MAGYAR NEMZETI BANK

ANNUAL REPORT

2003

Annual Report

Business Report and Financial Statements of the Magyar Nemzeti Bank

2003

Compiled by the Department of Management

Accounting and Financial Reporting of the Magyar Nemzeti Bank

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PART A

2003 BUSINESS REPORT

OF THE MAGYAR NEMZETI BANK




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I. THE GOVERNOR'S FOREWORD

The process of disinflation lasted from 2001 until mid-2003, when inflation turned around and began to rise again slowly. In the second half of 2003, the rate of headline inflation rose above the 4.5% target, finally reaching 5.7% by the end of the year, due to a number of factors including the depreciation of the forint, faster-than-expected wage growth, a higher budget deficit and a surprise increase in food prices. While inflation was 4.6% on a yearly average, in line with expectations, the rise in inflation in the second half of the year foreshadowed worse prospects for 2004.

Economic growth slowed down in 2003, and its underlying pattern deteriorated particularly strongly. Growth was driven mainly by rapidly increasing domestic consumption and the burgeoning general government deficit, rather than by stronger corporate activity.

These adverse macroeconomic developments made the task of monetary policy more difficult. The market's evaluation of the Hungarian economy and its expectations for the future outlook were volatile throughout the year, which in turn led to significant exchange rate and interest rate fluctuations.

Hungary made little progress in 2003 towards meeting the Maastricht convergence criteria required for adopting the euro. Although the general government deficit fell to 5.9% of GDP from its extremely high level in 2002, the general government debt jumped dramatically, rising close to 60% of GDP, inflation accelerated considerably in the second half of the year and long-term yields also rose.

Preparations for Hungary's accession to the European Union on 1 May 2004 played a key role in the changes in financial law. The Hungarian regulations were almost fully harmonised with the requirements of the European Union towards the year-end. The financial intermediary system and the banking sector were stable; the domestic payment and transfer systems operated smoothly; and the Bank's currency issue activity continued undisturbed.

The MNB's financial results for 2003 were shaped by the objectives of monetary policy and the instruments required to meet these objectives. The major part of profit for 2003 resulted from exchange rate fluctuations, although the reduction in operating costs contributed greatly to profitability. The Bank's restructuring, involving redundancies, was completed in 2003, thus MNB achieved its rationalisation objectives.

The players in the Hungarian economy made considerable efforts in 2003 to prepare Hungary for entry into the European Union under the best possible circumstances and to ensure that the country would prove its abilities in a challenging environment. However, restoring the confidence of the markets and adopting the euro require that Hungary choose a faster track to economic stabilisation in the coming years. Although the Magyar Nemzeti Bank was unable to meet its inflation target in 2003, due to the altered circumstances, it nevertheless performed its functions in an efficient and cost effective manner.

Zsigmond Járai, Governor of the Magyar Nemzeti Bank

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II. A BRIEF OVERVIEW OF THE MAGYAR NEMZETI BANK

Company name: Magyar Nemzeti Bank

Registered office: 1850 Budapest, Szabadság tér 8-9.

Form of operation: company limited by shares

Date of foundation: 1924

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

Core duties as defined by the Act on the Magyar Nemzeti Bank

Equity: HUF 10 billion

II. 1. THE MNB'S KEY OBJECTIVES AND TASKS

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

The MNB Act, which entered into force on 13 July 2001, sets forth the principles for the Bank's primary objectives, key functions, institutional, organisational, personnel and financial independence and operations, while also significantly restructuring its activities and profile. In accordance with Article 105 of the Treaty establishing the European Community, the MNB Act stipulates that the primary objective of the MNB shall be to achieve and maintain price stability. In addition, the MNB supports the government's general economic policies using the monetary policy instruments at its disposal, insofar as this does not jeopardise its primary objective.

In addition to implementing and promoting price stability, the Bank carries out the following key tasks specified in the MNB Act:

• the Bank defines and implements monetary policy in order to maintain the stability of the national currency;

• it is the sole issuer of banknotes and coins qualifying as the legal tender of the Republic of Hungary;

• it forms and manages the official reserves in foreign exchange and gold;

• it conducts foreign exchange operations in relation to the management of foreign exchange reserves and implementation of the exchange rate policy;

• it develops and regulates the domestic payment and settlement systems, and ensures the efficient and safe operation of these;

• in order to perform its tasks, the Bank collects and published required statistical information;

• it promotes the stability of the financial system and the development and smooth conduct of policies related to a prudent supervision of the financial system.

