MAGYAR NEMZETI BANK

ANNUAL REPORT

2004

Annual Report

Business Report and Financial Statements of the Magyar Nemzeti Bank 2004

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2004 Business Report of the Magyar Nemzeti Bank

1. The Governor's foreword

Hungary's accession to the European Union on 1 May 2004 opened up new possibilities which can benefit the country in its efforts to catch up with the more developed European economies. As a result of Hungary's accession, the Magyar Nemzeti Bank became a member of the European System of Central Banks (ESCB). The MNB's Governor participates in the quarterly meetings of the General Council of the European Central Bank (ECB) with voting rights. The Bank's experts are full members of 12 ESCB committees and the EU's Economic and Financial Committee.

At the end of 2004, the consumer price index was higher than the inflation target, with the main reason for this being the indirect tax increases in 2004. When the Government announced its intention to raise taxes in mid-2003, the Monetary Council decided not to offset any resulting immediate increase in the price level. It did, however, aim to prevent higher inflation from being incorporated into inflation expectations and to ensure that the rise in inflation was only temporary. According to evidence of currently available data, such as inflation indicators, the rate of wage growth and surveys of inflation expectations, the upsurge in inflation was not associated with a permanent increase in expectations. The stable forint exchange rate and cautious monetary policy were critical to mitigating the secondary impact of the tax increases on inflation.

The forint exchange rate appreciated significantly in early 2004, and then stabilised at a higher-than-earlier level. Showing less volatility than in 2003, the exchange rate continued to fluctuate in the upper domain of the ±15% intervention band throughout the year. Following a single 300 basis point increase in the base rate in November 2003, which was warranted by a sudden erosion of investor confidence, the Monetary Council lowered the central bank base rate by the same amount in 2004 in a series of cautious small steps, thus bringing the base rate back to 9.5% by end-2004. In order to enhance the transparency of monetary policy decision-making, the Monetary Council decided at its meeting on 6 December 2004 to publish abridged minutes of its regular rate-setting meetings.

The majority of the changes to monetary policy instruments in 2004 were attributable to the harmonisation of such instruments with ECB regulations. The MNB abandoned the practice of imposing an implicit tax on banks through reserve requirements. Since May 2004, the interest paid on required reserves is identical to the prevailing base rate. As a result, the instruments employed by the MNB approximated the ECB's practice considerably. In 2004, in addition to transforming its instruments to meet harmonisation requirements, the MNB also started selling part of the Government's net foreign currency supply in the foreign exchange market – the terms of the sale are announced prior to auctions and MNB is a price-taker – in order to sterilise excess liquidity arising from conversion.

Accession to the European Union entails an obligation for Hungary to adopt the euro in the foreseeable future. However, the country's debt continued to increase and the Government was unable to achieve a reduction in debt, which was one of the objectives set in the Convergence Programme, despite the implementation of extraordinary year-end fiscal policy measures.

Annual economic growth reached 4% of GDP. Exports and investment grew vigorously, thanks to an upturn in the business cycle in Europe. By contrast, household demand increased at a substantially lower pace than in previous years. The slowdown in consumption was explained by decreasing real wage growth. At the same time, however, growing household indebtedness partly offset the decline in consumer demand.

Uncertainties in the financial markets were exacerbated in 2004 as politicians of the governing party publicly criticised the monetary policy of the Magyar Nemzeti Bank on several occasions and amended the Central Bank Act in December. A number of important recommendations of the ECB were not taken into consideration. The Bank deemed the amendment of the MNB Act as intended to curb central bank independence and influence monetary policy.

One of the core tasks of the Magyar Nemzeti Bank is to put into circulation banknotes and coins in the appropriate amount, quality and denomination. The Bank discharged this task in full in Budapest and at its four regional centres in 2004. On 31 December 2004, cash in circulation amounted to HUF 1,444 billion, which was 1% (or HUF 14 billion) lower than at end-2003.

In 2004, the MNB continued its long-standing tradition of producing commemorative coins by issuing one gold coin, four silver coins and one jubilee circulation coin.

Official foreign exchange reserves rose from EUR 10.1 billion to EUR 11.6 billion in 2004. This rise in reserves was primarily attributable to the Government's foreign exchange borrowing with a maturity longer than the prevailing maturities and privatisation proceeds. The Bank's pre-announced sales of euro in the interbank market, on the other hand, had the effect of reducing the reserves. In 2004, EU transfers did not yet have any material impact on foreign exchange reserves.

Similarly to previous years, foreign exchange reserve management was in line with the Bank's risk management policy rules in 2004 as well. The euro continued to account for a dominant share in foreign exchange reserves. The Bank takes a conservative approach to investment policy, as is characteristic of central banks in general. Accordingly, the MNB purchases low-risk liquid securities with high credit ratings. In accordance with the evolving international practice, the Bank paid special attention to raising risk awareness and, hence, to the management of operational risks at a system level in 2004.

Consistent with legislation in several EU Member States, the MNB's regulatory powers were expanded to include the securities settlement systems, in addition to payment and settlement systems. The MNB designated the payment and securities settlement systems which are protected by bankruptcy law, and notified the Commission thereof. In the wake of Hungary's EU accession, the Bank formulated and disclosed its new policy on bank account keeping, and widened the range of institutions eligible for membership in VIBER. The new rules of procedure introduced in connection with the extended operating hours of VIBER improved the reliability of the system.

In line with EU and international methodological standards, there were significant methodological changes in the balance of payment, financial accounts and monetary statistics, including an expansion of their information content as well.

The MNB complied with all data provision obligations pertaining to EU Member States in 2004. Accordingly, it regularly provided data for Eurostat, the EU's statistical office, and the European Central Bank.

The framework of cooperation in between the Bank and the Central Statistical Office (CSO) and the Hungarian Financial Supervisory Authority is ensured by an agreement between these three parties and by their work programme which is updated annually. The 2004 work programme of the CSO and the MNB continued to emphasize the further development of the balance of payments methodology and the expansion of cooperation.

A trilateral agreement between the Magyar Nemzeti Bank, the Hungarian Financial Supervisory Authority and the Ministry of Finance, in accordance with international best practice, marked a major milestone of financial stability related cooperation. The parties set up a Committee for Financial Stability in order to perform their duties related to financial stability as efficiently as possible. The Committee held its inaugural meeting at the Magyar Nemzeti Bank on 6 October 2004.

In keeping with the priorities of its policy on central bank supervision, the Bank performed on-site inspections at 114 institutions in areas falling under its competence. Overall, the experience from these inspections confirms that, despite the deficiencies identified, data quality and the standards of law-abiding conduct have improved.

The most important achievement of the Bank's communication activity was the opening and successful operation of its Visitor Centre. The exhibition staged at the Visitor Centre provides excellent insight into the history of money in Hungary as well as the history of the central bank and its role in the financial system using interactive means of communication. The Centre aims to heighten the financial awareness of the general public and of the younger generation in particular.

In the field of human resources management, a performance management system was introduced in 2004. The assessment centre was integrated into the process of selection. Based on the skills and competences of the Bank's middle and top management, customised training courses aimed at developing general and managerial skills were provided for the staff concerned.

The MNB incurred a loss of HUF 42.8 billion in 2004, compared with a profit of HUF 78.5 billion in 2003. This was attributable to macroeconomic and factors related to monetary policy implementation, such as lower exchange rate gains and significantly higher forint interest expenses than in 2003. The MNB's objectives are the implementation of monetary policy and efficient discharge of other core duties, irrespective of their impact on the MNB's financial results.

The Bank's financial management continued to be characterised by tight cost management. Following a significant reduction in costs in previous years, operating costs did not increase in real terms in 2004.

2. Core duties and organisational structure of the Magyar Nemzeti Bank. Central bank independence

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
Core duties as defined by the Act on the Magyar Nemzeti Bank
Share capital: HUF 10 billion

2. 1. Objectives and core duties 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). As of the effective day of the promulgation of the international treaty on the accession of the Republic of Hungary to the European Union on 1 May 2004, 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 core duties 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. The MNB supports the realisation of the government's economic policy, using the monetary policy instruments at its disposal, insofar as this does not jeopardise this objective.

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

– it defines and implements monetary policy;

– it is the sole issuer of banknotes and coins, including collector 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, as part of its supervision duties, monitors their operation in order to ensure their efficient and safe 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.

The Bank may only perform additional tasks upon proper statutory authorisation, provided that such tasks do not jeopardise or interfere with performance of the tasks listed above.

In the spirit of central bank independence, the Bank defines monetary policy aimed at achieving and maintaining price stability and the instruments for the implementation of such independently within the framework provided by the MNB Act. 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 Organisations, 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 shareholder 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 Organisations 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 income statement, to elect and dismiss the auditor, who functions as a safeguard of statutory operations, and to determine the auditor's remuneration. Prior to the entry into force of the Act on the Promulgation of the Accession of the Republic of Hungary to the European Union, the powers of the General Meeting also included the establishment of the Bank's share capital. Act XXXI of 2004 on the Amendment of the MNB Act stipulates that it shall be specified in the MNB Act.

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

In respect of the Annual Report of the Magyar Nemzeti Bank, which consist 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 core duties, its right is confined to the acknowledgement thereof, in accordance with the principle of central bank independence.

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 key 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 CXXVI 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

Members of the Monetary Council of the Magyar Nemzeti Bank

Front row (from left to right): Dr. Béla Kádár, Dr. Ilona Hardy, Zsigmond Járai, Henrik Auth

Back row (from left to right): Dr. Gábor Oblath, Vilmos Bihari, Dr. György Szapáry, György Kopits, Péter Adamecz

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.

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 2004 were:

Zsigmond Járai, Governor – Chairman of the Monetary Council and the Board of Directors,

Henrik Auth, Deputy Governor with general responsibilities and member of the Board of Directors,

Péter Adamecz, Deputy Governor and member of the Board of Directors,

Riecke Werner, Deputy Governor and member of the Board of Directors (His term of office expired on 15 January 2004),

Dr. György Szapáry, Deputy Governor and member of the Board of Directors,

Vilmos Bihari, delegated member of the Monetary Council,

Dr. Ilona Hardy, delegated member of the Monetary Council,

Dr. Béla Kádár, delegated member of the Monetary Council,

Dr. György Kopits, delegated member of the Monetary Council, and

Dr. Gábor Oblath, delegated 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. The competences of the Monetary Council involve, *inter alia,*

– managing the implementation of the basic tasks;
– establishing limits on the assumption of market and credit risk and benchmarks in accordance with the basic principles determined by the Monetary Council as well as a partner list and investment instruments;
– submitting proposals to the General Meeting on the MNB's balance sheet, profit and loss account, payment of dividend, and approving a proposal to be submitted to the General Council on the MNB's business management, assets and policies;
– 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 attending to its duties as well as the development and operational budget plan;
– decisions on the business and non-business-related matters set forth in its Rules of Procedures;
– managing internal audits in relation to the tasks falling outside the competence of the Supervisory Board, and discussing the findings of and plans for internal audits;
– approving proposals for material amendments to the collective bargaining agreement;
– approving the extension of emergency loans to credit institutions in accordance with the basic principles determined by the Monetary Council;
– establishing and operating committees, establishing their rules of procedure and approving their agenda;
– decision on investments by the MNB;
– establishing capital projects;
– appointing members to be delegated to the special committees of the ESCB; and
– approving the policy on fees.

As of 1 May 2004, the MNB has independent legislative powers. Thus, it is entitled, within the framework of its tasks and on issues specified in the

Board of Directors of the Magyar Nemzeti Bank (from left to right): Dr. György Szapáry Deputy Governor; Zsigmond Járai Governor of the Magyar Nemzeti Bank – Chairman of the Monetary Council and the Board of Directors; Péter Adamecz Deputy Governor; Henrik Auth Deputy Governor with general responsibilities

MNB Act, to lay down statutory rules in the form of decrees by the Governor of the MNB. In consequence, the powers of the Board also include the approval of the texts of the decrees by the Governor of the MNB, which are consistent with the decisions passed by the Monetary Council, other than the decrees on the base rate and the statutory reserve requirement ratio, which, pursuant to the MNB Act, continue to fall under the competence of the Monetary Council. The powers of the Board also include the approval of the annual schedule of codifying decrees by the Governor of the MNB.

The Board of Directors, which functions as the MNB's operative management body, has no less than four but no more than six members. Its members include the Governor 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 Organisations, the Bank's Statutes, the Organisational and Operational Procedures of the MNB, as well as the rules of procedures formulated by these bodies.

Pursuant to a decision by the Board of Directors, these bodies are assisted in their work by specialist committees.

The **ALCO** (Asset-Liability Committee) is responsible for drafting Monetary Council decisions on foreign exchange reserve management, approving information materials on such activities and operational decisions within the competence delegated to it by the Monetary Council and the Board of Directors.

The **Audit Committee's** responsibilities include the follow-up of the findings made in the course of the operation of the MNB's supervisory system (internal audit, the auditor, the Supervisory Board and the State Audit Office), exchanging views on supervision-related experience, preliminary approval of the schedule of annual audit programmes and monitoring the implementation of such programmes.

The **Banking Committee** promotes decision-making on issues related to the stability of the financial system, the development of policies related to its prudent supervision and the regulation and safe operation of payment and settlement systems in Hungary.

Decisions on capital projects and cost management are passed by the **Investment and Cost Management Committee** within the framework of the budget approved by the Board of Directors.

With regard to the Logistics Centre project, the Investment and Cost Management Committee's rights and competences are held and exercised by the **Capital Projects Committee.** Its responsibilities include identifying Logistics Centre-related tasks and managing the project.

The **Monetary Committee** supports the conduct of monetary policy by the Monetary Council, performs regular assessments of monetary conditions by comparing the monetary programme with actual monetary developments and, based on such assessments, drafts operational monetary policy decisions, while fostering the concerted operation of the domestic foreign exchange and forint markets.

The **Owners' Committee** makes strategic and business policy decisions and plays a key role in preparing decisions in such matters.

The Magyar Nemzeti Bank is audited by the State Audit Office, the Supervisory Board and an auditor appointed by the General Meeting.

The supervisory competence of the State Audit Office in relation to the Bank is set forth Act XXXVIII of 1989 on the State Audit Office. The State Audit Office supervises the management of the Magyar Nemzeti Bank and its activities under the MNB Act that are not included in its core duties. 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 conducted supervision on two occasions in 2004. One was related to the MNB's operations in 2003 and the other to the inspection of its performance evaluation system.

Formulation of proposals for the appointment and dismissal of Bank's auditor by the General Meeting also falls within the competence of the State Audit Office.

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

Of the six members of the Supervisory Board, four (including the Chairperson) are appointed by the Parliament, one represents the Minister of Finance and one is an expert appointed 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 appoints new board members within three months of its opening session. In the event that the new Parliament fails to appoint such members before the aforementioned deadline, the Supervisory Board shall continue to operate until the new members are appointed.

In 2004, the members of the Supervisory Board of the MNB were:

László Akar, chairman,

László Baranyay,

Dr. József Kajdi,

Dr. László Urbán,

Dr. István Várfalvi, and

Dr. Éva Várhegyi.

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

2. 3. Organisational structure

The fact that as of 1 May 2004 the Magyar Nemzeti Bank falls under the scope of Act CXXIX of 2003 on Public Procurement has had a major organisational consequence. The Board of Directors established a new organisational unit, the Department for Public Procurement, which provides assistance for the organisational units in public procurement procedures. The key responsibilities of the new department include the supervision of public procurement procedures and ensuring that the objectives set in the public procurement plan are met in compliance with statutory regulations.

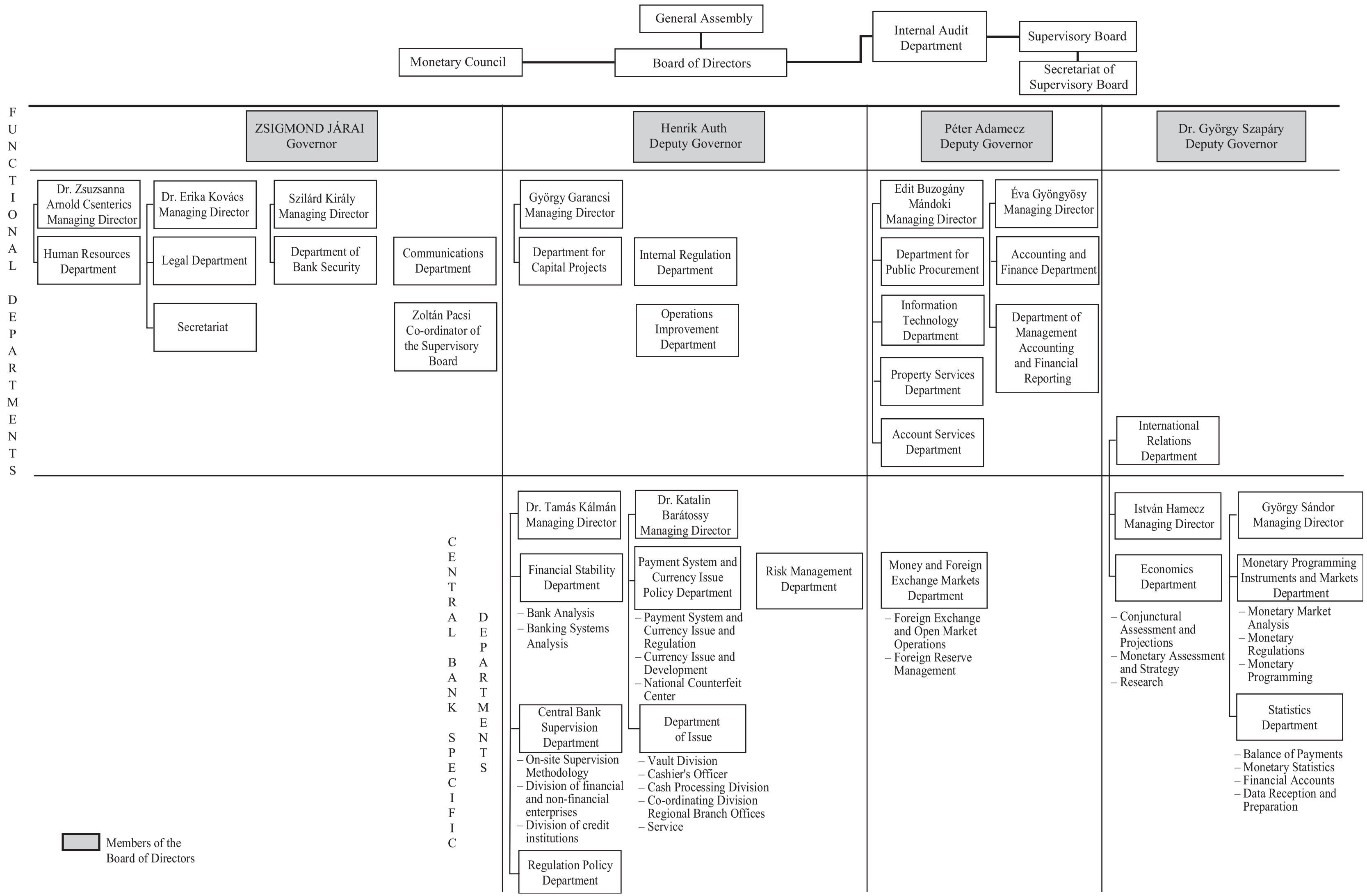
In addition to the Board of Directors and its members, performance of the Bank's operations-related statutory tasks and implementation of decisions are managed and supervised by the managing directors who are in charge of managing the Bank's day-to-day business.

As the heads of the departments and divisions assigned to them, the managing directors are responsible for the following areas: monetary policy and statistics, economic research, analyses and international relations, the macro-prudential supervision of the financial system, 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, technical 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.

Chart 2. 3-1

Organizational chart (31 December 2004)



The following is a complete list of the MNB's managing directors as of 31 December 2004:
Dr. Katalin Barátossy, who is in charge of the Department of Issue and the Payment System and Currency Issue Policy Department;
Dr. Zsuzsanna Arnold Csenterics, who is in charge of the Human Resources Department;
György Garancsi, who is in charge of the Department for Capital Projects;
Éva Gyöngyösy, who is in charge of the Accounting and Finance Department and the Department of Management Accounting and Financial Reporting;
István Hamecz, who is in charge of the Economics Department and the International Relations Department;
Dr. Tamás Kálmán, who is in charge of the Financial Stability Department, the Central Bank Supervision Department and the Regulation Policy Department;
Szilárd Király, who is in charge of the Department of Bank Security;
Dr. Erika Kovács, who is in charge of the Legal Department and the Secretariat;
Edit Buzogány-Mándoki, who is in charge of the Account Services Department, the Information Technology Department, Department for Public Procurement and the Property Services Department; and
György Sándor, who is in charge of the Monetary Programming Instruments and Markets Department and the Statistics Department.

