amount of 273.5 million lats (including an issue of eurobonds in the amount of 400 million euro). To service foreign debt, 183.4 million lats, equalling 5.7% of annual exports, were used (including 225 million euro for the redemption of the eurobonds issued in 1999). The structure of the Government external debt changed as a result: the share of liabilities in euro grew (from 83.7% to 89.2%) and that in US dollars diminished (from 13.1% to 9.2%).

SECURITIES MARKET

The Bank of Latvia acted as an agent for the initial placement of the central government's debt securities. In 2004, the amount of securities supplied by the Treasury on the domestic primary market was the second lowest supplied in the last ten years. To cover the budget deficit, the Government mainly used the receipts of the eurobond issue. General government budget collections were also successful, and the Treasury was not interested in trading securities with high interest rates, therefore only bank bids with the lowest interest rates were accepted. The average maturity of the government securities outstanding rose: in 2004, the second issue of 10-year Treasury bonds was offered, and 6-month and 12-month bills were supplied.

In 2004, the amount of government securities supplied at competitive multi-price auctions in the primary market was 96.0 million lats (2.1 times less than in 2003) and the banks' relative demand and the relative amount sold was slightly higher than in previous years. In 2004, banks' demand exceeded the supply twofold and the amount sold at auctions reached 76.1% of the supplied amount.

In 2004, 14 banks (three banks fewer than in the previous year) took part in competitive multi-price auctions in the primary market of government securities. Concentration increased in the primary market of government securities, as the four most active banks bid 83.0% of the total demand of government securities (70.1% in 2003).

The weighted average discount rate of 6-month Treasury bills rose from 3.15% in 2003 to 3.46% in 2004. The weighted average discount rate of 12-month Treasury bills grew from 3.25% to 3.56%, respectively. The average yield on 10-year bonds decreased from 5.05% to 4.86%. An increase in the Treasury bill yields was driven by a rise in RIGIBOR, whereas the yield on long-term securities fell due to Latvia's accession to the EU and the projected introduction of the euro (as a result the lats interest rate convergence with the euro interest rates is expected in a longer term), as well as shrinking risk premiums.

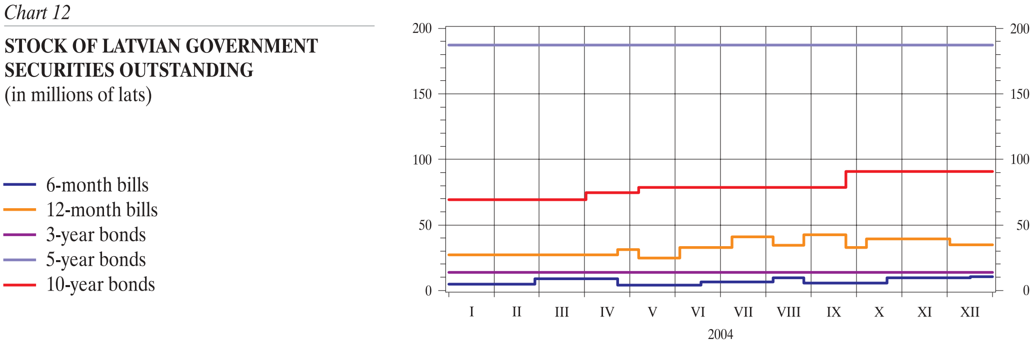
In 2004, the stock of government securities outstanding increased by 13.3% (to 425.7 million lats; for the stock of government securities outstanding of all maturity spectrum, see Chart 12). At the end of 2004, Latvian banks held 50.5% of the stock of government securities outstanding; the Bank of Latvia, resident non-MFIs, the Treasury and Government funds, non-resident non-MFIs held 23.5%, 14.8%, 7.0% and 4.2%, respectively.

The amount of government securities sold at the fixed rate auctions organised by the LCD in 2004, was also less than in 2003: in 2004 they were sold in the amount of 22.5 million lats (38.5 million lats in 2003).

In 2004, publicly traded corporate debt securities, denominated in lats and registered with the LCD, shrank by 25.0% (to 76.3 million lats). This decrease was

Chart 12

STOCK OF LATVIAN GOVERNMENT SECURITIES OUTSTANDING
(in millions of lats)



mainly driven by the redemption of a closed issue of the limited liability company *Lattelekom* bonds in the amount of 25.6 million lats before maturity: these securities were initially issued as 10-year Treasury bonds. Only one new issue of the securities, denominated in lats, was conducted (3-year Treasury bonds in the amount of 1.7 million lats). Five new issues of debt securities, denominated in US dollars and euro, were registered with the LCD, and mostly domestic banks were the issuers. The decrease in lats denominated fixed interest securities outstanding was related to the interest rate fluctuations, therefore refinancing of lats denominated debt securities using other instruments became profitable. Loans in euro and US dollars were attractive as interest rates on transactions in these currencies were lower than those in lats.

In 2004, the total turnover of debt securities on the RSE was 103.0 million lats, with government securities traded in the amount of 83.0 million lats. The total turnover of debt securities was by 28.1% lower than in 2003, moreover, the turnover of both government securities and private debt securities shrank. On the RSE, the turnover of the first issue of 10-year Treasury bonds was the highest (31.2 million lats), as was the outstanding amount. Of private debt securities, the turnover of the JSC *Latvijas Unibanka* bonds was the highest (5.8 million lats).

The bid rate of 10-year Treasury bonds amounted to 5.10% at the end of 2003, whereas at the end of 2004 it had fell to 4.45%. The bid rate of 12-month Treasury bills shrank from 3.50% to 3.38%, respectively, and the bid rate of 10-year bonds of the state JSC *Latvijas Hipotēku un zemes banka* declined from 5.90% to 5.25%. The decline resulted from a drop in yields on government long-term securities at primary auctions and the expected convergence of interest rates on short-term transactions in lats and euro.

At the end of 2003, the bid rate quoted for Latvian eurobonds maturing in November 2008 was 3.83% and 3.11% at the end of 2004. The bid rate for a new issue of Latvian eurobonds (redemption in April 2014) was quoted for the first time on March 31, 2004 (4.33%), and had declined to 3.84% by the end of 2004. Thus, the spread between the Latvian Treasury bond yields of longer maturity and German government securities' yields of the same maturity was 37 basis points at the end of March 2004, and 25 basis points at the end of December.

In 2004, the RSE with the Stock Exchanges in Tallinn and Helsinki continued the joining process to NOREX, Nordic Exchange Alliance. At the end of September, the major North European securities market manager, OMX Exchanges, launched the common trading platform SAXESS (which was already in use at the Stockholm Stock Exchange) in Riga, Tallinn and Helsinki. By implementing the common trading system SAXESS, the RSE stopped the calculation of capitalisation indices Dow Jones Riga Stock Exchange (DJRSE) and the stock price index RICI and began calculating the capitalisation index RIGSE, which includes shares of all companies listed on the official list and the secondary list. At the same time a new capitalisation index BALTIX comprising shares of all companies listed on the official list of all Baltic Stock Exchanges was introduced. The base date of both indices is January 1, 2000.

In 2004, the RSE capitalisation index RIGSE rose by 43.8% (to 413.6 points) and the capitalisation index of Baltic Stock Exchanges, BALTIX, increased by 37.9% (to 420.2 points). The RSE stock market capitalisation grew from 608 million lats to 849 million lats. A rise in stock prices on Latvian stock market was driven by sound corporate financial indicators, Latvia's accession to the EU, as well as companies' announcements about their future plans. The total turnover of shares shrank by 26.8% (to 58.9 million lats) compared to previous year. At the end of 2004, shares of 39 companies were quoted on the RSE; of those, four companies were listed on the official list, eight companies were included on the secondary list, and 27 companies made up the free list (at the end of 2003, three, nine and 24 companies were listed on the official, secondary and free lists, respectively).

INTERNATIONAL COOPERATION

EU MEMBERSHIP

In 2004, the Bank of Latvia continued its participation in the joint activities of the Latvian Government and governmental institutions to promote Latvia's deeper integration into the EU. Upon Latvia's accession to the EU, its representatives became full-fledged members of the EU institutions, as of May 1, 2004.

The Bank of Latvia's experts participated in the ESCB committees and working groups, as well as in the EU Economic and Financial Committee (EFC). The Bank of Latvia's representatives participated in the EC working groups dealing with the issues of euro coins, payment systems and economy forecast.

The EFC regularly assessed economic growth and financial development in the EU, as well as drafted proposals for the decisions related to the economic policy instruments and strategy. The EFC addressed issues regarding relations with third countries and international organisations. In 2004, the EFC paid particular attention to the issues of financial stability. Representatives of the ministries of finance and central banks of the EU countries participated in the EFC. EFC meetings whose agenda included issues beyond the central bank competence were held in restricted composition without representatives from central banks.

Representatives of the Bank of Latvia also participated in the EFC sub-committees. The Euro Coin Sub-Committee addressed crucial technical issues related to the preparation by the new EU Member States for the implementation of the euro coins. The Sub-Committee on IMF and Related Issues held discussions about topicalities of the international financial architecture and IMF policy.

In 2004, the Bank of Latvia participated in CEBS, which had to advise the EC on banking supervising issues, as well as establish common standards of banking supervision in the EU countries.

The Bank of Latvia's representatives also provided their opinion at the regular meetings of several working groups. The specialists of the Bank of Latvia participated in the work of the Public Administration Network II (PAN II) group. The group's activities were aimed at coordinating practical issues related to the introduction of the euro. The Bank's representatives also participated in the working group for developing and coordinating the information and communication strategies for the euro (the Directors of Communication Network; DirCom), in the Payment Systems Expert Group drafting proposals for the EC legislation initiatives to develop a single payment system, and in the Mint Directors' Working Group performing the coordinating activities of the mints in the EU countries and exchanging experience in minting the euro coins.

In March 2004, the Bank of Latvia's special attaché was appointed at the Latvian Mission to the EU in Brussels. His task is to represent the Bank's interests in its relations with the EU institutions and to provide the Bank of Latvia with information about new policy and legislation initiatives of the EU institutions, affecting the monetary and economic situation in Latvia.

To ensure compliance with the EU legislation, in 2004, the Bank of Latvia updated its regulations related to the monetary policy instruments and governing the methodology for drafting statistical reports, as well as approved the "Guidelines for the Formulation of an Internal Control System for the Prevention of Laundering of Proceeds Derived from Criminal Activity and Financing of Terrorism for Companies (Commercial Companies) and Businessmen Engaged in Buying and Selling Cash Foreign Currency".

INTERNATIONAL FINANCIAL INSTITUTIONS

The Bank of Latvia, the coordinating institution for the IMF affairs in Latvia, continued to represent the Republic of Latvia interests at the meetings of the IMF Board of Governors, as well as in daily matters. In 2004, the IMF Executive Board paid particular attention to the economic issues related to strengthening the IMF surveillance, crisis prevention and developing proposals for crisis resolution, policy monitoring arrangement and the role of the IMF in low-income countries.

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

Representatives of the Bank of Latvia participated in the work of the Nordic-Baltic Monetary and Financial Committee, established for developing strategies and guidelines. In 2004, the Bank of Latvia organised one of the meetings of Nordic-Baltic Monetary and Financial Committee Alternates.

In 2004, the cooperation with the IMF, based on consultations under Article IV of the IMF Articles of Agreement, continued. In August 2004, the IMF Executive Board reviewed a report on the implementation of the Latvian economic, monetary and financial policy.

In 2004, Latvia continued its activities as a member of the International Bank for Reconstruction and Development, the International Development Association, the International Finance Corporation and the European Bank for Reconstruction and Development. The Bank of Latvia continued its participation in the activities within the BIS.

COOPERATION WITH FOREIGN CENTRAL BANKS AND TECHNICAL ASSISTANCE

In 2004, the Bank of Latvia continued its cooperation as well as exchange of experience and information with the central banks of other countries.

The staff of the Market Operations Department proceeded with providing the technical assistance to other central banks. Under the World Bank project the Market Operations Department provided technical assistance to the central banks of Costa Rica, Cyprus, Iran, Romania, Tanzania, the Ukraine and Venezuela. Experts from the Department were invited to speak at various international workshops in Europe and Asia, as well as organised a three-day seminar at the Bank of Latvia on reserve management for the staff of the central bank of Bulgaria. Comprehensive advice was extended to the staff of the central banks of Slovenia and Turkmenistan. An article by an expert of the Market Operations Department on the asset allocation strategy of the central bank was published in the ECB publication Risk Management for Central Bank Foreign Reserves.

In February, under the IMF technical assistance programme an expert from the Accounting Department advised the central bank of Albania on issues related to accounting and drafting financial statements.

In March, experts from the Monetary Policy Department under the technical assistance programme hosted a visit of experts from the central bank of Georgia at the Bank of Latvia, discussing issues related to monetary policy instruments and bank liquidity. In October, two experts from the Bank of Latvia visited the central bank of Georgia to provide technical assistance with respect to monetary policy and international cooperation.

In August, the Internal Audit Department hosted a visit of two experts from the central bank of Kazakhstan, exchanging experience on issues of information systems audit.

To learn about topical issues of the Latvian financial system, two delegations from the Financial Academy of Uzbekistan visited the Bank of Latvia.

The Bank of Latvia organised several international meetings (exchange of experience seminar of central banks of the Baltic States in April, where issues of market operations, public relations, publications and translation were discussed; the meeting of Nordic-Baltic Monetary and Financial Committee Alternates in August).

International financial institutions and foreign central banks extended technical assistance to the Bank of Latvia, providing opportunities to participate in the workshops and courses hosted by these institutions, as well as to obtain advisory services on issues related to the operation of the central banks.

Under technical assistance programmes, the Bank of Latvia's employees participated in a number of training sessions organised by the ECB, the IMF Institute, the World Bank, the European Commission and the Joint Vienna Institute, and also took part in seminars hosted by the central banks of the Czech Republic, France, Germany, Italy, the Netherlands, and the United Kingdom.

THE BANK OF LATVIA IN THE EUROPEAN SYSTEM OF CENTRAL BANKS

After Latvia's accession to the EU on May 1, 2004, the Bank of Latvia became a member of the ESCB. By the time Latvia becomes a full-fledged member of the EMU and adopts the euro, the Bank of Latvia will continue to implement independent monetary policy. It will proceed with performing other functions as well, ensuring, inter alia, smooth operation of the payment system, cash circulation, compilation of financial statistics and Latvia's balance of payments. It will also gradually expand its macroeconomic analysis and research work, addressing the EU economic development trends as well.

The Governor of the Bank of Latvia participated in the ECB General Council meetings on a regular basis. Pursuant to the Statute of the ESCB and the ECB, the ECB General Council at its meetings addresses issues related also to the central banks of EU countries with a derogation as to the participation in the EMU.

The Bank of Latvia representatives were involved in 12 ESCB committees and more than 30 working groups, dealing with issues related to monetary policy, banking supervision, euro banknotes, statistics, accounting, market operations, payment systems, international relations and other issues.

On May 1, 2004, the Bank of Latvia became a subscriber of the capital of the ECB. At the end of 2004, the subscribed share of the Bank of Latvia in the ECB's registered capital was 0.2978% which corresponds to 16 572 thousand euro. The Bank of Latvia's share in the ECB's capital key was calculated on the basis of Latvia's GDP and population data, and it will be adjusted every five years. Since Latvia is not a full-fledged member of the EMU, the Bank of Latvia had to pay up a minimal contribution of 7% (1 160 thousand euro) of its total subscribed capital in the ECB.

The Bank of Latvia and FCMC together with the central banks and banking supervisory authorities of other new EU countries signed the *Memorandum of Un-*

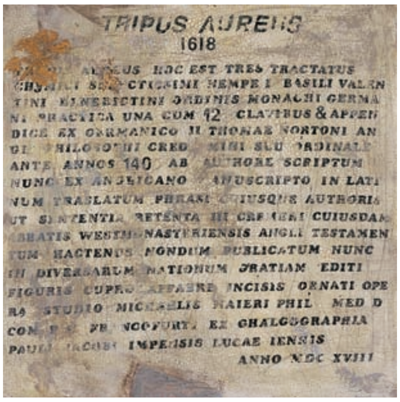
derstanding on High-Level Principles of Cooperation Between the Banking Supervisors and Central Banks of the European Union in Crisis Management Situations and *Memorandum of Understanding on Cooperation Between Payment Systems Overseers and Banking Supervisors in Stage Three of Economic and Monetary Union*. The above cooperation agreements are binding on the new EU Member States as of June 17, 2004.

The agreement on cooperation among the central banks and banking supervisory authorities of the EU in crisis management situations (effective as of March 1, 2003) is based on high-level principles of cooperation and stipulates a set of principles and procedures for cross-border cooperation in crisis management situations.

In October 2004, the EC and the ECB convergence reports were published. They assessed the readiness of Sweden and the 10 new EU countries and their central banks, including Latvia and Bank of Latvia, to join the EMU.

Pursuant to the Statute of the ESCB and the ECB, the Bank of Latvia ensured translation of the ECB Monetary Bulletin (quarterly issues), beginning with the June 2004 issue (published on the Internet). Furthermore, the Bank of Latvia ensured translation of the Introduction and Executive Summary of the ECB 2004 Convergence Report (printed and Internet editions), as well as the current edition of the General Documentation on Eurosystem Monetary Policy Instruments and Procedures. Translators of the Bank of Latvia had successful cooperation with the ECB translators and terminologists, and requested expert advice on central banking issues where necessary.

REPORT OF THE BOARD OF THE BANK OF LATVIA



The year 2004 was notable in Latvia's history for two extraordinarily significant events, both promoting the country's economic development: Latvia became a member of NATO and joined the European Union. Driven by both the strong domestic demand and the expansion of exports, GDP growth continued to be buoyant, reaching the highest level among all EU countries. Reflecting the supply factors and the strong domestic demand, the consumer price index grew rapidly in 2004, and the average annual inflation stood at 6.2%. Mortgage lending remained on the rise, with commercial credit and industrial credit also strengthening at the close of the year and pointing to the willingness of businesses to acquire and use the EU funds. The quality of bank loans was still high. A strong domestic demand, the necessity to modernise production and boost exports, as well as inflation expectations prior to the EU accession triggered an increase in imports which determined a pickup in the current account deficit. With the Government conducting a tight fiscal policy, the fiscal deficit of the general government consolidated budget was only slightly over 1% of GDP. The Bank of Latvia engaged in regular reviewing of Latvia's financial stability dynamics and financial risks, conducted the analysis of various scenarios and produced the assessment of the situation. International rating agencies *Fitch Ratings* and *Standard & Poor's* assigned higher ratings to Latvia for long-term liabilities in foreign currencies.

In terms of achieving real convergence with other EU Member States the remarkable economic growth rate shall be looked upon as a positive achievement; nevertheless, the Bank of Latvia was concerned about rising inflation, strengthening of external imbalances, the structure of economic sectors underlying growth, and the steep pickup in the pace of lending. Under these circumstances, the Bank of Latvia's Council raised the refinancing rate on two occasions, increased the reserve requirement for banks by one percentage point, and expanded the minimum reserve base to include more bank liabilities.

On December 30, 2004, the Bank of Latvia changed the peg of the lats from the SDR basket of currencies, which had served well as a factor stabilising the national economy in the course of the last decade, to the single European currency (in effect as of January 1, 2005). The pegging of the national currency to the euro was a significant adjustment towards the ERM II and a full-fledged participation in the EMU.

Along with central banks of the other new EU Member States the Bank of Latvia joined the ESCB; hence its activities in ESCB's institutions became more vigorous. The Bank of Latvia's Governor participated in the work of the ECB General Council, Bank of Latvia's Department heads and other experts were involved in the ESCB committees and working groups.