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

In order to achieve and maintain price stability in reflection of the central bank's autonomy, monetary policy and the instruments for the implementation of such are defined by the Bank in accordance with the provisions of the MNB Act. Such instruments include (i) accepting deposits, (ii) lending based on adequate collateral within the scope of its account management activities, subject to the restrictions set forth in the MNB Act, (iii) purchasing, selling and mediating securities, (iv) issuing its own securities, (v) influencing and setting exchange rates and interest rates, (vi) discounting securities and (vii) regulating minimum reserves.

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

Board of Directors of the Magyar Nemzeti Bank (left to right): Henrik Auth Deputy Governor; Dr. György Szapáry Deputy Governor; Zsigmond Járai Governor, Chairman of the Monetary Council and the Board of Directors; Péter Adamecz Deputy Governor; Werner Riecke Deputy Governor

II. 2. BODIES AND MANAGEMENT OF THE MNB AND THE DECISION-MAKING PROCESS

The decision-making bodies of the Magyar Nemzeti Bank are governed by the MNB Act and Act CXLIV of 1997 on Business Organisations, unless otherwise provided for by the MNB Act.

Under the aforementioned two Acts, despite its status as a single-member business organisation, one of the Bank's bodies is the General Meeting, at which the Hungarian State is represented as a shareholder by the Minister of Finance. The rules relating to the convening, quorum and powers of the General Meeting are laid down in the MNB Act, the Act on Business Organisations and in the Bank's Statutes. The General Meeting has the exclusive right to establish and amend the Statutes, to determine the equity of the Bank, to approve the balance sheet and income 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 the European Union's requirements, and as an additional guarantee of autonomy, the remuneration of the Bank's highest ranking officials, including the Governor, the Deputy Governors and the other members of the Monetary Council, is governed by the MNB Act (since its entry into force) rather than by the General Meeting.

In matters related to the performance of its key tasks, choice of the exchange rate regime, and activities as the lender of last resort, the MNB's main decision-making body is the Monetary Council. The Monetary Council has no less than seven and no more than nine members. Without prejudice to central bank autonomy, the Government is represented without voting rights by the Minister of Finance or a person duly authorised by the Minister at the meetings of the Monetary Council and the Board of Directors. This form of liaison with the Government is consistent with European Union guidelines. Thus, the Government is provided with information on the Bank's activities and monetary policy developments. In addition, by attending the meeting without voting rights, the Government representative is entitled to make comments on the agenda. In addition to establishing the legal framework for a liaison of this kind, the MNB Act stipulates the following: 'The Government may not give instructions to Bank officials in respect of the tasks and duties conferred upon them by this Act.'

The members of the Monetary Council in 2003 were:

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

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

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

• Werner Riecke, Deputy Governor and member of the Board of Directors,

• Dr. György Szapáry, Deputy Governor 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. György Kopits, external member of the Monetary Council,

• Dr. Gábor Oblath, external member of the Monetary Council.

The responsibility for implementing Monetary Council decisions and managing the operations of the Magyar Nemzeti Bank rests with the Board of Directors. Its competence involves inter alia (i) managing the Bank's key tasks, (ii) submitting proposals to the General Meeting on the MNB's balance sheet, income statement and dividend, and (iii) adopting proposals to be submitted to the General Meeting on the MNB's business management, assets and policies, (iv) approving professional plans and programmes, the development and operational budget plan as well as any issue associated with the Bank's organisation and internal management, (v) managing internal audit in relation to the tasks falling outside the competence of the Supervisory Board, (vi) discussing the results of and plans for internal audits, (vii) adopting proposals for significant amendments to the collective bargaining agreement and (viii) formulating the Bank's policy on fees to be charged to financial institutions.

The Board of Directors, which functions as the MNB's operative management body, has no less than four but no more than six members. Its members include the Governor and the Deputy Governor of the Bank.

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

Pursuant to a decision by the Board of Directors, these bodies are supported in their work by special committees. The ALCO (Assets/Liabilities Committee) is responsible for (i) drafting Monetary Council decisions on foreign exchange reserve management, (ii) approving information materials on such activities and (iii) operational decisions within the competence delegated to it by the Monetary Council and the Board of Directors. The Audit Committee's responsibilities include (i) following up the findings made in the course of the operation of the MNB's supervisory system (internal audit, the auditor, the Supervisory Board and the State Audit Office), (ii) exchanging views on supervision-related experience, (iii) pre-adopting the schedule of annual audit programmes and monitoring the implementation of such. The Banking Committee is in charge of making decisions on issues related to the financial intermediary sector. The decisions of the Investment and Cost Management Committee are taken within the framework of the budget approved by the Board of Directors. With regard to the Logistics Centre project, the Investment and Cost Management Committee's rights and competencies are held and exercised by the Committee of High-Profile Investment Projects. Its responsibilities include identifying Logistics Centre-related tasks and managing the project. The Monetary Committee (i) supports the conduct of monetary policy by the Monetary Council, (ii) makes regular assessments of monetary conditions by comparing the monetary programme with actual developments and (iii) based on this assessment, drafts operational monetary policy decisions, while fostering co-ordination between transactions on the domestic foreign exchange and forint markets. The Owners' Advisory (Investment Management) Committee makes strategic and policy decisions and has a key preparatory role in such matters.