The organisation chart (Chart 2.3-1) shows the Bank's organisational structure as of 31 December 2004.

2. 4. Relations between the MNB and the European System of Central Banks

Hungary's accession to the European Union on 1 May 2004 also entailed the MNB's membership in the European System of Central Banks. 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 is 1.3884%. As Hungary has not adopted the euro yet, pursuant to the statutes of the ECB, Hungary was required to contribute 7% 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 ESCB comprises the European Central Bank and the respective national central banks of the Member States of the EU, with the Governing Council, including the members of the ECB's Executive Board and the governors of those Member States that have adopted the euro, as its supreme decision-making body.

The General Council, with the President and the Vice-President of the European Central Bank and the governors of the national central banks of the 25 Member States as its members, addresses issues relevant to the ESCB as a whole and future expansion of the euro area and also has advisory and co-ordination-related responsibilities.

Special committees consisting of ECB and national central bank (NCB) experts and the working groups of such committees play an important role in the operation of the ESCB. The ESCB's thirteen committees prepare decisions and facilitate coordination as per the division of the various central bank duties. Since Hungary's accession to EU, the senior managers and experts of the MNB have been participating in the work of the ESCB Committees and their working groups (for a detailed discussion on the responsibilities of the individual ESCB committees, see Section 3.9).

3. Review of the MNB's performance in 2004

3. 1. Monetary policy

3. 1. 1. Monetary policy framework

Pursuant to the MNB Act, the primary objective of the MNB is to achieve and maintain price stability. In keeping with achieving this objective, the framework for monetary policy is determined by the ±15% intervention band of the forint vis-à-vis the euro and the regime of inflation targeting.

In agreement with the Government, the MNB set the inflation target for end-2004 at 3.5±1% in the summer of 2002. Since then inflation targets have also been set for later years. In October 2003, the MNB and the Government jointly set 4% as the end-2005 inflation target. In November 2004 the MNB, again in agreement with the Government, set the end-2006 inflation target at 3.5% with a tolerance band of ±1 percentage point.

3. 1. 2. Inflation developments

In 2004, average annual inflation stood at 6.8%, an increase of over 2 percentage points compared to annual average inflation in 2003. The 5.5% inflation in December 2004 was higher than the 3.5±1% inflation target set for that year due mainly to the increases in indirect tax in 2004. Without these tax increases inflation would have remained within the target band.

In mid-2003, when the increases in indirect taxes were announced, the Monetary Council judged that the maintenance of the original inflation target for 2004 would have called for excessive tightening of monetary policy. Therefore, the Council decided not to offset the immediate price increasing effect of the tax increases. It did, however, set the objective of preventing higher inflation from becoming incorporated into inflationary expectations and ensuring that any acceleration in inflation was only temporary. In early 2005, based on inflation indicators, the rate of wage growth and surveys on inflationary expectations, it seemed that the rise in inflation had not led to any permanent increase in inflationary expectations.

Changes in inflation occurred into two stages. In 2004 H1, the acceleration of inflation, which began in mid-2003 continued, after a rise in early 2004

Table 3.1-1

CPI and its components in 2004

(percentage changes on a year earlier)

	Weight	2002	2003	2004	2004				
	2004	Annual average	Annual average	Annual average	Q1	Q2	Q3	Q4	Dec.
Core inflation	67.6	6.0	4.8	5.8	6.0	6.2	5.9	5.3	5.0
Unprocessed food	6.0	2.2	0.7	6.6	4.9	8.0	11.9	1.5	5.4
Motor fuel and market energy	6.2	-0.9	5.2	6.6	1.0	7.8	7.6	10.0	8.1
Regulated prices	20.2	5.5	5.4	9.3	11.7	10.1	8.3	7.2	7.3
CPI	100	5.3	4.7	6.8	6.8	7.3	7.0	5.9	5.5

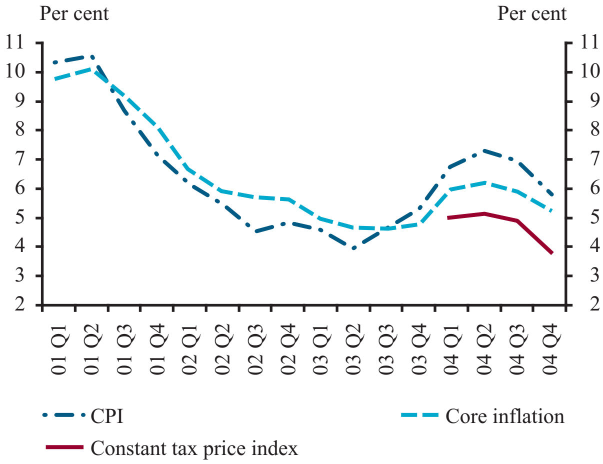
due to tax increases. In mid-2004, however, the CPI began to fall considerably. By the end of the year, the rate of increase in the price of the components affected by monetary policy had fallen to the level prevalent prior to the increases in indirect taxes.

A stable forint exchange rate, which was stronger than in 2003 H2, considerably contributed to rapid disinflation in H2, as this slowed down, directly through import prices, the rate of increase primarily in the prices of goods and food. The indirect effects of monetary policy are reflected in surveys suggesting a decline in inflation expectations. Thus, by anchoring expectations, a stable nominal environment managed to contribute to a deceleration in wage inflation. In addition, disinflation was further boosted by a significant slowdown in the growth rate of household consumption and increasing competition in retail trade, the food and the tobacco market.

Chart 3. 1-2

CPI and core inflation

(percentage changes on a year earlier)



3. 1. 3. The exchange rate and interest rates

The exchange rate of the forint appreciated significantly early in 2004 and then stabilised at a higher-than-earlier level. Somewhat less volatile than in the previous year, it continued to fluctuate in the upper section of the ±15% intervention band throughout the year.

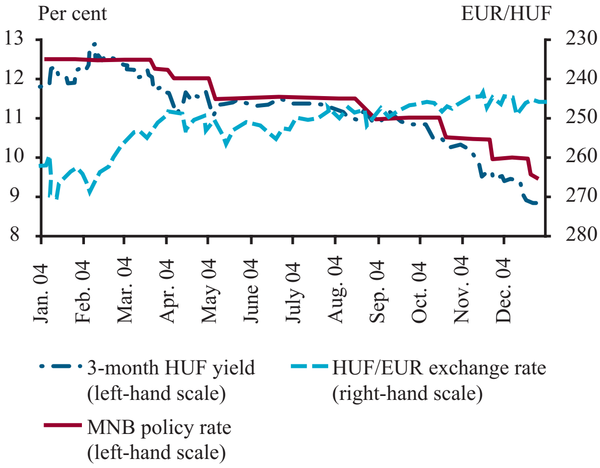
Following a single 300 basis point increase in the base rate in November 2003, which was warranted by a sudden erosion of investor confidence, the Monetary Council lowered the central bank base rate by the same amount in 2004 in a series of cautious small steps, thus bringing the base rate back to 9.5% by end-2004.

In 2004 H1, the MNB lowered the base rate by a total of 1 percentage point in three steps. These measures can be ascribed to the improving risk perception of forint-denominated investments, which was, in turn, attributable primarily to improved investor confidence in macroeconomic developments and Hungarian economic policy. At the same time, however, due to macroeconomic imbalances and the resulting precarious situation in the money market, the MNB stressed the importance of the need for a cautious, gradual monetary policy.

Chart 3. 1-3

Exchange rates and interest rates in 2004

(percentage changes on a year earlier)



In May 2004, the Government submitted the Convergence Programme to the European Commission, outlining the macroeconomic path leading to the adoption of the euro. The Programme changed the planned date of euro changeover from the original target of 2008 to 2010. In its press release, the MNB emphasized that realisation of the fiscal consolidation path was of key importance not only from the point of view of Hungary's commitments vis-à-vis the European Union and the adoption of the euro, but also from that of the country's risk assessment and achieving a current account deficit that was sustainable over the long run.

With effect from mid-2004, the Monetary Council changed its schedule of meetings. The Monetary Council continues to meet twice a month, but whenever reasonably possible it only decides on interest rates at its second meeting each month. However, if necessary, it can decide on changes in the base rate at an extraordinary meeting at any time.

In 2004 H2, the Bank lowered the base rate by a further 2 percentage points in four steps. These cuts were attributable mainly to a trend reversal in Hungarian inflation developments, which also had a beneficial effect on longer-term inflation prospects. The cuts were also justified by a stable exchange rate and the exceptionally favourable international investment climate. However, no improvement took place in the equilibrium of the economy, which continues to pose a serious risk to economic stability and calls for the continuation of a cautious monetary policy.

The Bank publishes abridged versions of the minutes of the regular interest rate-setting meetings prior to the subsequent meeting, in accordance with the Monetary Council's decision in December. The minutes present the decisions on the base rate, also disclosing voting ratios, the summary assessment of economic developments prepared by the Bank's experts, alternative proposals and a brief summary of the views set forth at the meeting. Publication of the minutes aims to make the process of monetary policy decision-making more transparent and to offer economic participants a more detailed picture of the MNB's view on Hungarian macroeconomic and money market developments.

3. 1. 4. Changes to monetary policy instruments

On 1 May 2004, Hungary joined the European Union and, simultaneously, the MNB became a member of the European System of Central Banks. In 2004, the majority of the changes to the MNB's instruments were attributable to Hungary's EU accession and bringing Hungarian regulations in line with those of the European Central Bank. As a result, the instruments of the MNB approximated those of the ECB to a large extent.

Absorbing excess liquidity arising from the conversion of the budget's foreign currency assets

On 17 February 2004, the Magyar Nemzeti Bank announced its intent to offset the liquidity-boosting effect of the conversion of the budget's foreign currency assets by a planned sale of EUR 1 billion in the foreign exchange market in the following year. The sale in the foreign exchange market was justified by the fact that, according to adopted practice, the budget's foreign currency assets are converted by the Bank rather than in the market, which has a major impact on the liquidity of the Hungarian banking system. In 2004, the Government planned a foreign exchange bond issuance in an amount that was to exceed the amount to mature, thereby reducing the net issuance of forint-denominated government securities, which, in turn, increased liquidity in the banking sector. Excess liquidity is also generated by the conversion of foreign exchange from EU funds into forint by making payments to economic participants in forint after converting the amounts transferred in euro. Channelling the net forint conversion of the Government vis-à-vis the MNB to the foreign exchange market is in compliance with the earlier practice of several Member States of the European Union.

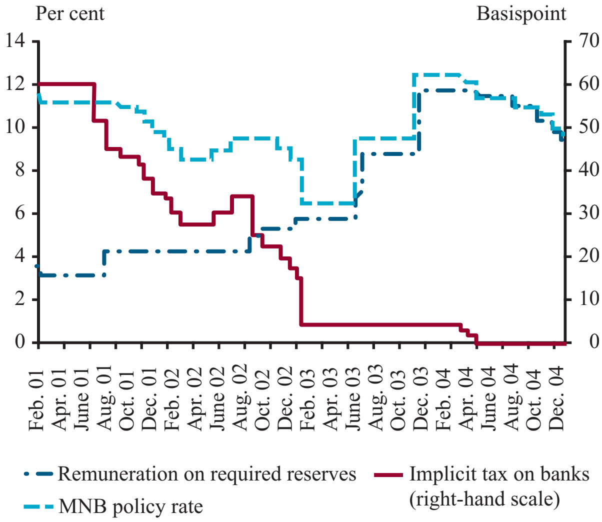
Therefore, the Bank's presence in the foreign exchange market serves liquidity management purposes. However, it does not intend to affect developments in the exchange rate of the forint. To this end, channelling liquidity to the market took place and will take place in a number of tranches, in small amounts and in a price-taking manner, taking into account interbank foreign exchange market standards. Subject to the foreign exchange financing policy of the budget and the expected amount of EU transfers, the MNB wishes to continue channelling the net forint conversion of the budget vis-à-vis the MNB to the market in the years to come.

Reserve requirement regulation

According to the decision of the Magyar Nemzeti Bank, the interest rate on required reserves was raised by 25 basis points on 1 May 2004 and with

Chart 3. 1-4

Reserve remuneration, the MNB's key policy rate and the implicit tax on banks



effect from this date, the interest rate on minimum reserves is identical to the prevailing central bank base rate. This decision led to the termination of the MNB's strategy of the past few years, which – in line with EU practice – targeted the gradual abolition of the implicit tax on the banking system through the reserve requirements prior to Hungary's accession to the European Union.

Foreign exchange market transactions

As of 1 May 2004, the Magyar Nemzeti Bank amended its Business Terms and Conditions applying to forint and foreign exchange market transactions. The most significant changes affected the Bank's foreign exchange market transactions. The range of eligible counterparties to the MNB's spot foreign exchange market transactions at the edges of the band was amended to include domestic credit institutions with a SWIFT code and current accounts held with the MNB (previously these counterparties included banks and specialised credit institutions with accounts held with the Bank). Spot foreign exchange market transactions at the edges of the intervention band have been available by an extra 1 business hour: the central bank is available for transactions from 09:00 hours to 17:00 hours as opposed to its earlier availability from 09:00 hours to 16:00 hours.

Wider range of counterparties

Prior to 1 May 2004, legal regulations did not allow for the possibility of the establishment of branches by non-resident credit institutions in Hungary. Following Hungary's accession to the EU, however, establishing bank branches by financial institutions with seats in the European Union became easier and more advantageous than previously. Thus, a few credit institutions are likely to be represented in the Hungarian market through branches in the near future. This change in circumstances called for an amendment to the counterparties to the Bank's instruments. The practice of the ECB and other European central banks outside the euro area shows that branches of non-resident banks are usually included in the circle of counterparties to the set of monetary policy instruments everywhere. This is due, primarily, to the fact that these branches play a role in financial intermediation similar to that of resident financial institutions, and thus, the principle of promoting fair competition supports their status as counterparties. Based on the above reasoning, if the terms and conditions applying to resident credit institutions are met by the branches of non-resident credit institutions, the MNB will allow them to have an access to the Bank's forint and foreign exchange market instruments in the future. The Business Terms and Conditions applying to the forint and foreign exchange market transactions were amended accordingly, and with effect from 15 July 2004 all branches meeting the technical requirements needed for the use of certain instruments are considered counterparties to the monetary policy instruments.

Annual regular revision of the acceptance ratio of eligible collateral

One basic principle associated with monetary policy instruments is that the Bank conducts lending transactions with its business partners only if they have acceptable collateral. Such lending transactions presently include the O/N credit facility and intraday credit related to payment turnover. The MNB is exposed to risks in the event that the price of securities pledged as collateral for loan transactions changes during the term of loans. Thus, the MNB does not accept securities pledged as collateral at their current market value. Rather, defines a lower acceptance ratio expressed as a percentage of the valid market value at the time. Different acceptance ratios apply to different types of securities depending on the risks associated with such. The methodology of defining the acceptance ratio complies with ECB practice based on the fundamental principle that the likelihood of the MNB having insufficient collateral should not exceed the very low threshold of 0.1%, due to changes in the market value of securities pledged as collateral. The acceptance ratios applied in the course of the daily collateral assessment are revised by the MNB at the end of each year. Consequently, with effect from 15 December 2004, the MNB amended the acceptance ratios of certain types of securities. These amendments involved the acceptance ratios of eligible corporate bonds and mortgage bonds, but left the ratios unchanged in the case of Hungarian government securities and MNB bonds.

3. 2. Stability of the financial intermediary system

3. 2. 1. Analysis of the stability of the financial intermediary system

In 2004, the Magyar Nemzeti Bank continued to accord high priority to analysing the events and developments affecting the stability of the financial intermediary system. As part of this duty, it laid greater emphasis on active communication and an exchange of views with the participants of the intermediary system throughout the year.

In February 2004, the MNB organised an international conference for the central banks of the accession countries under the title 'The role of the central banks of Central and Eastern Europe in maintaining financial stability', which was also open to the experts from the central banks of EU

Member States, as they had also expressed their interest in the conference. Vice-Presidents and managing directors of the ECB, the Polish, the Estonian and the Hungarian central banks outlined their tasks related to the financial stability functions of their institutions, shared their experience with the participants and had substantive debates on current challenges to and research on financial stability as well as the methodology adopted in analysing financial stability issues.

In addition to gaining a better understanding of international 'best practices', liaising with the members of the domestic financial intermediary system also improved. A framework for such liaising is provided by the Financial Stability Forum organised semi-annually and studies on risk assessment relying on the MNB's questionnaire-based surveys. In 2004, such studies included 'The practice of housing finance, related risks and their management in the Hungarian banking system' and 'Trends in and risks of consumer lending and their management in the Hungarian banking system and in the practice of financial enterprises'. Based on the conclusions of these studies, the Forum aims at providing for the possibility of professional consultation between the experts of the institutions showing the greatest activity in a given business. This, in turn, provides an excellent opportunity to share professional experience associated with the individual business lines, discuss issues arising in connection with risk assessment studies prepared by the MNB and review the expectations of future trends.

In 2004, the MNB and the Hungarian Financial Supervisory Authority (HFSA) held regular quarterly meetings. With a view to their responsibility to maintain the stability of the financial intermediary system, the two institutions discussed current topics requiring their cooperation. These meetings focused primarily on the risk assessment and reconciliation of different views on foreign exchange-based loan products. A better information flow for borrowers who cannot pledge any natural collateral and are exposed to interest and exchange rate risks (i.e. the preparation of information materials to increase their risk awareness and their active communication to borrowers) is one of the tangible outcomes of these meetings for the public at large.

In line with best international practice, the MNB, the HFSA and the Ministry of Finance entered into a trilateral agreement on cooperation in 2004 Q3. In order to ensure the stability of the financial intermediary system, efficiently coordinate effective micro and macro-prudential supervision, oversight, regulation and monitoring of the sector and fulfil the tasks related to financial stability by all three institutions as efficiently as reasonably possible, the parties agreed to set up a Financial Stability Committee. The members of this committee include the Deputy Governor of the MNB in charge of financial stability, the General Director of the HFSA and the Administrative State Secretary of the Ministry of Finance. The first meeting of the Financial Stability Committee took place at the Magyar Nemzeti Bank on 6 October 2004.

The MNB continues to publish its key assessments related to financial stability in its semi-annual *Report on Financial Stability.* The publications in 2004 focused on the problems with the external balance of the economy and the increase in unhedged foreign exchange-based household debts and associated risks. By identifying and communicating risks early on, the MNB's aim is to raise economic participants' risk awareness and to strengthen their confidence in the financial system.

In 2004, studies on housing loans, consumer lending and corporate governance at commercial banks were published in the *Report on Financial Stability* as part of a series of studies on risks in the banking sector. In 2004, three studies on stability were published in the Occasional Paper series. In addition to describing the methodology of measuring competition, the first study defined the degree of competition in the Hungarian banking market. The second methodological study examined the level of contagion risk in the Hungarian banking system, while the third paper analysed the relationships between the frequent structural discontinuities in risk management and financial time series.

In 2004, the semi-annual Lending Survey was published. The primary aim of the survey is to examine how banks' lending managers view and assess market developments and how they adjust their strategies to these developments and, within them, their lending policy. A summary list of their responses is published on the Bank's home page.

In December 2004, the European Central Bank published its first report on stability with the participation of the Banking Supervision Committee (BSC). The aim of this publication is to analyse financial stability in the European Union and to draw attention to potential risks and their sources. In the same month, the ECB completed a report analysing the structural characteristics of the financial systems of the EU Member States. The central banks of the new EU Member States, including the MNB, actively contributed to preparing this study.

3. 2. 2. The Bank's regulatory policy

From the point of view of regulation, 2004 was an important year. On 1 May 2004, Hungary became a member of the European Union and on that date a wide range of regulations adopted in the legal harmonisation process – the elaboration of which the MNB actively followed through – took effect.

In 2004, the MNB participated in the implementation of four new directives issued by the EU. Based on the directive on electronic money institutions (2000/46/EC), a regulation defining the prudential and institutional framework of the new financial service became effective upon accession. Simultaneously, based on the directive on financial collateral arrangements (2002/47/EC), an amendment ensuring more effective legal enforceability of financial collateral was drawn up. Based on the directive on the supplementary supervision of financial conglomerates (2002/87/EC), an amendment to the Act on credit institutions and capital markets was drafted in the summer of 2004. This amendment focuses on the uniform and comprehensive regulation of institutions in all three sectors while providing the supervisory structure needed for their monitoring. The adoption of the package of directives on market abuse (2003/6/EC) began also in the summer of 2004 and is expected to be completed in the spring of 2005. The amendment to the Act on capital markets under preparation will provide an updated list of prohibited and permissible market behaviour and expand the range of instruments used by the supervision authority in this area.

In addition to work related to legal harmonisation, preparation for the new European regulation on capital adequacy continued. In 2004, together with the Ministry of Finance and the Hungarian Financial Supervisory Authority, the MNB drew up a joint country opinion on the draft EU directives and sent it to the European Commission. The experts of the MNB participated in the work of the model validation task force of the Committee of European Banking Supervisors elaborating the convergence of the common EU minimum requirements of the internal ratings-based approach.

