# Annual Report

Business Report and Financial Statements of the National Bank of Hungary for 2001

2001

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# PART A

## *Business Report of the National Bank of Hungary*

## *for 2001*

# I. President's Foreword

## A year of transformation and modernisation

2001 was a year of fundamental changes in the life of the National Bank of Hungary. The Hungarian Parliament passed a new Act providing safeguards for the institutional, personnel and financial independence of the central bank, consistent with European standards.

In agreement with the Government of the Republic of Hungary, the National Bank set the objective of preparing the Hungarian economy for the adoption of the euro by 2006, which implies compliance with the Copenhagen and Maastricht criteria. The Bank's monetary policy, which underwent a radical transformation in the course of 2001, was formulated with an eye to achieving this medium-term goal.

By abandoning the crawling peg system and widening the Hungarian forint's fluctuation band against the euro from ±2.25% to ±15%, the Bank has given greater freedom for market forces to shape the exchange rate, which led to an appreciation of 7% in the course of eight months. The inflation targeting system adopted during the year and the tightening of monetary conditions has greatly boosted market participants' confidence in the Bank, bringing about a sharp decrease in inflation expectations and inflationary pressures in the economy. Thanks partly to favourable external conditions (such as a fall in oil prices), inflation dropped to 6.8% by late 2001, down from a roughly 10% rate, where it seemed to have been 'stuck' for years.

After 70 years, 2001 witnessed the liberalisation of foreign exchange rules, with the forint becoming fully convertible due to lifting all restrictions on firms and households.

During the post-September 11 period, prompted by the example of some large foreign central banks and the decline in domestic inflation, the Bank made five cuts in its base rate, bringing it down from 11.25% to 9%, in an effort to mitigate as much as possible the adverse effects of the global economic recession.

Despite the global economic slowdown, the Hungarian economy continued to grow rapidly in 2001. Annual GDP growth amounted to 3.8%, while the key indicators of macroeconomic equilibrium remained good, and the deficit on the current account of the balance of payments dropped to 2.1% of GDP, down from 2.8% in 2000. Direct capital investment continued to an extent more than offsetting the deficit on the current account.

Central bank reserves amounted to some EUR 12 billion, consistent with the decision of the Monetary Council that there was no need to raise the level of reserves further. The reserves held by the Government and the Central Bank exceed the amount of foreign denominated state debt.

The financial intermediary sector continued to be stable and efficient in 2001. Large banks from the European Union and the United States hold significant interests in Hungary's 38 commercial banks. Financial markets were stable, and interest rates in the government securities markets declined at a rate consistent with disinflation and the lowering of the Bank's base rate. For instance, the yield on ten-year government bonds fell from 9% early in the year to 6.9% at year-end.

The euro cash changeover by the countries of the European Union also posed a major challenge for the National Bank of Hungary. The Bank provided support to Hungarian banks in their preparation and operations, participating in the conversion of legacy currencies and the training of Hungarian foreign currency cashiers.

The Bank underwent major restructuring, which is continuing in the course of 2002 as well. The Monetary Council and the Board of Directors were assigned larger roles. The Bank eliminated its stake in its Viennese subsidiary, previously a source of grave losses. Other non-central bank activities were also abandoned, resulting in a more streamlined organisation. There was a significant reduction in staff, in addition to a 9% cut in operating costs in real terms, relative to the previous year.

# II. Brief Overview of the National Bank of Hungary

Corporate name: National Bank of Hungary
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
Scope: as laid down in the Act on the National Bank of Hungary
Equity: HUF 10 billion

## 1 Key objectives and tasks

The National Bank of Hungary is a legal entity operated as a special company limited by shares. During the first half of 2001, it conducted its operations as provided for by Act LX of 1991, while during the subsequent period, as governed by Act LVIII of 2001 on the National Bank of Hungary, which came into force on 13 July 2001.

The Act was promulgated on 5 July and laid down the principles for the Bank's primary objectives, key functions, institutional, organisational, personnel and financial independence and operations, while also significantly restructuring its activity and profile. In accordance with Article 105 of the Treaty establishing the European Community, the Act declares achievement and maintenance of price stability to be the primary goal of the Bank. In relation to autonomy, the Act provides that the central bank may only support the implementation of the government's economic policy using the monetary policy instruments at its disposal if such support does not jeopardise the aforementioned goal.

In addition to implementing and promoting price stability, the Bank carries out the following fundamental tasks specified by the Act:

- the Bank defines and implements monetary policy in the interests of maintaining the stability of the national currency;
- it has the exclusive right to issue banknotes and coins. The banknotes and coins issued by the NBH are 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 supports the efficient and sound operation of such;
– in order to undertake its tasks, the Bank collects the necessary statistical information and publishes such;
– 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.

Without prejudice to the achievement of its primary objective and performance of its basic tasks, the Bank may perform other activities, based on statutory authorisation.

The Bank may not extend loans to the State, to local governments, to other government institutions, nor to economic organisations operating under the dominant influence of the State or a local government, excluding credit institutions in direct or indirect ownership. Furthermore, the Act also prohibits the Bank from purchasing securities issued by such institutions directly from the issuer.

Under the aegis of central bank autonomy, the Bank formulates monetary policy, aimed at promoting the achievement and maintenance of price stability, and sets the instruments for conducting monetary policy within an independent framework as defined by Act LVIII of 2001. The Bank's core activities include acceptance of deposits within its accounts management system, credit extension against adequate collateral and subject to statutory regulation, securities buying, selling and brokering, issuing its own securities, influencing and setting exchange rates and interest rates, discounting securities and regulating required reserves.

The Bank's account management service is confined to entities specified by the Act. Thus, for instance, the Bank manages the single Treasury account, the current accounts of the Hungarian Privatisation and State Holding Company, the Government Debt Management Agency Ltd., credit institutions, clearing houses, the National Deposit Insurance Fund and the Investor Protection Fund.

## 2 Bodies and management of the Bank and the decision making process

The bodies of the National Bank of Hungary are governed by the Central Bank Act and by Act CXLIV of 1997 on Business Organisations, except for issues where the Central Bank Act provides otherwise. The entry into force of Act LVIII of 2001 has not only brought change in terms of the tasks of the Bank, but also in respect of its decision-making bodies and procedures.

Under the aforementioned two Acts, despite the fact that it is a single-member business organisation, the Bank shall hold **general meetings,** where 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 Act on the NBH, 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 determine the registered capital of the Bank, to establish the balance sheet and profit and loss statement, to elect and dismiss the auditor, who functions as a safeguard of statutory operation, and to establish the remuneration of the auditor. In accordance with European Union requirements and as an additional guarantee of autonomy, since it entered into force, Act LVIII of 2001 controls the remuneration of the highest ranking officials of the Bank (such as the President, Vice Presidents and other members of the Monetary Council) rather than the general meeting.

The main decision-making body of the Bank in relation to the performance of its core functions, the choice of the exchange rate regime, the role of lender of last resort to credit institutions, is the **Monetary Council**, which replaced the former central bank council when the new Act came into force. The activity of the Monetary Council, composed of at least seven but at most nine members, is more operative in nature, and it holds its meetings at more frequent intervals. At meetings of the Monetary Council and Board of Directors the Government may be represented by the Minister of Finance or a representative authorised by the Minister, paying due tribute to central bank autonomy and having no voting right. This kind of liaison with the Government is consistent with European Union guidelines. In addition to providing the Government with information about the Bank's activity and current monetary developments, participation at meetings without the right to vote also empowers the Government's representative to make a verbal contribution to the items on the agenda. It should be noted that in addition to the statutory framework for this relationship, the Act on the NBH also declares that the Government may not give instructions to officials of the Bank in respect of the tasks and duties conferred upon them by the Act.

The members of the Monetary Council are:
– Zsigmond Járai, President – chairman of the Monetary Council and the Board of Directors,
– Henrik Auth, Vice President with general responsibilities and member of the Board of Directors,
– Péter Adamecz, Vice President and member of the Board of Directors,
– Werner Riecke, Vice President and member of the Board of Directors,
– Dr György Szapáry, Vice President and member of the Board of Directors,
– Dr Béla Kádár, external member of the Monetary Council,
– Dr Tamás Káró, external member of the Monetary Council,
– Dr Gábor Oblath, external member of the Monetary Council.

Responsibility for implementing Monetary Council decisions and managing the operations of the National Bank rests with the **Board of Directors**, in contrast to the provisions of the previous Act, under which the President had sole responsibility in these matters. In another fundamental change, the Act shares responsibility between the different bodies of the Bank, declaring the Board of Directors, which previously functioned as a consultative body, a decision making organ. The Board of Directors now oversees performance of the Bank's core functions, the preparation of proposals to be put forward to the General Meeting on the balance sheet, profit and loss statement and assets of the Bank, as well as the distribution of income, the approval of the draft report on the Bank's business management, assets and business policy; the approval of issues associated with organisation and internal management, approval of professional plans and programmes; approval of the development and operating budget; discussing the results of and plans for internal audits, and passing proposals for significant amendments to the collective agreement.

The Board of Directors, acting as the operative executive body of the Bank, must have at least four but at most six members, comprising the President and Vice Presidents 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 Act LVIII of 2001 on the National Bank of Hungary, the Act on Business Organisations, the Bank's Statutes amended as of 11 October 2001, as well as the rules of procedures formulated by these bodies.

Under a Board of Directors decision, these bodies are supported in their work by special committees, whose function and composition have been changed. **ALCO (Assets/Liabilities Committee)** is responsible for preparing Monetary Council decisions on foreign exchange management, approving relevant briefing material and passing operative decisions under powers delegated by the Monetary Council and the Board of Directors. The **Banking Committee** is in charge of central bank decision making on matters relating to the financial intermediation sector. The **Investment and Cost Management Committee** discharges its tasks within the framework of the budget approved by the Board of Directors. The **Monetary Committee** supports monetary policy operations conduced by the Monetary Council, conducting a regular review of the monetary situation by comparing the monetary programme with actual developments. In addition, this committee prepares operative policy decisions and coordinates domestic foreign exchange market and forint market operations. The **Owners' Advisory Committee** lays the groundwork for and makes decisions on strategic and business policy matters.

Before Act LVIII of 2001 entered into force, the National Bank of Hungary, as other companies limited by shares, was supervised by a Board of Supervisors. The composition of the Board was defined by Act LX of 1991; six of its members were not elected by the General Meeting. Supervision of the Bank changed fundamentally after 13 July 2001, when this Board's supervisory function was taken over by the **State Audit Office (SAO).** Involvement of the SAO reinforces parliamentary control, thanks to on-site audits by this auditing agency and the unbiased opinions issued. In order to safeguard the independent conduct of monetary policy, the Act provides that the control of the Audit Office does not extend to the conduct and key tasks of monetary policy and their impact on the Bank's income.

## 3 Organisational structure

2001 was a year of change in the history of the National Bank, governed by the endeavour to meet EU requirements. When Dr György Surányi's term of office expired on 2 March 2001, Dr Zsigmond Járai was appointed as President. His work is assisted by Dr György Szapáry and Werner Riecke, two Vice Presidents appointed earlier, and two newly elected Vice Presidents Péter Adamecz and Henrik Auth. Simultaneously with these personnel changes, internal restructuring also began - partly due to the changing legal framework and partly to the need to boost efficiency and rationalise activities. This process is still under way.

In the course of renewing the Bank's operational framework and organisational structure, parallel functions and overlapping activities in the area of research and analysis have been eliminated. To assist the efficient implementation of legislative functions associated with the European Union and the European Central Bank, a new department was formed and put in charge of codification and legal harmonisation tasks. As a result of foreign exchange liberalisation, the Bank's role as a foreign exchange authority ceased, leading to the winding up of the Department of Foreign Exchange Regulation and Licensing. Registration and management of the external assets on the Bank's balance sheet as well as of guarantees issued by the Bank in foreign exchange to non-residents were transferred to the back office. Tasks of a legal nature relating to the recovery of these assets were delegated to the legal staff. Internal and external communication was unified in respect of control and organisational structure, and personnel and work-related administration was integrated. The Department of Banking Security was restructured, simultaneously with a broadening of its functions. Internal audit was modernised in order to better monitor the risks inherent in the Bank's operations. Back office work was centralised and the departments responsible for activities that had ceased were wound up.

In addition to the Board of Directors, the managing directors, in charge of operative control and supervision, are also responsible for the performance of the statutorily regulated functions associated with the operations of the Bank and the implementation of decisions. As the heads of the departments and divisions assigned to them, they are responsible for the following areas: monetary policy and statistics, research and economics, analysis and international relations, prudential oversight of the financial system, payment systems and currency issue, financial accounting and controlling, oversight of investments, central administration (such as legal issues, human resources, secretariat, communications and banking security), central auxiliary services (such as property services, information technology and back office).

In addition to their primary work as monetary policy makers, the President or the Vice Presidents also supervise, according to a distribution of functions, the managing directors.

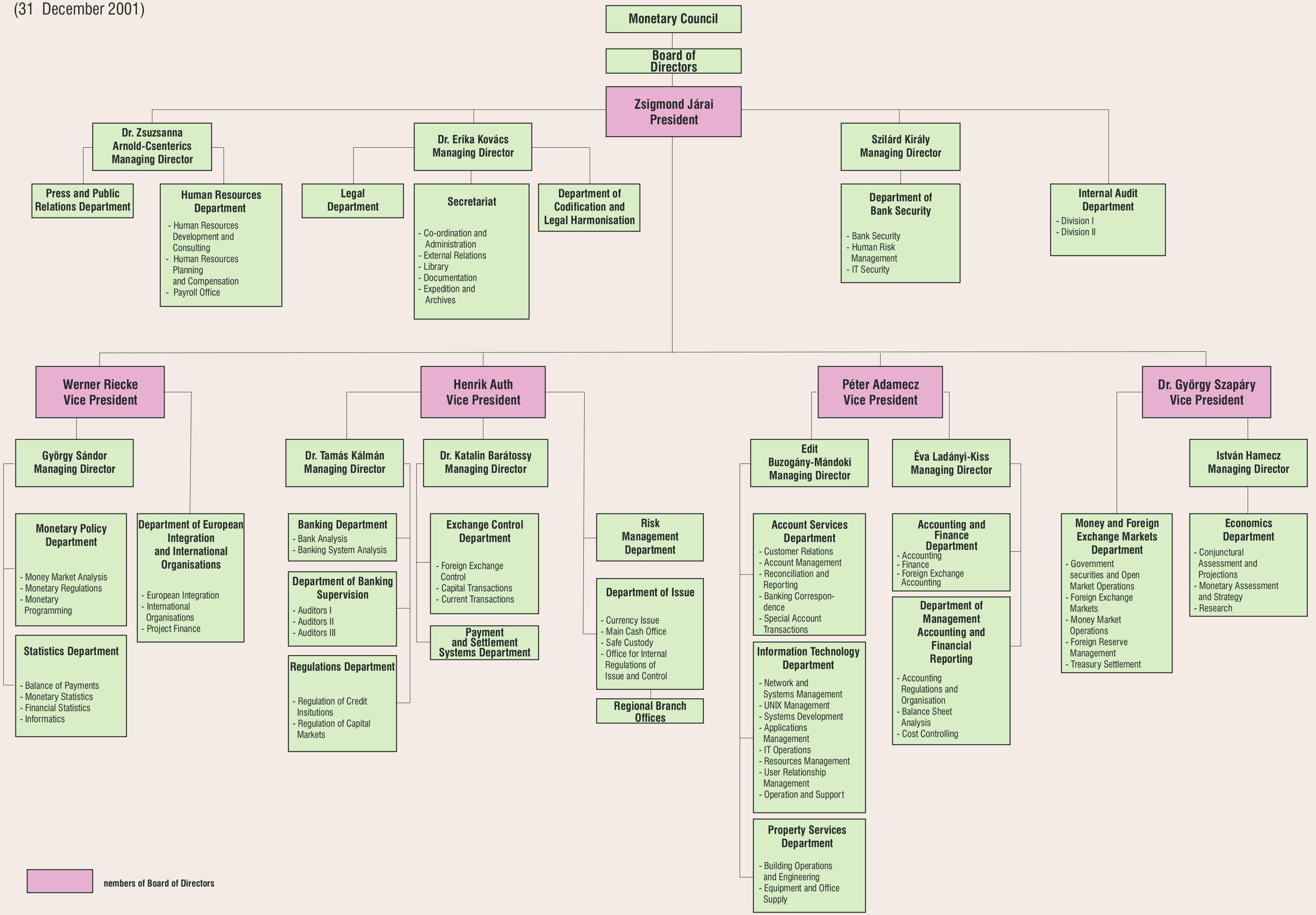
The Bank's management, rejuvenated both in respect of operation and organisational structure in 2001, was characterised by a more rational human resources policy. Average numbers employed were reduced by 8.5% in the course of the year, with the number of staff down by 11.6% (by 153 employees) at the year-end, compared with 1,316 at end-2000.

The Human Resources Department supported the ongoing restructuring work by its own means. Adopting a complex, new human resources strategy, they revised existing systems and designed several crucially important ones. One of the key elements of the strategy was the introduction of the HAY job evaluation system, which helped the Bank to design a new job structure consistent with the Bank's internal values. This also involved the adoption of a new pay strategy based on the value of individual jobs. This, in turn, entailed the modernisation of social welfare services. In 2001, the Bank also launched a perks system, a performance management system and an annual training scheme derived from organisational and individual training needs and adjusted to personal development goals required to achieve employees' career goals.

One of the key aspects of running the Bank as an organisation is to have the most rational human resources management possible in the process of achieving strategic objectives. This has been the cornerstone of the reforms.

The Bank's organisational structure, divided into departments and their sub-units called divisions, and employing 1,163 people, required for the performance of the Bank's functions, is presented in an organisational chart as of 31 December 2001.

## National Bank of Hungary Organisational Chart
(31 December 2001)



# III. Review of the National Bank's Activities in 2001 (Executive summary)

## 1 Monetary policy in 2001

The reform of Hungary's exchange rate regime was the pivotal event in monetary policy developments in 2001. Within the framework of this reform, the narrow-band exchange rate system and restrictions on capital movements, representing the building blocks of monetary policy in past decades, were also revised.

With the band widening and the subsequent abandonment of the crawling peg system, the Hungarian authorities introduced an exchange rate regime which is fully compatible with ERM II, the exchange rate system of the European Union. The forint was declared a fully convertible currency, and the existing restrictions on foreign exchange transactions were lifted. The Bank implemented the inflation targeting system. In the framework of the new regime, the target rate of the reduction in inflation is disclosed for a longer term of 18 to 24 months. Communication of monetary policy actions changed significantly – the *Quarterly Report on Inflation*, the Bank's quarterly publication, includes detailed forecasts of the key economic variables for the coming 6 to 8 quarters. Other publications of the Bank attempt to familiarise the general public with the Bank's evaluation of economic performance.

Looking at developments in monetary conditions, the exchange rate appreciated strongly in the aftermath of the band widening. The wider fluctuation band is naturally associated with wider swings in the forint exchange rate. In 2001, the Bank reduced official interest rates six times, by a total 200 basis points. Domestic long-term yields are not directly influenced by the Bank. The significant fall in these rates in 2001 shows an improvement in monetary policy credibility and suggests that market participants widely accept the anti-inflation policy announced by the Bank and the Government.

**The 7%±1% inflation objective of monetary policy, as set for the end of the year, was met in 2001.** With strong disinflation in the second half of the year, the consumer price index fell from its peak of 10.8% in May to 6.8% in December.

The reform of the Bank's monetary policy instruments continued in the year under review. The overriding principles that governed the reform were transparency, cost effectiveness and harmonisation with the policy tools of the European Central Bank.

## 2 Stability of the financial intermediary system

Promotion of financial stability is only feasible in a financial intermediary system which is functioning soundly and efficiently. A central bank must always have an up-to-date and reliable picture of the status of the country's financial sector. In order to fulfil these tasks efficiently and professionally, the National Bank of Hungary constantly monitors the developments in the domestic financial sector, examines the strength of the entire Hungarian financial system in withstanding external and domestic shocks and evaluates factors influencing the stability of various financial intermediary groups.

In 2001, the Bank actively participated in developing laws and regulations on the financial intermediary system and in the process of drafting the package of legislation on the domestic capital market.

Enhancing supervision was one of the Bank's primary goals in 2001. Special emphasis was placed on the task of examining data reporting by companies related to the balance of payments. Monitoring these developments, previously the task of the foreign exchange authorities, had to be done by statistical tools following the foreign exchange liberalisation.

In order to contribute to the improvement of the transparency in the financial intermediary system, the Bank publishes its assessment of the stability or vulnerability of the domestic financial intermediary system in the *Report on Financial Stability*, a semi-annual publication.

## 3 Payment systems

A number of development projects were completed in 2001. Their goal was to ensure that the Hungarian payment and settlement systems, including the securities settlement systems, operate safely and efficiently, and meet the recommendations of international organisations. The most important of these were the extension of opening hours in VIBER (Real-Time Gross Settlement System), the change to the method of calculating the acceptance value of eligible securities deposited as collateral for intra-day and end-of-day credit, and, in the area of international settlements, the introduction of DVP (delivery versus payment) based settlements for foreign securities.

## 4 Foreign exchange reserve management, risk management

The Bank's reserve management policy is determined by the Monetary Council. In 2001, the Council reviewed whether the level of reserves was consistent with the new challenges of band widening and foreign exchange liberalisation. It found that the current level of reserves was adequate. Looking ahead, reserves were judged to be sufficient to satisfy the basic objectives of reserve holdings without the need to borrow external funds.

Generally, the Bank's main principle in compiling investment guidelines is to adopt the best practices followed by the central banks of the developed countries. Accordingly, the Bank only invests in highly liquid, AA-AAA-rated securities, i.e. bonds issued by developed countries, and securities issued by large international financial institutions and government agencies. In 2001, the Bank slightly increased the proportion within the portfolio of adequately secure and highly liquid AA-rated securities ensuring higher returns, in line with international trends. This constituted the most important change in the Bank's investment guidelines in the year under review.

