Latvia's Participation in the Exchange Rate Mechanism of the European Monetary System

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Abstract
The first objective is to investigate the on-going monetary policy of the Bank of Latvia, to analyse the basic principles of its operations and influence on national economic growth. The second objective of this article is to follow the main trends in the development in the Latvian's monetary policy and the European Monetary system accession process, with a focus on the local currency stability problems. It discusses the process and strategies for choice of the strategy as well as the main issues that have arisen in the accession process. Both objectives fully corresponding to the article's research object, i.e. to a monetary policy of the Bank of Latvia. Regarding the developed countries the general monetary policy objectives deals not only with maintenance of stability of the exchange rate and general price level, but also with stimulation of economic development, growth of employment and incomes of the citizens. The period from 2004 till 2011 is being investigated. The author uses a wide range of research methods, such as : grouping method, method of comparison of financial ratios, etc.
Keywords central bank, economic growth, monetary aggregate, monetary instruments, monetary policy.

1 Introduction

The monetary policy instruments of the Bank of Latvia are already in line with those used in the euro area. Like the European Central Bank, the Bank of Latvia also uses the reserve requirements, market operations, as well as standing facilities of lending and deposit of funds. Assets of Bank of Latvia including gold and exchange currency reserves, serve as maintenance of money issue in Latvia. External reserves of Bank of Latvia which include gold reserves and foreign currency, and also currency from basket SDR in the end of 2012 has reached 7366,1 mill. lats (in 2003-830,5 mill. lats).

The choice of the strategy depends on the size of country, level of openness, economic growth, relations between the key objectives and the intermediate target, features of financial and capital markets and other economic factors. The key objective of the central bank's monetary policy is to facilitate the favourable macroeconomic environment for growth of the national economy in the long term. The course of global economic development assumes that monetary policy, employment and financial stability can foster the economic growth most of all by ensuring the low inflation rate. Economic growth has stopped and even decreased in Latvia, as well as Baltic States and euro area in general thus restricting possibilities of profitable transactions carried out by Latvian economic basic units-enterprises in both domestic and export markets. Rapid economic growth in recent years in Latvia was mostly based on private consumption increase and large credit resource injections mainly in activities related to real estate market development.

2008 marked a turning point in Latvia's economic development, which began to decelerate after several years of buoyant growth. Insufficient improvement in performance and efficiency of national economy, public administration and public services structure reduced the overall economic competitiveness, which was particularly influenced by recession in the export market. First signs of a slowdown of the economic growth became apparent in the second half of the year, when the implementation of the anti-inflation plan produced by the government, moderation of funding from parent bank and tightening of the banks' lending policies resulted in a rather abrupt deceleration of the domestic lending growth. The reasons of failures of monetary policy include the methods of monetary regulation used by the Bank of Latvia. There is a danger of traps in the course of application of the monetary policy instruments. It is necessary that the Bank of Latvia should carefully chose the necessary financial tools of monetary policy.

The author offers the ways of the solving of these problems on the basis of main principles using the achievements of world economic thought. In the conditions of a financial crisis the Bank of Latvia is able to achieve its targets while using the various financial instruments.

2 Preparation for the Participation in the European Monetary Union

Accession to the EU implies preparation for the participation in the Economic and Monetary Union and introduction of the euro, for the new Member States of the EU may not choose to stay outside the euro area. Hence, after joining the EU, Latvia will have to demonstrate its capability to meet the criteria for joining the Economic and Monetary Union. The Cabinet of Ministers and responsible public administration institutions will take steps necessary to comply with Maastricht convergence criteria to ensure euro changeover as soon as possible.

In the analysis of any definition there is the first important question, the answer to which is connected to all systems definitions and classifications. This question will be worded as follows : "Does a system really exist ?" Not many researchers ask this question, but those who are wondering, as a rule, respond to it positively. It seems to us that the question canąŕt be answered at all. Why ? Let's think constructively.

Economic convergence is a serious pre-requisite for successful operation of a monetary union ; therefore, prior to joining the euro area the EU Member States have to ensure compliance with the Maastricht convergence criteria : achieve price stability, sustainability of the Government's financial position, exchange rate stability against the euro and long-term interest rate convergence.