The Magyar Nemzeti Bank is supervised by the State Audit Office and the Supervisory Board.

The State Audit Office examines whether the Bank complies with the relevant laws and regulations, the Bank's Statutes and the resolutions adopted by the General Meeting. Its supervisory competence encompasses the Bank's entire operations and management except for the Bank's key tasks including their impact on the Bank's income statement. However, it also supervises the issuance of banknotes and coins. Making proposals for the appointment and dismissal of Bank's auditor by the General Meeting also falls within the competence of the State Audit Office.

The Supervisory Board ensures constant shareholder control. Its supervisory competence as defined by the MNB Act excludes the Bank's key tasks and their impact on the MNB's profit and loss. Within its competence, the Supervisory Board manages the MNB's internal audit system. The report it is required to write pursuant to the Companies Act is subject to these limitations.

Of the six members of the Supervisory Board, four (including the Chairperson) are appointed by Parliament, one represents the Minister of Finance and one is an expert appointed by the Minister of Finance. Their respective terms of office coincide with the Parliament's mandate. The Board of Supervisors remains in office until a new Parliament appoints new board members within three months of its opening session. In case the new Parliament should fail to appoint such members before the aforementioned deadline, the Supervisory Board shall continue to operate until the new members are appointed.

Members of the MNB's Supervisory Board:

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

II. 3. ORGANISATIONAL STRUCTURE OF THE MNB

To ensure operational efficiency and in part due to the changing legal environment, in 2001-2002 the Magyar Nemzeti Bank carried out a major restructuring programme, within the framework of which the MNB's senior management was guided by the principle of modernising the Bank's structure and rendering it a transparent, streamlined organisation.

As a result of this restructuring exercise, the structure itself has become simpler, the mechanisms have become more transparent and the operations less costly.

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

As heads of the departments and divisions assigned to them, the managing directors are responsible for the following areas: monetary policy and statistics, economic research, analysis and international relations, prudent supervision of the financial system, payment systems and currency issue, finance, accounting and controlling, supervision of investments, central administration related to various areas (legal, human resources, secretariat, communications and bank security) and central administration (such as property services, information technology and back office).

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

The following is a full list of the MNB's managing directors as of 31 December 2003:

Dr. Katalin Barátossy, who is in charge of the Chief Cashier's Department, the Payment Systems and Currency Issue Policy Department and the regional branch offices.

Dr. Zsuzsanna Arnold Csenterics, who is in charge of the Human Resources Department and the Internal Communication Department.

György Garancsi, who is in charge of the Department for Capital Projects (High Profile Investment Projects).

Éva Gyöngyösy, who is in charge of the Accounting and Finance Department and the Department of Management Accounting and Financial Reporting.

István Hamecz, who is in charge of the Economics Department and the International Relations Department.

Dr. Tamás Kálmán, who is in charge of the Financial Stability Department, the Central Bank Supervision Department and the Regulation Policy Department.

Szilárd Király, who is in charge of the Department of Bank Security.

Dr. Erika Kovács, who is in charge of the Legal Department and the Secretariat.