## 5 Issue operations

Currency in circulation grew by an annual average of 11% in 2001. The total value of currency in circulation amounted to HUF 1,129.2 billion at the year-end.

The number of discovered forint counterfeits fell significantly in 2001 in comparison with the previous year.

*Closely related to the introduction of the euro,* the Bank developed and implemented an action plan, in cooperation with the Hungarian Banking Association and credit institutions. At the Bank's recommendation, in the second half of 2001 credit institutions converted the balances on customers' foreign currency credit, deposit and current accounts held in the twelve legacy currencies into euro accounts, in most of the cases automatically and free of charge to customers. Savings held in the legacy currencies, estimated to be several tens of billions of forints, were also exchanged. The Bank pursued an information campaign with the aim of informing the wider public, which was also directed at individuals without banking relations. In a joint effort with the Hungarian National Committee for UNICEF, the Bank launched a charity programme to collect coins of the legacy currencies.

## 6 Profit of the National Bank of Hungary and its financial management

The financial result of the National Bank for 2001 amounted to a profit of HUF 3.6 billion and the balance sheet total stood at HUF 5,453 billion. Under the Central Bank Act, the Bank was required to make a dividend payment of HUF 27.7 billion for the year 2001. As the financial results for the year under review did not provide cover for the dividend payment, the Bank used HUF 24.1 billion of its retained earnings to the extent of the difference, as stipulated by the Act.

The Bank's financial results in 2001 featured higher interest income, lower gains from forint devaluation and level operating costs in nominal terms (9% lower in real terms) relative to the previous year. The improvement in interest income was the result of a fall in forint interest rates (and their approach to foreign currency interest rate levels).

The gradual lowering of the crawling peg devaluation rate, and its final abolishment on 1 October 2001, had an offsetting impact. Consequently, exchange rate gains fell by nearly one-third.

The fact that operating costs remained level (they actually fell significantly in real terms) was reflected in cost saving achieved by the start of the rationalisation of the organisation and the termination of activities which became redundant due to the changes in the Central Bank Act.

The decisive move of widening the intervention band and the subsequent forint appreciation in 2001 reduced the forint equivalent of net foreign currency assets on the Bank's balance sheet, at the same time causing a significant revaluation loss. This loss is reflected in the negative balance of the equalisation reserve on the liabilities side of the Bank's balance sheet.

In accordance with Section (4) of Article 17 and Section (3) of Article 72 of the Central Bank Act, by 31 March 2002 the central government settled the Bank's HUF 250.2 billion negative equalisation balance. This occurred in the form of a financial settlement that did not affect the budgetary estimates for 2001, and which was offset by a reduction of a similar size in forint terms in public sector foreign currency debt.

# IV. Review of Performance

## 1 Monetary policy in 2001

The reform of Hungary's exchange rate regime was the pivotal event in monetary policy developments in 2001. Its double goal was to accomplish harmonisation with European Union convergence criteria and to develop monetary policy instruments serving more pronounced disinflation. The new system's key elements are the following:

– The new Central Bank Act defines maintaining price stability as the primary objective of the central bank, and reinforces the central bank's operational independence;
– In agreement with the Government, the NBH has introduced an exchange rate system which is compatible with ERM II (the European exchange rate mechanism);
– The forint has been declared fully convertible, and the existing restrictions on foreign exchange transactions have been lifted;
– The Bank has implemented the inflation targeting system. In the framework of the new regime, the target rate of the reduction in inflation is disclosed for a longer term of 18 to 24 months.

In the crawling-peg exchange rate regime with a narrow intervention band, introduced in 1995, disinflation was based on a cautious, gradual reduction in the devaluation rate of the central parity. As a result of the monetary policy course which relied on the predictability of the pre-announced path of the exchange rate, domestic inflation fell from the initial 30% to 10%, while the competitiveness of the economy improved. However, the disinflation process faltered in mid-1999 – inflation remained locked in a range between 9%–11% for nearly two years. Factors beyond the control of monetary policy, for example, the rapid rise in energy and food prices, were the primary cause of disinflation coming to a halt. But under influence from inflation stagnating over a longer period, signs of inflation inertia soon began to emerge as well, reflected mostly in developments in wages and inflation expectations. Market participants' failure to lower their inflation expectations boosts the costs of disinflation. This required the declaration of a new monetary policy regime which maintains more efficient control over monetary conditions and provides guidance for inflation expectations over a period of several years.

**Box 1-1: Sequence of restructuring the monetary system**

The monetary regime was reformed in several steps.

– On 13 May 2001, the Government and the Bank widened the fluctuation band of the currency to ±15% relative to the central parity, while maintaining the crawling peg in operation. When defining the new width of the fluctuation band, the authorities kept an eye on the goal of creating consistency with the European ERM II exchange rate mechanism.
– On 12 June 2001, the Bank disclosed its new monetary policy strategy, the system of inflation targeting. In agreement with the Government, the Bank defined its disinflation objective for the period up to end-2002. The Bank set the inflation objectives at 7%±1% and 4.5%±1% respectively for December 2001 and December 2002.
– As one of the preconditions for Hungary's accession to the European Union, restrictions on capital movements were lifted as of 15 June 2001. Also as of 15 June, the forint was declared a fully convertible currency.
– The new Central Bank Act, fully consistent with the requirements of the European Union, entered into force on 13 July 2001.
– The crawling peg exchange rate system was abandoned as of 1 October 2001. With this move, the Hungarian exchange rate system became fully compatible with ERM II.
– In agreement with the Government, the Bank set the inflation objective for the period up to end-2003 in December 2001. The rate of inflation to be achieved by December 2003 was defined at 3.5%.
– The Government and the Bank expressed their views on Hungary's participation in EMU on several occasions. In their assessment, Hungary's membership in EMU would promote and speed up Hungary's economic convergence with the Member States of the European Union. For this reason, economic policy would make every effort to help the country join the EMU as early as possible. From the Bank's perspective, this means that inflation in 2004–2005 must be reduced to levels satisfying the Maastricht convergence criteria.[1]

[1] According to the Maastricht inflation criteria, the annual average harmonised index of consumer prices (HICP) of the country examined may not exceed the arithmetic average of inflation rates registered by the three best-performing EU member countries by more than 1.5 percentage points for a period of one year defined in the convergence report. This reference value has been fluctuating between 1.86% and 3.32% since 1997.

The narrow-band exchange rate regime reduced the monetary authorities' room for manoeuvre in controlling movements both in the exchange rate and interest rates. With the move to widen the fluctuation band, the pressure on the Bank to subordinate interest rate policy to exogenous factors lessened. Variations in the forint exchange rate vis-ŕ-vis the euro are now determined by demand and supply forces in the foreign exchange market within the confines of the fluctuation band.

The predictability of exchange rate movements diminished significantly with the band widening, and exchange rate volatility intensified. Increased exchange rate risk required implementing foreign exchange liberalisation in full.

The development of efficient monetary policy tools laid the groundwork for declaring the new monetary policy regime based on inflation targeting. The most important pillar of this system is the announcement and the Bank of inflation targets for a longer period in the future by the Government. Although the disclosed disinflation path is a gradual one, it helps to meet the inflation criteria set for introducing the euro. Setting the objective for several years in advance also helps economic agents accommodate to the changing inflation environment. The gradual approach and predictability both act to reduce the real economic costs of the reduction in inflation.

In the new system, monetary policy actions are taken if the Monetary Council judges that the future achievement of inflation objectives is in jeopardy. Inflation forecasts are issued quarterly. These analyses have a one-and-a-half to two-year horizon and help the Council to make its assessment. Market participants can draw conclusions regarding the probably course of monetary policy from the discrepancy between the forecasts and the inflation targets, so the system serves to guide interest rate and exchange rate expectations as well. Inflation targeting, therefore, plays the role of a *nominal anchor* – it is a credible intermediate target which stabilises expectations.

Most policy actions exert their influence indirectly and over a longer-term time horizon. This makes central bank communication more difficult. But the fact that the new nominal anchor directly expresses the inflation objective, i.e. the central bank target variable, removes some of this pressure. The structure of the *Quarterly Report on Inflation* has been changed significantly, in order to improve the effectiveness of central bank communication. From August 2001, the Bank has been publishing its inflation forecasts and the assumptions underlying the forecasts in the *Report*.

**External environment, risk perceptions**

Changes in the external economic environment also influenced developments in exchange rates and interest rates in the new monetary policy regime. Two of these influences in 2001 deserve special mention – the large-scale monetary relaxation in the developed countries in response to the global economic slowdown and massive fluctuations in risk assessments affecting both developed and developing countries.

The economic slowdown in the United States which started in 2000 spilled over to other regions of the world in 2001. Soon, this slowdown reached global dimensions, affecting both the large economies of the developed world and the emerging economies. Such a world-wide slowdown in economic activity had not happened for decades. The US Federal Reserve reduced its major policy rate 11 times in 2001, by a total 475 basis points, in order to keep the slowdown in check. As a result, US short-term interest rates fell below 2%, a low level unseen since the 1960s. In Europe, the ECB reduced interest rates by somewhat less, with the policy rate of the euro area falling 150 basis points to 3.25% during the year.

The monetary policy reaction in the US began to show results towards the end of the summer of 2001. Household consumption stopped losing momentum, and chances of an early recovery came into sight. Propensity to take risks increased, which was a particularly welcome development for emerging countries. But the terrorist attacks against the US on 11 September 2001 temporarily dashed any hopes of a swift recovery. Uncertainties overwhelmed not only the US but the whole world as well. The events of September 11 had an enormous immediate impact, but it wound down surprisingly quickly. Partly due to the brisk military successes in Afghanistan, uncertainties eased in November. At year-end, the effect of the terrorist attacks could no longer be seen in the perception of high-risk assets, such as emerging country equities and bonds.

As in earlier years, assessment of risk attached to Hungarian investments reflected the events not only in the developed countries but those in the emerging countries belonging to higher risk categories as well. The forint exchange rate weakened significantly in several rounds early in the summer, first under the influence of the Argentinean problems and then from the Turkish financial crisis. However, these episodes proved to be short-lived. Market participants had little experience in respect of the new monetary policy regime, including the wide band, the inflation target, etc. These must have played a role in the emergence of problems. The financial failure of the Argentinean government left Hungary and the other emerging countries broadly unaffected. Consequently, the improvement in the fourth quarter in investors' willingness to take risks, originating from the developed countries, was fully reflected in investments in emerging country assets.

### Interest rate policy

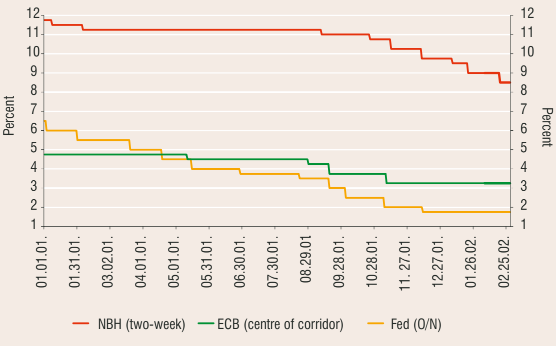
In Hungary, the effect of interest rates on inflation is much smaller and takes more time to feed through, due to the low outstanding debt of firms and households by international standards and the significant proportion of foreign currency within corporate sector debt. The Banks' interest rate policy is aimed primarily at developing an exchange rate path which helps to achieve the inflation objective.

The Bank reduced official interest rates six times in 2001, by a total 200 basis points. Out of this, the period preceding the band widening involved a 50 basis points cut. Following the band widening, monetary conditions tightened with the strong forint appreciation. In the Bank's evaluation, the exchange rate had reached the level required for achieving the inflation target set for end-2002 by the end of the summer. Therefore, it reacted to interest rate reduction by the ECB starting around that time by taking similar actions, in order to avoid further appreciation of the currency. From mid-November, the ECB did not change its policy rate further. However, the risk premium on Hungarian investments fell dramatically. For this reason, the Bank implemented another series of interest rate reductions which it continued in 2002 Q1, again to prevent the exchange rate from appreciating.

The Bank made a number of technical changes to its forint market instruments during the year. These are summarised in Box 1-2.

Developments in domestic long-term yields which are not directly influenced by the Bank show an improvement in monetary policy credibility and suggest that most market participants accept the anti-inflation policy announced by the authorities. On the assumption of real interest rate levels characteristic in the EU, the current forint interest rates suggest that in five years' time the rate of Hungarian inflation will not be higher than in European countries. Developments at the far end of the curve are also a sign of economic policy credibility – by end-2001 the ten-year yield had fallen below the reference level required for Hungary to join the Monetary Union.

**Chart 1-1:** Major central bank interest rates



**Box 1-2: Changes in the monetary policy instruments of the National Bank of Hungary**

The Bank follows three basic principles when developing its policy tools:
– *Simplicity and transparency* are required in order for monetary policy to be more efficient;
– *Cost effectiveness* implies that the instruments must be employed at the lowest possible costs;
– *Compatibility* means harmonising with the policy tools of the European Central Bank.

**Changes from early 2001 until the band widening**

In selling **three-month NBH bills,** the Bank changed over from competitive bidding to a system of variable rate tenders. In the system of volume tenders, the Bank offers for sale an amount of bills taking into account developments in liquidity. The Bank follows a rate-taking stance at the auctions, and does not wish to send interest rate signals through the yields evolving at the auctions. Simultaneously with this move, the Bank reinstated the unlimited availability of the **two-week central bank deposit facility.** It ensures access to the two-week deposit facility once a week, at a fixed interest rate, without imposing quantity limits.

The **overnight repo limits,** i.e. overnight lending against securities as collateral, and, simultaneously, the **supplementary repo facility** which had become redundant, were abandoned. As a consequence, the Bank's counterparties may now have access to central bank funding via the lending facility without quantitative restrictions, against government securities as collateral. In addition to simplifying the policy instruments, the abolishment of repo limits and the supplementary repo facility, both alien to the practice of European central banking, is believed to improve the symmetry of the overnight interest rate corridor, and thus may contribute to reducing the costs of financial intermediation and the development of financial markets. The interest rate conditions of overnight liquidity loans were standardised by abandoning the repo limits – in the settlement system, the holders of accounts with the Bank may have access to end-of-day funding at the overnight lending rate against government securities as collateral, after the closure of VIBER (the Hungarian real-time gross settlement system).

The Bank ceased to operate the **overnight foreign exchange swap** as a standing facility, as the development of the government securities market and the improvement in the market's liquidity had made it unnecessary to provide funding against foreign exchange cover.

The nominal reserve rate fell from 11% to 7%, and the interest rate remunerated on required reserves fell 275 basis points. However, the distinction between interest rates paid on forint and foreign currency liabilities remained. Until 1 August 2001 the Bank remunerated 3.75% on the former and 3.25% on the latter.

**Changes since the band widening**

There have been a number of changes to the Bank's monetary policy tools since the move to widen the fluctuation band on 4 May 2001.

The Bank reduced the **nominal reserve rate** from 7% to 6% in July 2001. Simultaneously, the distinction between domestic and foreign liabilities disappeared – the interest rate remunerated on reserves built for forint liabilities fell 1% and that remunerated on reserves built for foreign currency liabilities by 0.5%. This meant that the interest rate paid by the Bank on reserves built for forint and foreign currency-denominated liabilities was set at a standard 4.25%. Maturity became the new criteria for exempting liabilities from the reserve requirement, as seen in the practice of the ECB – reserves must be built for liabilities with maturities of less than 2 years, those with maturities of over two years being exempt from the reserve requirement. With the changes entering into effect on 1 August, forint vault cash was removed from the range of assets to be counted towards required reserves.

The Bank made changes to its standard **collateral assessment system**. In the reformed system, the value of collateral is assessed taking into account the gross rate of the financial asset derived from prices available on the day preceding the transaction. Acceptance varies depending on the maturity of the collateral and the duration of the loan transaction, in a way that, provided they are used, the Bank should not be inadequately secured in less than 1% of the cases on average, taking into account historical data. As regards intra-day and end-of-day lending transactions, the Bank has so far accepted collateral at nominal value, which has carried a significant risk of inadequate security. Consequently, the Bank will extend collateral assessment to these types of loan as well.

The opening hours of **VIBER** were extended by two-and-a-half hours from 17 September 2001. This measure was prompted by problems in the payment and settlement system following foreign exchange liberalisation. Simultaneously with extending the operating hours of VIBER, **the period of the Bank's availability** was also extended.

The **overnight standing facility** has so far been available in two forms within the Bank's instruments – as a hold-in-custody repo during the business day and as a secured loan to provide liquidity at the end of the day. On 18 December, together with the introduction of the collateral assessment system which is the same as that of repo, the Bank switched to the overnight standard facility in the form of a secured loan. Counterparties can now access the facility before the end of the day. With this step the Bank's standing facility on the active side, employed as one of its policy instruments, and its conditions are now compatible with the practice of the ECB.

The interest rate corridor was narrowed from the earlier 400 basis points to 300 basis points in mid-December, in order to reduce excessive interest rate volatility. Accordingly, reductions in the overnight reverse repo rate lagged behind those in other rates – it was 8.25% at year-end, after falling 100 basis points. The **central bank base rate**, playing a mere accounting role in the past, became the major interest rate of monetary policy. It is now equal to the Bank's two-week deposit rate.

**Chart 1-2: The Bank's fluctuation band, the central parity and the spot exchange rate**

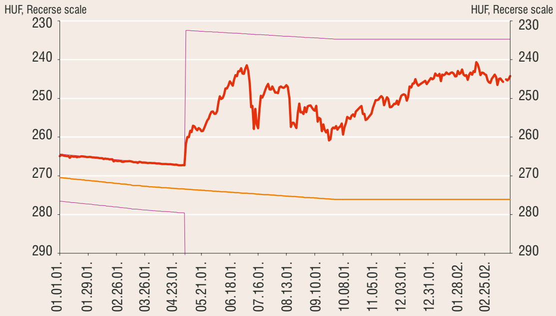
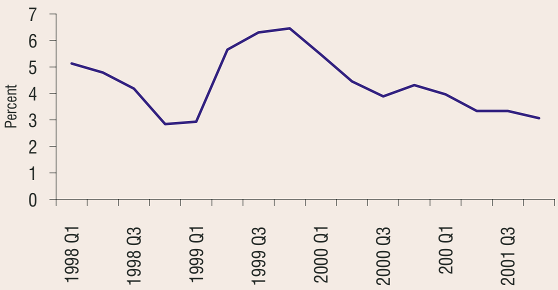



**Chart 1-3: Quarterly GDP growth**
(Annualised quarter-on-quarter rates, based on seasonally adjusted data)




## The exchange rate

The forint exchange rate has a swifter and larger influence on domestic inflation than interest rates. The exchange rate influences changes in the prices of durables, accounting for around 25% of the consumer basket, and the import costs of motor fuels and energy. In addition, it indirectly influences developments in market services prices and processed food prices. Overall, the forint exchange rate has a direct impact on more than one-third of the consumer basket and on 20%–30% indirectly. The exchange rate affects the profitability of a wide range of companies as well, which has an effect on inflation on the cost and aggregate demand sides via labour market adjustments over the longer term.

The currency appreciated strongly following the band widening. The wider fluctuation band is naturally associated with wider swings in the forint exchange rate. As was noted earlier, in 2001 a number of external factors, independent of Hungarian economic fundamentals, adversely influenced movements in the forint exchange rate (e.g. the Argentinean and Turkish crises, and the terrorist attacks against the US). However, during these temporary weaknesses the currency did not fall back to levels seen prior to the band widening. So a part of the appreciation in the post band widening period appears to be lasting, which, in turn, is confirmed by market analysts' exchange rate expectations for end-2002 and end-2003. From the trough following the terrorist attacks, the forint appreciated strongly, in line with the improvement in global risk perceptions in 2001 Q4.

### Real economic developments

According to preliminary data, the Hungarian economy grew by 3.8% in 2001 year-on-year. The rate of economic growth fell gradually during the year. The economy received a number of shocks, the dominant of these being the cyclical worsening of external conditions, the demand impact of fiscal policy, the widening of the currency's fluctuation band and the subsequent exchange rate appreciation, and faster-than-expected disinflation.

Real economic developments in 2001 were shaped by *the cyclical downturn in external markets.* As a consequence, import demand of Hungary's more important trading partners fell from a growth rate of above 10 per cent in the previous year below 1 per cent in 2001. The fall in external demand was strongly reflected in the slowdown in export growth from the second half of the year. Manufacturing firms responded to the worsening of their production and sales outlook by curtailing fixed investment and de-stocking. As an effect of the slowdown in external markets, industrial output stagnated from the start of the year. This was reflected in the fall in industrial firms' demand for labour as well.

In contrast with the contractionary effect of previous years, general government had a strong expansionary effect on demand in 2001. This boost to demand, which amounted to 2.2% of GDP, moderated the slowdown in economic growth caused by exogenous factors.

The *wide fluctuation band of the currency* is now expected to trigger a change in firms' pricing and wages policies. The decline in export receipts in the year under review due to forint appreciation worsened the market position of exporting companies. However, cost savings achieved on account of exchange rate appreciation offset some of the fall in profitability of businesses with foreign currency debt burdens. Wage policy in manufacturing was reluctant to adjust to the lasting appreciation of the domestic currency.

The *disinflation process* which started in 2001 H2 was attributable in large part to external factors, such as slower price increases due to the cyclical downturn in external markets, the decline in oil prices and, in a smaller part, to the monetary policy actions of the Hungarian authorities. Businesses were slow in adjusting to the faster-than-expected disinflation. Therefore, wage inflation remained high throughout the year. This adjustment was only reflected in the year-end data. The slow adjustment of private sector wages to the faster-than-expected disinflation caused strong real wage growth, which contributed to the rise in household sector consumption expenditure.