THE BANK OF LATVIA'S FOREIGN EXCHANGE POLICY AND FOREIGN RESERVES

Stability of the exchange rate of the Latvian lats against the euro is an indicator used in assessing Latvia's maturity for full participation in the EMU. For at least two years prior to the introduction of the euro, the lats is to be pegged to the euro, with the fluctuation margins of the lats exchange rate against the euro not exceeding ±15% against the peg rate. With that in mind, the Bank of Latvia's Council passed the Resolution "On Pegging the Lats to the Euro and Setting Foreign Exchange Rates" in November 2004. In accordance with this Resolution, the Bank of Latvia repegged the lats from the SDR basket of currencies to the euro as of the beginning of 2005. The Bank of Latvia set the peg rate of the lats to the euro on December 30, 2004. The exchange rate of the lats against the euro (EUR 1 =

LVL 0.702804) was calculated on the basis of market exchange rates set by the ECB on December 30 by applying the exchange rate formula of the SDR basket of currencies. As the information concerning the change of the peg of the lats and the related procedure was released more than a year before, the Latvian financial market showed no signs of disturbance on the eve of the new year. The money market had accumulated high liquidity, the lats money market interest rates were low, and the exchange rates remained stable.

As the Bank of Latvia pegged the lats to the SDR basket of currencies in 1994 with the fluctuation margins of ±1%, and since the fixed exchange rate regime has proved appropriate for the Latvian economy, the Bank of Latvia resolved to maintain the same fluctuation margins of the lats peg against the euro. As a result, the fixed exchange rate regime in Latvia was actually maintained, with only the peg currency changing at the beginning of 2005. The change of the peg was economically founded as well, for the share of the euro denominated flows in foreign trade is markedly above 50% and continues to increase, whereas the US dollar denominated flows account for hardly around 20%.

The Bank of Latvia's foreign reserves, which include gold, convertible foreign currencies and SDR, amounted to 1 043.4 million lats at the end of 2004 (830.5 million lats at the end of 2003). Foreign reserves increased both in terms of the euro (by 31.7%) and the US dollar (by 20.5%), reaching 1 484.2 million and 2 022.1 million, respectively, at the end of 2004. In 2004, the Bank of Latvia conducted significant currency interventions buying foreign currencies in the net amount of 215.4 million lats (97.4 million lats in 2003). Interventions were conducted in the US dollars, euros and British pounds sterling.

The Bank of Latvia manages its foreign reserves in compliance with the Bank of Latvia's Council Guidelines. In 2004, the Bank of Latvia's Council approved a revised edition of the "Guidelines for Managing the Bank of Latvia's Foreign Reserves" (in effect as of January 1, 2005). Main amendments to the Guidelines are related to the change of the peg of the lats. To minimise the currency risk to the largest extent possible, the euro has been established as the base currency of the benchmark portfolio.

The Bank of Latvia invests its foreign reserves in safe and liquid financial assets, primarily in debt securities issued by governments and government agencies of the euro area countries and the US, as well as international organisations. Within the limits stipulated by the Guidelines, the Bank of Latvia's foreign reserves were also invested in highly rated debt securities of banks and other institutions, asset backed securities and callable bonds, as well as interest rate future contracts. To secure the required currency structure of the foreign reserves, the Bank of Latvia uses forward foreign exchange transactions.

THE BANK OF LATVIA'S MONETARY POLICY INSTRUMENTS

Upon Latvia's accession to the EU, the Bank of Latvia continued to pursue its monetary policy to ensure economic stability in the country.

In 2004, the Bank of Latvia raised the refinancing rate by 50 basis points on two occasions (from 3.0% to 3.5% as of March 11, and from 3.5% to 4.0% as of November 12). The Bank did not change the interest rate on bank 7- and 14-day time deposits (2.00% and 2.25%, respectively), and also left unchanged the interest rate on Lombard loans with maturity of up to 10 days, from 11 to 20 days and over 20 days (5.00%, 6.00% and 7.00%, respectively).

The refinancing rate was raised to address macroeconomic risks – mainly external imbalances and inflation. The risks increased as a result of rapidly growing domestic demand, which was fueled by the acceleration of lending.

The effect of the increase in the Bank of Latvia's refinancing rate was offset by the growing role of foreign financing in Latvia. With the refinancing rate being raised, the lats and the euro money market interest rate spread widened, yet the financial stability was not jeopardised due to long-term capital inflows in Latvia. With the base rates raised also in the US, the lats and the US dollar money market interest rate spread narrowed.

In addition to the increase in refinancing rate, the Bank of Latvia raised to 4% the minimum reserve ratio for banks as of July 24, 2004. In order to harmonise the Bank of Latvia's "Regulation for Calculating and Fulfilling the Minimum Reserve Requirements for Banks" with the ECB Regulation (EC) No. 1745/2003 on the application of minimum reserves (ECB/2003/9) and with the aim to slow down the growth in lending, the increase in the minimum reserve ratio was accompanied by amending the "Regulation for Calculating and Fulfilling the Minimum Reserve Requirements for Banks", which stipulated that, as of January 24, 2005, the minimum reserve requirement was also to apply to short-term liabilities to foreign banks. At the end of 2004, 22 banks and one branch of a foreign bank were subject to the minimum reserve requirements. The amount of the minimum reserve requirements increased by 83.4 million lats or 78.7% and reached 189.5 million lats at the end of the year.

The principal monetary policy instruments in 2004 were repo agreements and currency swaps. Repo auctions were conducted in the amount of 2 053.2 million lats (2 609.8 million lats in 2003), whereas currency swaps amounted to 248.7 million lats (1 549.3 million lats in 2003). The role of the currency swaps weakened. The Bank of Latvia gradually brought its monetary policy in line with the monetary policy of the ECB whose core instrument – the main refinancing operations – is similar to repo agreements of the Bank of Latvia.

In 2004, the Bank of Latvia proceeded with offering repurchase agreements of 7- and 28-day maturity. The volume of the deals by 21.3% fell behind the figure of 2003. In 2004, the 7-day repo agreements accounted for 94.9% of total repo transactions (96.4% in 2003). Banks demanded repo agreements to a lesser extent as liquidity on the money market was high. The average end-of-day balance on repo transactions in 2004 was 46.5 million lats (18.5% less than in 2003). The average weighted interest rate on repo transactions with 7-day maturity was 3.54% (57 basis points above the level of the previous year). Its increase was triggered by the Bank of Latvia raising its refinancing rate.

In 2004, the Bank of Latvia conducted short-term currency swaps, albeit the offer (778.0 million lats) was 6.4 times smaller than in the previous year, with the number of concluded currency swap deals respectively decreasing 6.2 times. The average end-of-day balance on currency swaps was 24.1 million lats (78.3 million lats in 2003). Currency swaps with 7-day maturity accounted for 54.4% of total currency swap deals (65.6% in 2003), while their average weighted interest rate on lats resources was 3.34% (2.81% in 2003).

The average end-of-day balance on time deposits of banks and other financial institutions was 3.9 million lats in 2004 (1.5 times larger than in the previous year). The 7- and 14-day time deposit facility was offered to banks and other financial institutions. In 2003, only the 14-day time deposit facility was offered, whereas in 2004, the deposits with 7-day maturity accounted for 58.6% of the deposit volume received. This indicates strong liquidity fluctuations, as the banks were not willing to deposit their funds for 14 days because of the additional 25 basis points and opted for the 7-day term instead. Hence the average weighted interest rate on time deposits received declined from 2.25% in 2003 to 2.10% in 2004. Banks used this instrument more actively in the periods of a larger excess liquidity (e.g. in May and June), and it happened as a rule after the sale of a large amount of foreign currency to the Bank of Latvia through spot transactions.

The average end-of-day balance on Lombard loans was 0.4 million lats in 2004 (by one third exceeding the figure of the previous year). Of total Lombard loans granted, the demand Lombard loans amounted to 90.3 million lats or 79.2% (93.2% in 2003), whereas the automatic Lombard loans were in the amount of 23.7 million lats. The average weighted interest rate on Lombard loans was 5.00% in 2004.

In 2004, the Bank of Latvia purchased Latvian government securities in the amount of 37.2 million lats (2.2 times more than in the previous year). The Bank of Latvia conducted interventions in the secondary market of securities in February and October. The Bank bought securities in the secondary market because under the conditions of changing liquidity the demand for repo loans was also unstable, and banks often demanded Lombard loans or made time deposits with the Bank of Latvia. In such a way the short-term liquidity fluctuations were eased. Of the Bank of Latvia's securities portfolio, government securities were redeemed in the amount of 4.7 million lats, and the average end-of-day balance of the Bank of Latvia's government securities portfolio in 2004 (excluding securities pledged under repurchase agreements) was 81.3 million lats (21.9% larger than in 2003).

As in 2003, the reverse repo transactions with government securities were not conducted in 2004. With banks having only short-term excess liquidity, there was no need for the Bank of Latvia to limit their liquidity by this instrument.

The Government of Latvia deposited funds with the Bank of Latvia. In 2004, the average time deposit balance of the Government with the Bank of Latvia was 75.8 million lats (23.1% larger than in the previous year).

The Bank of Latvia continued to quote RIGIBID (deposit rates in the interbank market) and RIGIBOR (lending rates in the interbank market) in accordance with the Bank of Latvia's "Regulation for the Calculation of RIGIBID and RIGIBOR", including those banks in quotation lists that were active in the interbank market and able to conduct operations at the quoted money market rates on transactions in lats. The list of the banks whose money market quotes are used in RIGIBID and RIGIBOR calculations comprising JSCs the Baltic Trust Bank (former JSC *Baltijas Tranzītu banka*), *Hansabanka*, *Latvijas Krājbanka*, *Latvijas Unibanka*, *Parex banka* (former JSC *Parekss-banka*), HVB Bank Latvia (former JSC *Vereinsbank Rīga*) and the Latvia Branch of *Nordea Bank Finland Plc* was not changed in 2004.

CASH MANAGEMENT

In 2004, cash in circulation (banknotes and coins) increased by 6.6% (from 682.1 million lats to 727.4 million lats). Over the last five years, currency in circulation has grown 1.7 times.

Banknotes and coins received from the banking sector were checked for authenticity and fitness for circulation by using automated cash processing systems. In order to render cash processing more effective, the Bank of Latvia purchased two new systems for processing of banknotes and one for disintegration and briquetting

20-LATS BANKNOTE

Face value:
20 lats
Size: 130 x 65 mm
Colour: brown

Obverse
A traditional Latvian homestead and a stylised oak-leaf, which is a see-through register, are superimposed on an ornamental background, with two inscriptions of the nominal value 20 Ls in relief embedded above. Across the top of the banknote, there is the two-tone inscription LATVIJAS BANKAS NAUDAS ZĪME (banknote of the Bank of Latvia), beneath which the serial number of the banknote is printed in red. Across the bottom of the banknote, there are the inscriptions DIVDESMIT LATU (twenty lats; in two-tone print), LATVIJAS BANKA, the facsimile signature of the Governor of the Bank of Latvia, and the serial number of the banknote in black print. On the right side of the banknote, there is a vertical ornamental band, which is composed of a motif from the Lielvārde belt and topped by the numeral 20. On the ornamental band, the inscription 20 Ls is visible when the banknote is viewed at a slant. On the left side of the banknote, there are two brown relief dots (Braille) arranged horizontally on a white background, which is watermarked (a profile of a Latvian maiden). Beneath the watermark, there is a band comprising fine brown lines with the numeral 20 in special print, with the optical effect of changing colours depending on the angle of viewing. Beneath the numeral 20 there are bands with LATVIJAS BANKA in micro-lettering. On the left side of the numeral 20 there is a vertical band with the numeral 20 in relief repeated four times in different colours when viewed at different angles.

Reverse
The reverse depicts a motif of the traditional Latvian ornaments. A vertical metallic holographic band that is worked into the paper with the lettering Ls and the inscription Ls 20 (a see-through register) is across the motif. A stylised oak-leaf (a see-through register) is to the right of the centre. Across the top of the banknote, there is the two-tone inscription DIVDESMIT LATU and the numeral 20. The numeral 20 and the two-tone inscription LATVIJAS BANKAS NAUDAS ZĪME are at the bottom of the banknote. A vertical band with diagonal stripes that blend one into another is on the left of the ornamental motif. Along the edge of the band, there is the inscription © LATVIJAS BANKA 1992 on a white background. A graphic design of the large coat of arms of the Republic of Latvia, with the year of 2004 inscribed underneath, is depicted on the white background in the right corner of the banknote. Above the coat of arms, the paper is watermarked (a profile of a Latvian maiden).

SPECIAL CIRCULATION COINS WITH A LIMITED BATCH

"MUSHROOM"

Face value: 1 lats
Weight – 4.80 g; diameter – 21.75 mm
Material: cupro-nickel
Struck by *Rahapaja Oy* (Finland)
Artists: Guntars Sietiņš (graphic design),
Jānis Strupulis (plaster model)

"SPRĪDĪTIS"

Face value: 1 lats
Weight – 4.80 g; diameter – 21.75 mm
Material: cupro-nickel
Struck by *Royal Dutch Mint* (the Netherlands)
Artist: Ivars Mailītis

COMMEMORATIVE COIN

"COIN OF TIME"

Face value: 1 lats
Weight: 17.15 g (weight of the central circle – 7.15 g, weight of the outer ring – 10.00 g)
Diameter: 34 mm (diameter of the central circle – 23 mm)
Metal: the central circle – niobium; the outer ring – silver, fineness .900
Quality: UNC
Struck in 2004 by *Münze Österreich* (Austria)
Artists: Laimonis Šēnbergs (graphic design), Jānis Strupulis (plaster model)

NATIONAL COMMEMORATIVE COIN PROGRAM *LATVIA. TIMES AND VALUES*, SERIES *TIME*

"LATGALE"

Face value: 1 lats
Weight: 31.47 g; diameter: 38.61 mm
Metal: silver, fineness .925; quality: proof
Struck in 2004 by *Rahapaja Oy* (Finland)
Artists: Arvīds Priedīte (graphic design), Ligita Franckeviča (plaster model)

"VIDZEME"

Face value: 1 lats
Weight: 31.47 g; diameter: 38.61 mm
Metal: silver, fineness .925; quality: proof
Struck in 2004 by *Rahapaja Oy* (Finland)
Artists: Arvīds Priedīte (graphic design), Ligita Franckeviča (plaster model)

COIN ISSUED WITHIN THE EU COMMEMORATIVE COIN PROGRAM

"LATVIA – EU"

Face value: 1 lats
Weight: 31.47 g; diameter: 38.61 mm
Metal: silver, fineness .925; quality: proof
Struck in 2004 by Royal Mint (United Kingdom)
Artists: Sandra Belsone (graphic design), Jānis Strupulis (plaster model)

of banknotes; these systems will also operate after the introduction of the euro in Latvia. The amount of currency processed in 2004 (1 876.8 million lats) exceeded the amount of currency in circulation 2.6 times (2.1 times in 2003). Of the amount processed, 250.3 million lats or 13.3% was withdrawn from circulation (204.0 million lats or 14.1% in 2003). The nominal value of counterfeits detected in 2004 was 35.9 thousand lats (including 29.3 thousand lats in 100 lats banknotes), accounting for only 0.005% of total cash in circulation.

On October 19, 2004, the Bank of Latvia put into circulation a new 20-lats banknote with improved security features, hereby proceeding with the implementation of measures preventing counterfeiting of the national banknotes.

By issuing 1-lats silver coins *Vidzeme* (in circulation as of September 21, 2004) and *Latgale* (in circulation as of October 20, 2004), the Bank of Latvia continued the second series *Time* of the national coin program *Latvia. Times and Values*. The first bimetal (silver and niobium) commemorative coin of Latvia – the Coin of Time (in circulation as of November 8, 2004), which came into being in cooperation with *Münze Österreich* (Austria) and whose reverse, where space has been left for an engraved dedication, features an astronomical clock, is likewise devoted to the theme of time. The Bank of Latvia celebrated the accession to the EU by issuing 1-lats silver coin *Latvia – EU. 2004* (in circulation as of December 27, 2004). A limited number of special 1-lats coins *Mushroom* (in circulation as of March 30, 2004) and *Sprīdītis* (in circulation as of December 20, 2004) replenish the stock of circulation coins.

Upon becoming an EU Member State, Latvia was incorporated in the Counterfeit Monitoring System (CMS) for the single European currency – the euro, established under the auspices of the ECB. CMS gathers statistical data and technical information relating to the euro counterfeiting. CMS is accessible only to the EU national central banks, EU national police authorities and Europol. The system provides operative information on detected cases of counterfeiting in any of the EU countries, enabling countries to focus duly and timely on the local aspects of counterfeiting. The responsibility for CMS administration, supervision, the compliance with the user access procedures and information input in each country is conferred upon a national center for combating counterfeiting, established under the auspices of each national central bank. The National Counterfeit Center has also been established at the Bank of Latvia.

STATISTICS

In 2004, the central focus of methodological work in respect of preparing Latvia's balance of payments and financial statistics was on the compliance with the ECB requirements and the quality of collected data.

To harmonise the terminology used in Latvia's statistics with the requirements of the ECB Regulation (EC) No. 2423/2001 concerning the consolidated balance sheet of the monetary financial institutions sector (ECB/2001/13) and to lay down the requirements for statistical data on electronic money in accordance with the provisions of the EU and Latvian legislation, the Bank of Latvia's Council introduced amendments to the "Regulation for Compiling the Monthly Financial Position Report of Credit Institutions and Its Appendices", including a change of its title ("Regulation for Compiling the Monthly Financial Position Report of Monetary Financial Institutions and Its Appendices"; amendments came into effect on January 1, 2005). These amendments also stipulate the procedure for the development and maintenance of the List of MFIs of the Republic of Latvia. To introduce the requirements of this Regulation concerning flows statistics, the Bank of Latvia's Council approved the "Regulation for Compiling the 'Report on Adjustments in Respect of Write-Offs/Write-Downs of Loans and Price Revaluations of Securities' " (in effect as of June 1, 2004).

The compilation and transmission to the ECB of credit institutions' interest rate and flows statistics as well as the compilation of statistics on money market transactions and net open foreign exchange position started in 2004. The Bank of Latvia began to use the EU information exchange system maintaining the List of MFIs of the Republic of Latvia and using the opportunity to obtain MFIs lists of the other EU countries.

Under the ECB project concerning statistics of other financial intermediaries and for the purpose of identifying these intermediaries and statistical data compilation opportunities of this sector, studies of this sector were commenced in Latvia. The Bank of Latvia created a new section on its website providing a brief overview of the sector of other financial intermediaries. Using information of the CSBL, the Bank started compiling the quarterly aggregated balance sheet of leasing companies as well as publishing it and the list of leasing companies in this section. Likewise, a preliminary list of investment funds was developed jointly with the FCMC and sent to the ECB.

On a daily basis as of July 6, 2004, the Bank of Latvia forwarded to the ECB the information about long-term interest rates on selected Latvian securities, which is needed for monitoring the compliance with the Maastricht convergence criterion. By the approval of the Treasury, the Latvian government bond with the longest term to maturity has been selected for the assessment of the compliance with the convergence criteria.

After the implementation of the report on services rendered and received by the residents of Latvia at the beginning of 2004, the balance of payments information is compiled for transactions executed instead of payments made, which is consistent with the international standards.

In respect of investment statistics, methodological work continued to ensure the reporting of equity capital as close to the market value as possible. For the assessment of the value of the listed companies, the Riga Stock Exchange data are used, whereas the value of other companies is obtained by using the ECB-recommended assessment of own funds at book value. For the purpose of improving the quality of data on investment, portfolio investment and other investment, a new quarterly report on foreign investment allowing for compiling of the data not only on the investment position but also on flows (changes arising from transactions, prices, foreign exchange fluctuations and similar changes) was developed (in effect as of January 1, 2005).

Under the 2003 pilot project on compiling quarterly financial accounts, which are a component of the national accounts and characterise the financial system as a whole, the Bank of Latvia compiled the relevant quarterly statistical data and forwarded them to the ECB starting with the first quarter of 2004.

