



MAGYAR NEMZETI BANK

# ANNUAL REPORT

2005



# **ANNUAL REPORT**

## **Business Report and Financial Statements of the Magyar Nemzeti Bank 2005**



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**Part A**

**2005 Business Report of  
the Magyar Nemzeti Bank**





# 1. The Governor's foreword

2005 was a successful year for the Magyar Nemzeti Bank, both in terms of performing its core duties laid down by law and achieving its organisational objectives. In December 2005, the annual inflation rate stood at 3.3 per cent, lower than the targeted 4 per cent, but within the 1 percentage point tolerance range. Annual average inflation, which rose temporarily to 6.8 per cent in 2004, due to an increase in the VAT rate, declined to 3.6 per cent in 2005.

In 2005, several factors contributed to the decline in inflation. Due to fierce import competition and a stable forint exchange rate, the price increase of industrial goods slowed the most significantly, while market services inflation declined to a much smaller extent. During the year, no significant inflationary pressure was experienced from the side of domestic demand, as household consumption growth remained subdued in the course of the whole year, lagging far behind the dynamics of previous years. Although the rise in world market oil prices boosted inflation slightly through the increase in vehicle fuel prices, for the time being no second round effects have materialised.

Last year was characterised by an extremely favourable international investment climate. As yields on major markets were historically low, foreign financial investors turned to a greater extent to investment opportunities in emerging economies, including our region. Declines in the risk premium and an improvement in the inflation outlook allowed the Monetary Council to reduce the central bank base rate in nine steps by a total of 350 basis points in 2005.

Nonetheless, a further reduction in the risk premium required by investors and in the central bank base rate was limited by the fact that in 2005 the Hungarian economy continued to be characterised by significant imbalances judged to be unsustainable in the longer run. The main underlying reason was the steadily high general government deficit. The increase in indebtedness in a risky structure and the uncertainty surrounding the adoption of the euro impaired the country's risk assessment and added to the economy's sensitivity to potential future changes in the currently favourable external environment. The unfavourable market perception of domestic fundamentals was reflected by the forint's depreciation against the region's other currencies in a generally favourable investment atmosphere, and by the fact that the decline in the yields on long-term government securities fell behind that seen in other new EU Member States.

Despite overshooting the planned budget deficit and the deterioration in the credit rating of the government debt, the forint's exchange rate against the euro was marked by relatively moderate fluctuation and remained in a range which facilitated the return of inflation to a level that was broadly in line with price stability. In this process, the cautious interest rate policy and the MNB's communication policy played an important role. Our aim was to present the market with a realistic picture of the background of monetary decisions and of the inflationary and equilibrium risks perceived by the Bank. As a result of our communications policy, information uncertainty declined considerably among market participants. Undoubtedly, this contributed to investors remaining calm and to the decline in the risk premium.

Progress in reducing inflation in 2005 allowed the MNB, together with the government, to set a 3 per cent medium-term inflation target for the period starting from 2007. The main advantage of the new medium-term inflation target is that it provides a predictable monetary policy framework for economic agents, and helps to anchor inflation expectations.

By law, it is the responsibility of the Magyar Nemzeti Bank to support financial stability. In discharging this obligation, we continued to analyse economic developments, the functioning of financial markets and financial institutions in 2005. We found that risk-carrying developments increased in the operation of the financial system last year. The financial sector was forced to operate in a macroeconomic environment burdened with imbalances. Last year, the banking sector was characterised by a rapid rise in credit risks. Banks entered new customer segments with higher risks and no credit history. At the same time, they eased their lending conditions. From a stability aspect, it deserves special attention that within newly granted loans, foreign currency loans accounted for a decisive share, in respect of both household and corporate borrowing. Within that, Swiss franc loans grew the most dynamically. Small and medium-sized enterprises as well as households became more important for banks. Foreign currency loans offered by banks played an important role in competition for these clients. Due to the spreading of foreign currency lending, exchange rate exposure of borrowers without collateral increased considerably. Most customers became indebted at an exchange rate close to the strong edge of the exchange rate band, although the vulnerability of the exchange rate due to the macroeconomic environment

cannot be disregarded. We believe that a significant portion of customers are not sufficiently aware of the risks involved in the new financial products and in indebtedness in foreign currency, which in the event of a major change in the exchange rate, may carry an indirect risk for banks as well. Due to our responsibility for maintaining financial stability, we consider it especially important to assist economic agents to our best, so they can make their financial decisions with sufficient awareness of the risks involved. For this reason, the MNB drew the attention of both households and commercial banks to the dangers of becoming indebted in foreign currency. At the same time, increasing foreign exchange risk exposure also means that there is a wide stratum that is adversely affected by exchange rate fluctuations, which increases the costs of exchange rate volatility.

Private pension funds play an increasingly important role within the financial system. In 2005, we paid special attention to examining the operation of this sector. We identified several problems which deserve increased attention due to the special role of pension funds. We found that the yield of private pension funds with a bank or insurance company background is usually lower than what could be expected. Their investment policy is excessively conservative. Their operational costs are higher than justified, and their cost structure is difficult to assess. Competition between the funds is weak, and the self-governance organisational system required by law does not provide a suitable legal framework for efficient operation. These factors may represent risks, although not in the short run and mainly not in terms of the stability of the financial intermediary system. However, in the more distant future they may have an impact on the pension system's ability to operate and on the macroeconomic equilibrium.

One of our general goals is to increase the efficiency of our co-operation with financial institutions. Accordingly, we have revised our on-site inspection policy, and in accordance with the changing needs we have developed a new procedure. This allowed us to perform our inspection duties specified in the Central Bank Act in such a manner that the burdens imposed by inspection on our partners are also reduced. Following the practice in EU Member States, inspection is not performed by individual organisational units, but is integrated in the professional areas, while consultations and sharing information are becoming increasingly important in mitigating risks.

In 2005, the Magyar Nemzeti Bank joined EBA's STEP2 Pan-European Automated Clearinghouse as a direct mem-

ber. With this move, all bank accounts in Hungary became directly addressable by automated euro transfer instructions, and it became possible to transfer euro from Hungary to other Member States of the European Economic Area for a very reasonable fee.

A core responsibility of the Magyar Nemzeti Bank is to manage the country's official foreign exchange reserves. The most important aim of reserves is to support monetary policy and provide for the credibility of the exchange rate regime. The current magnitude of foreign exchange reserves is identified by the Monetary Council, based on considerations in line with international standards. In accordance with the Council's decision, the amount of official foreign exchange reserves increased from EUR 11.7 billion to EUR 15.7 billion in 2005, for which the necessary foreign exchange was purchased from the Hungarian government.

In addition to its banknote and coin issuing monopoly, the Magyar Nemzeti Bank also carries out expert analyses of forint and foreign banknotes and coins which are found in Hungary and are suspected to be counterfeits. In 2005, in accordance with the relevant EU regulations we established the National Counterfeit Centre, the most important task of which is to organise efficient, co-ordinated action against counterfeiting, in close cooperation with law enforcement agencies.

Last year, we also continued to strive for better transparency in the Bank's communications. Our experience is that the disclosure of easy-to-understand, open and consistent information on the aims and decisions of monetary policy has had a favourable impact on economic agents' inflation expectations. For the sake of a more transparent monetary decision-making process, the Monetary Council has been publishing abridged minutes of its rate-setting meetings since the beginning of last year. Based on these public minutes, the arguments for and against decisions on the level of the central bank base rate can be learnt, including, since October, the results of voting by name as well. This step, which also improves the predictability of monetary policy, was received favourably by market participants.

The Central Bank Act exempts the Magyar Nemzeti Bank from taking into consideration the potential impact of its decisions on the Bank's profit in the course of the implementation of monetary policy. Therefore, it is not an indication of better financial management that, in 2005, the Bank's losses amounted to HUF 21.4 billion, compared with a loss of HUF 42.8 billion in 2004. The decline in losses was the result of a fall in the interest rate level of our outstanding

forint liabilities and of the earlier repayment of a large portion of the government's foreign exchange loans.

As an institution performing public tasks, we consistently strive to fulfil our duties in the most efficient and cost-effective manner. Last year, we continued our profile streamlining which began in 2001, in the course of which non-central banking activities were gradually phased out and/or outsourced. In addition, by adopting the best practice of European central banks, in 2005 we took measures to rationalise the Bank's organisation. Within this framework we have identified and significantly reduced unnecessary bureaucracy and the number of staff. Our operational costs remained within the budget. As a result of our efforts

to improve operational efficiency in recent years, in 2005 our operational costs again remained below the level of five years ago.

Following Hungary's accession to the EU, the MNB integrated successfully into the European System of Central Banks (ESCB). Senior managers and relevant experts of the MNB, as full members, have been actively participating in the activities of the committees and their relevant working groups supporting the work of the ESCB. The experiences gained in the period since EU accession show that working in the committees has been highly useful for the exchange of professional experience, and has facilitated our preparations for joining the euro area.

## 2. A brief overview of the Magyar Nemzeti Bank

Company name: Magyar Nemzeti Bank

Registered office: 1054 Budapest, Szabadság tér 8–9.

Form of operation: company limited by shares

Date of foundation: 1924

Owner (shareholder): the Hungarian State, represented by the Minister of Finance

Basic tasks as defined by the Act on the Magyar Nemzeti Bank

Share capital: HUF 10 billion

as part of its oversight duties, monitors their operation in order to ensure their safe and efficient operation as well as smooth money circulation;

– in order to perform its tasks, it collects and publishes statistical information; and

– it promotes the stability of the financial system and the development and smooth conduct of policies related to the prudential supervision of the financial system.

### 2.1. OBJECTIVES AND BASIC TASKS OF THE MNB

The Magyar Nemzeti Bank is a legal entity operating as a special company limited by shares, which conducts its operations as provided for by Act LVIII of 2001 on the Magyar Nemzeti Bank (hereinafter referred to as: the MNB Act). The Magyar Nemzeti Bank is a member of the European System of Central Banks.

In accordance with Article 105 of the Treaty establishing the European Community, the MNB Act, which establishes the Bank's primary objectives and basic tasks as well as its institutional, organisational, personal and financial independence, stipulates that the primary objective of the MNB shall be to achieve and maintain price stability. Without jeopardising this primary objective, the MNB supports the realisation of the government's economic policy, using the monetary policy instruments at its disposal.

In addition to implementing (achieving and maintaining) price stability, the Bank carries out the following basic tasks specified in the MNB Act:

- it defines and implements monetary policy;
- it has the exclusive right to issue banknotes and coins, including commemorative banknotes and coins, qualifying as the legal tender of the Republic of Hungary;
- it forms and manages official reserves in foreign exchange and gold;
- it conducts foreign exchange operations in relation to the management of foreign exchange reserves and the implementation of exchange rate policy;
- it develops and regulates the domestic payment and settlement systems and securities settlement systems, and,

Further to the above, the Bank may only perform additional tasks upon proper statutory authorisation, provided that such tasks do not jeopardise or interfere with its primary objective and performance of the tasks listed above.

In the spirit of central bank independence and within the framework provided by the MNB Act, the Bank independently defines the monetary policy aimed at achieving and maintaining price stability and the instruments for the implementation of such. Such instruments include, within the scope of its bank account management services, accepting deposits and, subject to the restrictions set forth in the Act, lending against adequate collateral; buying, selling and mediating securities in open market transactions and under repurchase agreements in the derivatives market; issuing its own securities; influencing and setting exchange rates and interest rates, discounting (rediscounting) securities and regulating minimum reserves.

The Bank's account management services are restricted to the entities defined by law. Thus, for instance, the Bank manages the single Treasury account, the current accounts of the Hungarian Privatisation and State Holding Company (ÁPV), the Government Debt Management Agency Ltd. (ÁKK), credit institutions, clearing houses, the National Deposit Insurance Fund and the Investor Protection Fund.

### 2.2. BODIES AND MANAGEMENT OF THE MNB

The various bodies of the Magyar Nemzeti Bank are governed by the MNB Act and Act CXLIV of 1997 on Business Associations, except for issues where the MNB Act provides otherwise.

Pursuant to the aforementioned two Acts, despite its status as a single-member business organisation, the Bank has a General Meeting, at which the Hungarian State as a share-

holder is represented by the Minister of Finance. The rules relating to the convening, quorum and powers of the General Meeting are laid down in the MNB Act, the Act on Business Associations and in the Bank's Statutes. The General Meeting has the exclusive right to establish and amend the Statutes, to approve the balance sheet and the profit and loss statement, to elect and dismiss the auditor, who guarantees statutory operations, and to determine the auditor's remuneration.

Pursuant to the provisions of the MNB Act on income regulation, on the basis of the decision of the General Meeting the Bank pays dividends from either its profit for the reference year or from retained earnings.

In respect of the Annual Report of the Magyar Nemzeti Bank, which consists of two parts, namely the financial statements and the business report, the powers of the General Meeting are separated. As regards the financial statements, the General Meeting is entitled to exercise its right of approval, whereas in respect of the business report on basic tasks, its right in accordance with the principle of central bank independence is confined to the acknowledgement thereof.

Pursuant to the European Union's requirements, and as an additional guarantee of independence, in contrast to the

practice of other companies limited by shares, remuneration of the Bank's executive officers, including the Governor, the Deputy Governors and the other members of the Monetary Council as well as the members of the Supervisory Board, are governed by the MNB Act and not by the General Meeting.

In matters related to the performance of its basic tasks, the choice of the exchange rate regime and activities as the lender of last resort, the MNB's supreme decision-making body is the Monetary Council. Pursuant to Act CXXXVI of 2004 on the Amendment of the MNB Act, with effect from 29 December 2004, the members of the Monetary Council include the Governor of the MNB, a Deputy Governor proposed by the Governor and other members appointed by the President of the Republic of Hungary for a period of six years. As a result of the amendment of the MNB Act, the number of the Monetary Council members rose from the previous 'at least seven but not more than nine members' to 'at least nine but not more than eleven members' and provided that the Deputy Governors of the MNB who were also members when the amendment entered into force remain members until the expiry of their original term of office. As a result, the number of Monetary Council members temporarily exceeds 11.

In addition to the increase in the number of members, the aforementioned amendment resulted in another change



Members of the Board of Directors of the Magyar Nemzeti Bank (from left to right): Dr. György Szapáry Deputy Governor, Zsigmond Járai Governor, Péter Adamecz Deputy Governor and Henrik Auth Deputy Governor

## Members of the Monetary Council of the Magyar Nemzeti Bank



**Zsigmond Járαι**

Governor  
Chairman of the Monetary Council  
and the Board of Directors



**Péter Adamecz**

Deputy Governor, member of the Monetary  
Council and the Board of Directors



**Henrik Auth**

Deputy Governor with general responsibilities,  
Deputy Chairman of the Monetary Council  
and member of the Board of Directors



**Dr. György Szapáry**

Deputy Governor, member of the Monetary  
Council and the Board of Directors



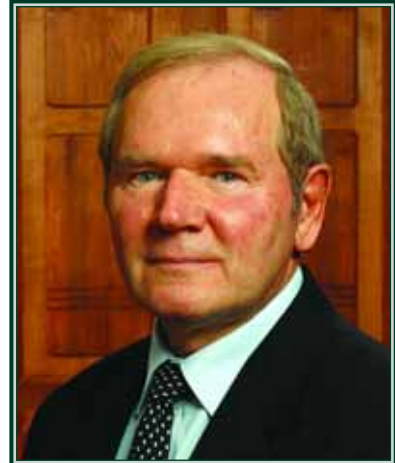
**Dr. Tamás Bánfi**

member of the Monetary Council  
(as of March 2005)



**Dr. Péter Bihari**

member of the Monetary Council  
(as of March 2005)



**Vilmos Bihari**

member of the Monetary Council



**Dr. Csaba Csáki**

member of the Monetary Council  
(as of March 2005)



**Dr. Ilona Hardy**

member of the Monetary Council



**Dr. Béla Kádár**

member of the Monetary Council



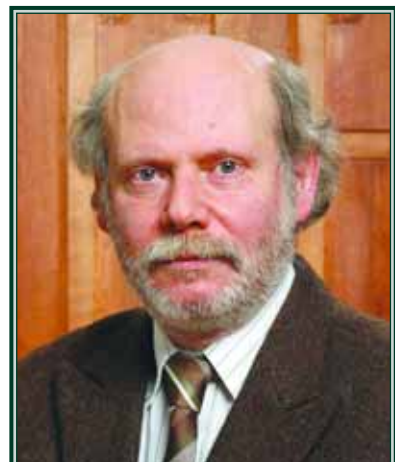
**György Kopits**

member of the Monetary Council



**Judit Neményi**

member of the Monetary Council  
(as of March 2005)



**Dr. Gábor Oblath**

member of the Monetary Council

with regard to the Monetary Council. Earlier, if the Chairman of the Monetary Council was unable to attend, he was substituted by the Deputy Governor designated to be substitute with general responsibilities. Following the amendment, each year – at the first meeting – the Monetary Council elects a Deputy Chairperson who will substitute the Chairman if the latter is unable to attend. In 2005, Deputy Governor Henrik Auth was elected as Deputy Chairman.

The Minister of Finance or a person duly authorised by the Minister has the right to attend the meetings of the Monetary Council and the Board of Directors, without voting rights, since – in accordance with EU guidelines – the MNB Act stipulates that ‘the Bank’s officials in carrying out their tasks shall neither seek nor take instructions from the Government or any other body’.

The members of the Monetary Council in 2005 were:

- Zsigmond Járjai, Governor – Chairman of the Monetary Council and the Board of Directors,
- Henrik Auth, Deputy Governor with general responsibilities, Deputy Chairman of the Monetary Council and member of the Board of Directors,
- Péter Adamecz, Deputy Governor and member of the Monetary Council and Board of Directors,
- Dr. György Szapáry, Deputy Governor and member of the Monetary Council and Board of Directors,
- Dr. Tamás Bánfi, member of the Monetary Council (as of March 2005),
- Dr. Péter Bihari, member of the Monetary Council (as of March 2005),
- Vilmos Bihari, member of the Monetary Council,
- Dr. Csaba Csáki, member of the Monetary Council (as of March 2005),
- Dr. Ilona Hardy, member of the Monetary Council,
- Dr. Béla Kádár, member of the Monetary Council,
- György Kopits, member of the Monetary Council,
- Judit Neményi, member of the Monetary Council (as of March 2005),
- Dr. Gábor Oblath, member of the Monetary Council.

Responsibility for implementing Monetary Council decisions and managing the operations of the Magyar Nemzeti Bank rests with the Board of Directors. Its competences involve, inter alia,

- managing the implementation of the basic tasks;
- establishing limits on the assumption of market and credit risks and benchmarks in accordance with the basic principles determined by the Monetary Council as well as

the methodology of determining partner limits and investment instruments;

- preparing the proposals to be submitted the General Meeting on the MNB’s balance sheet, profit and loss statement, allocation of profits, and approving the draft report to be submitted to the General Meeting on the business management, the financial situation of the MNB and the business policy;
- approving issues associated with the Bank’s organisation and internal management, including the introduction of human resource management systems and modification thereof;
- approving business policies, professional plans and programmes in connection with the Bank’s operation and performing its tasks as well as drafting of the development and operational budget;
- taking decisions on the business and non-business-related matters set forth in its Rules of Procedures;
- approving the annual schedule of passing decrees of the Governor of the MNB (MNB decrees) and the texts of the MNB decrees in accordance with the decisions made by the Monetary Council, not including the MNB decrees on the central bank base rate and the minimum reserve ratio;
- in matters falling outside the Supervisory Board’s competence, managing the internal audit system and discussing the results of internal auditing and plans for internal audits;
- approving proposals for major amendments to the collective bargaining agreement;
- in the event of a credit institution crisis – in accordance with the fundamental principles determined by the Monetary Council:
- with regard to emergency loans: determining credit rating limits related to eligible collateral, the currency and extent of acceptance of eligible collateral and the interest rate of the emergency loan;
- regulating at all times the procedural issues of the decision on emergency measures to be taken in case of a credit institution crisis;
- establishing and operating committees, establishing their rules of procedure and approving their agenda;

- taking decisions on investments by the MNB;
- implementing strategic capital projects;
- appointing members to be delegated to the special committees of the ESCB and
- defining the policy on fees.

With regard to issues which do not fall within the exclusive competence of the Monetary Council or the Board of Directors as a body, the Board of Directors is entitled to determine for its members spheres of authority to pass decisions.

The Board of Directors, which functions as the MNB's operative management body, consists of at least four and at most six members. Its members include the Governor, as the Chairman of the Board, and the Deputy Governors of the Bank.

Provisions relating to the legal status, powers, functions and operating procedures of the Monetary Council and the Board of Directors are set forth in the MNB Act, the Act on Business Associations, the Bank's Statutes, the Organisational and Operational Procedures of the MNB, as well as the rules of procedures formulated by these bodies.

In the spheres of authority to pass decisions determined by the Board of Directors for its members, decision-making is supported by special committees' preparatory works, proposals and opinions.

The task of the **Asset-Liabilities Committee (ALCO)** is to support decision-making, with regard to activities performed in foreign exchange and affecting the balance sheet of the MNB.

The **Audit Committee** facilitates decision-making related to the MNB's supervisory system, and discusses the auditing strategy and the report on operational risk management. It provides a forum for the follow-up of statements made by the MNB's supervisory system (internal audit, the auditor, the Supervisory Board and the State Audit Office), for exchanging views on the relevant experience and for monitoring implementation.

The **Banking Committee** promotes decision-making of the central bank on issues related to the financial intermediary system. Its tasks include discussing the memorandum of the Money Market Consultative Forum and requesting the head of the Forum to give an account of the key issues on the agenda that were discussed.

Within the framework determined by the Board of Directors, the **Investment and Cost Management Committee** supports decision-making on capital projects and cost management.

The responsibilities of the **Capital Projects Committee** include contribution to the decision-making related to the Logistics Centre and supervision of the fulfilment of the Board of Directors' decisions and the realisation of the investment programme.

The **Monetary Committee** supports decision-making related to the fulfilment of the Monetary Council's decisions. It provides a forum for the regular assessment of monetary conditions by comparing the monetary programme with actual monetary developments, and for the harmonisation of domestic foreign exchange market and forint market activities.

The **Operative Crisis Management Committee** supports decision-making related to potential crises of credit institutions, and discusses the result and experiences of the crisis simulation exercise.

The **Owners' Advisory Committee** facilitates decision-making related to the MNB's investments.

In addition to the auditor appointed by the General Meeting, the Magyar Nemzeti Bank is also audited by the State Audit Office, and the Supervisory Board.

The supervisory competence of the State Audit Office in relation to the MNB is set forth in the Act on the State Audit Office. The State Audit Office supervises the financial management of the Magyar Nemzeti Bank and its activities under the MNB Act that are not included in its basic tasks. The State Audit Office supervises the MNB's compliance with statutory regulations, its statutes and the resolutions passed by the General Meeting.