The amount of *whole-economy minimum wage* was raised by 57% in January 2001. But wage increase was slower than the statistical data reflect, due to the importance of informal pay in a significant part of the economy, so its impact on aggregate demand and corporate sector profitability in the total economy was insignificant. Although it had a negative influence on employment in some quarters of the economy, the minimum wage increase left labour demand in the private sector as a whole broadly unaffected. The impact of the minimum wage increase on labour supply is difficult to segregate from demographic developments and regulations on retirement from work; however, the 2001 minimum wage increase is unlikely to have provided the macroeconomy with a perceptible incentive.

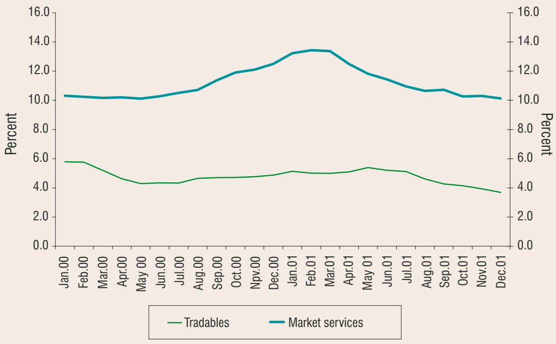
In 2001, general government demand expanded in such a manner that external balance did not deteriorate – the current account registered a lower deficit than in the previous year. An explanation for this may be the significant improvement in private sector financing capacity relative to 2000. Although household consumption and investment grew somewhat more rapidly as a percentage of GDP than disposable income, the corporate sector adjusted to the slow-

**Table 1-1: Consumer price inflation and its components in 2001**
Percentage changes relative to the same periods of the previous year

| | Weights | Q1 | Q2 | Q3 | Q4 | December |
|---|---|---|---|---|---|---|
| Foods | 19.0 | 16.6 | 19.5 | 13.3 | 11.1 | 9.9 |
| *Unprocessed* | *5.3* | *17.8* | *20.9* | *7.6* | *7.6* | *4,8* |
| *Processed* | *13.7* | *16.2* | *19.0* | *15.8* | *12.3* | *11.9* |
| Tradables | 26.8 | 5.0 | 5.2 | 4.7 | 3.9 | 3.7 |
| *Durables* | *7.4* | *1.5* | *1.6* | *1.2* | *–0.1* | *-0,7* |
| *Non-durables* | *19.4* | *6.3* | *6.6* | *6.0* | *5.5* | *5.4* |
| Market services | 20.4 | 13.3 | 11.9 | 10.8 | 10.2 | 10.1 |
| Market energy | 1.3 | 32.4 | 22.8 | 14.0 | 1.4 | -0.7 |
| Motor fuels | 5.0 | 5.3 | 3.3 | –4.8 | –13.1 | –13.9 |
| Drinks and tobacco | 9.1 | 11.3 | 11.7 | 11.2 | 10.4 | 10.3 |
| Regulated products | 18.5 | 7.6 | 8.1 | 9.5 | 8.9 | 8.9 |
| **Consumer price index** | **100.0** | **10.3** | **10.5** | **8.7** | **7.2** | **6.8** |
| Core inflation* | 65.2 | 10.2 | 10.5 | 9.3 | 8.2 | 8.1 |

* The new core inflation indicator published by the CSO in 2002.

**Chart 1-4: Market services and tradables price inflation**
(Percentage changes relative to the same periods of the previous year)




down in external markets by cutting back on fixed investment spending.

### Inflation

The 7%±1% inflation objective of monetary policy, set for the end of the year, was met in 2001. This success in achieving the target may be explained by the strong disinflation which began in the second half – the consumer price index fell from its peak of 10.8% in May to 6.8% in December (see Table 1-1).

A combination of external and domestic factors shaped developments in consumer prices in 2001. The most important of these were food prices, oil prices and imported inflation, as well as inflation expectations and the effect of changes to monetary policy at mid-year.

Food prices, particularly unprocessed food prices, were highly volatile in the year under review. High inflation in the first half proved to be the carry-through effect of an upsurge in pork prices in 2000. In addition, food price inflation rose to its annual peak in the second quarter, caused by another one-off jump in meat prices in May–August 2001. However, the favourable base effect and the decline in the prices of a few unprocessed foods triggered rapid disinflation from the second half of the year.

The price of oil, which rose in the early part of the year and then stagnated at high levels, as well as accelerating tradables prices inflation abroad contributed to price index outcomes being quite high in the first half. The effect of the drop in oil prices in the final quarter was reflected in falling motor fuel prices, while the pressure from imported price inflation did not abate, so tradables price disinflation in the second half was almost entirely attributable to the effects of forint appreciation.

Permanently high inflation expectations from mid-2000 also played a role in the consumer price index remaining stuck at around 10%. One sign of this was robust wage growth, which ran counter to the decline in market services and processed foods price inflation. Market services price inflation was 8 percentage points higher in the first quarter than tradables price inflation. This gap began to narrow gradually in the second half. The significant drop in observers' inflation expectations is also an indication of the marked changes in expectations which occurred in the second half.

## 2 Stability of the financial intermediary system

According to modern economic theory, two basic tasks of a central bank may be distinguished – defining and implementing monetary policy, and promoting financial stability. In harmony with EU regulations, the Act on the National Bank of Hungary defines fostering financial stability as one of the core tasks of the Bank. The Treaty on the European Union defined promoting the efficient operations and stability of the banking system as a primary interest of the European Central Bank. Explanation for this is that the operation of the Eurosystem and the efficiency of monetary policy conduct require a sound financial market. Fulfilling the primary task of the National Bank of Hungary, i.e. the development of monetary policy and its successful implementation with the goal of achieving price stability, is also only possible in a healthy and efficient financial intermediary system.

A central bank is afforded a special role in ensuring financial stability. It must have an up-to-date and reliable picture of the health of the financial sector of the country. In order to fulfil its tasks effectively and professionally, the National Bank continually monitors the developments in the domestic financial sector, analyses the effects on the money and capital markets of potential macroeconomic shocks, examines how strong the financial system is in withstanding external and domestic shocks, evaluates factors influencing the stability of various financial intermediary groups, and participates in the development of regulatory concepts and specific rules.

The Bank publishes its assessment of the stability or vulnerability of the domestic financial intermediary system in the *Report on Financial Stability*, a semi-annual publication. The Bank's goal with the *Report* is to contribute to the improvement of the transparency of the financial intermediary system and to the development of expert thinking about financial stability.

In line with its responsibility for maintaining stability, the Bank issued three *Reports on Financial Stability* in 2001 (in February, May and November), and prepared several studies on the stability of the financial system. Using and refining the methodology developed in the IMF FSAP (Financial Sector Assessment Program) project, the Bank twice analysed the Hungarian banking sector's exposure to extreme market events, based on audited financial statements for 1999 and 2000, using stress tests. Analysis of the current situation of domestic electronic bank services and related risks was required by the proliferation abroad and in Hungary of electronic bank services and their different risks compared with traditional banking activities. The key question of the article analysing banks' pricing behaviour was to discover the channels through which risks taken by banks are built in the prices of banking products. Building on international experience, the article 'Probable impact of Hungary's accession to the EU on Hungarian banking sector' provided insight into regulatory and market processes of the 1980s and 1990s, and offered some useful lessons for Hungary. In 'Reform of the international financial system', the Bank presented changes in the functions of international financial organisations (IMF, World Bank) and the efforts aimed at strengthening financial stability, and provided an overview of the operations of institutions and forums for cooperation created for the purpose of promoting stability. A number of studies were written by Bank staff on the characteristics of and risks related to the operations of savings cooperatives, judged by the Bank as carrying high risks. In 2001, the Bank continued to prepare short, thematic analyses on the stability of the financial intermediary system upon request from various international organisations (e.g. the EU, OECD, ECB and IMF).

In addition to detailed macroprudential analysis of systemic risks, participation in the development of regulatory policy related to the financial intermediary system and in work on specific legislation are also an integral part of the Bank's tasks stemming from its responsibility for maintaining financial stability. In 2001, the Bank actively participated in developing laws and regulations on the financial intermediary system. From among these, the Capital Market Code was especially important. In relation to capital market law, the Bank formed its opinion on bills related to the capital market and initiated changes particularly in relation to securities clearing and settlement systems, prudential areas important from the perspective of systemic stability (e.g. prudential rules for investment services, investment rules of funds, regulating the operations and security of clearing houses, yield guarantee regulations), changing the unjustified restrictions impeding the efficiency of financial intermediation (e.g. more liberalised rules on investment funds, introduction of securities innovations, rules of securities lending, repo regulations, enlarging securities issue techniques) and the accurate harmonisation with EU directives. From a macroprudential perspective, highly important work began in 2001 with the Bank's active participation in the prudential regulation and supervision of institutions at a consolidated group-level, being a harmonisation criteria with EU legislation.

The Bank's primary targets in 2001 were the enhancement of bank supervision, the revision of banks' methods of calculating required reserves, strengthening compliance with legal regulations in payment transactions and improving the quality of data reporting at every financial institution. Due to the significant increase in the proportion of banknote processing outside the central bank, a review of processing firms' activities was also a part of the programme. In 2001, a total 403 on-site examinations were carried out, involving 23 banks, 90 savings cooperatives, 4 investment companies, 4 money processing firms, 243 exchange offices and 39 companies. Examinations carried out in 2001 affected nearly 80% of the aggregate balance sheet total of the banking sector and 40% of that of savings cooperatives. Special emphasis was placed in 2001 on the task of examining data reporting related to the balance of payments. Monitoring these developments, previously the task of the foreign exchange authorities, had to be done by statistical tools following the foreign exchange liberalisation. As a result of the inspections, the Bank prescribed certain measures for the institutions examined, and initiated the imposition by the authorities of fines in a number of cases. Based on the experience with the examinations, a number of rules in force were modified.

Banking sector stability has utmost importance from the perspective of the stability of the Hungarian financial intermediary system, as credit institutions, including banks and savings cooperatives, handle some three-quarters of corporate and household sector savings, in line with the dominance of banks in the financial intermediary system. However, it is also important to monitor the operations of nonbank financial intermediaries, given the continuous increase year after year in their proportion of total financial intermediation.

The Bank judges banks' current activities within the broader range of credit institutions as basically stable. The sector performed very well in 2001. Banks increased their lending portfolio throughout the year, particularly lending to households, but loans to the corporate sector and non-bank financial institutions rose robustly as well. They responded to increased exchange rate risks following the move to widen the forint's fluctuation band by changing the denomination structure of loans – they shifted lending activities strongly towards forint loans. The expansion of lending was associated with increases in specific provisions and recognised losses in value. This suggests a slight deterioration in portfolio quality. However, it is a sign of banks' cautious lending behaviour that the total amount of qualified assets rose especially in the special-watch category in 2001. Banking sector profitability improved further, pre-tax profits in 2001 being 1.5 times those in 2000. In addition to a number of individual factors, the increase in outstanding loans, the reduction in the required reserve rate, the rise in fee income and the more modest increase in costs also played a role in the favourable change in profitability. Capital adequacy of the banking sector is seen as stable. After accounting for yearly net income, the capital adequacy ratio will likely meet the previous year's. This indicates that the increase in the sector's regulatory capital is keeping pace with the increase in lending risks taken by banks.

If banks' lending behaviour is insufficiently cautious amid the favourable business conditions, then the expansion of lending may carry dangers in the event of a possible downturn in the economic cycle. This may be a potential risk to banking sector stability. Therefore, the Bank places special emphasis on analysing whether there are any signs of procyclical lending behaviour in banks' activities. Indicating the importance of this issue, the slowdown in economic growth in 2001 affected banks' activities as well – the rate of lending growth fell in the second half, recognised losses in value increased and portfolio quality deteriorated slightly. In the Bank's view, however, this does not pose any risk to the sector's stability.

Cooperative credit institutions increased their balance sheet total by more than banks in the year under review. In contrast, growth in lending to households by cooperatives was less strong than in the banking sector. The improvement in cooperative credit institutions' profitability was broadly comparable with that of the banking sector, and consequently cooperatives closed the year 2001 with very strong results. Although cooperatives, accounting for a relatively small proportion of the sector, do not carry risks to the health of the banking sector as a whole, the Bank continues to judge cooperative credit institutions' stability as vulnerable – the composition of risks taken by the sector, the geographical distribution of its activities and capital strength remain unsatisfactory. The Bank views the improvement in the sector's stability and the tightening of rules on prudential and capital requirements as especially important issues, due to its significant role in the household market.

Three non-bank financial institutions which are regarded as financial intermediaries, namely investment funds, pension funds and insurers, are involved in re-channelling corporate and household sector savings. The year 2001 saw no substantial changes in respect of their stability. All three types of institution continue to pursue very risk averse, conservative investment policies. Government securities account for 75%–85% of their portfolio.

## 3 Payment systems

### The Bank's role in the field of the payments system

Implementing and developing domestic payment systems, and ensuring their smooth functioning as well as regulating payment services is one of the Bank's core duties. The Bank's firm goal is to make its operations more transparent and predictable in the area of payment systems development and regulation of payment services as well and, by highlighting the background to expected policy measures, to contribute to the achievement of the objectives that have been set. In 2001 there were major changes in this area, possibly related to the requirements of both domestic agents and the various international institutions.

The International Monetary Fund, as well as the Committee on Payment and Settlement Systems, working under the auspices of the Bank for International Settlements, have both formulated a requirement that national central banks develop and disclose their payment system policies.

Meeting these requirements, in spring 2001 the Bank publicly announced its policy of dealing with the operations of payments systems and the regulation of payment turnover. This is a concise summary of Bank's core objectives, the instruments to achieve those goals, and its basic tasks in the regulation of payment turnover and the safe and efficient operations of payment systems.

The Bank's fundamental objective is for the Hungarian payment and settlement systems, including the securities settlement systems, to operate safely and efficiently and to comply with the recommendations of international organisations. In its capacity as an overseer, the Bank collects data, prepares analyses and, by exercising its supervisory, regulatory and ownership rights, influences the operations and development of privately owned systems.

The Bank made publicly available on its web site the legal regulation on payment services, the operating rules of VIBER (RTGS run by the Bank), reports and statistics on the turnover of the systems and card payments and some other related publications that helps the public to better understand the functioning of the payments system.

### Development projects

The volume of transactions in VIBER surged following foreign exchange liberalisation, due mainly to the increased business activity of foreign banks in the forint market. This change made it more difficult for participating banks to manage their liquidity positions. Therefore, the Bank modified the rules of the system. As a result, the opening hours of VIBER are now closer to those of TARGET, the RTGS of the Eurosystem

Liberalisation allowed foreign banks to hold forint bank accounts and execute payment transactions through their correspondent banks. In order for foreign corresponding banks to not disturb liquidity management by VIBER member banks within the system, the concept of interbank order was clarified – instead of the corresponding SWIFT message type, the contents of the order became the basis of the definition.

The methods of calculating the intra-day credit line, which fosters the smooth operations of the payment system, and the acceptance value of eligible securities deposited as collateral for end-of-day credit were changed as of end-2001. The new valuation method was introduced in association with KELER Rt. This reform required substantial development at KELER.

Development of VIBER's remote hot back-up system, intended to enhance the reliability of the system's operation, has already commenced. So far, VIBER has had a back-up; the remote hot back-up facility is intended to ensure the uninterrupted operation of the system if an unexpected communication breakdown or other unforeseen events occur at the main operation site.

The system operated reliably in 2001. During operating hours VIBER was accessible 97%–100% on a monthly average.

Within its real-time securities settlement system, KELER Rt extended the operating hours for over-the-counter securities transactions in 2001, simultaneously with the extension of VIBER operating hours.

In respect of international settlements, KELER Rt introduced DVP (delivery versus payment) settlement for foreign securities as well, building on its accounting relationship established with Clearstream Banking, the Luxembourg-based international depository institution.

### Regulation

The modification of the Central Bank Act in 2001 and the adoption of the new Capital Market Act were designed in part to reach partial compliance with European Union Directive 98/26 on Settlement Finality in Payment and Securities Settlement Systems. These laws ensure bankruptcy protection of collateral security provided to the central bank and the securities clearing house, in order for the systems to operate safely and efficiently. The Capital Market Act, in agreement with the Bankruptcy Act, designates systemically important payment and settlement systems (VIBER, Interbank Clearing System, KELER securities and futures clearing system) in which the collateral pledged enjoy exemption in case of bankruptcy proceedings.

As a major change to regulations on payment services, the rules which were previously laid out in several different Government Decrees were re-formulated in a new Government Decree (232/2001), and the earlier central bank regulation was also replaced (by Decree 9/2001), as both the structure and contents of the earlier legislation required significant modifications.

Hungary's commitments to the EU, the termination of the special status of foreign currency accounts as a result of full foreign exchange liberalisation and the need to create a new standard and transparent regulation on payment services all made creation of these new rules necessary.

In line with Commission Recommendation 97/489/EC of the European Union, the new Government Decree stipulates that holders of electronic payment instruments are not liable for any losses arising after notification, and that they shall bear the loses arising prior to notification only up to a limit of HUF 45,000, provided that those damages have not arisen due to their fraudulent act or extreme negligence. However, credit institutions are only required to apply this rule from 1 December 2002, taking into account the time required for preparations.

The provisions of the Government Decree on transfers within the European Union were created entirely on the basis of the provisions of EU Directive 97/5 on Cross-border Credit Transfers. However, they are expected to enter into force only after Hungary has become a full member of the EU.

With the complete abolishment of foreign exchange controls, the exemption of foreign currency accounts from the scope of the regulations on payment turnover was no longer justified. According to the definitions of the Government Decree, the new rules on payment turnover apply to all bank accounts, irrespective of type and currency denomination. However, it takes into account the peculiarities of cross border and cross currency payments, which are reflected, among others, in the longer fulfilment deadlines arising from the conversion of various currencies, the use of special printed forms and the different system of bank account numbers.

In accordance with changes to international and domestic legal regulations adopted to take actions against terrorism and its financial background, and to prevent money laundering, the rules of client identification when opening bank accounts were tightened. The obligation to identify the actual holder was introduced as a new element, another being the obligation to keep documents underlying the opening of the account for a period of 10 years.

## 4 Foreign exchange reserve management, risk management

### Objectives of holding reserves

The Central Bank Act states that managing Hungary's foreign exchange reserves is one of the National Bank's basic duties.

The basic objectives of managing foreign exchange reserves are:

- supporting the implementation of monetary policy (intervention to keep the forint exchange rate within the fluctuation band);
- transaction goals (supporting debt and crisis management);
- wealth management function.

In recent years, the direct transaction goals, such as supporting debt repayment, have lost their importance with the country's economic development and the improvement in its credit rating and debt service indicators. Nevertheless, these goals are still important. This is indicated by the fact that debt servicing by the Bank and the Hungarian State amounted to some EUR 2.9 billion in 2001. This amount includes repayments of principal and interest payments as well as pre-payments.

Simultaneously with the transaction purpose becoming a secondary goal, supporting the implementation of monetary policy became a priority objective of reserve management. An adequate level of reserves is one of the guarantees for the credibility of the exchange rate regime, which, if necessary, supports the system of inflation targeting in the form of intervention, and fulfilling the Maastricht exchange rate criteria on the way to joining EMU. Within the framework of supporting monetary policy implementation, the Bank conducted interventions in the interbank foreign exchange market in a total amount of EUR 1,280.4 million in the first four months of 2001. This amount contributed to the increase in foreign exchange reserves. Direct interventions either to strengthen or weaken the forint have not been necessary since the band widening in May 2001.

Although the costs of holding reserves have fallen significantly with the improvement in Hungary's credit rating, the Bank still does not wish to maintain reserves purely for the purposes of accumulating wealth. Accordingly, in 2001 the Bank sought to keep the amount of reserves managed only to the extent which effectively supported the implementation of monetary policy and met the debt service requirements. The Bank optimises returns achievable on foreign exchange reserves without jeopardising the above objectives. As an effect of favourable capital market developments, the contribution of foreign reserve management to the increase in foreign exchange reserves was consistent with movements in euro and dollar interest rates.

### Organisational setting

Prior to 2001, the Board of Directors of the Bank set foreign exchange reserve management policy. Under the new Central Bank Act, in effect from 1 July 2001, this task has been delegated to the Monetary Council. This was the most important policy change in the year under review. The Monetary Council decides on the structure of reserves in respect of foreign exchange, interest rate and credit risk, approves the range of authorised investment products and business partners, and sets benchmarks corresponding to the investment guidelines for foreign exchange management departments. On a quarterly basis at least, the Monetary Council reviews the results of foreign exchange reserve management operations.

Whereas the venue for strategic decision-making is the Monetary Council, the body for tactical decision-making is the Asset-Liability Committee (ALCO) which convenes at least once a month. The ALCO decides upon operative issues related to foreign exchange reserve management, such as the discrepancy between the strategy formulated and the benchmark, modification of the defined limits, and closely monitors the operations of the foreign exchange reserve management departments. The Investment Division in the Bank's dealing room fulfils daily investment and liquidity management tasks. The fund managers working in the Division may depart from the tactical benchmark specified by the ALCO within strict risk limits. They are required at least to perform up to or to outperform the return criteria set by benchmarks.

Performance is measured on a daily basis, and continuous compliance with risk limits is controlled by a risk management division independent of the business area. This division is also responsible for developing the risk management policy and operating the senior level reporting system.

### Investment policy

In respect of the classical investment triad of return-safety-liquidity, the Bank's investment philosophy is to maximise profits on a given portfolio, while maintaining high-level safety and daily liquidity requirements.

Adequate safety refers to maintaining the value of reserves held by the central bank. Taking into account its special responsibility, the central bank may only take an amount of risk in the course of managing foreign exchange reserves which carries minimum possibility of loss of capital in a given year. The liquidity requirement means that investments must be convertible into liquid assets practically immediately and without material exchange rate loss for intervention or transaction purposes. Naturally, maximising returns must be allowed only within the limits set by the safety and liquidity requirements. Adopting these objectives in the Bank's investment philosophy is practically the choice of active versus passive portfolio management.