The submission to the ECB of a number of statistical indicators related to the national economy and the housing market began in 2004.

The Bank of Latvia proceeded with the dissemination of financial and balance of payments statistics via its regular publications and the Bank's website, IMF publications *International Financial Statistics* and *Balance of Payments Statistics Yearbook*, with the help of the Bank for International Settlements and Eurostat, and also within the IMF Special Data Dissemination Standard. In October 2004, the preparation of the summary of economic developments for the ECB publication *Green Book* was commenced. A chapter developed by the Bank of Latvia on the Latvian securities market and long-term securities interest rates was included in the ECB publication *Bond Markets and Long-Term Interest Rates in Non-Euro Area Member States of the European Union and in Accession Countries (November 2004)*. Taking into account the ECB practice of seasonally adjusting monetary aggregates and its recommendations for publishing more versatile and comprehensive statistical information, in 2004 the Bank of Latvia began to develop and release seasonally adjusted time series based on the ECB methodology.

PAYMENT SYSTEMS

The Bank of Latvia continued to ensure the operation of two payment systems (the SAMS ensuring settlements of both interbank and urgent customer payments, and the EKS executing only retail payment processing and clearing).

At the end of 2004, 22 banks, one branch of a foreign bank and the Bank of Latvia were the participants in the Bank of Latvia's payment systems. In the reporting year, payments processed within the SAMS increased by 16.3%, reaching 148.5 thousand, while their total value reached 34.7 billion lats (1.1 billion lats more than in 2003). Such an increase in the total volume and value of payments in the SAMS was facilitated by an increase in the volume and value of both interbank payments and customer payments. The share of interbank and customer payments in the SAMS remained broadly unchanged year-on-year (40.6% and 59.4% by volume and 82.6% and 17.4% by value, respectively).

In 2004, payments processed within the EKS increased by 16.1%, reaching 17.2 million, with the total value 22.5% higher than in the previous year (6.8 billion lats).

In 2004, substantial changes in both the payment systems and the relevant regulations were implemented. On January 9, 2004, a new version of the EKS started operating. Major changes in the system were the introduction of the second clearing cycle. It gave banks an opportunity to execute those retail payments that were submitted in the morning in the second clearing cycle, providing funds on the beneficiary's account on the same day.

In 2004, banks implemented the required changes to fully replace, at the beginning of 2005, the customer account numbers with the account numbers corresponding to the International Bank Account Number IBAN. The IBAN account numbers were assigned not only to the customers of all the banks, but also to the clients of both the non-profit organisation state JSC *Latvijas Pasts* and the Treasury. The necessary changes were also made in payment systems maintained by the Bank of Latvia and the respective systems' regulations to ensure, as of January 2005, processing of payments within the payment systems, using the IBAN to identify customer accounts. The Bank of Latvia, in cooperation with the commercial banks, provided the public with information on the change of the account numbers and the usage of the IBAN in Latvia (via mass media, including television and radio as well as on the Bank of Latvia's website).

On November 1, 2004, amendments to the "Regulation for Interbank Settlements Effected by the Bank of Latvia" took effect. Banks were actively involved in drafting the amendments, which were developed to streamline the information indicated in the bank customers' payment orders. The new procedure stipulated how the payments were to be transferred to entities servicing customer accounts without directly participating in the Bank of Latvia's payment systems. In the reporting year, such participants were the non-profit organisation state JSC *Latvijas Pasts* and the Treasury.

The Bank of Latvia's staff participated in the ESCB working groups dealing with issues related to payment systems, including the emerging Trans-European Automated Real-time Gross Settlement Express Transfer System TARGET2. Experts from the Bank of Latvia participated in developing the system's functionality as well as addressing other issues related to the system's implementation strategy, its oversight and other areas. Jointly with the banking sector, the Bank of Latvia has started preparing for participation in TARGET2. To co-ordinate activities related to joining TARGET2 once Latvia has become a full-fledged member of the EMU and introduced the euro, the Bank of Latvia has established a TARGET2 working group, which has already commenced its work. All Latvian banks have appointed project managers to coordinate the participation of the banking sector in TARGET2.

To inform the public about the Bank of Latvia's achievements, the publication *Oversight of the Payment System in Latvia* was prepared at the end of 2004. The publication describes the oversight of the systemically important payment system SAMS and the retail payment system EKS, as well as the day-to-day oversight of the SAMS and the EKS and oversight of payment instruments.

In 2004, the Bank of Latvia and the FCMC signed the *Memorandum of Understanding on Cooperation Between Payment Systems Overseers and Banking Supervisors in Stage Three of Economic and Monetary Union* and the *Memorandum of Understanding on High-Level Principles of Cooperation Between the Banking Supervisors and Central Banks of the European Union in Crisis Management Situations*. The purpose of the first is to promote safe and continuous operation of large-value interbank payment systems. Cooperation within the framework of the Memorandum takes place mainly via the exchange of information between the Bank of Latvia as the payment system overseer and the FCMC as the banking supervisory authority. The second Memorandum stipulates a set of principles and procedures regarding the cross-border cooperation between the central banks of the EU countries and supervisory institutions in crisis management situations.

On May 1, 2004, the Regulation (EC) No 2560/2001 of the European Parliament and of the Council "On cross-border payments in euro" took effect in Latvia. Pursuant to the Regulation, credit institutions are to ensure an equal price for both domestic and cross-border credit transfers in euros within the EU. In the reporting year, Latvian banks executed both cross-border and domestic payments in euros through foreign correspondent banks. The commission charged for cross-border and domestic payments in euros were generally the same, and the Regulation requirements were thus complied with. However, upon the introduction of the euro in Latvia, banks will be obliged to drastically reduce the fee charged for cross-border payments in euros to make it equal with the commission charged for domestic payments. In order for credit institutions to successfully comply with the requirements of this Regulation, a retail payment system STEP2 has been developed in the EU, ensuring cheap and fast settlements in euros among the EU countries. Latvian banks have commenced timely preparation for compliance with the requirements of the Regulation after the introduction of the euro in Latvia, and by the end of 2004 11 banks were registered as indirect participants and one bank as a direct participant in STEP2.

INFORMATION SYSTEMS

In 2004, the Bank of Latvia successfully joined the ESCB telecommunications network CoreNet, teleconference system and application infrastructure ESCB-Net. The new telecommunications infrastructure ensures fast and secure data transmission and voice communications among the central banks of the EU countries.

The Bank of Latvia updated the Interbank data communication network and the Bank of Latvia's regional branch data communication network. The new data communication network ensures higher speed and availability, simultaneously reducing the costs of infrastructure maintenance.

The Bank of Latvia connected to SWIFTNet, SWIFT system's new telecommunications infrastructure, thereby ensuring a state-of-the-art, faster and safer exchange of financial information with other SWIFT participants, including those within the SAMS system.

Complementary security systems were implemented to protect the Bank of Latvia's computer network and information system environment against the latest threats including computer viruses, malicious codes and disruptive programmes and other external threats.

At the close of 2004, a specialised translation system TRADOS was purchased and implemented, substantially facilitating translation of legal and informative documents, as well as ensuring the use of uniform terminology in all translations (including translations of the ECB publications).

The information system that enables non-banks to submit statistics required for compiling the state balance of payments electronically has been substantially updated. The scope of reports to be submitted in electronic form has been extended, including the statistical reports of currency exchange offices and credit unions.

A major project was commenced to update the Bank of Latvia's centralised data storage and management system, ensuring the highest level of availability and performance of all critical information systems.

INFORMATION TO THE PUBLIC

The Bank of Latvia's publications, the Internet, the press, television and radio were the media used by the Bank to inform the public about its activities and developments in the Latvian economy.

After the integration of the Bank of Latvia with the ESCB, the Bank's cooperation with the ECB and the central banks of the EU countries in the field of information exchange became closer. The performance of the ESCB External Communication Committee (ECCO) and its working group was particularly significant, e.g., in ensuring timely information to the Latvian public about the tasks of the Eurosystem, the single European currency, the conditions of its introduction and other aspects in preparation for a full-fledged participation in the EMU and introduction of the euro.

As of June, 2004, the ECB Monthly Bulletin has been provided in Latvian (published four times on the Internet). The "Introduction and Executive Summary" of the ECB Convergence Report 2004 was also published in Latvian both on the Internet and in print.

The Bank of Latvia's regular publications have provided comprehensive information on Latvia's financial sector and the economy. At the beginning of 2004, the Bank of Latvia published its *Bank of Latvia*: *Annual Report 2003* to disseminate information on the Bank of Latvia's operation and its financial performance results, as well as provide analysis of the developments in the Latvian economy in the context of global economic development. The *Financial Stability Report* describes the development trends in the financial sector. The Bank of Latvia's *Monetary Review*, *Monetary Bulletin*, *Latvia's Balance of Payments* and *Latvia's Balance of Payments (Key Items)* provide information on the key economic and monetary indicators. The economic developments in Latvia and abroad, particularly the integration of Latvia's economy with the EU, repegging of the national currency and the prospects for implementing the euro are analysed in the bulletin *Averss un Reverss*. In a series of working papers, several studies by the Bank of Latvia's experts were published and made available to economics and finance professionals: the anticipated impact of the introduction of the euro on the Latvian economy and money demand in Latvia, as well as on the foreign exchange and money market developments in view of the exchange rate band.

The mass media received regular information on resolutions passed by the Bank of Latvia's Council and Board and the Bank's activities. The Bank's experts prepared materials on issues falling within the competence of the central bank to be published in the press both in Latvia and abroad.

The Bank of Latvia's Governor held regular press conferences to inform the media about resolutions passed by the Council of the Bank of Latviaand developments in the national economy, followed by question-and-answer sessions.

In January, 2004, the Bank of Latvia announced an idea competition for the euro coin design, inviting any resident of Latvia to participate with ideas for the design of Latvia's new money. More than one thousand works were submitted for the competition. Incorporating as it did several ideas, the design with the motto: "Freedom: a European value" was acknowledged as the best work (author Ilze Kalniņa, city of Jēkabpils). The jury was of the opinion that the Freedom Monument, the folk-maiden once portrayed on the Latvian 5-lats silver coin and the Latvian coat of arms also represent Latvia and its key values best.

The Bank of Latvia provided information to the public on the repegging of the lats as of the beginning of 2005. The public was made aware of pegging the lats to the euro, its substance, progress and its anticipated effects on the economy and households. As pegging the lats to the euro will cause changes in the operation of commercial companies executing payments in US dollars, the Bank of Latvia has provided them with additional information on the foreign exchange risk increase.

At the beginning of 2004, the Bank of Latvia announced the second competition for student research papers. The purpose of the competition was to encourage the future specialists to engage in economic analysis and research, addressing topical financial and economic issues, including Latvia's macroeconomic development and the impact of integration with the EU on diverse areas of the Latvian national economy.

In September 2004, the Bank of Latvia organised a conference "The Latvian Economy in the European Union: Opportunities, Challenges, Prospects". The Bank of Latvia experts, representatives of other governmental institutions, entrepreneurs, financiers and scientists addressed the economic development trends and potential problems, as well as the actions by economic agents and the need for cooperation as the national economy integrates with the EU and Latvia joins the EMU.

In 2004, the Bank of Latvia established a financial education and information centre "Money World", aimed at any individual or group interested in the central bank's tasks, operation and role in the financial sector as well integration with the ESCB-related processes.

The Bank of Latvia participated in the production of the TV broadcast *Kā bankā* and the radio broadcast *Lata spogulī* to inform and educate the public about the monetary policy and other economy related issues. The public was informed about the launch of the IBAN in Latvia as well as the new lats banknotes and their security features.

All Bank of Latvia's publications are available on the Bank of Latvia's website. The information on the Bank of Latvia, its regulations, financial statistics, payment and settlement systems, Latvian money, and other areas of interest was regularly complemented and updated on the website. With the Bank of Latvia joining the ESCB, comprehensive information about the ECB's monetary policy and instruments, as well as the EMU and Latvia's preparation for full-scale participation therein, was available on the Bank of Latvia's website.

THE BANK OF LATVIA'S ORGANISATIONAL DEVELOPMENT

THE BANK OF LATVIA'S STRUCTURE

On June 2, 2004, the Saeima of the Republic of Latvia appointed Mr. Bush and Mr. Sautiņš Members of the Council of the Bank of Latvia for another term of six years. Mr. Gricenko and Mr. Skopiņš were appointed Members of the Council of the Bank of Latvia for a term of six years, which began on July 2, 2004.

The composition of the Council of the Bank of Latvia, as at the end of 2004, was as follows:

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

The composition of the Board of the Bank of Latvia remained unchanged and, as at the end of 2004, was as follows:

– Chairperson of the Board	**Māra Raubiško**;
– Deputy Chairmen of the Board:	**Reinis Jakovļevs**, **Helmūts Ancāns**;
– Members of the Board:	**Roberts L. Grava**, **Māris Kālis**, **Harijs Ozols**.

At the end of 2004, the number of the Bank of Latvia's employees was 698, of which 22 were employees with a job contract for a definite period (743 and 26 employees at the end of 2003, respectively). Of the Bank's staff, as at the end of 2004, 59% were males and 41% were females.

To ensure successful exchange of information between the Bank of Latvia and the EU institutions, the Bank of Latvia appointed a special attaché at the Latvian Mission to the EU at the beginning of 2004.

The Bank of Latvia continued to improve its organisational structure. To structure all engineering functions related to the Bank of Latvia's ownership management and the functions of engineering technical services, the General Service Department, the Construction Department and the Security Department's Engineering and Technical Unit were united and the Technical Support Department was established.

As a result of changes in the cash processing system in the Vidzeme region and optimisation of the use of resources, the Valmiera Branch was closed on December 30, 2004.

HUMAN RESOURCES DEVELOPMENT

The Bank of Latvia employees continued with their academic studies, as well as additional professional training, participating in seminars, workshops and conferences in Latvia and abroad to obtain the latest information in the fields of monetary policy, financial stability, macroeconomics, econometrics, foreign exchange operations, payment systems, statistics, bank accounting and information technologies. A number of the Bank's employees successfully participated in international professional certification programmes.

In 2004, 3.3% of total expense on wages, salaries and other personnel costs was used for the needs of the Bank's personnel training.

In the Bank of Latvia's personnel training, particular attention was still paid to developing skills necessary for successful cooperation of the Bank's personnel with the ECB and the national central banks of other EU countries. The personnel involved in the ECB's committees and working groups had an opportunity to improve their business English and to enhance their skills organising business meetings and presentations in an international context. In-depth studies in the fields of process management, communication, interaction psychology and efficient time management continued as did computer skills and foreign language training. A precondition for a wider cooperation with the ECB in the field of translation and publishing was the acquisition of the translation and terminology programme TRADOS.

The managers' development programme comprised training of managers in the fields of meeting skills, working group management and decision-making.

Special seminars were held for recently hired employees to inform them about the Bank's tasks and its organisational units' fulfilling these tasks. The employees of the International Department and the Monetary Policy Department presented topical information about the EU institutions, cooperation with the ECB, the ESCB and other international financial institutions to the Bank of Latvia's staff.

In 2004, the Bank continued cooperation with the ECB's Directorate Human Resources in the field of personnel selection. The Bank of Latvia's employees can apply for temporary and permanent employment at the ECB. In 2004, three Bank's employees improved their professional skills on short-term assignments at the ECB. After Latvia's accession to the EU, the Bank of Latvia's staff may also participate in workshops organised by the ESCB. This kind of participation provides knowledge about topical ESCB issues and processes.

THE "BANK OF LATVIA CODE OF CONDUCT"

In 2004, the Bank of Latvia's Council approved the "Bank of Latvia Code of Conduct", including the principles of professional conduct, rules and recommendations, which the Bank of Latvia's employees have to comply with regarding their attitude towards their tasks, interpersonal relations and relations with other institutions and the public. The "Bank of Latvia Code of Conduct" is a substantial component of the Bank's operational organisation indicating the quality of services other persons may expect to be provided upon collaborating with the Bank of Latvia.

Compliance with the core principles of the "Bank of Latvia Code of Conduct" fosters successful fulfilment of the Bank's tasks.

RISK AND QUALITY MANAGEMENT AT THE BANK OF LATVIA

In 2004, the Bank of Latvia's Board continued to develop risk management in line with the core principles and guidelines stipulated by the Bank of Latvia's Council, taking into consideration the development of the financial market and the Bank of Latvia's operation.

The Bank of Latvia's financial risks are managed in line with the "Guidelines for Managing the Bank of Latvia's Foreign Reserves", which the Council of the Bank of Latvia reviews and amends, if necessary, at least once a year. The new edition of the Guidelines (in force as of January 1, 2005) incorporates changes stipulating the measures for containing financial risks after the change of the lats peg. The management of the Bank of Latvia's core operation is coordinated by the Bank's risk management working group. The working group has assessed and summarised risk reports developed by the Bank's organisational units and has developed a classification of the risks, thereby maintaining and updating the Bank of Latvia's risk matrix.

The Bank of Latvia's risk matrix information system was substantially updated, supplementing both the scope of the documented information and the facilities for developing reports. Risks associated with the Bank of Latvia's branches and reorganised organisational units were re-valued in relation to the structural changes. In April 2004, the Bank of Latvia's Board reviewed and approved the Bank's risk report as well as reported to the Bank of Latvia's Council on the situation in the area of risk management. Personnel training in the field of information and information system security and personal data protection was organised.

In 2004, the implementation of continuous operation management improvement project commenced. The goal of the project is to introduce complementary organisational activities in the Bank of Latvia for better protection of the Bank against any potential disruptions of its operations. In keeping with the best practices, the core principles of continuous operation management were improved.

The Bank's quality management system has been functioning since 2000. In 2004, an external supervision audit of the Bank's quality management system was conducted and non-compliance with the standard ISO 9001:2000 was not detected during this audit.

INTERNAL AUDIT AT THE BANK OF LATVIA

The internal audit of the Bank of Latvia is conducted by the Internal Audit Department. The Audit Committee operates in the Bank of Latvia, supervising and helping to improve internal audit.

The internal audit is organised and conducted, taking into consideration the "International Standards for the Professional Practice of Internal Auditing" and "Code of Conduct" developed by the Institute of Internal Auditors as well as the standards established by the Control Objectives for Information and Related Technology (CobiT) and the Information System Audit and Control Association (ISACA). Pursuant to the "Bank of Latvia's Policy on Internal Audit", the internal audit comprises all areas of the Bank's operation.

The audit engagements are planned and conducted on the basis of risk assessment and taking into consideration the requirements of the Bank's Council. The results of each audit are reported to the Bank of Latvia's Governor. On a quarterly basis, the Bank of Latvia's Audit Committee is informed about the results of the conducted audit engagements, recommendations and their implementation. Once a year the results of the conducted internal audits and the most relevant conclusions are reported to the Bank of Latvia's Council.

In 2004, the Internal Audit Department also participated in the ECB audit engagements.

MANAGEMENT OF THE BANK OF LATVIA'S BUDGET AND ACCOUNTING

The Bank of Latvia's accounting system has been established and managed in line with the "Bank of Latvia Accounting Manual", approved by the Board of the Bank of Latvia, and the Bank's other regulations, in compliance with the Law "On the Bank of Latvia" and other laws and regulations binding on the Bank of Latvia.

The Bank of Latvia publishes monthly balance sheet, annual financial statements and other financial information. This information is also available on the Bank of Latvia's website. The management of the Bank of Latvia and other employees receive information about the Bank of Latvia's financial position, results of operation and the execution of the budget from information systems on a daily basis. The management of the Bank of Latvia assesses, on a regular basis, changes in the Bank of Latvia's assets and liabilities as well as income and expenditure, paying particular attention both to the results from managing foreign currency and gold reserves as well as to the consistency of operating costs and long-term investments with the Bank's approved budget.