Maastricht convergence criteria :

- price stability is measured as the average consumer price increase of the last 12 months in three EU Member States with the lowest inflation plus 1.5 percentage points ;

- sustainability of the Government's financial position means that the Government deficit and the Government debt do not exceed 3% and 60% of GDP, respectively ;

- long-term interest rates convergence criterion is interpreted as the average yield rate of 10-year Government bonds within a 12 months period in three countries with the lowest inflation plus 2 percentage points ;

- exchange rate stability criterion provides for participation in the Exchange Rate Mechanism II (ERM II) without severe tensions, which, in turn, primarily means without currency devaluation against the euro. If required, other adequate indicators may be used to assess stability.

In order to achieve the key objective as well as join the Economic and Monetary Union successfully, the Bank of Latvia has chosen its exchange rate strategy for the implementation of monetary policy. Now Latvia almost complies with the majority of the Maastricht convergence criteria necessary for joining the Economic and Monetary Union (except for a parameter of Interest rates on government long-term securities).

Table 1 The compliance with the Maastricht criteria [1-4]

	Criterion in 2005	Latvia's performance in 2005	Criterion in in 2005	Latvia's performance in 2008	Criterion in 2011	Latvia's performance in 2011
Budget deficit (% of GDP)	-3.0	-1.0	-3.0	-4.0	-3.0	-4.1
Government debt (% of GDP)	60.0	14.7	60.0	19.5	60.0	42.6
Average annual inflation rate (%)	2.5	6.7	4.1	15.3	2.4	4.0
Interest rates on government long-term securities(%)	5.4	3.96	6.24	6.43	7.80	6.00
Exchange rate regime	Fixed exchange rate against the euro and participation in ERM II for at least two years	Fixed exchange rate against the SDR since 1994	Fixed exchange rate against the euro and participation in ERM II for at least two years	Fixed exchange rate against the euro and participation in ERM II for since May 2005	Fixed exchange rate against the euro and participation in ERM II for at least two years	Fixed exchange rate against the euro and participation in ERM II for since May 2005

Statistical data available for the last years indicate that the initial plan of Latvia to adopt the euro in 2008 cannot be implemented due to the high inflation rate. The schedule has not been revised as yet but according to the information released by the Ministry of Finance, in 2007 the Government would discuss a new target for the changeover to the euro, tentatively in 2012-2014. The introduction of the euro in Latvia will be an issue of the EU multilateral relations affecting common interests of all EU countries. Therefore, the projected time frame for the introduction of the euro is merely tentative and will gain an official status only after the completion of all negotiations and other formal procedures.

The high rate of Lat stimulated a wide import of consumer goods displacing the Latvian producers from domestic market that brought to the decrease of internal accumulation. In 1936, the gold content of Lat was 0.29032254 grams of gold, and its parity to dollar equaled USD/LVL 3.03. The rate of Lat at the Riga Exchange quoted on the same level. However, after adoption of law «On currency reform» on September 28, 1936 which provided the devaluation of Lat on 40%, its rate at the Riga Exchange decreased to USD/LVL 5.04 [5].

The Latvian exporters returned what they have lost due to the growth of Lat rate before the currency reform, i.e. the same 40%. Considering the indicators of national economy of Latvia after Lat devaluation in 1936, we see that it promoted the improving of economic situation. In 1937, in comparison with 1935 the amount of bank deposits increased on 67%, employment grew on 18%, a number of the unemployed people was reduced by 50%.

The U.S. scientists carried out a study which stated that the fixed rate would bring Latvian economy to such a decline, which's incomparable with the U.S. recession during the Great Depression years of 1929-33 [6]. Therefore, it is not casual that the rating agency Moody's and British analytical center Capital Economics point out the risk of devaluation of the Lat. The news agency Bloomberg referring to the experts of the U.S. bank Brown Brothers Harriman & Co. reported that the Latvian currency may be devalued against the EURO by 50% [7].

Many Western economists spoke about the necessity of devaluation of national Latvian currency. Kenneth Rogoff, the Professor of the Harvard University and the former chief economist of the International Monetary Fund, considers that Latvia should devaluate Lat to avoid the toughening of economic crisis. It should be noted that the IMF has no univalent position concerning devaluation of Lat. According to Prime Minister Valdis Dombrovskis at discussions about financial aid to Latvia, the IMF wouldn't object the devaluation of national currency but without insisting on it [8].

Ilmars Rimshevich, the President of the Bank of Latvia expressed opinion that Lat devaluation would pull down the economy of Latvia for one night. It is necessary to agree with him as it is necessary to treat devaluation of Lat extremely carefully. The situation is similar to the tense spring. The devaluation must be based on exact calculations and shouldn't be carried out without any damage to the population. There required the thorough economic calculations for search of an optimal rate which would correspond to the parity of purchasing power of Lat to foreign currency more precisely than today.