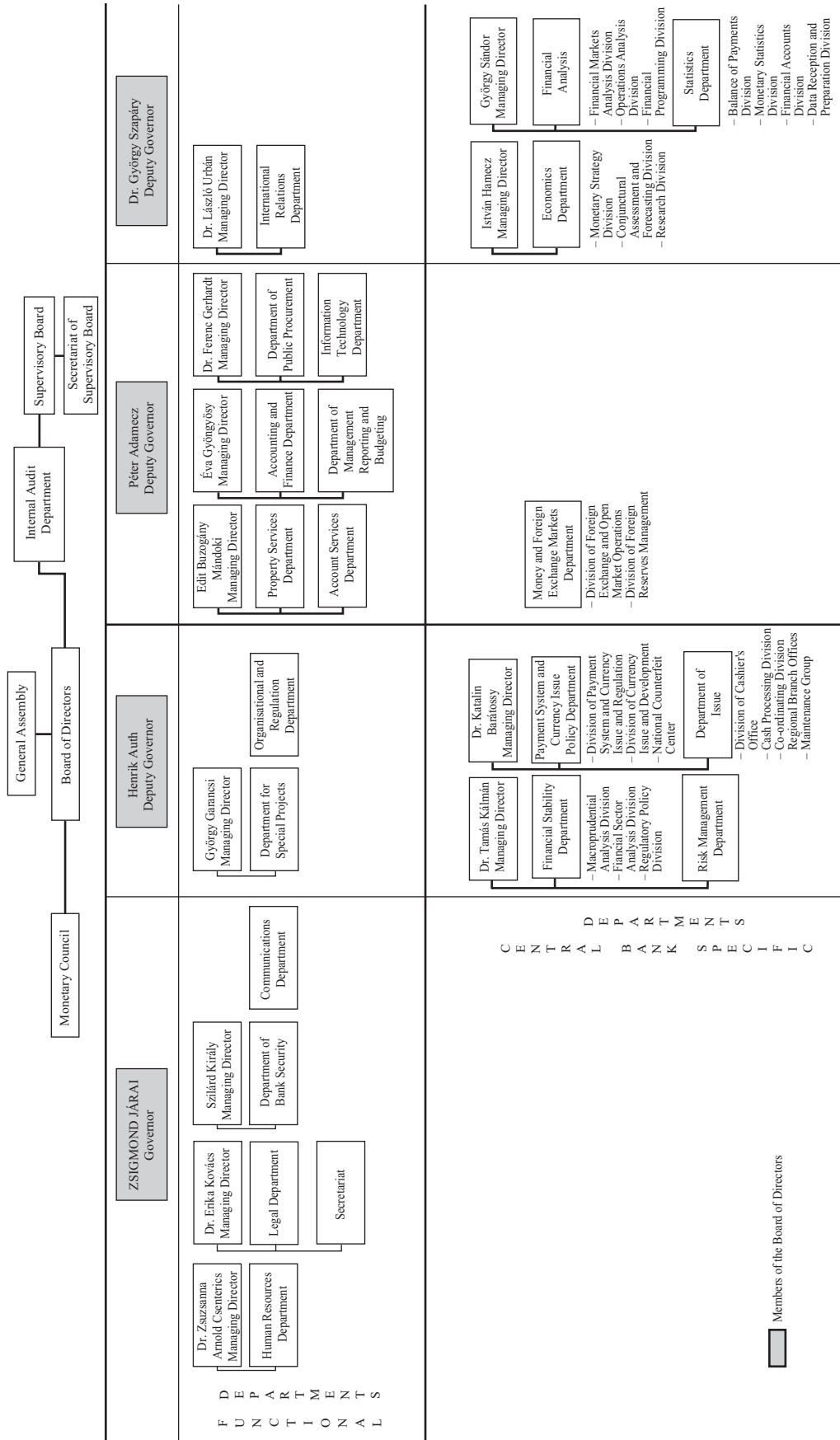
The State Audit Office submits a proposal for the appointment of the MNB's auditor and may submit proposals for the dismissal of such to the General Meeting.

The supervisory competence of the Supervisory Board as defined by the MNB Act excludes the supervision of the Bank's performance of its basic tasks and the impact thereof on the MNB's profit and loss. Accordingly, the report it is required to prepare pursuant to the Act on Business Associations is subject to these limitations.

Of the six members of the Supervisory Board, four (including the Chairman) are appointed by the Parliament, one represents the Minister of Finance and one is a consultant

Organisational chart

MAGYAR NEMZETI BANK  
Organisational chart (31. December 2005)



commissioned by the Minister of Finance. Their respective terms of office coincide with the Parliament's mandate. The Supervisory Board remains in office until a new Parliament elects the new Board members.

In 2005, the members of the Supervisory Board of the MNB were:

- László Akar, Chairman,
- László Baranyay,
- Dr. József Kajdi,
- Dr. László Urbán,
- Dr. István Várfalvi,
- Dr. Éva Várhegyi.

Neither the State Audit Office nor the Supervisory Board is entitled to supervise activities qualifying as basic central bank tasks.

### 2.3. ORGANISATIONAL STRUCTURE OF THE CENTRAL BANK

In recent years, the Bank's organisational structure has undergone a number of changes, mainly in the spirit of profile streamlining, organisational modernisation and rationalisation, which resulted in a considerable improvement in organisational and operational efficiency. The aim is for the MNB to belong to the most excellent central banks both in terms of professionalism and operational conditions.

In view of the results of the benchmarking analysis performed with the Sveriges Riksbank, which is considered to be one of the most efficient central banks in the European Union, in 2005 the Board of Directors decided on further efficiency improving measures, on launching an operational development programme to implement these measures and on organisational changes.

The structure of the organisation in charge of performing the tasks stemming from the central banking and banking operations is illustrated by the organisational chart dated 31 December 2005.

In addition to the Board of Directors and its members, performance of the Bank's statutory tasks, operation-related tasks and implementation of decisions are controlled and supervised by the managing directors who are in charge of managing the Bank's day-to-day business.

The managing directors controlling the activity of the departments and divisions assigned to them are responsible for the following areas: financial analysis and statistics, economic research, analyses, international relations, pru-

dential supervision of the financial system and risk analysis, money circulation and currency issue, finance, accounting and controlling, the supervision of investments, central administration related to various areas (legal, human resources, secretariat, communications and bank security) and central auxiliary services (such as public procurement, property services, information technology and back office).

The managing directors report to the Governor or to the relevant Deputy Governors, in accordance with the division of tasks and in addition to their primary role as monetary policy-makers.

The following is a complete list of the MNB's managing directors as of 31 December 2005:

Dr. Katalin Barátossy, responsible for the Department of Issue and the Payment System and Currency Issue Policy Department,

Dr. Zsuzsanna Arnold Csenterics, responsible for the Human Resources Department,

György Garancsi, responsible for the Department for Capital Projects,

Dr. Ferenc Gerhard, responsible for the Department of Public Procurement and the Information Technology Department,

Éva Gyöngyösy, responsible for the Accounting and Finance Department and the Department of Management Reporting and Budgeting,

István Hamecz, responsible for the Economics Department,

Dr. Tamás Kálmán, responsible for the Financial Stability Department and the Risk Management Department,

Szilárd Király, responsible for the Department of Bank Security,

Dr. Erika Kovács, responsible for the Legal Department and the Secretariat,

Edit Buzogány-Mándoki, responsible for the Account Services Department and the Property Services Department,

György Sándor, responsible for the Financial Analysis Department and the Statistics Department,

Dr. László Urbán, responsible for the International Relations Department.

## **2.4. RELATIONS BETWEEN THE MNB AND THE EUROPEAN SYSTEM OF CENTRAL BANKS**

Hungary's accession to the European Union also entailed the MNB's membership in the European System of Central Banks (ESCB).

The ESCB comprises the European Central Bank and the respective national central banks of the EU. Its supreme decision-making body is the Governing Council, consisting of the ECB's Executive Board and the governors of the euro area national central banks.

The General Council, with the President and the Vice-President of the European Central Bank and the governors of the EU national central banks as its members, addresses issues relevant to the ESCB as a whole and to the future expansion of the euro area. Moreover, it has an advisory role and co-ordinating functions.

ESCB members are also owners of the ECB. Ownership share is based on demographic and GDP data. Thus, Hungary's ownership share in the ECB's subscribed capital is 1.3884 per cent. As Hungary has not adopted the euro yet, pursuant to the Statutes of the ECB, Hungary

was required to contribute 7 per cent of its ownership share, i.e. EUR 5.4 million (HUF 1.4 billion), to the ECB's share capital upon accession to the European Union on 1 May 2004.

The work of the most important decision-making bodies of the ESCB (Governing Council, General Council) is assisted by the ESCB Committees and their respective working groups.

The committees consist of experts of the ECB and Member States' central banks; their basic role is to prepare decisions and facilitate coordination regarding the various central bank duties, covering all areas of central banking operation, from monetary policy through communication to statistical data reporting.

The committees discuss current issues relevant to their professional areas 5-6 times a year, according to a pre-determined schedule. Since Hungary's accession to the EU, the senior managers and experts of the MNB have been actively participating in the work of the ESCB Committees and their working groups as full members. Working in an ESCB Committee requires thorough knowledge and entails a significant amount of additional work as well. However, since Hungary's EU accession it proved to be a very useful forum for the exchange of professional experience (the activities of individual ESCB Committees are presented in Chapter 3.9).

# 3. Review of the MNB's performance in 2005

## 3.1. MONETARY POLICY

### Monetary policy framework

Pursuant to the Act on the MNB, the primary objective of the MNB shall be to achieve and maintain price stability. To this end, monetary policy is determined in the framework of inflation targeting, taking into account the 15 per cent intervention band of the forint exchange rate against the euro.

With effect from 29 December 2004, the Parliament amended Act LVIII of 2001 on the Magyar Nemzeti Bank. Accordingly, the number of Monetary Council members was increased to 9-11, although, temporarily, the number of Council members increased to 13, until the current Deputy Governors' mandates expire. The four new members of the Council started to take part in monetary policy decision-making in March 2005.

The meetings of the Monetary Council were held in accordance with a pre-determined meeting schedule in 2005 as well. Accordingly, decisions on changing the central bank base rate were made only at the second meeting of each month.

Based on its decision made at end-2004, the Monetary Council published abridged minutes of its regular rate-setting meetings. In this regard, the aim of the Council was to improve the transparency of monetary policy decision-making by publishing the minutes prior to the next rate-setting meeting, and to provide economic agents with more insight into the assessment of the situation by the central bank. The minutes comprise a summary of the assessment of economic and financial developments, a brief summary of opinions expressed at the meeting and the proposals with regard to changing the interest rate, together with the relevant arguments.

The minutes published since January 2005 have disclosed the decision on the central bank base rate including the voting record without names from the beginning. Starting with the rate-setting meeting in October full voting records have been published. Vote by call-over is a further step towards making monetary policy decision-making more transparent, and it also allows Council members to communicate their preferences as decision-makers to the market. This step, which also improves the predictability of monetary policy, was received favourably by market participants.

At the end of August 2005, the Government and the MNB set the medium-term inflation target for the period starting from 2007 at a 3 per cent rise in the consumer price index published by the Central Statistical Office. The most important advantage of the new medium-term target is that it provides a predictable environment for economic agents and helps to anchor inflation expectations, thus contributing to inflation remaining at a low level in a lasting manner, in accordance with price stability. This new medium-term target will be revised upon entering the European exchange rate mechanism (ERM II), but no later than in 3 years.

The 3 per cent target is somewhat higher than the level corresponding to price stability in developed countries, but due to Hungary's specific economic circumstances (i.e. the catching up process), this level takes account of the distortions of the consumer price index and provides for the adjustment of relative prices. A 3 per cent rate of inflation is expected to create an adequate basis for meeting the Maastricht price stability criterion.

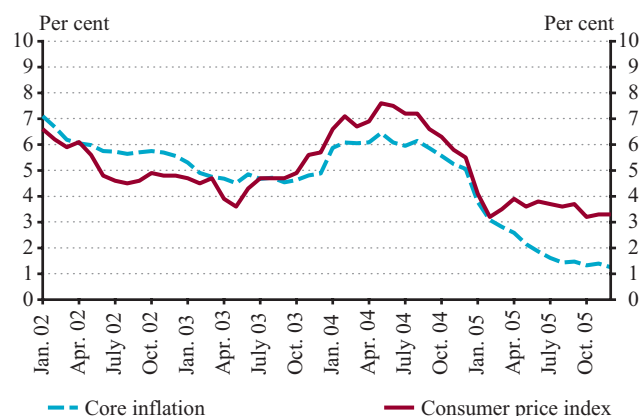
### Inflation developments

The year-on-year inflation rate of 3.3 per cent in December 2005 was lower than the 4 per cent inflation target, but within the  $\pm 1$  percentage point tolerance band. Thus, the central bank's 2005 inflation target was met. Annual average inflation declined to 3.6 per cent from 6.8 per cent in the previous year, while average core inflation fell from 5.9 per cent to 2.1 per cent.

### Chart 1

#### CPI and core inflation

(annual growth rates)



One significant factor in the decline in inflation during 2005 was that the basis of comparison, i.e. the inflation figure for 2004, was directly increased by approximately 2.0 per cent as a result of the rise in indirect taxes. Nonetheless, disinflation was significant even without this technical effect and was observed in a wide range of product groups.

An analysis of the underlying reasons reveals that in 2005 almost all of the factors driving inflation developments resulted in lower inflation. Although this led to the consumer price index declining to a low level, it is questionable whether the trend can be sustained in the longer run (or in a less favourable international economic environment), as the persistently high level of inflation expectations, the increase in the inflation differential of market services and tradables and also the potential pass-through of high oil prices may generate inflationary pressure.

The most significant decline in inflation was observed in the scope of tradables, which may be explained by the combination of global, regional and domestic developments. In 2005, the price increase of these products declined to a historically low level in developed countries as well, i.e. imported inflation was also moderate. In addition, disinflation was also supported by stable exchange rate developments. At the same time, disinflation of tradables was more intense than what would have been justified by the aforementioned factors, which can be ascribed to stronger market competition, due to changes in the pattern of trade as a result of EU accession.

Nevertheless, market services inflation declined to a much lesser extent, because in the services sector the nominal wage increase continued to significantly exceed productivity, which together with unchanged or slightly improving profitability did not allow for any substantial reduction in sales prices.

During 2005 there was probably no significant inflationary pressure from the side of domestic demand, as the

increase in household consumption was subdued in the whole year, and lagged behind previous years' dynamics, which also resulted in a more balanced structure of economic growth.

The rise in world oil prices boosted 2005 inflation somewhat, through the price increases of vehicle fuels, but for the time being no second round effects have materialised.

### Exchange rate and interest rates

In 2005, in line with improvements in investor sentiment and inflation expectations, the Monetary Council moved forward decisively in reducing interest rates, continuing the rate-cutting cycle which started with smaller steps in the spring of 2004. During these periods, monetary policy was driven by the goal of reducing the base rate to a level which can be maintained over the longer run, at a pace which supports the predictable developments of financial markets.

In 2005, the Monetary Council cut the central bank base rate in 9 steps, by a total of 350 basis points. As a result, by end-2005 the base rate declined to 6 per cent while the forint exchange rate remained within a range that facilitated the return of inflation to a level which is broadly in line with price stability.

During the year as a whole, the exchange rate of the forint fluctuated in the stronger part of the exchange rate band. It was mainly global factors which had an impact on exchange rate developments, while changes in the risk assessment of the Hungarian economy were mainly reflected in long-term government securities yields.

While inflation expectations and the overall favourable willingness to take risks allowed for interest rate cuts, more rapid reduction of the base rate would have been risky due to the persistently poor fundamentals. The publication of

## Table 1

### CPI and its components in 2005

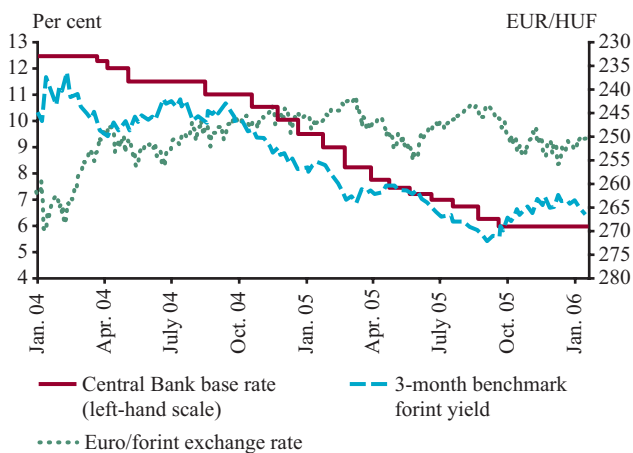
(percentage changes on a year earlier)

	2003	2004	2005	2005				
	Annual average			Q1	Q2	Q3	Q4	Dec.
Core inflation	4.8	5.8	2.1	3.2	2.2	1.5	1.3	1.3
Unprocessed food	0.7	6.6	4.3	-2.2	5.0	6.5	8.0	10.3
Vehicle fuel and market energy	5.2	6.6	8.6	6.3	8.6	12.0	8.0	7.6
Regulated prices	5.4	9.3	6.1	5.1	5.5	5.8	6.0	6.1
CPI	4.7	6.8	3.6	3.6	3.8	3.7	3.3	3.3

fiscal data throughout the year gradually made it clear to market participants that fiscal targets would not be met. As a result of the budget deficit which exceeded both the preliminary expectations and the level stated in the 2005 Convergence Programme, the risk premium required on forint assets increased significantly, which is also well reflected in the high long-term forward yields. Another factor contributing to this development was that the steadily high current account deficit did not decline significantly, although its financing structure did improve.

**Chart 2**

**Forint yields and exchange rate developments**



**Leading the state's foreign exchange funds to the market**

On 7 February 2005, the MNB announced that, continuing the practice of 2004, in order to neutralise the liquidity effects of the government's foreign exchange conversion, it will lead a part of the net obtained foreign exchange funds related to the budget to the market.

In 2005, the government's foreign exchange funds entailed foreign exchange conversion at the MNB in the magnitude of EUR 2.8 billion. The MNB used a part of this foreign exchange conversion to increase the level of foreign exchange reserves, while, in accordance with the practice established in 2004, it sold the other part in the foreign exchange market in order to reduce excess liquidity. As the MNB continued to refrain from influencing the developments in the forint exchange rate, in the course of the year, foreign exchange sales were carried out in the interbank foreign exchange market in a number of tranches, in small amounts and in a price-taking manner, in view of the market situation and OTC market practice. Domestic and foreign credit institutions with a foreign exchange market limit with the MNB were the possible partners in these transactions.

**Sale of bonds**

In order to reduce the growth rate of excess liquidity resulting from the deficit financing of the government from foreign exchange issuing, the MNB – following a prior announcement – started selling marketable government securities in its balance sheet on the secondary market in September 2005. For the sake of the smallest possible effect of the bond sales on market developments, the central bank sold its government debt securities in a price-taking manner, in small tranches and over the course of a longer period of time. The volume of daily average bond sales did not exceed HUF 2 billion, i.e. the transactions were well below secondary market turnover in government bonds, which amounted to HUF 141 billion on a daily average in the periods of selling bonds by the central bank. The MNB sold the 2008/C and 2014/C government bonds bought in November 2003, representing a value of approximately HUF 40 billion. As a result of the central bank's government securities transactions, excess liquidity declined in accordance with the bond sales, and the central bank's portfolio now mainly contains only non-marketable government bonds.

**Reserve requirement regulation**

In 2005, the reserve requirement regulation was amended twice by the MNB. As a result of the abolition of the implicit tax on the banking system upon EU accession, credit institutions' efforts to evade the reserve requirement declined significantly, and thus a reduction in the sanctioning of insufficient reserves became possible. Accordingly, starting from 1 July 2005, in the case of insufficient reserves found by audits of the MNB, only one and a half times of the outstanding amount (previously twice as much) has to be separated by the credit institution on a non-interest-bearing account for 30 days.

Starting from 1 January 2006, the decree on the reporting requirements for the central bank information system harmonised the categories in the balance sheet to be submitted to the central bank and to the Hungarian Financial Supervisory Authority with the classification according to maturity of liabilities which require reserves. As a consequence of the amendment dated 12 December 2005 to MNB Decree 10/2005. (VI. 11.), the harmonised maturity definitions allow the MNB to determine the amount of credit institutions' reserve requirements from February 2006 on. Credit institutions may request revision of their reserve requirement on one occasion up to the second MNB business day prior to the beginning of the maintenance period. Following the last MNB working day prior to the beginning of the maintenance period, the amount of credit institutions'

reserve requirement cannot be modified, and the MNB will sanction any subsequent modification in the data supply during the maintenance period as well.

### **Changes in the conditions of carrying out forint and foreign exchange market transactions**

Effective from 31 January 2005, several points of the business terms and conditions regulating the MNB's forint and foreign exchange market transactions were modified.

- In examining collateral for loans, the MNB takes into account the securities tied down as collateral for loans and blocked for the MNB. This allows rolling the loans on with the same securities collateral portfolio.
- In order to reduce default risks, in the scope of the spot foreign exchange transactions at the edge of the band, the MNB applies the 'payment versus payment' principle, which means that it meets its obligation stemming from the transaction only once the client has paid at the value date (before 13.00 hours, at the latest).

## **3.2. STABILITY OF THE FINANCIAL INTERMEDIARY SYSTEM**

As defined by the MNB Act, it is the responsibility of the Magyar Nemzeti Bank to support and strengthen financial stability using all available means. Within this framework, the MNB regularly analyses the operations of the macro-economy, financial markets and financial institutions, explores their interactions and identifies developments that jeopardise the stability of the financial system. The findings of the analyses and the evaluation of risks are made public in the *Report on Financial Stability*.

In 2005, two issues of the *Report on Financial Stability* were published by the central bank. Both *Reports* emphasised that, at present, the Hungarian economy was moving on a fragile path, and imbalances which could not be maintained in the longer run characterised the economy. The primary underlying reason for this vulnerability was a sustained high government deficit, which resulted in fiscal policy diverging significantly from the path undertaken with the Convergence Programme submitted to the European Commission in Brussels. All of this resulted in considerable external imbalance, and thus both the government debt and the external debt of the whole economy increased rapidly. The *Reports* pointed out that indebtedness was growing in a risky structure and the uncertainty surrounding the adoption of the euro impaired the country's risk assessment and reduced the economy's resilience, and therefore the MNB considered the negative effects of a possible

change in the international economic and financing environment more significant than in the past.

In addition to macroeconomic risks, in certain areas an increase in risks stemming from the behaviour of the banking sector and customers was also identified. Economic agents are becoming increasingly indebted in foreign exchange, and this is especially notable in the case of households and small and medium-sized enterprises. The most important threat for the banking sector is increased exchange rate uncertainty, as the exchange rate risk assumed by customers may entail lending losses for banks in the event of unfavourable exchange rate movements. However, due to the currently stable capital and outstanding income positions the banking sector's ability to resist shocks can be considered good.