In 2004, the MNB prepared a number of studies on regulatory policy. Of special importance is a survey examining the practice of corporate governance in the domestic banking system, prepared jointly by experts from the MNB and the Hungarian Financial Supervisory Authority. The key findings of the survey which were disclosed to the public were published in the June 2004 issue of the *Report on Financial Stability,* and the banks included in the survey also received direct feedback on the findings. Furthermore, the MNB's experts prepared an analysis of the regulatory environment of domestic securitisation and proposed possible directions for the development of legal regulation. The study was discussed by the trilateral Financial Stability Committee and the parties agreed that they would review the prevailing Hungarian regulatory environment based on the findings of the study in 2005.

3. 2. 3. On-site inspections by the central bank

In 2004, on-site inspections by the Bank – representing an integral part of the financial stability area – continued to be performed in accordance with the guidelines set forth and published in the Bank's policy on-site inspection. Last year, 114 inspections were carried out at headquarters as well as over 60 related branch offices and local representative offices. In 100 letters of instruction measures, the Bank prescribed approximately 800 tasks for the remedy of deficiencies identified in the course of comprehensive, full-scope, projected and follow-up inspections performed in accordance with the annual schedule and also paid special attention to their realisation.

Similarly to last year, the inspection of credit institutions was of key importance. The 53 instances of inspection involved 14 banks and 39 cooperative credit institutions. The inspections focused on compliance with certain data provision obligations and regulations governing payment transactions. In general, the quality of data supply by this sector has improved. However, while the quality of the balance sheet-type reports was essentially satisfactory, the compilation of data based on the detailed records containing turnover data was problematic and the adoption of modifications in MNB guidelines also seemed to cause difficulties in certain cases. Interest rate statistics, certain balance of payments reports and data supply on payment transactions were of the least acceptable quality.

Justified by significant changes in the legal regulations governing the legal title codes for the balance of payments, a series of project investigations were carried out at 13 credit institutions in order to check compliance with the regulations governing the order of transferring and receiving information on country and title codes applicable to forint payment transactions as well as the title codes applicable to forint and foreign exchange transactions up to a value limit of EUR 12,500. These inspections helped the MNB gain insight into the initial difficulties and shortcomings of adopting new legal regulations. The findings, on-site consultations and prescribed measures contributed to the earliest possible remedy of deficiencies.

In the course of the inspections of payment transactions, the Bank inspected 38 credit institutions from the point of view of how they viewed compliance with regulations, checked the credibility of the data provided on payment transactions at 5 banks and tested cash circulation related activities at 25 credit institutions. The settlement deadlines were generally satisfactorily met, although credit institutions should pay special attention to the fact that deficiencies occurred more frequently at branches than at the headquarters.

As in 2003, in 2004 special attention was again paid to the inspection of non-financial companies, in the course of which on-site inspections were conducted at 47 non-financial corporations for the first time and follow-up inspections at 5 companies. The Bank's findings at the companies inspected for the first time were the same as those the year before: due to insufficient knowledge of data provision obligations and inadequate interpretation of the guidelines, incomplete and deficient reports had been submitted to the MNB. In the wake of correction of errors, balance of payment adjustments were also made. The findings of follow-up inspections were favourable: the quality of the data provided had improved to a great degree.

In 2004, all 6 money processing companies were inspected. It was found that they had made great efforts to comply with legal regulations and with the Bank's requirements in the course of their money processing activities. A negative finding worth mentioning was the insufficient level of scrapping, experienced primarily in the course of manual processing of banknotes with resultant deterioration in the quality of the processing activity.

3. 3. Payment systems and securities settlement systems

In relation to payment and securities settlement systems, the MNB fulfils a number of simultaneous functions. As a service provider, it manages credit institutions' accounts, on which the final settlement of forint positions from interbank transactions is performed; it also operates VIBER and is a co-owner of GIRO Elszámolásforgalmi Rt and KELER Rt. It is thus a participant in all three settlement systems. Taking into account the entire 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 promotes and actively promotes the development of infrastructure requiring the joint approval of all stakeholders.

3. 3. 1. Key changes to laws related to the MNB's functions

As a result of the amendment to Act XXXI of 2004 on the MNB, which entered into effect on 1 May 2004, the Bank's authority to oversee and regulate payment and settlement systems has changed.

The MNB's scope of power as an overseer – one of its main tasks related to its responsibility to ensure the safe and efficient operations of payment and settlement systems – has been expanded by the amendment to the Act on the MNB to include securities settlement systems as well. Pursuant to this, the Act on the MNB authorises the Bank to issue decrees in connection with securities settlement systems: the MNB has the power to instruct in decrees securities clearing houses and settlement institutions, in addition to payment clearing houses, on risk provisioning, the manner of such provisioning as well as the size and use of risk provisions. The Act allows the Bank to define in decrees its requirements for the Business Terms and Conditions and regulations of organisations conducting credit institution and securities settlement activities.

The essence of a more accurate definition of the regulatory powers lies in a clearer segregation of the powers of the government and the Bank associated with payments system. The definitions of the requirements for opening an account, giving instructions in connection with the account and limiting the scope of instructions for the account – already regulated by a government decree – has been unambiguously taken out from the MNB's scope of authority. The MNB draws up regulations on supplying preliminary and follow-up information to clients, payment methods and their application.

As of 1 May 2004, legal regulations relating to payments with EU Member States changed. The chapter of Government Decree 232/2001 on cross-border credit transfers which had been formerly drawn up and promulgated as part of the transposition of Community legislation and Decree 2560/2001 of the European Parliament and the European Council became directly effective in Hungarian law. Act XXIII of 2003 on the Settlement Finality in Payment and Securities Settlement Systems also took effect upon Hungary's accession to the European Union.

3. 3. 2. The MNB as an overseer

The methodology of the MNB's activities as an overseer was compiled based on international guidelines and recommendations (BIS, ECB) on payment and securities settlement systems and central bank oversight as well as the practices adopted by the member countries of the Eurosystem. It covers the definition of requirements related to the systems, the continuous monitoring and supervision of the operation of the systems through the collection of data and analyses, comprehensive periodic assessments of the systems based on internationally accepted standards and recommendations, the prescription of measures needed for the safe operation of the systems and the monitoring of their fulfilment.

The MNB exercises its authority in all three systems that are critical from the point of view of systemic risk; the VIBER system operated by the Bank, the ICS operated by GIRO Rt. and the securities settlement system operated by KELER Rt.

3. 3. 3. Implementation of the Act on the Finality of Settlements by the Bank

The MNB is responsible for the implementation of Act XXIII of 2003 on Settlement Finality of Settlements in the Payment and Securities Settlement Systems, which entered into effect as of 1 May 2004, as the designated authority to notify partner institutions of the Member States of the commencement of insolvency proceedings and as the authority that specifies systems subject to the Act as well as the operator of VIBER.

In order to enact the procedural regulations in compliance with the provisions of the Settlement Finality Act, the Business Terms and Conditions of keeping bank accounts with the MNB – as well as the description of the VIBER system constituting its integral part – were amended as of 3 May 2004 and a separate supplementary agreement was drawn up among the direct and indirect members of the VIBER system to implement the provisions of the Act.

The system operated by the MNB is considered to be a system subject to the Act. In the case of the other two specified systems, the Bank played an active role in preparing the amendments enhancing implementation by way of consultations, while paying special attention to elaborating the required procedural regulations in compliance with the provisions of the Act ensuring real protection to the participants of the systems as well as those of the system provided by the Act. In the course of this work, the Bank laid special emphasis on defining the rules referred to the systems' own scope of authority by the Act – such as the definition of the moment entry of transfer instructions into the system – on the basis of uniform principles in the case of the VIBER, the ICS and the securities settlement systems, taking into account the systems' different characteristics.

Reports on the system and on the members of the systems were supplied to the authorities entitled to initiate insolvency procedure.

As an authority entitled to specify the systems under the scope of the law, the Bank carried out the designations concerning GIRO Rt. (Interbank Clearing System) and KELER Rt. (securities settlement system) in the framework of public administration procedures by 31 October 2004.

3. 3. 4. The MNB as an owner

Last year, the Bank's role as an owner and as an operator associated with payment and securities settlement systems remained unchanged in the case of VIBER arranging for the settlement of payments involving large amounts. This cannot be said of KELER Rt., in which the Bank increased its ownership share from 50% to 53.3%, by purchasing a part of the share package of the Budapest Commodity Exchange. In 2004, the MNB initiated negotiations on the sale of its share in GIRO Rt., which was sold in 2005.

In line with EU practices, the MNB prefers to influence the functioning of these systems primarily in its role as an overseer (as described in 3.3.2) in the future and will rely less on its ownership control. Already, as an owner, the MNB achieved its original aim of establishing payment and securities clearing and settlement institutions that operate safely and efficiently with sufficient capital. In international comparison, both KELER Rt. and GIRO Rt. are institutions with well designed infrastructure operating reliably and smoothly. Accordingly, the MNB can ensure the enforcement of its goals associated with the safe and efficient operation of the clearing and settlement systems regardless of its ownership share.

3. 3. 5. The MNB as a catalyst for change

As a catalyst for the development of the payment and settlement infrastructure and cashless payment methods or means of payment instruments, the MNB made efforts to deepen communication and cooperation among the participants of the payment system during the year. The first recommendations of the Payment System Forum – set up at the MNB's initiative in 2003 – were drawn up primarily on cashless payment methods and on migration of bank cards to chip technology.

The series of international payment system conferences that was launched in 2002 with the intention of establishing a tradition continued. The current topic was interbank cooperation among banks in Hungary and at the international level. The Bank's experts gave presentations on the subjects of accession to the EU, small value payment systems and bank cards at a number of international conferences.

3. 3. 6. The MNB as a provider of services

The rules for lengthening VIBER operating hours were re-defined. In order to operate the system reliably and efficiently, the MNB deemed it necessary to adopt a stringent practice and amended the relevant part of its Business Terms and Conditions to this end in March. In the future, requests for longer operating hours will have to be submitted in writing, supported by adequate justification. Operating hours should not be extended by more than one hour. The new regulation contains a detailed description of the acceptable reasons for longer hours and an itemised list of technical and liquidity management procedures. The regulation lays special emphasis on the safety of securities settlement, and, for this reason, approves any request from KELER for an extension. As a result of these new regulations, the number of requests for longer operating hours decreased and the operational reliability of the system also improved.

As the operator of VIBER, the MNB successfully carried out the SWIFTNet migration, affecting the entire domestic infrastructure.

In order to promote the single market for low value payments in euro (i.e. not exceeding EUR 12,500), cross-border payments in euro may not be charged more than a domestic payment. Uniform charges, however, are only to be applied in the case of a simple transfer when data provided on the payment instruction comply with the specifications of the regulation, namely, if the payer provides the international bank account number (IBAN) of the payee and the bank identification code (BIC) of the payee's bank. The principle of applying a single price has also been in effect in Hungary since May 2004, but, for the time being, it only means lower charges for transfers from euro zone countries to Hungary. Aiming primarily to reduce banks' costs related to the euro payments in question and consequently the prices of the transactions and in order to shorten the timeframe of payments in euro, the MNB and GIRO Rt. launched a common project to join STEP2, a Pan-European clearing system, operated by EBA Clearing S.A.S., dealing with low-value euro payments. This project assists the Hungarian banking community in meeting the expectation of the ECB and the European Payments Council to make any bank accounts addressable within the European Economic Area (EEA) through this system.

The Bank reviewed and amended its policy on account-keeping and payment system membership. Since Hungary's accession to the European Union on 1 May 2004, credit institutions established in EEA countries may open branches under significantly simpler conditions than before, or may offer financial services cross-border without establishing a branch. For this reason, the MNB developed and published its policy on accounts keeping, participation in VIBER and intraday credit supply.

According to the policy announced on 1 September 2004 and under its Business Terms and Conditions which were modified accordingly, the MNB can open a bank account for any credit institution registered in an EEA country directly or via their branches. In addition to this, the MNB can open accounts for established branches of banks with a registered office outside the EEA, as well as for foreign central banks and international financial institutions.

The MNB grants direct VIBER participant status for credit institutions registered in EEA member countries with remote access or through their branches in Hungary and for Hungarian branches of third-country credit institutions. A special condition for joining VIBER is that the legislation of the country of the applicant's registered office supports the enforcement of the provisions of Act XXIII of 2003 on the Settlement Finality in the Payment and Securities Settlement Systems mentioned under point 3.3.3 in the case of an insolvency proceeding initiated against the participant.

In line with the practice of the Eurosystem, credit institutions having their seat in another country of the EEA and joining VIBER through remote access are not entitled to intraday credit: the Bank offers this service only to those institutions which join VIBER through their branches in Hungary.

3. 3. 7. VIBER's operations

In 2004, the number of VIBER participants remained unchanged compared to year-end 2003, with 36 participants on both dates. Konzumbank and Postabank, which terminated during the year, were replaced by Sopronbank and OTP Mortgage Bank.

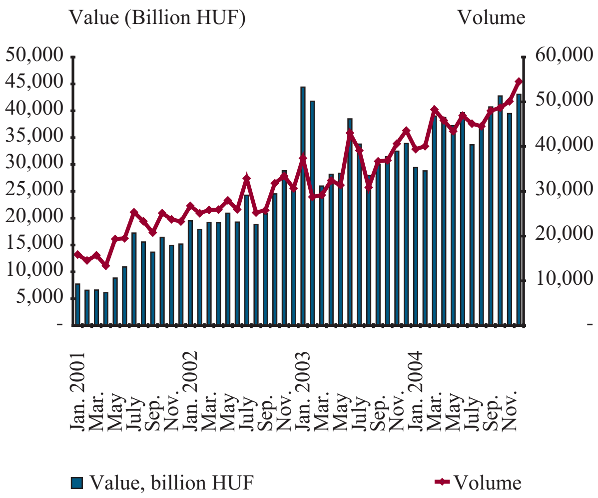
In 2004, the combined turnover of the Interbank Clearing System and VIBER was HUF 501 trillion, 89.8% of which was settled in VIBER. The combined settlement turnover of the two systems was 24.7 times the amount of Hungary's GDP forecast for the year, slightly exceeding the level of turnover in 2003, which was exactly 24 times the amount of GDP.

In the real-time system payment orders transacted during the year represented HUF 449.8 trillion, the number of payment orders was 554,900. The value of transactions grew by 13.4%, while the number of transactions grew by 29.0% relative to the preceding year. In 2004, continuous growth in the average amount of payment transaction characteristic to previous years came to a halt, with the average amount of a payment transaction in 2004 at HUF 810.5 million, as opposed to HUF 922.4 million per transaction in the preceding year. The high basis was partly due to the speculative attack in January 2003 anticipating the appreciation of the forint and the increased turnover following a shift of the exchange rate band in mid-2003.

Monthly changes to the values and number of payment transactions are shown in the chart below containing data from 1 January 2001.

Chart 3. 3-1.

Value and volume of transactions in VIBER (2001–2004)



In 2004, the average number of daily transactions amounted to 2,185, with an average daily VIBER turnover of HUF 1,771 billion. Daily turnover record according to the number of transactions (3,259 transactions) fell on 15 December 2004, while the value of turnover peaked on 20 October 2004 at HUF 2,850 billion (the record high for the year). In terms of VIBER turnover, the absolute record was registered in January 2003, when the number of transactions was 5,221, with a total value of HUF 6,043 billion.

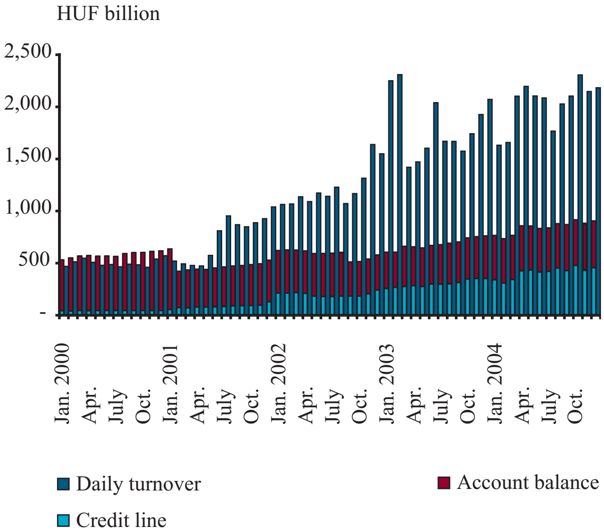
The average daily intraday credit line set up for banks – which is provided by the MNB for the purposes of settling payments against blocked securities held as collateral and which supplements the bank account balance – amounted to HUF 412.3 billion in 2004, a 36% increase on the previous year. Compared to the previous year, the combined average daily available balance on banks' accounts increased by 13.5%, reaching HUF 429 billion. Total liquidity for settlements – 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 2,107 billion, representing a 16% increase on the daily turnover in the previous year. The banks therefore had 'more abundant' liquidity than previously, clearly favouring free of charge intraday credit. Credit available at the end of the day turns into overnight credit. The MNB extended a cumulated amount of HUF 2,659.7 billion of this type of credit, 40% more than in 2003, with an average daily amount of HUF 10.5 billion.

In 2004, the average daily turnover was 2.5 times the daily liquidity. By international standards, the liquidity of VIBER was fairly high. The following chart shows the monthly changes to the average daily liquidity and payment transactions of the banking system.

Last year, the availability ratio of VIBER was 99.77%, a considerable improvement on the 99.22% in the previous year. In 2004, there were 9 system failures or delayed starting (compared to 18 in 2003) with total breakdown time amounting to 6.7 hours, the longest breakdown having

Chart 3. 3-2.

Comparison of banks' daily average liquidity (account money+limit) and payment transactions



occurred in September, when the breakdown of the network and the SWIFT connection lasted for more than two hours. The index of availability is in the target range of ESCB in connection with the TARGET system. The reserve back-up system was not used.

3. 4. Management of foreign exchange reserves and risk-management

3. 4. 1. Objectives of holding reserves

The MNB Act stipulates that management of Hungary's foreign exchange reserves is a core duty of the Magyar Nemzeti Bank. Foreign exchange reserves serve several basic objectives in the economy including:

• support for the implementation of monetary policy (intervention to keep the forint exchange rate within the announced fluctuation band),

• transaction goals (supporting the management of government debt, meeting domestic needs for foreign exchange, managing possible crises), and

• asset management functions.

The primary aim of reserve management is to support monetary policy. In addition to inflation targeting, 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 2004, there were no open intra-band interventions, nor passive interventions at the edges of the band.

Transactions goals – the second objective – continue to play an important role, especially in the light of cash movements experienced last year. The main transaction goal is still to support the management of government debt. Foreign exchange movements related to EU transfers have not had a major impact on foreign exchange reserves.

Due to the decrease in premia on Hungarian bond issues in 2004, the cost of holding reserves fell significantly. This can also be explained by the increase in demand and the parallel decrease in premia associated with EU accession in May and continuation of the convergence process, as well as by the expectations regarding meeting the deadline for joining EMU in 2010. Despite all these factors, the MNB still does not wish to maintain reserves purely for the purposes 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.

3. 4. 2. Investment policy

In respect of the classic investment triad of return-safety-liquidity, the Bank's investment philosophy is to maximise profit on a given portfolio, while complying with stringent safety and liquidity requirements. The MNB's principal approach behind the investment guidelines is usually to adopt the best practice followed by the central banks of developed countries. Similar to the majority of other central banks, the MNB also pursues a fundamentally conservative investment policy.

A conservative investment policy means that the MNB tries to avoid securities with large price fluctuations, e.g. equities. The investment universe is restricted in a way that the maximum allowed maturity of bonds is 10 years, with credit ratings of AA or AAA. 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. Since 2004, the MNB has been investing in inflation-indexed bonds with a credit rating of AAA.

In 2004 once again, the euro played a key role in the foreign exchange structure of reserves. Its weight is justified by the level of economic integration of Hungary into the euro area and the foreign exchange structure of government debt, as well as by the fact that the euro is the currency of interventions.

Regarding the structure of reserves, the MNB distinguishes between liquidity and investment portfolios. Although the aim of the liquidity portfolio is to ensure daily liquidity (repayments of interest and principal, interventions, other transactions, transfers), inflows increasing foreign exchange reserves (government funds, interventions) are also included first in this portfolio. The investment portfolio, accounting for a higher share of the total reserves, looks at longer time horizons when assessing investments laying 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.

In 2004, the MNB held 20% of the reserves in liquidity and 80% of reserves in investment portfolios.