The price reform will demand many efforts because the standard of price expressed in a new rate of Lat will change that should affect the size of salaries, pensions and other social payments, the state budget and its external balance of payments. The volume of export of the Latvian industrial and agricultural output will increase. Accordingly, the taxes and also the sums required for repayment of received earlier foreign loans will increase. All these points should be considered while starting such painful operation as devaluation of national currency.

3 Problems of Devaluation of Lat

The Bank of Latvia should be regarded as a state administrative body which carries out the main responsibility for development of events of the monetary sphere. Its priority direction was always the external stabilization of the national currency which strengthening shall promote the internal sustainability as well.

Over the past 20 years, the Latvian currency had a fixed exchange rate. Since June 1993 Lat had a floating rate, and in February 1994, the Bank of Latvia pegged the Latąős exchange rate to the SDR basket (1 SDR=0.7997 LVL). On January 1, 2005 it was pegged to the EURO (1 EUR=0.702804 LVL). The fluctuations are admitted within +/-1% of the pegged rate.

On May 1, 2004, when Latvia has joined EU, the Bank of Latvia became a member of the European central banks system and began the preparations on Euro adoption that was planned to take place in early 2008 according to the plans at those times. No big changes in the activities of the Bank of Latvia have happened. Bank continued to perform the former economic functions, including monetary policy to ensure the operation of the payment system, the circulation of cash, preparation of financial statistics and balance of state payments and perform the macroeconomic analysis and research including the identification of trends in economic development in the scales of the European Union. The administrative functions including licensing and control over the banks have been handed over to the Financial and Capital Market Commission in 2001.

Since May 1, 2004, the Bank of Latvia became the holder of the shares of the capital of the European Central Bank (ECB). The total share in the registered capital of the European Central Bank was established at 0.2978%, or 16,571.6 thousand euro. The share of the Bank of Latvia in the ECB's capital was calculated on the basis of volume of the country's economy and population. The Bank of Latvia brought 750 thousand Lats and 1763 thousand Lats into the fixed capitals of the European Central Bank and Bank respectively for International Payments. The Bank of Latvia uses the available foreign currency for the corresponding installments.

The Bank of Latvia aspired to direct the currency rate policy on achievement of low inflation and convergence of the prices for the goods and services and level of inflation similar the countries, which national currencies are included into SDR basket. Latvia enjoys one of the most liberal currency regimes in the world. Both the citizens and foreigners can open accounts in Lats and in other currencies without restrictions and freely sell and buy Lats by other currencies.

The commercial banks credited in foreign currency not only the entities, but also the individuals. As a result, the real estate transactions have been carried out not in foreign currency rather than in national one. The same picture could be observed in the automobile market. The Bank of Latvia have been buying and selling the basket of SDR currencies on requests of commercial banks without restrictions.

The primary long-term goal of approximately 65% of the world's central banks is the prices stabilization ; the second most common goal is the sustainability of national currency. The small countries with open economies (like Latvia) usually stick to the second long-term goal. It is impossible to achieve both goals at once because the central bank can control just one direction : either inflation or exchange rate.

Initially, the activity of the Bank of Latvia in the conditions of high inflation was directed on fight against inflation by the means of strict monetary policy. In 1992-1994, the monetary base ğő0 was the main indicator of Bank of Latvia because it was easier to supervise the monetary base, rather than other monetary aggregates in the conditions of high inflation (58.7% in 1992, 34.9% in 1993).

The situation analysis after inflation decrease showed that the fiscal policy and monopolists' price regulation incl. power industry, transport etc., became the determining factors. The internal assets of Bank of Latvia became the target parameter ; and the minimum limit of net external assets of the Bank of Latvia was set to maintain the stability of Lat what was connected with an unofficial pegging of Lat to SDR.

The Baltic States started their programs of sustainability of national currency in the middle of 1992. The economists had faced a problem when choosing the exchange rate mode : to accept the floating exchange rate or to operate the fixed rate. Though the programs of sustainability of the Baltic States differed from each other, however, all of them came nearly to the same result, i.e. Estonia stuck the national currency to the fixed rate of DM, Lithuania stuck to US dollar and Latvia stuck to SDR.

The main criteria were : to prevent the national economy from external shocks in a best possible way and to ensure the financial and economic sustainability of the restructuring of the economy.