Stemming from the responsibility for financial stability, it is especially important for the MNB to inform the public about the risks which develop and to assist economic agents as much as it can in evaluating risks and in making adequate decisions. As part of this responsibility, raising the general level of financial culture is also key, as we believe that, at the moment, a significant part of customers are not aware of the risks of the new financial products and indebtedness in foreign exchange, the possible consequences of a potential interest rate or exchange rate change and the magnitude of potential losses. This is also confirmed by the findings of our questionnaire-based survey carried out in the corporate sector. Based on the answers, the risk awareness of small and medium-sized enterprises proved to be especially low. We see similar developments and risks in relation to household indebtedness. As the losses not expected by customers may even lead to an erosion of confidence in the financial intermediary system, it has become one of the priorities for the MNB to improve financial culture.

In the field of financial stability, the MNB maintains close professional contacts with a number of international institutions, organisations and central banks. It participates, inter alia, in compiling the ECB's *Financial Stability Review*, in the activities of working groups and expert teams dealing with financial stability and in international research projects covering this field.

The members of the Financial Stability Committee, the representatives of the MNB, the HFSA and the MoF decided – similarly to other European central banks – to hold a simulation exercise in order to test authorities' co-operation in crisis situations. In addition to the co-operation between domestic organisations, the exercise held on 6 October 2005 also tested the efficiency of information sharing and external communication. This first exercise, which was

held with the involvement of domestic organisations only, can be considered successful; the co-operation between authorities was efficient and intense. As a result of the simulation exercise, a decision was made on formulating an agreement which would enhance the co-operation between institutions in crisis situations. The central bank intends to organise similar exercises in the future, involving Hungarian and international authorities and focusing on different target areas.

The analysis of the operation of private pension funds was one of the most important subjects of financial stability research in 2005. Focusing on bank- and insurance company-based funds, the aim of the analysis was to examine the operation of Hungarian private pension funds and to draft proposals on regulations which would allow a more efficient operation of the sector. According to the findings of the study, the operational problems of the pension fund system are caused by weak competition, inadequate operational form of funds with a bank or insurance company background and the low level of diversification of funds' portfolios.

Preparation related to the new Basel capital rules was a priority in the central bank's financial regulatory activity in 2005. In October 2005, the final form of the regulation (CRD) introducing capital rules in the European Union was created, and thus banks will be allowed to apply new risk measurement and capital requirement calculations starting from 2007. Continuing the work started in 2004, the MNB took an active part in the European-level formulation of the validation methodology related to the licensing of CRD implementation and developed methods. In relation to this, the MNB participated in the preparation of the domestic supervision's recommendation containing interpretation issues and validation methodology.

In addition to the above, the MNB prepared a comprehensive study on eligible loan collateral and other risk-reducing techniques in relation to the new capital requirement rules, where it outlined the main obstacles to enforceability in Hungary. The action proposals outlined in the study aim at preventing banks' capital position from deteriorating simply because of the incompatibility of relevant provisions of law. If these proposals fail to be taken account of, unnecessary deterioration in the capital position will entail a financial stability risk on the one hand and also a weakening of domestic institutions' international competitiveness on the other.

### **3.3. PAYMENT SYSTEMS AND SECURITIES SETTLEMENT SYSTEMS**

In relation to payment and securities settlement systems, the MNB has multiple roles. As provider of services, it manages

credit institutions' accounts, on which the final settlement of forint positions from interbank transactions is performed. It also operates the real time gross settlement system (VIBER) and is a co-owner of GIRO Clearing House Limited (GIRO Zrt.) and the Central Clearing House and Depository Ltd. (KELER Zrt.). It is thus a participant in all three settlement systems. Taking into account the clearing and settlement infrastructure, it fulfils regulatory, licensing and supervisory functions as an overseer. As a neutral partner from the point of view of market competition, the MNB is a catalyst for change in the development of privately-owned infrastructure in areas requiring joint decision of the stakeholders.

#### **Oversight, regulation**

Decree 23/2005 (XI. 23.) MNB of the Governor of the Magyar Nemzeti Bank on the material, technical, security and business continuity requirements related to carrying out clearing transactions by clearing houses for credit institutions was published in November 2005 and entered into force on 1 January 2006. Compared to the earlier regulation, this decree specifies the requirements vis-à-vis clearing houses for credit institutions in a more detailed manner and with a wider scope. With regard to VIBER, the provisions of the decree also relate to the MNB, which ensures equal treatment of domestic interbank payment and settlement systems.

As a reply to GIRO Zrt's initiative to redesign its automated clearinghouse system, the central bank elaborated a guideline consisting of six points for the credit institutions involved in making the decisions related to the development of the system, and sent this in a letter to those concerned. According to these requirements, the new platform should be able to completely reproduce the functions of the current system. It should also meet those known requirements related to the introduction of SEPA credit transfer and direct debit schemes and compatibility to TARGET2. It should be able to meet the known domestic development needs and future development needs (i.e. it should be able to perform automated processing of transactions on bank customers' level, meet the requirement of compatibility with SWIFT standards), and support the tasks related to the introduction of the euro. It should also be in conformity with the internationally-recognised ten core principles for systematically important payment systems. Giro should render possible gradual adoption of new standards and procedures in order to avoid disturbances in the clearing of payment transactions.

The MNB revised its on-site inspection policy, and by re-evaluating the risks, it formulated a new medium-term con-

cept of on-site inspection activity, as a means of reducing risks for the central bank. The expectations resulted in the decentralisation of inspection activity and in the future, on-site inspection will be integrated into the various professional areas.

On-site inspection of payments focuses on the following four main areas:

1. The quality of data supply on payments, authenticity of data, meeting the relevant requirements, with special regard the 'Blue book' data which are to be forwarded to the ECB.
2. Payment and securities settlement systems within the framework of the oversight.
3. Cash processing services including related provisions of law to prevent money laundering.
4. MNB's regulations on payments.

### **New services**

The Magyar Nemzeti Bank joined the STEP2 clearing system which specialises in low-value euro transfers as a direct member. The MNB offers indirect membership to domestic credit institutions under the HUNSTEP2 trade name. In addition, by providing for the 'entry point' function, the MNB ensures full receiver capability of bank accounts in Hungary.

At the end of 2005, 16 banks and savings cooperatives were using the HUNSTEP2 service. Handling of messages related to the service is performed by GIRO Zrt.

#### **• Branches in Hungary**

In the summer of 2005, Dresdner Bank AG became the first bank to open a branch in Hungary, followed by the Belgian credit institution Fortis Bank SA/NV. On its website, the MNB published a branch establishment schedule, in which the terms and conditions of opening an account, direct or indirect participation in VIBER and ICS and the documents to be presented are determined.

#### **• VIBER monitoring tool**

The smooth operation of VIBER requires efficient liquidity management. Queries about the account position processed and queued items was earlier performed only by exchange of SWIFT messages. Introducing SWIFTNet

allowed providing monitoring service based on browse function offered to a limited group of users. The MNB does not charge entry or usage-based fee for the service. The cost of the add-on service is included in the transaction fees of VIBER.

### **The operation of VIBER**

In 2005, the number of VIBER participants was 37, one more than at the end of the previous year. Of the total turnover of HUF 624 trillion of the Interbank Clearing System and VIBER, 91.1 per cent was processed in VIBER, while the share of VIBER in the volume of transactions was 0.36 per cent. The total turnover of the two systems was 28.6 times as much as the projected GDP figure for the year, while this ratio was 24.7 in 2004.

In the real-time system payment orders processed during the year represented HUF 568.7 trillion in value, while the annual number of payment orders was 676,200. The value of transactions grew by 26.4 per cent, while the number of transactions was 21.9 per cent higher relative to the preceding year. In 2005, the average value per item amounted to HUF 840.9 million, i.e. 3.7 per cent higher than the average of the previous year. In 2005, the average daily number of transactions was 2,652, while the average daily VIBER turnover amounted to HUF 2,230 billion. The highest daily turnover by volume was processed on 21 February 2005, with 5,191 transactions. In value terms the turnover reached its peak of the year on 16 March 2005 with HUF 4,190 billion.

Banks' average daily intraday credit line – which is provided by the MNB against blocked securities held as collateral and which supplements the bank account balance – amounted to HUF 371.9 billion in 2005, 9.8 per cent below the figure for 2004. Compared to the previous year, the combined average daily available balance on banks' accounts increased by 10.7 per cent, reaching HUF 475 billion. Total liquidity – arising from the two aforementioned sources – rendered it possible to settle the combined turnover of VIBER and ICS at an average daily value of HUF 2,551 billion, representing a 21 per cent increase on the daily turnover in the previous year. In 2005, the average daily turnover was three times the daily liquidity, compared to the previous year's average of 2.4 times. In international comparison, the liquidity of VIBER can be considered especially high. The outstanding credit at the end of the day becomes an overnight credit, of which a cumulative HUF 1,197 billion was granted by the MNB in 2005, which corresponds to 45 per cent of the credit made available in 2004. The daily average holding of these credits amounted to HUF 4.7 billion.

In 2004, the MNB reduced the fee of VIBER transfers by 40 per cent, from HUF 750 to HUF 450. The MNB's fee policy is based on the principle of cost return; the reduction was allowed by an increase in turnover, together with a decline in depreciation costs.

### **Co-operation with market participants**

There were two major issues on the agenda of the two regular meetings of the Payment System Council (PSC) decision making body of the Hungarian Payment System Forum in 2005. The subjects of the meetings were clearly domestic matters, on the one hand, and issues related to the adoption of the euro and the implementation of SEPA (Single Euro Payments Area) which are expected to arise with increasing frequency, on the other hand.

In terms of domestic matters, the briefing on the results and working plans of activities pursued in the various working groups of the Committee for Development of Cashless Payments was discussed, and decisions were made on further projects.

With relation to SEPA – based on the request of EPC (European Payments Council) – the proposal on the establishment of the national SEPA organisation was approved, and at the same time the Legal Working Group was assigned to prepare the documents necessary for the establishment of the organisation.

The initiative to renew the ICS (Interbank Clearing System) attracted intense interest. The MNB also assisted the stakeholders to put the matter in international context with special regards to euro-related aspects, and this is why it chose the 'Domestic ACHs in SEPA' as the title of the annual international payment system conference in 2005.

The presentations by foreign experts as speakers confirmed the adequacy of the above mentioned six point guideline for the re-design of the ACH system.

## **3.4. MANAGEMENT OF FOREIGN EXCHANGE RESERVES**

### **Objectives of holding reserves**

Similarly to other central banks, one of the most important tasks of the Magyar Nemzeti Bank is the management of the country's foreign exchange reserves. The foreign exchange reserves contain the liquid foreign exchange assets of the central bank, which the monetary authority may directly use in the event of payment problems and

which provide coverage for foreign exchange market intervention serving monetary policy objectives.

The primary aim of reserve management is to support monetary policy. One of the guarantees for the credibility of the exchange rate regime is an adequate level of reserves, which, if necessary, protects the intervention band in the form of interventions, and supports the fulfilment of the Maastricht exchange rate criteria on the way to joining Economic and Monetary Union (EMU). In 2005, there was neither open intra-band intervention nor passive interventions at the edges of the band.

Among transactions goals, last year the main objective was to support the management of government debt. Foreign exchange flows related to EU transfers have an increasingly major impact on foreign exchange reserves.

The costs of holding reserves moderately further decreased in 2005 as a result of the narrowing premia of Hungarian bond issues. Notwithstanding the above, the MNB still does not wish to maintain reserves solely for the purpose of accumulating wealth. At the same time, however, it aims to meet total return criteria when managing foreign exchange reserves in an amount necessary at all times, i.e. it intends to preserve their value as a responsible asset manager and achieve an additional return if possible.

### **Investment policy**

Similarly to the majority of central banks, the MNB also pursues a fundamentally conservative investment policy, but in respect of the classic investment triad of return-safety-liquidity, the Bank places emphasis on the latter two. Thus, the aim of holding reserves serves the maximising of profit on these, while maintaining maximum safety and liquidity. The investment universe is restricted in such a manner that the maximum allowed remaining maturity of bonds is 10.5 years, with the top two credit ratings (AA-AAA) of the major international ratings companies. Liquidity requirements, in addition to credit ratings, also allow only for purchase of securities issued by developed countries, large international financial institutions and government agencies, and rule out the purchase of securities with large price fluctuations (e.g. equities).

The euro plays a key role in the foreign exchange structure of reserves; the MNB also holds a smaller amount of USD reserves. Its weight is justified by the exchange rate system of Hungary, its economic integration in the euro area and the foreign exchange structure of government debt where, again, the euro dominates.

Regarding the structure of reserves, the MNB distinguishes between liquidity and investment portfolios in both currencies. The aim of the liquidity portfolio is to fully ensure daily liquidity (repayments of interest and principal, interventions, other transactions), thus, its value changes on a day-to-day basis with inflows and disbursed amounts. The investment portfolio, accounting for a higher share of the total reserves, lays more emphasis on total return expectations. Although it is a basic requirement of the investment portfolio that securities should be quickly and efficiently marketable, its stable composition makes it possible to invest in bonds with longer average durations, depending on the market outlook. The MNB determines the proportion of the two types of portfolio to each other on the basis of the amount and spread of cash inflows and outflows witnessed in previous years. Thus, the MNB continues to hold 20% of the reserves in liquidity and 80% of reserves in investment portfolios.

**Adequacy of reserves**

Official foreign exchange reserves rose from EUR 11.7 billion to EUR 15.7 billion in the course of 2005. Reserves fluctuated moderately in the second half of the year; the predominant proportion of the rise is related to the first half of the year and the privatisation of the Budapest Airport in the final month of the year. The current amount of reserves is considered satisfactory on the basis of indicators most commonly used for determining the optimal amount of reserves.

The increase in reserves is primarily attributed to the inflow of government borrowing from foreign capital markets in the total value of 4.7 billion euro. The sale of Budapest Airport represents the other important source of increased reserves, in relation to which EUR 1.85 billion was collect-

ed in December. A return on reserve portfolios of EUR 285 million and EUR 289 million in transfers from the European Commission also contributed to the rise in reserves. Foreign exchange deposits at the MNB increased by EUR 79 million in 2005, also adding to the amount of reserves.

The repayment of principal, interest on the foreign exchange debt of the state and the MNB and other liabilities, corresponding to EUR 2.7 billion in 2005, reduced the amount of reserves. The pre-announced euro sale on the interbank foreign exchange market reduced reserves by EUR 514 million.

**Managing financial risks at the MNB**

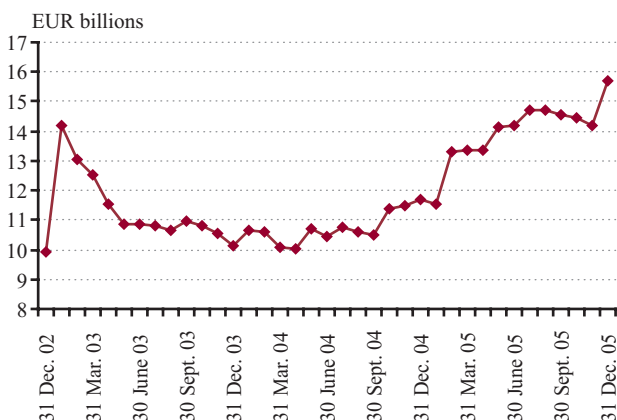
In the course of conducting its core tasks, the MNB is necessarily confronted with financial risks. As a general principle, the degree of the risks assumed should be known, risk assumption should be conscious, and the degree of the risks in question should correspond to the targets of the core tasks. The MNB mitigates financial risks related to the management of foreign exchange reserves by the use of limits. As a basis for comparison, it applies benchmarks in relation to investment portfolios which reflect the MNB's preferences with regard to the safety of the managed reserve's value, the liquidity of the reserves and the rate of yield expected on the reserves. The performance of the foreign exchange management activity is indicated in the context of these reference portfolios.

The framework of conscious risk-taking to be applied in 2005 was decided by the Monetary Council. It determined the basic principles of reserve and risk management, defining market, credit and liquidity risks as risks which are consciously taken. It decided on the benchmark policy, establishing a strategic benchmark and defining the types of currencies to be held on the assets side in the gross reserve structure.

The Board of Directors approved the limit system within the framework defined by the Monetary Council: deviation limits permitted vis-à-vis the credit, liquidity and other risks related to the benchmarks of reserve portfolios and partner limits, and the scope of investment instruments permitted in reserve management. Throughout the year, the Asset-Liability Committee (ALCO) reviewed market developments and the Bank's exposure to risk regularly each month.

The two main pillars of our risk management policy are the two-tier benchmark system and the limit system partly attached to the benchmarks. A risk management organisa-

**Chart 3**  
**Foreign exchange reserves between 31 December 2002 and 31 December 2005**



tional unit independent of any specific market area reviewed each month the benchmarks serving yield risk preferences and the measurement of performance. In the course of the year, tactical benchmarks were not established: strategic benchmarks were in effect. Maximum deviations from the benchmarks are restricted by limits defined by the Board of Directors.

The Bank manages investment and liquidity portfolios on the basis of separate strategies. In 2005, the benchmark of both the euro and the dollar investment portfolio contained government securities, corporate bonds, money and capital market assets with at least an AA rating and a with a remaining maturity of maximum 10.5 years. The composition of the benchmark portfolios, by credit ratings of assets and remaining maturity, reflects the conservative appetite for risk characteristic of central banks in general.

The total return on the EUR-denominated investment portfolio was 2.43% in the 2005 calendar year, 0.31 percentage points higher than the relevant benchmark, while the total return on the USD-denominated portfolio was 2.71%, outperforming the relevant benchmark by 0.29 percentage points. The annual total return on the EUR-denominated liquidity portfolio was 2.12% as opposed to the 2.06% total return on the benchmark, while the USD-denominated total return was 3.32% compared to 2.96% for the benchmark.

On the final day of the year, the interest rate risk on the MNB's total foreign exchange balance of payments was EUR 41 million expressed by the value-at-risk (VaR) (at a one-month time horizon and at a confidence level of 95%), while the tracking error of investment portfolios to the benchmarks corresponded to EUR 7 million, similarly with a 95% confidence level. The value-at-risk of the net open currency position (OCP) (measured with euro, at a 1-day time horizon and a confidence level of 95%) was EUR 1,282. The value of the amounts reflects the implementation of conservative principles in risk-taking policies.

### **Managing operational risks**

In 2005, the Bank focused on the management of risks arising from system faults and shutdowns, generally characterising the area. The shutdown of the IT systems and the original location of work is a critical factor in relation to payment transactions and other important banking work processes. The testing of the operability of the immediate reserve centre (IRC), serving the prevention of financial losses and adverse impacts on reputation resulting from such shutdowns, is therefore of fundamental importance. Accordingly, several tests were conducted in the course of the year, resulting in improvement measures.

In addition to the above, the analysis of risks underlying IT systems from several points of view has also been performed.

## **3.5. CURRENCY ISSUING ACTIVITIES**

Two MNB decrees, regulating national currency distribution, were published in the course of 2005, and the central bank implemented several measures related to cash turnover.

### **New MNB decrees relating to cash distribution**

Two new MNB decrees related to cash distribution were published in June 2005.

- MNB Decree No. 13/2005 (VI. 27.) on technical tasks and other duties relating to the protection of Hungarian and foreign legal tenders against counterfeiting, and
- MNB Decree No. 14/2005 (VI. 27.) on cash processing and on the conditions of cash distribution.

### **Major modifications related to cash transactions**

The MNB reviewed the fees of cash transactions, and as of 1 July 2005, the MNB reduced cash handling fees by 25% in relation to banknotes, while the lodgement of coins to accounts was made free of charge. Exchange fees applied to the exchange of currency into other denomination of currency have risen, while the range of coins (1, 2 and 5 forint coins) exchanged free of charge has been broadened to include the 10 forint coin denomination.

From July 2005, the decree of the Governor of the MNB regulates the quality of forint legal tender reissued into circulation and the procedural order related to the handling of suspected counterfeit Hungarian and foreign legal tenders. In connection with the above, the central bank introduced a new monitoring method in relation to credit institutions and organisations conducting cash processing. In the process of monitoring the cash processing area of the central bank, on the basis of a randomly selected sample, the MNB checks the quality of banknotes processed by credit institutions and cash processing organisations with high-performance banknote processing machinery.

As of 1 July 2005, the MNB charges a HUF 20,000 fee per counterfeit in relation to any counterfeits lodged by credit institutions or detected among cash submitted for exchange. In the period following the introduction of the

**Table 2****Currency in circulation on the last day of the year**

	2004	2005	Change	
	HUF billions		HUF billions	Per cent
Banknotes	1,415.8	1,675.3	259.5	118.3
Coins	25.5	27.5	2.0	107.8
Cash for circulation	1,441.3	1,702.8	261.5	118.1
Collector notes and coins	3.0	3.2	0.2	106.7
Cash in circulation	1,444.3	1,706.0	261.7	118.1

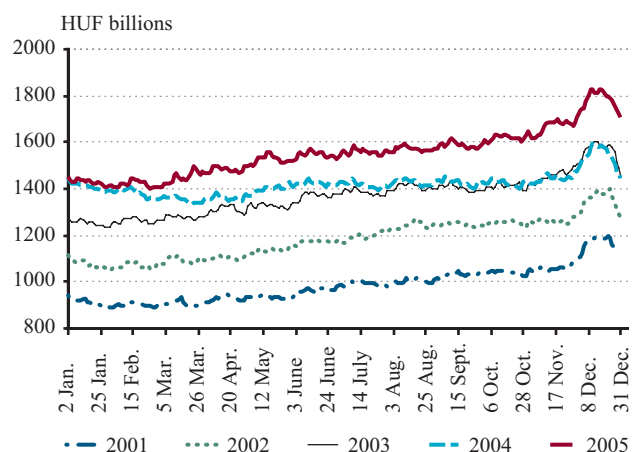
fee, the already low occurrence of counterfeits further decreased in lodgements.

**Currency in circulation**

In 2005, the value of currency outside the central bank increased by 10% at an annual average, significantly exceeding the 3% growth rate recorded in 2004. The higher growth rate in the value of cash stocks is firstly attributed to growing household consumption, and secondly, to reduced interest rates, whereby the cost of holding currency and savings in other liquid financial assets (sight deposits) fell.

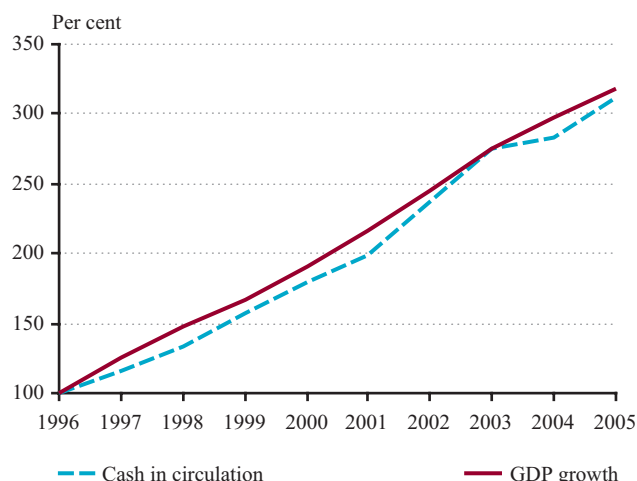
Cash in circulation rose at an accelerated pace throughout the whole year, exhibiting the strongest growth in December. At the end of 2005, the value of cash in circulation was HUF 1,706.0 billion, up 18% or HUF 261.7 billion on the end of the previous year.

