Einars Repse: Links between the Central Bank and financial markets after the establishment of the Financial and Capital Market Commission in Latvia

Speech by Mr Einars Repse, Governor of the Bank of Latvia, at the Conference “Banking and Finance in the Baltics 2001”, held in Riga, 19 September 2001.

* * *

Since 1st of July 2001, the **Financial and Capital Market Commission (FCMC) has taken over the regulation and supervision** of the Latvian banking system from the Bank of Latvia. It is widely recognized that banking supervision was handed over to the new institution in good shape. The banking sector in Latvia is solid, adequately capitalized and well regulated in conformity with the European Union (EU) standards. This was confirmed by the joint International Monetary Fund and World Bank Financial Sector Stability Assessment that took place in the first half of this year.

The **FCMC is now the primary institution** responsible for stability and development of the financial market in Latvia. However, this does not mean that the overall stability of the financial system as a whole has become less important for the Bank of Latvia. Both institutions will continue to cooperate, as adequate monitoring of financial stability requires a combination of ‘‘macro’’ and ‘‘micro’’ perspectives. In the future, the Bank of Latvia will **concentrate more on macro-prudential analysis**, while the Commission - on supervision and regulation at the micro level.

Pursuant to the Law “On the Bank of Latvia”, **the central bank has to implement monetary policy** in Latvia by controlling the amount of money in circulation with the aim to maintain price stability.

Robust health of the financial sector is essential to ensure an efficient monetary policy transmission mechanism. Therefore, **stability** of the financial and banking system will remain an **important issue for the Bank of Latvia**.

Only a sound and competitive banking sector will be able to:

- **intermediate savings** efficiently, thus contributing to the economic growth;
- **provide transaction services** and payment systems that increase the efficiency of economic activities;
- **ensure mutual confidence among banks**, which is a precondition for smooth functioning of money and securities markets, through which monetary policy is transmitted;
- **contribute to the accuracy of the data** needed for the formulation of monetary policy;
- and, last but not least - **support exchange rate stability**, as a sound banking system serves to stabilize foreign exchange market and diminish exchange rate volatility.

The **Bank of Latvia has the ability and possesses the necessary tools** to influence the market environment:

- The commitment to maintain a **fixed exchange rate** has a favourable impact on savings and investments in Latvia, thereby strengthening the country’s financial system in the long run.
- The central bank’s **focus on price stability** enhances long-term planning and hence improves the process of resource allocation over time, thus contributing to a more efficient functioning of the economy. For these purposes **it can use monetary policy instruments to smooth out excessive interest rate fluctuations** and influence money supply in the short run.

Hence, the Bank of Latvia will influence and at a certain level control the financial system through existing monetary policy instruments:

- **First: Reserve requirements.**

  Reserve requirements **facilitate implementation of monetary policy** and to some extent create liquidity reserves that help to stabilize interbank rates. On the down side, reserve requirements can **act as a strain on commercial banks** and thus limit financial intermediation.

In line with Latvia's economic development and to narrow the spread between deposit and lending rates, the Bank of Latvia has, step by step, lowered **reserve requirements**. As a result, the required reserve ratio has been reduced to 6%, and in the future will be targeted to gradually reach the 2% level currently set by the European Central Bank.

- **Second: Open market operations.**

  The Bank of Latvia currently has the same set of open market instruments as the ECB, and the **most actively used instruments are swap and repo operations**. The widespread use of swap operations was dictated by commercial banks' desire to use their foreign currency holdings as a collateral for central bank's loans. However, as the market for government and corporate securities develops over time, it is expected that traditional repo operations will progressively become more important.

  By regulating liquidity in the banking sector through open market operations, the **Bank of Latvia can influence interest rates in the interbank market**. Insofar as the lending rates to the non-banking sector respond to changes in the interbank market rates, the actions of the central bank can have **implications for the real sector** of the economy.

- **Third: Lender of last resort.**

  If temporary economic difficulties of a financial institution can threaten the stability of the whole financial system, the Bank of Latvia is entitled to **provide emergency financial support**.

  According to the Law "On the Financial and Capital Market Commission", the Commission is "authorised to request the Bank of Latvia to extend a loan against collateral to any credit institution with short-term liquidity problems."

  The Latvian law clearly separates the function of the lender of last resort from banking supervision. Although the law stipulates that the necessary **coordination** between the FCMC and the Bank of Latvia must take place, it is the **Bank that has the final say** in this matter and therefore has to weigh the consequences of its decision.

Effective functioning and security of **payment and settlement systems** is a crucial element of the stability of the banking system. Therefore, this is an issue to which the Bank of Latvia pays particularly close attention.

In the domestic settlement systems, all interbank **settlements are conducted through the Bank of Latvia**. Currently there are **two systems** in operation at the Bank of Latvia and both are used for interbank settlement.

From November 1998, the **Electronic Clearing System** replaced the previous, paper-based clearing system. Electronic clearing is used for processing retail payments. It can be regarded as an *Automated Clearing House* system where payment processing is fully automated and only electronic documents are accepted.

A year ago, in September 2000, the Bank of Latvia introduced the **Real Time Gross Settlement System (RTGS)**. The RTGS system is designed for large volume, urgent payments related to interbank market transactions, open market and other Bank of Latvia monetary policy operations. The system enhances risk control and is an effective tool for the implementation of monetary policy. With the introduction of the RTGS system, the Bank of Latvia's **interbank payment systems** have been fully automated and **harmonised with EU requirements**.