The Bank's principal idea with the compilation of the investment guidelines is to take over the best practices followed by the central banks of developed countries. As all other central banks, the National Bank of Hungary pursues a basically conservative investment policy. This means that it avoids trading in securities with wide fluctuations in prices, and thus it does not invest in equities. The maximum maturity of bonds for choice is 10 years, with required credit ratings of AA or AAA. Liquidity requirements, in addition to credit ratings, also allow only the purchase of securities issued by governments of developed countries, large international financial institutions and government agencies. In 2001, the adequately high level of reserves and the vast development of bond markets of recent years made it possible for the Bank to gradually increase the proportion of the adequately secure and liquid AA-rated sector ensuring higher returns.

Since the forint exchange was pegged to the euro basket, the euro has played a decisive role in the composition of foreign exchange reserves. But beyond this, the direction of Hungary's economic integration, the composition of its foreign currency debt and the fact that the euro is the number one intervention currency for the Bank all justify the significant weight of the euro. (The euro accounts for 70%–80% of turnover in the domestic interbank spot forint-foreign exchange market.) In addition to the euro, the US dollar accounts for a smaller portion within foreign exchange reserves.

Within its foreign exchange reserves, the Bank distinguishes between liquidity and investment portfolios, in accordance with international practice. Its aim with the liquidity portfolio is to ensure daily liquidity, such as actual repayments of interest and principal and foreign exchange market intervention, and specific transactions and transfers. The maturity profile of this portfolio is partly determined (scheduled repayments of interest and principal) and partly unknown in advance (interventions). This portfolio can be characterised by low interest rate risk and a short-term investment horizon. The investment portfolio, which is related to more pronounced return requirements than the liquidity portfolio of reserves, is the part of reserves which is intended to be held stable over the long term. Although it is a basic requirement of the investment portfolio that securities should be easily marketable, the fact that they are less likely to be used makes it possible to invest for longer average durations, depending on market outlook and the slope of the yield curve. Optimising the percentage shares of the two portfolios, the Bank held 20 per cent of its reserves in the liquidity portfolio and 80 per cent in the investment portfolio.

### Financial risks

The Bank follows two basic principles in financial risk taking. One is that risks taken must be in line with the objectives of the basic tasks. The second is that risk taking must be conscious – its extent must be known and limited over a certain level. The Bank adopted independent exchange rate and credit risk management policies for the first time in 2001, in order to implement these principles. These include all basic principles and practical guidelines which must be complied with in order to function as a basis for conscious, regulated risk management. Another objective is that risk management policy must be consistent with the basic principles of the risk management guidelines of the Basle Committee on Banking Supervision.

From among the various types of risk, market risks (foreign exchange and interest rate) as well as credit and liquidity risks are viewed as the most important.

In respect of market risks, such as those arising from variations in market factors/prices, especially risks posed by exchange rate movements and shifts in the yield curve, the Bank follows a conservative risk management strategy. The Bank takes a risk averse stance meaning that, at the accepted level of risk, it tries to achieve the highest possible returns. Market risk can be divided into two major components – interest rate and exchange rate risk.

Interest rate risk is the potential loss which unfavourable changes in interest rates may cause to the Bank. Its asset-liability interest rate structure is determined by special factors stemming from the unique nature of central banking. The Bank's risk taking policy defines desirable average remaining maturities; deviation from these is allowed on the basis of pre-determined limits and rules of procedure.

The Bank treats exchange rate risks as an important issue, given that it holds a significant amount of foreign exchange for various objectives. In line with its monetary policy, the euro is treated as a reference currency when defining foreign exchange rate risk. Accordingly, all positions that are not denominated in the euro represent exchange rate risk for the Bank. In order to limit exchange rate risks on open foreign currency positions, a foreign exchange benchmark has been defined, deviation form which is only allowed within the limits determined by the risk management policy. The composition of reserves is consistent with the currency composition of liabilities. In respect of the net foreign exchange position, minimising risks which cannot be influenced is an important goal. This, taking into account the currency basket of the forint, means the dominant role of the euro.

Generally, credit risks are uncertainties related to the failure by the Bank to recover partially or fully its certain claims. Credit risk policy is similarly conservative as the policy of taking market risks. One of the basic elements of the investment and risk taking philosophies is that loss of capital arising from non-fulfilment is not acceptable; this risk must be reduced to the lowest possible level. The Bank operates a limit system to handle credit risks.

How readily sufficient amounts of liquid assets are available at a given moment constitutes a liquidity risk for the Bank. Therefore, it operates a liquidity portfolio, in addition to the investment portfolio of reserves, in order to maintain immediate liquidity.

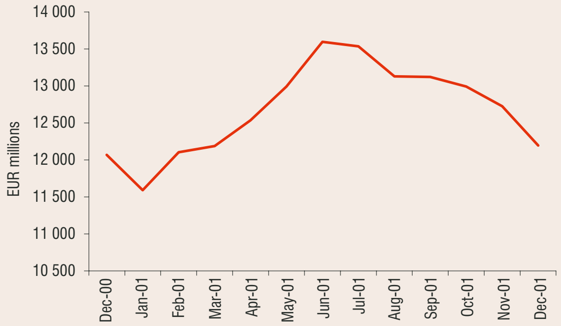
### Adequacy of foreign exchange reserves

The Bank's foreign exchange reserves fluctuated between EUR 11.5–13.5 billion in 2001. They amounted to EUR 12.2

billion at year-end, remaining practically level taking the year as a whole. Looking at changes in reserves over time (see Chart 4-1), there was a continuous rise up to the middle of the year. Interventions conducted near the upper limit of the fluctuation band until early May, the widening of the band, accounted for some EUR 1,280.4 million. Issuance by the State of bonds in the amount of EUR 1.0 billion in June 2001 was another contributing factor. Reserves fell in the latter half of the year. Repayments of medium-term loans, interest rate payments and the decline in domestic commercial banks' deposits with the Bank played a decisive role in this respect. Offsetting the drop in reserves, the Bank purchased a total EUR 362.5 million in the domestic foreign exchange market in equal daily amounts from end-June 2001 to cover foreign currency interest payments of ÁKK, the Government Debt Centre. As a result of the decline in the second half, reserves practically returned to their levels at the start of the year.

In the second half of 2001, the Bank's Monetary Council, taking into account the experiences with the new exchange rate regime, reviewed whether the level of reserves was consistent with the new challenges of the band widening and foreign exchange liberalisation. It found that the current level of reserves was adequate. Looking ahead, reserves were judged to be sufficient to satisfy the basic objectives of reserve holdings without the need to borrow external funds. Accordingly, at its meeting of 19 November 2001 the Monetary Council decided to suspend purchases of foreign currency in equal daily amounts from 1 January 2002.

**Chart 4-1:** Official foreign exchange reserves in 2001




## 5 Issue operations

### Issue of cash

The National Bank of Hungary issued the highest denomination of its new banknote series, the 20,000 forint note, on 1 February 2001. The new note was produced in 1999, as a reserve note. With the issue of the 20,000 forint banknote, a composition of denominations was developed which fitted better to the needs of cash payments. Currently, the forint banknote series consists of seven denominations, similary to that of the euro. The ratio of the smallest to the largest denominations is one to one hundred. In addition, the Bank issued commemorative coins which were linked to various anniversaries and different themes, following the practice of previous years.

The dates of lapse of the old 500, 1,000 and 5,000 forint notes, withdrawn from circulation, were extended to 31 December 2009, in order to reduce potential losses to individuals. Of the three denominations being phased out, 7.8 million pieces were held outside the central bank at end-2001, in a total value of more than Ft 9 billion.

Chart 5-1: Average amount of cash as a percentage of GDP at current prices

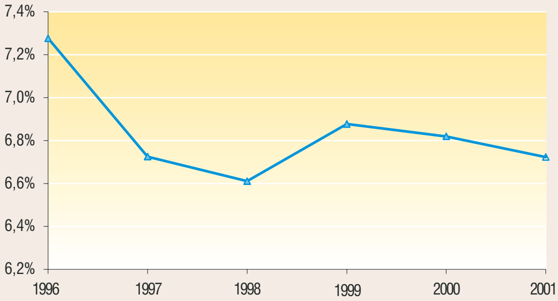



Chart 5-2: Increases in GDP at current prices and the average amount of cash on a 1996 base

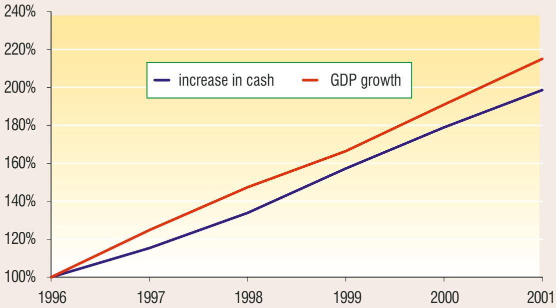



Table 5-1: Cash in circulation on the last business day of 2001

| | 2000 | 2001 | Change | |
|---|---|---|---|---|
| | HUF billions | | | Per cent |
| Notes | 940.8 | 1105.8 | 165.0 | 117.5 |
| Coin | 19.6 | 21.1 | 1.5 | 107.7 |
| Cash for circulation | 960.4 | 1126.9 | 166.5 | 117.3 |
| Commemorative notes and coins | 1.9 | 2.3 | 0.4 | 121.1 |
| Cash in circulation | 962.3 | 1129.2 | 166.9 | 117.3 |

Table 5-2: Banknotes in circulation on 31 December 2001

| Denomination | Quantity | Value | Percentage share | |
|---|---|---|---|---|
| | mill. pieces | millions HUF | Quantity | Value |
| 20,000 forint | 9.3 | 185 571 | 4.3 | 16.8 |
| 10,000 forint | 68.5 | 685,120 | 31.7 | 61.9 |
| 5,000 forint | 29.3 | 146,357 | 13.6 | 13.2 |
| 2,000 forint | 14.8 | 29,520 | 6.9 | 2.7 |
| 1,000 forint | 42.8 | 42,808 | 19.8 | 3.9 |
| 500 forint | 20.3 | 10,177 | 9.4 | 0.9 |
| 200 forint | 31.0 | 6,205 | 14.3 | 0.6 |
| Total | 216.0 | 1,105,758 | 100.0 | 100.0 |

## Cash in circulation

### *Forint cash*

The total value of currency in circulation was HUF 1,129.2 billion at the end of 2001, up 17.3% on the previous year's end. Annual average growth in currency in circulation amounted to 11%, dropping by 3 percentage points relative to 2000. The decline in growth rate is explained by slower GDP growth and a fall in inflation. The change in interest rates on household deposits had an insignificant impact on the amount of currency in circulation in 2001.

During the year, the average amount of cash in circulation, as a percentage of GDP at current prices, was 6.7%, down 0.1 percentage point on the previous year. (This ratio was 3%–7% on average in the member states of the European Union.)

There is a close relationship between GDP growth and growth in cash in circulation. In previous years, GDP grew by 2 percentage points more strongly on average than cash in circulation.

Within-year variations in cash in circulation have shown similar seasonal patterns in the past few years – the lowest values were measured in early February, the highest ones in December, prior to the Christmas holiday. Aside from the months of January and December, the difference between the highest and lowest values was HUF 23–50 billion. The increase in cash in circulation in the period prior to Christmas, closely related to the holidays, amounted to HUF 107 billion compared with end-November. Looking at the previous few years, example for an increase of such magnitude was only recorded in 1999, in the year of the millennium date change.

In 2001, the average amount of cash per capita was HUF 99,224, the number of notes and coins being 20 and 165 respectively (more than 0.6 kg). The value of cash per capita rose by 12% relative to the previous year, the number of notes and coin increasing by 1 and 18, respectively. (In 2000, the number of notes per capita in the member states of the European Union was nearly 40, that of coins being around 400.)

Within cash for circulation, notes and coins accounted for 98% and 2%, respectively in 2001, broadly comparably with earlier years.

### *Banknotes in circulation*

Whereas the average value of notes in circulation increased by 12.1%, by nearly HUF 100 billion during the year relative to 2000, the average number of notes increased by only 5.6%, or 11 million pieces, due primarily to the more favourable composition of denominations on account of the issue of the 20,000 forint note in 2001. As regards the number and value of notes in circulation, the 10,000 forint note continued to account for the highest percentage share, although it had fallen strongly by year-end, declining by 13.5 percentage points within the total value and 3.3 percentage points within the total number of notes, following the issue of the 20,000 forint note.

***Coins in circulation***

The number of coins in circulation was 170 million, or 10.8%, more at end-2001 than at the end of the previous year. As seen in earlier years, the increase was accounted for by the stronger-than-average rise in the number of coins with small denominations.

The value of coins in circulation was HUF 1.5 billion, or 8%, higher in 2001 relative to the previous year.

Neither the number nor the value of coins in circulation changed significantly in 2001 in comparison with 2000. The percentage share of 1 and 2 forint coins within the total continued to rise slightly, reaching 63% by year-end. Nevertheless, their share of the total value amounted to 7.5%.

**Table 5-3: Coins in circulation on 31 December 2001**

| Denomination | Quantity | Value | Percentage share | |
|---|---|---|---|---|
| | mill. pieces | millions HUF | Quantity | Value |
| 100 forint | 115.0 | 11,503 | 6.6 | 54.4 |
| 50 forint | 60.8 | 3,039 | 3.5 | 14.4 |
| 20 forint | 125.6 | 2,513 | 7.2 | 11.9 |
| 10 forint | 153.8 | 1,538 | 8.8 | 7.3 |
| 5 forint+ | 189.0 | 945 | 10.9 | 4.5 |
| 2 forint | 500.1 | 1,000 | 28.7 | 4.7 |
| 1 forint | 597.4 | 597 | 34.3 | 2.8 |
| **Total** | **1741.7** | **21,135** | **100.0** | **100.0** |

## Cash turnover and processing activity

In 2001, the Main Cashier's Desk of the National Bank of Hungary, together with the cashiers' desks at the regional offices, registered turnover of HUF 3,409 billion. This was 16% higher than turnover in 2000.

The introduction of cash management and exchanging fees in 1998 encouraged credit institutions to reorganise their cash supplies, rationalise transportation and develop cash trading among themselves. As a result, the value of central bank cash turnover fell in the two years following the introduction of fees. This trend turned around in 2001, the value of lodgements, at HUF 1,622 billion, exceeding that of the previous year by 10%. The value of withdrawals was HUF 1,787 billion, up 22% from 2000.

Including exchange transactions, customers paid 332 million notes into the cash offices of the Bank, in a total value of HUF 1,612 billion. This was 2% and 11% higher, respectively, in terms of quantity and value than in the previous year.

Including exchange transactions, 344 million notes were put into circulation, in a total value of HUF 1,775 billion. This represented a 7% and a 21% increase in terms of quantity and value relative to the previous year. Explanation for the different rates at which the quantities and values of both the lodgements and the withdrawals grew is the more favourable composition of denominations on account of the issue of the 20,000 forint note in 2001.

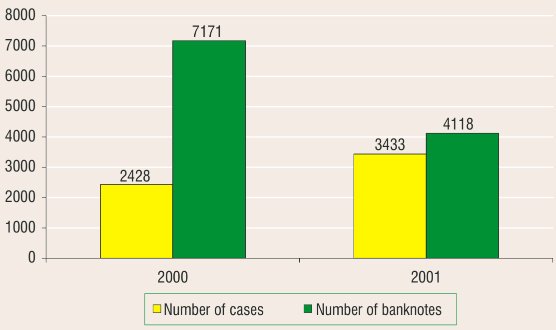
As seen in the previous year, each banknote returned to the Bank's processing units 1.7 times on average in 2001.

## Counterfeits

Since the beginning of the launch of the new forint banknote series in 1997, 2001 was the second year when the notes of the old series were no longer involved in cash turnover. Owing to the new series with state-of-the-art security features and the developments implemented in due time, the number of counterfeits fell by nearly 40% in 2001 relative to the previous year.

In comparison with 34 in 2000, the number of counterfeits in 2001 was 20 per 1 million pieces of banknote in circulation. This is favourable even by international standards. In contrast with the fall in the number of counterfeits, the

**Chart 5-3: Forint counterfeits: number of cases and quantity**



number of cases increased. This reflects the individual or unorganised nature of counterfeiting.

Although the number of counterfeits fell, the Bank continued to view it as important to further develop the security features of banknotes. As a result of this work, the 500 forint note was printed with optically variable ink and the 200 forint note with a feature fluorescing when exposed to ultra-violet light.

Comparing with the previous year, the number of both seized counterfeits and the number of cases remained at a level which did not disturb currency turnover.

### Central bank measures linked to the introduction of the euro

On 11 May 2001, the Bank's Board of Directors reviewed the central bank tasks related to the introduction of the euro, and defined the Bank's action plan. The plan was prepared and implemented in cooperation with the European Central Bank, the Hungarian Banking Association and Hungarian commercial banks.

Influencing and regulating credit institutions' activities, preparing those professionally involved in the foreign currency business, and keeping individuals informed were at the heart of the Bank's action plan. From mid-November, the Bank pursued a one month long information campaign which was also directed at individuals without banking relations. Showing the favourable reception of the campaign, Hungarian individuals were well informed about the introduction of the euro – 98% of them had heard about the introduction of the euro.

The Bank submitted a written account to the Hungarian Government on the interim implementation of the action plan in September 2001, and then to the European Integration Affairs Committee of the Hungarian Parliament in November 2001.

On 19 July 2001, the Bank issued recommendation on the conversion into the euro of accounts held in the legacy currencies which recommended that credit institutions convert the balances on those accounts into euros free of any fee, commission or other charge. Credit institutions converted several hundred thousand credit, deposit and current accounts held in the twelve legacy currencies into euro accounts in the second half of 2001, in most cases automatically and free of charge to customers.

On 27 September 2001, the Bank issued a regulation, in order to create a legal framework for the acceptance and conversion of legacy currencies. Credit institutions were mandated to accept the twelve legacy currencies until 15 February 2002. The conversion of savings held in the legacy currencies, estimated to be several tens of billions of forints, progressed at a rapid pace, in line with the central bank regulation. A large part of individuals had converted their savings before the end of 2001.

The Bank developed a training programme with the aim of familiarising those dealing with foreign currencies as a profession with the euro banknotes and coins before they were introduced. For this reason, Bank staff compiled a training brochure which presented the security features of the euro banknotes and information about the coins. At 360 training courses between October–mid-December, the

Bank's banknote specialists prepared 11,000 foreign currency cashiers, exchange agents and other experts for knowledge of euro cash.

In a joint effort with the Hungarian National Committee for UNICEF, the Bank launched a charity programme to collect legacy currency coins. In addition to the originators, 14 credit institutions, the Hungarian Post Office, some 50 schools and quite a number of companies collected a total 13 tons of coin from the public up to end-February 2002. UNICEF will use one-half of money collected to support Hungarian child protection programmes and one-half to support international child protection programmes.

## 6 Statistical service

### Legal regulation

Act LVIII of 2001 on the National Bank of Hungary defines the collection and dissemination of statistical information as one of the Bank's core duties. The Act also defines the range of institutions providing financial services that the Bank may directly mandate to report data. A central bank regulation sets reporting obligations. The Bank has developed the methodology related to data collection and the operation of the information systems in cooperation with the Central Statistical Office.

In order to fulfil its tasks, the Bank collects data from a broader range of institutions than that defined by the Central Bank Act. Such data collection is carried out in accordance with Act XLVI of 1993 on Statistics, within the framework of the National Statistical Data Collection Programme (OSAP). OSAP is coordinated by the CSO, and is regulated annually by government decree.

### European Union requirements

Two important preconditions for joining the European Union are to adopt the statistical methods recommended by the Union and to fulfil obligations related to data reporting and the provision of statistical information. In its statistical reports, the Bank endeavours to follow the harmonised methodological principles of international institutions. Fulfilling the data reporting requirements applied to Accession Countries, reports are submitted regularly to Eurostat. Since September 2001, the Bank has been reporting regularly to the European Central Bank (ECB) and the range of reports has been expanded continuously. Data providers' reports have been harmonised gradually with the requirements of the ECB since early 1999. Another step towards adopting the methodology recommended by international institutions was the changeover to a standard sector classification system in 2001. This equally applied to data reporting as well as the release of statistical data.

### Statistical activity

Based on the processed statistical data on monetary developments and Hungary's balance of payments, the Bank issues press releases on a monthly basis regarding its balance sheet, the aggregate balance of monetary institutions and developments in the monetary aggregates, developments in forint interest rates of the non-financial corporate, household sectors and the interbank market as well as Hungary's balance of payments. The press releases are issued at dates fixed in the Bank's release calendar which in turn is disclosed six month in advance. In addition to those noted above, monthly press releases are issued on the financial savings of households and quarterly releases on the distribution of securities holdings by sector. These data are all required to compile the financial accounts.

The press releases as well as the long time series of monetary statistics, balance of payments statistics and household and securities data related to the financial accounts, price and exchange rate data are accessible for users on the Internet.

Accommodating to users' needs and the international practice of publishing statistical data, the Bank twice published a comprehensive methodological description as part of its *Monthly Report*, at the beginning of the year and at the time of changing over to the new sector classification system. These descriptions are also available on the Internet.

In order to meet users' requirements in an up-to-date manner, the focus in all of the Bank's publications, particularly its statistical publications, has been gradually shifted from the printed to the electronic format.

### Monetary statistics

By processing the balance sheet data of monetary institutions, i.e. credit institutions and the central bank, the monetary statistics compiled by the Bank provide information on the banking sector's assets and liabilities, developments in credit and money aggregates and changes in the net position of other sectors vis-ŕ-vis monetary institutions. Compiling statistical data on market interest rates is also one of the Bank's statistical activities.

In addition to changing over to the new sector classification, a major overhaul of balance sheet statistics became necessary with the launch of data reporting to the ECB in 2001, meeting the requirements of the ECB. The review conducted by the International Monetary Fund in 2001 (ROSC) gave a positive evaluation of the Bank's monetary statistical activity.