3. 4. 3. Adequacy of reserves

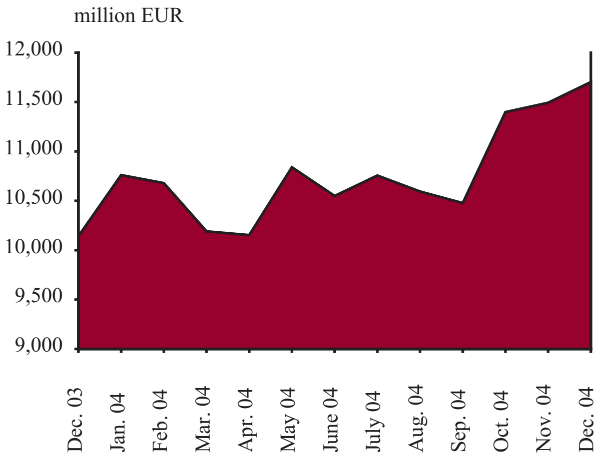
Official foreign exchange reserves rose from EUR 10.1 billion to EUR 11.6 billion in 2004. Reserves only fluctuated moderately in the first three quarters, with most of the increase taking place in the final quarter.

The most important factor affecting the increase in reserves was the foreign exchange borrowing of the government. In 2004, the government raised funds in bond markets in several foreign currencies (in euro, Japanese yen, pound sterling, US dollar) in a total of EUR 3.2 billion. In addition, items connected to privatisation (Richter, MOL) contributed approximately EUR 0.7 billion to the increase of foreign exchange reserves, while the return on reserves added EUR 0.3 billion to this increase.

The amount of reserves was reduced by the repayments of principal and interest on the foreign exchange debt of the government and the MNB, totalling EUR 2.1 billion last year. The open market sales of euros by the MNB announced in February amounted to EUR 0.4 billion. Due to foreign exchange reserves held in US dollars, the weakening of the dollar caused euro-denominated reserves to drop by approximately 100 million. Changes in mark-to-market hedging balances and short-term deposits had a negligible impact on the size of reserves.

Chart 3. 4-1.

Official foreign exchange reserves since early 2004



3. 4. 4. Managing financial risks at the MNB

In the course of conducting its core tasks, the MNB carries out high-risk activities as well. As part of risk awareness – which forms the basis of the Bank's risk taking – the Bank continuously measures and restricts exposure to risk, thereby reducing to the minimum the possibility of financial loss. A part of the risks is an objective factor, inseparable from the Bank's core activities. One of these typical risks is represented by the potential change in the MNB's income statement arising from the changes in the forint-foreign exchange rates.

Risks related to the management of foreign exchange reserves, however, are mostly taken consciously. Such risks are reduced by the MNB through limits reflecting the MNB's preferences regarding the safety of the value of the reserves managed, the liquidity of the reserves and the expected return on such.

In accordance with the regulations on the scope of competence in decision-making, the framework of conscious risk-taking to be applied in 2004 was decided by the Monetary Council. The Council determined the basic principles of reserve and risk management, defining market, credit and liquidity risks as risks which are consciously taken. It decided on 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. Management of financial risks and preparation of decisions are carried out by an organisational unit independent of any specific market area.

The two main pillars of risk management policy are the two-tier benchmark system and the limit system partly attached to the benchmarks. Benchmarks are theoretical reference portfolios with which performance on actually managed reserve portfolios can be measured. The Bank manages investment and liquidity portfolios based on two separate strategies. 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.

In 2004, the benchmarks of both euro and dollar-denominated investment portfolios included government securities, corporate bonds, as well as money and capital market assets of at least AA credit rating and with a remaining maturity of 10 years at the most. The composition of benchmark portfolios by credit ratings of assets and the remaining maturity reflects the conservative appetite for risk characteristic of central banks in

Chart 3. 4-2.

Composition of the benchmark of the euro and dollar-denominated investment portfolios by credit ratings, 2004

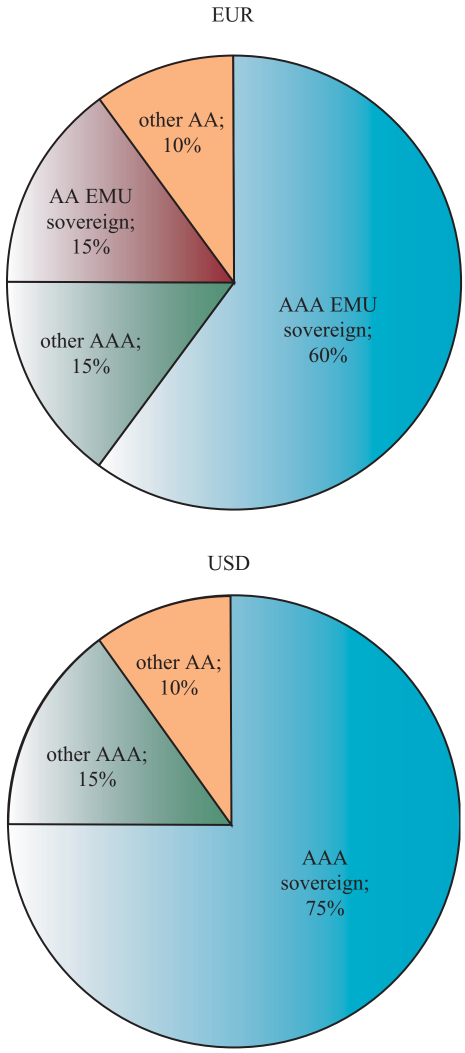
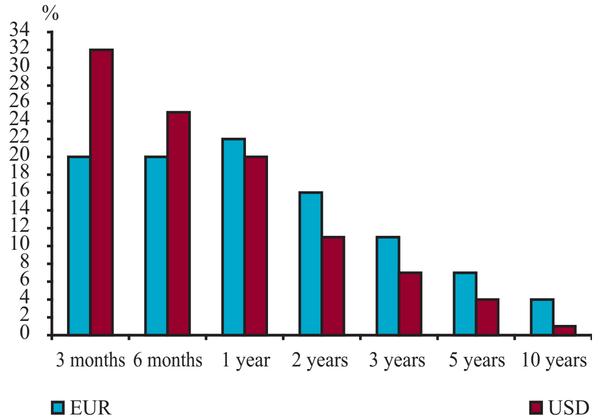


Chart 3. 4-3.

Composition of the benchmark of the euro and dollar-denominated investment portfolios by remaining maturity, 2004



general. Chart 3.4.-2 shows that both the euro and the dollar-denominated benchmarks were dominated by government securities with the highest credit rating (AAA), which are considered the safest investments. The government securities segment of the euro-denominated portfolio contained French and German (AAA) and Italian securities (AA), while the benchmarks of other sectors were based on money and capital market yields (Libor, swap). Other sectors with an AAA credit rating were represented by institutions with government guarantees in the dollar-denominated benchmark, while others with an AA rating were based on Libor and swap rates as well.

Chart 3. 4-3 shows the weight of certain maturity segments within the benchmarks. In order to reduce liquidity and interest rate risks, the weight of securities with a remaining maturity of up to one year exceeded 60% in both currencies.

The benchmark of the liquidity portfolio contained 3-month money market deposits in both currencies.

The total return on the euro-denominated investment portfolio was 3.30% in 2004, 0.29 percentage points higher than the relevant benchmark, while the total return on the dollar-denominated portfolio was 1.45%, outperforming the relevant benchmark by 37 basis points. The monthly annualised average total return on the euro-denominated liquidity portfolio was 2.11% as opposed to the 2.04% total return on the benchmark, while the dollar-denominated total return was 1.36% compared to 1.14% 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 30.4 million expressed by the value-at-risk (VaR) at a one-month time horizon and at a confidence level of 95%, while the surplus interest rate risk from the deviation from the benchmarks of the investment portfolios resulted in the total value-at-risk of EUR 3.3 million.

3. 4.5. Managing operational risks at the MNB

In the course of its operation the Bank faces risks not included in the range of financial risks. Such non-financial risks (i.e. operational risks) are related to errors, internal or external fraud, infrastructure system breakdowns, failures due to disasters in the course of working processes, resulting in unfavourable effects on the Bank's reputation and financial losses. By managing these risks appropriately the above losses can be avoided or contained and the confidence in the reliable operation of the country's central bank can be preserved and even increased in certain cases. The strengthening of risk awareness was one of the main objectives of the MNB in 2004.

By applying a model which ensures the monitoring of changes in working processes and serves as a basis for systematic risk assessment developed with the purpose of the realization of the best practice, the MNB's operational risk map was compiled in the framework of self-assessment, which covers the entire Bank.

The results of the 2004 survey naturally reflect the fact that a significant part of the Bank's operational risks expressed in cash are primarily associated with working processes characterised by significant financial risks and relate to cash management. In addition to this, the MNB's reputation related to operational risks is also substantially jeopardised in the course of monetary policy elaboration and decision and the communication of such to the public, supply of data in connection with international organizations, supervision of the financial system, provision of statistical data, purchase of information technology systems and provision of accounts demonstrating transparency.

The risk management instruments applied by the specific organisational units include the elaboration and application of controls based on regulations, preparation of plans to manage crises of varying degrees of severity and responses aimed to mitigate damages stemming from any risk events which may occur.

By way of its human risk map which has been set up and maintained autonomously, the Bank also paid special attention to maintaining the instruments for the management of operational risks relating to human resources.

In managing operational risks, the Business Continuity Planning (BCP) system serving the management of crises is of key importance. Security of the Bank's activities is substantially increased by filtering the Bank's activities critical from the point of view of the BCP, comprehensive maintenance of the business continuity plans, tests, and establishment of the Disaster Recovery Centre in 2004 which serves as a background centre for information technology and an alternative site for the continuation of critical working processes.

Thorough elaboration of the risk assessment practice based on risk self-assessment and its consistent application in the orientation of risk management is a longer-term task based on strategies requiring an appropriate organizational, decision-making and regulatory framework. Dialogues between different areas of expertise, publications and workshops on various subjects have had a favourable impact on increasing the organisation's risk awareness and the Bank's reputation.

3. 5. Currency issuing activities

One of the fundamental tasks of the Magyar Nemzeti Bank is to provide banknotes and coins in the

appropriate amount, quality and denomination for Hungary's currency circulation. The Bank fully discharged this task in Budapest and at the four regional currency issuing centres in 2004.
The banknotes and coins required for the national cash turnover are manufactured by Pénzjegynyomda Rt. and Magyar Pénzverő Rt., both of which are business organizations in the Bank's ownership.

3. 5. 1. Currency turnover and processing activity

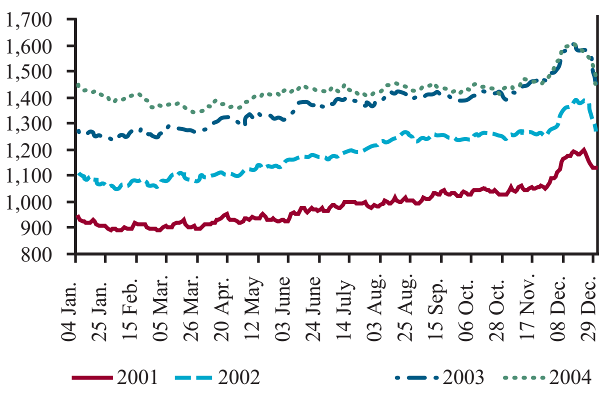
In 2004, the cashier's desks of the Magyar Nemzeti Bank handled a currency turnover of HUF 3,888 billion, up 8% on the previous year. Within currency turnover there was a strong 14.6% increase in lodgements, while withdrawals rose by a moderate 2.5%.
In the course of 2004, 358 million banknotes were paid in and 354 million banknotes were withdrawn at the MNB's cash desk. With the help of high-capacity cash processing machines, the MNB examined the overwhelming majority of lodged banknotes for authenticity and circulability. In 2004, the upgrading of the high capacity banknote processing machines was completed. Sensors of a new kind were installed, which allow for the possibility of higher standard processing of banknotes. Annual banknote return frequency rate stood at 1.5 on average in 2004, which represents a slight increase relative to the corresponding figure of the previous year. The increased frequency rate allows more frequent checking of the banknotes by the MNB.
In the Magyar Nemzeti Bank, the overwhelming majority (roughly 95%) of currency is processed by modern machines. Processing by machines allows for the possibility of the inspection of the security features applied on the different means of payment, which is of paramount importance in the detection of counterfeits.
No major change was recorded in the amount of coin distribution by the MNB in 2004. Customers lodged 237 million coins at the cash desks of the MNB, up 4% on the previous year, while 424 million coins were withdrawn by customers, down 2% on 2003.
In total, 2.9 million banknotes and 2.7 million coins were lodged and withdrawn at the MNB's main cashier's desk in Budapest and four regional cashier's desks on a daily average. In terms of weight, this represents daily circulation of 16 tons of currency.

3. 5. 2. Cash in circulation

As illustrated in Chart 3. 5-1, the change in the value of cash in circulation over the year was different compared to previous years. The amount of currency which was returned to the Bank at the beginning of the year was higher than usual and this phenomenon was observed for a longer period (up to the end of March) than in previous years. In line with seasonal effects, the value of currency increased slightly in the second quarter of 2004, and then remained broadly unchanged till November, in contrast with the gradual increase seen in

Chart 3. 5-1.

Changes in the value of cash in circulation



previous years. The value of currency rose considerably in the period leading to the Christmas holidays and thereafter it suddenly dropped below the level measured at the beginning of the year, a development never seen in the past 15 years. At the end of December 2004, cash in circulation amounted to HUF 1,444.3 billion, down 1% (HUF 14 billion) on a year earlier.

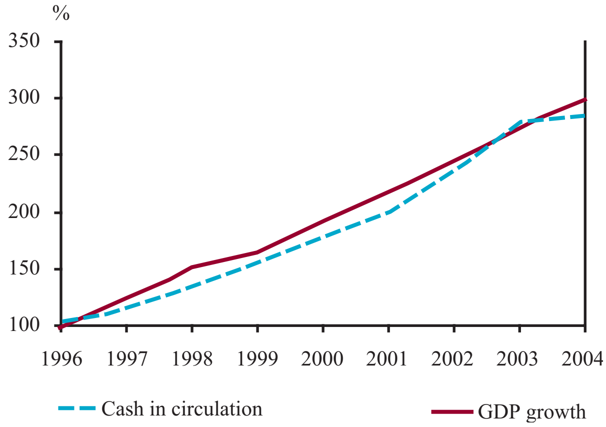
The fact that the developments related to cash in circulation in 2004 were different than in previous years can be attributed to several factors. The drop in the value of currency was due to a decrease in real wages, and the related growth in retail trade turnover, which was considerably slower than in 2003, as well as the significant increase in the cost of holding currency (opportunity cost) as a result of the sharp rise in interest rates after November 2003. Higher interest rates prompted households to shift their portfolios and invest in interest-bearing assets. Non-interest bearing assets, including currency, saw a strong drop in the first quarter of 2004, and this was reflected in a significant rise in the amount of lodgements made at the MNB.

Every year, cash is returned to the MNB in large quantities after the Christmas holidays. In December 2004, there were more working days available for the lodgement of currency at the MNB than in the previous years. Amongst other factors, this longer lodgement period at the end of December also contributed to the fact that on 31 December 2004, the value of cash in circulation dropped to a level below the data recorded a year earlier.

The average ratio of currency, in relation to GDP at current prices, fell from 7.3% in 2003 to 6.9% in 2004 as a result of a substantially lower growth rate for currency than for GDP. The average growth rate of cash in circulation was 3% in 2004; 6 percentage points less than the growth rate of GDP at current prices.

Chart 3. 5-3.

Increase in GDP at current prices and the annual average amount of currency on a 1996 base



In 2004, the average per capita amount of forint cash was HUF 144,000, the number of banknotes and coins being 24 and 230, respectively. The per capita value of cash rose by 6.7%; while the number of banknotes and coins increased by 1, and 30, respectively (in the euro area, the per capita

Table 3. 5-2.

Cash in circulation on 31 December 2004

	2003	2004	Change	
	HUF billions			%
Banknotes	1,431.3	1,415.8	-15.5	98.9
Coins	24.5	25.5	1.0	104.1
Cash for circulation	1,455.8	1,441.3	-14.5	99.0
Collector notes and coins	2.6	3.0	0.4	115.4
Cash in circulation	1,458.4	1,444.3	-14.1	99.0

number of euro banknotes and coins in circulation was 31 and 182, respectively at the end of 2004). As in previous years, in 2004, banknotes accounted for 98%, and coins for 2% of the total value of cash in circulation.

3. 5. 3. Banknotes in circulation

At the end of 2004, the total value of banknotes in circulation was HUF 1,416 billion, down 1% on a year earlier. The number of banknotes in circulation decreased by 1%, but the denominations changed at considerably different rates. The fastest increase (9%) was observed in the number of 20,000 forint banknotes, while the number of 10,000 forint and 5,000 forint banknotes fell by 5% and 12%, respectively.
The average value of a banknote in circulation (i.e. the value of banknotes in circulation divided by the number of banknotes in circulation) was HUF 5,877 at the end of 2004, practically unchanged on a year earlier. By comparison: the average value of a euro banknote in circulation was EUR 52 (HUF 12,768) at end-2004.

3. 5. 4. Coins in circulation

The 2004 increase in the volume of coins in circulation fell short of the 11-12% growth rate recorded in 2002 and 2003. The number of coins in circulation was 2,326 million, up 9% or 187 million on a year earlier. As in previous years, over 70% of this increase was due to a stronger-than-average rise in the number of coins of small denominations (1 and 2 forint coins). In contrast with the 4–8% increases observed in previous years, the number of 100 forint coins in circulation grew by a mere 1%. The 2004 value of coins in circulation rose by 4% (HUF 1 billion), more moderately than in previous years.

Table 3. 5-4.

Banknotes in circulation on 31 December 2004

Denomination	Quantity	Value	Percentage share	
	Millions	HUF billions	Quantity	Value
20 000 forint	24.6	491.4	10.2	34.7
10 000 forint	71.7	717.0	29.8	50.6
5000 forint	22.2	111.2	9.2	7.9
2000 forint	16.7	33.4	6.9	2.4
1000 forint	43.5	43.5	18.0	3.1
500 forint	22.8	11.4	9.5	0.8
200 forint	39.4	7.9	16.4	0.5
Total	**240.9**	**1,415.8**	**100.0**	**100.0**

Table 3. 5-5.

Coins in circulation on 31 December 2004

Denomination	Quantity	Value	Percentage share	
	Millions	HUF millions	Quantity	Value
100 forint	130.5	13,052	5.6	51.2
50 forint	78.3	3,913	3.4	15.4
20 forint	156.9	3,137	6.7	12.3
10 forint	189.5	1,895	8.1	7.4
5 forint	252.4	1,262	10.9	5.0
2 forint	694.3	1,389	29.8	5.5
1 forint	824.3	824	35.5	3.2
Total	2,326.2	25,472	100.0	100.0

3. 5. 5. Expert analyses concerning the authenticity of banknotes and coins

The MNB performs analyses of suspected forint counterfeits detected in Hungary and various foreign banknotes and coins.

In the field of cash expert analyses, the creation of appropriate operating conditions for the National Counterfeit Centre, established in the spirit of the EU accession, continued in the course of 2004 and was completed by the year-end. The national information technology infrastructure required for full-scale connection to the Counterfeit Monitoring System, set up by the ECB in order to protect the euro against counterfeiting, was developed.

In line with the development and spread of information technology-based colour copying technologies (colour photocopiers and printers), the counterfeiting of forint banknotes rose in 2004 in comparison with the previous year. Printing methods are no longer used for counterfeiting forint banknotes. Despite this increase, the extent of counterfeiting does not jeopardise the safety of cash circulation: the number of detected counterfeits may be qualified to be in medium range in international comparison. In 2004, the experts of the Magyar Nemzeti Bank identified 12,638 counterfeits in 11,097 cases of counterfeiting. Fifty-three counterfeits were recorded for every one million banknotes in circulation, which can be regarded as average by European comparison. Accounting for 70% of all the counterfeits, the most frequently counterfeited denomination was the 1,000 forint banknote. Some of the counterfeits produced by colour photocopiers or printers were seized before they were put into circulation. With an adequate knowledge of authentic banknotes and reasonable checking, counterfeits can

Chart 3. 5-6.

Forint counterfeits: number of cases and quantity

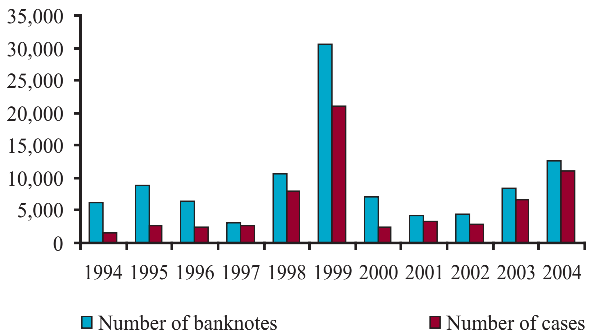
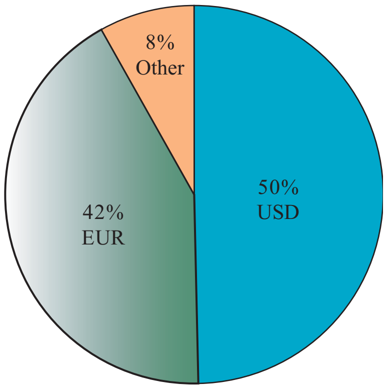


Chart 3. 5-7.