In 1992, Estonia exchanged the Soviet rubles at the market rate of 10 :1 and equated Krone at a rate of DM/EEK 8. Lithuania replaced the intermediate currency in the form of coupon by Lit in June, 1993, and pegged it to US dollar at a rate of USD/LTL 4 since April, 1994. It is interesting that in 1936 the rates of Estonian Krone, Lithuanian Lit and Latvian Lat against US dollar were following : USD 1/EEM 6.95/LTL 4.38/LVL 5.04. In 1999, the rates of three Baltic currencies to US dollar were respectively : USD 1/EEK 11.2/LTL 4/LVL 0.59.

There is a question how the current rate of Lat against US dollar could be established almost ten times higher in comparison with 1936. On September 28, 1936 one British pound had been cost 25.11 LVL [5]. Presently, the Latvian Lat is the main competitor for the pound. The Latvian Lat was heavier than pound, i.e. its rate was GBP/LVL 0.7910 as of March 1, 2010 [6]. So, the purchasing power of Lat was approximately set on the same level as in 1936.

Let's view the chronology of events related to the establishment of the new national currency rate in 1990-ies. It is known that Latvia lost independence on July 17, 1940. The Latvian Lat was in circulation as a legal payment instrument till November 25, 1940 when the Soviet ruble had been introduced in parallel at a rate of 1 Lat=1 ruble. Since March 25, 1941 all Lat cash and deposits over 1000 Lats (rubles) have been cancelled without any warning. Such monetary confiscation has been carried out in three Baltic republics.

Two currencies were functioned in Latvia from 1941 to 1945. There were the German occupational money Reichsmark (RM), and also the Soviet rubles at a rate 10 rubles=1 Reichshsmark. After the Second World War till 1992 only Soviet rubles were in circulation.

Only after Latvia had regained its independence and the law "On the Bank of Latvia" had been adopted on May 12, 1992, there was an opportunity to carry out the monetary reforms targeted to establishing of a national currency circulation. To do this, the Bank of Latvia has specially established a committee for monetary reform (Latvijas Republikas Augst$\bar{a}k\bar{a}$s padomes Naudas reformas komiteja) that decided to introduce a temporary currency-the Latvian ruble on May 2, 1992.

The first stage of reform began on May 7, 1992, when the Bank of Latvia issued a temporary money - the Latvian ruble, which were in circulation along with the Soviet rubles at a rate 1 Latvian ruble = 1 ruble. Since July 20, 1992 the parallel circulation was stopped, and the Latvian ruble became the sole legal payment instrument.

Finally, the first five-banknotes came into circulation on March 5, 1993, which were used in parallel with the Latvian rubles at a rate of 1 Lat=200 Latvian rubles. The Latvian ruble was in parallel circulation with the Lat till October 18, 1993.

Within 1992 there was a sharp shortage of cash in circulation in the state what was threatening to cause a serious social crisis. So, if in February, 1992 the amount of cash exported from Latvia exceeded the quantity of Soviet rubles imported to Latvia on 122 million banknotes (5.9%), in April of the same year this amount equaled to 686 million banknotes (29.2%) [10]. Moreover, at the beginning of 1993 the Latvian parliament discussed a case connected with unauthorized export of cash in amount of 665 million Soviet rubles in railway car to Russia.

The Commodity Exchange carried out its operations in the building of the Ministry of Agriculture. Commodity brokers have been changing the meat to paper, shoes to cereal, etc. The employees have been paid often by the enterprises products. In November 1993, there were 66 registered banks. The annual interest rate for deposits was as follows : Banka Baltija-90%, Latvijas Depozitu banka-45%, Latvijas Industriala banka-60%.

Now it is difficult to apprehend, but the liter of milk cost 14 centimes at the end of 1992, and the US dollar buying rate fixed by the Bank of Latvia was 0.8350 LVL and 0.5919 LVL already at the end of 1993. For January 1, 1995 the official rate of US dollar was fixed by the Bank of Latvia on a level 0.5480 LVL.

As we can see, the Bank of Latvia took as a basis the rate of Soviet ruble while establishing a rate of Lat. Therefore, on a moment national currency introduction, its rate initially was artificially overestimated. The high rate of Lat allowed supporting one of the highest rates of economic growth among the countries of Eastern and Central Europe (see tab. 2). The nominal GDP has been growing on more than 20% a year in pre-crisis years. For example, its growth was 23.3% in 2006, and 32.3% in 2007.

4 Trends of Latvia's Monetary Policy

The major quantity indicator of monetary circulation is the money supply representing a total purchasing volume and legal tenders, which serve for economic circulation of financial recourses of private persons, enterprises and state. The analysis of structure and dynamics of money supply has a great significance for development of reference points of the monetary policy of central bank.