### Balance of payments statistics

The balance of payments statistics and the related data on international investment position serve the purpose of presenting economic transactions between resident and nonresidents, outstanding assets and liabilities as well as changes therein. In 2001, the Bank also changed over to the sector classification in balance of payments statistics. This made it necessary to implement changes in the data processing methods. Another change was required in data collection rules and data processing by foreign exchange liberalisation.

In the early stage of preparing data reports to the ECB, those on Hungary's balance of payments were launched first. This was accompanied by a methodological description on the balance of payments. The examination by the IMF in 2001 affected the balance of payments statistics as well. According to the findings of the review, the method followed by the Bank fulfilled the international statistical standards, aside from a number of differences, such as the inclusion of customs statistics and accounting for reinvested earnings.

### Financial accounts

In a continuous harmonisation of ideas with the CSO, the Bank views the compilation of financial accounts fitting in the system of national accounts and the launch of regular data reporting as priority strategic tasks within its statistical activity. Most of the required preparatory work was accomplished in 2001.

The statistics on households' financial savings present assets and liabilities of the sector in a breakdown by various financial instruments and changes therein. After harmonising with the CSO, the changeover to the new sector classification system was also accomplished in statistics measuring household savings. This required the modification of sector boundaries as well.

The statistics on securities holdings which rely on reports by custodians, provides a picture of outstanding government securities, investment units and exchange-traded shares as well as their distribution across economic agents. General government accounts are a constituent of financial accounts. These were compiled in 2001 for several years retrospectively. The Bank publishes the accounts of general government and the composition of changes therein in its *Monthly Report*.

### International data provision

In accordance with its position and the requirements arising from international cooperation as well as its membership obligations, the Bank provides regular data reports to the following international organisations, in addition to Eurostat and the ECB: International Monetary Fund, World Bank, Organisation for Economic Co-operation and Development, and the Central European Statistical Co-operation (CESTAT). The Bank provides the Monetary Fund with data, meeting the high-standard requirements of the IMF (SDDS: Special Data Dissemination Standard). In 2001, the Bank joined the database of the Bank for International Settlements; however, full-scale data reporting to the BIS has not yet started.

### Cooperation with domestic institutions

Statistical work in the Bank makes it indispensable to have a close cooperation with domestic fellow institutions, particularly with the Central Statistical Office, the Ministry of Finance and the State Supervisory Authority of Financial Institutions, in addition to the international organisations. In the framework of this cooperation, the CSO and the Bank in 2001 agreed on the new method of calculating the core inflation indicator. According to the agreement, the CSO calculates core inflation on the basis of a methodology agreed with the Bank.

## 7 Profit of the National Bank of Hungary and its financial management

### Development of the Bank's income in a breakdown by functions

**(The following breakdown of the acconting profit/loss is based on reference yield principle, the methodology of which has been described in a separate paper prepared by the Bank.)**

The financial result of the National Bank for 2001 amounted to a profit of HUF 3.6 billion and the balance sheet total stood at HUF 5,453 billion.

The development of the financial statements of the National Bank of Hungary is primarily influenced by the objectives and instruments of monetary policy. Furthermore, management of the country's foreign currency reserves - with a view to increasing their value as part of the Bank's functions defined by law - also has a significant impact on the balance sheet and income of the central bank.

**Seigniorage, one of the key sources of income for the Bank related to its core function,** arises from its monopoly of issuing notes and coin and its authority to set the reserve requirement. The Bank invests its non-interest-bearing and non-market interest liabilities arising from these functions in various other instruments yielding higher rates of interest.

Central bank seigniorage must cover the Bank's operating costs. The seigniorage adjusted for currency issue and banking operations costs amounted to a **profit of HUF 118.7 billion in 2001,** up by HUF 3.2 billion on a year earlier. Within the liabilities underlying this constituent of profit, the average size of the required reserves, on which the Bank

Table 7-1

HUF billions

| No | Desciption | 2000 | 2001 | Change |
|---|---|---|---|---|
| 1 | seigniorage | 133.4 | 137.7 | 4.3 |
| 2 | Cost of currency issue | *-3.1* | *-4.4* | *-1.3* |
| 3 | Net operating expenses* | -14.8 | -14.6 | 0.2 |
| 4 | **Corrected seigniorage (1+2+3)** | **115.5** | **118.7** | **3.2** |
| 5 | **Cost of fiscal activity undertaken on behalf the government** | **-21.0** | **-10.6** | **10.4** |
| 6 | **Cost of foreign currency reserves and liquidity management** | **-72.7** | **-88.2** | **-15.5** |
| 7 | **Other (primarily equalisation reserves and capital)** | **-7.3** | **-16.3** | **-9.0** |
| 8 | **Accounting profit** (4+5+6+7) | **14.5** | **3.6** | **-10.9** |

** 'Operating income' less 'Operating costs and expenses' in the profit and Loss Account.*

incurs some interest expenses, fell by 25%. The relevant rate of interest fell by 2.25% due to the change in the regulation of reserve requirement rules, while the average stock of notes and coin in circulation increased by 11%.

**The impact of non-central bank functions on the balance sheet and the profit and loss account has steadily declined, due partly to the revision and elimination of the Bank's activities of this nature.** The HUF 10.6 billion charge incurred on the Bank's **participation in state financing** is due to the fact that the Bank previously actively participated in providing development credit to the economy via lending to financial institutions and the Budget. The source of the forint loans was foreign currency borrowing from abroad. The weight of lending associated with the Bank's participation in state financing has declined every year, causing the related loss to drop as well. The process gained momentum in 2001, when the Bank began a transfer of such non-central-bank activities and the existing loans to the Hungarian Development Bank (MFB).

As the foreign exchange reserves under the Bank's management are largely financed by market-interest forint liabilities currently, this activity reduced the Bank's income significantly, by HUF 88.2 billion, in 2001 as well.

In an effort to keep the forint exchange rate within limits, during previous years and up to May 2001 the central bank was forced to undertake multiple interventions in the foreign exchange market, that is, it bought increasingly larger amounts of foreign currency for forints. The resulting outflow of forint funds had to be sterilised lest an excessive supply of liquidity exerts upward pressure on inflation or causes the balance of payments to deteriorate. To this end, the Bank issued bills and took money market deposits from banks.

As a result, the Bank's balance sheet began to include increasing amounts of market interest bearing forint liabilities against the country's growing foreign exchange reserves. This implies that the central bank was persistently forced to finance its lower interest bearing foreign exchange assets with higher interest bearing liabilities denominated in forints. The total loss resulting from the Bank's role as the manager of foreign exchange reserves and regulator of liquidity (linked to central bank monetary policy) amounted to HUF 88.2 billion (see Line 6, Table 7-1).

The HUF 16.3 billion relative cost incurred on **other items** (Line 7, Table 7-1) was due to missing interest income on non-interest bearing assets.

### Measures and events affecting items on the balance sheet

The amendment in 2001 of the rules on the **reserve requirement** imposed on credit institutions affected several items on the Bank's balance sheet.

The reserve requirement was reduced from 11% to 7% as of 1 February 2001. The shift to this lower ratio meant that for a temporary period credit institutions had to satisfy the reserve requirement in securities designated by the Bank to an extent of 4% of the reserve base. Accordingly, the Bank sold government bonds of HUF 194.5 billion to credit institutions, and issued five-year bonds of HUF 33 billion.

Table 7-2

HUF billions

| No. | ASSETS | 2000 | 2001 | No. | LIABILITIES | 2000 | 2001 |
|---|---|---|---|---|---|---|---|
| 1 | Forint receivables from the government | 657 | 389 | 7 | Notes and coin in circulation | 962 | 1129 |
| 2 | Foreign currency receivables from the government | 1545 | 1167 | 8 | Bank Account Deposits | 558 | 421 |
| 3 | Refinancing credits | 90 | 44 | 9 | Sterilisation instruments | 959 | 878 |
| 4 | Foreign currency reserves | 3197 | 3004 | 10 | Forint deposits by central government | 171 | 345 |
| 5 | Operating and other assets | 1020 | 849 | 11 | Foreign currency liabilities to government and credit institutions | 526 | 367 |
| | | | | 12 | Foreign and other foreign currency liabilities | 3118 | 2356 |
| | | | | 13 | Operating and other liabilities (net of equalisation reserves) | 260 | 204 |
| | | | | 14 | Equalisation reserves | -45 | -247 |
| 6 | **Total assets** (1+2+3+4+5) | **6509** | **5453** | 15 | **Total liabilities** (7+8+9+10+11+12+13+14) | **6509** | **5453** |

The reduction in government securities holdings also pushed down the level of *Forint claims on the Budget.* Simultaneously the value of *Bank account deposits* on the liabilities side, which also comprises reserves, also fell.

**The size of the *foreign exchange reserves* remained virtually unchanged in foreign currency terms in 2001. Its value increased in 2001, due to further purchases of foreign currency,** as the central bank was forced to sterilise strong foreign currency inflows by HUF 341 billion (EUR 824 million and USD 413.5 million). Although intervention in the foreign exchange market came to an end when the forint's intervention band was widened in early May, the Bank continued to purchase currency totalling HUF 91.2 billion (EUR 362.5 million) to satisfy interest payment obligations associated with the foreign currency debt of general government.

At the same time, servicing the Bank's foreign exchange debt reduced the level of foreign exchange reserves, causing it to remain virtually unchanged in euro terms. (Note, however, that this represented a fall of HUF 193 billion in forint terms, due to the strengthening of the forint.)

**The appreciation of the forint following the band widening in May 2001 affected each and every foreign currency item on the balance sheet. The fall in the net foreign currency surplus on the assets side in terms of forints, simultaneously with a drop in the balance sheet total, pushed up the negative balance of the *equalisation reserve.*** In accordance with the provisions of the new NBH Act, the central government settled by 31 March 2002 the HUF 250.2 billion deficit recorded at end-2001. This partly occurred in the form of a financial settlement that did not affect the budgetary estimates for 2001, and which was offset by a reduction of a similar size in forint terms in the foreign currency public debt.

***Other foreign exchange liabilities,* which include foreign debt, fell by altogether HUF 762.3 billion.** In addition to the strengthening of the forint, this was due to the repayment of debt undertaken earlier primarily to finance the central government deficit.

In addition to the repayment of debt, the claims on credit institutions decreased as refinancing development loans (amounting to 31.3 billion in 2001) were transferred to the MFB (Hungarian Development Bank). Due to the transfer of related foreign loans, this had a downward pressure on foreign liabilities.

As part of eliminating non-central-bank functions, the Bank sold CW AG in 2001, reducing the volume of investments stated on the balance sheet.

### Factors affecting profit and loss

Due to the changes in balance sheet items outlined above and forint and foreign currency interest rates, the **financial result recorded by the Bank for the year 2001 was a profit of HUF 3.6 billion,** down by HUF 10.9 billion on a year earlier.

Table 7-3

HUF billions

| | Description (P/L lines) | 2000 | 2001 | Difference |
|---|---|---|---|---|
| 1 | Net interest and interest related income | -41.7 | -31.6 | 10.1 |
| 2 | Income arising from exchange rate changes | 75.5 | 55.1 | -20.4 |
| 3 | Other constituents of net income* | -19.3 | -19.9 | -0.6 |
| 4 | Profit for the year (1+2+3) | 14.5 | 3.6 | -10.9 |
| 5 | Net equalisation reserves stated with other operating liabilities in the balance sheet | -44.7 | -247.3 | -202.6 |
| 6 | *of which: -due to changes in foreign currency and precious metal prices* | -38.3 | -250.2 | -211.9 |
| 7 | *- due to changes in the market value of foreign currency securities* | -6.4 | 2.8 | 9.2 |

** Other constituents of net income: net expenses of money circulation and operations, net provisions and other income.*

The Bank incurred a net **loss** of HUF 31.6 billion **on interest and interest related income**, an improvement of HUF 10.1 billion compared with the previous year, as a combined outcome of several positive and negative effects.

The total average level of interest rates on interest-bearing forint assets fell by 0.9 percentage points (from 9.95 to 9.0%), while that on liabilities dropped by merely 0.2 percentage points (from 9.6% to 9.4%). The difference was primarily due to the impact on composition of the change in the reserve requirement and foreign exchange market intervention, occurring predominantly in the first half of the year.

The removal of higher interest bearing government paper from the balance sheet and its transfer to credit institutions caused a further reduction in the average level of yields.

Table 7-4

| No | Description | 2000 Average balance HUF billions | 2000 Average interest rate % | 2000 Interest amount HUF billions | 2001 Average balance HUF billions | 2001 Average interest rate % | 2001 Interest amount HUF billions |
|---|---|---|---|---|---|---|---|
| 1 | Interest-bearing forint receivables | 824.4 | 9.9 | 81.5 | 527.1 | 9.0 | 47.3 |
| 2 | Non-interest bearing forint receivables | 24.6 | - | - | 3.5 | - | - |
| 3 | Interest-bearing foreign currency receivables* | 4690.7 | 5.2 | 243.5 | 4733.6 | 5.3 | 248.8 |
| 4 | Non-interest bearing foreign currency receivables | 317.2 | - | - | 288.4 | - | - |
| 5 | Other assets | 279.3 | - | - | 228.9 | - | - |
| 6 | **ASSETS*** | **6 136.2** | **5.3** | **325.0** | **5 781.5** | **5.1** | **296.1** |
| 7 | Interest-bearing forint liabilities | 1 662.8 | 9.6 | 160.0 | 1 716.4 | 9.4 | 161.6 |
| 8 | Non-interest bearing forint liabilities | 913.5 | - | - | 1 000.4 | - | |
| 9 | Interest-bearing foreign currency liabilities* | 3 043.9 | 6.8 | 206.7 | 2 696.7 | 6.2 | 166.1 |
| 10 | Non-interest bearing foreign currency liabilities | 326.8 | - | - | 294.3 | - | - |
| 11 | Other liabilities | 189.2 | - | - | 73.7 | - | - |
| 12 | **LIABILITIES*** | **6 136.2** | **6.0** | **366.7** | **5 781.5** | **5.7** | **327.7** |

**The balance sheet total is stated as a corrected value, as yields on derivatives transactions cannot be interpreted by themselves. Therefore they are stated together with hedged transactions in the table.*

At the same time, the need to sterilise the excess liquidity arising in the wake of the lowering of the reserve ratio and the intervention in the foreign exchange market led to the inclusion of new market interest bearing liabilities on the balance sheet, dampening the effect of the drop in the average cost incurred on liabilities.

The primary effect of further instances of intervention aggravates interest rate losses by itself, as it makes forint liabilities finance an increased proportion of foreign currency assets.

The average level of interest rates on **foreign currency assets and liabilities** increased by 0.1 percentage points (from 5.2% to 5.3%) and fell by 0.6 percentage points (from 6.8% to 6.2%), respectively.

The rapid alternation of credit institution deposits on the liabilities side enabled the Bank to all but fully realise the drop in market interest rates. This positive impact was further reinforced as part of the higher interest foreign debt was paid off.

The unit interest income on foreign currency assets rose by 0.1 percentage points despite the fall in market interest rates on foreign currency instruments. This was because as securities increased in market price, lower interest rates improved earnings from selling securities over the short term, which caused yields to rise even in percentage terms. By contrast, over the longer term (also affecting 2002), the drop in interest rates may cause interest income to contract, due to the change of portfolios.

The other main constituent of the Bank's income in the reviewed year was the **exchange rate gain.** The exchange rate gain recorded on the profit and loss account and arising from the official devaluation of the forint, in accordance with statutory regulations, amounted to HUF 55.1 billion in 2001, down by HUF 20.4 billion on the previous year. This was because the reduction in the rate of the crawling peg, and the subsequent abandonment of the system was only partially offset by the effect of the increase in net foreign currency position in euro terms, due to central bank intervention.

Net expenses arising from **other factors of income** amounted to HUF 19.9 billion, similar to that seen in 2000.

This comprised **operating costs of banking operations of HUF 15.2 billion,** virtually the same in nominal terms as the level for the previous year.

### General information on internal operations in 2001

The internal operations of the Bank are essentially aimed at providing the resources required for high quality fulfilment of the responsibilities as prescribed by the NBH Act.

With an increased emphasis on the principle of cost-effectiveness in 2001, the Bank reviewed its medium-term institutional objectives and began to lay the groundwork for the performance of the related tasks. This work involved rationalisation of the organisational structure and procedures, in order to establish transparent banking operations that impose low costs on society.

The review resulted in a revision of the financial plans approved previously for 2001.

In addition to rationalising the Bank's long-term profile, several functions that were not - strictly speaking - part of the central bank's statutory responsibilities or were not necessary for the fulfilment of its core functions were wound up already in 2001. These included:

– areas involved in foreign exchange management, in the aftermath of foreign exchange liberalisation;
- the winding up of accounting services consistent with the NBH Act;
- ceasing special banking transactions;
- closing down the office in Tokyo.

Thanks to the above measures, the Bank was already able to start operating in a more cost-saving way in 2001.

## Operating costs

The operating budget for 2001, amounting to HUF 16,729 million, was approved at the Board of Directors meeting on 18 December 2000. This amount was later revised down to HUF 16,244 million (by HUF 485 million).

At HUF 15,196 million, the actual operating costs were even less in 2001.

Thanks to the organisational restructuring the Bank embarked on, costs were curbed significantly, falling by 8.6% in real terms compared with 2000.

***a) Personnel costs***

In 2001, personnel costs (HUF 9,837 million) increased by altogether 7.0%, as a result of three factors at work within this cost group as a whole:

- An average rise of 9.5% in base wages, implemented in 2001 taking consideration of the average earnings rise approved by the government sector and the National Labour Council (OMT);
- An 8.5% fall in average numbers employed (from 1,316 at end-2000 to 1,163 at end-2001);
- An increase in expenses in respect of dismissals and resignations.

In addition to dismissals initiated by the employer for purposes of rationalising the organisational structure and operations, the personnel changes also involved the employment of new staff with higher qualifications for various posts.

Part of the expenses incurred in respect of dismissals and resignations (HUF 745 million in 2001) was recovered as

Table 7-5

HUF millions

| Description | Actual data for 2000 | Revised budget for 2001 | Actual data for 2001 | Index (actual figure for 2001/plan for 2001) | Index (actual figure for 2001/ actual figure for 2000) |
|---|---|---|---|---|---|
| 1. Personal costs | 9 194 | 10 147 | 9 837 | 96,9% | 107,0% |
| 2. General operating costs | 6 026 | 6 097 | 5 359 | 87,9% | 88,9% |
| **Total** | **15 220** | **16 244** | **15 196** | **93,5%** | **99,8%** |
| ***Change in real terms*** | | | | | ***91,4%*** |

early as 2001, thanks to saving on wage costs by reducing numbers employed. Full recovery of expenses is projected by May 2002.

**b) General banking operation costs**

In 2001, general banking operation costs (HUF 5,359 million) fell by a total of 11.1%, relative to 2000.

This included an 11.4% drop in **IT costs** (to HUF 953 million). The only IT areas incurring higher costs were software change management, maintenance and licence fees (10.9%), due to higher service prices. By contrast, there was a reduction in the costs incurred on:

- hardware, thanks to savings on repair and maintenance expenses;
- transmission costs, thanks to lower traffic on leased lines;
- news service fees, due to reducing the number of users;
- consultancy fees, via less frequent employment of external consultants.

**Operating and other costs** (HUF 2,292 million in 2001) fell by HUF 530 million (nearly 19%) compared with the previous year. This decrease was due to the following main factors:

- a reduction of 5.4% in property-related costs, due to suspension of the renovation of the central building block launched several years ago and the termination of office and warehouse leasehold agreements;
- a cut of nearly 30% in other operating costs, such as telephone and postal service fees, in addition to a roughly 10% drop in vehicle maintenance costs;
- a considerable, HUF 260 million, reduction in legal fees, due primarily to high legal representation fees incurred in 2000 in respect of the liquidation of CWAG;
- a 43.6% cut in business trip expenditures compared with the previous year, due to stringent cost saving measures in respect of foreign travel;
- a 33.0% cut in costs incurred on the Bank's foreign representation, thanks to the closing down of the representative office in Tokyo during the year.

**Depreciation charge-off** increased by 12% in 2000, compared with the previous year, due primarily to information technology developments implemented a short time before.

The budget for 2001 estimated a similar increase, taking account of new investment scheduled initially for 2001. However, the actual depreciation of tangible and intangible fixed assets (at HUF 2,114 million) was 1% lower than in 2000, due essentially to the fact that only one-third of the planned new projects were completed.

***Investment projects***

The investment budget for 2001 was originally approved in an amount of HUF 2,113 million, which was revised down to HUF 1,400 million during the year.

The actual amount of development expenditure in 2001 (HUF 656 million) was merely 46.9% of the approved

Table 7-6

HUF millions

| Investment programmes | 1999 | | 2000 | | 2001 | |
|---|---|---|---|---|---|---|
| | HUF millions | Percent share | HUF millions | Percent share | HUF millions | Percent share |
| 1. Modernisation of information technology | *2 208* | 64,1% | *1 130* | 48,6% | *336* | 51,2% |
| 2. Logistics and other investment and procurement | *995* | 28,9% | *984* | 42,3% | *277* | 42,2% |
| 3. Modernisation of currency issue | *241* | 7,0% | *213* | 9,1% | *43* | 6,6% |
| ***Investment programmes, total*** | ***3 444*** | ***100,0%*** | ***2 327*** | ***100,0%*** | ***656*** | ***100,0%*** |

amount, considerably lower than average expenditures in previous years, both in actual sums and as a percentage.

The factors behind the reduction included a change in the Bank's strategic objectives, which entailed the stoppage or postponement of planned or ongoing investment projects in several areas of banking operations.