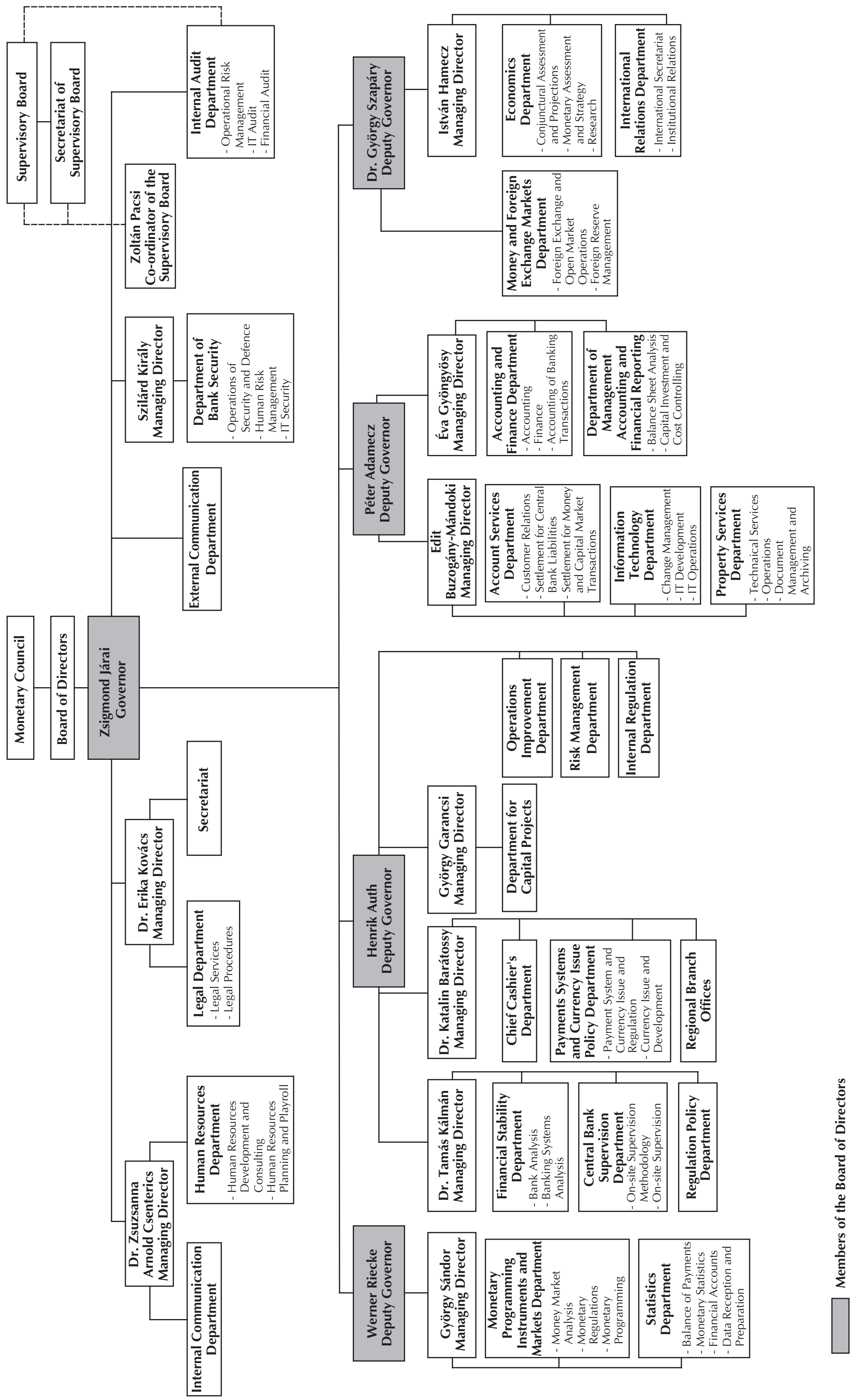
Edit Buzogány-Mándoki, who is in charge of the Account Services Department, the Information Technology Department and the Property Services Department.

György Sándor, who is in charge of the Monetary Programming Instruments and Markets Department and the Statistics Department.

The organisation chart (Chart II.3-1) shows the Bank's organisational structure as of 31 December 2003.

Chart II. 3-1.

Operational Organisation of the Magyar Nemzeti Bank - 31 December 2003



II. 4. RELATIONS BETWEEN THE MNB AND THE EUROPEAN SYSTEM OF CENTRAL BANKS

Hungary's accession to the European Union also entails the entry of the MNB into the European System of Central Banks (ESCB).

The ESCB consists of the European Central Bank (ECB) and the national central banks (NCBs) of all EU Member States. The ESCB's committees, sub-committees and working groups, all of which are composed of ECB and NCB experts, play a key role in the ESCB's operations. The ESCB's twelve committees have preliminary decision-making and co-ordinating roles in the division of central banking duties. In view of enlargement in 2004, the MNB's senior executives and experts began contributing to the ESCB's work as observers in May 2003. The main decision-making body of the ESCB and the Eurosystem is the ECB's Governing Council, which consists of the members of the ECB's Executive Board and the governors of the NCBs, which have adopted the euro. Matters with implications to the ESCB as a whole are also submitted to the General Council. From May 2003, the Governor of the MNB took part in the General Council's meetings as an observer until becoming a full member on 1 May 2004.