Counterfeits seized in Hungary in 2004, in a breakdown of foreign currencies



be detected without any devices. With this end in view, the MNB increasingly participated in the training and advanced training of cashiers working in credit institutions and trade.

The number of counterfeit foreign currencies seized in 2004 was insignificant, and decreased by 30% in comparison with the previous year. In this context more specifically, the amount of euro counterfeits dropped considerably: 42% of all the counterfeits seized in Hungary were euro counterfeits.

3. 5. 6. Issue of collector and commemorative coins

In 2004 the Magyar Nemzeti Bank issued collector and commemorative coins on four themes. Silver 5,000 forint coins were issued in honour of the Olympics organized in Athens, in recognition of the Visegrád Castle, and the Ancient Christian Necropolis in Pécs. On the occasion of Hungary's accession to the European Union, the MNB issued a 50,000 forint gold and a 5,000 forint silver collector coin and 50 forint base metal commemorative circulation coin.

3. 6. Statistical services

3. 6. 1. 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 dissemination of information as fundamental responsibilities of the central bank.

Pursuant to the provisions of Article 60(1)i) of the Act, effective as of 1 May, 2004, the governor of the MNB is authorised to regulate the scope of information required for the central bank's information system, as well as the manner and deadline of information provision in decrees instead of resolutions which were used in the past.

Accordingly, the Governor of the MNB stipulated the 2005 data provision obligations of financial institutions, investment companies and institutions engaged in auxiliary financial services in a decree.

In a wider context of persons, the MNB still requires 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.

3. 6. 2. 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 data provision obligations.

The MNB revises the collection of statistical data once every year, and specifies data provision obligations for a calendar year. The MNB specified the 2004 data provision obligations in its resolution 3/2003. (PK. 16.), subsequently replaced by Decree 7/2004. (XII. 7.) MNB of the Governor of the MNB, within the framework of the National Programme for the Collection of Statistical Data (OSAP).

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.

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 web site. 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 6 months 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 2004

The most significant methodological changes were introduced in the balance of payments statistics. On the one hand, in adjustment to the international methodological standard, the MNB adopted the accrual basis in the income on debt, instead of the settlement basis, while on the other, reinvested earnings on direct investment were included in the balance of payments statistics. On 31 March 2004 for the first time, the MNB published the 2003 balance of payments data including reinvested earnings and the time series revised back to 1995. With this methodological change, the difference which resulted from the non-inclusion of reinvested earnings in these statistics against the income and financial accounts of the national accounts was eliminated. Interests were settled on an accrual basis for the first time in the 30 June 2004 press release of the MNB.

In line with the requirements of the European Union, in the course of 2004 the time series disclosed in the financial accounts statistics were extended and revised back to 1995. For households and the general government these data were revised back as far as 1991. In addition, the MNB supplied Eurostat with data on general government financing and debt for the first time in February 2004, within the framework of the so-called excessive deficit procedure (EDP report: government deficit and debt indicators compiled in accordance with the methodology required by the European Union).

The methodology of monetary statistics also underwent changes in the course of 2004: as of the release of the January 2004 data, interest rate statistics contain more broad-based and detailed information. The publication was enlarged because data for the preceding calendar year, collected in accordance with the requirements specified by the European Union and containing more details than previous bodies of data, were available.

3. 6. 3. International reporting

The MNB complied with all the reporting obligations pertaining to EU Member States in 2004. Accordingly, it supplied Eurostat, the EU's statistical office, and the European Central Bank with data on a regular basis.

In order to comply with international recommendations and requirements in relation to Hungary's membership of the European Union and monitor changes in such, the MNB sent representatives to every EU institutional forum affecting the central bank's statistical activity, including the meetings of the Statistical Committee of the ESCB and its working group, and the working group meetings organized by Eurostat.

In accordance with the obligations arising from its position as well as the requirements of international co-operation and membership, in addition to Eurostat and the ECB, the MNB regularly reports data 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 has been providing data to the Bank for International Settlements (BIS) on a regular basis since 2003.

3. 6. 4. 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.

The framework of professional cooperation between the MNB and the CSO was established in an agreement signed by the Governor and the president of the CSO on 8 February 2002. The two institutions specify the fields of cooperation and the specific tasks in an annually updated, itemised work schedule. Just as in previous years, the 2004 work schedule assigns priority to the further development of the balance of payments methodology, broadening of cooperation and a reconciliation of the methods of general government statistical records.

While preparing general government sector accounts, which constitute an integral part of financial accounts, the MNB also consulted with the Ministry of Finance in 2004.

As regards monetary statistics, the MNB and the HFSA have requested credit institutions to submit joint balance sheet reports since early 1998. These two institutions reinforce cooperation in an annually updated agreement.

3. 7. Communication strategy

In agreement with the central banking practices of European and other developed countries, the MNB lays special emphasis on the dissemination of detailed information on its objectives, activities, operation and decisions in order to ensure transparency and public accountability. In addition to the dissemination of information, it strives for a dialogue with groups of specialists as well as the general public, and combines classic means of central bank communication with user-oriented channels. Acting in co-operation with educational institutions, the MNB actively participates in the development of financial culture in Hungary. In addition to inflation expectations, macroeconomic conditions and financial stability, its messages increasingly address information related to Hungary's accession to the euro area.

In 2004, the most significant means and act of communication, focused on the population, and more specifically on educational institutions, was the opening and efficient operation of the MNB's Visitor Centre. With its money and banking history exhibitions, various services (including screening films, lectures in the profession, a specialised library and a coin shop) and interactive games, the Visitor Centre received a total of 38,000 visitors in nine months. It has become a favourite destination for secondary school outings and a popular spot for family programmes during open-house days (three weekends), and has also served as a venue for MNB press conferences and workshops. According to visitor feedback, the Centre's unique exhibits and entertaining educational programmes have made it a key source of information on the financial world in Hungary. Another significant pillar of developing financial culture in 2004 was the so-called Stúdium Program. In response to a call for studies by secondary and tertiary-school students on issues related to inflation and the adoption of the euro, 923 studies were submitted. Further means to raise the population's awareness include regular press communications addressing issues of general interest such as the programme entitled 'Let's talk about money!' launched as a joint initiative with the public service radio, and professional assistance to the macroeconomic supplement in the Hungarian financial daily 'Világgazdaság'.

In its communication the MNB lays special emphasis on keeping the Hungarian and international press posted through a balanced, simultaneous provision of information. Regular communications, releases, detailed press materials, interviews, club events, the monthly newsletter entitled 'Jegybankunk' (available free of charge for the press for unrestricted use), its website and the online press-room all contribute to fostering an effective, unbiased working relationships with representatives of the media.

Aware of the mediating role and opinion forming power of financial specialists, market analysts and economic research institutes, the MNB supports and endeavour to facilitate professional dialogue and networked thinking. In addition to regular and occasional papers, the MNB also plays an active role in the organisation of professional discussions, forums, conferences and workshops.

Apart from its central and national communication, the MNB also disseminates information at the regional level. Once a month, the Governor of the MNB visits a provincial town in order to meet local businesspeople, the representatives of educational institutions and the press, public personalities and

the general public within the framework of public lectures held at universities.
In the course of developing its communication strategy, the MNB deems it significant to integrate the results of feedback from the population. Annual polls and focus group research is conducted on public opinion regarding the MNB, awareness of its objectives and activities, and the expectations related to the adoption of the euro. The success of its communication activity is marked by the fact that 65% of the population supported its professional decisions in 2004.

3. 8. Financial performance of the MNB

The MNB incurred a loss of HUF 42.8 billion in 2004, compared to a profit of HUF 78.5 billion in 2003. The financial result of the Magyar Nemzeti Bank is primarily influenced by the objectives and instruments of monetary policy. The ramifications of such activities on the financial result may not prejudice the performance of the MNB's core duties as defined in the MNB Act; as a result the MNB's financial management is confined to ensuring that the Bank has sound and cost-efficient operations.
The following sections outline the impact of the MNB's major duties as a central bank, events and measures on its results, and its internal operations in 2004.

3. 8. 1. A breakdown of the MNB's results by functions

In addition to return on equity, seigniorage – a special source of income for central banks only – also contributes to covering the operating costs of central banks. Seigniorage arises from a central bank's monopoly on issuing notes and coins and its authority to set minimum reserve requirements for credit institutions: the resulting interest-free or below-market rated funds generate a far more significant income than market-rated funds do.
The MNB's balance sheet reflects the very structure of assets and liabilities that arises from central bank operations. In the majority of cases assets

Table 3. 8-1.

A breakdown of the MNB's results by functions

HUF billions

No	Description	2003	2004	Change
(1)	(2)	(3)	(4)	(4)-(3)
1	*Seigniorage*	119.4	163.4	44.0
2	*Cost of currency issue*	-4.1	-5.0	-0.9
3	*Net operating expenses**	-10.7	-12.1	-1.4
4	Adjusted seignoirage (1+2+3)	**104.6**	**146.3**	**41.7**
5	Cost of fiscal activity undertaken on behalf of the government	-0.9	-2.0	-1.1
6	Cost of foreign currency reserves and liquidity management	-39.8	-202.4	-162.6
7	Other (primarily revaluation reserves and capital)	14.6	15.3	0.7
8	Accounting profit/loss (4+5+6+7)	**78.5**	**-42.8**	**-121.3**

** "Operating income" less "operating cost and expenses" in the Profit and Loss Account.*

may not be clearly matched with liabilities. Seigniorage can be calculated relative to the central bank base rate, the interest on market-rated funds. One can gain an insight into the use of seigniorage by comparing the base rate to rates on individual assets and liabilities. Table 3.8-1 shows the effects of the different activities on the 2004 results of the MNB.

Seigniorage not only provides the financial background for the MNB to perform its tasks as a central bank, it is also closely related to two fundamental central bank tasks, i.e. currency issuance and activities related to credit institutions, and therefore it must provide coverage primarily for the costs of currency issuance and banking operation. Seigniorage adjusted for currency issue and banking operations costs resulted in a profit of HUF 146.3 billion in 2004, up HUF 41.7 billion on the previous year. This can be attributed to several, mutually conflicting developments:

• there was a rise of HUF 42 billion as a result of an increase in the annual average central bank base rate;

• a 3.6% increase in the average stock of banknotes and coins in circulation improved it by HUF 5 billion; and

• owing to higher interest – due to the higher level of the base rate – on the statutory reserves of credit institutions and an increase in the average stock of deposits, additional interest expenses reduced the amount of seigniorage by HUF 3 billion on a year earlier.

The MNB's activities related to fiscal activity undertaken on behalf the government include the economic policy-related refinancing of credit institutions and earlier lending to the general government (Table 3.8-1 line 5). As a result of maturities and prepayments by the government, refinancing loans granted for economic policy purposes has been gradually declining in the previous years. Owing to rationalisations in earlier years and prepayments, refinancing loans no longer exert a significant impact on the MNB's results. The HUF 2 billion cost recorded as 'Cost of fiscal activity' in the above table, arises predominantly from the difference between the interest on government securities and the central bank base rate.

A loss of HUF 202.4 billion was incurred on foreign exchange reserve and liquidity management functions performed as part of the central bank's monetary policy activities (Table 3.8-1 line 6). The reason for this loss is that foreign exchange market rates remained considerably below the central bank base rate. In addition to the interest rate differential, another important factor is the exchange rate gain or loss arising from foreign exchange reserve management, which also fell in 2004. The underlying reason for the HUF 162.6 billion increase in the cost of implementing monetary policy lies in the simultaneous effect of the above factors.

The profit recorded under 'Other items' (Table 3.8-1 line 7), was HUF 15.3 billion, which represents a slight improvement in comparison to the previous year.

3. 8. 2. Major events and measures determining the balance sheet and income statement

The structure of the MNB's balance sheet has essentially been shaped by macroeconomic developments and monetary policy measures implemented over the past few years. The major events that determined the balance sheet and income statement in 2004 were as follows:

• the maturities of forint receivables from the government and foreign exchange debts partially transferred to the government,

• strengthening forint exchange rate,

• decrease in the central bank base rate,

• adjustment of the interest on credit institutions' minimum reserves to the central bank base rate, and
• changes in the number of banknotes and coins in circulation.

Owing to foreign exchange purchases and sales, the net foreign exchange position rose by EUR 2.2 billion in comparison with end-2003 to EUR 10.9 billion (HUF 2,678.7 billion). Increase in the net foreign exchange position was reflected in falling foreign exchange debts and an increase of EUR 1.5 billion in foreign exchange reserves; as a result, foreign exchange reserves amounted to EUR 11.6 billion, or HUF 2,847.4 billion, at end-2004. Despite the year-end rise in foreign exchange reserves, the 2004 annual average was lower than in the previous year, and as foreign exchange interest rates remained broadly unchanged, foreign exchange interest revenues fell by HUF 11.8 billion.

In 2004, the official forint exchange rate strengthened by 6.2% relative to the euro, leading to a decline in the forint-denominated value of foreign exchange reserves and all FX-denominated items. The overall 2004 revaluation effect was a loss of HUF 157.1 billion, including the total realised foreign exchange gain/loss. Of this, the MNB realised HUF 22.6 billion profit on the sales; thus revaluation reserves, forming a part of the MNB's equity, decreased to HUF 19.5 billion.

Net forint-denominated liabilities increased in line with the changes in the net foreign exchange position, as clearly reflected in the developments of stocks in the abbreviated balance sheet.

Table 3. 8-2.

Balance sheet of the MNB

HUF billions

No	Assets	2003	2004	No	Liabilities	2003	2004
1	Forint receivables from the central government	269	195	*7*	Banknotes and coins in circulation	1,458	1,444
	of which: receivables because of the forint exchange rate revaluation reserve*	0	1	*8*	Minimum reserve requirements	303	573
2	Foreign currency receivables from the central government	623	403	*9*	Liquidity absorbing instruments	445	575
3	Refinancing credits	12	10	*10*	Forint deposit by central government	94	265
4	Foreign exchange reserves	2,659	2,847	*11*	Foreign currency liabilities to central government and credit institutions	182	56
5	Operating and other assets	616	443	*12*	Foreign and other foreign currency liabilities	1,305	850
				13	Operating and other liabilities	97	68
				14	Equity	295	68
					Revaluation reserve due to exchange rate changes	*199*	*20*
					Revaluation reserve of foreign currency securities	*4*	*0*
6	Total assets (1+2+3+4+5)	4,179	3,899	*15*	Total liabilities (7+8+9+10+11+12+13+14)	4,179	3,899

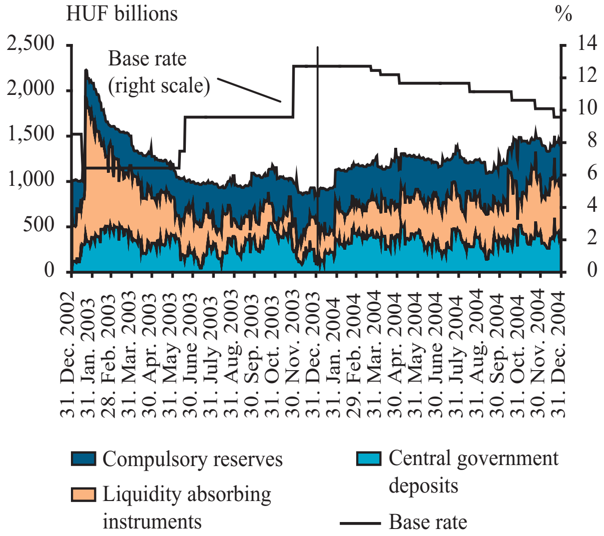
** In 2004 the negative revaluation reserve of the fx securities was restated in the balance sheet as forint receivables from central government.*

Developments in interest income

In addition to the structural rearrangement of portfolios, rising interest rates had the strongest impact on the MNB's forint interest income.

Chart 3. 8-3.

Major forint-denominated liabilities incurred by the MNB in 2003–2004



Despite the favourable effect of the rise in the average amount of cash in circulation, constituting an interest-free fund, forint interest income dropped by HUF 44.9 billion. The primary underlying reason for this deterioration in net forint interest income was an increase in forint expenditures.

Chart 3. 8-3 plots developments in the forint-denominated liabilities, which determine net interest and interest-related forint expenditures, and the central bank base rate.

As a result of the HUF 46.1 billion rise in the aggregate annual average of the predominant forint-denominated liabilities (liquidity-absorbing instruments, forint deposits of the central government and the minimum reserves deposited by credit institutions) on the previous year, and the increase in the annual average interest rate – which is tied to the central bank base rate – paid by the MNB on these instruments, interest expenses increased by HUF 49.5 billion.

Liquidity absorption accounted for HUF 16.1 billion of the increase in interest expenses on the previous year; the interest paid on deposits by the central government explained HUF 14.1 billion; and the interest reimbursed on the minimum reserves contributed HUF 19.3 billion to the increase.

Despite the HUF 74 billion drop in receivables from the central government, interest revenues increased by HUF 4.0 billion.

Table 3. 8-4.

Abbreviated income statement of the MNB

HUF billions

	Description (P&L lines)	2003*	2004	Change
1	Net interest and interest related income (I+II+IV)-(X+XI+XIV)**	7.0	-47.9	-54.9
2	Income arising from exchange rate changes (III-XII)	88.8	22.6	-66.2
3	Other constituents of net income*** (V+...+VIII)-(XIII+XV+...+XVII)	-17.3	-17.5	-0.2
4	**Profit/loss for the year (1+2+3)**	**78.5**	**-42.8**	**-121.3**
5	Revaluation reserves in the balance sheet			
6	*- due to unrealized foreign exchange gain/loss*	199.2	19.5	-179.7
7	*- due to changes in the market value of the foreign currency securities*** **	4.2	-1.1	-5.3

** Reclassified in accordance with the structure of the profit and loss account in 2004.*
*** This line contains the realised gains/ losses arising from financial operations as well.*
**** Other constituents of net income: net expenses of cash circulation and operations net provision and other income/expense.*
***** In the balance sheet the negative revaluation account is restated as receivables from central government.*

Compared to 2003, foreign exchange interest and interest-related income decreased by HUF 11.8 billion to HUF 70.6 billion in 2004.

Income realised on financial operations – recorded in (Table 3.8-4. line 1) the interest income statement – improved by HUF 1.7 billion in the course of the year.

In summary of the above, as a result of various developments in stocks and interests, the MNB's interest income declined by HUF 54.9 billion in 2004.

Profit/loss arising from exchange rate changes and other income factors

As a result of a 6.2% strengthening in the official forint exchange rate, declining foreign currency sales on 2003, and the outstanding 2003 results related to an intervention that appeared as a base effect[1], income resulting from changes in foreign exchange rates dropped by HUF 66.2 billion, while the other income factors[2] declined by HUF 0.2 billion.

In comparison to the previous year, the MNB's income dropped by HUF 121.3 billion.

Revaluation reserve

At the end of December 2004, the revaluation reserve due to foreign exchange-denominated securities amounted to HUF -1.1 billion. Due to regulatory changes, as of 1 January 2004, bonds issued by the MNB abroad and subsequently repurchased must be reported at their purchase price instead of the market price. Thus, the difference between the market value and the book value of these securities, which amounted to HUF 7.1 billion, decreased the revaluation reserves for foreign exchange denominated securities. If accounting rules had not been amended, the revaluation reserve would have improved by HUF 1.8 billion relative to end-2003. The Government reimbursed the negative balance of the revaluation reserve prior to 31 March of the year following the year under review.

3. 8. 3. General information on internal operations in 2004

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 2003.

Operating costs

In terms of the operating costs, the organizational and process rationalisation measures taken in 2002 and 2003 led to considerable savings. In 2004, this tendency stopped and costs at nominal value increased by 6% in comparison to 2003. The most important reason for this is that the costs of the IT developments undertaken in 2003–2004 were incurred in 2004 for the first time. However, in real terms operating costs in 2004 were in line with 2003.

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1 The overwhelming majority of the 2003 profit of HUF 88.8 billion was generated when, subsequent to the considerable weakening of the forint, the MNB sold the foreign exchange that had been purchased during the intervention performed in defence of the forint at the beginning of the year.
2 For a detailed list of the developments in other factors of income, see the relevant sections of the Notes.

Table 3. 8-5.