The table below reviews investment expenditures in the past three years (1999-2001):

The majority of the Bank's recent fixed investment has occurred in the area of IT (amounting to roughly 50-60% of the annual expenditure). This also holds true for 2001, when investment was subdued on the whole.

In respect of the financial requirement of investment projects, 1999 was an exceptional year, due to the creation of the VIBER (RTGS) system, facilitating high-quality and high-security real-time electronic payments, also crucial for the country's infrastructure development, and the Bank's own IT development.

### a) Modernisation of information technology

A modern IT infrastructure is indispensable for the performance of the Bank's functions as laid down in the NBH Act.

The groundwork for a high-tech environment was laid in the course of development projects implemented over the past few years, when obsolete equipment was replaced by state-of-the-art, integrated systems.

IT development in 2001 was confined to crucially important projects, until the new IT strategy and objectives are defined.

### b) Logistics and other investment and acquisitions

In each of the three years, a great share of non-IT and non-currency issue expenditures served the preservation and technological modernisation of the central premises.

The approved budget initially earmarked an amount of approximately HUF 680 million for investment relating to the central building block, more than half of which went to the ongoing works on renovating the interior of the buildings floor by floor.

This renovation project was stopped in accordance with the medium-term objectives relating to the utilisation of the central buildings and establishment of a new logistics centre. Furthermore, related bank security investment plans were also put on hold.

The development expenditure for the replacement of tangible fixed assets (such as minor office, printing and communication equipment, vehicles, uniforms and protective wear) and for renewal projects amounted to HUF 130 million.

Expenditure for equipment procurement covered the purchase of 8 cars in 2001, enabling the Bank to replace cars older than 5 years or those with a mileage of over 150 thousand kilometres. Furthermore, a decision was passed on reducing the Bank's car fleet by nearly 30%.

**c) Modernisation of currency issue**

The planned programme, originally estimated to cost over HUF 350 million in 2001, remained for the most part unaccomplished. Further uncompleted projects, consistent with the decision to create a new logistics centre, were the logistics investment relating to the storage and transport of coins kept in the existing three-storey depository, and the closely related plan of establishing barcode systems.

Development expenditure in respect of modernising currency issue amounted to HUF 43 million in 2001. Of this, 60% was accounted for by the transformation of the automatic coin storage system.

In view of the fact that some of the development tasks planned to be implemented in 2001 were rescheduled and partly placed on new foundations, and that maintaining the standard of the existing technical infrastructure requires large-scale development, 2002 will likely see developments exceeding those in 2001.

# PART B

*Audited Financial Statements*
*of the National Bank of Hungary, 2001*

# I. Independent Auditor's Report

## To the Owner and Board of Directors of the National Bank of Hungary

(Free translation)
We have audited the components including the balance sheet, the profit and loss account and the supplementary notes of and disclosures in the financial statements forming part of the annual report as at 31 December 2001 and for the year then ended of the National Bank of Hungary ("the Bank") along with the underlying accounting records and supporting documentation. The financial statements show a balance sheet total of HUF 5 453 364 million, a profit for the year of HUF 3 642 million and a profit per balance sheet of HUF 0 million. The financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit and to assess whether or not the accounting information disclosed in other parts of the annual report is consistent with that contained in the financial statements. These financial statements have been prepared for the consideration of the shareholders at the forthcoming General Meeting and as such do not reflect the effects, if any, of resolutions that might be adopted at that meeting.

Referring to our audit report issued on 28 February 2001 we confirm to you that on the basis of our audit we issued an unqualified audit opinion for the prior year.

We conducted our audit in accordance with International and Hungarian Standards on Auditing and with applicable laws and regulations in force in Hungary. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatements. 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 statements presentation. Our work with respect to the business report was limited to checking it within the aforementioned scope and did not include a review of any information other than that drawn from the audited accounting records of the Company. We believe that our audit provides a reasonable basis for our audit opinion.

In our opinion, the financial statements have been prepared in accordance with the provisions of the Act on Accounting and the accounting principles generally accepted in Hungary, considering Act No LX of 1991 and its replacement, Act No LVIII of 2001 regulating the activity of the Central Bank and the special attributes of the annual report making requirements set for the Central Bank (statutory legislation). The financial statements give a true and fair view of the equity and financial position of the Central Bank as at 31 December 2001 and of the results of its operations for the year then ended in compliance with the statutory legislation.

Without qualifying our auditor's report, we would draw attention to the fact that the balance of the equalisation reserve, introduced in 1999 by the Act No LX of 1991 and the government decree specifying the special attributes of the annual report of the Central Bank, as at 31 December 2001 showed a deficit of HUF 247 349 million (2000: HUF 44 673 million). The combined balance of the own equity and the equalisation reserve was HUF 206 487 million negative (2000: HUF 20 279 million positive). In accordance with current legislation, a reserve-replenishment obligation of the state budget arose in the amount of HUF 250 180 million equivalent of the part of the equalisation reserve with negative balance, which was settled prior to 31 March 2002. A summary of the accounting provisions and the changes introduced by the Act No LVIII of 2001 in respect of the equalisation reserve effective from 1 January 2002 have been provided in section 1/b of the Notes to the financial statements and the quantified analyses of the equity and equalisation reserve have been presented in sections 14 and 16 of the Notes.

Budapest, 22 April 2002

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Translation note:

The accompanying financial statements are not intended to present the financial position and results of operations and cash flows in accordance with accounting principles generally accepted in jurisdictions other than Hungary.

# II. Balance Sheet of the National Bank of Hungary, 2001

HUF millions

| Appendix | ASSETS | 31. 12. 2000* | 31. 12. 2001 | Change |
|---|---|---|---|---|
| | 1 | 2 | 3 | 3-2 |
| | **I. RECEIVABLES IN FORINT** | **755,056** | **430,369** | **-324,687** |
| 3. | 1. Receivables from the central government | 657,019 | 389,458 | -267,561 |
| 7. | 2. Receivables from credit institutions | 83,915 | 40,186 | -43,729 |
| | 3. Receivables from money issue and circulation | 10,000 | 0 | -10,000 |
| | a) Receivables from the Hungarian Post Administration | 10,000 | 0 | -10,000 |
| | b) Items in transit | 0 | 0 | 0 |
| | 4. Other receivables | 4,122 | 725 | -3,397 |
| | **II. RECEIVABLES IN FOREIGN CURRENCY** | **5,471,058** | **4,789,003** | **-682,055** |
| 9. | 1. Gold and foreign currency reserves | 3,197,343 | 3,004,098 | -193,245 |
| 4. | 2. Receivables from the central government | 1,545,359 | 1,166,917 | -378,442 |
| | 3. Receivables from credit institutions | 6,427 | 4,202 | -2,225 |
| 10. | 4. Other foreign currency receivables | 721,929 | 613,786 | -108,143 |
| | **III. BANKING ASSETS** | **28,124** | **24,504** | **-3,620** |
| 12. | 1. Fixed assets, intangibles, investments | 25,622 | 23,500 | -2,122 |
| | 2. Value adjustment | 0 | 0 | 0 |
| | 3. Liquid assets | 4 | 6 | 2 |
| | 4. Other assets | 2,498 | 998 | -1,500 |
| 15. | **IV. PREPAID EXPENSES/ACCRUED INCOME** | **255,112** | **209,488** | **-45,624** |
| | **V. TOTAL ASSETS (I+II+III+IV)** | **6,509,350** | **5,453,364** | **-1,055,986** |
| | **LIABILITIES** | **31 Dec. 2000** | **31 dec. 2001** | **Change** |
| | 1 | 2 | 3 | 3-2 |
| | **VI. LIABILITIES IN FORINT** | **2,670,272** | **2,791,897** | **121,625** |
| 5. | 1. Central government deposits | 170,727 | 344,752 | 174,025 |
| | 2. Deposits by credit institutions | 1,051,042 | 788,716 | -262,326 |
| | 3. Liabilities from money issue and circulation | 963,584 | 1,130,314 | 166,730 |
| | a) Notes and coin in circulation | 962,278 | 1,129,247 | 166,969 |
| | b) Items in transit | 1,306 | 1,067 | -239 |
| | 4. Other deposits and liabilities | 484,919 | 528,116 | 43,197 |
| | **VII. LIABILITIES IN FOREIGN CURRENCY** | **3,643,616** | **2,722,819** | **-920,797** |
| 5. | 1. Central government deposits | 263,687 | 208,057 | -55,630 |
| | 2. Deposits by credit institutions | 262,090 | 159,238 | -102,852 |
| 11. | 3. Other foreign currency liabilities | 3,117,839 | 2,355,524 | -762,315 |
| 13. | **VIII. PROVISIONS** | **7** | **0** | **-7** |
| | a) For liabilities | 7 | 0 | -7 |
| | b) Other | 0 | 0 | 0 |
| | **IX. OTHER BANKING LIABILITIES** | **-31,376** | **-237,396** | **-206,020** |
| 14. | Of which: equalisation reserve | -44,673 | -247,349 | -202,676 |
| 15. | **X. ACCRUED EXPENSES/DEFERRED INCOME** | **161,879** | **135,181** | **-26,698** |
| 16. | **XI. EQUITY** | **64,952** | **40,862** | **-24,090** |
| | 1. Share capital | 10,000 | 10,000 | 0 |
| | 2. Retained earnings | 54,952 | 30,862 | -24,090 |
| | 3. Valuation reserve | 0 | 0 | 0 |
| | 4. Profit per balance sheet | 0 | 0 | 0 |
| | **XII. TOTAL LIABILITIES (VI+VII+VIII+IX+X+XI)** | **6,509,350** | **5,453,364** | **-1,055,986** |

* Presented in the 2001 balance sheet structure

# III. Profit and Loss Account of the National Bank of Hungary, 2001

HUF millions

| Appendix | INCOME | 2000 | 2001 | Change |
|---|---|---|---|---|
| 18. | I. FORINT INTEREST AND INTEREST RELATED INCOME | 81,522 | 47,279 | -34,243 |
| | 1. Interest income on receivables from the central government | 71,840 | 40,028 | -31,812 |
| | 2. Interest income on receivables from credit institutions | 9,348 | 6,384 | -2,964 |
| | 3. Interest income on other receivables | 140 | 201 | 61 |
| | 4. Interest related income in forint | 194 | 666 | 472 |
| 18. | II. FOREIGN CURRENCY INTEREST AND INTEREST RALATED INCOME | 622,906 | 548,271 | -74,635 |
| | 1. Interest income on foreign currency reserves | 169,080 | 158,250 | -10,830 |
| | 2. Interest income on receivables from the central government | 117,310 | 93,573 | -23,737 |
| | 3. Interest income on receivables from credit institutions | 238 | 198 | -40 |
| | 4. Interest income on other receivables | 10,563 | 10,500 | -63 |
| | 5. Interest related income in foreign currency | 325,715 | 285,750 | -39,965 |
| 19. | III. INCOME ARISING FROM EXCHANGE RATE CHANGES | 79,625 | 59,361 | -20,264 |
| | IV.INCOME FROM MONEY CIRCULATION | 1,345 | 1,407 | 62 |
| | V. OTHER INCOME | 1,698 | 2,131 | 433 |
| | 1. Commission and fees received in forint | 207 | 186 | -21 |
| | 2. Commission and fees received in foreign currency | 1,396 | 1,638 | 242 |
| **20.** | 3. Ordinary and extraordinary income not included above | 95 | 307 | 212 |
| | VI. PROVISIONS RELEASED/USED | 10,991 | 21 | -10,970 |
| | VII. DEPRECIATION | 0 | 10,893 | 10,893 |
| 21. | VIII. OPERATING INCOME | 877 | 853 | -24 |
| | IX. TOTAL INCOME (I+II+III+IV+V+VI+VII+VIII) | 798,964 | 670,216 | -128,748 |
| | | | | |
| | **EXPENSES** | | | |
| 18. | X. FORINT INTEREST AND INTEREST RELATED EXPENSES | 160,031 | 161,578 | 1,547 |
| | 1. Interest expenses on central government deposits | 31,852 | 35,309 | 3,457 |
| | 2. Interest expenses on deposits by credit institutions | 97,627 | 60,972 | -36,655 |
| | 3. Interest expenses on other deposits | 30,533 | 65,297 | 34,764 |
| | 4. Interest related expenses in forint | 19 | 0 | -19 |
| 18. | XI. FOREIGN CURRENCY INTEREST AND INTEREST RELATED EXPENSES | 586,080 | 465,558 | -120,522 |
| | 1. Interest expenses on central government deposits | 8,773 | 6,309 | -2,464 |
| | 2. Interest expenses on deposits by credit institutions | 15,186 | 9,027 | -6,159 |
| | 3. Interest expenses on other liabilities | 190,641 | 153,551 | -37,090 |
| | 4. Interest related expenses in foreign currency | 371,480 | 296,671 | -74,809 |
| 19. | XII. EXPENSES RESULTING FROM EXCHANGE RATE CHANGES | 4,168 | 4,239 | 71 |
| | XIII. EXPENSES RELATED TO MONEY CIRCULATION | 4,472 | 5,803 | 1,331 |
| | XIV. OTHER EXPENSES | 9,929 | 13,479 | 3,550 |
| | 1. Commissions and costs recorded in forint | 68 | 57 | -11 |
| | 2. Commissions and costs recorded in foreign currency | 4,122 | 3,298 | -824 |
| **20.** | 3. Ordinary and extraordinary expenses not included above | 5,739 | 10,124 | 4,385 |
| | XV. PROVISIONS | 4,167 | 14 | -4,153 |
| | XVI. DEPRECIATION | 0 | 485 | 485 |
| 21. | XVII. OPERATING COSTS AND EXPENSES | 15,634 | 15,418 | -216 |
| | XVIII. TOTAL EXPENSES (X+XI+XII+XIII+XIV+XV+XVI+XVII) | 784,481 | 666,574 | -117,907 |
| | XIX. PROFIT FOR THE YEAR | 14,483 | 3,642 | -10,841 |
| | XX. Dividend payment from retained earnings | 5,629 | 24,090 | 18,461 |
| | XXI. DIVIDEND PAID | 20,112 | 27,732 | 7,620 |
| | XXII. PROFIT PER BALANCE SHEET | 0 | 0 | 0 |
| | **XXIII. GRAND TOTAL (XVIII+XIX)** | **798,964** | **670,216** | **-128,748** |

# IV. Cash Flow Statement, 2001

HUF millions

| Cash Flow statement | 2000 | 2001 |
|---|---|---|
| **Cash flow arising from banking operations** | | |
| Net income before dividend payment (+profit/-loss) | 14,483 | 3,642 |
| Amortisation charge | 2,344 | 2,324 |
| Difference between provisions made and used (+making/-release) | -6,823 | -5,214 |
| Change in accruals related to foreign currency and forint transactions (+increase/-decrease of receivables) | -20,294 | 18,790 |
| Change in other assets and liabilities net of issued NBH securities and equalisation reserves (+net increase in assets) | -21,651 | -33,285 |
| Dividend payable (-dividend payment obligation) | -20,112 | -27,732 |
| Dividend payment from retained earnings | 5,629 | 24,090 |
| **Total operating cash flow** | **-46,423** | **-17,385** |
| **Cash flow from financial activities** | | |
| Change in forint receivables (-increase/+decrease) | 156,181 | 325,672 |
| Change in forint liabilities (net of other liabilities, including NBH bonds) (+increase/-decrease) | 374,385 | 128,924 |
| Change in other foreign currency receivables (-increase/+decrease) | 176,232 | 493,017 |
| Change in foreign currency liabilities / (+increase/-decrease) | -219,699 | -920,797 |
| Change in equalisation reserves (+increase/-decrease) | 15,908 | -202,676 |
| **Total cash flow from financial activities** | **503,007** | **-175,860** |
| **Change in foreign currency reserves (+increase/-decrease)** | **456,584** | **-193,245** |

# V. Notes to the Accounts

## 1 The Bank's accounting policy

The accounting policy of the National Bank of Hungary is formulated within the framework of the Accounting Act (Act C of 2000), Act LVIII of 2001 on the National Bank of Hungary (hereinafter: NBH Act) and Government Decree 221/2000 (XII. 19.) on the special features of the Bank's obligation to draw up its annual financial statements and of the applicable bookkeeping standards (hereinafter: NBH Decree).

### a) Changes in the legal environment

The Accounting Act and the NBH Decree entered into effect on 1 January 2001, while the NBH Act came into force on 13 July 2001.

Under the provisions of the NBH Act, the Bank shall make a dividend payment in 2001 derived from average profits in 1998 and 1999. Payment is due in equal monthly instalments.

Pursuant to the NBH Decree, the Bank shall close its assets and liabilities accounts, as well as profit and loss accounts once every quarter, and prepare its trial balance.

The person entitled to sign the annual report is the President of the Bank, Mr Zsigmond Járai, resident at 1024 Budapest, Rózsahegy u. 1/b.

### b) Evaluation of assets and liabilities, statement of profit

All assets and liabilities of the National Bank are stated at historical cost. Foreign exchange assets and liabilities on the balance sheet, and related hedging transactions, are translated into HUF at the exchange rate ruling on the last day of 2001 (fixing). Due to exchange rate changes, the cost of acquisition of foreign exchange assets and liabilities is modified by revaluation at the daily official exchange rate.

In order for foreign exchange reserves to be stated at fair value, acquisition of foreign exchange securities must be stated at market value.

The Bank's claims on the central Budget, including securities held for monetary purposes, are stated at historical cost, and no impairment may be charged on such assets.

Derivative transactions must be stated as assets and liabilities off-balance sheet. The consolidated translation difference of assets and liabilities arising from *hedging* to reduce the risk exposure of balance sheet items must be included on the balance sheet (in the lines for other foreign currency receivables and liabilities, and the lines for foreign currency receivables from the central government or central government deposits), while the relevant time-proportionate interest must be stated in the profit and loss account (in the line for interest and interest-related income). When *forward transactions for purposes other than hedging* are involved, consistent with the principle of prudence, a provision shall be made equalling the negative market value of the transaction.

The Bank translates its foreign currency receivables and liabilities on a daily basis, and in the balance sheet they are translated at the official exchange rate ruling on the last day of the year. The law makes special provisions for the Bank with regard to accounting for gains and losses arising from exchange rate changes. The exchange rate differential arising from the daily translation can be divided into two parts:

– the translation difference arising between book value and central parity (fixed euro exchange rate); and
– the translation difference arising between central parity and the official exchange rate.

The former must be accounted for as gains or losses on foreign currency translation in the income statement, and the latter item, reflecting the market fluctuation of the forint's exchange rate around central parity, on the balance sheet of the Bank, included within **equalisation reserve for exchange rate changes.**

In the same, way, the difference between the market value and book value of securities denominated in foreign currency prevailing at valuation date is stated within **equalisation reserve for foreign currency securities**.

Equalisation reserves are recorded with other banking liabilities on the balance sheet. Under the NBH Act, if the balance of either of the equalisation reserves is negative, the central Budget shall make a direct cash reimbursement to the appropriate equalisation reserve in the amount of the negative balance by 31 March of the year following the year under review. The balance of **equalisation reserves shall be transferred to the items constituting equity from 1 January 2002.**

The new NBH Act provides for changing the accounting framework from 2002 relating to exchange rate income and hence equalisation reserves arising from exchange rate changes in an effort to bring Hungarian accounting practices in line with those of EMU member countries. In addition to the need for harmonisation, this change can also be accounted for by the new exchange rate regime. With the abandonment of the crawling peg system and the widening of the intervention band of the forint, divergence of the forint's exchange rate from central parity can no longer be viewed as temporary fluctuation. In terms of the new regulation, the Bank will only state financially realised profit as exchange rate gain or loss, while unrealised income will be included in the equalisation reserve.

## 2 Effects of macroeconomic trends on the balance sheet and profit and loss account of the National Bank

The balance sheet and profit and loss account of the National Bank of Hungary are primarily influenced by the objectives and instruments of monetary policy, as well as domestic and international economic developments.

A fall in **the rate of interest on forint instruments** reduces both the Bank's interest income and expenses. As interest-bearing liabilities denominated in forint exceed forint assets substantially, the effect of the reduction in the level of interest rates caused an improvement of HUF 6.1 billion in the Bank's income.

Due to a **7% strengthening of the forint**, the value of foreign currency receivables and liabilities fell in forint terms. Consequently, the forint value of the foreign currency position fell by HUF 156.8 billion. Under the provisions of the NBH Act, the HUF 55.1 billion gain arising from exchange rate changes due to the official devaluation of the forint must be stated in the profit and loss account, while the difference between this amount and the effect of actual exchange rate changes (a loss of HUF 211.9 billion) must be included in the balance sheet in the equalisation reserve line. Thus, together with the net value for the previous year, the equalisation reserve deficit arising from exchange rate changes amounted to HUF 250.2 billion.

The **level of international interest rates** fell steadily throughout most of 2001 at maturities near the average remaining maturity (duration) of the securities included in the Bank's foreign exchange reserves, causing net realised exchange rate loss on foreign currency denominated securities (arising as the difference between purchase and selling price when the security is sold or at redemption) to be HUF 35.2 billion lower than in 2000. The unrealised gain on foreign currency denominated securities (i.e. the difference between the market value at year end and acquisition cost) was HUF 9.2 billion higher than in 2000. The latter item is accounted for not in the profit account but the balance sheet, in the line for equalisation reserve for foreign currency securities.

## 3 Forint receivables from the central government

HUF millions

| B/S line | Term to maturity | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|---|
| | Government bonds maturing within one | 0 | 5,053 | 5,053 |
| | Government bonds maturing within one to five | 7,240 | 361 | -6,879 |
| | Government bonds maturing over five | 360,281 | 166,689 | -193,592 |
| | **Securitie** | **367,521** | **172,103** | **-195,418** |
| | Loans maturing within one | 72,144 | 73,325 | 1,181 |
| | Loans maturing within one to five | 216,140 | 143,478 | -72,662 |
| | Loans maturing over five | 1,214 | 552 | -662 |
| | **Loans** | **289,498** | **217,355** | **-72,143** |
| **I.1.** | **Total** | **657,019** | **389,458** | **-267,561** |

The stock of government bonds declined as in the course of changing the reserve requirement of credit institutions, the Bank sold government bonds of HUF 194.5 billion to credit institutions. Receivables from the budget declined due to debt repayments according to schedule.