The monetary aggregates are applied to money supply definition. The cash assets are the basis of all monetary aggregates. The share of cash in money offer can vary depending on the circumstances. So, the more economy of the state is developed, the more banking system is stable and wide and the fewer shares of cash. The Bank of Latvia applies the following main monetary aggregates to the characteristic of monetary system and banking :

(M0) monetary base - monetary base is calculated on the basis of the Bank of Latvia's methodology and comprises the lats banknotes and coins issued by the Bank of Latvia and demand deposits of resident MFIs and financial institutions (overnight deposits) with the Bank of Latvia. The Central bank directly creates this part of the monetary offer. By increasing the assets the Central bank creates the money of high efficiency, by reducing it destroys them. The opportunities of Central bank towards the creation of money of high efficiency are extremely great, as its liabilities (passives) are the money itself.

M2X (wide money) - broad money aggregates are calculated on the basis of the Bank of Latviaąŕs methodology and comprise the lats banknotes and coins issued by the Bank of Latvia (less vault cash of MFIs) and overnight deposits and time deposits in lats and foreign currencies (including deposits redeemable at notice and repurchase agreements) held with MFIs by resident non-financial corporations, financial institutions, households and non-profit institutions serving the households. M2X incorporates the deposits placed by local governments as a net position on the demand side. This parameter characterizes the total money in national economy. As foreign currency is of great significance for Latvian economics, this parameter includes both the deposits of the enterprises and private persons in foreign currency [11]. Let's review the monetary parameters presented in table 2[1-4].

Table 2 The basic indicators of monetary policy in Latvia from 2004 till 2011(mill. lats)

	2004	2005	2006	2007	2008	2009	2010	2011
GDP (Current prices)	7434.5	9059.1	11171.6	14779.8	16243.2	13070.6	12784.1	14275.2
Growth GDP (%)	116.3	121.0	123.3	132.3	109.9	80.5	97.8	111.7
M0	957.2	1350.7	2248.8	2471.2	2111.5	1645.8	1755.2	2168.9
M2X	2816.5	3905.8	5479.9	6171.3	5931.4	5796.2	6390.0	6486.1
Growth M2X (%)	127.0	138.7	140.3	112.6	96.1	97.7	110.2	101.5
M2X/M0 (%)	294.2	289.2	243.6	249.7	280.9	352.2	364.1	299.1
GDP/M2X	2.7	2.3	2.0	2.3	2.7	2.3	2.0	2.2

The velocity of money testifies the communication between monetary circulation and processes of economic development. Aggravation of the macroeconomic risks and lower savings induced acceleration of the velocity of money, growing from 2.3 in 2007 to 2.7 in 2008. Resident financial institution, non-financial corporation and household deposits with MFIs decreased by 205.9 million lats or 3.9% in 2008 in comparison with an increase of 16.9% in 2007. In 2004, the velocity of money made 2,7 times per year. The economic situation stimulated the decrease of rate of the money turnover from 2.7 in 2008 till 2.2 in 2011. In relation to this parameter

Latvia approaches to the developed countries where the speed of money turnover does not exceed 1.5 times. The decrease of rate of turnover of monetary volume (in 1.5 times) for the last 8 years cannot lower the negative influence of prompt monetary growth which increases more than by 40 % in 2006.

The behaviour of the monetary aggregates in 2008 mirrored the sharp downturn of the economic development with both domestic and external demand shrinking, as well as the impact of the global financial crisis on the Latvian banking system and money market. In 2009 M2X decreased by 2.3% (a growth of 10.2% in 2010) and amounted to 5796.2 million lats at the end of 2009 (see table 2). With the economic development coming to a halt in the second half of the 2008, banks cutting down on their lending business remarkably and confidence with regard to the financial sector deteriorating. The negative rate of the monetary expansion was primarily a result of the decelerating growth of MFI loans to the private sector, with the total loans outstanding shrinking in the last three year of the 2000s.

The monetary situation in Latvia is characterized also by other parameters : monetary multiplicator (M2X/M0) and velocity of money (nominal GDP/M2X). The great importance has monetary multiplicator - a parameter describing the opportunities of economy as a whole and banking system in particular to increase a money stock in a turnover. Its size pays off as the attitude of M2X to monetary base(M0). The monetary multiplicator is necessary to control over the monetary volume dynamics and the rate of inflation in Latvia. In 2011, the monetary multiplicator has decreaseed essentially, and by the end of the year it consisted 299.1% (in 2010-364.1%).