The changes in the value of cash in circulation during the year revealed seasonal trends similar to previous years; the lowest value was recorded at the end of February,

**Chart 4****Change in the value of currency in circulation**

while the highest value was before Christmas. Some of the cash issued due to the outflow of wages at the beginning of the month was returned to the central bank by the middle of the month. Each year, a major amount of cash is returned to the central bank following the Christmas holidays. The rate of the return was smaller in December 2005 than in previous years.

The ratio of the average value of cash in circulation, in relation to GDP at current prices, rose from 6.9% in the previous year to 7.1% in 2005, as a result of the higher growth rate in cash compared to GDP. The 10% average growth rate of currency in circulation was 3 percentage points higher than the growth rate of GDP at current prices.

**Chart 5****GDP growth at current prices and the annual average amount of cash on a 1996 base**

On 31 December 2005, the average amount of forint per capita in cash corresponded to HUF 169,000 with 26 banknotes and 252 coins per capita. The per capita value of cash rose by 17% in comparison to the end of the previous year; the number of banknotes increased by 2, the number of coins by 22 (at the end of 2004, the per capita number

**Table 3****Banknotes in circulation on 31 December 2005**

Denomination	Quantity	Value	Percentage share	
	Millions	HUF billions	Quantity	Value
20 000 forint	34.7	693.2	13.1	41.4
10 000 forint	76.8	767.8	29.1	45.8
5000 forint	22.6	112.9	8.5	6.8
2000 forint	17.5	35.0	6.6	2.1
1000 forint	45.6	45.6	17.3	2.7
500 forint	24.3	12.2	9.2	0.7
200 forint	42.9	8.6	16.2	0.5
<b>Total</b>	<b>264.3</b>	<b>1,675.3</b>	<b>100.0</b>	<b>100.0</b>

of euro banknotes in circulation in the euro zone was 33, with 202 coins).

The rate of banknotes and coins within the value of cash in circulation remained similar to previous years, with 98% and 2%, respectively.

**Banknotes in circulation**

In 2005, the value of banknotes in circulation increased by 18% in comparison to the end of 2004 and reached HUF 1,675.3 billion by the end of the year. The number of banknotes in circulation grew at a more moderate rate of only 10%, owing to a sustained increase in the number of banknotes with higher denomination. The quantity of all banknote denominations rose, with the number of 20,000 forint banknotes increasing at an exceptionally high rate of 41%. The number of 10,000 forint banknotes rose by a considerable 7%, and the quantity of the two smallest denominations in circulation, the 500 and 200 forint banknotes, also increased significantly, by 7% and 9%, respectively.

The average value of banknotes in circulation (the value of banknotes in circulation divided by the number of banknotes in circulation) was HUF 6,339 at the end of the year, HUF 462 more than in the similar period of the previous year. In comparison, the average value of euro banknotes in circulation was 54.3 euro (HUF 13,700) at the end of 2005.

**Coins in circulation**

There were 2,545 million coins in circulation at the end of 2005, up 9% or 218 million on a year earlier. Similarly to previous years, over 68% of the increase is related to the higher-than-average outflow of coins of small denomination (1 and 2 forint coins). The number of 50 forint coins rose at the highest rate, by 12% in 2005. This increase is caused by the MNB's issue of 2 million commemorative coins of 50 forint face value in 2005, upon the 15th anniversary of the International Children's Safety Service, most of which – owing to their uniqueness – are not in circulation anymore. The value of coins in circulation rose by 8% (by HUF 2 billion) in the past year.

**Table 4****Coins in circulation on 31 December 2005**

Denomination	Quantity	Value	Percentage share	
	Millions	HUF millions	Quantity	Value
100 forint	138.3	13,835	5.4	50.3
50 forint	87.4	4,371	3.4	15.9
20 forint	171.3	3,427	6.7	12.5
10 forint	205.3	2,053	8.1	7.5
5 forint	276.2	1,381	10.9	5.0
2 forint	764.2	1,528	30.0	5.6
1 forint	902.4	902	35.5	3.3
<b>Total</b>	<b>2,545.0</b>	<b>27,498</b>	<b>100.0</b>	<b>100.0</b>

### **Prevention and reduction of counterfeiting**

The Magyar Nemzeti Bank performs analyses of suspected forint and foreign counterfeit banknotes and coins detected in Hungary.

In 2005, the activity of the National Counterfeit Centre, established in the spirit of EU accession, focused on strengthening cooperation with institutions ensuring efficient and coordinated action against counterfeiting on a national level. A written agreement reached in October between the MNB and the National Police Headquarters, defining areas of cooperation and joint tasks, serves the above objective.

During last year, the experts of the Magyar Nemzeti Bank identified 10,257 forint counterfeits in 9,369 cases which were withdrawn from circulation. The 1,000 forint banknote was counterfeited the most often with a share of 50%. Forint banknotes are not counterfeited with printing methods: all seized counterfeits were produced with office reproduction equipment (colour photocopier, printer). Knowledge of authentic banknotes and their reasonable checking in purchase circumstances allows for the detection of counterfeits. The rate of counterfeits does not pose a risk to the safety of cash circulation.

The number of counterfeiting cases and the number of seized counterfeits remains encouraging and did not change significantly in comparison to the previous year. Although the counterfeiting of euros rose at a moderate rate, it remains at an insignificant level; our experts analysed a total of only 816 euro counterfeits withdrawn from circulation in 2005.

### **Issue of collector and commemorative coins**

In 2005, the Magyar Nemzeti Bank issued six different collector coins and two commemorative coins. The bank issued silver collector coins of a denomination of 5,000 forints including the castle of Diósgyőr, the 150th anniversary of the birth of Ignác Alpár, the karst caves of Aggtelek, the 150th anniversary of the founding of the Budapest Calvinist Theological Academy and the 400th anniversary of the election of Prince István Bocskai. A non-precious metal collector coin was issued on the first Hungarian postal vehicle designed 100 years ago. The MNB issued a 10 forint coin commemorating the birthday of Attila József 100 years ago and a 50 forint coin commemorating the 15th anniversary of the International Children's Safety Service, the obverse of which corresponds to the obverse of common circulation coins.

## **3.6. STATISTICAL SERVICES**

### **Legal framework for the MNB's statistical activities**

Article 4 of Act LVIII of 2001 on the Magyar Nemzeti Bank defines the collection of information, the operation of an information system and the issue of statistical publications as fundamental responsibilities of the central bank.

Pursuant to the provisions of Article 60(1) i) of the MNB Act, effective as of 27 June 2004, amended in accordance with EU legal harmonisation requirements, the governor of the MNB regulates by decree the scope of information required for the central bank's information system, to be provided by financial institutions, investment companies and institutions engaged in auxiliary financial services, as well as the manner and deadline of such information provision. With regard to a wider range of institutions, the MNB continues to require data provision within the framework of the National Programme for the Collection of Statistical Data (OSAP).

In compliance with Act LXIII of 1992 on the Protection of Personal Data and the Disclosure of Information of Public Interest, the provisions of Act XLVI of 1993 on Statistics are also applicable to the statistical activities performed by the MNB as a member of the National Statistical Service.

### **Statistical activity**

The MNB's statistical activity includes the collection, use and processing of the data required for performing its duties, such as the establishment and operation of its information systems, in order to carry out data analyses and to publish its statistical releases, as well as meeting its international reporting obligations.

The MNB revises the collection of statistical data once every year, and specifies reporting obligations for a calendar year. The MNB specified the 2005 data provision obligations in its resolution 24/2005 (XII.12.), within the framework of the National Programme for the Collection of Statistical Data (OSAP) for 2005.

The statistical activities performed by the MNB extend to the following three major fields: monetary and balance of payments statistics, as well as the financial accounts.

Monetary statistics provide information on the developments of credit portfolios and monetary aggregates and changes in the position of the individual sectors vis-à-vis monetary financial institutions on the basis of the

processed balance sheet data of monetary financial institutions (i.e. credit institutions, money market funds and the central bank). Monetary statistics also include market (i.e. non-financial corporate, household and interbank) interest rate statistics.

Balance of payments and related international investment position statistics record economic transactions between what are defined in terms of the economy as residents and non-residents, their assets and liabilities, and changes in such.

The financial accounts provide information on the financial assets and liabilities in the Hungarian economy, and the elements of the changes in such. Financial accounts form an integral part of the system of national accounts, and are a useful contribution to the analysis of the development and level of financial mediation, as well as the financing relations between various economic participants. Securities statistics, which are closely related to financial accounts, are based on reports by securities custodians, and provide information on government securities, investment fund units and quoted shares as well as their distribution between economic participants. From 2004, the MNB has been participating in the compilation of the Excess Deficit Procedure report related to the financing of general government and government debt.

The Internet is the primary channel for the release of statistical data. Processed data are published as a long-time series on the MNB's website. Currently, under the menu 'Statistical time series', the MNB publishes time series for monetary, balance of payments, financial accounts, price, exchange rate, as well as money and capital market statistics. In addition to the publication of time series, the MNB also publishes, on dates set one year ahead in the publication timetable, monthly and quarterly press releases on certain topics, including monetary and balance of payments statistics and the ownership distribution of securities.

### **Changes in 2005**

In 2005, major methodological changes were implemented in the balance of payments statistics. The data of the Central Statistical Office was adopted and incorporated in the balance of payments statistics in the area of the tourism sector and business services, replacing the previously used data on payment transactions. The balance of payments statistics were thus harmonised with data published by the Central Statistical Office in the area of tourism and business services. Data related to the tourism sector and business services was revised back up to 2000 and 2004, respective-

ly. The incorporation of new information resulting from the processing of questionnaires related to direct investments also comprised an additional change. The MNB carried out the adjustment resulting from the above changes in accordance with the published revision policy, publishing the adjusted data on 31 March 2005, concurrently with the publication of statistics for the fourth quarter of 2004.

In March 2005, the MNB issued the publication entitled 'Foreign direct investment, Hungary 1995-2003' in which it reveals developments in the direct investments of foreigners in Hungary and Hungarians abroad, arranging stock and turnover statistics in a uniform structure.

The contents of published time series were significantly expanded from July 2005 in the area of financial accounts statistics. The time series were revised back up to 1989 in relation to all sectors; the previously published data was simultaneously reviewed with improved accuracy. The detail of the published time series was also enhanced; the supplementary breakdown of HUF/foreign exchange and partner sectors were also included in the published statistics. The (operational) transaction and balance data net of inflation have become accessible in relation to all sectors, widening the range of data. In addition to normal data publication, financial accounts adjusted with the classification of private pension funds in the general government sector are also included. The range of statistical methodological publications has been expanded with a new publication including the detailed methodology of compiling financial accounts and analyses on the use of data.

In the course of 2005, changes were also introduced in relation to monetary statistical publications. Interest rate statistical publications were supplemented with data on loans and deposits denominated in euro and data on the average interest rates and new contracts of consumer loans (personal, consumer, car purchase, free purpose mortgage loans) denominated in forints, euro and Swiss francs. With regard to loans denominated in Swiss francs, in addition to consumer loans, the MNB publishes data on housing loans and the value of stocks recorded at the end of the month. As a further change, the publication on monetary balance sheet statistics were expanded with the sectoral breakdown of housing loans and details on the types of consumer loans provided to households.

### **International reporting**

The MNB complied with all the reporting obligations pertaining to EU Member States in 2005. Accordingly, it supplied Eurostat, the EU's statistical office, and the European Central Bank (ECB) with data on a regular basis.

The MNB regularly reports data, information to the following international organisations: International Monetary Fund (IMF), World Bank, Organisation for Economic Co-operation and Development (OECD) and the Central European Statistical Co-operation (CANSTAT). Data provision by the MNB meets the high-standard requirements of SDDS (Special Data Dissemination Standard) and relies on the methodology recommended by various international organisations. The MNB also provides data to the Bank for International Settlements (BIS) on a regular basis, with continuously expanded content.

### **Cooperation with domestic institutions**

In addition to international institutions, statistical activities require the MNB to cooperate closely with domestic partner institutions, primarily the Central Statistical Office, the Ministry of Finance and the Hungarian Financial Supervisory Authority. In 2005, the further development of the balance of payments methodology, broadening of cooperation and a reconciliation of the methods of general government statistical records comprised an important part of the itemised working plan defining cooperation between the MNB and the CSO. The MNB and the HFSA establish cooperation by concluding annually updated agreements in relation to the joint balance sheet reports compiled since early 1998.

### **3.7. FACTORS SHAPING THE COMMUNICATIONS OF THE MNB IN 2005, TARGETS AND RESULTS**

External communication by the management of the central bank represents the highest level of the communication activity of the MNB. The governor, the deputy governors, the Monetary Council and its members independently maintain external contacts, as suggested by their function, position and order of designation, therefore the statements of the external members of the Monetary Council do not necessarily reflect and/or represent the statements of the central bank.

The communication of the central bank's management is of major strategic relevance, producing high potential impact. The communications department provides professional background support to the governor, the deputy governors and the members of the Monetary Council, enabling them to facilitate and maintain contacts with the outside world at the highest possible level (e.g. availability for possible media requests, use of press relations, organisation of media events, follow-ups, etc.).

The statements of the governor are of particular relevance in the area of communications, requiring special tools.

Communication not only coordinates and follows up press inquiries and statements, but also mediates the central bank's message to the world in a proactive manner, through the organisation of press conferences and media events, the participation of the governor at regional information events, conferences and events.

At the second level, the activities, results, publications, comments and proposals of the analysis areas are externally communicated, disseminated and promoted, these directly contributing to the fulfilment of the MNB's statutory tasks.

The target groups of the internal expert level are most specific, therefore adequate and up-to-date information supply to highly qualified experts, proficient in economic and monetary issues, such as domestic and foreign economic and macroeconomic analysts, journalists, academic researchers, teachers, etc., represents a challenge in the area of communications, as well.

The communications function, in parallel with continuous and regular consultations, provides services to the analysis areas. It monitors communication demands related to the activity of internal expert areas, and on the basis of mutual agreements, mediates the messages of experts to the various target groups in the framework of the communication strategy.

The other chief task of the communications function comprises packaging the specialised materials of individual areas in a comprehensible form, enabling the understanding of the central bank's messages.

In addition to proactive media activity, events (MNB Club, inflation conference series, etc.) proving successful in the past, often aimed at special target groups, were organised in 2005 particularly to convey the messages of the central bank's analysis areas.

In terms of the broader public (third level of communication), the MNB wishes to promote the image of an open and people friendly central bank, in addition to conveying professional messages and projecting reliability and credibility on a continuous basis. In 2005, again, the professional communications pillars established in 2004 were adapted to the MNB's statutory tasks, the macroeconomic messages and the communications demands of the analysis departments. Accordingly, the communication projects and activities were concentrated in generally three major areas:

- Enhancing public awareness and recognition,
- Information supply,
- International relations.

Over one and a half years of experience suggests that the MNB Visitor Centre is one of the most effective means in conveying the messages of the central bank. The Centre received over 75,000 visitors up to December 2005. The importance of the Visitor Centre is underlined by the fact that it offers the first meeting point with the MNB for many people. In addition to a high level of professional expertise, its interactive and unique solutions contribute to the expansion of the public's financial skills, particularly to the most receptive group: students and young adults. The Stúdium program, introduced in 2004 with a view to providing new knowledge in the Visitor Centre and the promotion of financial culture, was continued this year with great success, expanded with a new quiz series (Monetary) for secondary school students.

Within communications activity, where possible, the MNB continued to organise and further develop events and venues which proved successful in the past. The press conferences, regional press meetings, press seminars, press tours (Hungarian-Polish central bank conference, ECB Hungarian days, press tour to the Slovakian central bank), press lunch with the Governor, year-end press reception, MNB media competition, etc., offered favourable means of transmitting our messages to the media in a proactive manner. In 2005, major emphasis was again placed on informing the wider public, supported by various forms of cooperation with the media and columns. In the framework of the above process, the broadcasting of the successful radio and television columns (Kossuth Rádió, Hír TV) and the issue of the macroeconomic supplement of *Világ-gazdaság* continued. Access to the wider public was appropriately facilitated by the Governor's regional presentations, MNB Open House, the newsletter 'Jegybankunk', the issue of 8 commemorative coins annually and the automatic phone information system on exchange rates launched in 2005.

Communication activity also includes online availability at the MNB's website and other sites (e.g. origo.hu), providing information to the wider public. In 2005, in addition to the development of contents and the implementation of new cooperation, the website was also renewed in its outer appearance, offering a user friendly navigating system, thematic mini-sites, a virtual walk through the building and online registration interfaces.

International relations, based on the exchange of experience, also contributed to the successful operation and further development of communications systems which fulfil the needs of various target groups.

The public opinion surveys conducted each year suggest

that public awareness and recognition of the MNB further increased in 2005. This success is partly attributable to the communications projects which implemented the strategic objectives, built on and mutually strengthening one another.

### 3.8. FINANCIAL PERFORMANCE OF THE MNB

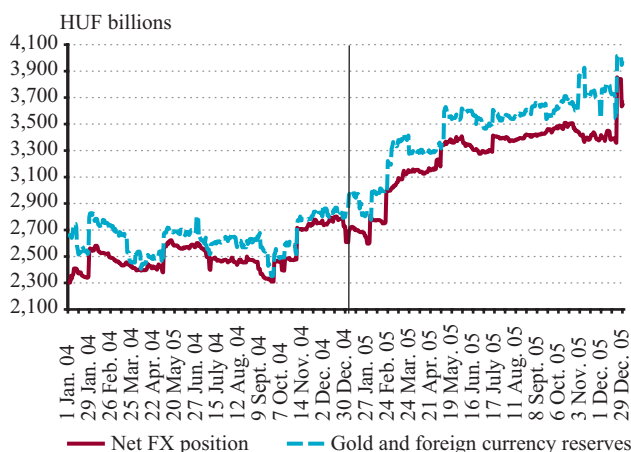
#### Major events and measures determining changes in the balance sheet and in the income statement

In 2005, the Magyar Nemzeti Bank incurred a loss of HUF 21.4 billion. The financial result and balance sheet structure of the Bank are primarily determined by the macroeconomic developments of recent years and measures implemented for monetary policy purposes. The major factors determining changes in the balance sheet and the income statement in 2005 were as follows:

- sale to the MNB of foreign currency from the issue of foreign currency bonds by the Hungarian government,
- prepayment of the central government's foreign exchange debt vis-à-vis the MNB,
- increase of foreign exchange market yields,
- decrease of the central bank base rate,
- weakening exchange rate of the forint.

In 2005, the Republic of Hungary issued foreign currency bonds in the amount of EUR 3.5 billion. The foreign exchange revenue of the central government also increased by the GBP 1.3 billion from the privatisation of Budapest Airport Rt. in December. A smaller proportion of

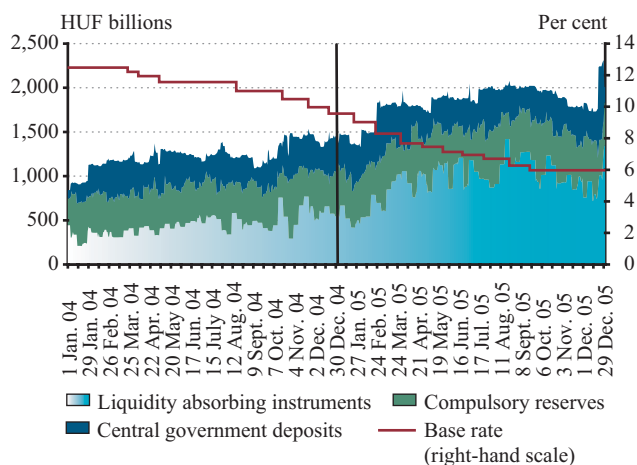
**Chart 6**  
Net FX position and foreign exchange reserves, 2004–2005



foreign exchange revenue was spent by the central government on the reduction of the foreign exchange debt vis-à-vis the MNB, while the larger proportion was converted to forints at the MNB. As a result of the above, the net foreign exchange position of the MNB increased by EUR 3.9 billion (by HUF 1,053 billion), and the HUF liabilities of the MNB increased by the same rate.

## Chart 7

**Major forint-denominated liabilities incurred by the MNB, 2004–2005**



Of the amount originating from the sale of Budapest Airport Rt., the central government spent HUF 207.3 billion on the prepayment of its foreign exchange debt vis-à-vis the MNB. Since prepayment causes continuous interest loss to the MNB in the period extending to the original maturity of the loans, as compensation for the above, prepayment was made at market value. The market value exceeded the original denomination of the debt by HUF 15.2 billion, therefore this amount arose as interest related income in the results.

The rise in foreign exchange purchases and foreign exchange yields increased foreign exchange interest and interest related income by HUF 13.3 billion which, jointly with the interest related income arising from the aforementioned prepayment, improved the result of the MNB by HUF 28.5 billion in comparison to the previous year.

The forint amounts paid for foreign exchange purchased from the central government increased the amount of forint liabilities. However, the fall in the base rate significantly moderated the effect of the above on rising interest expenses: in 2005, the central bank average base rate was 7.2%, 4.2 percentage points lower than in the previous year. On the whole, net forint interest expenses increased by HUF 4.2 billion in 2005.

The HUF 5.9 billion increase in the row realised gains/ losses arising from financial operations is primarily related to the realised gain arising from the sale of forint government securities and the lower loss incurred on the sale of foreign exchange securities.

As a result of the 2.8% weakening of the forint, the total revaluation effect amounted to HUF 101.1 billion. In relation to the sales, the Bank realised a profit of HUF 14.6 billion, thus, by the end of December, the balance of the revaluation reserve due to unrealised foreign exchange gain/ loss rose by a total of HUF 86.5 billion to HUF 106 billion.

In 2005, EUR foreign exchange market yields rose in relation to all maturities, excluding maturity of over 6 years, and the USD foreign exchange market yields also revealed an upward trend. In reaction to changes in stocks and changing interest rates, on the whole, the market value of securi-

## Table 5

**Abbreviated income statement of the MNB**

		HUF billions		
	Description	2004	2005	Change
	1	2	3	3–2
1	Net interest and interest related income <sup>1</sup> (I+II+IV)–(X+XI+XIV)	-47.9	-19.0	28.9
2	Income arising from exchange rate changes (III–XII)	22.6	14.6	-8.0
3	Other constituents of net income <sup>2</sup> (V+...+VIII)–(XIII+XV+...+XVIII)	-17.5	-17.0	0.5
4	<b>Profit/loss for the year (1+2+3)</b>	<b>-42.8</b>	<b>-21.4</b>	<b>21.4</b>
5	Revaluation reserves in the balance sheet			
6	– due to unrealized foreign exchange gain/loss	19.5	106.0	
7	– due to changes in the market value of the foreign currency securities	-1.1	-14.8	

1) This line contains the realised gains/losses arising from financial operations as well.