III. AN OVERVIEW OF THE MNB'S ACTIVITIES IN 2003 (EXECUTIVE SUMMARY)

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III. 1. MONETARY POLICY IN 2003

Pursuant to the MNB Act, the primary objective of the Magyar Nemzeti Bank is to achieve and maintain price stability. In keeping with achieving this objective, the operational framework of monetary policy is defined by (i) the ±15% fluctuation band of the forint vis-à-vis the euro and (ii) the regime of inflation targeting.

Set in agreement with the Government, the inflation target for end-2003 and 2004 stood at 4.5% and 3.5%±1%, respectively. In October 2003, the target for end-2005 was set at 4%.

However, the trend of disinflation reversed in mid-2003, and the year-end inflation stood at 5.7%, meaning that the inflation target had been missed. The main factors behind the unfavourable inflatory tendencies were a quicker-than-expected increase in household consumption expenditure and higher-than-projected wage inflation. These factors were linked directly to a material expansion of the budget in 2002.

In 2003, the MNB was unable to counterbalance the growing inflationary pressure using monetary policy instruments. Monetary conditions changed considerably during the year, reflecting sharp fluctuations in market participants' risk assessment. In mid-January, a group of foreign exchange market participants launched a massive pro-forint speculative manouvre expecting that the MNB and the Government would tolerate an exchange rate stronger than the edge of the band. By the way of a substantial rate-cut and employing a broad range of monetary instruments, the MNB managed to fend off this speculative attack and defend the exchange rate band. However, the consequences of the Bank's attempt to protect the band were lower interest rates and a weaker exchange rate i.e. looser monetary conditions overall. As a result, the likelihood of meeting the year-end inflation target diminished considerably. The situation did not improve when the Government – as part of a series of economic policy measures – initiated a slight devaluation of the intervention band to please exporters. This unexpected measure caused considerable confusion: investor confidence faltered and the forint took a sharp downward turn. Following the adjustment of the intervention band, only a series of massive rises in interest rates enabled the MNB to stabilise the forint exchange rate. However, in the fourth quarter of 2003, the attention of the market shifted to imbalances in the Hungarian economy, particularly the budget deficit and the higher-than-expected current account deficit. Due to these factors, market confidence dwindled again in November and the risk premium rose sharply. As a result of the mounting downward pressure on the exchange rate, the Bank was once again forced to raise its key interest rate in November. Since then the market's assessment of the balance of the Hungarian economy has improved somewhat, due in part to certain measures taken by the Government, as well as the fact that some of earlier concerns turned out to be exaggerated.

In line with the fluctuations in risk assessment, the volatility of the forint's exchange rate in 2003 was far higher than in recent years, but the exchange rate remained within the stronger half of the ±15% fluctuation band.

III. 2. STABILITY OF THE FINANCIAL INTERMEDIARY SYSTEM

The MNB continues to publish its key statements on the stability of the financial intermediary system in its Report on Financial Stability. Published semi-annually, the reports issued in 2003 highlighted the extraordinary events in the money market and the unprecedented increase in subsidised housing loans. The MNB also continued to analyse banks' risk awareness and risk management systems. In 2003, a survey was conducted on banking groups' risk management and risks implied in the provision of housing loans.

III. 3. THE PAYMENT SYSTEM

Like in developed countries, large-value and retail clearing and settlement form two markedly distinct fields in Hungary. If the turnover of the MNB's Real-time Gross Settlement System (VIBER) is added to that of Giro Elszámolásforgalmi Rt's batch clearing system, the following result is obtained: whereas the share of VIBER is hardly noticeable in terms of volume (amounting to just 0.2%), it amounts to 90% in terms of value. Turnover rose by 53% to HUF 397 trillion in 2003. Despite the exceptional turnovers recorded on peak days, the system operated smoothly. In accordance with the principle of cost-effectiveness in its pricing policy, the Bank significantly cut commissions and other pricing associated with VIBER and other payment services. The MNB extended by one hour the operating hours available in VIBER for customer orders. The new pool-based collateral assessment system is fully compatible with the system used by the ESCB. Hungary is the only new Member State that has adopted such a practice.

One of the tasks the MNB regards as important is enhancing co-operation between institutions engaged in payment and settlement activities. Domestic participants in the payment and settlement systems face a number of challenges associated with the EU accession and the creation of a single euro-payment area. In response to the need for change, the MNB and other institutions involved in settlement and clearing set up the Payment System Forum which operates as a multilayer consultative body.

III. 4. MANAGEMENT OF FOREIGN EXCHANGE RESERVES AND RISK MANAGEMENT

Reserves rose from EUR 9.9 billion at the end of 2002 to EUR 10.1 billion in 2003. However, in the course of the year, the amount of reserves fluctuated sharply – as a result of the intervention at the upper limit of the band on 15-16 January, reserves swelled to EUR 14.2 billion, then followed a steadily declining trend throughout the rest of the year until reaching their final level at EUR 10.1 billion.