In 2004, the Bank of Latvia continued to improve its accounting procedures and internal financial control systems, as well as to develop an integrated banking information system *Globus*, ensuring a standardised, automated and efficient execution of the Bank's financial transactions, their uniform accounting and preparation of financial statements. In the reporting year, major changes were effected in relation to the provision of statistical information for the ECB, updating the financial risk management system as a result of the changes in foreign reserve management conditions, the usage of two clearing cycles and the IBAN standard in the payment systems, as well as improving maintenance, change management and continuous operation procedures of the banking information system *Globus*.

In 2004, the Bank's expenses were incurred and long-term investments made in accordance with the 2004 budget as approved by the Bank of Latvia's Council. The Bank of Latvia's Board, together with the heads of the relevant Bank's organisational units, made sure, on a regular basis, that the expenses were incurred and long-term investments made in accordance with the approved budget, and reported to the Council of the Bank of Latvia and Budgetary Commission on the execution of the 2004 budget. The Bank of Latvia's expenses and long-term investments for the year 2004 did not exceed the budgeted amount.

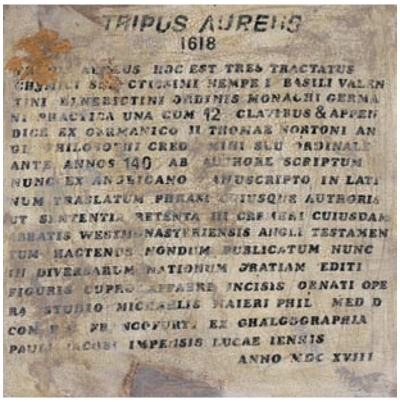
The management of the Bank of Latvia's budget for the year 2004 proceeded in compliance with the "Regulation for Managing the Bank of Latvia's Budget" approved by the Council of the Bank of Latvia and aimed at ensuring the financial fund spending efficiency. The Regulation provides for the procedure of drafting, approving and monitoring the execution of the Bank's budget. In 2004, the principles of the Bank of Latvia's budget management remained substantially unchanged.

FINANCIAL RESULTS OF THE BANK OF LATVIA

In 2004, the Bank of Latvia earned 3 289 thousand lats in profit (11 908 thousand lats in 2003). In 2004, the Bank of Latvia's net interest and similar income amounted to 23 475 thousand lats (30 652 thousand lats in 2003). The income was mainly derived from investing convertible foreign currency reserves in secure financial instruments of high liquidity, and income from Latvian Government securities and domestic money market transactions. In view of the lats repegging from the SDR currency basket to the euro, the Bank of Latvia had to restructure its foreign currency reserves by mostly disposing of debt securities denominated in British pounds sterling. A decrease in the market value of these debt securities was previously recognised in the valuation account. Moreover, the rise in US financial market interest rates had a negative impact on the market value of other debt securities in 2004. Therefore interest and similar income from foreign operations (21 760 thousand lats) decreased by 5 567 thousand lats in comparison with 2003. Interest income on loans to banks registered in the Republic of Latvia slightly decreased (1 698 thousand lats in 2004; 1 744 thousand lats in 2003). Interest income from Latvian Government securities (5 299 thousand lats; 4 216 thousand lats in 2003) increased as a result of higher investment in these securities in 2004. The Bank of Latvia's interest expense (5 290 thousand lats; 2 659 thousand lats in 2003) was largely comprised of interest on credit institution and Latvian Government deposits. In 2004, the Bank of Latvia began paying interest on part of credit institution minimum reserves deposited with the Bank of Latvia, and it was the major underlying factor for an increase of 1 091 thousand lats in interest expense for credit institution deposits. By implementing monetary policy, the Bank of Latvia received a considerable amount of Latvian Government funds as deposits, therefore interest expense on Government deposits grew by 1 544 thousand lats in the reporting year.

Increase in the net value of foreign debt securities and other financial instruments held by the Bank of Latvia, as reported in the Bank of Latvia's balance sheet caption "Valuation account", amounted to 1 409 thousand lats in 2004 (8 677 thousand lats decline in 2003).

THE BANK OF LATVIA'S FINANCIAL STATEMENTS FOR THE YEAR ENDED DECEMBER 31, 2004



THE BANK OF LATVIA'S BALANCE SHEET

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

ASSETS	Notes[1]	**2004**	2003
FOREIGN ASSETS		**1 170 605**	937 526
Gold	4	56 901	55 543
Special Drawing Rights		77	75
Convertible foreign currencies	5	986 458	774 834
International Monetary Fund	6	101 144	101 144
Participating interest in the European Central Bank	7	760	–
Participating interest in the Bank for International Settlements	8	1 000	1 000
Other foreign assets	9	24 265	4 930
DOMESTIC ASSETS		**145 283**	162 716
Loans to credit institutions	10	12 880	59 320
Transit credits	11	–	3 018
Government securities	12	93 208	62 273
Fixed assets	13	35 931	34 200
Other domestic assets	14	3 264	3 905
TOTAL ASSETS		**1 315 888**	1 100 242

[1] The accompanying notes set out on pages 64 to 92 are an integral part of these financial statements.

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

LIABILITIES, CAPITAL AND RESERVES	Notes	**2004**	2003
FOREIGN LIABILITIES		**131 291**	113 545
Convertible foreign currencies	15	2 445	149
International Monetary Fund	16	101 773	104 423
Other international institution deposits in lats	17	21 515	268[1]
Foreign bank deposits in lats		396	409[1]
Non-convertible currencies		36	36
Other foreign liabilities	18	5 126	8 260
LATS IN CIRCULATION	19	**727 354**	682 145
DOMESTIC LIABILITIES		**362 500**	213 521
Balances due to credit institutions	20	228 872	123 810
Balances due to the Government	21	107 156	80 254
Balances due to other financial institutions		1 300	1 670
Other domestic liabilities	22, 23	25 172	7 787
CAPITAL AND RESERVES		**94 743**	91 031
Nominal capital	24	25 000	25 000
Reserve capital	24	48 089	45 787
Valuation account	25	21 121	19 712
European Union grant		533	532
TOTAL LIABILITIES, CAPITAL AND RESERVES		**1 315 888**	1 100 242
MEMORANDUM ITEMS	27, 33		

These financial statements, which are set out on pages 58 to 92, were authorised by the Bank of Latvia's Board on March 3, 2005.

BANK OF LATVIA'S BOARD

Māra Raubiško

Reinis Jakovļevs

Helmūts Ancāns

Roberts L. Grava

Māris Kālis

Harijs Ozols

[1] In the financial statements for the year ended December 31, 2003, other international financial institution deposits in lats (268 thousand lats) were reported under the balance sheet caption "Foreign bank deposits in lats".

THE BANK OF LATVIA'S PROFIT AND LOSS STATEMENT

(in thousands of lats)

	Notes	**2004**	2003
INTEREST AND SIMILAR INCOME			
Foreign operations			
Interest on deposits with foreign credit institutions and other foreign financial institutions		1 504	1 838
Income from debt securities	26	20 076	25 395
Dividends on shares in the Bank for International Settlements		180	94
GROSS foreign interest and similar income		**21 760**	27 327
Domestic operations			
Interest on loans to credit institutions		1 698	1 744
Income from transit credits		8	24
Income from government securities	26	5 299	4 216
GROSS domestic interest and similar income		**7 005**	5 984
INTEREST EXPENSE			
Foreign operations			
Interest on deposits		8	8
GROSS foreign interest expense		**8**	8
Domestic operations			
Interest on deposits of credit institutions	26	1 120	29
Interest on government deposits	26	4 134	2 590
Interest on deposits of other financial institutions		28	32
GROSS domestic interest expense		**5 282**	2 651
NET INTEREST AND SIMILAR INCOME	26	**23 475**	30 652

(cont.)			(in thousands of lats)
	Notes	**2004**	2003
OTHER OPERATING INCOME		**447**	994
OTHER OPERATING EXPENSE			
Salaries, wages and other personnel costs		9 497	9 385
Social security costs		1 880	1 857
Depreciation and amortisation charges	13, 14	2 645	2 302
Costs of financing the Financial and Capital Market Commission	27	960	1 200
Maintenance of information systems		896	753
Banknote production and coinage costs	28	888	180
Other operating expense	29	3 867	4 061[1]
TOTAL other operating expense		**20 633**	19 738
PROFIT BEFORE APPROPRIATION		**3 289**	11 908
APPROPRIATION OF PROFIT			
Profit appropriated to the State budget		987	4 049
Increase in reserve capital		2 302	7 859

[1] Additionally includes renovation and repair costs (425 thousand lats), which were reported under the caption "Renovation and repair costs" in the profit and loss statement for the year ended December 31, 2003.

THE BANK OF LATVIA'S STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

(in thousands of lats)

	Notes	**2004**	2003
RESULT ON REVALUATION			
Increase in market value of gold reserves	4	1 358	4 531
Result on revaluation of assets and liabilities denominated in foreign currencies	25	1 402	570
Increase/decrease (–) in fair value of non-traded financial derivative contracts	25	1 990	–3 119
Decrease in fair value of securities	25	–3 341	–10 659
NET RESULT ON REVALUATION		**1 409**	–8 677
PROFIT BEFORE APPROPRIATION		**3 289**	11 908
TOTAL		**4 698**	3 231

THE BANK OF LATVIA'S CASH FLOW STATEMENT

(in thousands of lats)

	Notes	**2004**	2003
Net cash and cash equivalents inflow arising from operating activities	30 (1)	**37 609**	32 242
Investment in the capital of the European Central Bank		**–760**	–
Acquisition of fixed assets		**–3 719**	–3 198
Acquisition of intangible assets		**–452**	–386
Net cash and cash equivalents inflow	30 (2)	**32 678**	28 658

NOTES TO THE BANK OF LATVIA'S FINANCIAL STATEMENTS

1. PRINCIPAL ACTIVITIES

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

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

In the execution of its tasks, the Bank of Latvia is not subject to decisions and instructions by the Government or other institutions. 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 entrepreneurial activity, and its operation related to the execution of its tasks is financed mainly from revenue received from foreign currency and gold reserves management as well as monetary operation income.

The Head Office of the Bank of Latvia is situated in Riga, K. Valdemāra Street 2A. The Bank of Latvia ensures storing, processing and circulation of cash via its Riga Branch and the regional branches in Daugavpils, Liepāja and Rēzekne. Taking into account the changes in the cash processing system in the Vidzeme region and for the purpose of optimisation of resource allocation, the Bank of Latvia closed its Valmiera Branch at the end of 2004. The Bank of Latvia employed the staff of 698 at the end of 2004 (743 at the end of 2003).

2. RISK MANAGEMENT

The main risks associated with the Bank of Latvia's activities are financial risks and the operational risk. 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 operation. Financial risks of the Bank of Latvia are managed by the Investment Committee of the Bank of Latvia and the Market Operations Department. At the Bank of Latvia, management of operational risk is coordinated by the Risk Management Working Group of the Bank of Latvia headed by the security manager of information systems. Monitoring of the risk management system is in the competence of the Board of the Bank of Latvia. The risk management framework is subject to regular reviews by the Internal Audit Department personnel. At least quarterly, the Audit Committee of the Bank of Latvia reviews auditors' findings and recommendations as well as improvements in the risk management framework made by the Bank of Latvia. The Audit Committee of the Bank of Latvia is comprised of three members of the Council of the Bank of Latvia.

FINANCIAL RISKS

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

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

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

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

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

MARKET RISK

Market risk is exposure to losses due to adverse changes in financial markets (for example, movements in interest rates or exchange rates). The Bank of Latvia manages interest rate risk inherent mainly in financial instruments sensitive to interest rate fluctuations by using a modified duration limit set individually for each investment portfolio.

The Bank of Latvia monitors the currency risk by determining open currency position limits. For foreign reserves portfolios, except for portfolios of borrowed funds, the foreign currency profile of the net position on financial instruments, which corresponded to the structure of the SDR basket of currencies, was taken as a benchmark until the end of 2004. In line with the repegging of the lats from the SDR basket of currencies to the euro, which was carried out at the end of 2004, the Bank of Latvia made amendments to the currency structure of the foreign reserves benchmark portfolio (as of January 1, 2005 the euro is the benchmark portfolio currency; see Note 34). For portfolios of borrowed funds, the benchmark currency structure is formed in compliance with parameters of respective liabilities. Deviations from the benchmark currency structure give rise to the open currency position. Every working 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 aggregated market risk of foreign reserves portfolios, except for portfolios of borrowed funds, is managed by determining the portfolio tracking error limit. It is calculated as the annualised standard deviation of the difference in return between the investment portfolio and a respective benchmark portfolio.

The Bank of Latvia manages interest rate risk arising from foreign reserves by investing only in financial instruments denominated in the currencies of the OECD countries.

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

Exposure of the Bank of Latvia to market risk (as at the end of 2004) is provided in Notes 34 and 35.

CREDIT RISK

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

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

Short-term loans granted to domestic credit institutions are secured by collateral of Latvian Government securities and such private sector debt securities, which have been included on the list of securities approved by the Chairperson of the Board of the Bank of Latvia and whose issuers' ratings assigned by international rating agencies are not below the rating thresholds established by the Council of the Bank of Latvia in respect of the issuers' long-term liabilities in foreign currencies. The Monetary Policy Department reviews the compliance of ratings assigned to issuers of securities on the list referred above with the requirements of the Council of the Bank of Latvia and monitors the adequacy of collateral on a regular basis. Exposure of the Bank of Latvia to credit risk (as at the end of 2004) is provided in Notes 36 to 38.

LIQUIDITY RISK

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

Latvia's liabilities. The structure of the Bank of Latvia's cash and its equivalents is provided in Note 30.

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

OPERATIONAL RISK

Operational risk is exposure to financial and non-financial losses resulting from unexpected interruption of operation, unauthorised use of information, non-compliance with security requirements and other internal and external factors related to inadequate internal control system. To minimise operational risk inherent in security and information systems, the Bank of Latvia has established the Committee for Managing the Development of the Bank of Latvia's Complex Security Strategy and the Committee for Managing the Bank of Latvia's Information Systems, which review, on a regular basis, the operational risk management system. The Council of the Bank of Latvia has adopted "The Bank of Latvia's Security Guidelines", which provides the set of key principles for risk management and defines responsibilities in respect of managing risks. The Board of the Bank of Latvia has adopted the "Regulation for Managing the Bank of Latvia's Risks", which lays down the procedure for identifying, documenting, assessing and minimising risks. The Bank of Latvia has established the Risk Management Working Group, which summarises and evaluates risk reports prepared by the Bank's organisational units and identifies and classifies risks by maintaining and improving the Bank of Latvia's risk matrix.

In order to minimise operational risk, the Bank of Latvia has developed respective regulations for the improvement of the internal control system, and the Board of the Bank of Latvia monitors abidance by them jointly with managers of organisational units. Under the internal control system, information and relevant technical resources are classified to ensure confidentiality, availability and integrity of information. The Bank of Latvia has appointed owners of information and information systems who are responsible for classification, risk analysis and protection of particular information or information systems, and determination of the access rights and their application procedure.

On a regular basis, the Bank of Latvia's management reviews the adequacy and availability of resources for ensuring the continuity of the Bank's operations in case of emergency. Improvement of ensuring the continuity of the Bank of Latvia's operations started in 2004.

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

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

3. PRINCIPAL ACCOUNTING POLICIES

A summary of the principal accounting policies adopted by the Bank of Latvia in the preparation of these financial statements is set out below. The adopted accounting policies have been applied consistently in the preparation of financial statements for the years ended December 31, 2004 and December 31, 2003.

BASIS OF PRESENTATION

These financial statements have been prepared in accordance with the historical cost basis of accounting, modified for revaluation of certain assets and liabilities as referred to in the accompanying notes.

FOREIGN CURRENCY TRANSLATION

Transactions denominated in foreign currencies are recorded in lats at the exchange rates quoted by the Bank of Latvia for the day of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into lats at the exchange rates set by the Bank of Latvia at the end of the reporting period. Non-monetary items measured at cost or amortised cost are translated into lats at the exchange rate for the respective foreign currency set by the Bank of Latvia on the day of the transaction. Until the end of 2004, the official exchange rates of the lats against foreign currencies as quoted by the Bank of Latvia were determined taking into account the peg of the lats to the SDR basket of currencies on the basis of the exchange rate of the US dollar against the SDR, and the exchange rates of other currencies against the US dollar as quoted in the information system *Reuters*. As of 2005, the Bank of Latvia sets the exchange rates taking into account the lats peg to the euro on the basis of the exchange rate of the US dollar against the euro, and the exchange rates of other currencies against the US dollar as quoted in the information system *Reuters*. Gains and losses resulting from the translation of monetary assets and liabilities denominated in foreign currencies into lats are credited or charged to the balance sheet caption "Valuation account".

The principal exchange rates of foreign currencies and gold set by the Bank of Latvia and used in the preparation of the balance sheet for the year ended December 31, 2004 and the year ended December 31, 2003 are as follows:

(at the end of the year)

	2004	2003	Changes (%)
XDR	**0.7997**	0.7997	0
USD	**0.516**	0.541	–4.6
EUR	**0.703**	0.674	4.3
GBP	**0.996**	0.96	3.8
JPY	**0.00499**	0.00506	–1.4
XAU	**228.9**	223.44	2.4

RECOGNITION AND DERECOGNITION OF FINANCIAL ASSETS AND LIABILITIES

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

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

FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

Fair value of the Bank of Latvia's financial assets and financial liabilities at the end of 2004 and 2003 did not differ materially from the reported book value of the respective assets and liabilities.

OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

GOLD

Gold reserves are recorded at market value in the balance sheet. Any surplus or deficit arising from the revaluation of gold reserves is credited or charged to the balance sheet caption "Valuation account".

SECURITIES

Debt securities of foreign issuers and Latvian Government securities are stated at fair value in the balance sheet. Adjustments to the value of securities arising from revaluation of these financial instruments are reported in the balance sheet caption "Valuation account" until their disposal. Upon disposal of such securities, the accumulated revaluation result is transferred from the balance sheet caption "Valuation account" to the relevant profit and loss statement caption.

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

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

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 treated as interest income and recognised in the profit and loss statement over the term of the agreement.

REPURCHASE AGREEMENTS

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

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

PARTICIPATING INTEREST

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

FINANCIAL DERIVATIVES

The Bank of Latvia enters into commitments involving forward exchange rate contracts, currency and interest rate swap arrangements and interest rate future contracts, which are reported in off-balance sheet accounts at their contract or notional amount. Subsequent to initial recognition, financial assets and financial liabilities arising from these derivative financial instruments are revalued on a regular basis and reported in the balance sheet at fair value.

Any surplus or deficit arising from a change in fair value of forward exchange rate contracts and currency and interest rate swap arrangements is credited or charged to the balance sheet caption "Valuation account". Realised gains or losses arising from a change in fair value of interest rate future contracts are transferred to the profit and loss statement upon settlement.

ACCRUED INTEREST INCOME AND EXPENSE

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

FIXED ASSETS

Fixed assets are tangible long-term investments costing not less than 50 lats and with the useful life over one year. These assets are used in the provision of services as well as in the maintenance of other fixed assets and for the Bank of Latvia's administrative purposes.

Fixed assets are recorded at cost less accumulated depreciation.

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

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

	(percentage)
Buildings	1–3
Transport vehicles	20
Office furniture	10
Computer equipment	25–33
Other office equipment	20
Cash processing equipment	20
Tools	50
Other fixed assets	14–20

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

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

Loss on disposal of fixed assets is determined on the basis of the carrying amount of the fixed assets as at the time of disposal and is reported under the profit and loss statement caption "Other operating expense".

INTANGIBLE ASSETS

Intangible assets, which include information system software application rights and other rights, are reported in the balance sheet at cost less accumulated amortisation.

Acquisition costs of such rights are amortised over the period of the licensed use as specified in the relevant agreements 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 as expense on the maintenance of information systems when incurred. Expense on the maintenance of information systems software is recognised in the profit and loss statement for the relevant period.