Monetary base M0 decreased by 14.6% in 2008 and totalled 2111.5 million lats at the end of the year, whereas the cash component of the monetary base grew to 48.2% in comparison with 42.5% at the end of 2007. Deposits from credit institutions and other financial institutions held by the Bank of Latvia declined by 328.3 million lats or 23.1% in 2008 as opposed to a 21.0% increase in 2007. For the second consecutive year, the demand for cash decreased, and currency in circulation shrank by 31.4 million lats or 3.0% (by 2.3% in 2007).

The development trends of monetary aggregates were influenced by drying up capital inflows and foreign exchange interventions of the central bank reflected in the changes of net external assets. Negative net foreign assets of MFIs grew by 31.9% during the year, amounting to 5914.6 million lats, whereas the respective indicator of the Bank of Latvia decreased by 16.0% and totalled 2332.3 million lats at the end of 2008. Thus the growth of the negative net foreign asset position decelerated considerably in comparison with 2007, when it expanded 1.7 times.

Nevertheless, Latvia experience significant economic growth beginning in 2004 with EU accession. This followed the U.S. strategy to prevent an economic recession through asset inflation following the collapse of its stock markets in 2000.

The USA and other developed countries flooded a world economy cheap credit resources. Thus, developed countries created credit found its way into Latvia through Swedish banks. Combine with EU structural funds, the Latvian economy headily increased of GDP, until the inevitable global economy crisis led to Latvia's disastrous fall. But, Latvia's economy was not purely the victim of induced events. The Bank of Latvia and other state regulators are also responsible.

The basic problem of Latvia for the last 20 years was a balance of payments deficit of current transactions. Balance of payments deficit arises as a result of excess of import over export. Within last 8 years the volume of foreign trade of Latvia has considerably increased in 3 times. The volume of foreign trade has been increasing year from a year, except 2009 when the consequences of the financial crisis have occurred (table 3) [1-4].

Table 3 Parameters of foreign trade of Latvia from 2004 till 2011(mill. lats)

	2004	2005	2006	2007	2008	2009	2010	2011
Import	2989.2	4866.9	6378.5	7780.2	7484.4	4709.8	5911.9	7719.4
Export	1650.6	2888.2	3293.2	4040.3	4406.0	3602.0	4695.0	5998.5
Balance	-1338.6	-1978.7	-3085.3	-3739.9	-3078.4	-1107.8	-1216.9	-1720.9

In 2008, the foreign trade dynamics was affected by the global financial crisis and weakening domestic and external demand. Exports of goods expanded by 9.1% (a 15.1% rise in the first nine months of the year and 7.2% drop in the fourth quarter). Imports of goods continued to shrink gradually, recording a 3.8% downslide on an annual basis. The excess of imports of goods over exports of goods decreased to 69.9% (92.6% in 2007) and the foreign trade deficit narrowed by 17.7%. The role of the EU in Latvia's foreign trade is strengthening : 76.1% of total export from Latvia went to the EU countries in 2011 (73.1% in 2008).

Let's consider the main financial instruments and principles of monetary policy in Latvia. The choice of monetary instruments is wide enough. The basic tools of monetary regulation are : the standing facilities of lending and deposit of funds (refinancing) ; the reserve requirements ; the market operations. The choice and combination of instruments of monetary regulation depends, first of all, on issues, which are settled by central bank at the stage of economic development.

The regulation of discount rate relates to market instruments of monetary regulation. The mechanism of regulation is simple enough ; therefore it is widely used in developed and developing countries. The official discount rate is a reference point for other market rates. The above level of official discount rate is the above cost of central bank refinancing. It means that the policy of change of discount rate represents a variant of regulation of qualitative parameter of money market - the cost of bank credits.

The refinancing of commercial banks is carried out by holding of credit auctions, granting of Lombard loans, etc. The Bank of Latvia has started using of refinancing as monetary policy instrument in 1993 only by granting the short-term credits to commercial banks for liquidity maintenance. Originally the credits were granted to each bank within the limits depending on the bank's performance in accordance with regulatory requirements established by the Bank of Latvia.

Such an order was necessary because the credits were granted without collateral. Since November 1993, when the demand for credits exceeded the supply of credit resources, the Bank of Latvia has started carrying out of the credit auctions. As earlier, the credits were granted without collateral, therefore the quantity of the participants of auction was defined depending on the size of the equity capital of the bank, liquidity, and the bank performance in accordance with regulations of the Bank of Latvia.