2) Other constituents of net income consist of net expenses of money circulation and operations, net provision and other income/expenses.

ties classified under foreign exchange reserves decreased, thus, the revaluation reserve due to changes in the market value of the foreign currency securities indicated a HUF 14.8 billion negative balance on 31 December 2005. Pursuant to the Central Bank Act, this amount is paid by the central government by 31 March 2006; it is recorded in the balance sheet as a receivable vis-à-vis the central government until it is financially settled.

The loss of the MNB for 2005 amounted to HUF 21.4 billion, down HUF 21.4 billion on the loss recorded for the previous year. The retained earnings of the MNB covers the loss, therefore, reimbursement is not necessary pursuant to the Central Bank Act.

### Internal operations of the Magyar Nemzeti Bank in 2005

The internal operations of the Bank are essentially aimed at providing the resources required for the efficient discharge of the duties stipulated by the MNB Act and facilitating risk-free operations in the most cost-effective manner. Upon inspection of the operation of the Magyar Nemzeti Bank, the State Audit Office (SAO) reviews compliance of the institutional management with the statutory regulations and by-laws, and if the requirement of cost-effectiveness has been applied in operating costs and investments. The SAO made no remarks or recommendations on these issues following the audit of the year 2004.

The operating costs of the MNB fell significantly from 2001 to 2003. This trend was reversed in 2004, but the amount of operating costs in 2005 (HUF 14,883 million) remained nearly 20% less in real terms than the figure for 2001 (HUF 15,196 million). The changing trend in the development of costs is primarily linked to the cost of IT development, arising in relation to the operating costs of computer systems and depreciation, and the increase in personnel expenses.

The financially realised value of investment implemented in 2005 was HUF 3,113 million. The modernisation of the IT infrastructure and enhanced integration of the systems continued. The implementation of the mid-term statistical IT program is of fundamental importance among the development projects; and the major projects were in part completed in 2005. The development of the Logistics Centre continued. Some of the work and payments planned for 2005 have been rescheduled, but this will not likely affect meeting the final deadline.

### Operating costs

The Board of Directors approved a HUF 15,668 million operating cost budget for 2005 (including central reserves in the amount of HUF 231 million), whereas actual costs amounted to HUF 14,883 million.

### Personnel costs

In 2005, personnel costs (HUF 9,501 million) rose by 8.0% in comparison to 2004. Generally speaking, the following factors determined the development of the costs:

- a 5.3% decline in the average number of employees,
- a more than three-fold rise in costs related to the termination of employment,
- increase in the size of the Monetary Council's membership,
- an average increase of 6.0% in base wages in 2005,
- of the 8% rise in costs, 5.9% is related to an increase in payments linked to the termination of employment – partly planned and partly related to the implementation of the operations improvement program – and the expansion of the Monetary Council, which jointly accounted for 74.4%

## Table 6

### 2005 operating costs of the MNB

1	2	3	4	5	6
Description	Actual data for 2004	Budget for 2005	Actual data for 2005	Index (2005 actual/2005 budgeted)	Index (2005 actual/2004 actual)
	HUF millions			4 ÷ 3	4 ÷ 2
1. Personnel expenses	8,797	9,550	9,501	99.5%	108.0%
2. General operation costs	4,727	5,887	5,382	91.4%	113.9%
<b>Total</b>	<b>13,524</b>	<b>15,437</b>	<b>14,883</b>	<b>96.4%</b>	<b>110.0%</b>

**Table 7****Headcount (2001-2005)**

Description	2001	2002	2003	2004	2005	Difference (2005/2004)	
	(persons)	(persons)	(persons)	(persons)	(persons)	(persons)	(Per cent)
Number of employees at year-end	1,163	984	946	938	809	-129	86,2%
Average number of employees	1,246	1,058	958	946	896	-50	94,7%

of the increase in costs. Savings related to the lower average number of employees reduced personnel costs by 5.2%.

In 2005, the personnel management of the MNB focused on organisational transformation implemented during the year, on special measures for improving operating efficiency and on tasks, measures related to the implementation of the operations improvement program launched in the second half of 2005. As a result of the above mentioned efforts, the number of employees at year-end was 129 less than the closing figure for the year 2004. In 2005, the average number of employees at the Bank decreased by 5.3%.

Savings arising from the reduced number of employees were moderated by the cost of single payments related to the termination of employment. Membership of the Monetary Council was expanded pursuant to the amendment to the Central Bank Act; unplanned payments related to the above also reduced savings.

**General operating costs**

In 2005, general operating costs (HUF 5,382 million) rose by 13.9% in comparison to 2004, primarily as a result of initial costs related to the operation of the new computer systems. Among such costs, only the amount of depreciation increased at a rate of over 10%.

In 2005, the amount of IT costs (HUF 1,161 million) exceeded the figure for 2004 by 21.6%. This increase is primarily related to new and expanded computer and consulting services used for the operation of software; because the focal point of strategic targets has shifted in the direction of supporting statistical systems and areas of analysis.

*Operating costs* (HUF 1,548 million) increased by 7.6% in comparison to the previous year. Having maintained the level of secured operation in the previous years, the rise in costs was primarily related to the increase in public utilities costs – particularly electricity fees – which significantly exceeded the rate of inflation. In addition, as a result of the interim outsourcing of some of the armed guards, in accor-

dance with the mid-term bank security strategy of the MNB, the related costs were reclassified from personnel costs to operating costs.

The amount of *depreciation* charge of tangible assets and intangible assets in 2005 (HUF 1,855 million) was 25.4% higher than in the previous year, because the volume of investments in past years exceeded the rate of earlier years. Among implemented investments, the proportion of IT developments, with higher depreciation rates (for faster amortisation), increased.

In 2005, *other costs* amounted to HUF 914 million, down 6.6% on 2004. This decrease is primarily attributed to the fact that consulting and data purchase costs, supporting the realisation of the MNB's economic research activity and the high-standard preparation of its statistical reports, decreased significantly in comparison to the previous year. This essentially resulted from the cost reduction of collecting data from the tourism sector, required for ensuring the adequate quality of the balance of payments statistics; the Central Statistical Office performs such data processing.

**Capital expenditure (capex)**

The Board of Directors approved a HUF 6,047 million capex budget for the year 2005, including interim adjustments (of this itemised investments amounted to HUF 5,751 million and central reserves amounted to HUF 296 million).

The primary reason for the 54% rate of completion is that a major proportion of payments planned for 2005 in relation to the implementation of the Logistics Centre was rescheduled, but this is unlikely to have an effect on meeting the final deadline.

The financial fulfilment of the budget for 2005 was also affected by the fact that parties awarded public procurement contracts undertook implementation at a more favourable price than planned, in relation to certain (particularly IT) development projects. In addition, national security checks related to certain, primarily bank security investments and tenders regulated by state secret legislation consumed more time than expected.

**Table 8****Capital expenditure budget of the MNB in 2005**

1	2	3	4
Description	Adjusted budget for 2005	Actual data for 2005	Index
	HUF millions		3 ÷ 2
Logistics Centre	3,100	1,221	39%
Modernisation of information technology	1,938	1,397	72%
Other investments, purchases	713	495	69%
<b>Total</b>	<b>5,751</b>	<b>3,113</b>	<b>54%</b>

**Establishment of the Logistics Centre**

The MNB will relocate the issue of banknotes and coins, along with its IT support and Magyar Pénzverő Zrt., to a sophisticated, new logistics centre.

The Board of Directors approved the complete (projected) financial plan of the Logistics Centre in 2003, and has continued to monitor progress on a regular basis.

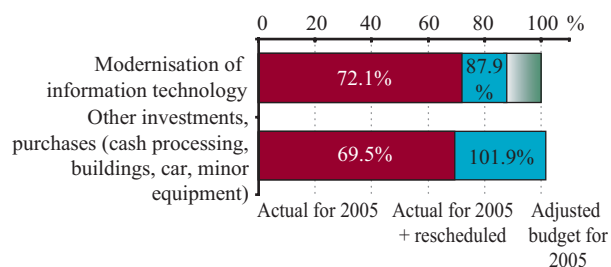
The investment budget for the 2005 phase of the Logistics Centre amounted to HUF 3,100 million which was determined – jointly with the related scheduling of tasks – in the tender phase of specific partial tasks, on the basis of the average value of available offers. As a result of the above and the rescheduling of the general contractor's tasks, HUF 1,221 million was financially realised in 2005, most of which is linked to the construction work of the building. The rescheduling of tasks is not likely to affect performance by the final deadline.

In 2005, following the conclusion of the contract in May, the general contractor completed most of the earthwork, concrete and insulation work. Most of the public procurement procedures announced for the implementation of the investment's various technological partial elements and the purchase of machinery have been successfully concluded, while a smaller number of these are still underway.

**Additional investments**

Chart 8 illustrates the implementation of planned, additional investment projects for 2005, included in the approved budget, without general reserves, taking consideration of the value of investments carried forward to 2006.

The majority of new investments originally planned for 2005 were commenced. Of these, 83% have been completed or put into operation in the course of the year; 12% are under construction and 5% are in the public procurement phase

**Chart 8****Development of investments planned for 2005, together with amounts carried forward to 2006 (not including the Logistics Centre)**

or in preparation. The value of investments budgeted for 2005, or approved during the year, which were commenced but not realised financially (not including the Logistics Centre) was HUF 538 million. These will be continued or completed in 2006.

**IT investments**

According to the financial plan approved for the year 2005, the main targets of IT investments are as follows:

- commencement and implementation of the development defined in the mid-term IT strategy approved by the Board of Directors, and
- ensuring the high level, continuous availability of the technical infrastructure and the systems.

IT investments in the value of HUF 1,397 million were implemented in 2005 for the purpose of achieving the above targets. These include:

- the implementation of phase 1 of the server consolidation comprised of a fundamental area of *IT infrastructure modernisation*, representing one of the special projects in 2005. According to the mid-term IT strategy, the objec-

tive of the investment is to replace the 'one system – one server' operating practice with the implementation of efficient management of IT resources, in parallel with the replacement of partly outdated technical facilities and the improvement of operating safety. The investment will be continued in 2006.

- within *the development of integrated operating systems*, the project aimed at replacing the subledger keeping system was completed in early 2005, extended from 2004. The replacement of the accounting system's (SAP) licence, platform and version has commenced, and is likely to be completed in April 2006 according to the original schedule.
- in the framework of *the development of the central bank's statistical systems*, the implementation of the mid-term statistical IT program (ISTAT) has commenced in accordance with the IT strategy. Major projects – planned for completion in early 2006 – have been completed (collected data submitted in electronic form, securities statistics, implementation of the statistical data receipt system and supporting functions). The final deadline of the program approved by the Board of Directors can be met.
- serving *support for administrative processes*, user systems were developed and modified on a smaller scale and faults limiting uninterrupted operation of critical applications were remedied.

### **Other investments, purchases**

Two-thirds of other investments and purchases (HUF 495 million) in 2005 are related to the preservation and technological modernisation of property, while the remaining amount was linked to the purchase of various, minor equipment.

### **Human resources management of the MNB**

In the past years, human resources strategy focused on the development, introduction and institutionalisation of modern human resources management systems. In 2005, the Bank's management reviewed and updated the previously set medium-term institutional targets until 2007. Considering that the future human resources management activities of the Bank will be required to support the implementation of mid-term targets, these must contribute to the successful management of organisational challenges arising in the coming years, also adopting the expectations of staff with factors shaping their commitment. In consideration of the above factors, the Bank's human resources strategy for the next 3 years was prepared in 2005, with the

involvement of senior managers. The strategy defines the targets of human resources management, the main directions of further development and the measures needed for implementing the targets.

### **Competence system**

In 2005, we further developed our competence system with the participation of an outside consultant: we defined the job-specific competences for each job group. Such competences are incorporated in the job-related requirements; in the future, these will represent one of the pillars of selection, training development, performance management and wages.

### **Recruitment and selection**

In 2005, we sought staff to fill in 64 empty or newly-created posts. By continuing to promote incentives for internal mobility, in the first round, the positions were announced within the Bank; 24 of the jobs were successfully applied for by internal employees (37.5%). During the year, we developed the system of Internet-based recruiting which accelerates the management of job applicants.

In the course of 2005, 10 employees participated in short-term (3-11-month) jobs at the European Central Bank. Experience has shown that these assignments are highly beneficial for both the receiving and the sending party and greatly facilitate the Banks' efficient integration into the European System of Central Banks.

Within the framework of the Visiting Researcher Programme, 7 PhD students were employed at the Bank for a period of 1-3 months in 2004. They actively participated in the MNB's workshop.

### **Training, development**

In 2005, we launched the MNB Executive Academy which ensured the customised, high level development of executive competences, in line with the development plans elaborated on the basis of feedback on surveys conducted in the previous years.

In 2005 again, the colleagues of the Bank were offered participation in numerous programmes which develop professional and personal skills and competences. Internally organised training courses, relying on accurate knowledge of demand, play an increasingly important role.

The rising trend of participation in professional training abroad continued in 2005. In addition to participation in

specialised courses organised by central banks, employees of the MNB had the chance to take part in high-standard managerial and personal skills development courses in the organisation of the ESCB.

### **Career management**

In 2005, career management placed emphasis on expert career development. As a first step in this process, we modified the structure of the jobs of experts in theoretical areas by establishing transparency and enabling colleagues to clearly identify the conditions and performance expectations required for advancement and promotion.

### **Development of the corporate culture**

In June 2005, the management of the MNB defined the need to replace the current, primarily instruction based operation with a work culture based on mutually accepted standards, guidelines and authorities which enables faster and less bureaucratic work with the consumption of less resources and time.

On the basis of the background report comparing the organisation's operating efficiency, organisational characteristics and the declared and desirable bank values, in the autumn of 2005, the Bank adopted the decisions required for transforming the corporate culture; these establish the foundation for transforming the organisational form and structure and the resolving of measures serving a change in culture. Thus, the development of the new operating model commenced in the autumn of 2005, yet most of it will be implemented in the course of 2006.

### **Number of employees**

In 2005, the human resources management of the MNB was characterised by the rationalisation of organisational operation, the improvement of efficiency and measures relating to the implementation of the operations improvement program launched by the senior management of the Bank. The combined above measures resulted in the reduction of the MNB's number of employees by over 5%. In relation to the improvement of operating efficiency, the planned number of employees, in a breakdown of organisational units, has been determined for the years 2006-2008, with the participation of managers heading the organisational units.

In 2005, the employment of 157 employees was terminated; termination was initiated by the employer in 105 cases, 26 employees retired and or otherwise terminated employment (e.g. termination of trial period, fixed term employ-

ment contract, etc.). At the end of 2005, there were 2 fewer employees filling executive positions and 127 fewer employees in subordinate positions than in 2004.

## **3.9. INTRODUCTION OF THE ESCB COMMITTEES**

Since Hungary's accession to the EU the management and experts of the MNB have been participating in the work of the ESCB committees and their working groups as members.

The fields of activity (mandate) of individual ESCB committees can briefly be summarised as follows:

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

Develops and regularly reviews the accounting policy principles which define the framework of financial statements in accordance with the Statute of the ESCB, the methodology of the preparation of regular financial reports, the principles and mechanism of the determination and redistribution of monetary income and also of settlements within the ESCB, especially in relation to the capital and reserves and foreign exchange reserves of the ECB, to the redistribution of the seigniorage and to the settlements related to the operation of TARGET.

#### **Banknote Committee (BANCO):**

Determines the euro banknote needs of euro area countries, coordinates the production of banknotes and works out the stockpiling and banknote processing policies of euro banknotes. Its tasks include: exchange of experience deriving from the production of euro banknotes, examination and development of security features which prevent euro banknotes from being counterfeited and assessment of security risks related to the production of euro. It contributes to the harmonisation of the practice applied in the euro area, to the development of the system which monitors counterfeiting and to the control of statistics related to euro banknotes and coins.

#### **Banking Supervision Committee (BSC):**

Regularly examines the possible effect of developments in business conditions on the EU banking sector, the stability and proper functioning of the EU banking sector and the impact of medium-term structural changes on EU banks. It also provides assistance to the ESCB in carrying out regulatory tasks related to prudential supervision and financial stability. The Magyar Nemzeti Bank represents Hungary in this committee together with the Hungarian Financial Supervisory Authority.

#### **External Communications Committee (ECCO):**

Contributes to the development of the external communication policy of

the Eurosystem, of the ESCB and of the ECB in order to make the set targets more transparent and apparent and to inform the public about the tasks and activity of the Eurosystem and the ESCB.

**Internal Auditors Committee (IAC):** By reviewing the relevant common projects, systems and activities and by providing for cooperation in certain auditing issues which are of 'common interest' for the ECB and for national central banks, it assists the ESCB in achieving its targets.

**International Relations Committee (IRC):** Assists carrying out the tasks of the ESCB related to international cooperation. It contributes to the forming of the position of the Eurosystem in various areas of relations with non-EU countries, while within the EU it analyses the status of the accession process to the EU and to the EMU and issues related to ERM II.

**Information Technology Committee (ITC):** Contributes to the elaboration of the information technology policy and strategy of the Eurosystem and the ESCB, develops related guidelines, with special regard to security concerns, and gives technical advice to other committees. In addition, it initiates and carries out specified developments and independent projects, which result in the introduction of systems.

**Legal Committee (LEGCO):** Contributes to the maintenance of the regulatory framework of the Eurosystem and the ESCB, monitors and reports on how national authorities and the Community comply with their consultation obligations related to draft laws in areas within the competence of the ECB.

**Market Operations Committee (MOC):** Assists the ESCB in the realisation of the single monetary policy and foreign exchange transactions, in the management of the reserves of the ECB and in the proper adaptation of the set of monetary policy instruments applied by the central banks of those Member States that have not yet introduced the euro and also in the application of ERM II.

**Monetary Policy Committee (MPC):** Assists the ESCB in the realisation of the single monetary and exchange rate policy of the Community. In addition, it provides assistance in carrying out those tasks of the ESCB which derive from the coordination of monetary and exchange rate policies of the non euro area Member States and of the ECB.

**Payment and Settlement Systems Committee (PSSC):** Assists the ESCB in the smooth operation of the payment system, also giving advice on the cross-border use of col-

laterals in respect of the operation of TARGET (Trans-European Automated Real-time Gross Settlement Express Transfer System) and CCBM (Correspondent Central Banking Model); on general and 'oversight' issues related to payment systems; and on issues concerning central banks with regard to securities clearing and settlement systems.

**Statistics Committee (STC):** Provides assistance in collecting statistical information required for carrying out the tasks of the ESCB. It contributes to, inter alia, the elaboration and cost effective application of alterations required in statistical data collection.

### 3.10. PUBLICATIONS, CONFERENCES ORGANISED BY THE MNB IN 2005

#### Publications

*Quarterly Report on Inflation:* published four times a year in order to enable the public to understand and clearly follow the central bank's policy. In this publication the MNB regularly reports on the past and expected developments in inflation, and evaluates those macroeconomic processes that affect inflation. This publication also presents summaries of the forecasts and considerations that constitute a basis for the Monetary Council's decisions.

*Report on Financial Stability:* published biannually. This report outlines the position of the central bank vis-à-vis the changes in the financial system, and describes the effect of these changes on the stability of the financial system.

*Report on the activity of the MNB is published quarterly.*

*Annual Report.*

*Report on Convergence:* this publication was first issued by the Magyar Nemzeti Bank in November 2005, to be issued annually in November. Although in Hungary the government is generally responsible for the elaboration and enforcement of the convergence program, the Magyar Nemzeti Bank plays an important role in its implementation, primarily in the area of monetary and exchange rate policy. With this new publication, the MNB wishes to provide information to decision makers, experts and the wider public which improves their knowledge of rather complex issues related to membership in the monetary union.

*MNB Occasional Papers:* In this series economic analyses related to monetary decision-making by the Magyar Nemzeti Bank are published. The series aims at increasing

the transparency of monetary policy. Thus, in addition to studies also describing technical details of forecasting, economic issues arising during decision-making are published as well.

*MNB Working Papers:* These publications contain the results of analyses and research works conducted at the Magyar Nemzeti Bank. The analyses reflect the opinions of the authors, and may not necessarily coincide with the official stance of the MNB.

*Statistical publications:* the publication entitled Financial Accounts of Hungary was issued in 2005.

*Other publications:* the publication entitled Chart-pack on recent economic and financial market developments was issued in 2005.

All publications of the Magyar Nemzeti Bank are available on its website (<http://english.mnb.hu>). Certain publications are available in both English and Hungarian.

#### Events, lectures

**25 January** Péter Karádi–Judit Krekó–Gábor P. Kiss: *Structural Challenges Towards the Euro: Fiscal Policy*

**2 March** Gábor Békés: *Location of Manufacturing FDI in Hungary: How Important Are Inter-Company Relationships?*

Ádám Reiff: *Costs of Investment*

**30 March** Júlia Lendvai: *The Dynamics of Hungarian Inflation*

**27 April** András Rezessy: *Estimating the Immediate Impact of Monetary Policy Shocks on the Exchange Rate*

**8 June** Gábor P. Kiss–Gábor Vadas: *Mind the Gap – Watch the Ways of Cyclical Adjustment of the Budget*

**17-18 June** *International Research Meeting*

**22 June** Gábor Orbán–Zoltán Szalai: *Monetary Policy Transmission Before and After the Introduction of the Euro*

**29-30 Sept.** *International Research Meeting*

**19 October** Szilárd Benk–Zoltán Jakab–Gábor Vadas: *Potential Output Estimations for Hungary: A Survey of Different Approaches*

**27 October** Viktor Várpalotai: *The Optimal Horizon of Inflation Targeting in Hungary*

**9 November** Gábor Orbán–Dániel Palotai: *The Sustainability of the Hungarian Pension System: a Reassessment*

**16 November** Péter Kondor: *Risk in Dynamic Arbitrage: Price Effects of Convergence Trading*

**29 November** Zoltán M. Jakab–Viktor Várpalotai–Balázs Vonnák: *How Does Monetary Policy Affect Aggregate Demand? A Multimodel Approach for Hungary*

**15 December** Csilla Horváth–Judit Krekó–Anna Naszódi: *Is There a Bank Lending Channel in Hungary?*

**21 December** Péter Benczúr–Ilut Cosmin: *Determinants of Spreads On Sovereign Bank Loans: the Role of Credit History*

### 3.11. EXPLANATION OF ABBREVIATIONS AND TERMS SPECIFIC TO CENTRAL BANKING

#### Abbreviations

ALCO: Asset-Liability Committee

AMICO: Accounting and Monetary Income Committee (an ESCB committee)

BANCO: Banknote Committee (an ESCB committee)

BIS: Bank for International Settlements

BSC: Banking Supervision Committee (an ESCB committee)

BUCO: Budget Committee

CANSTAT: Central European Statistical Co-operation

CEBS: Committee of European Banking Supervisors

CSO: Central Statistical Office

DRC: Disaster Recovery Centre

EBA: Euro Banking Association, an organisation established by private banks to enhance the development of euro payment transactions. EBA Clearing S.A.S. operates clearing systems Euro1/STEP1 and STEP2.