IMPAIRMENT OF ASSETS

The Bank of Latvia's organisational units assess the quality of the Bank of Latvia's assets on a regular basis. When an impairment of an asset is identified, adequate specific provisions for a relevant asset are established. Such provisions are recognised in the profit and loss statement with the respective reduction in the asset carrying amount.

LATS IN CIRCULATION

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

GOLD CIRCULATION COINS

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

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

COMMEMORATIVE COINS

The issued commemorative coins that represent the Bank of Latvia's liability to holders of these coins are included in the balance sheet caption "Lats in circulation". The issued commemorative coins that are not circulation coins are not included in the balance sheet caption "Lats in circulation".

CASH AND CASH EQUIVALENTS

For the purposes of the cash flow statement, cash and cash equivalents are defined as the amounts comprising convertible foreign currency in cash, demand deposits with foreign credit institutions and other foreign financial institutions, foreign debt securities, which are readily convertible to cash close to their fair value within twenty-four hours less demand deposits from foreign institutions, Latvian Government, domestic credit institutions, and other domestic financial institutions.

INTEREST AND SIMILAR INCOME AND EXPENSE

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

Interest and similar income includes interest on bonds purchased, loans granted and deposits made, as well as the result on disposal of debt securities, the result on changes in the fair value of interest rate future contracts and dividends on BIS shares.

Interest expense includes interest on deposits received from the Latvian Government, domestic credit institutions and other financial institutions, and loans of foreign financial institutions.

FEES

Fees are charged or credited to the profit and loss statement on an accrual basis.

BANKNOTE PRODUCTION AND COINAGE COSTS

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

4. GOLD

Movements in gold reserves during 2004 were as follows:

	Troy ounces	Amount in thousands of lats
As at December 31, 2003	248 583	55 543
Increase in gold market value	–	1 358
As at December 31, 2004	**248 583**	**56 901**

5. CONVERTIBLE FOREIGN CURRENCIES

Convertible foreign currency assets of the Bank of Latvia are invested primarily in short-term cash deposits and debt securities of high liquidity.

Carrying amount of interest bearing debt securities include both interest income purchased at the date of acquisition and interest income accrued subsequent to the date of acquisition of the securities (12 225 thousand lats at the end of 2004 and 9 095 thousand lats at the end of 2003).

At the end of the year, the Bank of Latvia's balance sheet asset caption "Convertible foreign currencies" was comprised of the following assets:

(in thousands of lats)

	2004	2003
Debt securities of foreign governments, financial institutions and non-financial corporations	**803 601**	695 518
Demand deposits with foreign central banks, credit institutions and international institutions	**165 565**	52 911
Time deposits with foreign credit institutions and other foreign financial institutions	**16 718**	25 710
Foreign currency in cash	**574**	695
Total	**986 458**	774 834

6. INTERNATIONAL MONETARY FUND

Latvia's quota in the IMF, secured by Latvian Government promissory notes issued to the Fund, is recorded as an asset denominated in SDR and recognised in the balance sheet. The IMF holdings in lats are stated in the balance sheet as a liability (see Note 16).

At the end of 2004 and 2003, Latvia's quota in the IMF reported in the Bank of Latvia's balance sheet was 126 478 thousand SDR (101 144 thousand lats).

At the end of 2004 and 2003, Latvia's total quota in the IMF was 126 800 thousand SDR.

7. PARTICIPATING INTEREST IN THE EUROPEAN CENTRAL BANK

On May 1, 2004 Latvia joined the EU, and the Bank of Latvia became a member of the ESCB. In accordance with the Statute of the ESCB and the ECB, the Bank of Latvia became the subscriber of the capital of the ECB. The share of the Bank of Latvia in the ECB's capital is 0.2978%, which corresponds to 16 572 thousand euro. In accordance with the Statute of the ESCB and the ECB, the share of the Bank of Latvia in the ECB's capital was calculated on the basis of population and GDP data provided by the EC and is adjusted every five years. As Latvia does not participate in the euro area, pursuant to the transitional provisions of the Statute of the ESCB and the ECB, the Bank of Latvia paid up a minimal 7% contribution of its total subscribed capital in the ECB amounting to 1 160 thousand euro (760 thousand lats), while the unpaid share (93% of the Bank of Latvia's total subscribed capital in the ECB) is reported in the off-balance sheet accounts in the amount of 15 412 thousand euro (10 834 thousand lats; see Note 33).

8. PARTICIPATING INTEREST IN THE BANK FOR INTERNATIONAL SETTLEMENTS

The Bank of Latvia owns 1 000 shares in the BIS, which are denominated in SDR. The nominal value of the Bank of Latvia's share holding in the BIS is 5 000 thousand SDR of which 25% in the amount of 1 250 thousand SDR (1 000 thousand lats) has been paid up. The Bank of Latvia' share in the subscribed and paid-up BIS capital is 0.18%.

The uncalled portion of the above share holding in the amount of 3 750 SDR (2 999 thousand lats) is reported under the off-balance sheet accounts (see Note 33).

9. OTHER FOREIGN ASSETS

At the end of the year, other foreign assets consisted of the following items:

(in thousands of lats)

	2004	2003
Non-traded financial derivative contracts with foreign financial institutions	**23 805**	4 628
Spot exchange rate contracts with foreign financial institutions	**207**	–
Accrued interest income on deposits with foreign credit institutions and other foreign financial institutions	**45**	118
Other foreign assets	**208**	184
Total	**24 265**	4 930

10. LOANS TO CREDIT INSTITUTIONS

At the end of the year, credit facilities provided to domestic credit institutions were as follows:

(in thousands of lats)

	2004	2003
Repo loans by original maturity		
7-day	**5 980**	45 000
28-day	**6 900**	14 320
Total	**12 880**	59 320

11. TRANSIT CREDITS

The Bank of Latvia acts as an agent for the Latvian Government for distribution of funds received from various international institutions. This balance sheet caption states credit facilities granted under Latvian Government foreign borrowings to support the government investment programs. In 2004 these credit facilities were repaid.

12. GOVERNMENT SECURITIES

At the end of the year, the Bank of Latvia held Latvian Government securities with the following residual maturity:

(in thousands of lats)

Residual maturity	**2004**	2003
Up to 3 months	**20 062**	1 707
3 to 12 months	**272**	51
1 to 3 years	**53 568**	43 608
Over 3 years	**19 306**	16 907
Total	**93 208**	62 273

13. FIXED ASSETS

The following changes in fixed assets took place in 2004:

(in thousands of lats)

	Buildings and land	Furniture and office equipment	Cash processing equipment	Transport vehicles	Other fixed assets	Total
As at December 31, 2003						
Cost	30 375	5 826	2 162	1 442	4 273	44 078
Accumulated depreciation	–1 251	–3 705	–1 833	–801	–2 288	–9 878
Net book value	29 124	2 121	329	641	1 985	34 200
During 2004						
Additions	1 026	733	1 699	8	253	3 719
Disposals	–	–481	–4	–274	–72	–831
Net change in cost	1 026	252	1 695	–266	181	2 888
Depreciation charge	–425	–732	–110	–162	–555	–1 984
Depreciation on disposals	–	478	4	274	71	827
Net change in accumulated depreciation	–425	–254	–106	112	–484	–1 157
As at December 31, 2004						
Cost	31 401	6 078	3 857	1 176	4 454	46 966
Accumulated depreciation	–1 676	–3 959	–1 939	–689	–2 772	–11 035
Net book value	**29 725**	**2 119**	**1 918**	**487**	**1 682**	**35 931**

14. OTHER DOMESTIC ASSETS

At the end of the year, other domestic assets consisted of the following items:

(in thousands of lats)

	2004	2003
Intangible assets	**2 682**	2 891
Currency swap arrangements with domestic credit institutions	**183**	567
Spot exchange rate contracts with the Treasury	**141**	–
Gold circulation coins in vault	**32**	32
Accrued interest income on loans to domestic credit institutions	**13**	36
Other domestic assets	**213**	379
Total	**3 264**	3 905

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

The following changes in intangible assets took place in 2004:

(in thousands of lats)

As at December 31, 2003	
Cost	3 626
Accumulated amortisation	–735
Net book value	2 891
During 2004	
Additions	452
Amortisation charge	–661
As at December 31, 2004	
Cost	4 078
Accumulated amortisation	–1 396
Net book value	**2 682**

15. CONVERTIBLE FOREIGN CURRENCIES

At the end of 2004, convertible foreign currency liabilities increased year-on-year as in 2004 the Bank of Latvia opened a settlement account in euros for EC. The respective account is used by EC for distribution of EU budgetary funds (see also Note 17).

At the end of the year, the Bank of Latvia's balance sheet liability caption "Convertible foreign currencies" consisted of the following items:

(in thousands of lats)

	2004	2003
European Commission demand deposits	**2 313**	–
Other liabilities in convertible foreign currencies	**132**	149
Total	**2 445**	149

16. INTERNATIONAL MONETARY FUND

At the end of 2004, liabilities to the IMF consisted of the IMF holdings in lats (see Note 6).

The credit facility under the Systemic Transformation Facility (STF) was provided to Latvia with the aim of supporting the Latvian Government's economic and financial programme. The credit facility was repaid in 2004.

Movements in liabilities to the IMF during 2004 were as follows:

(in thousands of lats)

	STF	Holdings in lats	Total
As at December 31, 2003	3 049	101 374	104 423
Increase in holdings in lats	–	399	399
Repayment	–3 049	–	– 3 049
As at December 31, 2004	**–**	**101 773**	**101 773**

17. DEPOSITS OF OTHER INTERNATIONAL INSTITUTIONS IN LATS

At the end of 2004, deposits of other international institutions denominated in lats increased considerably year-on-year as in 2004 the Bank of Latvia opened a settlement account in lats for the EC which is used for effecting Latvian Government payments to the EU budget (see also Note 15).

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

(in thousands of lats)

	2004	2003
European Commission demand deposits	**21 185**	–
Other deposits	**330**	268
Total	**21 515**	268

18. OTHER FOREIGN LIABILITIES

At the end of the year, other foreign liabilities consisted of the following items:

(in thousands of lats)

	2004	2003
Non-traded financial derivative contracts with foreign financial institutions	**4 476**	7 929
Spot exchange rate contracts with foreign financial institutions	**391**	–
Accrued expense	**238**	300
Other foreign liabilities	**21**	31
Total	**5 126**	8 260

19. LATS IN CIRCULATION

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

Nominal	Amount (in thousands of lats)		Number (in thousands of units)		Percentage (%)	
	2004	2003	**2004**	2003	**2004**	2003
Banknotes						
LVL 500	**128 188**	97 328	**256**	195	**17.6**	14.3
LVL 100	**147 413**	140 369	**1 474**	1 404	**20.3**	20.6
LVL 50	**44 294**	50 717	**886**	1 014	**6.1**	7.4
LVL 20	**249 473**	237 391	**12 474**	11 870	**34.3**	34.8
LVL 10	**70 627**	71 866	**7 063**	7 187	**9.7**	10.5
LVL 5	**52 347**	53 194	**10 469**	10 639	**7.2**	7.8
Total banknotes	**692 342**	650 865	**x**	x	**95.2**	95.4
Coins						
LVL 100	**359**	326	**4**	3	**0**	0
LVL 10	**144**	139	**14**	14	**0**	0
LVL 5	**88**	77	**18**	15	**0**	0
LVL 2	**6 585**	6 504	**3 293**	3 252	**0.9**	1.0
LVL 1	**14 551**	11 768	**14 551**	11 768	**2.0**	1.7
50 s	**5 261**	4 980	**10 522**	9 961	**0.7**	0.7
20 s	**2 799**	2 627	**13 995**	13 133	**0.4**	0.4
10 s	**1 749**	1 655	**17 493**	16 547	**0.3**	0.3
5 s	**1 315**	1 227	**26 298**	24 532	**0.2**	0.2
2 s	**1 200**	1 095	**60 004**	54 777	**0.2**	0.2
1 s	**961**	882	**96 158**	88 247	**0.1**	0.1
Total coins	**35 012**	31 280	**x**	x	**4.8**	4.6
Total lats in circulation	**727 354**	682 145	**x**	x	**100.0**	100.0

At the end of 2004, the total nominal value of gold circulation coins (fineness .999) issued, with the denomination of LVL 100, was 1 981 thousand lats (1 980 thousand lats at the end of 2003). The respective coins in circulation are not included in the balance sheet caption "Lats in circulation", since their nominal value is directly supported by their content of gold.

Among coins in circulation, there were also commemorative coins that did not represent any liability of the Bank of Latvia to holders of these coins, and their total nominal value was 994 thousand lats at the end of 2004 (963 thousand lats at the end of 2003). These coins are not included in the balance sheet caption "Lats in circulation".

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

At the end of 2004, demand deposits of domestic credit institutions amounted to 228 872 thousand lats (123 810 thousand lats at the end of 2003). The increase in balances due to the respective credit institutions was also affected by the Bank of Latvia's decision to increase the minimum reserve ratio from 3% to 4% in 2004. Domestic credit institutions had placed no time deposits with the Bank of Latvia at the end of 2003 and 2004.

21. GOVERNMENT DEPOSITS

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

At the end of the year, the breakdown of Latvian Government deposits was as follows:

(in thousands of lats)

	2004	2003
Demand deposits in lats	**677**	3 253
Demand deposits in foreign currencies	**58 174**	12 426
Time deposits in lats	**32 000**	42 500
Time deposits in foreign currencies	**16 305**	22 075
Total	**107 156**	80 254

22. OTHER DOMESTIC LIABILITIES

At the end of the year, other domestic liabilities consisted of the following items:

(in thousands of lats)

	2004	2003
Forward exchange rate contracts with the Treasury	**20 970**	–
Spot exchange rate contracts with the Treasury	**207**	–
Currency swap arrangements with domestic credit institutions	**121**	1 074
Bank of Latvia's profit appropriated to the State budget	**987**	4 049
Deferred liabilities to constructors	**766**	640
Accrued interest expense on Government deposits	**37**	256
Other accrued expense and similar liabilities	**1 438**	1 088
Tax and compulsory social security contribution liabilities	**133**	14
Other domestic liabilities	**513**	666[1]
Total	**25 172**	7 787

[1] Including deferred income that has been reported in the financial statements for the year ended December 31, 2003 separately.

23. TAXES AND COMPULSORY SOCIAL SECURITY CONTRIBUTIONS

In 2004, the Bank of Latvia calculated and paid the following taxes and compulsory social security contributions:

(in thousands of lats)

	Liabilities	Paid	Increase deferred liabilities	Calculation	Liabilities
	2004				2003
Personal income tax	**–**	2 039	–	2 039	–
Compulsory social security contributions (by employer)	**6**	1 878	2	1 880	6
Compulsory social security contributions (by employee)	**2**	704	–	704	2
Tax on real estate	**–**	446	–	446	–
Value added tax	**125**	308		427	6
Other taxes	**–**	2	–	2	–
Total	**133**	5 377	2	5 498	14

In addition to the tax payments and compulsory social security contributions indicated herein, the Bank of Latvia transfers a part of the profit for the reporting year and the payment for the usage of State capital (987 thousand lats in 2004; 4 049 thousand lats in 2003; see Note 22 and 24) to the State budget.

24. NOMINAL CAPITAL AND RESERVE CAPITAL

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 annual profit, calculated by applying the tax rate set for residents by the Law "On Enterprise Income Tax", and a payment in the amount of 15% of the profit earned during the reporting year for the usage of State capital shall be transferred to the State budget. At the end of 2004, the enterprise income tax rate applicable to residents of Latvia was 15% (19% in 2003). Hence, 30% of the Bank of Latvia's profit earned during 2004 shall be transferred to the State budget.

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

25. VALUATION ACCOUNT

At the end of the year, the valuation account comprised the following items:

(in thousands of lats)

	2004	2003
Surplus on revaluation of assets and liabilities in foreign currency and gold	**29 372**	26 612
Deficit on revaluation of securities	**–6 422**	–3 081
Deficit on revaluation of spot exchange rate contracts	**–250**	–
Deficit on revaluation of forward exchange rate contracts	**–2 702**	–4 258
Surplus on revaluation of interest rate swap arrangements	**1 062**	946
Surplus/deficit (–) on revaluation of currency swap arrangements	**61**	–507
Total	**21 121**	19 712

26. NET INTEREST AND SIMILAR INCOME

In 2004, the Bank of Latvia's net interest and similar income amounted to 23 475 thousand lats (30 652 thousand lats in 2003). The income was mainly derived from investing foreign currency reserves, and income from Latvian Government securities and money market transactions.

In view of the lats repegging from the SDR currency basket to the euro, the Bank of Latvia had to restructure its foreign currency reserves by mostly disposing of debt securities denominated in British pounds sterling. A decrease in the market value of these debt securities was previously recognised in the valuation account. Moreover, the rise in US financial market interest rates had a negative impact on the market value of other debt securities in 2004. Therefore, interest and similar income from foreign operations decreased by 5 567 thousand lats in comparison with 2003.

Interest income from Latvian Government securities increased by 1 083 thousand lats as a result of higher investment in these securities in 2004.

Interest expense (5 290 thousand lats; 2 659 thousand lats in 2003) was largely comprised of interest on domestic credit institution and Latvian Government deposits. In 2004, the Bank of Latvia began paying interest on part of credit institution minimum reserves deposited with the Bank of Latvia, and it was the major underlying factor for an increase of 1 091 thousand lats in interest expense on credit institution deposits. By implementing monetary policy, the Bank of Latvia received a considerable amount of Latvian Government funds as deposits, therefore interest expense on Government deposits grew by 1 544 thousand lats in the reporting year.

27. FINANCING OF THE FINANCIAL AND CAPITAL MARKET COMMISSION

Pursuant to Article 5 of the Transition Rules of the Law "On the Financial and Capital Market Commission", the operation of the Financial and Capital Market Commission shall be financed from payments made by financial and capital market participants, the State budget and the Bank of Latvia. In 2004, the Bank of Latvia covered expenses pertaining to the supervision of credit institutions in the amount of 960 thousand lats. The Bank of Latvia is to make such payments also in 2005 and 2006 according to the following schedule: 600 thousand lats in 2005, and 240 thousand lats in 2006.

28. BANKNOTE PRODUCTION AND COINAGE COSTS

To maintain high quality of cash in circulation and ensure timely replacement of worn-out banknotes and coins by the time the euro is introduced, in 2004 the Bank of Latvia supplemented its stock of the lats banknotes, mainly resulting in an increase of 708 thousand lats in banknote production and coinage costs.

29. OTHER OPERATING EXPENSE

In 2004, Bank of Latvia's other operating expense decreased by 194 thousand lats year-on-year. Business travel expense grew by 78 thousand lats in 2004, mostly due to the Bank of Latvia's participation in the ESCB committees and working groups. The increase in information and public relations expense (93 thousand lats) was mostly caused by the costs related to the development of the exhibition of the Bank of Latvia's financial education and information centre "Money World". In 2004, other expense (except for municipal services expense which increased due to a price rise) decreased or remained approximately in the same level as in the previous year.

Other operating expense was as follows:

(in thousands of lats)

	2004	2003
Business travel	**473**	395
Tax on real estate	**446**	423
Municipal services and rent	**404**	344
Information and public relations	**369**	276
Telecommunications services	**351**	341
Maintenance of buildings, territory and equipment	**349**	360
Renovation and repair costs	**278**	425[1]
Insurance	**212**	195
Acquisition of low value office supplies	**190**	301
Personnel training	**155**	224
Maintenance of transport vehicles	**103**	118
Legal and other professional services	**45**	46
Other operating expense	**492**	613
Total	**3 867**	4 061

[1] In the financial statements for the year ended December 31, 2003, renovation and repair costs were reported under the profit and loss statement caption "Renovation and repair costs".