Operating costs, 2001–2004

Description	2001	2002	2003	2004
Operation costs (HUF million)	15,196	13,507	12,700	13,524
Nominal index (previous year = 100%)	100%	89%	94%	106%
Inflation (yearly average)	*109%*	*105%*	*105%*	*107%*
Change in real terms (previous year = 100%)	91%	84%	90%	100%

Table 3. 8-6.

2004 operating costs of the MNB

1	2	3	4	5	6
Description	Actual data for 2003	Budget for 2004	Actual data for 2004	Index (2004 actual/ 2004 budgeted)	Index (2004 actual/ 2003 actual)
	HUF millions			4 ÷ 3	4 ÷ 2
1. Personnel expenses	8,418	9,192	8,797	95.7%	104.5%
2. General operation costs	4,282	5,461	4,727	86.6%	110.4%
Total	**12,700**	**14,653**	**13,524**	**92.3%**	**106.5%**

The Board of Directors approved a HUF 14,873 million operating cost budget for 2004, of which central reserves amounted to HUF 220 million, whereas actual costs amounted to HUF 13,524 million.

Personnel costs

In 2004, personnel costs amounted to HUF 8,797 million, an increase of 4.5% on 2003. Fundamentally, three factors exerted an impact on costs:

- a 1.3% decline in the average number of employees,
- an average increase of 7.2% in basic wages, implemented in 2004, and
- an approximately 15% decline in costs incurred in relation to termination of employment.

The closing number of employees was 8 persons less than the corresponding 2003 figure, and thus the average 2004 headcount dropped by 1.3%. This was due in part to delayed filling of vacancies, and in part to terminations of employment required by restructuring and improvement of efficiency.

In the course of 2004, 81 employment relationships were terminated and 57 new staff were hired by the MNB. The new hires served the purposes of filling vacancies and meeting labour demand created by new tasks (e.g. Hungary's accession to the European Union and MNB membership in ESCB), while in a few cases staff was exchanged for quality reasons. 2004 saw the rate of employees holding degrees further increase: their number rose by 20 persons. The number of people employed in executive positions in 2004 was up 3 persons on 2003.

Actual personnel costs fell short of the 2004 budget by 4%, which was mainly the result of a lower-than-planned average staff number.

Table 3. 8-7.

Headcount 2001–2004

Description	2001	2002	2003	2004	Difference (2004/2003)	
	(persons)	(persons)	(persons)	(persons)	(persons)	(%)
Number of employees at year-end	1,163	984	946	938	-8	-0.8%
Average number of employees	1,246	1,058	958	946	-12	-1.3%

General operating costs

In 2004, general operating costs (HUF 4,727 million) increased by 10.4% in total, primarily due to the first accounting of the costs of operating the new IT systems. In addition to this, only depreciation increased in real terms.

The IT costs incurred in 2004 (HUF 954 million) exceeded the 2003 data by 26%. For the most part, these costs were related to the start-up and ongoing operation of the Disaster Recovery Centre. The most significant cost increases were registered in material, maintenance and repair costs and rental of hardware and telecommunications assets. Furthermore, data transmission costs also increased.

The 2004 *operating costs* (HUF 1,438 million) remained broadly unchanged in comparison to 2003. Costs decreased in real terms primarily due to tendering certain services (such as cleaning and maintenance of minor currency issuing machines), parts and materials were used more sparingly and processes were redesigned (e.g. electronic transmission of documentary evidence and data).

The total amount of 2004 depreciation (HUF 1,480 million) was up 8% on the previous year as the volume of capital expenditure in 2003-2004 exceeded that in earlier years.

Other costs amounted to HUF 978 million in 2004, representing an increase of 2% over 2003. Within this category, the costs of business data purchases (and more specifically, the system developed in 2003 for the collection of data on services and foreign trade) dropped in 2004. However, costs of performing tasks related to Hungary's accession to the European Union (e.g. business trips and attendance in conferences abroad) saw a significant increase.

Capital expenditure (capex)

The Board of Directors approved a HUF 3,810 million capex budget – including interim adjustments – for 2004 (of this, itemised fixed asset capital expenditure amounted to HUF 3,609 million, while central reserves accounted for HUF 201 million).

In 2004, HUF 2,967 million was spent on capital expenditure, representing 82% of the budgeted target.

The primary reason for the 82% rate of completion is that through the tenders MNB was able to realize savings on one part of capital expenditures and that some of the projects were not completed by the end of the year, because of rescheduling. When accounting for projects with deadlines rescheduled to 2005 as well, budget fulfilment is at 89%.

IT capital expenditure

According to the approved 2004 budget, the main IT projects are the following:

– continuous availability of the technical infrastructure and systems,

Table 3. 8-8.

2004 capital expenditure budget of the MNB

1	2	3	4
Description	Adjusted budget to 2004	Actual data for 2004	Index
	HUF millions		3 ÷ 2
Modernisation of information technology	2,089	1,618	77%
Logistics Centre	270	251	93%
Other investments, purchases	1,250	1,098	88%
Total	**3,609**	**2,967**	**82%**

– set up of the Disaster Recovery Centre,
– creating the conditions for a state-of-the-art storage and archiving system for large amounts of data, and
– implementation of the new analytical account management system.

In order to achieve the above goals, projects in the value of HUF 1,618 million were implemented in 2004. Within this,
– to upgrade the IT infrastructure;
• the implementation of the centralised data storage, saving and archiving system which began in 2003 was completed, providing a less risky solution than earlier (when various individual storage capacities were used for each system);
• outdated user-side hardware tools (terminals, monitors and printers) were replaced in compliance with the MNB's policy;
• the software licences installed on the facilities used in the Disaster Recovery Centre were purchased; and
• the conditions for connection to the ECB's Corenet and to the ESCB-net were created for both the live and the back-up system;
– within the context of developing integrated operative systems, the new system developed in the framework of a project for a replacement of the analytical account management system ('Bankmaster') was successfully launched on 31 January 2005;
– a large proportion of the development of central banking statistical systems was linked up with the 'Data Warehouse' Project to support the MNB's analyses and publications and will be completed in 2005; and
– within the framework of support for administrative processes, amongst other things, services provided via the Internet Web site of the MNB were broadened and the MNB's intranet portal was revamped, while the existing systems, (the document handling and the working time registration systems) were further developed; the IT system supporting the human resources management processes were fully integrated.

Logistics Centre

The MNB intends to relocate the issue of banknotes and coins, one of its core activities, along with its IT support and Magyar Pénzverő Rt, to a sophisticated, new logistics centre.
The Board of Directors approved the complete (projected) financial plan of the Logistics Centre at its 24 June 2003 meeting, and has continued to monitor progress on a regular basis.

The amount of money actually paid in relation with the project in 2004 was HUF 251 million. In the course of the year, following completion of the preparatory stage in the broader sense, implementation plans were made for the facilities and for the bank security technology, and tenders were called for the position of the main contractor and the technology to be used in the depository. These tenders are likely to be completed by the end of April 2005.

Other investment projects and purchases

Over 70% of the other projects and purchases, representing an amount of HUF 1,098 million, were related to the preservation and technological upgrading of the buildings, close to 10% to the modernisation of the cash processing equipment and approximately 20% to the purchase of minor equipment. The main projects were the following:

– insulation of the streetside walls of the building at 8–9, Szabadság tér by soil injection, and simultaneous renovation of the surrounding pavement surface;

– the reserve electricity and compressed air supply of the central buildings were provided for to replace the energy supply systems in building at 4 Hold u. (handed over to the Hungarian State Treasury earlier);

– complete modernisation of 2000 BPS banknote processing machine in order to ensure smooth and safe operation;

– replacement of the outdated V. Band digital transaction telecommunication system for a modern system with the expected functionality; and

– development of an area, suitable among others to function as an office and a crisis centre in the place of the former depository vault.

3. 8. 4. Human resources management

Recruitment and selection

Simultaneously with the conversion of the system of entrance into the career management system, the method of the assessment centre was introduced into the executive selection process, whereby the objectivity and substantiation of the selection decisions have been considerably increased. In 2004, the number of transfers to vacancies and new positions was clearly more favourable than in the previous years: altogether 122 employees were transferred within the MNB.

In the course of 2004, 16 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, 5 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 and knowledge management

With the involvement of an external consultant and the MNB's executives, the system of executive competences was elaborated for the medium and top levels. The executives were measured against these competences in the framework of a 360° survey. Based on the outcomes of the survey, they were enrolled into customised management training and skills development.

On the basis of the concept elaborated in 2003, codification and classification of the knowledge, expertise and command available at the MNB and the institutionalisation of the different forms of knowledge sharing were launched in 2004. As a result, the proportion of programmes held by our own colleagues was higher in the training courses offered. The number of internal professional training courses increased considerably in a great number of fields (e.g. econometrics, changes in the accounting rules, the organisational structure and legal framework of the ECB, financial accounts, etc.). In-house courses were launched with the participation of more than 300 colleagues, with the majority of the lecturers also coming from the MNB.

Also as a result of knowledge management, all the publications and reports of study tours and conferences prepared by employees of the MNB, as well as the external and internal relationships required for work, useful links, news of training courses and congresses and other information are available in a schematic and structured form for every employee on the renewed intranet system.

The rising trend of participation in professional training abroad continued in 2004. 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

The process of admission to the career management system was modified in 2004 in order to increase the efficiency and objectivity of decisions on the lists of potentials and lay its foundations by the application of more sophisticated selection and filtering methods.

In 2004 potential medium-level managers' development needs – primarily directed at managerial skills – were met with the help of the Development Centre's method. On this basis, a two-year management training course was compiled with the aim of a conscious preparation for the executive's role and responsibility through improvement of skills.

In 2004, the majority of executive positions were filled by advancement of MNB employees, several of them were promoted from the list of potential managers.

Performance management

The State Audit Office controlled the operation of the performance management system at the MNB in 2004. It was established that the system had introduced a performance-oriented value system in the MNB and facilitated the efficient operation of the organisation.

Within the performance management system, the methodology of assessment was improved in 2004 in a way to allow managers greater leeway for manoeuvre to apply more sophisticated differentiation in performance. In addition to methodological development, the full electronic documentary background was created and subsequently applied in the 2005 performance management cycle.

Development of the corporate culture

The action plans of the 2004 Pillar Programmes were successfully completed, and accordingly the three-year programme was finished at the end of 2004. In 2004, employee satisfaction was measured by a new method: with the direct involvement of the employees at forums where the executives acted as facilitators. As a result, once again a number or action plans were elaborated with the improvement of efficiency, cooperation, the working place environment and the conditions of work. Some of them were actually performed in 2004, while others have been launched and will be accomplished this year.

The new portal developed in 2004 provides efficient support to the renewal of corporate culture in the MNB. As a channel of two-way communication, it places the intra-institutional information flow on a new footing by giving prompt information, supporting work processes, raising individual as well as collective knowledge to an organisation-wide level and offering a chance for interaction.

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 reserve 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 collaterals 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. Chronological order of events related to the central bank

March

1 March Two new members, Dr. Ilona Hardy and Vilmos Bihari, were appointed to the Monetary Council as from 1 March.

19 March Opening of the Visitor Centre.

23 March The Magyar Nemzeti Bank reduced the central bank base rate by 0.25 percentage point to 12.25%.[3]

29 March Issue of a commemorative coin with a nominal value of HUF 5,000 in honour of the XXVIII Summer Olympic Games in Athens.

April

6 April In accordance with the decision of the Monetary Council, the central bank base rate was reduced by a further 0.25 percentage point to 12%.

30 April Issue of jubilee 50 forint coins and of commemorative silver and gold coins with nominal values of HUF 5,000 and HUF 50,000: 'Hungary – Member of the European Union'.

[3] The interest rates of facilities tied to the base rate in terms of remuneration changed to the same degree (these are interest rates calculated for deposits placed with the central bank on the basis of a party's own decision, and from 1 May 2004 interest rates paid for reserves held on the basis of foreign exchange and forint assets and charged on debt transactions).

May

1 May On 1 May 2004, Hungary entered the European Union, which also resulted in the MNB joining the European System of Central Banks (ESCB) as a member.

The MNB increased the amount of interest based on the minimum reserve by 0.25 percentage point, which thus amounted to 12% both for the reserves held on the basis of forint and foreign currency assets (accordingly, since May 2004 the remuneration of required reserves equals to the prevailing base rate).

4 May The Magyar Nemzeti Bank reduced the central bank base rate by 0.5 percentage point to 11.5%.

August

17 August The central bank base rate was reduced by a further 0.5 percentage point. Thus, the central bank base rate dropped to 11%.

September

7 September The MNB increased its share in KELER Rt. by 3.3%.

28 September Issue of a commemorative coin with a nominal value of HUF 5,000 celebrating castles in Hungary: Visegrád Castle.

October

19 October The MNB reduced the base rate by another 0.5 percentage point to 10.5%.

November

23 November As a result of a further 0.5 percentage point interest rate cut the central bank base rate decreased to 10%.

December

6 December At its meeting on 6 December, the Monetary Council decided to publish abridged minutes of its regular rate-setting meetings.

9 December Commemorative coin with a nominal value of HUF 5,000 was issued in November celebrating World Heritage in Hungary: The Ancient Christian Necropolis in Pécs.

21 December As a result of a further interest rate cut the central bank base rate decreased to 9.5%.

3. 11. Publications, conferences organised by the MNB in 2004

3. 11. 1. Publications

The Magyar Nemzeti Bank publishes several publications every year. The most important ones are:

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: the central bank reports on the financial result of its activities and on the assets position of the previous business year annually. The Annual Report includes the Business Report, the Notes to the Financial Statements, the Balance Sheet and the Income Statement of the Magyar Nemzeti Bank.

MNB Background Studies: 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.

Other publications: in 2004 a book titled 'Monetary Strategies for Joining the Euro', edited by György Szapáry, Deputy Governor, MNB and Jürgen von Hagen, Director, Center for European Integration Studies (ZEI).

All publications of the Magyar Nemzeti Bank are available on its website (www.mnb.hu). Certain publications are available in both English and Hungarian.

3. 11. 2. Conferences

6 February The Magyar Nemzeti Bank organised an international conference on stability at the Hungarian Academy of Sciences.

11 October The conference titled 'International dialogue about the EMU' of the Centre for Economic Policy Research and of the European Summer Institute was hosted by the Magyar Nemzeti Bank.

28 October In cooperation with the Hungarian Economic Association the Magyar Nemzeti Bank held a Conference on Inflation.

3 November Organisation of a money market conference.

19 November Conference on payment transactions, focussing on interbank cooperation.

3. 12. Explanation of abbreviations and terms specific to central banking

3. 12. 1. 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 (an ESCB committee)

CANSTAT: Central European Statistical Co-operation

CEBS: Committee of European Banking Supervisors

CSO: Central Statistical Office

DRC: Disaster Recovery Center

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.

ECB: European Central Bank

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.

EIB: European Investment Bank

EMU: Economic and Monetary Union

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 Elszámolásforgalmi Rt.

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.

3. 12. 2. 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.
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 (repurchase security agreement) 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 (completion): 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

ERNST & YOUNG

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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 December 31, 2004, which shows a balance sheet total of HUF 3,898,717 million and a loss for the year of HUF 42,766 million, the related profit and loss account for the year then ended and the notes included in the National Bank's 2004 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, 2004 on the National Bank's annual financial statements as at 31 December, 2003.

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 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 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 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 December 31, 2004 and of the results of its operations for the year then ended. The business report corresponds to the disclosures in the financial statements.

Budapest, April 5, 2005

Ernst & Young Kft.
Registration No. 001165

Mariann Hergovits
Registered Auditor
Chamber membership No.: 004648

2. Balance sheet of the Magyar Nemzeti Bank

HUF millions

Note	ASSETS	31.12.2003*	31.12.2004	Change
	1	2	3	3-2
	I. RECEIVABLES DENOMINATED IN FORINT	**281,163**	**205,522**	**-75,641**
IV.3.	1. Receivables from the central government	269,293	195,181	-74,112
	of which: receivables to refund the revaluation reserve of foreign currency securities**	0	1,112	1,112
IV.7.	2. Receivables from credit institutions	10,424	9,583	-841
	3. Other receivables	1,446	758	-688
	II. RECEIVABLES DENOMINATED IN FOREIGN CURRENCY	**3,763,029**	**3,581,087**	**-181,942**
IV.9.	1. Gold and foreign currency reserves	2,659,072	2,847,446	188,374
IV.4.	2. Receivables from the central government	622,609	402,883	-219,726
	3. Receivables from credit institutions	2,027	1,442	-585
IV.10.	4. Other receivables	479,321	329,316	-150,005
	III. BANKING ASSETS	**23,719**	**26,562**	**2,843**
IV.12.	of which: invested assets	23,270	26,022	2,752
IV.15.	**IV. PREPAID EXPENSES/ACCRUED INCOME**	**110,619**	**85,546**	**-25,073**
	V. TOTAL ASSETS (I+II+III+IV)	**4,178,530**	**3,898,717**	**-279,813**

Note	LIABILITIES AND EQUITY	31.12.2003*	31.12.2004	Change
	1	2	3	3-2
	VI. LIABILITIES DENOMINATED IN FORINT	**2,306,129**	**2,867,049**	**560,920**
IV.5.	1. Central government deposits	94,139	265,460	171,321
IV.8.	2. Deposits by credit institutions	712,298	1,114,216	401,918
	3. Banknotes and coins in circulation	1,458,371	1,444,303	-14,068
	4. Other deposits and liabilities	41,321	43,070	1,749
	VII. LIABILITIES DENOMINATED IN FOREIGN CURRENCY	**1,486,950**	**906,570**	**-580,380**
IV.5.	1. Central government deposits	160,204	49,101	-111,103
	2. Deposits by credit institutions	21,653	7,244	-14,409
IV.11.	3. Other deposits and liabilities	1,305,093	850,225	-454,868
IV.13.	**VIII. PROVISIONS**	**0**	**10**	**10**
	IX. OTHER BANKING LIABILITIES	**10,137**	**9,626**	**-511**
IV.15.	**X. ACCRUED EXPENSES/DEFERRED INCOME**	**80,753**	**47,599**	**-33,154**
IV.16.	**XI. EQUITY**	**294,561**	**67,863**	**-226,698**
	1. Share capital	10,000	10,000	0
	2. Retained earnings	2,659	81,123	78,464
	3. Valuation reserve	0	0	0
IV.14.	4. Revaluation reserve due to exchange rate changes	199,240	19,506	-179,734
IV.14.	5. Revaluation reserve of foreign currency securities	4,198	0	-4,198
	6. Profit/Loss for the year	78,464	-42,766	-121,230
	XII. TOTAL EQUITY AND LIABILITIES (VI+VII+VIII+IX+X+XI)	**4,178,530**	**3,898,717**	**-279,813**

** Breakdown in accordance with the regulations for the year 2004.*

*** Pursuant to 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.*

Budapest, 5 April 2005

Zsigmond Járai

Governor, Magyar Nemzeti Bank

3. Income statement of the Magyar Nemzeti Bank

HUF millions

Note	INCOME	2003*	2004	Difference
	1	2	3	3-2
IV.18.	**I. INTEREST AND INTEREST RELATED INCOME DENOMINATED IN FORINT**	**25,002**	**29,581**	**4,579**
	1. Interest on receivables from the central government	22,776	26,278	3,502
	2. Interest on receivables from credit institutions	2,085	2,622	537
	3. Interest on other receivables	41	46	5
	4. Interest related income	100	635	535
IV.18.	**II. INTEREST AND INTEREST RELATED INCOME DENOMINATED IN FOREIGN CURRENCY**	**315,868**	**214,009**	**-101,859**
	1. Interest on foreign currency reserves	101,481	75,917	-25,564
	2. Interest on receivables from the central government	44,978	23,822	-21,156
	3. Interest on receivables from credit institutions	94	65	-29
	4. Interest on other receivables	8,082	4,159	-3,923
	5. Interest related income	161,233	110,046	-51,187
IV.19.	**III. INCOME ARISING FROM EXCHANGE RATE CHANGES**	**97,643**	**28,145**	**-69,498**
IV.18.	**IV. REALIZED GAINS ARISING FROM FINANCIAL OPERATIONS**	**13,925**	**9,489**	**-4,436**
IV.21.	**V. OTHER INCOME**	**2,615**	**2,507**	**-108**
	1. Fees and commissions	1,023	1,102	79
	2. Income other than fees and commissions	1,592	1,405	-187
IV.13.	**VI. PROVISIONS RELEASED**	**0**	**14**	**14**
IV.13.	**VII. IMPAIRMENT RELEASED**	**1,201**	**13**	**-1,188**
IV.23.	**VIII. OPERATING INCOME**	**1,085**	**183**	**-902**
	IX. TOTAL INCOME (I+II+III+IV+V+VI+VII+VIII)	**457,339**	**283,941**	**-173,398**

Note	EXPENSES	2003*	2004	Difference
	1	2	3	3-2
IV.18.	**X. INTEREST AND INTEREST RELATED EXPENSE DENOMINATED IN FORINT**	**92,107**	**141,592**	**49,485**
	1. Interest on central government deposits	25,643	39,711	14,068
	2. Interest on deposits by credit institutions	62,245	97,647	35,402
	3. Interest on other deposits	4,219	4,234	15
	4. Interest related expenses	0	0	0
IV.18.	**XI. INTEREST AND INTEREST RELATED EXPENSES DENOMINATED IN FOREIGN CURRENCY**	**233,414**	**143,302**	**-90,112**
	1. Interest on government deposits	1,998	829	-1,169
	2. Interest on deposits of credit institutions	775	533	-242
	3. Interest on other liabilities	70,269	32,380	-37,889
	4. Interest related expenses	160,372	109,560	-50,812
IV.19.	**XII. EXPENSES RESULTING FROM EXCHANGE RATE CHANGES**	**8,856**	**5,559**	**-3,297**
IV.20.	**XIII. COST OF ISSUING BANKNOTES AND COINS**	**4,701**	**5,947**	**1,246**
IV.18.	**XIV. REALIZED LOSSES ARISING FROM FINANCIAL OPERATIONS**	**22,271**	**16,100**	**-6,171**
IV.21.	**XV. OTHER EXPENSES**	**4,316**	**501**	**-3,815**
	1. Fees and commissions	1,062	389	-673
	2. Expenses other than fees and commissions	3,254	112	-3,142
IV.13.	**XVI. PROVISIONS CHARGED**	**0**	**24**	**24**
IV.13.	**XVII. IMPAIRMENT**	**-32**	**11**	**43**
IV.23.	**XVIII. OPERATING COSTS AND EXPENSES**	**13,242**	**13,671**	**429**
	XIX. TOTAL EXPENSES (X+XI+XII+XIII+XIV+XV+XVI+XVII+XVIII)	**378,875**	**326,707**	**-52,168**
	XX. PROFIT/LOSS BEFORE DIVIDENDS	**78,464**	**-42,766**	**-121,230**
	XXI. Dividends from retained earnings	0	0	0
	XXII. Dividends	0	0	0
	XXIII. PROFIT/LOSS FOR THE YEAR (XIX+XX-XXI)	**78,464**	**-42,766**	**-121,230**

** Breakdown in accordance with the regulations for the year 2004.*

Budapest, 5 April 2005

Zsigmond Járai

Governor, Magyar Nemzeti Bank

4. Notes to the financial statements

4.1. The Bank's accounting policy

The Magyar Nemzeti Bank 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. Changes in the legal environment

The regulations determining the accounting policies of the Magyar Nemzeti Bank were modified on 1 January 2004. Consistent with the amendment of the MNB Act, from 2004 the Bank pays dividends from its annual profits or its retained earnings based on the resolution of the shareholders rather than on the basis of a formula. The amendment was already applicable to the distribution of profits for the year 2003.