ECCO: External Communications Committee (an ESCB committee)

EEA: European Economic Area, a free trade zone comprising the EU-25 Member States, Norway, Iceland and Liechtenstein.

ECB: European Central Bank

EIB: European Investment Bank

EMU: Economic and Monetary Union

EPC: European Payments Council

ERM II: an exchange rate mechanism starting from the third stage of EMU; its essence is that the currencies of non-euro area Member States are linked to the euro.

ESCB: European System of Central Banks

GIRO: Giro Clearing House Limited

HFSA: Hungarian Financial Supervisory Authority

IAC: Internal Auditors Committee (an ESCB committee)

ICS: Interbank Clearing System

IMF: International Monetary Fund

IRC: International Relations Committee (an ESCB committee)

ITC: Information Technology Committee (an ESCB committee)

KELER: Central Clearing House and Depository

LEGCO: Legal Committee (an ESCB committee)

MOC: Market Operations Committee (an ESCB committee)

MPC: Monetary Policy Committee (an ESCB committee)

O/N, overnight (deposit/loan)

OECD: Organisation for Economic Cooperation and Development

OSAP: National Statistical Data Collection Programme

PSSC: Payment and Settlement Systems Committee (an ESCB committee)

SAO: State Audit Office

SDDS: Special Data Dissemination Standard

SEPA: Single Euro Payments Area, the target of the EU in order to make the quality of payment transactions in the internal market attain the level of that of intra-member transactions in the foreseeable future.

STC: Statistics Committee (an ESCB committee)

SWIFT: Society for Worldwide Interbank Financial Telecommunication, an international society specialising in secure financial messaging

SWIFTnet: the IP-based closed network of SWIFT

TARGET: Trans-European Automated Real-time Gross Settlement Express Transfer system, the real-time gross settlement system of the euro area

VIBER: Real-Time Gross Settlement system, a payment system operated by the MNB

### Explanation of terms

**Settlement (clearing):** Control and transmission of payment transactions, calculation of interbank balances in accordance with specified rules; in case of securities transactions: matching and confirmation of positions, calculation of accounts receivable/payable, handling the arising financial risk.

**Chip migration:** Equipping bank cards with intelligent chips, which contributes to cracking down on abuses and allows for the provision of additional services.

**Foreign exchange swap:** A usually short-term transaction, consisting of the exchange of different currencies and, on closing the transaction, changing them back at the price determined in the contract by the cross rate and the interest rate of the currencies.

**EDP report:** Indicators compiled according to EU methodology regarding general government deficit and public debt, prepared jointly by the MNB, CSO and MF.

**IMF reserve quota:** the freely drawable, i.e. not yet drawn portion of the IMF quota paid to the International Monetary Fund in SDR (Special Drawing Right).

**Interest rate futures:** Interest rate futures is a stock exchange transaction where the basis of future settlement

is a determined amount of standardised (expressed-in-contract) deposits with interest determined when making the deal.

**Interest bearing currency swap transaction:** A usually medium or long-term transaction which comprises the exchange of different currencies, a series of interest payments on the principal and repayment of principals when closing the transaction.

**Interest rate swap:** the exchange of fix rate and variable rate – adjusted to market rates and certain conditions – interest on principal at special intervals.

**Revaluation reserve:** The revaluation reserve of the forint exchange rate and the revaluation reserve of foreign exchange securities are reserves that are part of the equity of the MNB, which, in the event of a negative balance, to the extent of the negative balance, are paid by the government budget to the adequate revaluation reserve by 31 March of the year following the year in question. This payment must be reported in the balance sheet of the year under review.

**Revaluation reserve due to exchange rate changes:** Exchange gains and exchange losses of foreign exchange assets and liabilities resulting from the changes in the forint exchange rate must be stated in the forint exchange rate revaluation reserve, which is a part of equity.

**Revaluation reserve of foreign exchange securities:** The valuation differential between the market value and purchase value of foreign exchange assets based on securities (except for bought-back foreign exchange bonds) must be reported in the revaluation reserve of foreign exchange securities which are a part of equity.

**Monetary financial institutions:** The central bank, the other financial institutions (credit institutions) and money market

funds together form this institutional category within financial corporations.

**Option transaction:** For the owner of the foreign exchange option it means a right, but not an obligation to buy or sell a certain amount of currency against another currency at a pre-determined rate, at or before a pre-determined date. For the seller (writer) of the option, if the possessor of the option practises the right, it is to be interpreted as an obligation.

**Money market funds:** Money market funds are those investment funds of which shares are similar to bank deposits from the aspect of liquidity. Money market funds invest 85% of their assets in money market instruments or transferable debt securities with a maximum one-year residual maturity or instruments with a return similar to that of the interest rate of money market instruments. Money market instruments: low-risk, liquid securities traded at markets with high turnover of significant quantities of securities, and where their changing into cash is possible immediately and at a low cost.

**Repo and reverse repo transaction:** An agreement on the transfer of ownership right of a security with a repurchase obligation at a determined price at a future date determined or to be determined when concluding the contract. Within the maturity of the transaction the buyer may obtain the security which is the subject of the transaction, and may freely dispose over it (delivery repo transaction) or may not obtain and may not freely dispose over it, and in this case the security is deposited as a bail to the benefit of the buyer during the maturity (hold-in-custody repo).

**STEP2:** A Pan-European clearing system for settling small-amount payments (transfers up to EUR 12,500).

**Settlement (clearing):** Final settlement of accounts payable and receivable between banks on the account with their common bank, which is usually the MNB.



## **Part B**

# **Audited Financial Statements of the Magyar Nemzeti Bank**





# 1. Independent auditor's report



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Cg. 01-09-267553

**This is a translation of the Hungarian report**

## **Independent Auditors' Report**

To the Shareholder of Magyar Nemzeti Bank

We have audited the accompanying balance sheet of Magyar Nemzeti Bank ("the National Bank") as at 31 December 2005, which shows a balance sheet total of HUF 4,711,038 million and a loss for the year of HUF 21,421 million, the related profit and loss account for the year then ended and the notes included in the National Bank's 2005 annual financial statements. The annual financial statements are the responsibility of the National Bank's management. The auditor's responsibility is to express an opinion on the financial statements based on the audit and to assess whether the business report is consistent with that presented in the financial statements.

We issued an unqualified opinion on 5 April 2005 on the National Bank's annual financial statements as at 31 December 2004.

We conducted our audit in accordance with Hungarian National Audit Standards and with applicable laws and regulations in Hungary. 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. Our work in respect to the business report was limited to the above-mentioned procedures, and did not include the review of other information derived from records of the National Bank not audited by us. We believe that our audit provides a reasonable basis for our opinion.

We have audited the elements of and disclosures in the annual financial statements, along with underlying records and supporting documentation, of Magyar Nemzeti Bank in accordance with Hungarian national audit standards and have gained sufficient and appropriate evidence that the annual financial statements have been prepared in accordance with the Act of LVIII of 2001, regulating the operations of the National Bank, and with the government decree of 221/2000 (XII.19.) regulating the accounting and preparation of the annual financial statements of the National Bank, and with the Hungarian accounting law and with generally accepted accounting principles in Hungary. In our opinion, the annual financial statements give a true and fair view of the equity and financial position of Magyar Nemzeti Bank in accordance with the relevant regulations as at 31 December 2005 and of the results of its operations for the year then ended. The business report corresponds to the disclosures in the financial statements.

Budapest, 21 March 2006

Ernst & Young Kft.  
Registration No.: 001165

Mariann Hergovits  
Registered Auditor  
Chamber membership No.: 004648

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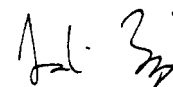
## 2. Balance sheet of the Magyar Nemzeti Bank

HUF millions

Note	ASSETS	31. 12. 2004	31. 12. 2005	Change
	1	2	3	3-2
	<b>I. Receivables denominated in forint</b>	<b>205,522</b>	<b>174,139</b>	<b>-31,383</b>
4.3.	1. Receivables from the central government	195,181	169,528	-25,653
4.14.	<i>of which: receivables to refund the revaluation reserve of foreign currency securities*</i>	1,112	14,816	13,704
4.7.	2. Receivables from credit institutions	9,583	3,924	-5,659
	3. Other receivables	758	687	-71
	<b>II. Receivables denominated in foreign currency</b>	<b>3,581,087</b>	<b>4,432,773</b>	<b>851,686</b>
4.9.	1. Gold and foreign currency reserves	2,847,446	3,931,059	1,083,613
4.4.	2. Receivables from the central government	402,883	117,253	-285,630
	3. Receivables from credit institutions	1,442	114	-1,328
4.10.	4. Other receivables	329,316	384,347	55,031
	<b>III. Banking assets</b>	<b>26,562</b>	<b>30,915</b>	<b>4,353</b>
4.12.	<i>of which: invested assets</i>	26,022	29,644	3,622
4.15.	<b>IV. Prepaid expenses/accrued income</b>	<b>85,546</b>	<b>73,211</b>	<b>-12,335</b>
	<b>V. TOTAL ASSETS (I+II+III+IV)</b>	<b>3,898,717</b>	<b>4,711,038</b>	<b>812,321</b>
Note	LIABILITIES AND EQUITY	31. 12. 2004	31. 12. 2005	Change
	1	2	3	3-2
	<b>VI. Liabilities denominated in forint</b>	<b>2,867,049</b>	<b>3,716,843</b>	<b>849,794</b>
4.5.	1. Central government deposits	265,460	175,039	-90,421
4.8.	2. Deposits by credit institutions	1,114,216	1,799,180	684,964
	3. Banknotes and coins in circulation	1,444,303	1,705,998	261,695
	4. Other deposits and liabilities	43,070	36,626	-6,444
	<b>VII. Liabilities denominated in foreign currency</b>	<b>906,570</b>	<b>817,220</b>	<b>-89,350</b>
4.5.	1. Central government deposits	49,101	108,476	59,375
	2. Deposits by credit institutions	7,244	4,319	-2,925
4.11.	3. Other deposits and liabilities	850,225	704,425	-145,800
4.13.	<b>VIII. Provisions</b>	<b>10</b>	<b>62</b>	<b>52</b>
	<b>IX. Other banking liabilities</b>	<b>9,626</b>	<b>10,796</b>	<b>1,170</b>
4.15.	<b>X. Accrued expenses/deferred income</b>	<b>47,599</b>	<b>33,216</b>	<b>-14,383</b>
4.16.	<b>XI. Equity</b>	<b>67,863</b>	<b>132,901</b>	<b>65,038</b>
	1. Share capital	10,000	10,000	0
	2. Retained earnings	81,123	38,357	-42,766
	3. Valuation reserve	0	0	0
4.14.	4. Revaluation reserve due to exchange rate changes	19,506	105,965	86,459
4.14.	5. Revaluation reserve of foreign currency securities	0	0	0
	6. Profit/Loss for the year	-42,766	-21,421	21,345
	<b>XII. TOTAL EQUITY AND LIABILITIES (VI+VII+VIII+IX+X+XI)</b>	<b>3,898,717</b>	<b>4,711,038</b>	<b>812,321</b>

\* Pursuant to the Article 17, par. (4) of the MNB Act in the case of a negative balance the central government refunds the negative balance by 31 March of the following year, which is to be booked in the balance sheet of the year under review.

21 March 2006



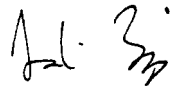
Zsigmond Járαι  
Governor of the Magyar Nemzeti Bank

### 3. Income statement of the Magyar Nemzeti Bank

HUF millions

Note	INCOME	2004	2005	Difference
	1	2	3	3-2
4.18.	I. Interest and interest related income denominated in forint	29,581	15,687	-13,894
	1. Interest on receivables from the central government	26,278	15,013	-11,265
	2. Interest on receivables from credit institutions	2,622	638	-1,984
	3. Interest on other receivables	46	29	-17
	4. Interest related income	635	7	-628
4.18.	II. Interest and interest related income denominated in foreign currency	214,009	218,278	4,269
	1. Interest on foreign currency reserves	75,917	101,550	25,633
	2. Interest on receivables from the central government	23,822	16,240	-7,582
	3. Interest on receivables from credit institutions	65	18	-47
	4. Interest on other receivables	4,159	3,827	-332
	5. Interest related income	110,046	96,643	-13,403
4.19.	III. Income arising from exchange rate changes	28,145	21,147	-6,998
4.18.	IV. Realised gains arising from financial operations	9,489	11,499	2,010
4.21.	V. Other income	2,507	3,560	1,053
	1. Fees and commissions	1,102	1,166	64
	2. Income other than fees and commissions	1,405	2,394	989
4.13.	VI. Provisions released	14	51	37
4.13.	VII. Impairment released	13	43	30
4.23.	VIII. Operating income	183	743	560
	IX. TOTAL INCOME (I+II+III+IV+V+VI+VII+VIII)	283,941	271,008	-12,933
Note	EXPENSES	2004	2005	Difference
	1	2	3	3-2
4.18.	X. Interest and interest related expense denominated in forint	141,592	132,503	-9,089
	1. Interest on central government deposits	39,711	28,940	-10,771
	2. Interest on deposits by credit institutions	97,647	100,476	2,829
	3. Interest on other deposits	4,234	3,087	-1,147
	4. Interest related expenses	0	0	0
4.18.	XI. Interest and interest related expenses denominated in foreign currency	143,302	119,089	-24,213
	1. Interest on government deposits	829	1,462	633
	2. Interest on deposits of credit institutions	533	285	-248
	3. Interest on other liabilities	32,380	27,293	-5,087
	4. Interest related expenses	109,560	90,049	-19,511
4.19.	XII. Expenses resulting from exchange rate changes	5,559	6,590	1,031
4.20.	XIII. Cost of issuing banknotes and coins	5,947	5,349	-598
4.18.	XIV. Realised losses arising from financial operations	16,100	12,836	-3,264
4.21.	XV. Other expenses	501	892	391
	1. Fees and commissions	389	503	114
	2. Expenses other than fees and commissions	112	389	277
4.13.	XVI. Provisions charged	24	103	79
4.13.	XVII. Impairment	11	0	-11
4.23.	XVIII. Operating cost and expenses	13,671	15,067	1,396
	XIX. TOTAL EXPENSES (X+XI+XII+XIII+XIV+XV+XVI+XVII+XVIII)	326,707	292,429	-34,278
	XX. Profit/Loss before dividends	-42,766	-21,421	21,345
	XXI. Dividends from retained earnings	0	0	0
	XXII. Dividends	0	0	0
	XXIII. PROFIT/LOSS FOR THE YEAR (XIX+XX-XXI)	-42,766	-21,421	21,345

21 March 2006

  
 Zsigmond Járai  
 Governor of the Magyar Nemzeti Bank

## 4. Notes to the financial statements

### 4.1. THE BANK'S ACCOUNTING POLICY

The Magyar Nemzeti Bank, the central bank of Hungary, is owned by the Hungarian State. Ownership rights are exercised by the Minister of Finance.

The accounting policies of the Magyar Nemzeti Bank are based on the Accounting Act (Act C of 2000), Act LVIII of 2001 on the Magyar Nemzeti Bank (hereinafter: MNB Act) and Government Decree 221/2000 (XII.19.) on special reporting and accounting requirements applicable to the Magyar Nemzeti Bank (hereinafter MNB Decree).

As of the effective day of the Act promulgating the international treaty on the accession of the Republic of Hungary to the EU i.e. 1 May 2004, the Magyar Nemzeti Bank has been a member of the European System of Central Banks.

The following section presents a brief description of the accounting system of the MNB, and the valuation and profit recognition rules, whenever such differ from the general rules.

#### 4.1.1. The MNB's accounting framework

One of the key accounting principles of the MNB is that transactions are booked for the period when they arise unless the financial year is already closed. This is especially important in the view of the accurate measurement of exchange rate gains and losses (see valuation rules), with special regard to foreign exchange sales and purchases. Spot foreign currency transactions that involve foreign exchange translations are recorded in the books at the date of the transactions. Assets and liabilities arising from such transactions affect the MNB's foreign currency position from the day entering into a transaction. The same procedure is applied to recording the translation difference in the balance sheet relating to derivative transactions for hedging purposes.

On a daily basis the MNB records:

- the exchange rate difference arising from the revaluation of its foreign assets and liabilities and derivative transactions for hedging purposes recorded off-balance sheet, and
- the accrued/deferred interest arising on in- and off-balance sheet assets and liabilities from hedging transactions.

Pursuant to the MNB Decree, for the purpose of reporting data to the owner, the MNB is required to close accounts relating to its assets and liabilities and to net income on a quarterly basis, and prepare trial balances following the procedure specified under its accounting policies.

For internal use, the MNB draws up a balance sheet and income statement every month, which are supported by the following:

- market valuation of foreign currency securities, with the exception of foreign currency bonds issued and repurchased by the Bank,
- allocation and recording of realised and unrealised parts of foreign exchange gains and losses arising on the daily revaluation, and
- charging depreciation.

Upon the quarterly closing of accounts, the MNB qualifies its contingent liabilities and claims, commitments and future receivables originating from derivative transactions for other purposes stated among off-balance sheet assets and liabilities.

ities, at the end of the year the invested assets, claims and other off-balance sheet liabilities. It then recognises impairment loss as necessary and makes provisions for liabilities and for expected losses.

The balance sheet date is 15 January of the year following the reporting year.

By law, the MNB is also obliged to report to Parliament. The MNB submits one single report to both Parliament and the Ministry of Finance, which exercises the rights of ownership as laid down in the MNB Act. This is in the form of an Annual Report, which contains the MNB's annual financial statements as defined by the Accounting Act, and a business report describing the MNB's structure, operations and state of affairs in the reporting year. The Annual Report is published unabridged both in print and on the Internet.

The MNB Decree does not require the Bank to draw up consolidated financial statements. Consequently, as investments have no considerable impact on its balance sheet or profit, the MNB does not prepare consolidated financial statements.

The person authorised to sign the Annual Report is the Governor of the Bank, Mr Zsigmond Járαι, residing at 1/B Rózsahegy u., 1024 Budapest.

The person responsible for the accounting services is Éva Gyöngyösy, Head of the Accounting and Finance Department and the Department of Management Reporting and Budgeting, MKVK membership number: 005792.

#### **4.1.2. Major principles of valuation**

##### **Receivables from the central government**

The securities stated among the receivables from the central government are recorded in the balance sheet at purchase price net of interest. The difference between the purchase price excluding interest and face value is stated in the MNB's income statement as a valuation gain or loss in proportion to the time elapsed.

The receivables from the central government also include receivables associated with the reimbursement of revaluation reserves (due to their negative year-end balance).

No provision for impairment loss may be recorded in connection with receivables from the central government.

##### **Valuation of foreign currency assets and liabilities and the recording of exchange rate gains**

The MNB records in its books all foreign currency assets and liabilities at the official exchange rate prevailing on the day of purchase. If a foreign currency asset or liability is created as a result of foreign exchange conversion, then the exchange rate gain or loss arising from the difference between the actual conversion rate and the official rate is recorded as translation income for that particular day and is stated under gains from exchange rate changes in the income statement.

With the exception of suppliers' foreign currency liabilities and foreign currency accruals, the MNB carries out a daily revaluation of all foreign currency assets and liabilities as well as off-balance sheet assets and liabilities arising from derivative transactions for hedging purposes, taking account of variations in the official exchange rate. As a result of this revaluation, balance sheet items denominated in foreign currency are stated in an amount translated at the official exchange rate prevailing on 31 December (fixing).

Income received in foreign currency is stated at the official exchange rate prevailing on that particular day.

Daily accounting for accrued income is preceded by reversing the accrued income on the previous day. This implies that foreign currency accruals are recorded in the balance sheet at the official exchange rate without revaluation.

Of the foreign exchange gains and losses arising in the course of the daily revaluation, realised exchange rate gain can be

stated as a profit item, while unrealised income is stated under equity, in the item 'Revaluation reserve due to exchange rate changes'.

Realised income is created as a result of selling and buying foreign currency. The latter occurs when the assets in a given currency are exceeded by counterpart liabilities. Realised income arises as the difference between the value of the traded foreign currency at the official exchange rate and the average acquisition price.

### **Foreign currency securities**

Foreign currency securities are stated at market price. The difference between the market value on valuation day and the book value is recorded in the revaluation reserve of foreign currency securities. Gains or losses realised on selling securities are stated within 'Realised gains/losses arising from financial operations'.

The Magyar Nemzeti Bank values its securities on the basis of market prices prevailing on 31 December in respect of securities quoted on American stock exchanges. Due to the fact that 31 December is not a trading day on European stock exchanges, securities quoted there are valued on the basis of market prices prevailing on 30 December.

Securities issued by the MNB abroad and subsequently repurchased must be recognised in the item 'Other foreign currency receivables', i.e. in gross. Repurchased own-issue foreign currency bonds are valued at historic cost. Interest on repurchased bonds is recorded under both income and expenses.

Security repurchase transactions are reported as credit/deposit transactions, while the related receivables or liabilities are stated as off-balance sheet items.

### **Accounting rules relating to the IMF quota**

Part of the IMF quota subscribed in foreign currency and denominated in SDR is stated under foreign exchange reserve.

The other part of the quota, which does not have to be transferred to the IMF, is presented 'Other foreign currency receivables' in the balance sheet. The related IMF forint deposit is presented in the liabilities side of the balance sheet. It is the MNB's duty to ensure at least annually that the amount of the IMF's forint deposit is identical to the forint equivalent of the SDR value of the unsubscribed part of its quota. As this deposit account is a HUF account only formally, it is stated under 'Other foreign currency receivables' in the balance sheet.

### **Accounting rules relating to derivatives**

On the basis of transaction purpose, the MNB distinguishes between two groups of derivative transactions: hedging transactions and derivatives transactions for other purposes.

Hedging transactions are defined as transactions which are aimed at reducing the risk arising from changed in the exchange rate or market value of a specific asset or liability or position, are directly related to such and are announced as hedging transactions at the start of a deal. Derivative transactions with the government or non-resident counterparts on behalf of the government are also regarded as hedging transactions.

Derivative transactions must be stated among off-balance sheet assets and liabilities. The aggregate revaluation difference of foreign currency assets and liabilities arising from hedging transactions must be stated in the balance sheet (depending on their balance, either in the item 'Other foreign currency receivables or liabilities', or 'Foreign currency receivables from or liabilities to the central government'), including the interest accrued in proportion to time elapsed (as accrued income or accrued expenses).

When derivative transactions for purposes other than hedging are closed, the income from such transactions must be stated in the lines of income and expenses arising from exchange rate changes when foreign exchange transactions are involved, and in the lines of interest income and interest expenses in the case of transactions linked to interest rate

changes. While such transactions are not translated, consistent with the principle of prudence, a quarterly provision shall be made equalling the negative market value of the transaction.