## 4 Long-term foreign currency credits to the central government and related hedging transactions

### Maturity structure of foreign currency credits to the central government

HUF millions

| | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|
| **Foreign currency credits to the central government** | **1,545,359** | **1,166,917** | **-378,442** |
| –within one year | 198,618 | 221,096 | 22,478 |
| –within on to five years | 980,157 | 624,377 | -355,780 |
| –over five years | 366,584 | 321,444 | -45,140 |

The stock of foreign currency loans granted to the central government decreased due to repayments and the appreciation of the forint.

***Currency structure of foreign currency credits to the central government and related hedging transactions***

HUF millions

| | | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|---|
| 1 | **Foreign currency credits to the central government (II. 2) (2+3+4)** | **1,545,359** | **1,166,917** | **-378,442** |
| 2 | -USD currency group | 170,838 | 167,418 | -3,420 |
| 3 | -EUR currency group | 519,956 | 330,092 | -189,864 |
| 4 | -JPY | 854,565 | 669,407 | -185,158 |
| 5 | **Swap receivables (6+7+8)** | **1,698,267** | **1,470,772** | **-227,495** |
| 6 | -USD currency group | 507,787 | 428,222 | -79,565 |
| 7 | -EUR currency group | 1,190,480 | 1,042,550 | -147,930 |
| 8 | -JPY | 0 | 0 | 0 |
| 9 | **Swap payables (10+11+12)** | **1,877,767** | **1,594,953** | **-282,814** |
| 10 | -USD currency group | 980,655 | 885,131 | -95,524 |
| 11 | -EUR currency group | 42,547 | 40,415 | -2,132 |
| 12 | -JPY | 854,565 | 669,407 | -185,159 |
| 13 | **Net swap receivables (5-9) (VII.1)** | **-179,500** | **-124,181** | **55,319** |

## 5 Forint and foreign currency deposits by the central government

### a) Forint deposits by the central government

HUF millions

| B/S line | Description | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|---|
| | Deposits maturing within one year | 170,727 | 344,752 | 174,025 |
| | – Single Treasury account (KESZ) | 138,678 | 328,860 | 190,182 |
| | – Desposit by State Privatisation and Holding Co.(ÁPV Rt.) | 32,049 | 15,508 | -16,541 |
| | – Desposit by Government Debt Management Agency | 0 | 296 | 296 |
| | – Hungarian State Treasury | | 88 | 88 |
| | Deposits maturing over one year | 0 | 0 | 0 |
| **VI/1** | **Total deposits** | **170,727** | **344,752** | **174,025** |

### b) Foreign currency deposits by the central government

HUF millions

| B/S line | Desciption | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|---|
| | Within one year | 33,671 | 46,334 | 12,663 |
| | Within one to five years | 99,264 | 89,254 | -10,010 |
| | Over five years | 130,752 | 72,469 | -58,283 |
| **VII/1** | **Total deposits** | **263,687** | **208,057** | **-55,630** |

## 6 Net position vis-a-vis the central government

| B/S line | Description | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|---|
| I/1-VI/1 | Net forint position | 486,292 | 44,706 | -441,586 |
| II/2-VII/1 | Net foreign currency position | 1,281,672 | 958,860 | -332,812 |
| | **Total** | **1,767,964** | **1,003,566** | **-764,398** |

## 7 Forint receivables from credit institutions

HUF millions

| B/S line | Description | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|---|
| | Receivables maturing within one year | 2,016 | 7,378 | 5,362 |
| | – credit to Hungarian Development Bank | | 5,362 | 5,362 |
| | Receivables maturing over one year | 85,346 | 35,271 | -50,075 |
| | – Credit against foreign currency deposits | 27,017 | 20,942 | -6,075 |
| | – E-loans | 15,364 | 224 | -15,140 |
| | – Refinancing loans from EXIM Bank | 17,810 | 1,164 | -16,646 |
| | – ESOP* refinancing credit | 7,973 | 38 | -7,935 |
| | – START loans | 9,029 | 7,628 | -1,401 |
| | – Other priority loans | 561 | 115 | -446 |
| | – World Bank loans | 2,600 | 1,530 | -1,070 |
| | – Other loans | 4,992 | 3,630 | -1,362 |
| | Provisions for claims on credit institutions | -3,447 | | 3,447 |
| | Impairment provision for claims on credit institutions | | -2,463 | -2,463 |
| **I/2** | **Total assets** | **83,915** | **40,186** | **-43,729** |

** Employees Share Ownership Programme*

The credit extended to credit institutions typically consists of credits nearing maturity, and the use of credit is also on a decrease. The table below lists such credits classified according to remaining maturity.

HUF millions

| B/S line | Remaining maturity | 31. 12. 2001 |
|---|---|---|
| | Short-term receivables | 7,378 |
| | Long-term receivables | 35,271 |
| | – within one year | 11,556 |
| | – 1-5 years | 23,129 |
| | – over 5 years | 586 |
| **I/2** | **Total receivables (w/o impairments)** | **42,649** |

On 30 November 2001 the Bank transferred refinancing credit of HUF 31 billion to the Hungarian Development Bank (MFB). Simultaneously, the MFB took over foreign currency liabilities of HUF 25.6 billion, which served as a source of funds for the aforementioned credits. Transfer of the liabilities associated with the remaining credits is currently in progress, which accounts for a technical credit of HUF 5.4 billion outstanding in respect of the MFB (Hungarian Development Bank).

## 8 Net position vis-à-vis credit institutions

HUF millions

| B/S line | Description | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|---|
| I/2-VI/2 | Net forint position | -967,127 | -748,530 | 218,597 |
| II/3-VII/2 | Net foreign currency position | -255,663 | -155,036 | 100,627 |
| | **Total** | **-1,222,790** | **-903,566** | **319,224** |

In addition to the fall in the level of money market deposits, the reduction in forint liabilities was also due to amending the rules on the reserve requirement of credit institutions. The reserve ratio was lowered from 11% to 7% as of 1 February 2001. In the course of the shift to a lower level, credit institutions had to make their reserves via buying securities prescribed by the Bank in an amount of 4% of the reserve base.

## 9 Gold and foreign currency reserves of the central bank

### a) Forint balances

HUF millions

| B/S line | Desciption | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|---|
| | Gold reserve | 7,839 | 7,813 | -26 |
| | Reserve position in the IMF | 74,824 | 112,695 | 37,871 |
| | Convertible foreign currency cash on hand | 451 | 402 | -49 |
| | Foreign currency deposits | 189,736 | 194,040 | 4,304 |
| | of this: SDR | 3,327 | 5,726 | 2,399 |
| | Foreign currency securities | 2,897,999 | 2,595,643 | -302,356 |
| | Foreign currency repo transaction | 26,494 | 93,505 | 67,011 |
| **II.1.** | **Total gold and foreign currency reserves** | **3,197,343** | **3,004,098** | **-193,245** |

The decline in foreign currency reserves can be attributed to the appreciation of the forint. The increase in the reserve position of the IMF was primarily due to the IMF drawing SDR 120 million (HUF 43.6 billion). The IMF quota represents SDR claims part of which has to be contributed in foreign currency, and part of which is held in the IMF's forint account maintained at the National Bank. The former is called "the IMF's reserve tranche", and constitutes part of the international reserves, as it has been effectively transferred to the IMF in foreign exchange. The latter part is stated in the books with other foreign currency receivables as forint subscription to the IMF quota. Drawing on the quota refers to an agreement between the IMF and the government and central bank of a country to change the composition of the quota by the IMF converting its forint deposit into foreign exchange.

### b) Balances calculated in EUR

EUR millions

| Desciption | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|
| Gold reserve | 30 | 32 | 2 |
| Reserve position in the IMF | 282 | 457 | 175 |
| Convertible foreign currency cash on hand | 2 | 2 | 0 |
| Foreign currency deposits | 716 | 788 | 72 |
| of this: SDR | 13 | 23 | 10 |
| Foreign currency securities | 10,938 | 10,537 | -401 |
| Foreign currency repo transaction | 100 | 380 | 280 |
| **Total gold and foreign currency reserves** | **12,068** | **12,196** | **128** |

## 10 Other foreign currency receivables

HUF millions

| B/S line | Desciption | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|---|
| | Forint payment of IMF quota | 310,230 | 250,781 | -59,449 |
| | Total foreign credits and deposits | 18,510 | 6,546 | -11,964 |
| | Repurchased bonds | 220,796 | 236,944 | 16,148 |
| | Foreign hedging transactions* | 170,200 | 115,662 | -54,538 |
| | Other | 7,381 | 4,840 | -2,542 |
| | Loss in value/Provisions | -5,188 | -987 | 4,201 |
| II.4. | Other foreign currency receivables, total | 721,929 | 613,786 | -108,143 |

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

The forint contribution to the IMF quota declined due to drawing on the quota as noted above and the strengthening of the forint.

The line for foreign credits and deposits includes foreign currency claims on CWAG, which fell from HUF 17.8 billion at end-2000 to HUF 6.5 billion at end-2001, due to debt servicing and exchange rate changes.

## 11 Other liabilities in foreign currency

### a) End-period level of other foreign currency liabilities

HUF millions

| B/S line | Desciption | 31. 12. 2000 | 31. 12. 2001 | Change |
|---|---|---|---|---|
| | Short-term liabilities | 338,366 | 265,124 | -73,242 |
| | Long-term liabilities | 2,779,473 | 2,090,400 | -689,073 |
| | - Bonds | 2,238,766 | 1,766,690 | -472,076 |
| | - Credits payable | 225,178 | 68,002 | -157,176 |
| | - IMF forint deposit | 310,230 | 250,781 | -59,449 |
| | - Other liabilities | 5,299 | 4,927 | -372 |
| VII.3. | Other foreign currency liabilities | 3,117,839 | 2,355,524 | -762,315 |

The drop in short-term liabilities was largely due to the fall in the balance of marked-to-markets associated with derivatives transactions.

Foreign currency bonds included with long-term liabilities declined due to debt servicing and the strengthening of the forint's exchange rate. Borrowing also declined as financing loans from abroad matured. The forint deposit of the IMF also fell in value because of the aforementioned drawing by the IMF and the strengthening of the forint. The IMF's forint deposit is stated with the foreign currency liabilities, consistent with accounting rules, as it is stated in forint terms on the accounts, but is denominated in SDRs, which gives rise to revaluation.

### b) Maturity structure of other long-term foreign currency liabilities

HUF millions

| Description | Balance | | Change |
|---|---|---|---|
| | 31. 12. 2000 | 31. 12. 2001 | |
| **Long-tern liabilities** | **2,779,473** | **2,090,400** | **-689,073** |
| –within one year | 399,835 | 277,888 | -121,947 |
| –within one to five years | 1,606,265 | 1,175,828 | -430,437 |
| –over five years | 773,373 | 636,684 | -136,689 |

## c) Currency structure of other foreign currency liabilities

HUF millions

| B/S line | Description | Balance | | Change |
|---|---|---|---|---|
| | | 31. 12. 2000 | 31. 12. 2001 | |
| | USD | 853,115 | 666,987 | -186,128 |
| | EUR currency group | 895,804 | 645,043 | -250,761 |
| | JPY | 1,040,278 | 790,906 | -249,372 |
| | Other | 328,642 | 252,587 | -76,055 |
| **VII/3** | **Other foreign currency liabilities** | **3,117,839** | **2,355,524** | **-762,315** |

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

## 12 Invested assets

The category of invested assets comprises shareholdings (HUF 12.7 billion) in addition to intangibles, tangibles and investment (HUF 10.8 billion).

### a) Changes in the gross value, depreciation and net value of intangibles, tangibles and investment

HUF millions

| Assets | Gross value | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 31.12.2000 | Installation | Other* | Scrapping | Disposal | Transfer of assets free charge | Other deduction* | 31.12.2001 (2+3+4-...-8) |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
| Intangibles | 4,649 | 596 | 0 | 10 | 0 | 0 | 312 | 4,923 |
| Buildings | 9,469 | 71 | | | | -5 | 201 | 9,344 |
| Equipment | 8,075 | 372 | 178 | 13 | 37 | 6 | 467 | 8,102 |
| Banknote and coin collection assets | 129 | | 12 | | | | | *141* |
| Tangibles, total | 17,673 | 443 | 190 | 13 | 37 | 1 | 668 | 17,587 |
| Investment | 202 | 330 | 4 | 0 | 0 | 5 | 450 | 81 |
| **Intangibles, tangibles and investment, total** | **22,524** | **1,369** | **194** | **23** | **37** | **6** | **1,430** | **22,591** |

* *This item includes turnover on investment accounts, transfer of entries between general ledger accounts, inventory deficits and surpluses, revisions to entries for previous years. Note: data shown in the table do not always add up correctly, due to rounding.*

HUF millions

| Assets | Details of depreciation | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 12.31.2000 | Planned depreciation | Extraordinary depreciation | Depreciation due to damage | Increase due to reclassific-ation | Interim decrease due to removal from the account | Decrease due to reclassifi-cation | 31.12.2001 (10+...+14-15-16) |
| 1 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 |
| *Intangibles* | *2,229* | *1,140* | *0* | *0* | *0* | *10* | *12* | *3,347* |
| Buildings | 1,772 | 286 | | | | | 106 | 1,952 |
| Equipment | 6,040 | 897 | 1 | 0 | 81 | 46 | 453 | 6,520 |
| Banknote and coin collection assets | | | | | | | | |
| *Tangibles, total* | *7,812* | *1,183* | *1* | *0* | *81* | *46* | *559* | *8,472* |
| *Investment* | *2* | *0* | *0* | *0* | *0* | *0* | *0* | *2* |
| **Intangibles, tangibles and investment, total** | **10,043** | **2,323** | **1** | **0** | **81** | **56** | **571** | **11,821** |

HUF millions

| Assets | End-of-period net value | | |
|---|---|---|---|
| | 31.12.2000 (2-10) | 31.12.2001 (9-17) | Change (19-18) |
| 1 | 18 | 19 | 20 |
| *Intangibles* | *2,420* | *1,576* | *-844* |
| Buildings | 7,697 | 7,392 | *-305* |
| Equipment | 2,035 | 1,582 | *-453* |
| Banknote and coin collection assets | 129 | *141* | 12 |
| *Tangibles, total* | *9,861* | *9,115* | *-746* |
| *Investment* | *200* | *79* | *-121* |
| **Intangibles, tangibles and investment, total** | **12,481** | **10,770** | **-1,711** |

### b) Depreciation rates applied by the National Bank of Hungary

| Description | 31.12.2001 |
|---|---|
| Land and works of art in offices | 0.0% |
| Buildings and structures | 3.0% |
| Lease rights | 5.0% |
| Mechanical and electronic office equipment, printing, telecommunications equipment**, as well as other machines and | 14.5% |
| Office equipment and fittings, other tangible assets | 14.5% |
| Rights representing money and money's worth | 17.0% |
| Cars and currency issue equipment | 20.0% |
| Computers, instruments, IT equipment, tools, bank security equipment* | 33.0% |
| Intellectual property | 20.0-50.0% |
| * excluding: guns, bullet-proof vests and fire extinguishers | 14.5% |
| **excluding: mobile phones | 33.0% |

The depreciation rates applied did not change relative to 2000.

### c) Investments and dividends from investments

In 2001, the Bank had equity investments in the following undertakings:

HUF millions

| Description | 31.12.2001 Ownership stake% | 31.12.2000 Book value | 31.12.2001 Book value | 2000 Dividend received | 2001 Dividend received |
|---|---|---|---|---|---|
| CWAG (HUF millions, | – | 262 | | | |
| *ATS millions)* | | *13,6* | | | |
| BIS (HUF millions, | – | 2,327 | 2,224 | 454 | 461 |
| *gold CHF millions)* | | *6,7* | *6,7* | | |
| SWIFT (HUF millions, | – | 0,5 | 0,4 | | |
| *EUR thousands)* | | *2* | *2* | | |
| Pénzjegynyomda | 100 | 8,927 | 8,927 | | |
| Magyar Pénzverő Rt. | 100 | 505 | 575 | | 9 |
| MNB Érmekereskedelmi Rt.* | | 115 | | 14 | 65 |
| KELER Rt. | 50 | 250 | 250 | | |
| GIRO Elszámolásforgalmi Rt. | 15 | 91 | 91 | 91 | 73 |
| Nemzetközi Bankárképző Központ Rt. | 13 | 31 | 31 | | |
| Bankjóléti Kft. | 100 | 602 | 602 | | |
| Budapesti Értéktőzsde | 6 | 30 | 30 | | |
| **Befektetések összesen:** | | **13,140** | **12,731** | **559** | **608** |

*Note:* removal from books due to merger with Magyar Pénzverő Rt. on 26 November 2001, based on a Court of Registration decision.*

During the first half of 2001, the Bank sold its interest in the Viennese **Central Wechsel- und Creditbank AG** (CWAG), currently under liquidation, at net asset value to Magyar Követeléskezelő Rt. (MKK).

**Pénzjegynyomda Rt.** produces documents, tax stamps and securities, primarily for institutional users, in addition to banknotes.

**Magyar Pénzverő Rt.** produces coins to be used in circulation and commemorative coins. To the extent that it has free capacity, it performs contract work in international markets, in addition to producing precious metal coins which are not legal tender, within the framework of its own coin programme. **MNB Érmekereskedelmi Rt.**, which performs the sale of precious and non-precious metal coins which are legal tender issued by the central bank, both on international and domestic markets, merged with Magyar Pénzverő Rt. in 2001.

**MNB Üdültetési és Jóléti Szolgáltató Kft. (Bankjóléti Kft.)** was founded to attend to the Bank's social and welfare responsibilities. This limited liability company manages the vacation houses and sports facilities which were transferred into its ownership by the MNB as a contribution in kind.

## 13 Provisions and loss in value

HUF millions

| B/S line | Description | 31.12.2000 Loss in value/ provisions | Changes in 2001 Increase(+) | Use/ Release (-) | Interim exchange rate effect due to Increase, Use/ Release | 31.12.2001 Sum off loss in value/ provisions (3+4+5) |
|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| I/2 | Forint receivables from credit institutions | 3,447.4 | 174.6 | -1,159.4 | 0.0 | 2,462.6 |
| II/3 | Foreign currency receivables from credit institutions | 5.9 | 0.4 | -6.3 | 0.0 | 0.0 |
| II/4 | Other foreign currency receivables | 5,188.4 | 309.6 | -4,510.9 | -68.6 | 987.1 |
| III/1 | Invested assets | 5,514.3 | 0.0 | -5,514.3 | 0.0 | 0.0 |
| III/4 | Other assets | 448.6 | 252.0 | -267.2 | 0.0 | 433.4 |
| | Forint liabilities | 6.6 | 11.0 | -17.6 | 0.0 | 0.0 |
| | Foreign currency liabilities | 0.0 | 3.4 | -3.4 | 0.0 | 0.0 |
| | **Total** | **14,611.2** | **751.0** | **-11,479.1** | **-68.6** | **3,883.1** |

A major constituent of the change in provisions/loss in value was a release of HUF 1.2 billion (I/2) of provisions allocated for receivables from individual credit institutions based on improvement in rating.

The decline in the loss in value was primarily due to the fact that the Bank covered expenses arising in respect of the sale of CWAG in an amount of HUF 6.9 billion in June (comprised of HUF 5.5 billion in respect of invested financial assets and HUF 1.4 billion in respect of receivables from non-residents). Further HUF 2.8 billion loss in value was released as a result of the assignation of receivables from a firm taken over from CWAG. The effect of the forint's appreciation caused both a rise and release in provisions for foreign currency receivables in an amount of HUF 0.3 billion. Accordingly, there was a release of HUF 4.5 billion in loss in value allocated for other foreign currency receivables, which mostly comprise receivables from non-residents.

## 14 Equalisation reserves

As the forint appreciated by 7% during the year, the deficit in the equalisation reserve arising from changes in exchange rates and precious metal prices rose to HUF 250.2 billion by 31 December 2001. This amount was recovered by the budget by 31 March 2002.

### Changes in equalisation reserves

HUF millions

| | Description | 31.12.2000 | 31.12.2001 | Change |
|---|---|---|---|---|
| 1 | *Due to changes in exchange rate* | *-38 110* | *-249 189* | *-211 079* |
| 2 | *Due to changes in bullion price* | *-172* | *-991* | *-819* |
| 3 | Due to changes in exchange rates and precious metal prices (1+2) | -38 282 | -250 180 | -211 898 |
| 4 | Due to changes in market value of foreign currency securities | -6 391 | 2 831 | 9 222 |
| 5 | **Equalisation reserves (3+4)** | **-44 673** | **-247 349** | **-202 676** |

### Annual rate of revaluation of the forint in 2001

| Description | NBH mid rate | Central parity |
|---|---|---|
| HUF/EUR exchange rate | 246,33 | 276,10 |
| HUF annual revaluation* | 7,0% | -2,1% |

** + appreciation/ - depreciation*

In 2001, the Bank lowered the devaluation rate by 0.1%, and then in agreement with the Government abandoned the crawling peg system as of 1 October 2001. The end to the crawling peg regime represented a further move towards joining the exchange rate mechanism of the European Union.

With effect from 4 May 2001, the Bank widened the fluctuation band of the exchange rate to ±15% around central parity. This measure enabled the appreciation of the official exchange rate of the forint.