As a result of the amendments to the MNB Decree and the MNB Act, the following major changes were introduced:

• Realised gains and losses arising from financial operations, which are mainly differences between gains and losses realised on the sale of securities, appeared as a new income item. Earlier, this income item was shown under interest related income.

• In line with the settlement practice of other European central banks, income and expenses related to money circulation are no longer treated as independent categories. Some of the items previously recorded under this item were transferred to other income and other expenses and to interest related income and interest related expenses, respectively, while costs of issuing banknotes and coins are to be named as a separate expense category.

• Foreign currency bonds issued by the Bank and repurchased before maturity are no longer marked to market (these are only revalued as foreign currency assets and the effect of the change in the exchange rate is recorded); such bonds are to be valued in the future in accordance with the general rules of valuation at historic cost.

• Further modifications aim at making the breakdown of the balance sheet and of the income statement more accurate and simple.

In addition, in conformity with the MNB Decree, dividends received from investments by the MNB have been reclassified from operating income to other income.

Changes in the breakdown of income and expenses

HUF millions

INCOME	2003	INCOME	2003	Structural change in 2003	2004
1	2	3	4	5 (4-2)	6
I. Interest and interest related income denominated in forint	24,999	I. Interest and interest related income denominated in forint	25,002	3	29,581
II. Interest and interest related income denominated in foreign currency	328,496	II. Interest and interest related income denominated in foreign currency	315,868	-12,628	214,009
III. Income arising from exchange rate changes	97,643	III. Income arising from exchange rate changes	97,643	0	28,145
		IV. Realized gains arising from financial operations	13,925	13,925	9,489
IV. Income from money circulation	956			-956	
V. Other income	1,456	V. Other income	2,615	1,159	2,507
VI. Provisions released	0	VI. Provisions released	0	0	14
VII. Impairment released	1,201	VII. Impairment released	1,201	0	13
VIII. Operating income	2,588	VIII. Operating income	1,085	-1,503	183
IX. TOTAL INCOME (I+II+III+IV+V+VI+VII+VIII)	457,339	IX. TOTAL INCOME (I+II+III+IV+V+VI+VII+VIII)	457,339	0	283,940

EXPENSES	2003	EXPENSES	2003	Structural change in 2003	2004
1	2	3	4	5 (4-2)	6
X. Interest and interest related expenses denominated in forint	92,107	X. Interest and interest related expenses denominated in forint	92,107	0	141,592
XI.Interest and interest related expenses denominated in foreign currency	253,825	XI. Interest and interest related expenses denominated in foreign currency	233,414	-20,411	143,302
XII. Expenses resulting from exchange rate changes	8,856	XII. Expenses resulting from exchange rate changes	8,856	0	5,559
XIII. Expenses on money circulation	5,048	XIII. Cost of issuing banknotes and coins	4,701	-347	5,947
		XIV. Realized losses arising from financial operations	22,271	22,271	16,100
XIV. Other expenses	5,829	XV.Other expenses	4,316	-1,513	501
XV. Provisions charged	0	XVI. Provisions charged	0	0	24
XVI. Impairment	-32	XVII. Impairment	-32	0	11
XVII. Operating costs and expenses	13,242	XVIII. Operating costs and expenses	13,242	0	13,671
XVIII. TOTAL EXPENSES (X+XI+XII+XIII+XIV+XV+XVI+XVII)	378,875	XIX. TOTAL EXPENSES (X+XI+XII+XIII+XIV+XV+XVI+XVII+XVIII)	378,875	0	326,707
XXII. Profit/loss for the year	78,464	XXIII. Profit/loss for the year	78,464	0	-42,766

** Breakdown in accordance with the regulations for the year 2004.*

4. 1. 2. 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 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 transaction. Assets and liabilities arising from such transactions affect the MNB's foreign currency position from the day of 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 currency 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 the 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 debtors and recognises impairment loss as necessary impairment loss and makes provisions for liabilities and for expected losses.

In the Bank's accounting policies the balance sheet date changed from 31 January to 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 Járai, residing at 1/b Rózsahegy u., 1024 Budapest.

4. 1. 3. Major principles of valuation

Receivables from the central government

The securities stated among the receivables from 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 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 of 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 or 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 valuates 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 valuated 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 no longer marked to market but are valuated at historic cost in accordance with the amendment to the MNB Decree effective from 1 January 2004. 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 that are aimed at reducing the risk arising from changes 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 metal 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	31.12.2003	31.12.2004*
Intellectual property	33.0%	33.0%
Foundation-restructuring (maximum)	20.0%	20.0%
Buildings	3-5%	3-5%
Vehicles	20.0%	20.0-30.0%
Telecommunication devices, office equipment, machines	14.5%-33.0%	6.5%-33.0%
Computer hardware	33.0%	33.0%
Emission machinery	20.0%	20.0%
Instruments	33.0%	33.0%
Bank security devices	14.5%-33.0%	14.5%-33.0%
Other not specified devices**	14.5%	14.5%

** Depreciation rates to be applied for new purchases from 1 January 2004.*
*** 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 case of intellectual property and especially of 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.

Compared to 2003, there were significant changes in the applied depreciation rates applicable to assets acquired after 1 January 2004. The depreciation rates of groups of assets have become more detailed in order to better reflect the useful life of various assets.

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 2004 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 and instruments of monetary policy, as well as by domestic and international economic events.

Compared to the previous year, net interest received and interest related income deteriorated by HUF 56.7 billion. The increase in the central bank base rate in November 2003 resulted in much higher interest expenses in 2004. Despite several cuts in the central bank base rate during the reporting year, the annual average central bank base rate was 11.4% in 2004, in comparison with a 8.5% average in 2003.

Due to the 6.2% appreciation of the forint, the value of foreign currency receivables and liabilities fell in forint terms. As a result, the revaluation effect for the whole year of 2004 was a loss of HUF 157.1 billion. The Bank realised a profit of HUF 22.6 billion from sales; thus the revaluation reserve fell by HUF 179.7 billion to a year-end amount of HUF 19.5 billion.

International interest rates at maturities corresponding to those of securities held in the MNB's foreign exchange reserves did not change significantly in case of euro securities in 2004, while the interest rates of USD securities rose by 1.4–1.5 percentage points. Compared to the end of 2003, foreign exchange reserves increased, but on average were lower throughout 2004, due to the high levels in early 2003. Mainly this explains the HUF 11.8 billion decrease in the foreign currency interest profit or loss.

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
		31.12.2003	31.12.2004	
	Government bonds maturing within one year	4,000	4,000	0
	Government bonds maturing within one to five years	30,368	27,795	-2,573
	Government bonds maturing over five years	163,701	162,274	-1,427
	Securities	**198,069**	**194,069**	**-4,000**
	Loans maturing within one year	43,335	0	-43,335
	Loans maturing within one to five years	27,889	0	-27,889
	Loans maturing over five years	0	0	0
	Loans	**71,224**	**0**	**-71,224**
	Receivables to refund the revaluation reserve of foreign currency securities	**0**	**1,112**	**1,112**
I.1.	**Total**	**269,293**	**195,181**	**-74,112**

Due to a scheduled repayment related to an amortising bond (to be repaid annually over five years), the portfolio of government securities decreased by HUF 4 billion.

Due to maturities and prepayments, loans to the central government fell to zero by the end of 2004, and only government bonds and short-term receivables related to the revaluation reserve remained under the balance sheet item 'Forint receivables from the central government'.

Receivables due to the negative balance of the revaluation reserve at the end of 2004 related to the market valuation of foreign currency securities amounted to HUF 1.1 billion, which, based on the MNB Act, was reimbursed by the central government by 31 March 2005, and thus had to be stated under 'Receivables from the central government' in the year-end balance sheet.

In 2004, 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
		31.12.2003	31.12.2004	
II.2.	Foreign currency receivables from the central government	622,609	402,883	-219,726
	Receivables from central government due from debt swap	537,381	331,469	-205,912
	Swap transactions with maturity over 1 year	85,228	71,414	-13,814

Foreign currency credits vis-à-vis the central government originates from the debt exchange conducted in 1997. In 2004, their portfolio decreased due to maturities and pre-instalments. 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
		31.12.2003	31.12.2004	
II.2.	Foreign currency receivables from the central government	622,609	402,883	-219,726
	- within 1 year	121,906	76,015	-45,891
	- within 1 to 5 years	374,361	208,586	-165,775
	- over five years	126,342	118,282	-8,060

Currency structure of foreign currency credits to the central government HUF millions

B/S line	Description	Balance		Change
		31.12.2003	31.12.2004	
II.2.	Foreign currency receivables from the central government	537,381	331,469	-205,912
1.	- USD	41,584	36,058	-5,526
2.	- JPY	495,797	295,411	-200,386

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

Nr	Description	Balance		Change
		31.12.2003	31.12.2004	
1.	Swap receivables (2+3+4)	1,062,107	686,479	-375,628
2.	- USD	220,870	56,910	-163,960
3.	- EUR currency group*	841,237	608,468	-232,769
4.	- JPY	0	21,101	21,101
5.	Swap payables (6+7+8)	976,879	615,065	-361,814
6.	- USD	462,645	261,236	-201,409
7.	- EUR currency group*	18,437	37,317	18,880
8.	- JPY	495,797	316,512	-179,285
9.	Net swap receivables (1-5)	85,228	71,414	-13,814

** 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
		31.12.2003	31.12.2004	
	Single Treasury Account (KESZ)	44,199	180,681	136,482
	Deposit by State Privatisation and Holding Co. (ÁPV Rt.)	49,530	84,404	34,874
	Deposit by Government Debt Management Agency (ÁKK Rt.)	319	300	-19
	Hungarian State Treasury	26	11	-15
	Other	65	64	-1
VI.1.	Total deposits	94,139	265,460	171,321

Foreign currency deposits of the central government

HUF millions

B/S line	Description	Balance		Change
		31.12.2003	31.12.2004	
	Foreign currency deposits of the central government	37,381	48,994	11,613
	Foreign currency deposits of the Hungarian State Treasury	119,366	0	-119,366
	Other than money market deposits of the central government	530	107	-423
	Short-term derivatives	2,927	0	-2,927
VII.1.	Total deposits	160,204	49,101	-111,103

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

HUF millions

B/S line	Remaining maturity	Balance		Change
		31.12.2003	31.12.2004	
	- within 1 year	160,204	49,101	-111,103
	- within 1 to 5 years	0	0	0
	- over five years	0	0	0
VII.1.	Total deposits	160,204	49,101	-111,103

The short-term foreign currency deposits of the central government fell by HUF 111 billion relative to 31 December 2003. HUF 119 million of the 2003 deposits is due to the fact that, for two days at the end of 2003, deposits increased because in compliance with the relevant contractual terms, a bond that matured in January 2004 had to be repaid two working days before maturity. Consequently, this amount appeared as a deposit for two days. As this bond had been issued abroad and was then transferred to the central government, the same amount is stated on the assets side as the foreign deposit of the MNB (see Section 4.10.).

4. 6. Net position vis-à-vis the central government

HUF millions

B/S line	Description	Balance		Change
		31.12.2003	31.12.2004	
I.1-VI.1.	Net forint position	175,154	-70,279	-245,433
II.2-VII.1.	Net foreign currency position	462,405	353,782	-108,623
	Total	637,559	283,503	-354,056

4. 7. Forint receivables from credit institutions

Forint receivables from credit institutions

HUF millions

B/S line	Description	Balance		Change
		31.12.2003	31.12.2004	
	Receivables from credit institutions	12,242	11,389	-853
	Liqudity refinancing credit on credit institutions	0	4,006	4,006
	Liquidity refinancing credit on credit institutions in liquidation	1,571	1,571	0
	Loans granted for foreign currency deposits	8,744	2,708	-6,036
	Security-backed loans	0	2,106	2,106
	Long-term refinancing credit	1,927	998	-929
	Impairment provision for claims on credit institutions	-1,818	-1,806	12
I.2.	Total receivables	10,424	9,583	-841

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 so they 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 during 2004 was due to repayments. Some of the loans granted in return for the foreign currency deposit were converted into loans available against securities as collateral.

The liquidity refinancing loans to credit institutions are overnight loans granted by the MNB against securities as collateral.

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

HUF millions

B/S line	Remaining maturity	Balance		Change
		31.12.2003	31.12.2004	
	- within 1 year	6,502	9,318	2,816
	- within 1 to 5 years	5,732	2,065	-3,667
	- over five years	8	6	-2
I.2.	Receivables from credit institutions	12,242	11,389	-853

4. 8. Net position vis-à-vis credit institutions

HUF millions

B/S line	Description	Balance		Change
		31.12.2003	31.12.2004	
I.2-VI.2.	Net forint position	-701,874	-1,104,633	-402,759
II.3-VII.2.	Net foreign exchange position	-19,626	-5,802	13,824
	Total	-721,500	-1,110,435	-388,935

Net forint receivables from credit institutions increased by HUF 403 billion on 31 December 2004, explained by a HUF 402 billion rise in credit institutions' forint deposits. The latter was due to an increase of HUF 132 billion in two-week and overnight money market deposits and a rise of HUF 270 billion in minimum reserves.

4. 9. Gold and foreign exchange reserves of the central bank

Forint balances

HUF millions

B/S line	Description	Balance		Change
		31.12.2003	31.12.2004	
	Gold reserve	8,751	7,797	-954
	Reserve position in the IMF	140,056	96,627	-43,429
	Foreign currency deposits	235,549	282,146	46,597
	Foreign currency securities	2,149,394	2,352,253	202,859
	Security repurchase transactions in foreign currency	125,322	108,623	-16,699
II.1.	Total gold and foreign currency reserves	2,659,072	2,847,446	188,374

Foreign exchange reserves increased by EUR 1.44 billion, equivalent to HUF 188.4 billion, primarily due to foreign currency purchases following bond issuance of the government and also to the appreciation of the forint. As some of the bonds issued by the MNB abroad expired, the repayment of their face value decreased the amount of foreign exchange reserves.

Euro balances

EUR millions

B/S line	Description	Balance		Change
		31.12.2003	31.12.2004	
	Gold reserve	33	32	-1
	Reserve position in the IMF	534	393	-141
	Foreign currency deposits	898	1,147	249
	Foreign currency securities	8,197	9,565	1,368
	Security repurchase transactions in foreign currency	478	442	-36
II.1.	Total gold and foreign currency reserves	10,140	11,579	1,439

4. 10. Other foreign currency receivables

HUF millions

B/S line	Description	Balance		Change
		31.12.2003	31.12.2004	
	Forint payment of IMF quota	179,616	193,149	13,533
	Repurchased bonds	172,780	130,236	-42,544
	Foreign hedging transactions*	6,830	5,704	-1,126
	Other	120,095	227	-119,868
II.4.	Other foreign currency receivables	479,321	329,316	-150,005

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

The bonds issued abroad and later repurchased by the MNB decreased by HUF 42.5 billion as these matured. Most of the increase in 'Other' items resulted from the repayment of a foreign currency bond at year-end, which, under the bond indenture, the MNB was obliged to repay two days before maturity, but earned interest at the foreign bank for two days (see also Section 4. 5.).

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
		31.12.2003	31.12.2004	
	Bonds	884,317	503,361	-380,956
	Security repurchase transactions	125,320	37,205	-88,115
	IMF forint deposit	179,617	193,149	13,532
	Foreign deposits and loans	23,449	14,262	-9,187
	Hedging transactions	85,549	89,092	3,543
	Other liabilities	6,841	13,156	6,315
VII.3.	Other foreign currency liabilities	1,305,093	850,225	-454,868

As a result of repayments and pre-instalments, foreign currency bonds declined. 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
		31.12.2003	31.12.2004	
	- within 1 year	503,499	475,902	-27,597
	- within 1 to 5 years	446,285	211,430	-234,855
	- over five years	355,309	162,893	-192,416
VII.3.	Other foreign currency liabilities	1,305,093	850,225	-454,868

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

B/S line	Description	Balance		Change
		31.12.2003	31.12.2004	
	- USD	59,551	58,457	-1,094
	- EUR currency group*	337,550	103,980	-233,570
	- JPY	641,619	404,432	-237,187
	- Other	180,824	194,264	13,440
VII.3.	Other foreign currency liabilities	1,219,544	761,133	-458,411

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

Other foreign currency liabilities include a HUF 193.1 billion deposit by the IMF.

Hedging transactions vis-à-vis non-residents by currency HUF millions

Nr	Description	Balance		Change
		31.12.2003	31.12.2004	
1.	Hedging transactions receivables (2+3+4)	998,558	688,522	-310,036
2.	- USD	476,449	311,242	-165,207
3.	- EUR currency group*	25,014	16,808	-8,206
4.	- JPY	497,095	360,472	-136,623
5.	Hedging transactions payables (6+7+8)	1,084,107	777,614	-306,493
6.	- USD	218,964	102,796	-116,168
7.	- EUR currency group*	860,282	674,570	-185,712
8.	- JPY	4,861	248	-4,613
9.	Net hedging transactions payables (5-1)	85,549	89,092	3,543

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

4. 12. Invested assets

In addition to intangibles, tangibles and capital expenditure (HUF 10.7 billion), invested assets also include shares in investments (HUF 15.3 billion).