### Banking assets and liabilities

Banking assets and liabilities are stated on the respective sides of the balance sheet. These are the following:

- assets and liabilities not directly related to central bank functions and bank operations (such as settlements relating to taxes, contributions, payments to personnel, creditors, precious metals unsold held for non-central bank purposes), as well as
- liabilities arising from banknotes no longer accepted as legal tender but not yet exchanged,
- investments, and
- assets required for operating the organisation (such as intangibles, tangibles, inventories).

### Depreciation rates applied by the Magyar Nemzeti Bank

Description	31. 12. 2005
Intellectual property	33.0%
Foundation-restructuring (maximum)	20.0%
Buildings	3.0-5.0%
Vehicles	20.0-33.0%
Telecommunication devices, office equipment, machines	6.5-33.0%
Computer hardware	33.0%
Emission machinery	20.0%
Instruments	33.0%
Bank security devices	14.5-33.0%
Other not specified devices*	14.5%

\* *Other non-specified devices above, for example office equipment, other equipment and devices.*

The above depreciation rate of assets and the useful lives indicated are reference values; any deviation from this is allowed depending on the actual time of use. In the case of intellectual property and in particular software there may be deviations from the depreciation rate.

The table does not show the depreciation rates for patents and similar rights, or property rights, as the Bank sets the applicable depreciation rate based on the useful life of the related property or as set out in an underlying contract. Depreciation is charged on a straight line basis.

The depreciation rates applied did not change relative to 2004.

In the MNB's balance sheet only housing loans provided by the Bank to its employees via OTP are presented among liquid assets. The central bank is the exclusive issuer of banknotes and coins. Notes and coins stored with the Cashier and in the Depository are not in circulation and therefore are deducted from banknotes and coins on the liabilities side of the balance sheet.

## 4.2. EFFECTS OF MACROECONOMIC TRENDS ON THE YEAR 2005 BALANCE SHEET AND INCOME STATEMENT OF THE MAGYAR NEMZETI BANK

The balance sheet and income statement of the Magyar Nemzeti Bank are primarily influenced by the objectives of monetary policy, as well as by domestic and international economic events.

Compared to the previous year, net interest received and interest related income increased by HUF 23.7 billion. The numerous cuts in the central bank base rate throughout the year resulted in an annual average central bank base rate of 7.2% in 2005, in comparison with 11.4% in 2004.

Due to the 2.8% depreciation of the forint, the value of foreign currency receivables and liabilities increased in forint terms. As a result, the revaluation effect for the whole year of 2005 was a gain of HUF 101 billion. The Bank realised a profit of HUF 14.5 billion from sales; thus the revaluation reserve increased by HUF 86.5 billion to a year-end amount of HUF 105.9 billion.

Compared to the end of 2004, foreign exchange reserves increased; this increase mainly explains the HUF 28.5 billion increase of the foreign exchange interest and interest related income.

For details about factors with an impact on income, see Section 3.8. of the Business Report.

### 4.3. FORINT RECEIVABLES FROM THE CENTRAL GOVERNMENT

HUF millions

B/S line	Terms to maturity	Balance		Change
		31. 12. 2004	31. 12. 2005	
	Government bonds maturing within one year	4,000	4,000	0
	Government bonds maturing within one to five years	27,795	8,302	-19,493
	Government bonds maturing over five years	162,274	142,410	-19,864
	<b>Securities</b>	<b>194,069</b>	<b>154,712</b>	<b>-39,357</b>
	Receivables to refund the revaluation reserve of foreign currency securities	1,112	14,816	13,704
I.1.	<b>Total</b>	<b>195,181</b>	<b>169,528</b>	<b>-25,653</b>

The increase of more than HUF 39 billion in the portfolio of government securities is partly due to a scheduled repayment related to an amortising bond (to be repaid annually over five years) totalling a HUF 4 billion, and the sale of two government bonds.

Receivables due to a negative balance of the revaluation reserve at the end of 2005 related to the market valuation of foreign currency securities amounted to HUF 14.8 billion, which, based on the MNB Act, the central government is obliged to reimburse by 31 March 2006 and which thus must be stated under 'Receivables from the central government' in the year-end balance sheet.

In 2005, there was no profit from the withdrawal of notes and coins; therefore there was no change in the related receivables from the central government (pursuant to the MNB Act, the profit from the withdrawal of notes and coins should not be stated in the income statement of the MNB but rather should be used for servicing the central government's outstanding debt to the MNB).

### 4.4. FOREIGN CURRENCY CREDITS TO THE CENTRAL GOVERNMENT AND RELATED HEDGING TRANSACTIONS

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
II.2.	Foreign currency receivables from the central government	402,883	117,253	-285,630
	Receivables from central government due from debt swap	331,469	91,931	-239,538
	Swap transactions with maturity over 1 year	71,414	25,322	-46,092

Foreign currency credits vis-à-vis the central government originate from the debt exchange conducted in 1997; their portfolio decreased to HUF 117.3 billion in 2005, due to maturities and prepayments (part of the privatisation income from the sale of the Budapest Airport was used by the central government for prepayment of its foreign exchange debt vis-à-vis the MNB).

The prepayment was carried out at market value, whereby the MNB realised interest income of HUF 15.2 billion.

Hedging transactions with the central government are stated on either the assets or liabilities side of the balance sheet, depending on whether they have a net debit or credit balance.

**Foreign currency receivables from the central government by remaining maturity**

HUF millions

B/S line	Remaining maturity	Balance		Change
		31. 12. 2004	31. 12. 2005	
II.2.	Foreign currency receivables from the central government	402,883	117,253	-285,630
	– within 1 year	76,015	17,364	-58,651
	– within 1 to 5 years	208,586	3,183	-205,403
	– over five years	118,282	96,706	-21,576

**Currency structure of foreign currency credits to the central government (without long-term swaps concluded with the central government)**

HUF millions

Nr	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
1.	Foreign currency receivables from the central government	331,469	91,931	-239,538
2.	– USD	36,058	42,716	6,658
3.	– JPY	295,411	49,215	-246,196

**Currency structure of long-term swaps concluded with the central government**

HUF millions

Nr	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
1.	Swap receivables (2+3+4)	686,479	322,371	-364,108
2.	– USD	56,910	0	-56,910
3.	– EUR currency group*	608,468	322,371	-286,097
4.	– JPY	21,101	0	-21,101
5.	Swap payables (6+7+8)	615,065	297,049	-318,016
6.	– USD	261,236	235,751	-25,485
7.	– EUR currency group*	37,317	12,084	-25,233
8.	– JPY	316,512	49,214	-267,298
9.	Net swap receivables (1-5)	71,414	25,322	-46,092

\* The euro currency group includes the euro, the currencies of the EMU member countries and other European currencies (such as GBP, CHF) that may be listed here with regard to foreign exchange risk.

**4.5. FORINT AND FOREIGN CURRENCY DEPOSITS OF THE CENTRAL GOVERNMENT**

**Forint deposits of the central government**

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
	Single Treasury Account (KESZ)	180,681	33,290	-147,391
	Deposit by State Privatisation and Holding Co. (ÁPV Rt.)	84,404	141,429	57,025
	Deposit by Government Debt Management Agency (ÁKK Rt.)	300	256	-44
	Hungarian State Treasury	11	0	-11
	Other	64	64	0
VI.1.	Total deposits	265,460	175,039	-90,421

**Foreign currency deposits of the central government**

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
	Foreign currency deposits of the central government	48,994	108,473	59,479
	Foreign currency deposits of the Hungarian State Treasury	0	0	0
	Other than money market deposits of the central government	107	3	-104
	Short-term derivatives	0	0	0
VII.1.	<b>Total deposits</b>	<b>49,101</b>	<b>108,476</b>	<b>59,375</b>

**Foreign currency deposits of the central government in a breakdown by remaining maturity**

HUF millions

B/S line	Remaining maturity	Balance		Change
		31. 12. 2004	31. 12. 2005	
	– within 1 year	49,101	108,476	59,375
	– within 1 to 5 years	0	0	0
	– over five years	0	0	0
VII.1.	<b>Total deposits</b>	<b>49,101</b>	<b>108,476</b>	<b>59,375</b>

The short-term foreign currency deposits of the central government increased by HUF 59.3 billion relative 31 December 2004.

**4.6. NET POSITIONS VIS-À-VIS THE CENTRAL GOVERNMENT**

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
I.1–VI.1.	Net forint position	-70,279	-5,511	64,768
II.2–VII.1.	Net foreign currency position	353,782	8,777	-345,005
	<b>Total</b>	<b>283,503</b>	<b>3,266</b>	<b>-280,237</b>

**4.7. FORINT RECEIVABLES FROM CREDIT INSTITUTIONS**

HUF millions

**Forint receivables from credit institutions**

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
	<b>Receivables from credit institutions</b>	<b>11,389</b>	<b>5,688</b>	<b>-5,701</b>
	Security-backed loans	2,106	2,622	516
	Liquidity refinancing credit on credit institutions in liquidation/ pending liquidation	1,571	1,571	0
	Loans granted for foreign currency deposits	2,708	1,040	-1,668
	Long-term refinancing credit	998	455	-543
	Liquidity refinancing credit on credit institutions	4,006	0	-4,006
	<b>Impairment provision for claims on credit institutions</b>	<b>-1,806</b>	<b>-1,764</b>	<b>42</b>
I.2.	<b>Total receivables</b>	<b>9,583</b>	<b>3,924</b>	<b>-5,659</b>

Part of the receivables from credit institutions are preferential loans associated with the earlier role of the MNB in the implementation of the government's economic policy and thus are not linked with any of the central bank functions. Consequently, since 2001, the Bank has made efforts to reduce such outstanding loans. The decrease in preferential loans in 2005 was due to repayments.

In the reporting year, the stock of liquidity refinancing credit on credit institutions was replaced by overnight loans granted for foreign currency, this change is also reflected in the general ledger.

The table below lists forint credits in a breakdown of remaining maturity.

B/S line	Remaining maturity	Balance		Change
		31. 12. 2004	31. 12. 2005	
	– within 1 year	9,318	5,385	-3,933
	– within 1 to 5 years	2,065	303	-1,762
	– over five years	6	0	-6
	<b>Receivables from credit institutions</b>	<b>11,389</b>	<b>5,688</b>	<b>-5,701</b>

HUF millions

#### 4.8. NET POSITIONS VIS-À-VIS CREDIT INSTITUTIONS

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
I.2–VI.2.	Net forint position	-1,104,633	-1,795,256	-690,623
II.3–VII.2.	Net foreign exchange position	-5,802	-4,205	1,597
	<b>Total</b>	<b>-1,110,435</b>	<b>-1,799,461</b>	<b>-689,026</b>

HUF millions

The forint receivables from credit institutions increased by HUF 690.6 billion as at 31 December 2005, explained by a HUF 684.9 billion rise in credit institutions' forint deposits.

#### 4.9. GOLD AND FOREIGN EXCHANGE RESERVES OF THE CENTRAL BANK

##### Forint balances

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
	Gold reserve	7,797	10,840	3,043
	Reserve position in the IMF	96,627	41,072	-55,555
	Foreign currency deposits	282,146	550,863	268,717
	Foreign currency securities	2,352,253	3,150,888	798,635
	Foreign currency repo transactions	108,623	177,396	68,773
II.1.	<b>Total gold and foreign currency reserves</b>	<b>2,847,446</b>	<b>3,931,059</b>	<b>1,083,613</b>

HUF millions

For statistical purposes, the MNB publishes the amount of the gold and foreign currency reserves regularly. According to the statistical rules, foreign currency reserves also include its accumulated interest, consequently the gold and foreign currency reserves differ in amount according to statistical and accounting rules.

Foreign exchange reserves increased by EUR 3.9 billion, equivalent to HUF 1,083 billion.

Around half of the increase is a result of the issue of foreign currency bonds by the Republic of Hungary, while the other half originates from a single considerable privatisation income (Budapest Airport) in December.

The major part of the foreign currency revenue originating from the issue of foreign currency bonds in the amount of EUR 3.5 billion by the Republic of Hungary was converted to forints by the ÁKK at the MNB; a smaller proportion was spent on prepayment of the foreign exchange debt of the central government vis-à-vis the MNB.

**Euro balances**

EUR millions

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
	Gold reserve	32	43	11
	Reserve position in the IMF	393	162	-231
	Foreign currency deposits	1,147	2,180	1,033
	Foreign currency securities	9,565	12,467	2,902
	Foreign currency repo transactions	442	702	260
II.1.	<b>Total gold and foreign currency reserves</b>	<b>11,579</b>	<b>15,554</b>	<b>3,975</b>

**4.10. OTHER FOREIGN CURRENCY RECEIVABLES**

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
	Forint payment of IMF quota	193,149	275,876	82,727
	Repurchased bonds	130,236	108,283	-21,953
	Foreign hedging transactions*	5,704	0	-5,704
	Other	227	188	-39
II.4.	<b>Other foreign currency receivables</b>	<b>329,316</b>	<b>384,347</b>	<b>55,031</b>

\* The revaluation difference of hedging derivatives transactions is stated in net terms, in accordance with the MNB Act.

Bonds issued abroad and later repurchased by the MNB decreased by HUF 21.9 billion as these matured.

**4.11. OTHER LIABILITIES IN FOREIGN CURRENCY****Other foreign currency liabilities at the end of the period**

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
	Bonds	503,361	315,716	-187,645
	Repo transactions	37,205	51,031	13,826
	IMF forint deposit	193,149	275,876	82,727
	Foreign deposits and loans	14,262	9,513	-4,749
	Hedging transactions	89,092	46,006	-43,086
	Other liabilities	13,156	6,283	-6,873
VII.3.	<b>Other foreign currency liabilities</b>	<b>850,225</b>	<b>704,425</b>	<b>-145,800</b>

As a result of repayments and pre-instalments, foreign currency bonds declined by HUF 187.6 billion. For the most part 'Hedging transactions' include the net credit balance of long-term currency swaps with non-residents.

**Other foreign currency receivables in a breakdown of remaining maturity**

HUF millions

B/S line	Remaining maturity	Balance		Change
		31. 12. 2004	31. 12. 2005	
	- within one year	475,902	365,425	-110,477
	- within one to five years	211,430	201,239	-10,191
	- over five years	162,893	137,761	-25,132
VII.3.	<b>Other foreign currency liabilities</b>	<b>850,225</b>	<b>704,425</b>	<b>-145,800</b>

**Currency structure of other foreign currency liabilities (excluding hedging transactions)**

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005.	
	USD	58,457	51,879	-6,578
	EUR currency group*	103,980	57,662	-46,318
	JPY	404,432	273,000	-131,432
	Other	194,264	275,877	81,613
<b>VII.3.</b>	<b>Other foreign currency liabilities</b>	<b>761,133</b>	<b>658,418</b>	<b>-102,715</b>

\* The euro currency group includes the euro, the currencies of the EMU member countries and other European currencies (such as GBP, CHF) that may be listed here with regard to foreign exchange risk.

Other foreign currency liabilities include a HUF 275.9 billion deposit by the IMF.

**Hedging transactions vis-à-vis non-residents by currency**

HUF millions

Nr	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
1.	Hedging transactions receivables (2+3+4)	688,522	989,927	301,405
2.	– USD	311,242	308,509	-2,733
3.	– EUR currency group*	16,808	453,918	437,110
4.	– JPY	360,472	227,500	-132,972
5.	Hedging transactions payables (6+7+8)	777,614	1,035,933	258,319
6.	– USD	102,796	470,263	367,467
7.	– EUR currency group*	674,570	530,140	-144,430
8.	– JPY	248	35,530	35,282
9.	Net hedging transactions payables (5-1)	89,092	46,006	-43,086

\* The euro currency group includes the euro, the currencies of the EMU member countries and other European currencies (such as GBP, CHF) that may be listed here with regard to foreign exchange risk.

## 4.12. INVESTED ASSETS

In addition to intangibles, tangibles and capital expenditure (HUF 11.9 billion), invested assets include share in investments (HUF 17.7 billion).

### Changes in the gross value, depreciation and net value of intangibles, tangibles and capital expenditure

HUF millions

	Assets							
	Immaterial goods		Buildings	Equipment	Assets of banknote and coin	Tangible assets of MNB, total	Work in progress and advances given	Intangibles, tangibles and investments, total
	Intangible assets	Software under development						
<b>Gross value</b>								
31. 12. 2004	6,295	375	8,147	8,424	196	16,767	391	23,828
Installation	984	0	143	789	10	942	1 340	3 266
Other	0	0	0	-505	0	-505	0	-505
Disposal	0	0	0	-7	0	-7	0	-7
Selling	0	0	0	-29	0	-29	0	-29
Transfer free of charge	0	0	0	-60	0	-60	0	-60
Other deduction	-416	-156	0	0	0	0	0	-572
31. 12. 2005	6,863	219	8,290	8,612	206	17,108	1,731	25,921
<b>Details of depreciation</b>								
31. 12. 2004	4,988	0	2,167	5,932	0	8,099	0	13,087
Planned depreciation	706	0	230	936	0	1,166	0	1,872
Extraordinary depreciation	0	0	0	0	0	0	0	0
Depreciation due to damage	0	0	0	0	0	0	0	0
Increase due to reclassification	0	0	0	0	0	0	0	0
Interim increase due to removal from the account	0	0	0	-40	0	-40	0	-40
Decrease due to reclassification	-415	0	0	-497	0	-497	0	-912
31. 12. 2005	5,279	0	2,397	6,331	0	8,728	0	14,007
<b>Closing net value</b>								
31. 12. 2004	1,307	375	5,980	2,492	196	8,668	391	10,741
31. 12. 2005	1,584	219	5,893	2,281	206	8,380	1,731	11,914
Change	277	-156	-87	-211	10	-288	1,340	1,173

**Investments and dividends from investments**

HUF millions

Description	Ownership share (per cent)		Book value		Dividends received*	
	31. 12. 2004	31. 12. 2005	31. 12. 2004	31. 12. 2005	2004	2005
BIS (HUF millions, SDR millions) gold millions CHF)	1.33	1.43	2,790.6 10 0	5,247.5 10 13	545	562
European Central Bank (HUF millions, thousand EUR)	1.4	1.4	1,330 5,408	1,367 5,408	0	0
SWIFT (HUF millions, thousand EUR)	0.02	0.02	0.4 1.8	2.2 8.6	0	0
Pénzjegynyomda Zrt.	100.0	100.0	8,927	8,927	234	288
Magyar Pénzverő Zrt.	100.0	100.0	575	575	239	125
KELER Zrt.	53.3	53.3	643	643	138	1,067
GIRO Elszámolásforgalmi Zrt.	14.6	7.3	91	46	189	134
MNB Üdültetési és Jóléti Szolg. Kft.	100.0	100.0	602	602	0	0
Budapesti Értéktőzsde	6.9	6.9	321	321	24	0
<b>Total investments</b>			<b>15,281</b>	<b>17,730</b>	<b>1,369</b>	<b>2,176</b>

\* Dividends financially settled in the given year.

On 1 May 2004, Hungary joined the European Union, and consequently the MNB became a member of the European System of Central Banks (ESCB). The ESCB consists of the European Central Bank and the national central banks of the 25 EU Member States.

Pursuant to the provisions of Article 28 in the Statutes of the ESCB and the ECB (hereinafter referred to as "the Statutes"), the MNB has become a subscriber to the capital of the ECB.

## Ownership distribution in the ECB as of 1 May 2004

National Central Banks (NCB)	Subscribed capital	Paid-up capital	Capital key (per cent)
	thousand EUR		
Nationale Bank van België / Banque Nationale de Belgique	141,910	141,910	2.5502
Deutsche Bundesbank	1,176,171	1,176,171	21.1364
Bank of Greece	105,584	105,584	1.8974
Banco de España	432,698	432,698	7.7758
Banque de France	827,533	827,533	14.8712
Central Bank and Financial Services Authority of Ireland	51,301	51,301	0.9219
Banca d'Italia	726,278	726,278	13.0516
Banque centrale du Luxembourg	8,725	8,725	0.1568
De Nederlandsche Bank	222,336	222,336	3.9955
Oesterreichische Nationalbank	115,745	115,745	2.0800
Banco de Portugal	98,233	98,233	1.7653
Suomen Pankki-Finlands Bank	71,712	71,712	1.2887
<b>Total euro area NCBs</b>	<b>3,978,226</b>	<b>3,978,226</b>	<b>71.4908</b>
Danmarks Nationalbank	87,159	6,101	1.5663
Sveriges Riksbank	134,292	9,400	2.4133
Bank of England	800,322	56,023	14.3822
Česká národní banka	81,155	5,681	1.4584
Eesti Pank	9,927	695	0.1784
Central Bank of Cyprus	7,234	506	0.1300
Latvijas Banka	16,572	1,160	0.2978
Lietuvos bankas	24,624	1,724	0.4425
Magyar Nemzeti Bank	77,260	5,408	1.3884
Central Bank of Malta / Bank Centrali ta' Malta	3,600	252	0.0647
Narodowy Bank Polski	285,913	20,014	5.1380
Banka Slovenije	18,614	1303	0.3345
Národná banka Slovenska	39,771	2784	0.7147
<b>Total non-euro area NCBs</b>	<b>1,586,443</b>	<b>111,051</b>	<b>28.5092</b>
<b>Total euro area and non-euro area NCBs</b>	<b>5,564,669</b>	<b>4,089,277</b>	<b>1.000.000</b>

Sub-item 'Invested assets' among 'Banking assets' in the balance sheet of the MNB represents the MNB's participating interest in the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the ESCB Statute and which must be adjusted every five years. Based on demographic and GDP data provided by the European Commission, Hungary's share in the ECB's capital is 1.3884%.

As Hungary does not participate in the euro area, pursuant to Article 48 of the Statute, under transitional provisions it was required to contribute 7% of its share, i.e. EUR 5.4 million (HUF 1.4 billion), to the ECB's share capital upon its accession to the European Union on 1 May 2004.

On 1 July 2004, the Magyar Nemzeti Bank undertook participation in the London-based CEBS Secretariat Ltd. established under UK law to provide, pursuant to its deed of foundation, administrative services to the Committee of European Banking Supervisors. Every year members contribute their respective quotas to its operating costs according to an annual payment schedule. As membership required the investment of a mere GBP 1, it is not recorded in the MNB's books.