## 15 Prepaid expenses/accrued income and accrued expenses/deferred income

HUF millions

| B/S line | Description | Balance 31.12.2000 | Balance 31.12.2001 | Change |
|---|---|---|---|---|
| | Due to banking transaction | 254 880 | 209 398 | -45 482 |
| | Due to internal operations | 232 | 90 | -142 |
| **IV.** | **Prepaid expenses/accrued income** | **255 112** | **209 488** | **-45 624** |
| | Due to banking transaction | 161 774 | 135 083 | -26 691 |
| | Due to internal operations | 105 | 98 | -7 |
| **X.** | **Accrued expenses/deferred income** | **161 879** | **135 181** | **-26 698** |

Accrued income and accrued expenses denote interest and interest related income and expenses which arise in the period under review in an economic sense, but are realised financially only during a subsequent period.

## 16 Equity

HUF millions

| B/S line | Description | 31.12.2000 | Interim change | 31.12.2001 |
|---|---|---|---|---|
| XI/1. | Share capital | 10 000 | | 10 000 |
| XI/2. | Retained earnings | 54 952 | | 30 862 |
| | Dividend payment from retained earnings | | 24 090 | |
| XI/4. | Profit per balance sheet | 0 | 0 | 0 |
| **XI.** | **Equity** | **64 952** | **24 090** | **40 862** |

Under Article 78 of Act LX of 1991 on the National Bank of Hungary, as amended, the National Bank was required to pay HUF 27.7 billion as dividend for 2001. As the profit obtained in the reviewed year did not provide cover for the dividend paid, the Bank drew HUF 24 billion from its retained earnings, as provided by the Act.

## 17 Off-balance sheet assets and liabilities

HUF millions

| Sorsz. | Description | 2000.12.31 | 2001.12.31 | Change |
|---|---|---|---|---|
| | **Receivables** | | | |
| 1 | hedging transactions (2+3+4+5) | 4,509,488 | 3,932,500 | -576,987 |
| 2 | *- swaps* | *214,430* | *88,775* | *-125,655* |
| 3 | *- currency swaps* | *3,594,433* | *3,091,452* | *-502,981* |
| 4 | *- interest rate swaps* | *700,625* | *752,274* | *51,649* |
| 5 | Receivables from foreign currency repos | 25,312 | 85,443 | 60,130 |
| 6 | Other derivatives transactions (7+8) | 569 | 49,266 | 48,697 |
| 7 | *-option deals* | *569* | *49,266* | *48,697* |
| 8 | *- other derivatives deals* | *0* | *0* | *0* |
| 9 | Guarantees | 185,110 | 163,899 | -21,211 |
| 10 | Foreign currency receivables written off as losses | 18,280 | 12,145 | -6,135 |
| 11 | Receivables from securities lending | 109,782 | 163,451 | 53,669 |
| 12 | Credit line and other off-balance sheet receivables | 13,001 | 14,001 | 1,000 |
| 13 | **TOTAL (1+5+6+9+10+11+12)** | **4,861,542** | **4,420,704** | **-440,838** |
| | **Liabilities** | | | |
| 14 | Hedging transactions (16+17+18+19) | 4,519,402 | 3,944,336 | -575,065 |
| 15 | *- swaps* | *215,043* | *92,092* | *-122,951* |
| 16 | *- currency swaps* | *3,603,734* | *3,099,970* | *-503,764* |
| 17 | *- interest rate swaps* | *700,625* | *752,274* | *51,649* |
| 18 | Liabilities from foreign currency repos | 0 | 22,909 | 22,909 |
| 19 | Non-hedging derivatives transactions (20+21) | 570 | 24,633 | 24,063 |
| 20 | *- option deals* | *570* | *24,633* | *24,063* |
| 21 | *- other derivatives transactions* | *0* | *0* | *0* |
| 22 | Guarantees | 175,062 | 160,851 | -14,211 |
| 23 | Contingent liabilities | 0 | 779 | 779 |
| 24 | Credit line commitments | 872 | 407 | -465 |
| 25 | Other off-balance sheet liabilities | 512 | 684 | 172 |
| 26 | **TOTAL (14+18+19+22+23+24+25)** | **4,696,417** | **4,153,820** | **-542,597** |

Hedging transactions (lines 1 - 4 and 14 - 17) serve the purpose of reducing risk to the net foreign currency position, arising from cross exchange rate fluctuations and interest rate changes. They also facilitate establishing the benchmark foreign currency structure approved by the Bank's Board of Directors. Under the NBH Decree, hedging transactions also include the derivatives contracts between the Government Debt Management Agency (ÁKK) and the central bank to hedge exchange rate and interest rate risk in respect of the foreign exchange debt, as well as counter deals by the Bank in international capital markets to cover the former transactions.

The main instruments of hedging exchange rate risk are short-term currency swaps and forward deals, 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 (lines 4 and 17) include the Bank's transactions with ÁKK as well, which serve to limit the interest rate risk of the debt denominated in foreign currencies and are hedged on the capital market with opposite transactions.

Repos (lines 5 and 18) must be stated among credit/deposit transactions and the related securities either as receivables or liabilities must be stated among the off-balance sheet items.

The National Bank concludes general security lending agreements with the entities holding the largest securities accounts at the Bank (line 11). As the securities lent constitute part of the foreign exchange reserves, their yields raise the yields on the reserves.

Contingent liabilities (line 23) denote the guarantees undertaken in connection with the sale of CWAG, and their size depends on the further outcome of the ongoing liquidation process.

## 18 Changes in the net interest income by sector

### a) Net forint and foreign currency interest and interest-related income

| P/L line | Description | 2000 | 2001 | Change |
|---|---|---|---|---|
| (I/1+II/2)-(X/1+XI/1) | Central government | 148,525 | 91,983 | -56,542 |
| (I/3+II/1+II/4)-(X/3+XI/3) | Credit institutions | -103,227 | -63,417 | 39,810 |
| (I/2+II/3)-(X/2+XI/2) | Other | -41,390 | -49,897 | -8,507 |
| | Net interest income | 3,908 | -21,331 | -25,239 |
| I/4 | forint interest related income | 194 | 666 | 472 |
| | foreign currency securities | 3,489 | 19,133 | 15,644 |
| | bonds issued abroad | 431 | 430 | -1 |
| | Derivatives transactions for hedging and other purposes* | 321,780 | 266,187 | -55,593 |
| | Other | 15 | 0 | -15 |
| I/4+II/5 | Interest related income | 325,909 | 286,416 | -39,493 |
| X/4 | Interest related expenses in forint | 19 | 0 | -19 |
| | foreign currency securities | 43,514 | 23,929 | -19,585 |
| | bonds issued abroad | 1,132 | 1,242 | 110 |
| | Derivatives transactions for hedging and other purposes* | 326,834 | 271,500 | -55,334 |
| | Other | 0 | 0 | 0 |
| X/4+XI/4 | Interest related expenses | 371,499 | 296,671 | -74,828 |
| | Net forint interest related income | 175 | 666 | 491 |
| | foreign currency securities | -40,025 | -4,796 | 35,229 |
| | bonds issued abroad | -701 | -812 | -111 |
| | Derivatives transactions* | -5,054 | -5,313 | -259 |
| | Other | 15 | 0 | -15 |
| | Net interest related income | -45,590 | -10,255 | 35,335 |
| **(I+II)-(X+XI)** | **Net interest and interest related income, total** | **-41,682** | **-31,586** | **10,096** |

** For details on derivatives transactions for hedging and other purposes, see section b)*

Interest-related income is comprised of:

- net income from derivative transactions that is not related to exchange rate changes;
- the difference between the purchase price and selling price of foreign currency denominated securities, and – in respect of securities held to maturity – the difference between the purchase price and notional value; and
- the difference between the notional value and the acquisition value of bonds issued by the Bank abroad and repurchased at a later date, in proportion to the time elapsed.

### b) Details of income from derivatives transactions for hedging and other purposes represented in the interest-related income

| No. | Description | 2000 | 2001 | Change |
|---|---|---|---|---|
| 1 | Income arising from derivatives transactions for hedging and other purposes (2+3+4) | 321,780 | 266,187 | -55,592 |
| 2 | – long-term swaps | 302,210 | 265,301 | -36,909 |
| 3 | – short-term swaps | 1,647 | 220 | -1,427 |
| 4 | – exchange rate gains on derivatives transactions | 17,530 | 188 | -17,342 |
| 5 | – other transactions | 392 | 478 | 85 |
| 6 | Expenses on derivatives transactions for hedging and other purposes (7+8+9) | 326,834 | 271,500 | -55,334 |
| 7 | – long-term swaps | 304,881 | 266,627 | -38,254 |
| 8 | – short-term swaps | 10,749 | 4,331 | -6,417 |
| 9 | – exchange rate loss on derivatives transactions | 9,186 | 0 | -9,186 |
| 10 | – other transactions | 2,018 | 541 | -1,477 |
| 11 | Net income from derivatives transactions for hedging and other purposes (1-6) | -5,054 | -5,312 | -258 |
| 12 | – long-term swaps (2-7) | -2,672 | -1,326 | 1,346 |
| 13 | – short-term swaps (3-8) | -9,101 | -4,111 | 4,990 |
| 14 | – exchange rate gains on derivatives transactions* (4-9) | 8,345 | 188 | -8,156 |
| 15 | – other transactions (5-10) | -1,626 | -64 | 1,562 |

**In 2000, the majority of net exchange rate gain on derivatives transactions arose as a one-off gain resulting from the technical settlement and reopening (reset) of certain hedging transactions. These technical settlements occurred for the purposes of reducing risk.*

## 19 Components of income from the translation of foreign exchange holdings

HUF millions

| | Description | 2000 | 2001 |
|---|---|---|---|
| * | Average net foreign currency position | 1681.9 | 2030.2 |
| * | Devaluation of central parity (%) | 3.9% | 2.1% |
| * | Deviation from the centre of the band (%) | -2.04% | -10.78% |
| 1 | Revaluation difference at official exchange rate | 66.6 | -156.2 |
| 2 | Correction for deviation from central parity | 9.0 | 211.9 |
| 3 | Gains on translation (III.1. - XII.1.) (1+2) | 75.6 | 55.7 |
| 4 | Gains on conversion (III-2 - XII.2) | -0.2 | -0.6 |
| 5 | Gains on exchange rate change (3+4) | 75.4 | 55.1 |
| 6 | Change in equalisation reserves due to currency and precious metal price changes | -9.0 | -211.9 |

*Lines with an asterisk are for information.*

*[1] The product of average net foreign currency position and official devaluation differ from the revaluation difference, due to the intra-band volatility of the forint's exchange rate and the net currency position.*

Income from foreign currency exchange rate changes includes the effect of changes in the exchange rate of the forint as well as cross-rate changes of other currencies. Income from foreign currency conversion comes from spot exchange transactions and completed non-hedging futures transactions. For the purposes of analysis, it seems expedient to treat this item together with the income from the translation of foreign currency holdings in a netted way. For technical reasons, separate treatment could not be interpreted from a business point of view.

Total loss on exchange rate changes of the forint amounted to HUF 156.2 billion in 2001 (see line 1, Table 19). Of this, correction for the deviation of the official exchange rate from central parity in the wake of the widening of the exchange rate band amounted to HUF 211.9 billion, under the NBH Act. Accordingly, the income includes a translation gain of HUF 55.7 billion (line 3, Table 19). Together with a loss of HUF 0.6 billion from conversion, the income arising from exchange rate changes amounted to a gain of HUF 55.1 billion.

## 20 Breakdown of ordinary and extraordinary results not included in the above items

HUF millions

| No. | Description | 2000 | 2001 | Change |
|---|---|---|---|---|
| | **Ordinary and extraordinary income not included above** | | | |
| 1 | Arising from financial investment | 36 | 306 | 270 |
| 2 | Other revisions | 24 | 0 | -24 |
| 3 | Other extraordinary income | 35 | 1 | -34 |
| **4** | **Total (1+2+3)** | **95** | **307** | **212** |
| | **Ordinary and extraordinary expenses not included above** | | | |
| 5 | Extraordinary loan loss and other loss | 5515 | 2673 | -2842 |
| 6 | Incurred on financial investments | 35 | 6481 | 6446 |
| 7 | Cash contribution | 0 | 919 | 919 |
| 8 | Other extraordinary expenses | 189 | 51 | -138 |
| **9** | **Total (5+6+7+8)** | **5739** | **10 124** | **4385** |

Components of extraordinary income for 2001 are as follows:

– The HUF 236 million recorded within extraordinary income arose from selling Central Wechsel- und Creditbank AG (CWAG), while the rest of this income is associated with the increase in the Bank's share in the Hungarian Mint Works in the wake of its merger with the NBH Érmekereskedelmi Rt (Coin Trading Company).
– Losses on lending included the charge-off of receivables of HUF 2.7 billion arising from the assignation of the claim, which was covered by the item of loss in value made earlier;.
– The greatest part of the extraordinary expenses incurred on invested financial assets was accounted for by the sale of CWAG, as the Bank's ownership stake was removed from the books and the subordinated loan capital was written off as credit loss. This extraordinary expense of HUF 6.4 billion was covered by the release of a provision for loss in value made in previous

years. The termination of the stake in the MNB Érmekereskedelmi Rt. (amounting to HUF 115 million), due to a merger, was also stated in this line.
– The line for final money transfer predominantly states the termination of CWAG's own deficit.

## 21 Operating incomes and expenses

HUF millions

| P/L line | Description | 2000* | 2001 | Change |
|---|---|---|---|---|
| | Dividend from investments | 559 | 608 | 49 |
| | Income from selling assets and inventories | 164 | 121 | -43 |
| | Income export sales | 5 | 7 | 2 |
| | Income from mediated services | 0 | 47 | 47 |
| | Income from invoiced services | 113 | 52 | -61 |
| | Other income | 35 | 12 | -23 |
| | Extraordinary income | 1 | 6 | 5 |
| **VIII.** | **Total operating income** | **877** | **853** | **-24** |
| | Cost of materials, total | 4,078 | 3,441 | -641 |
| | Personnel-related costs, total | 9,194 | 9,837 | 643 |
| | Depreciation | 2,330 | 2,323 | -7 |
| | Transfer of capitalised value of own-produced stocks | -37 | -39 | -2 |
| | Transfer of costs of other activities | -345 | -366 | -21 |
| | **Total operating costs** | **15,220** | **15,196** | **-24** |
| | Costs incurred on assets and inventories | 182 | 155 | -27 |
| | Costs incurred on invoiced services | 104 | 44 | -60 |
| | Taxes | 70 | 23 | -47 |
| | Assets transferred free of charge | 52 | 0 | -52 |
| | Other expenses | 6 | 0 | -6 |
| | **Total operating expenses** | **414** | **222** | **-192** |
| **XVII.** | **Total operating costs and expenses** | **15,634** | **15,418** | **-216** |

* in the structure applied in 2001
*Note: the figures in the table do not always add up correctly, due to rounding.*

The operating costs of banking operations (HUF 15.2 billion) were HUF 24 million lower than in 2000, a drop of approximately 9% in real terms. The downward revision to the initial budget was achieved by more efficient and economical management, a rationalisation of processes, elimination of overlapping activities and redundant institutional units, in accordance with the Bank's medium-term institutional objectives. All these measures contributed to a real reduction in costs despite one-off extra expenses (such as severance pay) incurred in the course of staff rationalisation. The completed and imminent measures in respect of the numbers of employed at the Bank and with regard to infrastructure will make their full cost-curbing impact from next year.

## 22 Changes in data on the number of employees and the wage bill, and remuneration of executive officers of the Bank

HUF millions

| Description | 2000 | 2001 | Change(%) |
|---|---|---|---|
| Wage costs incurred on staff | 5 302 | 5 287 | **-0,3** |
| Other wage costs* | 202 | 539 | **166,8** |
| **Wages paid** | **5 504** | **5 826** | **5,9** |
| Adjusments, total | -53 | 26 | |
| *– expenses deferred to 2002* | *0* | *26* | |
| *– due to changes in the Accounting Act in 2001* | *-53* | *0* | |
| **Wage bill** | **5 451** | **5 852** | **7,4** |
| **Other personal payments** | **1 317** | **1 483** | **12,6** |
| **Taxes on wages** | **2 426** | **2 502** | **3,1** |
| **Personal costs, total** | **9 194** | **9 837** | **7,0** |

**Other wage costs include amounts paid in connection with dismissals and resignations and in exchange for vacation time not used, as well as pay to non-staff employees.*

| Description | 2000 | 2001 | Change(%) |
|---|---|---|---|
| **Average statistical number of staff** | 1 361 | 1 246 | -8,5 |

**REMUNERATION OF OFFICERS**

| Bodies | Fees |
|---|---|
| Board of Directors, 1 January–12 July 2001 | 9 677 752 HUF |
| Board of Supervisors, 1 January–12 July 2001 | 14 599 800 HUF |

*Following 13 July 2001, officers of the above bodies did not receive remuneration under the above title*

**LOANS TO OFFICERS**

| Bodies | Loaned amount | Outstanding balance at 31 December 2001 | Final maturity | Rate of interest |
|---|---|---|---|---|
| Board of Directors | 66 590 572 HUF | 64 014 529 HUF | 2016 | Floting (central bank base rate at 31 December 2001 +1% point) |

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

# PART C

*Appendices*

# *Resolution 1/2002 (V. 8.) passed by the Annual General Meeting of the National Bank of Hungary held on 8 May 2002*

I. The 2002 Annual General Meeting of the National Bank of Hungary has approved
- the audited financial statements for the year ended 31 December 2001,
- the business report for 2001,
- and stated the National Bank of Hungary's

*A. balance sheet total as at 31 December 2001 at HUF 5,453,364 million, that is, five trillion four hundred and fifty-three billion three hundred and sixty-four million forints*

*B. and the profit for the year ended 31 December 2001 at HUF 3,642 million,that is, three billion six hundred and forty-two million forints.*

II. Under Article 65 of Act LVIII of 2001 on the National Bank of Hungary, the General Meeting approved the settlement relating to the Bank's income in 2001 as follows:

*A. In 2001, the financial obligation of the National Bank of Hungary to its founder is the payment of a dividend amounting to HUF 27,732 million,that is, twenty-seven billion seven hundred and thirty-two million forints.*

*B. The advance payment of dividend by the Bank in 2001 was HUF 27,732 million, that is, twenty-seven billion seven hundred and thirty-two million forints. Consequently, there is no amount due and payable between the Founder and the Bank.*

III. In accordance with Section 20 of Government Decree 221/2000 (XII. 19.) on the special features of the obligation of the National Bank of Hungary to draw up its annual financial statements and of the applicable book-keeping standards, the General Meeting provides for the method and format of publishing the Bank's financial statements as follows:

The National Bank of Hungary shall publish its financial statements for 2001 in an Annual Report, which also contains the Bank's business report, on the Bank's Internet homepage. In addition to the electronic release, the Annual Report shall be also published in a printed format in a limited number of copies.

# *Executive officers of the National Bank of Hungary*

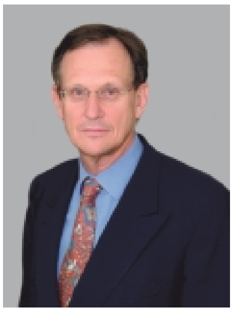
**Members of the Monetary Council**

Zsigmond Járai
President of the National Bank of Hungary
Chairman of the Board of Directors and the Monetary Council
(from 2 March 2001)
(Chairman of the Central Bank Council until 12 July 2001)

Henrik Auth
Vice President
(from 2 July 2001)

Péter Adamecz
Vice President
(from 2 July 2001)

(Members of the Central Bank Council until 12 July 2001)



Dr György Szapáry
Vice President
(from 21 Feb. 2001)

Werner Riecke
Vice President
(from 15 Jan. 1998)

(Members of the Central Bank Council until 12 July 2001)

Dr Béla Kádár
External Member
of the Monetary Council

Dr Gábor Oblath
External Member
of the Monetary Council

(External Members of the Central Bank Council until 12 July 2001)

Dr Tamás Káró
External Member
of the Monetary Council
(from 25 September 2001)

## Managing Directors of the National Bank of Hungary, at 31 December 2001:

*Katalin Barátossy*, Foreign Exchange Control and Authorisation, Payment Systems

*Zsuzsanna Arnold Csenterics*, head of Human Resources Department and Managing Director for Communications

*György Garancsi*, responsible for shareholders' rights-related functions

*István Hamecz*, Economics Department

*Dr Tamás Kálmán*, Banking Department, Banking Supervision and Regulation Policy

*Szilárd Király*, Bank Security

*Éva Ladányi Kiss*, Accounting and Finance, Management Accounting and Financial Reporting

*Dr Erika Kovács*, Secretariat, Legal Department, Codification and Legal Harmonisation

*Edit Buzogány Mándoki*, Account Services, Information Technology and Property Services

*György Sándor*, Monetary Policy and Statistics

# Senior Officers of the National Bank of Hungary January - February 2001

## Members of the Central Bank Council

Dr György Surányi
President of the National Bank of Hungary
Chairman of the Central Bank Council and the Board of Directors
(until 28 February 2002)

Werner Riecke
Vice President

Dr György Szapáry
Vice President
(from 21 February 2001)

Dr Béla Kádár
External Member
of the Central Bank Council

Dr János Kornai
External Member
of the Central Bank Council
(until 21 June 2001)

Dr János Száz
External Member
of the Central Bank Council
(until 20 Feb. 2001)

## Managing Directors of the National Bank of Hungary, at 1 January 2001:

*Dr Ádám Farkas*, Money and Foreign Exchange Markets, Account Services, Special Banking Transactions, International Capital Markets, Risk Management

*Dr András Gálszécsy*, Bank Security

*Dr József Kajdi*, Secretariat

*Ferenc Karvalits*, Banking Department, Banking Supervision, Exchange Control and Regulations

*Éva Ladányi Kiss*, Accounting and Finance, Management Accounting and Financial Reporting

*Álmos Kovács*, Legal Department and areas under direct supervision of Attila Végh and Éva Ladányi Kiss

*Judit Neményi*, Economics and Research

*Dr László Török*, Currency Issue, Payment Systems and the National Bank's Branch Office Network

*Attila Végh*, Information Technology and Institutional Development