Underlying the latter was the fact that the MNB's measures of 16 January (whereby in addition to lowering interest rates, the MNB widened the O/N interest rate corridor) marked the start of an outflow of speculative capital. This initially took the form of open interventions, whereas later the Bank used foreign exchange auctions and other foreign exchange instruments to facilitate euro outflows. The Government's two bond issues of EUR 1 billion each, its receipt of EUR 500 million in syndicated loans coupled with an additional EUR 200 million in other loans, and settlement of Russia's government debt of USD 82 million to Hungary resulted in an upsurge in reserves. The return earned on the portfolio amounted to EUR 300 million. Mark-to-market hedging transactions and the weakening of the dollar caused euro-denominated reserves to drop by EUR 460 million and EUR 210 million, respectively. The changes in the total outstanding holdings of foreign exchange deposits with the MNB brought about a decrease of EUR 180 million. The items stemming from the Government's and the MNB's debt service (interest payment, repayment and prepayment) were high, reducing the foreign exchange reserves by around EUR 3.5 billion.

Adopting other central banks' best practice continues to be a key aspect of reserve management. In accordance with the principles followed by developed countries and EU Member States in particular, the MNB only invests in highly liquid securities with exceptionally good ratings. In practice, this means that only AAA or AA rated bonds may be included in the portfolio, i.e. government bonds, large international financial institutions, and those issued by government agencies. In 2003, no major changes were made to investment guidelines.

III. 5. CURRENCY ISSUING ACTIVITIES

One of the fundamental tasks of the Magyar Nemzeti Bank is to provide banknotes and coins in an appropriate amount, quality and denomination for Hungary's currency circulation. The Bank fully performed this task at the Main Cashier's Desk in Budapest and at the cashiers' desks at the regional directorates in 2003.

In 2003, the Main Cashier's Desk of the Magyar Nemzeti Bank, together with the cashiers' desks at the regional directorates, registered a turnover of HUF 3,610 billion, up 2.5% on the previous year.

On 31 December 2003, currency in circulation amounted to HUF 1,458 billion, which was 15% (HUF 188 billion) higher than at end-2002.

In 2003, the MNB continued its rich tradition of producing commemorative coins by issuing four silver coins and one jubilee circulation coin.

III. 6. STATISTICAL SERVICES

The Bank's statistical activities are governed by the MNB Act and the Act on Statistics. The MNB's Statistics Department is responsible for collecting, processing and disseminating data related to monetary, balance of payments and financial accounts statistics, and for fulfilling duties linked to the Bank's reporting obligations. In statistical matters as well, preparation for EU accession (namely adopting required or recommended methodologies, and fulfilling reporting obligations related to data and information) were given top priority in 2003. These preparations were underway since 1999. As a result, the MNB's statistical activities in 2003 were broadly in line with the ECB's requirements, and complied with all the reporting obligations for accession countries.

Data dissemination requirements for 2003 were stipulated by MNB Decree No. 5/2002. (PK. 20) and as part of the National Data Collection Programme. As regards data collection, monetary statistics was the field in which the most important changes were made. This was, on the one hand, due to the adoption of the ECB's requirements, and, on the other, by the fact that the Bank required new data collections for the compilation of the financial accounts.

In addition to the harmonisation of data collection, the Bank reviewed its publications in order to follow EU practice, and specifically, it began to release data on monetary aggregates calculated using ECB's methodology. As regards balance of payments statistics, a major methodological shift took place: based on a decision of the Monetary Council, customs statistics were integrated into balance of payments statistics and the recording of tourism data was harmonised with the national accounts. Concurrently, a new publication and data revision timetable was introduced as of January 2003. The introduction of regular data releases on the financial accounts as of 1 April 2003 was a landmark in the MNB's statistical activities. Moreover, new data were added to the release of securities statistics, which are closely related to the financial accounts. Based on the ECB's recommendations and expectations, the MNB's statistics on securities issuance was first published in June 2003.

III. 7. THE FINANCIAL RESULT OF THE MAGYAR NEMZETI BANK AND ITS FINANCIAL MANAGEMENT

The financial result of the Magyar Nemzeti Bank is primarily influenced by the objectives and instruments of monetary policy. The implications of such activities on the financial result may not prejudice the performance of the MNB's key tasks as defined in the MNB Act; as a result in its business activities the MNB focuses mainly on ensuring efficient operations.