30. CASH FLOW STATEMENT

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

(in thousands of lats)

	2004	2003[1]
Profit before appropriation	**3 289**	11 908
Adjustments:		
Depreciation of fixed assets and amortisation of intangible assets	**2 645**	2 302
Loss on disposal of fixed assets	**4**	12
Net change in balance sheet items:		
Net decrease in gold	**–**	13
Net increase in Special Drawing Rights	**–2**	–34
Net increase in foreign debt securities and other foreign investments	**–7 020**	–20 590
Net decrease in other foreign assets	**49**	272
Net increase (–)/decrease in loans to domestic credit institutions	**46 440**	–28 630
Decrease in transit credits	**3 018**	8 731
Net increase (–)/decrease in Latvian Government securities	**–32 426**	1 451
Net decrease in other domestic assets	**189**	432
Net decrease in liabilities to the International Monetary Fund	**–3 049**	–6 097
Net increase/decrease (–) in other foreign liabilities	**–72**	101
Net increase in lats in circulation	**45 209**	59 513
Net decrease in time deposits of domestic credit institutions	**–**	–2 430
Net increase/decrease (–) in Latvian Government time deposits	**–16 270**	13 317
Net decrease in time deposits of other financial institutions	**–570**	–1 480
Net decrease in other domestic liabilities	**–3 826**	–6 550
Increase in European Union grant	**1**	1
Net cash and cash equivalents inflow arising from operating activities	**37 609**	32 242

[1] The comparative figures for 2003 have been restated, as the net surplus/deficit arising from revaluation and financial instruments' market value adjustment previously reported under a separate item has been attributed to the respective financial instruments in 2004.

(2) Analysis of cash and cash equivalents

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

	2004	Change	2003
Assets			
Convertible foreign currencies in cash	**574**	–121	695
Demand deposits with foreign credit institutions and other foreign financial institutions	**165 565**	112 654	52 911
Foreign debt securities, which are readily convertible to cash within twenty-four hours	**626 846**	92 107	534 739[1]
Liabilities			
Demand deposits from foreign institutions	**–23 988**	–23 528	–460
Demand deposits from domestic credit institutions	**–228 872**	–105 062	–123 810
Demand deposits from the Latvian Government	**–58 851**	–43 172	–15 679
Demand deposits from other domestic financial institutions	**–1 000**	–200	–800
Total cash and cash equivalents	**480 274**	32 678	447 596

31. PLEDGED ASSETS

Securities in the carrying amount of 2 568 thousand lats at the end of 2004 (3 121 thousand lats at the end of 2003) have been pledged to provide collateral for interest rate future contract transactions. These securities are included in the balance sheet asset caption "Convertible foreign currencies".

32. TRANSACTIONS WITH THE LATVIAN GOVERNMENT

The Bank of Latvia is fully owned by the Republic of Latvia and acts as the financial agent of the Latvian Government. The Bank of Latvia carries out transactions with the Treasury as well as conducts Government securities transactions in the secondary securities market in order to implement monetary policy. In the above transactions the Bank of Latvia is not subject to decisions and orders issued by the Government or its institutions and makes its decisions at its own discretion.

[1] As a result of changes in the securities classification this figure differs from the one reported in the financial statements for the year ended December 31, 2003.

At the end of the year, 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 (%)	
	2004	2003	**2004**	2003
Assets				
Transit credits	**–**	3 018	**–**	0.25
Government securities	**93 208**	62 273	**3.88–9.13**	5.13–9.13
Spot exchange rate contracts	**141**	–	**–**	–
Total assets	**93 349**	65 291	**x**	x
Liabilities				
Demand deposits	**58 851**	15 679	**1.83–2.00**	0.63–2.08
Time deposits	**48 305**	64 575	**2.06–4.05**	1.50–4.10
Forward exchange rate contracts and spot exchange rate contracts	**21 177**	–	**–**	–
Tax and compulsory social security contribution liabilities	**133**	14	**–**	–
Accrued interest expense	**37**	256	**–**	–
Bank of Latvia's profit appropriated to the State budget	**987**	4 049	**–**	–
Total liabilities	**129 490**	84 573	**x**	x

As at the end of the year the Bank of Latvia had concluded the following foreign exchange contracts with the Treasury:

(in thousands of lats)

	Claims		Liabilities	
	2004	2003	**2004**	2003
Spot exchange rate contracts	**233 818**	–	**233 884**	–
Forward exchange rate contracts	**212 848**	–	**233 818**	–
Total foreign exchange contracts	**446 666**	–	**467 702**	–

In 2004 and 2003, the breakdown of the Bank of Latvia's income and expense related to the Latvian Government, as well as the Bank of Latvia's profit appropriated to the State budget was as follows:

(in thousands of lats)

	2004	2003
Income		
Income from transit credits	**8**	24
Income from Government securities	**5 299**	4 216
Total income	**5 307**	4 240
Expense and the Bank of Latvia's profit appropriated to the State budget		
Interest on Government deposits	**4 134**	2 590
Taxes and compulsory social security contributions	**5 498**	5 148
Bank of Latvia's profit appropriated to the State budget	**987**	4 049
Total expense and the Bank of Latvia's profit appropriated to the State Budget	**10 619**	11 787

33. OFF-BALANCE SHEET ACCOUNTS

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

At the end of 2004, the Bank of Latvia made changes in the currency profile of the foreign reserve benchmark portfolio, hence the amount of non-traded financial derivative and spot exchange rate contracts outstanding at the end of the reporting year considerably exceeded the respective indicators for 2003.

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

(in thousands of lats)

	Contract or notional amount		Fair value			
			Assets		Liabilities	
	2004	2003	**2004**	2003	**2004**	2003
Non-traded financial derivative contracts and spot exchange rate contracts						
Spot exchange rate contracts						
with foreign financial institutions	**300 849**	7 522	**207**	–	**391**	–
with the Treasury	**233 884**	–	**141**	–	**207**	–
Forward exchange rate contracts						
with foreign financial institutions	**1 006 938**	237 427	**22 743**	3 671	**4 476**	7 929
with the Treasury	**233 818**	–	**–**	–	**20 970**	–
Currency swap arrangements						
with domestic credit institutions	**8 274**	75 707	**183**	567	**121**	1 074
Gold interest rate swap arrangements						
with foreign financial institutions	**43 949**	28 600	**1 062**	946	**–**	–
Other interest rate contracts						
with foreign financial institutions	**–**	3 679	**–**	11	**–**	–
Total non–traded financial derivative contracts and spot exchange rate contracts						
with foreign financial institutions	**x**	x	**24 012**	4 628	**4 867**	7 929
with domestic credit institutions and the Treasury	**x**	x	**324**	567	**21 298**	1 074
Traded financial derivative contracts						
Interest rate future contracts						
with foreign financial institutions	**413 796**	35 572	**421**	183	**797**	52
Other transactions						
Agreements concluded on a regular way purchase and sale of securities	**6 757**	3 830	**x**	x	**x**	x
Agreements concluded on a regular way receipt and placement of time deposits	**3 044**	7 268	**x**	x	**x**	x
Unpaid participating interest in the European Central Bank	**10 834**	–	**x**	x	**x**	x
Uncalled participating interest in the Bank for International Settlements	**2 999**	2 999	**x**	x	**x**	x
Contracted commitments related to acquisition of fixed assets	**7**	33	**x**	x	**x**	x

34. CURRENCY PROFILE

In 2004 and at the end of 2003, the net position of the Bank of Latvia's assets, liabilities and memorandum items within the limits stipulated by the Guidelines corresponded to the currency profile of the SDR currency basket. By December 31, 2004, the lats was pegged to the SDR currency basket, but as of January 1, 2005, the Bank of Latvia has pegged the lats to the euro. In view of the repegging of the lats, the Bank of Latvia made changes in the currency profile of the foreign reserve benchmark portfolio at the end of 2004 (as of January 1, 2005, the benchmark portfolio currency is the euro).

At the end of the year, the currency profile of the Bank of Latvia's assets, liabilities and memorandum items was as follows:

(in thousands of lats)

	LVL	XDR	USD	EUR	GBP	JPY	Gold	Other	Total
As at December 31, 2004									
Foreign assets									
Gold	–	–	–	–	–	–	56 901	–	56 901
Special Drawing Rights	–	77	–	–	–	–	–	–	77
Convertible foreign currencies	–	–	372 628	581 446	629	31 661	–	94	986 458
International Monetary Fund	–	101 144	–	–	–	–	–	–	101 144
Participating interest in the European Central Bank	–	–	–	760[1]	–	–	–	–	760
Participating interest in the Bank for International Settlements	–	1 000[1]	–	–	–	–	–	–	1 000
Other foreign assets	24 018	–	50	75	106	–	6	10	24 265
Domestic assets									
Loans to credit institutions	12 880	–	–	–	–	–	–	–	12 880
Government securities	93 208	–	–	–	–	–	–	–	93 208
Fixed assets	35 931	–	–	–	–	–	–	–	35 931
Other domestic assets	3 257	–	–	–	–	–	–	7	3 264
TOTAL ASSETS	**169 294**	**102 221**	**372 678**	**582 281**	**735**	**31 661**	**56 907**	**111**	**1 315 888**
Foreign liabilities									
Convertible foreign currencies	–	–	–	2 445	–	–	–	–	2 445
International Monetary Fund	101 773[2]	–	–	–	–	–	–	–	101 773
Other international institution deposits in lats	21 515	–	–	–	–	–	–	–	21 515
Foreign bank deposits in lats	396	–	–	–	–	–	–	–	396
Non-convertible currencies	–	–	–	–	–	–	–	36	36
Other foreign liabilities	4 906	–	143	73	–	–	–	4	5 126
Lats in circulation	727 354	–	–	–	–	–	–	–	727 354
Domestic liabilities									
Balances due to credit institutions	228 872	–	–	–	–	–	–	–	228 872
Balances due to the Government	32 677	77	1	74 401	–	–	–	–	107 156
Balances due to other financial institutions	1 279	–	19	2	–	–	–	–	1 300
Other domestic liabilities	24 471	–	4	697	–	–	–	–	25 172
TOTAL LIABILITIES	**1 143 243**	**77**	**167**	**77 618**	**–**	**–**	**–**	**40**	**1 221 145**

[1] The respective assets are recorded in the balance sheet at cost and the Bank of Latvia is not exposed to currency risk related to these assets.
[2] The Bank of Latvia is exposed to the SDR currency risk related to IMF holdings in lats based on changes in the underlying SDR balances determined in accordance with the exchange rate set by the IMF.

(cont.) (in thousands of lats)

	LVL	XDR	USD	EUR	GBP	JPY	Gold	Other	Total
Net position on balance sheet	–973 949	102 144	372 511	504 663	735	31 661	56 907	71	94 743
Net position on financial instruments' off-balance sheet accounts	8 323	–	–375 768	451 271	–760	–31 136	–56 822	3 063	–1 829
Net position on balance sheet and off-balance sheet accounts	–965 626	102 144	–3 257	955 934	–25	525	85	3 134	92 914
Net position on balance sheet and off-balance sheet accounts exposed to currency risk	–862 093	–629	–3 257	955 174	–25	525	85	3 134	92 914
Foreign currency profile of the net position on balance sheet and off-balance sheet accounts exposed to currency risk (%)	x	–0.07	–0.34	100.02	0	0.05	0.01	0.33	100.0
As at December 31, 2003									
TOTAL ASSETS	164 322	102 219	310 809	347 908	76 992	38 693	55 555	3 744	1 100 242
TOTAL LIABILITIES	970 264	3 124	941	34 845	–	–	–	37	1 009 211
Net position on balance sheet	–805 942	99 095	309 868	313 063	76 992	38 693	55 555	3 707	91 031
Net position on financial instruments' off-balance sheet accounts	69 075	–	–32 061	–46 319	6 836	56 982	–55 445	–2 876	–3 808
Net position on balance sheet and off-balance sheet accounts	–736 867	99 095	277 807	266 744	83 828	95 675	110	831	87 223
Net position on balance sheet and off-balance sheet accounts exposed to currency risk	–634 493	–3 279	277 807	266 744	83 828	95 675	110	831	87 223
Conformity with the currency profile of the SDR currency basket									
Foreign currency profile of the net position on balance sheet and off-balance sheet accounts exposed to currency risk (%)	x	–0.45	38.49	36.96	11.61	13.26	0.02	0.11	100.0
Currency profile of the SDR currency basket (%)	x	x	39.00	35.94	11.78	13.28	x	x	100.0

35. REPRICING MATURITY

(in thousands of lats)

	Interest bearing					Non-interest bearing	Total
	Up to 3 months	3–6 months	6–12 months	1–3 years	Over 3 years		
As at December 31, 2004							
Foreign assets							
Gold	12 596	7 393	–	–	–	36 912	56 901
Special Drawing Rights	77	–	–	–	–	–	77
Convertible foreign currencies	248 921	21 837	28 909	557 522	128 611	658	986 458
International Monetary Fund	–	–	–	–	–	101 144	101 144
Participating interest in the European Central Bank	–	–	–	–	–	760	760
Participating interest in the Bank for International Settlements	–	–	–	–	–	1 000	1 000

(cont.) (in thousands of lats)

	Interest bearing					Non-interest bearing	Total
	Up to 3 months	3–6 months	6–12 months	1–3 years	Over 3 years		
Other foreign assets	–	–	–	–	–	24 265	24 265
Domestic assets							
Loans to credit institutions	12 880	–	–	–	–	–	12 880
Government securities	20 062	272	–	53 568	19 306	–	93 208
Fixed assets	–	–	–	–	–	35 931	35 931
Other domestic assets	–	–	–	–	–	3 264	3 264
TOTAL ASSETS	**294 536**	**29 502**	**28 909**	**611 090**	**147 917**	**203 934**	**1 315 888**
Foreign liabilities							
Convertible foreign currencies	–	–	–	–	–	2 445	2 445
International Monetary Fund	–	–	–	–	–	101 773	101 773
Other international institution deposits in lats	–	–	–	–	–	21 515	21 515
Foreign bank deposits in lats	367	–	–	–	–	29	396
Non-convertible currencies	–	–	–	–	–	36	36
Other foreign liabilities	–	–	–	–	–	5 126	5 126
Lats in circulation	–	–	–	–	–	727 354	727 354
Domestic liabilities							
Balances due to credit institutions	94 744	–	–	–	–	134 128	228 872
Balances due to the Government	107 156	–	–	–	–	–	107 156
Balances due to other financial institutions	1 127	–	–	–	–	173	1 300
Other domestic liabilities	–	–	–	–	–	25 172	25 172
TOTAL LIABILITIES	**203 394**	**–**	**–**	**–**	**–**	**1 017 751**	**1 221 145**
Net position on balance sheet	91 142	29 502	28 909	611 090	147 917	x	x
Assets on financial instruments' off-balance sheet accounts	1 764 251	15 182	14 863	15 104	15 090	x	x
Liabilities on financial instruments' off-balance sheet accounts	1 811 097	15 222	–	–	–	x	x
As at December 31, 2003							
TOTAL ASSETS	256 477	32 231	49 979	400 042	173 142	188 371	1 100 242
TOTAL LIABILITIES	76 920	4 485	–	–	–	927 806	1 009 211
Net position on balance sheet	179 557	27 746	49 979	400 042	173 142	x	x
Assets on financial instruments' off-balance sheet accounts	318 277	1 002	–	29 576	–	x	x
Liabilities on financial instruments' off-balance sheet accounts	351 651	1 012	–	–	–	x	x

The table above reflects the sensitivity of the Bank of Latvia's assets, liabilities and memorandum items to a change in interest rates. Items reported in this table are stated at carrying amounts, categorised by the earlier of contractual interest repricing or residual maturity dates.

36. SECTORAL PROFILE OF ASSETS

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

	Amount (in thousands of lats)		Percentage (%)	
	2004	2003	**2004**	2003
Claims				
Foreign central governments and other governmental institutions	**514 852**	407 786	**39.1**	37.2
Foreign local governments	**16 807**	25 216	**1.3**	2.3
Foreign central banks and credit institutions	**393 578**	233 734	**29.9**	21.2
Other foreign financial institutions	**73 287**	90 341	**5.5**	8.2
Foreign non-financial corporations	**38 080**	33 410	**2.9**	3.0
International institutions	**133 874**	142 408	**10.2**	12.9
Latvian central government	**106 242**	124 651	**8.1**	11.3
Domestic credit institutions	**201**	29	**0**	0
Unclassified assets	**38 967**	42 667	**3.0**	3.9
Total	**1 315 888**	1 100 242	**100.0**	100.0

For the purposes of credit risk analysis, claims arising from securities purchased under reverse repurchase agreements are classified herein according to the issuer of the security. As a result, claims arising from government securities purchased under agreements to resell to domestic credit institutions in the amount of 12 880 thousand lats (59 320 thousand lats at the end of 2003) and the related accrued interest income in the amount of 13 thousand lats (36 thousand lats at the end of 2003) are reported as exposure to the Latvian central government.

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

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

	Amount (in thousands of lats)		Percentage (%)	
	2004	2003	**2004**	2003
EU	**527 356**	450 800	**45.0**	48.1
US	**265 028**	208 008	**22.6**	22.2
Japan	**28 011**	23 441	**2.4**	2.5
Other countries	**216 336**	112 869	**18.6**	12.0
International institutions	**133 874**	142 408	**11.4**	15.2
Total	**1 170 605**	937 526	**100.0**	100.0

38. ASSETS BY CREDIT RATINGS ASSIGNED TO THE COUNTERPARTY

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

	Credit rating	Amount (in thousands of lats)		Percentage (%)	
		2004	2003	**2004**	2003
FOREIGN ASSETS					
Gold	AAA	**34 586**	33 761	**2.6**	3.1
	AA+	**–**	7 217	**0**	0.7
	AA	**22 315**	14 565	**1.7**	1.3
Special Drawing Rights	AAA	**77**	75	**0**	0
Foreign debt securities	AAA	**599 789**	529 921	**45.5**	48.2
	AA+	**61 957**	23 593	**4.7**	2.1
	AA	**32 748**	56 700	**2.5**	5.1
	AA–	**48 236**	26 714	**3.6**	2.4
	A+	**20 817**	16 864	**1.6**	1.5
	A	**33 408**	33 705	**2.5**	3.1
	A–	**6 646**	8 021	**0.5**	0.7
Deposits with foreign financial institutions	AAA	**152 514**	39 017	**11.6**	3.4
	AA+	**1 605**	1 799	**0.1**	0.2
	AA	**12 999**	8 831	**1.0**	0.8
	AA–	**5 227**	22 576	**0.4**	2.0
	A+	**1 008**	1 473	**0.1**	0.1
	A	**1 401**	2 789	**0.1**	0.3
	A–	**7 529**	2 136	**0.6**	0.2
Foreign currency in cash	AAA	**574**	695	**0.0**	0.1
International Monetary Fund	AAA	**101 144**	101 144	**7.7**	9.2
Participating interest in the European Central Bank	AAA	**760**	–	**0.1**	–
Participating interest in the Bank for International Settlements	AAA	**1 000**	1 000	**0.1**	0.1
Derivative financial instruments	AAA	**–**	11	**–**	0
	AA+	**19**	42	**0**	0
	AA	**6 163**	634	**0.5**	0.1
	AA–	**4 819**	799	**0.4**	0.1
	A+	**12 999**	2 563	**1.0**	0.2
	A–	**12**	579	**0**	0.1
Accrued interest income	Different	**45**	118	**0**	0
Other foreign assets	Different	**208**	184	**0**	0
DOMESTIC ASSETS					
Loans to credit institutions	Different	**12 880**	59 320	**1.0**	5.4
Transit credits	BBB+[1]	**–**	3 018	**–**	0.3
Government securities	A–	**93 208**	62 273	**7.1**	5.7
Other	Different	**39 195**	38 105	**3.0**	3.5
TOTAL		**1 315 888**	1 100 242	**100.0**	100.0

[1] The Bank of Latvia is not exposed to the credit risk arising from transit credits.