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

HUF millions

	Assets							
	Intangible assets		Buildings	Equipment	Banknote and coin collection assets	Tangible assets of MNB, total	Capital expenditure	Intangibles, tangibles and capital expenditure, total
	Patents and similar rights, intellectual property	Software under development						
Gross value								
31.12.2003	5,419	257	6,912	8,486	162	15,560	1,338	22,574
Commissioning/Acquisition	957	99	1,201	1,612	34	2,847	1,910	5,813
Other	0	0	36	0	0	36	0	36
Scrapping	0	0	0	-128	0	-128	-13	-141
Disposal	0	0	0	-144	0	-144	0	-144
Assets contributed free of charge	0	0	0	-4	0	-4	-21	-25
Other deduction	-81	19	-2	-1,398	0	-1,400	-2,823	-4,285
31.12.2004	6,295	375	8,147	8,424	196	16,767	391	23,828
Depreciation charge								
31.12.2003	4,386	0	1,924	6,840	0	8,764	0	13,150
Ordinary depreciation	686	0	216	740	0	956	0	1,642
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	29	0	0	29	0	29
Interim decrease due to removal from the account	0	0	0	-1,648	0	-1,648	0	-1,648
Decrease due to reclassification	-84	0	-2	0	0	-2	0	-86
31.12.2004	4,988	0	2,167	5,932	0	8,099	0	13,087
Closing net value								
31.12.2003	1,033	257	4,988	1,646	162	6,796	1,338	9,424
31.12.2004	1,307	375	5,980	2,492	196	8,668	391	10,741
Change	274	118	992	846	34	1,872	-947	1,317

Investments and dividends from investments

HUF millions

Description	Ownership share (%)		Book value		Dividends received*	
	31.12.2003	31.12.2004	31.12.2003	31.12.2004	2003	2004
BIS (HUF millions,	1.33	1.33	3,079	2,791	543	545
SDR millions)			10.0	10.0		
European Central Bank (HUF millions,	0	1.4	0.0	1,330	-	-
thousand EUR)			0.0	5,408		
SWIFT (HUF millions,	0.02	0.02	0.5	0.4	0	0
thousand EUR)			1.8	1.8		
Pénzjegynyomda Rt.	100.0	100.0	8,927	8,927	256	234
Magyar Pénzverő Rt.	100.0	100.0	575	575	138	239
KELER Rt.	50.0	53.3	250	643	150	138
GIRO Elszámolásforgalmi Rt.	14.6	14.6	91	91	406	189
Nemzetközi Bankárképző Központ Rt.	0.0	0.0	0	0	6	
MNB Üdültetési és Jóléti Szolgáltató Kft.	100.0	100.0	602	602	0	0
Budapesti Értéktőzsde	6.9	6.9	321	321	4	24
Total investments			13,846	15,280	1,503	1,369

** 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. The euro system consists of the ECB and the national central banks of the Member States that have already adopted the euro.

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.

Magyar Nemzeti Bank

Ownership distribution in the ECB as of 1 May 2004

National Central Banks (NCB)	Subscribed capital	Paid-up capital	Capital key
	thousand EUR		%
National 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 Luxemburg	8,725	8,725	0.1568
De Nederlandsche Bank	222,336	222,336	3.9955
Österreichische 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
Total euro area NCBs	**3,978,226**	**3,978,226**	**71.4908**
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
Ceská 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	3,600	252	0.0647
Narodowy Bank Polski	285,913	20,014	5.1380
Banka Slovenije	18,614	1,303	0.3345
Národná banka Slovenska	39,771	2,784	0.7147
Total non-euro area NCBs	**1,586,443**	**111,051**	**28.5092**
Total euro area and non-euro area NCBs	**5,564,669**	**4,089,277**	**100.0000**

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 Statutes, 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 became a member and quotaholder of 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 in line with their respective quotas to the Committee's operating costs according to an annual payment schedule. As membership required the investment of only 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
	31.12.2004	31.12.2004	31.12.2004	2003	Preliminary 2004
Budapesti Értéktőzsde Rt. 1052 Budapest, Deák Ferenc u. 5.	4,349	541	3,807	0	1,038
GIRO Elszámolásforgalmi Rt. 1054 Budapest, Vadász utca 31.	4,726	2,496	2,230	0	0
KELER Rt. 1075 Budapest, Asbóth utca 9-11.	12,109	4,500	7,609	817	2,245
Magyar Pénzverő Rt. 1089 Budapest, Könyves Kálmán krt. 38.	1,082	575	507	0	0
Pénzjegynyomda Rt. 1055 Budapest, Markó utca 13-17.	9,100	8,927	173	0	186
MNB Üdültetési és Jóléti Szolgáltató Kft. 1054 Budapest, Vadász utca 16.	755	602	160	207	-8

The MNB's receivables from and liabilities to affiliated companies

HUF millions

Investment	Receivables	Liabilities
Budapesti Értéktőzsde Rt.	-	-
GIRO Elszámolásforgalmi Rt.	-	0.6
KELER Rt.	-	1.8
Magyar Pénzverő Rt.	0.4	3.6
Pénzjegynyomda Rt.	-	138.1
MNB Üdültetési és Jóléti Szolgáltató Kft.	-	-
Total	0.4	144.1

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 Rt. 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 Rt. 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 Rt. produces circulation and commemorative coins. When capacity allows, it performs contracted work for foreign markets and also produces non-legal tender precious metal coins. The company also sells 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 Rt. for the production of euro coins.

GIRO Elszámolásforgalmi Rt. was established to perform clearing and interbank settlement transactions. In 2004, the MNB started negotiations on the sale of its share in GIRO Rt., and under a purchase and sale agreement effective as of February 2005, 50% of its share was sold.

By purchasing a share package from the Budapest Stock Exchange, the MNB increased its share in **KELER Rt.** from 50% to 53.3%.

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 sports facilities which were contributed to it by the MNB. As the company had incurred substantial losses in previous years, 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	31.12.2003	Interim changes in 2004			31.12.2004
		Impairment loss/ provisions	Increase (+)	Released (-)	Interim exchange rate effect due to Increase/ Release	Total impairment loss/ provisions
1	2	3	4	5	6	7
I.2.	Forint receivables from credit institutions	1,818.4	0.0	-12.7	0.0	1,805.7
II.3.	Foreign currency receivables from credit institutions	0.0	0.0	0.0	0.0	0.0
II.4.	Other foreign exchange 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	433.4	10.7	0.0	0.0	444.1
VIII.	Liabilities	0.0	24.2	-13.9	0.0	10.3
	Total	**2,251.8**	**34.9**	**-26.6**	**0**	**2,260.1**

Impairment loss and provisions increased by a moderate HUF 8.3 million in 2004.

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 10.3 million on end-2003.

Due to partial collection of a receivable from a credit institution, HUF 12.7 million of the impairment loss was reversed.

4. 14. Revaluation reserves

HUF millions

Nr	Description	31.12.2003	31.12.2004.	Change
1.	Revaluation reserve due to exchange rate changes	199,240	19,506	–179,734
2.	Revaluation reserve of foreign currency securities*	4,198	0	–4,198
3.	**Revaluation reserves (1+2)**	**203,438**	**19,506**	**–183,932**

** The end-2004 balance on the revaluation reserve of foreign currency securities indicated a loss of HUF 1,112 million, which had been reimbursed by the central government by 31 March 2005, and thus is no longer included among revaluations reserves but in the line 'Receivables from the central government'.*

In the course of 2004, the official exchange rate of the forint vis-à-vis the euro appreciated by 6.2%. 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) fell by a considerable HUF 179.7 billion to stand at HUF 19.5 billion at the end of the year.

At the end of 2004, the net foreign exchange position was HUF 2,679 billion (EUR 10.9 billion), up HUF 400 billion (EUR 2.2 billion) on the end of 2003.

Up to 2003, the revaluation reserves of foreign currency securities included the difference in the market value and the book value of foreign currency securities issued and repurchased by the MNB. Pursuant to an amendment of the MNB Decree, as of 1 January 2004 repurchased bonds are no longer valued at market price, but in accordance with the general rules of valuation at historic cost. At the end of 2003, the market value of repurchased bonds was HUF 7.1 billion. Exclusive of this amount, the balance of the revaluation reserves would have resulted in a loss of HUF 2.9 billion at the end of 2003, which improved by HUF 1.8 billion, thus pressing the loss down to HUF 1.1 billion.

Annual changes in the forint exchange rate, 2003–2004 (+ appreciation / - depreciation)

	MNB official mid-exchange rate
End-of-period exchange rate	
31.12.2003 (EUR)	262.23
31.12.2004 (EUR)	245.93
Annual depreciation/appreciation	
In 2003	-11.2%
In 2004	6.2%

4. 15. Prepaid expenses/accrued income and accrued expenses/deferred income

HUF millions

B/S line	Description	Balance		Change
		31.12.2003	31.12.2004	
	Due to banking transactions	110,519	85,499	-25,020
	Due to internal operation	100	47	-53
IV.	Prepaid expenses/accrued income	110,619	85,546	-25,073
	Due to banking transactions	80,662	47,535	-33,127
	Due to internal operation	91	64	-27
X.	Accrued expenses/deferred income	80,753	47,599	-33,154

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 only in the next period.

4. 16. Changes in equity

HUF millions

B/S line	Description	31.12.2003	Interim changes	31.12.2004
XI.1.	Share capital	10,000	0	10,000
XI.2.	Retained earnings	2,659	78,464	81,123
XI.3.	Valuation reserves	0	0	0
XI.4.	Revaluation reserve due to exchange rate changes	199,240	-179,734	19,506
XI.5.	Revaluation reserve of foreign currency securities	4,198	-4,198	0
XI.6.	Profit/Loss for the year	78,464	-121,230	-42,766
XI.	Equity	294,561	-226,698	67,863

The share capital consists of a single registered share with the nominal value of HUF 10 billion.
Pursuant to the amendment of the MNB Act in December 2003, the MNB's dividend is specified by the General Meeting. According to the resolution of the General Meeting, in 2005 the MNB will not pay dividend from the profits retained for the year and from the profit of 2004.
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	31.12.2003	31.12.2004	
		Book value of liabilities	Book value of liabilities	Net market value
1.	**Hedging transactions (2+3+4+5)**	**3,473,006**	**2,623,041**	**-17,459**
2.	- FX forward transactions	5,246	98,620	0
3.	- FX swap transactions	492,789	449,233	5,687
4.	- currency swap transactions	2,057,447	1,392,431	-20,950
5.	- interest rate swap transactions	917,524	682,757	-2,196
6.	**Other forward transactions (7+8)**	**32,082**	**18,035**	**41**
7.	- options	32,082	0	0
8.	- future transactions	0	18,035	41
9.	**Total (1+6)**	**3,505,088**	**2,641,076**	**-17,418**

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
		31.12.2003	31.12.2004	
1.	Hedging transactions	3,473,006	2,623,041	-849,965
	- within 1 year	950,843	1,079,609	128,766
	- within 1 to 5 years	1,858,382	864,817	-993,565
	- over five years	663,781	678,615	14,834
2.	Other forward transactions	32,082	18,035	-14,047
	- within 1 year	32,082	18,035	-14,047
	- within 1 to 5 years	0	0	0
	- over five years	0	0	0
3.	Total (1+2)	3,505,088	2,641,076	-864,012

Other off-balance sheet liabilities

HUF millions

Nr	Description	31.12.2003	31.12.2004
		Book value of liabilities	Book value of liabilities
1.	Liabilities from security repurchase transactions in foreign currency	123,510	36,723
2.	Guarantees	12,278	10,634
3.	Other off-balance sheet liabilities	2	643
4.	Total	135,790	48,000

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 it is needed.

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

Structure of other off-balance sheet liabilities by remaining maturity

HUF millions

	Remaining maturity	Balance		Change
		31.12.2003	31.12.2004	
	- within 1 year	135,790	48,000	-87,790
	- within 1 to 5 years	0	0	0
	- over five years	0	0	0
	Total other liabilities	**135,790**	**48,000**	**-87,790**

Bond lending

At the end of 2004, 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 610.2 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	2003	2003*	2004	Change
(I.1.+II.2.)-(X.1.+XI.1.)	Central government	40,113	40,113	9,560	-30,553
(I.2.+II.3.)-(X.2.+XI.2.)	Credit institutions	-60,840	-60,841	-95,493	-34,652
(I.3.+II.1.+II.4.)-(X.3.+XI.3.)	Other	34,714	35,116	43,508	8,392
	Net profit from interest	**13,987**	**14,388**	**-42,425**	**-56,813**
	Forint similar income	97	100	635	535
	Foreign currency securities	-8,347	0	0	0
	Bonds issued abroad	-1,513	-1,513	-1,281	232
	Derivative transactions for hedging and other purposes**	3,322	3,322	2,901	-421
	Other	18	-948	-1,134	-186
(I.4.+II.5.)-(X.4.+XI.4.)	**Net interest related profit**	**-6,423**	**961**	**1,121**	**160**
(I.+II.)-(X.+XI.)	**Net interest and interest related income**	**7,564**	**15,349**	**-41,304**	**-56,653**

** Breakdown in accordance with the regulations for the year 2004.*

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

Realized loss from financial operations

HUF millions

P/L line	Description	2003*	2004	Change
IV.	Realized gains arising from financial operations	13,925	9,489	-4,436
XIV.	Realized losses arising from financial operations	22,271	16,100	-6,171
	Net financial loss (IV.-XIV.)	-8,346	-6,611	1,735

** Breakdown in accordance with the regulations for the year 2004.*

Under the amendment of the MNB Decree effective as of 1 January 2004, a new line for gains and losses from financial operations was inserted in the income statement mainly to record realized gains and losses from the sale of securities. Before 2004, this item was presented in interest related profit or loss. Also in connection with the Government Decree, certain items were shifted from other income to interest related profit or loss. These include all commissions and fees paid in connection with the basic operation upon which interest was also calculated.

Bond lending fees paid in foreign currency were posted to interest income related to foreign exchange reserves, while in 2003 these were shown in the line 'Other income'.

In 2004, the Bank recorded a HUF 41.3 billion net interest and interest related loss, a decline of HUF 56.7 billion relative to the income in 2003.

Similar to previous years, the interest income of HUF 4.2 billion arising from the securities previously issued by the MNB abroad and subsequently repurchased is included in the income statement not as an item reducing expenses but as an item under other foreign currency gains.

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.

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

HUF millions

Nr	Description	2003	2004	Change
1.	Income from derivative transactions (2+3+4+5+6)	160,061	109,692	-50,369
2.	- interest on currency swaps	151,303	102,228	-49,075
3.	- interest on over one year interest rate swaps	2,359	977	-1,382
4.	- interest gains on hedge FX swaps	6,295	5,655	-640
5.	- FX gains on derivative transactions	0	531	531
6.	- other transactions	104	301	197
7.	Expenses on derivative transactions (8+9+10+11+12)	156,739	106,791	-49,948
8.	- interest on currency swaps	152,947	103,265	-49,682
9.	- interest on over one year interest rate swaps	2,530	2,380	-150
10.	- interest loss on hedge FX swaps	733	489	-244
11.	- FX losses on derivative transactions	0	0	0
12.	- other transactions	529	657	128
13.	Net income from derivative transactions (1-7)	3,322	2,901	-421
14.	- interest on currency swaps (2-8)	-1,644	-1,037	607
15.	- interest on over one year interest rate swaps (3-9)	-171	-1,403	-1,232
16.	- interest gains on hedge FX swaps (4-10)	5,562	5,167	-395
17.	- FX gains on derivative transactions (5-11)	0	531	531
18.	- other transactions (6-12)	-425	-356	69

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 reverse 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 non-residents and the ÁKK are recorded in the net interest related income more than once. The net profit and loss effect of currency swaps is HUF 1.0 billion.

4. 19. Components of income from the translation of foreign exchange holdings

HUF millions

Description	2003	2004
Net income from exchange rate changes (realised and conversion spread)	88,787	22,586
Change in revaluation reserve in the balance sheet* (due to unrealised revaluation net income)	199,240	-179,734
Total effect of exchange rate changes	**288,027**	**-157,148**

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

In 2004, the official exchange rate of the forint vis-à-vis the euro strengthened by 6.2% leading to a decrease in the amount of the revaluation reserve with a total exchange rate change effect of a HUF 157.1 billion loss.

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

4. 20. The cost of issuing banknote and coin

HUF millions

B/S line	Description	2003	2004	Change
	Issuing banknote	3,106	3,458	352
	Coin production	1,495	2,096	601
	Commemorative coin production	100	393	293
XIII.	Total	4,701	5,947	1,246

In the reporting year, the net cost of banknote and coin production totalled HUF 5.9 billion, up HUF 1.2 billion on the previous year. The increase in production cost was mainly due to an increase in the quantity of produced banknotes and coins in circulation and partly to the growing number of commemorative coins minted in 2004.

4. 21. Other income/expenses

HUF millions

P/L line	Description	2003	2004	Change
1.	Fees and commissions	1,023	1,102	79
2.	Income other than fees and commissions	1,592	1,405	-187
V.	**Total other income**	**2,615**	**2,507**	**-108**
1.	Fees and commissions	1,062	389	-673
2.	Expenses other than fees and commissions	3,254	112	-3,142
XV.	**Total other expenses**	**4,316**	**501**	**-3,815**
	Net income/expenses (V-XV.)	**-1,701**	**2,006**	**3,707**

Other net income totalled HUF 2 billion in 2004.

Income from commissions slightly increased due to an increase in turnover. The decrease in the expenses from commissions is attributable to the fact that, in an effort to clean up its balance sheet and in view of efficiency calculations, the loans repaid by the MNB in 2003 and the related fees considerably increased the expenses from commissions.
For more details on extraordinary profit or loss, see Section 4. 22.

4. 22. Income other than fees and commissions

HUF millions

Nr	Description	2003	2004	Change
1.	Dividends from investments	1,503	1,369	-134
2.	Income related to coins and commemorative coins	38	35	-3
3.	Other income correction	50	0	-50
4.	Other income	1	1	0
5.	Income other than fees and commissions	1,592	1,405	-187
6.	Losses on loans and other losses	975	0	-975
7.	Amounts contributed free of charge	141	56	-85
8.	Other expenses	2,138	56	-2,082
9.	Expenses other than fees and commissions	3,254	112	-3,142

In 2004, income other than fees and commissions included the following:

• dividends received from investments fell by HUF 0.1 billion relative to 2003 (for more details, see Section 4. 12.). In 2004, dividends received were posted from bank operating income to other income;

• income arising from the issue of commemorative coins above face value when the market value of the precious metal used in the coins issued is higher than their face value;

• in 2004, the line 'Amounts contributed free of charge' included mainly donations to international and domestic organizations and to foundations; and

• in 2003, other expenses included mainly the written off book value (HUF 2.1 billion) of a property contributed to ÁKK free of charge, as approved by the shareholders.

4. 23. Operating income and expenses

HUF millions

P/L line	Description	2003	2004	Change
	Export sales	809	0	-809
	Foreign exchange gain on disposal of investment	55	0	-55
	Sale of assets and inventories	52	64	12
	Income from mediated services	48	55	7
	Income from invoiced services	75	37	-39
	Other income	45	26	-19
	Extraordinary income	1	1	0
VIII.	**Total operating income**	**1,085**	**183**	**-902**
	Cost of materials, total	3,263	3,486	223
	Personnel-related costs, total	8,418	8,797	379
	Depreciation	1,574	1,642	68
	Transfer of capitalised value of own-produced assets	-147	-92	55
	Transfer of costs of other activities	-409	-309	100
	Operating costs	**12,699**	**13,524**	**825**
	Loss on fixed asset disposal	0	0	0
	Expenses incurred on assets and inventories	469	115	-354
	Expenses incurred on invoiced services	73	31	-42
	Income taxes	1	1	0
	Total operating expenses	**543**	**147**	**-396**
XVIII.	**Total operating costs and expenses**	**13,242**	**13,671**	**429**

Operating costs increased to HUF 13.5 billion in 2004, up HUF 0.8 billion (6%) relative to 2003.
Personnel related costs increased by HUF 0.4 billion mainly as a combined effect of the average salary increase and the decrease in the average number of staff in 2004. In addition, the cost of materials in 2004 increased by HUF 0.2 billion relative to the previous year mainly due to IT operation costs arising from capital expenditure for the first time. The HUF 0.1 billion growth in depreciation is also associated with an increase in the volume of capital expenditure in the previous years.
The 2004 decrease in operating income and expenses is due primarily to the fact that the balance of operating income and expenses in 2003 contained the HUF 0.5 billion net gain on the sale of surplus non-monetary gold reserves.

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	2003	2004	Change (%)
Payroll	4,867	5,181	6.5
Other payroll expenses*	242	159	-34.3
Total payroll expenses	5,109	5,340	4.5
Other payments to personnel	1,291	1,389	7.6
Taxes, social security and similar deductions	2,018	2,068	2.5
Total personnel expenses	8,418	8,797	4.5

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

Description	2003	2004	Change (%)
Average number of staff	958	946	-1,3

Remuneration of executive officers

forints

Bodies	Fees
Monetary Council*	128,433,159
Supervisory Board	51,272,400

** Pursuant to Article 3, c) par. (49) of the MNB Act, this includes the salaries of external members of the Monetary Council in an employment relationship with the MNB.*

Credits to executive officers

forints

Bodies	Amount of loans drawn	Outstanding at 31. 12. 2004	Final maturity	Rate of interest
Board of Directors	67,090,572	11,366,300	15.10.2013	Floating*
Supervisory Board	–	–	–	–

** Central bank base rate + 1% 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.

Budapest, 5 April 2005

Zsigmond Járai
Governor, Magyar Nemzeti Bank

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