The MNB's profit in 2003 amounted to HUF 78.5 billion, up HUF 83.4 billion on the previous year. This increase can primarily be ascribed to exchange rate gains generated by the sale of the foreign currency bought by the MNB as part of the aforementioned intervention.

The internal operations of the Bank are essentially aimed at (i) providing the resources required for the efficient fulfilment of the responsibilities stipulated by the MNB Act and (ii) facilitating risk-free operations in the most cost-effective manner.

Regarding operating costs, rationalisation of the organisational structure and processes launched in 2001 and continued in 2002 resulted in significant savings. Calculated at 2000 prices, operating costs were nearly 30% lower than in 2000. As compared with 2002, annual operating costs in 2003 fell by 6% (i.e. over HUF 800 million) in nominal terms, and by 10% in real terms.

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IV. REVIEW OF PERFORMANCE IN 2003

IV. 1. MONETARY POLICY IN 2003

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

In the summer of 2002, in agreement with the Government, the MNB revised down its inflation target for year-end 2003 to below 4.5%. Simultaneously, it set 3.5±1% as the inflation target for 2004. In October 2003, the MNB and the Government jointly set 4% as the 2005 inflation target.

IV. 1. 1. Inflation developments

In 2003, average annual inflation was 4.7%. The 5.7% year-on-year inflation in December 2003 exceeded the inflation target of less than 4.5%. Core inflation stood at 4.9% at year-end 2003, indicating that the pace of rises in the prices of the items that monetary policy can influence exceeded the target, although to a lesser extent than consumer price inflation.

The development of inflation in 2003 can be divided into two stages. The first quarter of 2003 was characterised by disinflation, a process which had been underway for approximately 2 years at that point and was due partly to developments in the prices of items that monetary policy can affect, and partly to favourable

Chart IV. 1-2

CPI and core inflation

(Annual growth rates)

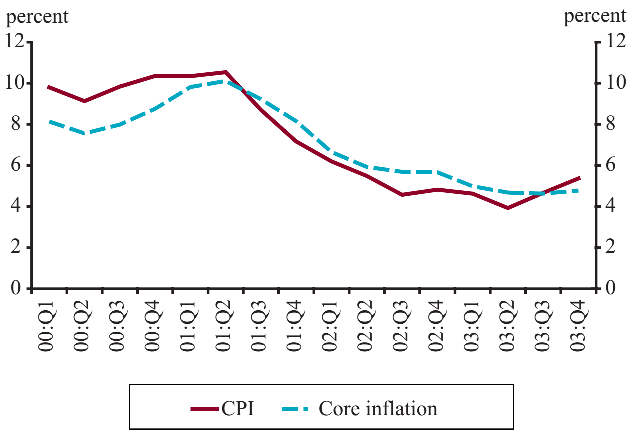


Table IV. 1-1

CPI and its components in 2003

(Percentage changes on a year earlier)

	Weight	2001	2002	2003	2003				
	2003	Annual average	Annual average	Annual average	Q1	Q2	Q3	Q4	Dec.
Core inflation	68.1	9.3	6.0	4.8	5.0	4.7	4.7	4.8	4.9
Unprocessed food	6.3	14.9	2.2	0.7	-0.8	-2.3	0.1	5.7	7.4
Motor fuel and market energy	6.2	1.7	-0.9	5.2	12.5	3.7	2.9	2.3	3.6
Regulated prices	19.4	8.6	5.5	5.4	3.0	3.9	6.9	7.8	7.8
CPI	**100**	**9.2**	**5.3**	**4.7**	**4.6**	**3.9**	**4.7**	**5.4**	**5.7**

external factors. In the second quarter, however, disinflation came to a halt, only to be followed by accelerating inflation in the second half of the year.

As evidenced by month-on-month indices in early 2003, the reverse in the trend of disinflation first manifested itself in core inflation. Sustained dynamic growth in domestic demand and increasing inflation expectations allowed the weakening of the forint exchange rate in 2003 to be reflected in prices rapidly. The strong and steady rise in the prices of market services was attributable to vigorous domestic demand, rapid private-sector wage growth and a few exogenous shocks. The depreciation of the forint and strong consumer demand for processed food also contributed to an increase in prices.

Of the items excluded from core inflation, unprocessed food, the prices of which increased sharply in the final quarter, particularly in November, was of key importance. In terms of items with regulated prices, the increase in the excise duty on alcohol and tobacco and a rise in the administered price of gas in May had a major impact.

IV. 1. 2. The exchange rate and interest rates

In line with sharp changes in risk perception, fluctuations in the exchange rate of the forint were more hectic in 2003 than in the preceding years. Although these fluctuations were larger than usual, the exchange rate of the forint remained on the strong side of the ±15% band throughout 2003.