The Bank of Latvia has started granting the Lombard loans in September 1995. It is the form of refinancing when the Central bank grants the credit under pledge. The Bank of Latvia grants two types of Lombard loans : the automatic Lombard loans and Lombard loans on demand. The commercial banks can exceed the balance of the correspondent account within the limit of the Lombard loan during a payday for maintenance of efficiency of the interbank payment system. The Bank of Latvia grants the credits to commercial bank for one day in amount of the debit balance of corresponding account, in case the commercial bank could not involve the money resources till the end of a payday to liquidate the lack of resources on a corresponding account. The Bank of Latvia grants the Lombard loans to commercial banks automatically in the end of a payday without special requirement.

The basis for the Lombard loan issuance is the special agreement between the Bank of Latvia and commercial bank. Usually the Lombard loan interest rate is higher than credits repo interest rate. It is a kind of "penalty" for the usage of resources of the Central bank. The interest rate of Lombard loans can vary depending on the terms of drawdown. As the Lombard loans interest rate is higher than the interbank market interest rates and the interest rate of refinancing of the Bank of Latvia, the demand for these credits is usually small. The commercial banks use the Lombard loans only in case of emergency.

The Bank of Latvia supports the money volume in the set parameters and adjusts the level of liquidity of commercial banks by changing the minimal reserve requirements. It is assumed that credit institutions have to hold a certain share (currently 3.5%) of the attracted non-bank deposits with the Bank of Latvia. In event the reserve requirements are increased, these credit institutions will have to hold more funds with the Central bank. It means that the amount of funds attracted by credit institutions, which is at their disposal and could be freely placed in the economics, thus increasing the level of credit and broad money, will decrease. The reserve requirements as a monetary policy instrument ensure the higher stability in the monetary base demand and facilitate the effectiveness of market operations, preventing the excessive interbank interest rate daily fluctuations.

5 Three Dogmatic "Rule"

There is a dogmatic "rule" of the monetary policy : the actual rate of refinancing should be positive (though it was negative in many developed countries in specific years, and in 2007 the refinancing rate was below the rates of inflation in the majority of these countries). In Latvia, the monetary market rate is below the inflation rates. It is obvious there is an imported inflation in the conditions of prices rise which is underestimated by the Central Bank. Accordingly, it overestimates the measurements of the base inflation depending only on the monetary factors. Therefore, the refinancing rate should be minimal, i.e. at a level of correctly estimated base inflation.

In the first half of 2007, the Bank of Latvia continued to pursue the tough monetary policy and in two occasions raised the refinancing rate by a total of 100 basis points (to 6.0%), thereby dampening the excessive domestic demand. Later, when the signs of economic overheating abated, the Bank of Latvia left its interest rates unchanged, but in the first half of 2008 due to the slowdown in the growth of lending and the associated deterioration in the banks' role in fuelling the domestic demand, it lowered the minimum reserve requirement for bank liabilities with agreed maturity of over 2 years by 2.0 percentage points (to 6.0%).

The reasons of failures of monetary policy include the methods of monetary regulation used by the Bank of Latvia. They are reduced by application of several "rules" which are considered to be suitable for any condition in any country. The first "rule" : in order to decrease the rates of inflation it is necessary to limit the monetary offer or to apply the quantitative credit restrictions or to overestimate the refinancing rate.

One more dogmatic "rule"-In order to decrease the inflation it is necessary to strengthen the rate of national currency ; on other hand, it reduces the price competitiveness of national commodity producers. It could be raised by depreciation of the credits, but it is forbidden by the first "rule". The application of such "rule" of monetary policy by no means is rather offensive : the economics can get to a condition called by the "trap". In such conditions the measures of state regulation do not bring positive results. These traps are known : "the debt", "the liquidities" and "the negative effect rendered by strengthening of actual exchange rate of national currency on economic development".

The debt trap occurs at excessive debts of the state and private sector at small duration of debt. By involving the short-term and intermediate term loans under low interests the borrowers count them as refinance by new loans. In case of steep increase of interest rates in the financial markets its long service sharply rises. If the borrower is not in position to extinguish it, the avalanche growth of debts begins, and it is impossible to extinguish it even after decrease of the interest rates. Now, there is a growth of interest rates which were on rather low level for the long period. The Latvian enterprises borrowed the financial resources abroad and can shortly face the refinancing problem and service of debts.

The liquidity trap occurs at too low nominal interest rates when the Central Bank decreases refinancing rate, but it do not lead to expansion of the credits and stimulation of economic growth.