At the end of the year, 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 (%)	
		2004	2003	**2004**	2003
Foreign assets	AAA	**890 444**	705 624	**76.1**	75.3
	AA	**196 088**	163 470	**16.7**	17.4
	A	**83 820**	68 130	**7.2**	7.3
	Different	**253**	302	**0**	0
Total		**1 170 605**	937 526	**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 year. The rating "AAA" is the highest possible long-term creditworthiness rating, which indicates an extremely strong capacity of the counterparty to meet its financial commitments. The rating "AA" confirms the counterparty's very strong capacity and the rating "A" the counterparty's strong capacity to meet its financial commitments in the long term. Ratings below "AAA" are modified by marks "+" or "–" to show the relative standing within the major categories of an international agency's ratings.

REPORT OF THE AUDIT COMMISSION TO THE COUNCIL OF THE BANK OF LATVIA

We have audited the balance sheet of the Bank of Latvia as at 31 December 2004, and the related statements of profit and loss, total recognised gains and losses, and cash flows for the year then ended and the accompanying notes (hereinafter, the financial statements). These financial statements, which are set out on pages 58 to 92, are the responsibility of the Bank of Latvia's management. 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 issued by the International Federation of Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank of Latvia as at 31 December 2004, and the results of its operations and its cash flows for the year then ended in conformity with the accounting principles adopted by the Bank of Latvia and the Law "On the Bank of Latvia".

ERNST & YOUNG

THE STATE AUDIT OFFICE
OF THE REPUBLIC OF LATVIA

Riga
3 March 2005

RESOLUTION OF THE COUNCIL OF THE BANK OF LATVIA

On March 21, 2005, the Bank of Latvia's Council passed Resolution No. 117/7 "On the Bank of Latvia's Annual Report for 2004".

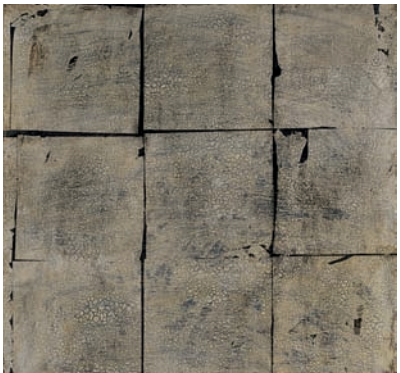
Having reviewed the results of the audit of the Bank of Latvia's economic activity in 2004, the Bank of Latvia's Council resolves:

1. To approve the Bank of Latvia's Annual Report for 2004, including the balance sheet, profit and loss statement, statement of recognised gains and losses and cash flow statement.

2. To appropriate the Bank of Latvia's profit for 2004 in the following way:
2.1 987 thousand lats to be transferred to the state revenue.
2.2 2 302 thousand lats to be transferred to the Bank's reserve capital.

ILMĀRS RIMŠĒVIČS
GOVERNOR
BANK OF LATVIA

APPENDICES



Appendix 1

MONETARY INDICATORS IN 2004

(at end of period; in millions of lats)

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	**XII**
BANK OF LATVIA												
M0	789.9	764.1	756.1	821.8	802.7	836.2	853.9	891.8	878.7	909.4	914.7	**957.2**
Currency in circulation	659.0	659.7	649.6	666.3	657.9	667.9	685.8	683.4	686.2	697.9	694.4	**727.4**
Deposits with the Bank of Latvia	131.0	104.5	106.5	155.5	144.8	168.3	168.2	208.4	192.5	211.6	220.3	**229.9**
Currency vs monetary base (%)	83.4	86.3	85.9	81.1	82.0	79.9	80.3	76.6	78.1	76.7	75.9	**76.0**
Net foreign assets	822.9	806.7	812.5	1 010.8	869.7	871.4	916.7	954.1	964.2	1 032.6	1 023.5	**1 039.3**
Net domestic assets	–33.0	–42.5	–56.4	–189.0	–67.1	–35.2	–62.7	–62.3	–85.4	–123.2	–108.9	**–82.1**
Credit	29.4	22.2	5.9	–134.9	–2.2	19.8	–7.0	–2.2	–21.3	–51.8	–32.3	**–1.1**
To MFIs	77.2	48.9	49.4	63.5	5.9	28.7	52.3	92.0	102.0	88.8	37.3	**12.9**
To central government (net)	–47.8	–26.7	–43.5	–198.4	–8.0	–8.9	–59.3	–94.2	–123.3	–140.6	–69.6	**–13.9**
Other items (net)	–62.3	–64.7	–62.3	–54.1	–64.9	–55.0	–55.7	–60.1	–64.1	–71.5	–76.6	**–81.0**
BANKING SYSTEM												
M2X	2 285.1	2 332.4	2 349.0	2 420.9	2 475.3	2 534.8	2 580.8	2 630.4	2 640.5	2 699.9	2 719.2	**2 867.9**
Currency outside MFIs	587.5	587.1	578.4	587.6	585.4	596.5	614.0	611.5	614.2	624.6	620.0	**645.4**
Deposits of resident financial institutions, non-financial corporations and households	1 697.6	1 745.3	1 770.6	1 833.3	1 889.9	1 938.3	1 966.8	2 018.9	2 026.3	2 075.3	2 099.2	**2 222.5**
In foreign currencies	645.3	669.5	645.8	656.9	672.4	691.4	732.9	752.0	770.8	803.2	818.1	**850.0**
M2D	1 639.8	1 663.0	1 703.2	1 763.9	1 802.9	1 843.4	1 847.8	1 878.3	1 869.7	1 896.7	1 901.1	**2 017.9**
M3[1]	2 244.5	2 287.8	2 305.3	2 375.8	2 436.3	2 494.0	2 542.9	2 604.1	2 611.6	2 673.0	2 692.9	**2 818.9**
Net foreign assets	60.0	23.3	–35.7	174.5	49.4	13.0	7.7	–19.6	–76.7	–90.2	–158.5	**–231.0**
Net domestic assets	2 225.1	2 309.1	2 384.7	2 246.3	2 425.8	2 521.8	2 573.1	2 649.9	2 717.2	2 790.1	2 877.7	**3 098.8**
Loans to resident financial institutions, non-financial corporations and households	2 591.5	2 680.2	2 776.8	2 894.6	2 976.2	3 061.4	3 145.4	3 262.1	3 392.1	3 523.0	3 623.9	**3 737.0**
Bank of Latvia refinancing rate (at end of period; %)	3.0	3.0	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	4.0	**4.0**
Weighted average interest rates on transactions in lats (%)												
Interbank loans	3.5	2.9	3.4	3.5	2.6	2.8	2.8	3.6	3.4	3.8	3.4	**3.5**
Loans to non-financial corporations and households with a floating interest rate and an initial rate fixation of up to 1 year	6.6	7.0	7.9	7.5	7.5	7.4	7.0	7.5	7.9	7.8	7.6	**7.6**
Time deposits of non-financial corporations and households	2.8	2.6	3.3	3.6	3.1	3.4	3.4	3.5	3.4	3.4	3.7	**3.7**
LVL vs USD (at end of period)	0.539	0.538	0.543	0.553	0.544	0.544	0.548	0.550	0.544	0.534	0.522	**0.516**
LVL vs EUR (at end of period)	0.671	0.672	0.661	0.655	0.667	0.663	0.661	0.660	0.671	0.680	0.692	**0.703**

[1] In accordance with the methodology of the ECB.

Appendix 2

THE BANK OF LATVIA'S MONTH-END BALANCE SHEETS FOR 2004

(in thousands of lats)

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	**XII**
FOREIGN ASSETS	930 253	912 497	919 003	1 123 069	980 962	985 716	1 036 376	1 063 973	1 076 999	1 151 533	1 144 449	**1 170 605**
Gold	54 848	53 127	56 420	52 814	53 510	54 141	53 135	55 205	55 762	56 177	58 574	**56 901**
Special Drawing Rights	150	132	132	18	10	10	85	77	77	77	77	**77**
Convertible foreign currencies	768 007	751 689	754 752	956 695	815 349	821 061	872 738	900 678	911 282	977 760	963 065	**986 458**
International Monetary Fund	101 144	101 144	101 144	101 144	101 144	101 144	101 144	101 144	101 144	101 144	101 144	**101 144**
Participating interest in the European Central Bank	–	–	–	–	760	760	760	760	760	760	760	**760**
Participating interest in the Bank for International Settlements	1 000	1 000	1 000	1 000	1 000	1 000	1 000	1 000	1 000	1 000	1 000	**1 000**
Other foreign assets	5 104	5 405	5 555	11 398	9 189	7 600	7 514	5 109	6 974	14 615	19 829	**24 265**
DOMESTIC ASSETS	178 118	169 448	169 172	187 972	125 864	149 543	172 758	212 617	215 995	220 297	168 335	**145 283**
Loans to credit institutions	77 210	48 892	49 380	63 530	5 850	28 720	52 305	92 000	102 000	88 848	37 347	**12 880**
Transit credits	1 503	1 501	1 515	1 542	1 517	1 517	–	–	–	–	–	–
Government securities	61 528	81 597	80 986	81 213	80 961	81 348	80 763	80 997	75 826	92 946	92 548	**93 208**
Fixed assets	34 034	33 911	33 779	33 603	33 737	33 806	33 884	34 007	35 167	35 318	35 326	**35 931**
Other domestic assets	3 843	3 547	3 512	8 084	3 799	4 152	5 806	5 613	3 002	3 185	3 114	**3 264**
TOTAL ASSETS	1 108 371	1 081 945	1 088 175	1 311 041	1 106 826	1 135 259	1 209 134	1 276 590	1 292 994	1 371 830	1 312 784	**1 315 888**
FOREIGN LIABILITIES	107 354	105 826	106 519	112 281	111 222	114 325	119 720	109 897	112 848	118 888	120 917	**131 291**
Convertible foreign currencies	133	121	114	118	118	1 642	10 032	2 333	6 430	13 104	1 146	**2 445**
International Monetary Fund	102 898	102 896	102 896	102 896	103 297	103 297	101 773	101 773	101 773	101 773	101 773	**101 773**
Other international institution deposits in lats	238	238	202	182	5 445	7 173	3 053	728	749	1 384	11 467	**21 515**
Foreign bank deposits in lats	468	408	419	401	394	391	623	399	575	397	456	**396**
Non-convertible currencies	37	37	37	37	37	37	37	37	36	36	36	**36**
Other foreign liabilities	3 580	2 126	2 851	8 647	1 931	1 785	4 202	4 627	3 285	2 194	6 039	**5 126**
LATS IN CIRCULATION	658 974	659 655	649 555	666 298	657 914	667 907	685 762	683 350	686 186	697 859	694 388	**727 354**
DOMESTIC LIABILITIES	251 525	224 092	239 151	444 800	252 207	269 641	319 157	393 656	404 502	463 887	407 648	**362 500**
Balances due to credit institutions	128 155	103 525	105 717	154 324	147 596	167 445	164 995	205 159	188 315	210 063	217 923	**228 872**
Balances due to the Government	110 852	109 828	125 960	281 172	90 526	91 804	140 091	175 208	199 151	233 567	162 180	**107 156**
Balances due to other financial institutions	3 649	1 245	1 101	1 438	4 459	1 168	3 484	3 569	4 506	1 794	2 646	**1 300**
Other domestic liabilities	8 869	9 494	6 373	7 866	9 626	9 224	10 587	9 720	12 530	18 463	24 899	**25 172**
CAPITAL AND RESERVES	90 518	92 372	92 950	87 662	85 483	83 386	84 495	89 687	89 458	91 196	89 831	**94 743**
Nominal capital	25 000	25 000	25 000	25 000	25 000	25 000	25 000	25 000	25 000	25 000	25 000	**25 000**
Reserve capital	45 787	45 787	45 787	45 787	45 787	45 787	45 787	45 787	45 787	45 787	45 787	**48 089**
Valuation account	19 199	21 053	21 631	16 343	14 164	12 067	13 175	18 367	18 138	19 876	18 511	**21 121**
European Union grant	532	532	532	532	532	532	533	533	533	533	533	**533**
TOTAL LIABILITIES, CAPITAL AND RESERVES	1 108 371	1 081 945	1 088 175	1 311 041	1 106 826	1 135 259	1 209 134	1 276 590	1 292 994	1 371 830	1 312 784	**1 315 888**

Appendix 3

THE BANK OF LATVIA'S YEAR-END BALANCE SHEETS FOR THE YEARS 2000–2004

(in thousands of lats)

	2000	2001	2002	2003	**2004**
FOREIGN ASSETS	669 551	881 489	894 613	937 526	**1 170 605**
Gold	41 917	44 443	51 025	55 543	**56 901**
Special Drawing Rights	3	54	41	75	**77**
Convertible foreign currencies	521 512	732 799	737 313	774 834	**986 458**
International Monetary Fund	101 144	101 144	101 144	101 144	**101 144**
Participating interest in the European Central Bank	–	–	–	–	**760**
Participating interest in the Bank for International Settlements	983	1 043	1 197	1 000	**1 000**
Other foreign assets	3 992	2 006	3 893	4 930	**24 265**
DOMESTIC ASSETS	143 859	98 121	146 321	162 716	**145 283**
Loans to credit institutions	42 530	18 833	30 690	59 320	**12 880**
Transit credits	23 835	18 612	11 749	3 018	**–**
Government securities	51 725[1, 2]	24 715	64 382	62 273	**93 208**
Fixed assets	22 657	32 819	32 798	34 200	**35 931**
Other domestic assets	3 112[2]	3 142	6 702	3 905	**3 264**
TOTAL ASSETS	813 410	979 610	1 040 934	1 100 242	**1 315 888**
FOREIGN LIABILITIES	129 053	122 306	116 778	113 545	**131 291**
Convertible foreign currencies	–	–	–	149	**2 445**
International Monetary Fund	122 014	116 012	110 388	104 423	**101 773**
Other international institution deposits in lats[3]	92	42	257	268	**21 515**
Foreign bank deposits in lats[3]	66	412	422	409	**396**
Non-convertible currencies	42	41	37	36	**36**
Other foreign liabilities	6 839	5 799	5 674	8 260	**5 126**
LATS IN CIRCULATION	482 314	556 003	622 632	682 145	**727 354**
DOMESTIC LIABILITIES	140 723	226 374	209 676	213 521	**362 500**
Balances due to credit institutions	80 453	82 433	134 223	123 810	**228 872**
Balances due to the Government	45 926	119 587	62 079	80 254	**107 156**
Balances due to other financial institutions	3 950	3 441	3 012	1 670	**1 300**
Other domestic liabilities	10 394	20 913	10 362	7 787	**25 172**
CAPITAL AND RESERVES	61 320	74 927	91 848	91 031	**94 743**
Nominal capital	4 750	10 100	25 000	25 000	**25 000**
Reserve capital	3 297	5 512	37 928	45 787	**48 089**
Other reserves	32 497	38 224	–	–	**–**
Valuation account	20 254[4]	20 567	28 389	19 712	**21 121**
European Union grant	522	524	531	532	**533**
TOTAL LIABILITIES, CAPITAL AND RESERVES	813 410	979 610	1 040 934	1 100 242	**1 315 888**

[1] Latvian government securities, which in the financial statements for 2000 were reported at amortised acquisition cost, are stated at their fair value, applying the current Latvian government securities valuation policy retrospectively.
[2] Restated to include accrued interest income on Latvian government bonds, which was reported under the caption "Other domestic assets" in the financial statements for 2000.
[3] Other international institution deposits in lats were reported under the caption "Foreign bank deposits in lats" in the financial statements for the years 2000–2003.
[4] Restated to include the revaluation result arising after retrospectively revaluing Latvian government securities in accordance with the current Latvian government securities valuation policy.

Appendix 4

THE BANK OF LATVIA'S PROFIT AND LOSS STATEMENTS FOR THE YEARS 2000–2004

(in thousands of lats)

	2000	2001	2002	2003	**2004**
INTEREST AND SIMILAR INCOME					
Foreign operations[1]	28 075	35 985	30 762	27 327	**21 760**
Domestic operations	5 496	6 340	5 550	5 984	**7 005**
INTEREST EXPENSE					
Foreign operations[1]	55	44	127	8	**8**
Domestic operations	3 754	2 797	3 688	2 651	**5 282**
NET INTEREST AND SIMILAR INCOME	29 762	39 484	32 497	30 652	**23 475**
OTHER OPERATING INCOME	527	520	605	994	**447**
SPECIFIC PROVISIONS	290	–	–	–	**–**
LOSS ON DISPOSAL OF INVESTMENT IN ASSOCIATE	2 030	–	–	–	**–**
OTHER OPERATING EXPENSE	16 809	17 850	18 668	19 738	**20 633**
PROFIT BEFORE APPROPRIATION	11 160	22 154	14 434	11 908	**3 289**

[1] The amounts reported under the interest income caption "Foreign operations" for 2000 have been reduced by including expense on transactions with foreign debt securities, which were reported under the interest expense caption "Foreign operations" in the financial statements for 2000.

Appendix 5

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

(LVL vs foreign currency)

2004	EUR			GBP			100 JPY			USD		
	Maximum	Average	Minimum	Maximum	Average	Minimum	Maximum	Average	Minimum	Maximum	Average	Minimum
I	0.6830	0.6763	0.6700	0.9860	0.9750	0.9590	0.5080	0.5042	0.4990	0.5420	0.5370	0.5320
II	0.6810	0.6753	0.6690	1.0100	0.9968	0.9790	0.5100	0.5024	0.4940	0.5400	0.5347	0.5290
III	0.6730	0.6662	0.6580	1.0100	0.9927	0.9800	0.5160	0.4997	0.4840	0.5460	0.5431	0.5380
IV	0.6640	0.6569	0.6520	1.0000	0.9893	0.9780	0.5190	0.5105	0.5020	0.5530	0.5465	0.5370
V	0.6670	0.6608	0.6560	1.0000	0.9833	0.9760	0.5020	0.4926	0.4850	0.5570	0.5511	0.5440
VI	0.6690	0.6620	0.6570	1.0000	0.9991	0.9930	0.5050	0.4979	0.4910	0.5490	0.5455	0.5420
VII	0.6700	0.6661	0.6610	1.0100	0.9985	0.9880	0.5040	0.4972	0.4910	0.5480	0.5427	0.5380
VIII	0.6700	0.6646	0.6590	1.0000	0.9938	0.9820	0.5010	0.4942	0.4880	0.5500	0.5459	0.5410
IX	0.6710	0.6665	0.6620	0.9860	0.9787	0.9730	0.5010	0.4967	0.4900	0.5490	0.5461	0.5440
X	0.6830	0.6745	0.6700	0.9820	0.9767	0.9720	0.5030	0.4956	0.4910	0.5460	0.5411	0.5330
XI	0.6930	0.6855	0.6780	0.9900	0.9816	0.9780	0.5100	0.5032	0.4970	0.5350	0.5293	0.5200
XII	0.7030	0.6954	0.6920	1.0100	1.0010	0.9870	0.5070	0.5007	0.4960	0.5230	0.5196	0.5160

Appendix 6

THE BANK OF LATVIA'S ORGANISATIONAL UNITS AT THE END OF 2004

1. ACCOUNTING DEPARTMENT
(Head of Department, Chief Accountant – Māris Kālis; Deputy Chief Accountants – Jānis Caune, Antonija Sileniece)
1.1 Financial Statements and Accounting Policy Division (Head of Division – Maija Kurpniece)
1.2 Internal Banking Operations Division (Head of Division – Anita Jakāne)

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

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

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

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

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

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

8. LEGAL DEPARTMENT
(Head of Department;[1] Deputy Heads of Department – Edvards Kušners, Bruno Mačs)

[1] Vacancy. As of January 24, 2005, Ms. Ilze Gaņģe.

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(cont.)