**Key indicators of domestic investments (preliminary data)**

HUF millions

Investment	Equity less profit/loss for the reporting year	Share capital	Reserves	Profit/loss for the year	Profit/loss for the year
	31. 12. 2005	31. 12. 2005	31. 12. 2005	2004	Preliminary 2005
Budapesti Értéktőzsde Rt. 1052 Budapest, Deák Ferenc u. 5.	7,387	541	6,846	1,038	2,000
GIRO Elszámolásforgalmi Zrt. 1054 Budapest, Vadász utca 31.	5,026	2,496	2,530	0	300
KELER Zrt. 1075 Budapest, Asbóth utca 9–11.	14,158	4,500	9,658	1,523	1,561
Magyar Pénzverő Zrt. 1089 Budapest, Könyves Kálmán krt. 38.	1,082	575	507	0	0
Pénzjegynyomda Zrt. 1055 Budapest, Markó utca 13–17.	9,287	8,927	360	25	0
MNB Üdültetési és Jóléti Szolgáltató Kft. 1054 Budapest, Vadász utca 16.	794	602	192	-10	41

**The MNB's receivables from and liabilities to affiliated companies**

HUF millions

Investment	Receivables	Liabilities
Budapesti Értéktőzsde Rt.	0.0	0.0
GIRO Elszámolásforgalmi Zrt.	0.0	0.5
KELER Zrt.	0.0	1.5
Magyar Pénzverő Zrt.	0.8	1.9
Pénzjegynyomda Zrt.	0.0	248.1
MNB Üdültetési és Jóléti Szolg. Kft.	0.0	0.0
<b>Total</b>	<b>0.8</b>	<b>252.0</b>

The above table specifies short-term liabilities.

In compliance with the MNB's investment strategy and the relevant provisions of the MNB Act, the MNB intends to sell its shares in all companies whose operations are not related to those of the Bank.

In addition to banknotes, **Pénzjegynyomda Zrt.** produces documents, tax stamps and securities, primarily for institutional users. Over the longer term, after adoption of the euro, forint banknotes will no longer be issued. According to the MNB's decision, Pénzjegynyomda Zrt. will not produce euro banknotes in the future. As this may incur potential but presently unquantifiable losses for MNB, the Bank has not recognised an impairment loss on the investment.

**Magyar Pénzverő Zrt.** produces circulation and commemorative coins. When capacity allows, it performs contractive work for foreign markets and also produces non-legal tender precious metal coins. The company also sell precious and base metal coins constituting legal tender and issued by the MNB, both internationally and locally. The MNB's long-term strategy includes the preparation of Pénzverő Zrt. for the production of euro coins.

**GIRO Elszámolásforgalmi Zrt.** was established to perform clearing and interbank settlement transactions. In 2005, the MNB sold 50% of its shares in the GIRO Zrt.

**MNB Üdültetési és Jóléti Szolgáltató Kft.** (Bankjóléti Kft.) was founded to attend to the MNB's social and welfare responsibilities. This company manages the vacation houses and sport facilities which were contributed to it by the MNB. The MNB's management made a decision in 2002 to wind the company up. The liquidation process is in progress.

**4.13. IMPAIRMENT LOSS AND PROVISIONS**

HUF millions

B/S line	Description	31. 12. 2004	Interim changes in 2005			31. 12. 2005
		Loss in value/provisions	Increase (+)	Use/ release (-)	Interim exchange rate effect due to Increase, Use/Release	Total loss in value/provisions (3+4+5)
1	2	3	4	5	6	7
I/2.	Forint receivables from credit institutions	1,805.7	0.0	-42.2	0.0	1,763.5
II/3.	Foreign currency receivables from credit institutions	0.0	0.0	0.0	0.0	0.0
II/4.	Other foreign currency receivables	0.0	0.0	0.0	0.0	0.0
III.	Invested assets	0.0	0.0	0.0	0.0	0.0
III.	Other assets	444.1	0.0	-0.9	0.0	443.2
VIII.	Liabilities	10.3	51.9	0.0	0.0	62.2
	<b>Total</b>	<b>2,260.1</b>	<b>51.9</b>	<b>-43.1</b>	<b>0.0</b>	<b>2,268.9</b>

Impairment loss and provisions increased by a moderate HUF 8.8 million in 2005.

The provision for the negative market value of derivatives held for non-hedging purposes, shown in the liabilities line, resulted in an increase of HUF 51.9 million on end-2004.

Due to a partial collection of a receivable from a credit institution, HUF 42.2 million of the impairment loss was reversed.

**4.14. REVALUATION RESERVES**

HUF millions

	Description	31. 12. 2004	31. 12. 2005	Change
1.	Revaluation reserve due to exchange rate changes	19,506	105,965	86,459
2.	Revaluation reserves of foreign exchange securities*	0	0	0
3.	<b>Revaluation reserves (1+2)</b>	<b>19,506</b>	<b>105,965</b>	<b>86,459</b>

\* The end-2005 balance on the revaluation reserve of foreign currency securities indicated a loss of HUF 14,316 million, which the central government is obliged to reimburse by 31 March 2006, and thus is no longer included among revaluations reserves but in the line 'Receivables from the central government'. (For the same reason the loss of the revaluation reserve in the year 2004 was included in the aforementioned line.)

In the course of 2005, the official exchange rate of the forint vis-à-vis the euro depreciated by 2.8%. As a result, the revaluation reserves (the unrealised revaluation of the net foreign exchange position, calculated as a difference between the purchase and the official exchange rate) increased by HUF 86.5 billion, to stand at HUF 105.9 billion at the end of the year.

The net foreign exchange position of the MNB increased by EUR 3.9 billion (by HUF 1,053 billion) to EUR 14.5 billion (HUF 3,661.1 billion).

**Annual changes in the forint exchange rate, 2004-2005 (+ appreciation / - depreciation)**

	MNB official mid-exchange rate
End-of-period exchange rate	
31. 12. 2004 (EUR)	245.93
31. 12. 2005 (EUR)	252.73
Annual appreciation*	
In 2004	6.2%
In 2005	-2.8%

\* + appreciation / - depreciation.

**4.15. PREPAID EXPENSES/ACCRUED INCOME AND ACCRUED EXPENSES/DEFERRED INCOME**

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2004	31. 12. 2005	
	Due to banking transactions	85,499	73,120	-12,379
	Due to internal operation	47	91	44
IV.	<b>Prepaid expenses/accrued income</b>	<b>85,546</b>	<b>73,211</b>	<b>-12,335</b>
	Due to banking transactions	47,535	33,051	-14,484
	Due to internal operation	64	165	101
X.	<b>Accrued expenses/deferred income</b>	<b>47,599</b>	<b>33,216</b>	<b>-14,383</b>

Prepaid expenses and accrued income and accrued expenses and deferred income include interest received/charged and interest related income/charges and expenses which incurred in the reporting period, but will be financially realised in the next period.

**4.16. CHANGES IN EQUITY**

HUF millions

B/S line	Description	31. 12. 2004	Interim changes	31. 12. 2005
XI.1.	Share capital	10,000	0	10,000
XI.2.	Retained earnings	81,123	-42,766	38,357
XI.3.	Valuation reserves	0	0	0
XI.4.	Revaluation reserve due to exchange rate changes	19,506	86,459	105,965
XI.5.	Revaluation reserves of foreign exchange securities	0	0	0
XI.6.	Profit/loss for the year	-42,766	21,345	-21,421
XI.	<b>Equity</b>	<b>67,863</b>	<b>65,038</b>	<b>132,901</b>

The share capital consists of a single registered share with a nominal value of HUF 10 billion.

Pursuant to the MNB Act, the MNB's dividend is specified by the General Meeting. According to the resolution of the General Meeting, in 2006 the MNB will not pay dividend from the retained earnings for the year and from the profit of 2005.

For more details on the revaluation reserves, see Section 4.14.

**4.17. OFF-BALANCE SHEET LIABILITIES OF THE MNB****Liabilities arising from derivative transactions**

HUF millions

Nr	Description	31. 12. 2004	31. 12. 2005	
		Book value of liabilities	Book value of liabilities	Net market value
1.	<b>Hedging transactions (2+3+4+5)</b>	<b>2,623,041</b>	<b>1,775,166</b>	<b>-81,788</b>
2.	– FX forward transactions	98,620	0	0
3.	– FX swap transactions	449,233	445,687	-4,013
4.	– currency swap transactions	1,392,431	887,223	-53,395
5.	– interest rate swap transactions	682,757	442,256	-24,380
6.	<b>Other forward transactions (7+8)</b>	<b>18,035</b>	<b>14,010</b>	<b>-65</b>
7.	– options	0	0	0
8.	– future transactions	18,035	14,010	-65
9.	<b>Total (1+6)</b>	<b>2,641,076</b>	<b>1,789,176</b>	<b>-81,853</b>

Hedging transactions (lines 1-5) serve the purpose of reducing risks related to the net foreign exchange position arising from cross exchange rate fluctuations and interest rate changes. They also facilitate establishing the benchmark foreign exchange structure approved by the MNB's Board of Directors. They comprise predominantly transactions with or on behalf of the central budget.

The main instruments of hedging against exchange rate risk are short-term currency swaps and forward transactions as well as medium and long-term currency swaps. Interest rate swaps linked to specific bond issues are aimed at obtaining the interest rate structure sought by the Bank.

Interest rate swaps include the central bank's transactions with ÁKK, which serve to limit the interest rate risks carried by debt denominated in foreign currencies and these are hedged by the MNB on the capital market through reverse transactions.

### Structure of liabilities arising from derivative transactions by remaining maturity

HUF millions

Nr	Remaining maturity	Balance		Change
		31. 12. 2004	31. 12. 2005	
1.	Hedging transactions	2,623,041	1,775,166	-847,875
	– within 1 year	1,079,609	801,399	-278,210
	– within 1 to 5 years	864,817	369,234	-495,583
	– over five years	678,615	604,533	-74,082
2.	Other forward transactions	18,035	14,010	-4,025
	– within 1 year	18,035	14,010	-4,025
	– within 1 to 5 years	0	0	0
	– over five years	0	0	0
3.	Total (1+2)	2,641,076	1,789,176	-851,900

### Other off-balance sheet liabilities

HUF millions

Nr	Description	31. 12. 2004	31. 12. 2005
		Book value of liabilities	Book value of liabilities
1.	Liabilities from security repurchase transactions in foreign currency	36,723	50,546
2.	Guarantees	10,634	12,358
3.	Other off-balance sheet liabilities	643	5,448
4.	Total	48,000	68,352

The line 'Guarantees' comprises export and import guarantees, always involving some reversible contract or government guarantee. When exercising a guarantee, the MNB has the right to a reverse guarantee if needed.

Other off-balance sheet liabilities largely comprise liabilities arising from cash against documents initiated or received by the MNB.

The MNB opened a letter of credit of USD 25.5 million in the name of the Hungarian State Treasury.

**Structure of other off-balance sheet liabilities by remaining maturity**

HUF millions

	Remaining maturity	Balance		Change
		31. 12. 2004	31. 12. 2005	
	– within 1 year	48,000	62,906	14,906
	– within 1 to 5 years	0	5,446	5,446
	– over five years	0	0	0
	<b>Total other liabilities</b>	<b>48,000</b>	<b>68,352</b>	<b>20,352</b>

**Bond lending**

At the end of 2005, the nominal value of securities lent under the general bond lending agreement made between the MNB and its largest securities account managers amounted to HUF 630.9 billion.

**4.18. NET INTEREST INCOME AND REALISED NET INCOME OF FINANCIAL OPERATIONS**

**Net forint and foreign currency interest and interest related income**

HUF millions

P/L line	Description	2004	2005	Change
1	2	3	4	4-3
(I.1.+II.2.)-(X.1.+XI.1.)	Central government	9,560	851	-8,709
(I.2.+II.3.)-(X.2.+XI.2.)	Credit institutions	-95,493	-100,105	-4,612
(I.3.+II.1.+II.4.)-(X.3.+XI.3.)	Other	43,508	75,026	31,518
	<b>Net profit from interest</b>	<b>-42,425</b>	<b>-24,228</b>	<b>18,197</b>
	Forint similar income	635	7	-628
	Foreign currency securities	0	0	0
	Bonds issued abroad	-1,281	0	1,281
	Derivative transactions for hedging and other purposes*	2,901	7,803	4,902
	Other	-1,134	-1,209	-75
(I.4.+II.5.)-(X.4.+XI.4.)	<b>Net interest related profit</b>	<b>1,121</b>	<b>6,601</b>	<b>5,480</b>
(I.+II.)-(X.+XI.)	<b>Net interest and interest related income</b>	<b>-41,304</b>	<b>-17,627</b>	<b>23,677</b>

\* For details on derivative transactions for hedging and other purposes, see the last table in this section.

In 2005, the Bank recorded a HUF 17.6 billion net interest and interest related loss, an increase of HUF 23.7 billion relative to the income in 2004.

The increase of interest related income was due to the HUF 15.2 billion gain realised from the prepayment of the central government of its foreign exchange debt vis-à-vis the MNB. Of the amount originating from the privatisation of the Budapest Airport in December, central government converted it to forints at the MNB, and from the income made prepayments at market value of its foreign exchange debt and the joined swaps.

The average annual forint central bank base rate decreased considerably, and consequently forint interest income and expenses diminished as well.

Along with the decline of the forint central bank base rate, the HUF 13.9 billion decrease in forint interest income is partly the result of the prepayments made by the central government at the end of the year 2004, of its debts originating before the year 1992. Accordingly there was no interest income stemming from these debts. The other reason for the decrease in income is – to a lesser extent – the lower interest income arising from the decreasing stock of the forint government securities due to sales.

In addition to the above interest related profit or loss includes:

- net gain or loss on derivative transactions that are not related to exchange rate changes, and
- the difference between the purchase price and the face value of securities recorded at cost attributable to the reporting period.

### Realised loss from financial operations

HUF millions				
P/L line	Description	2004	2005	Change
IV.	Realised gains arising from financial operations	9,489	11,499	2,010
XIV.	Realised losses arising from financial operations	16,100	12,836	-3,264
	<b>Net financial loss (IV.-XIV.)</b>	<b>-6,611</b>	<b>-1,337</b>	<b>5,274</b>

Gains and losses from financial operations mainly record realised gains and losses from the sale of securities.

In the reporting year, the net financial loss increased by HUF 5.3 billion relative to 2004. This increase is primarily related to the exchange gain arising from the sale of forint government securities and the lower loss incurred on the sale of foreign exchange securities.

### Details of income from derivative transactions for hedging and other purposes represented in interest related income

HUF millions				
Nr	Description	2004	2005	Change
1.	<b>Income from derivative transactions (2+3+4+5+6)</b>	<b>109,692</b>	<b>96,528</b>	<b>-13,164</b>
2.	– interest on currency swaps	102,228	76,021	-26,207
3.	– interest on over one year interest rate swaps	977	2,761	1,784
4.	– interest gains on hedge FX swaps	5,655	1,947	-3,708
5.	– FX gains on derivative transactions	531	15,235	14,704
6.	– other transactions	301	564	263
7.	<b>Expenses on derivative transactions (8+9+10+11+12)</b>	<b>106,791</b>	<b>88,725</b>	<b>-18,066</b>
8.	– interest on currency swaps	103,265	78,651	-24,614
9.	– interest on over one year interest rate swaps	2,380	3,456	1,076
10.	– interest loss on hedge FX swaps	489	5,006	4,517
11.	– FX losses on derivative transactions	0	0	0
12.	– other transactions	657	1,612	955
13.	<b>Net income from derivative transactions (1-7)</b>	<b>2,901</b>	<b>7,803</b>	<b>4,902</b>
14.	– interest on currency swaps (2-8)	-1,037	-2,630	-1,593
15.	– interest on over one year interest rate swaps (3-9)	-1,403	-695	708
16.	– interest gains on hedge FX swaps (4-10)	5,167	-3,059	-8,226
17.	– FX gains on derivative transactions (5-11)	531	15,235	14,704
18.	– other transactions (6-12)	-356	-1,048	-692

The MNB hedged exchange rate and interest rate risks arising from bonds issued abroad with currency swaps (and with other derivative transactions).

Under the debt exchange implemented in 1997, the MNB converted a large part of its forint loans granted to the central government into foreign currency loans by making reverses transactions with the Government under same terms as those of the bonds issued by the MNB. The MNB has also concluded with the ÁKK the majority of the currency swaps linked

to the bonds under nearly identical terms. Income from and expenses on the currency swaps are stated in the income statement in gross. The income from and expenses on swaps vis-à-vis both on residents and the ÁKK are recorded in the net interest related income more than once. The net profit and loss effect of the currency swaps is HUF 2.6 billion.

#### 4.19. COMPONENTS OF INCOME FROM THE TRANSLATION OF FOREIGN EXCHANGE HOLDINGS

HUF millions		
Description	2004	2005
Net income from exchange rate changes (realised and conversion spread)	22,586	14,557
Change in revaluation reserve in the balance sheet* (due to unrealised revaluation net income)	-179,734	86,459
<b>Total effect of exchange rate changes</b>	<b>-157,148</b>	<b>101,016</b>

\* *Revaluation reserves due to exchange rate changes (balance sheet line XI. 4.).*

In 2005, the official exchange rate of the forint vis-à-vis the euro depreciated by 2.8%, and the total effect of exchange rate changes totalled HUF 101 billion.

For more details on the revaluation reserve, see Section 4.14.

#### 4.20. THE COST OF ISSUING BANKNOTE AND COIN

HUF millions				
P/L line	Description	2004	2005	Change
	Cost of banknotes production	3,458	3,512	54
	Cost of coins production	2,096	1,758	-338
	Cost of production of commemorative coins	393	79	-314
<b>XIII.</b>	<b>Total</b>	<b>5,947</b>	<b>5,349</b>	<b>-598</b>

In the reporting year, the net cost of banknote and coin production totalled HUF 5.3 billion, down HUF 0.6 billion on the previous year. The decrease in production cost was mainly due to a decrease in the quantity of produced coins in circulation and commemorative coins.

#### 4.21. OTHER INCOME/EXPENSES

HUF millions				
P/L line	Description	2004	2005	Change
1.	Fees and commissions	1,102	1,166	64
2.	Income other than fees and commissions	1,405	2,394	989
<b>V.</b>	<b>Total other income</b>	<b>2,507</b>	<b>3,560</b>	<b>1,053</b>
1.	Fees and commissions	389	503	114
2.	Expenses other than fees and commissions	112	389	277
<b>XV.</b>	<b>Total other expenses</b>	<b>501</b>	<b>892</b>	<b>391</b>
	<b>Other results (V.-XV.)</b>	<b>2,006</b>	<b>2,668</b>	<b>662</b>

Income from fees and commissions slightly decreased relative to 2004.

For more details on extraordinary profit or loss, see Section 4.22.

**4.22. INCOME OTHER THAN FEES AND COMMISSIONS**

HUF millions

Nr	Description	2004	2005	Change
1.	Dividends from investments	1,369	2,176	807
2.	Income related to coins and commemorative coins	35	199	164
3.	Other income correction	0	0	0
4.	Other income	1	19	18
5.	<b>Income other than fees and commissions (1+2+3+4)</b>	<b>1,405</b>	<b>2,394</b>	<b>989</b>
6.	Loan and other losses exceeding normal extent	0	2	2
7.	Final money transfer	56	132	76
8.	Other expenditures	56	255	199
9.	<b>Expenses other than fees and commissions (6+7+8)</b>	<b>112</b>	<b>389</b>	<b>277</b>

In 2005, income other than fees and commissions included the following:

- Dividends received from investments increased by HUF 0.8 billion relative to 2004 (for more details, see Section 4.12).
- Income arising from the issue of commemorative coins above face value when the market value of the precious metal used in coins issued is higher than their face value.
- In 2005, the line 'Amounts contributed free of charge' included mainly donations to international and domestic organisations and to foundations.
- In 2005, other expenses included mainly the face value of the sold commemorative coins in circulation, banknotes.

**4.23. OPERATING INCOME AND EXPENSES**

HUF millions

P/L line	Description	2004	2005	Change
	Export sales	0	6	6
	Exchange gain from selling investment	0	555	555
	Income from selling assets and inventories	64	39	-25
	Income from mediated services	55	59	4
	Income from invoiced services	37	62	25
	Other income	26	21	-5
	Extraordinary income	1	1	0
VIII.	<b>Total operating income</b>	<b>183</b>	<b>743</b>	<b>560</b>
	Cost of materials, total	3,486	3,743	257
	Personnel-related costs, total	8,797	9,501	704
	Depreciation	1,642	1,872	230
	Transfer of capitalised value of own-produced stocks	-92	-38	54
	Transfer of costs of other activities	-309	-195	114
	<b>Total operating costs</b>	<b>13,524</b>	<b>14,883</b>	<b>1,359</b>
	Loss on exchange from selling investments	0	0	0
	Expenses incurred on assets and inventories	115	125	10
	Expenses incurred on invoiced services	31	58	27
	Income taxes	1	1	0
	<b>Total operating expenses</b>	<b>147</b>	<b>184</b>	<b>37</b>
XVIII.	<b>Total operating costs and expenses</b>	<b>13,671</b>	<b>15,067</b>	<b>1,396</b>

Operating costs increased to HUF 14.9 billion, up HUF 1.4 billion (10%) relative to 2004.

Personnel related costs increased by HUF 0.7 billion mainly as a combined effect of the decline in the average number of employees, the rise in costs related to the termination of employment, an increase in the size of the Monetary Council's membership and the average wage increase in 2005. In addition, the cost of materials in the reporting year increased by HUF 0.3 billion relative to the previous year primarily due to modernisation of the IT infrastructure in the recent years, which is principally connected to the new and extended services employed by the IT systems. The HUF 0.2 billion increase in depreciation is also associated with a rise in the volume of capital expenditure in the previous years.

#### 4.24. CHANGES IN THE NUMBER OF EMPLOYEES, PAYROLL COSTS AND IN THE REMUNERATION OF THE BANK'S EXECUTIVE OFFICERS

##### Number of staff and payroll information

HUF millions

Description	2004	2005	Change (per cent)
Wage costs incurred on staff	5,181	5,399	4.2
Other wage costs*	159	414	160.4
<b>Wages</b>	<b>5,340</b>	<b>5,813</b>	<b>8.9</b>
Other personnel payments	1,389	1,452	4.5
Taxes on wages	2,068	2,236	8.1
<b>Total personnel expenditures</b>	<b>8,797</b>	<b>9,501</b>	<b>8.0</b>

\* Other wage costs include payments on dismissal and in exchange of vacation time used and amounts paid to non-staff and non-MNB employees.

Description	2004	2005	Change (per cent)
Average number of staff	946	896	-5.29

##### Remuneration of executive officers

HUF millions

Bodies	Fees
Monetary Council*	234.8
Supervisory Board	52.0

\* Includes the salaries of external members of the Monetary Council in an employment relationship with the MNB.

##### Credits to executive officers

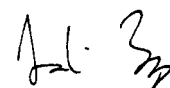
HUF millions

Bodies	Amount of loans	Outstanding at 31. 12. 2005	Final maturity	Rate of interest
Board of Directors	12.0	4.6	01. 06. 2007	Floating*
Supervisory Board	-	-	-	-

\* Central bank base rate at 31 December 2005. + 1 percentage point.

The Bank has no obligation to pay pension benefits to its former senior officers, such as former members of the Boards of Directors and Supervisors.

21 March 2006



Zsigmond Járai  
Governor of the Magyar Nemzeti Bank

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