The third trap is caused by the increase in balance of the international payments. It leads to the strengthening of national currency and shifting of employment to sphere of services. The Bank of Latvia can use the maintenance of the exchange rate by buying up the foreign currency, and it conducts to the growth of monetary offer and inflation strengthening. At high inflation the strengthening or stability of the nominal exchange rate leads to strengthening of the actual exchange rate. In other words, the efforts of the Central Bank do not achieve the object on maintenance of price competitiveness. Thus, there is a necessity of sterilisation of superfluous liquidity. The escalating of the gold and exchange currency reserves by Latvia basically is crediting of the USA and the European Union countries.

The inflation is mostly supported by excessive inflows of a variety of financing : the credit resources from foreign parent banks, the foreign direct investment, the EU funding, the workers' remittances from abroad. To avoid the imported inflation the high validity of monetary policy is required. For example, the most effective remedy of the negative effect rendered by strengthening of actual exchange rate is crediting of the enterprises by the government and the Central Bank by replacing the foreign loans. Certainly, such replacement of credits is better than the accumulation of superfluous currency provisions. However, from the macroeconomic point of view the replacement of foreign loans of the Latvian enterprises by local credits is similar to repayment of external debt. Now, the Latvian commercial banks involve the foreign loans, and the Central Bank is compelled to buy up the foreign currency, generating the superfluous monetary offer which needs to be sterilised immediately.

With the view of restriction of money growth the Bank of Latvia does not refinance sufficiently the credit organisations by establishing the refinancing rate at high level. It leads to the overestimate of credit resources cost for banks and enterprises. Therefore, the Latvian enterprises increase the foreign loans. The vicious circle turns out-the Bank of Latvia is compelled to get the additional volumes of the foreign currency arriving in the form of foreign credits to private sector of economy, increasing thereby the monetary base. The government is compelled to “freeze” huge budgetary funds on accounts of the Bank of Latvia in order not to admit an excessive monetary issue and inflation strengthening. The failure includes the preservation of high average rates of inflation which exceed 15.4% in 2008. The ways of their decrease in conformity with anti-inflationary program developed by the government are not enough clear. At low technological efficiency of the majority of Latvian economic branches and growing world prices for energy sources it is impossible to stop inflation, including the attempts to limit the growth of monetary weight. However, the high inflation at stable or raising exchange rate of Lat leads to the strengthening of the actual rate of exchange, and consequently-to corresponding decrease of competitiveness of the Latvian enterprises. Though the indicator of parity of purchasing capacity is considerably underestimated regarding the currencies of the developed countries, the actual exchange rate strengthening brakes the economic growth and promotes the advancing growth of import. At high inflation the investors of banks receive negative real percent on deposits, and the enterprises pay the overestimated income and added cost taxes.

6 Conclusions

For the past years the modern two-level banking system was established and developed in the country. Gradually, there formed the competitive credit and financial infrastructure which basic elements were the commercial banks. Some of them have already got a high international rating. The Association of the Latvian Banks turned into national bank association.

At the same time, there is an unpredictability of actions of the Latvian administrative bodies. A main goal of the Bank of Latvia and the Financial and Capital Market Commission is the ensuring of the general sustainability in the monetary and credit markets. Thus, exercising all rights defined by the law, the Bank of Latvia should provide a stability of the prices, and the Financial and Capital Market Commission should treat everyone who forms the instability in finances and capital market in whole or in its separate sectors by their activity or non-activity. The results of research testify the mistakes of the central bank made at the moment of establishment of national currency rate. The country had a possibility to provide unreasonably high rates of GDP growth due to the overestimated currency especially in the middle of the 2000th.

In order to solve these problems it is necessary to boost the access of Latvia into Euro zone since the adaption of Euro will help the Bank of Latvia not to carry out a number of aforementioned actions. An effective banking system is one of the most important conditions of economic development of Latvia. It is assumed that Latvian economy will be able to implement positively the experience of monetary and credit regulation accumulated in world practice.

In spite of the fact that devaluation of Lat is matured, Euro adoption is more of big modern importance. Therefore, referring to a world experience, we should not abandon the possibility of joining the Euro zone de facto, although the process of co-ordination with the European Central Bank may not be less complex than the joining of Euro zone.

In Latvia, a market undergoes a process of Euroization for a long time . Euro has pressed Lat long ago in the conclusion of credit and trading agreements. In order to find the correct options it is possible to make use of experience of the European and other countries which use Euro as national currency, but didn't enter the Euro zone : Montenegro, Kosovo, Andorra, Monaco, San Marino, Mayotta, etc.

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