9. MARKET OPERATIONS DEPARTMENT
(Head of Department – Roberts L. Grava; Deputy Head of Department – Toms Siliņš)
9.1 Trading and Investment Division (Head of Division – Kārlis Bauze)
9.2 External Debt Management Division (Head of Division – Agita Birka)
9.3 Risk Management Division (Head of Division – Daira Brunere)
9.4 Analysis Division (Head of Division, Deputy Head of Department – Aigars Egle)
9.5 Payments and Settlements Division (Head of Division – Una Ruka)

10. MONETARY POLICY DEPARTMENT
(Head of Department – Helmūts Ancāns; Deputy Heads of Department – Ēriks Āboliņš, Zoja Medvedevskiha)
10.1 Macroeconomic Analysis Division (Head of Division – Vilnis Purviņš)
10.2 Financial Market Analysis Division (Head of Division – Mārtiņš Prūsis)
10.3 Monetary Research and Forecasting Division (Head of Division – Mārtiņš Bitāns)
10.4 Securities Settlement Division (Head of Division – Anda Kalniņa)

11. PAYMENT SYSTEMS DEPARTMENT
(Head of Department – Egons Gailītis; Deputy Head of Department – Agnija Hāzenfuss)
11.1 Payment Systems Policy Division (Head of Division – Anda Zalmane)
11.2 Payment Systems Operations Division (Head of Division – Aigars Tatarčuks)
11.3 Account Service and Maintenance Division (Head of Division – Natālija Popova)

12. PERSONNEL DEPARTMENT
(Head of Department – Inta Lovnika; Deputy Head of Department – Elita Lukina)

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

14. SECURITY DEPARTMENT
(Head of Department – Romualds Namnieks; Deputy Heads of Department – Igors Fleitmanis, Oļegs Rītiņš)
14.1 Analytical Unit (Head of Unit – Juris Jansons)
14.2 Armament Unit (Head of Unit – Juris Kušķis)
14.3 Central Division (Head of Division – Māris Dzelme)
14.4 Riga Division (Head of Division – Andis Bērziņš)
14.5 Daugavpils Division (Head of Division – Ilmārs Suhockis)
14.6 Liepāja Division (Head of Division – Gints Liepiņš)
14.7 Rēzekne Division (Head of Division – Andrejs Gugāns)

15. STATISTICS DEPARTMENT
(Head of Department – Agris Caune; Deputy Head of Department – Ilmārs Skarbnieks)
15.1 Banking and Monetary Statistics Division (Head of Division – Zigrīda Aušta)
15.2 Balance-of-Payments Statistics Division (Acting Head of Division – Aigars Kalniņš)
15.3 General Economic and Financial Statistics Division (Head of Division – Iveta Salmiņa)

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(cont.)

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

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

18. DAUGAVPILS BRANCH
(Branch Manager – Jolanda Mateša; Deputy Branch Manager – Bernarda Kezika)

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

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

21. TRAINING AND RECREATION CENTRE
(Director – Zaiga Blūma)

Appendix 7

THE BANK OF LATVIA'S STRUCTURE AT THE END OF 2004

Governor's Office Guntis Valujevs	COUNCIL Governor Ilmārs Rimšēvičs Deputy Governor Andris Ruselis	Internal Audit Department Modris Briedis
	BOARD Chairperson of the Board Māra Raubiško Deputy Chairmen of the Board Reinis Jakovļevs Helmūts Ancāns	
Information Systems Department Harijs Ozols	Monetary Policy Department Helmūts Ancāns	Public Relations Department Press Secretary Mārtiņš Grāvītis
Payment Systems Department Egons Gailītis	Market Operations Department Roberts L. Grava	Legal Department[1]
Statistics Department Agris Caune	Accounting Department Māris Kālis	International Department Juris Kravalis
Communications Department Aina Raņķe	Personnel Department Inta Lovnika	Security Department Romualds Namnieks
Technical Support Department Andris Ņikitins	Cashier's and Money Operations Department Veneranda Kausa	Training and Recreation Centre Zaiga Blūma
Daugavpils Branch Jolanda Mateša	Riga Branch Jānis Strēlnieks	Liepāja Branch Gundars Lazdāns
	Rēzekne Branch Anna Matisāne	

[1] Vacancy. As of January 24, 2005, Ms. Ilze Gaņģe.

Appendix 8

REPRESENTATION OF THE BANK OF LATVIA IN INTERNATIONAL ORGANISATIONS

EUROPEAN UNION

Economic and Financial Committee (EFC)
Members: Helmūts Ancāns, Deputy Chairman of the Bank of Latvia's Board, Head of Monetary Policy Department (together with Valentīna Andrējeva, State Secretary of the Ministry of Finance of the Republic of Latvia)
Committee of Alternates (EFC Alternates): Juris Kravalis, Head of International Department (together with Inta Vasaraudze, Deputy State Secretary of the Ministry of Finance of the Republic of Latvia)

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

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

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

Committee of European Banking Supervisors (CEBS)
Zoja Medvedevskiha, Deputy Head of Monetary Policy Department (Banking Supervisory Institution is represented by Jānis Placis, Member of the Council of FCMC)

Republic of Latvia Mission to the EU
Aldis Austers, Special Attaché of the Bank of Latvia

EUROPEAN CENTRAL BANK

General Council
Ilmārs Rimšēvičs, Governor of the Bank of Latvia
Andris Ruselis, Deputy Governor of the Bank of Latvia

Accounting and Monetary Income Committee (AMICO)
Māris Kālis, Member of the Bank of Latvia's Board, Chief Accountant
Jānis Caune, Deputy Chief Accountant of the Bank of Latvia

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

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

External Communications Committee (ECCO)
Mārtiņš Grāvītis, Head of Public Relations Department
Aina Raņķe, Head of Communications Department

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

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(cont.)

Egons Bušs, Deputy Head of Information Systems Department, Head of Computer Network and Server Systems Division

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

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

Legal Committee (LEGCO)
Pēteris Putniņš[1], Head of Legal Department
Iveta Krastiņa, Legal Adviser

Market Operations Committee (MOC)
Roberts L. Grava, Member of the Bank of Latvia's Board, Head of Market Operations Department
Aigars Egle, Deputy Head of Market Operations Department, Head of Analysis Division

Monetary Policy Committee (MPC)
Helmūts Ancāns, Deputy Chairman of the Bank of Latvia's Board, Head of Monetary Policy Department
Santa Bērziņa, Chief Economist of Macroeconomic Analysis Division, Monetary Policy Department

Payment and Settlement Systems Committee (PSSC)
Egons Gailītis, Head of Payment Systems Department
Ēriks Āboliņš, Deputy Head of Monetary Policy Department

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

INTERNATIONAL MONETARY FUND

Board of Governors
Ilmārs Rimšēvičs, Governor of the Bank of Latvia

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

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

Nordic-Baltic IMF Office in Washington
Jeļena Zubkova, Advisor to Executive Director, Latvia's representative in IMF

[1] As of February 8, 2005, Ms. Ilze Gaņģe.

Appendix 9

THE BANK OF LATVIA'S 2004 PUBLICATIONS

This list contains publications prepared and issued by the Bank of Latvia in 2004. These publications are free of charge and available both on the Bank's website (www.bank.lv) and in print at the Bank of Latvia. It is also possible to receive the publications by mail sending a request to the address indicated on the last page of this publication.

REGULAR PUBLICATIONS

Bank of Latvia: Annual Report 2003
Monetārais Apskats. Monetary Review (3, 4/2003 and 1, 2/2004)
Latvijas Maksājumu Bilance. Latvia's Balance of Payments (3, 4/2003 and 1, 2/2004)
Financial Stability Report (2/2003 and 1/2004)
Monetary Bulletin (11, 12/2003 and 1–11/2004)
Latvia's Balance of Payments (Key Items) (11, 12/2003 and 1–10/2004)

WORKING PAPERS

Ajevskis, V.; Pogulis, A.; Bērziņš, G. "Foreign Exchange and Money Markets in the Context of the Exchange Rate Target Zone".
Bitāns, M.; Kaužēns, E. "Impact of the Euro Adoption on the Economy of Latvia".
Tillers, I. "Money Demand in Latvia".
Bitāns, M. "Pass-Through of Exchange Rates to Domestic Prices in East European Countries and the Role of Economic Environment".

Appendix 10

2004 HIGHLIGHTS OF RESOLUTIONS AND REGULATIONS ADOPTED IN PURSUIT OF THE BANK OF LATVIA'S MAIN TASKS

January 15
The Council of the Bank of Latvia approved the "Regulation for Compiling the 'Report on Adjustments in Respect of Write-offs/Write-downs of Loans and Price Revaluations of Securities' " (in effect as of June 1, 2004).

March 11
The Council of the Bank of Latvia passed a resolution "On Interest Rates", increasing the refinancing rate by 0.5 percentage point, to 3.5% per annum.

The Council of the Bank of Latvia approved the "Regulation for Calculating and Maintaining the Bank Minimum Reserve Requirement" (in effect as of May 24, 2004).

The Council of the Bank of Latvia made amendments to the Resolution No. 76/8 of the Council of the Bank of Latvia "On Adopting a New Version of the 'Regulation for Compiling Information on External Payments of Non-Banks' " of July 13, 2000 (in effect as of May 1, 2004).

July 15
The Council of the Bank of Latvia passed a resolution "On the Reserve Requirements for Banks", increasing the reserve requirement for banks and foreign bank branches from 3% to 4% (in effect as of July 24, 2004).

September 9
The Council of the Bank of Latvia approved a new version of the "Regulation for Compiling the 'Quarterly Foreign Investment Report' " (in effect as of January 1, 2005).

The Council of the Bank of Latvia approved a new version of the "Regulation for Compiling the 'Annual Foreign Investment Report' " (in effect as of January 1, 2005).

The Council of the Bank of Latvia approved a new version of the "Regulation for Buying and Selling Cash Foreign Currency" (in effect as of October 1, 2004).

November 11
The Council of the Bank of Latvia passed a resolution "On Interest Rates", increasing the refinancing rate by 0.5 percentage point, to 4% per annum (in effect as of November 12, 2004).

The Council of the Bank of Latvia made amendments to the "Regulation for Calculating and Maintaining the Bank Minimum Reserve Requirement" (in effect as of January 24, 2005).

The Council of the Bank of Latvia passed a resolution "On Pegging the Lats to the Euro and Setting Foreign Currency Exchange Rates" (in effect as of January 1, 2005).

The Council of the Bank of Latvia made amendments to the "Regulation for Compiling the Monthly Financial Position Report of Credit Institutions and Its Appendices", also changing the title ("Regulation for Compiling the Monthly Financial Position Report of Monetary Financial Institutions and Its Appendices"; in effect as of January 1, 2005).

The Council of the Bank of Latvia passed a resolution "On Approval of the 'Guidelines for the Formulation of an Internal Control System for the Prevention of Laundering of Proceeds Derived from Criminal Activity and Financing of Terror-

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ism for Companies (Commercial Companies) and Businessmen Engaged in Buying and Selling Cash Foreign Currency' " (in effect as of December 1, 2004).

Appendix 11

GLOSSARY

Automatic Lombard loan – a Lombard loan granted to a bank or a branch of a foreign bank registered in the Republic of Latvia, holding a cash account for settlements in lats with the Bank of Latvia and participating in the securities settlement system organised by the Bank of Latvia, until the next business day for the purpose of eliminating an overdraft resulting from interbank settlements (see also *Lombard loan*).

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

Central government – public institutions, including ministries, embassies, representative offices, agencies, councils, educational, healthcare, law enforcement, cultural and other public institutions whose competence covers the whole economic territory of a country. Central government includes state non-profit institutions managed and financed by the central government (see also *general government*).

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

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

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

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

Demand Lombard loan – a Lombard loan granted upon request of a bank or a branch of a foreign bank registered in the Republic of Latvia holding a cash account for settlements in lats with the Bank of Latvia and participating in the securities settlement system organised by the Bank of Latvia, for an agreed period which does not exceed 30 consecutive days (see also *Lombard loan*).

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.

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Deposits with 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.

Economic and Financial Committee (EFC) – a committee for economic and financial issues established by the EU Council, comprising representatives of the governments and central banks of the EU Member States, as well as representatives of the EC and ECB.

Economic and Monetary Union (EMU) – the Treaty establishing the European Community (often referred to as the Treaty of Rome, as amended) describes the process of achieving the EMU in the EU in three stages. Stage One of the EMU started on July 1, 1990 and ended on December 31, 1993. It was mainly characterised by the dismantling of all barriers to the free movement of capital within the EU. Stage Two of the EMU began on January 1, 1994. It provided for the establishment of the European Monetary Institute, prohibition of financing of the public sector by the central banks, prohibition of privileged access to financial institutions by the public sector and avoidance of excessive government budget deficits. Stage Three started on January 1, 1999 with the transfer of monetary competence to the ECB (see also *European Central Bank*) and the introduction of the euro. The euro cash changeover on January 1, 2002 completed the process setting up the EMU.

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

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 – the area encompassing the EU Member States which have adopted the euro as their single currency in accordance with the Treaty establishing the European Community (often referred to as the Treaty of Rome, as amended) and in which a single monetary policy is conducted under the responsibility of the Governing Council of the ECB. As at the end of 2004, the euro area comprised Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

European Central Bank (ECB) – the central institution of the ESCB and the Eurosystem having a legal personality under the Community law. It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through the ECB's own activities or through those of the national central banks, pursuant to the Statute of the ESCB and ECB. The ECB is governed by the Governing Council and the Executive Board, and, as a third decision-making body, by the General Council (see also *European System of Central Banks*, *Eurosytem* and *General Council of the ECB*).

European System of Central Banks (ESCB) – includes the European Central Bank (ECB) and the national central banks of the EU Member States. The national central banks of those Member States which have not adopted the single currency in accordance with the Treaty establishing the European Community (often referred to as the Treaty of Rome, as amended) retain their powers in the field of

Appendix 11
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monetary policy according to national law and are thus not involved in the conduct of the monetary policy of the Eurosystem.

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

Exchange rate mechanism II (ERM II) – the exchange rate arrangement that ensures exchange rate policy cooperation between the euro area countries and the EU Member States not participating in Stage Three of EMU. A central parity exchange rate vis-à-vis the euro is established for each ERM II member currency, against which the ERM II fluctuation band is defined. As at the end of 2004, Denmark, Estonia, Lithuania and Slovenia were members of the ERM II.

Financial institutions – other financial intermediaries, excluding insurance corporations and pension funds (OFIs), financial auxiliaries, insurance corporations and pension funds.

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

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

Foreign exchange swap – a simultaneous spot purchase/sale and forward sale/purchase of one currency against another.

General Council of the ECB – one of the decision-making bodies of the ECB, comprising the President and the Vice-President of the ECB and the Governors of all EU NCBs.

General government – public institutions engaged in production of non-market goods and services intended for individual and collective consumption or public institutions engaged in redistribution of national income or wealth. General government in the Republic of Latvia includes central government and local government (see also *central government* and *local government*).

Gross settlement system – a transfer system in which the cash settlement or the transfer of securities occurs on an instruction-by-instruction basis.

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

IBAN (International Bank Account Number) – an international bank account number that a bank has granted to an account of a customer, compliant with the international standard ISO 13616:1997, developed by the European Committee for Banking Standards and the International Organization for Standardization.

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Interbank automated payment system (SAMS) – the Bank of Latvia's real-time gross settlement system used for interbank settlements in real-time (see also *Real-Time Gross Settlement (RTGS) system*).

International Monetary Fund (IMF) – an international organisation, founded in July 1944, to facilitate international monetary cooperation, exchange rate stability, national economic growth and employment growth, and ensure short-term financial assistance, should any of the IMF Member States need to solve balance-of-payments related problems.

Latvian IBAN – IBAN granted by credit institutions or institutions other than credit institutions but making non-cash/cashless payments and registered in the Republic of Latvia and IBAN granted by institutions not registered in the Republic of Latvia that are compliant with Latvia's IBAN structure.

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

Local government – public institutions, whose competence covers only a local economic territory. Local government includes state non-profit institutions managed and financed by the local government. In the Republic of Latvia the local government level is comprised of the local authorities.

Lombard loan – a short-term loan of the Bank of Latvia granted to a bank or a branch of a foreign bank registered in the Republic of Latvia, holding a cash account for settlements in lats with the Bank of Latvia and participating in the securities settlement system organised by the Bank of Latvia, in exchange for an unencumbered securities collateral owned by the bank or the branch of a foreign bank. The Bank of Latvia grants automatic Lombard loans and demand Lombard loans (see also *automatic Lombard loan* and *demand Lombard loan*).

M0 (monetary base) – the lats banknotes and coins in circulation and resident MFI and financial institution demand deposits with the Bank of Latvia.

M2D (domestic money supply) – the lats banknotes and coins in circulation (less vault cash of MFIs) and deposits in lats made by resident non-financial corporations, financial institutions, households and non-profit institutions serving households.

M2X (broad money) – the lats banknotes and coins in circulation (less vault cash of MFIs) and deposits in lats and foreign currencies made by resident non-financial corporations, financial institutions, households and non-profit institutions serving households.

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

Monetary financial institutions (MFIs) – institutions forming the money-issuing sector, i.e. credit institutions and 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, and the national central banks. The Bank of Latvia compiles and regularly updates the "List of Monetary Financial Institutions of the Republic of Latvia" (see the Bank of Latvia's website at www.bank.lv, under the menu "Laws, Regulations", section "Statistical Reports"). The ECB regularly publishes the "List of MFIs of the EU Member States" (see the Bank of Latvia's website at www.bank.lv, under the menu "Links").

Operational risk – the risk of incurring financial or non-financial losses as a result of an unexpected disruption of operations, unsanctioned use of information, non-compliance with security requirements and other internal or external circumstances relating to gaps in the internal control system.

Other financial intermediaries, except insurance corporations and pension funds (OFIs) – financial institutions primarily engaged in financial intermediation by incurring liabilities in forms other than currency, deposits and close substitutes for deposits to their customers other than MFIs, or insurance technical reserves. OFIs are financial 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.

Real-Time Gross Settlement (RTGS) system – a settlement system in which processing of payments and settlement take place on an order-by-order basis (without netting) in real time (continuously) (see also *Interbank automated payment system (SAMS)* and *TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system*).

Repos – operations whereby a tender participant (a bank or a branch of a foreign bank registered in the Republic of Latvia holding a cash account for settlements in lats with the Bank of Latvia and participating in the securities settlement system organised by the Bank of Latvia) sells securities owned by it to the Bank of Latvia and repurchases them from the Bank of Latvia at a specified price upon maturity.

Reserve base – the sum of the balance sheet items which constitute the basis for calculating the reserve requirements of banks and branches of foreign banks registered in the Republic of Latvia.

Reserve holdings – holdings of banks and branches of foreign banks registered in the Republic of Latvia on their reserve accounts which serve to fulfil reserve requirements.

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

Reserve requirement – requirement for banks and branches of foreign banks registered in the Republic of Latvia to hold an amount of reserves compliant with the reserve ratio on their reserve accounts with the Bank of Latvia.

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

Reverse repos – operations whereby a tender participant (a bank or a branch of a foreign bank registered in the Republic of Latvia or a foreign bank, international foreign exchange, financial or credit institution holding a cash account for settlements in lats with the Bank of Latvia and participating in the securities settlement

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system organised by the Bank of Latvia) purchases securities owned by the Bank of Latvia from the Bank of Latvia and resells them to the Bank of Latvia at a specified price upon maturity.

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

TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system – a real-time gross settlement system for the euro. It is a decentralised system consisting of 15 national RTGS systems, the ECB payment mechanism and the Interlinking mechanism at the end of 2004.

Time deposit with the Bank of Latvia – cash assets in lats accepted by the Bank of Latvia for a fixed term and with a fixed interest rate from a bank registered in the Republic of Latvia, including a bank which has been rendered insolvent or to undergo liquidation, or from a branch of a foreign bank registered in the Republic of Latvia, repaid by the Bank of Latvia to the above counterparties upon maturity together with interest.

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