In January 2003, there was a massive inflow of speculative capital aimed at forcing a revaluation of the intervention band. In order to defend the band, the MNB lowered its key policy rate from 8.5 to 6.5% in two phases. Simultaneously, changes were also made to other components of monetary policy instruments. By participating in the foreign exchange market actively and modifying its instruments temporarily, the MNB was successful in defending the exchange rate of the forint. The bulk of the speculative capital that had flowed into Hungary exited the market by May 2003. Thus, it did not pose a threat to financial stability. Nor did it engender any inflationary pressure. In mid-January, the exchange rate depreciated by approximately 4%, and then stabilised again during the consolidation period following the speculative attack.

In June 2003, at the Government's request, the Bank agreed to devalue the central parity of the currency by 2.26%. This unexpected move undermined market confidence, and resulted in a considerable depreciation of the market rate of the forint. The risk premia demanded by investors rose significantly as uncertainties surrounding future developments in the exchange rate of the forint built up. In order to counter these developments, the MNB raised its key policy rate by 3 percentage points to 9.5% in two stages in June.

In July 2003, the Government set 1 January 2008 as the date for Hungary's euro changeover. The Government also indicated that, following Hungary's accession to the EU, it would urge the country's earliest possible entry into ERM II. On a number of occasions, the MNB voiced its opinion that it would support the introduction of the euro as soon as realistically possible, as the euro would bring considerable benefits to Hungary's economy, all things considered. It also stressed, however, that there was still much work to be done in bringing the fiscal deficit and inflation down, in order for the country to be able to meet the Maastricht criteria.

Chart IV. 1-3

The exchange rate and interest rates

(Annual growth rates)

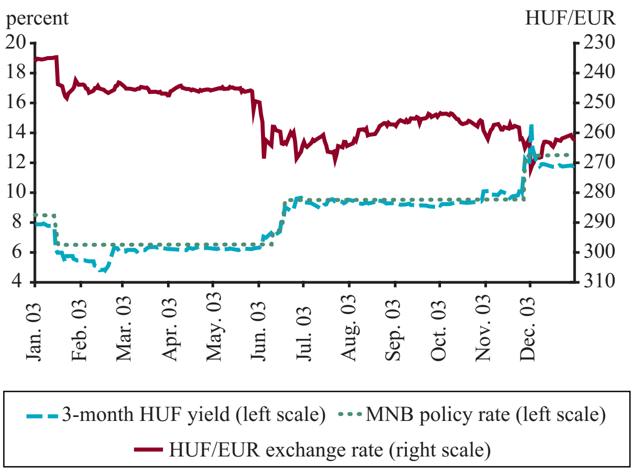
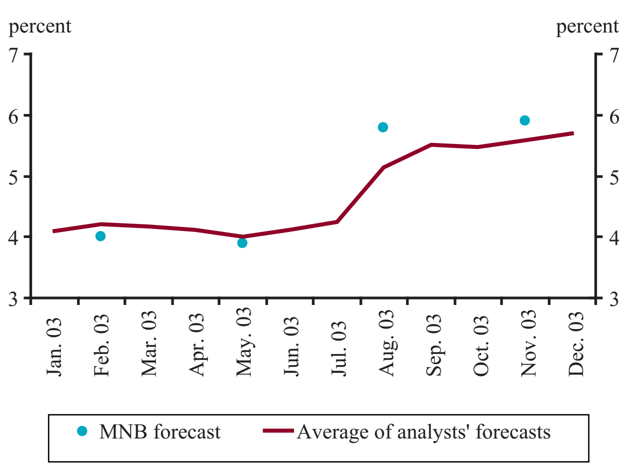


Chart IV. 1-4

Inflation projections for end-2004 during 2003 by analysts in the Reuters survey and the MNB respectively



Concurrently with the official announcement of its euro strategy, the Government also declared its intention to increase tax revenues in 2004 in order to reduce the fiscal deficit. As the Government intended to do so primarily by raising VAT rates and excise duties, the inflation outlook for 2004 deteriorated significantly. Until August 2003 the inflation forecast for year-end 2004 indicated that inflation would stay within the tolerance band. However, the inflation forecast for December 2004, published in the Inflation Report in August, exceeded the inflation target set by the MNB. According to the calculations presented in the August Inflation Report, in total, increase in indirect taxes and other macro-economic trends would account for a rise of 1.4 and 0.5 percentage points in CPI, respectively, throughout 2004.

The exchange rate of the forint appreciated marginally between August and October 2003. With 2003 drawing to an end, the market shifted its attention to Hungary's increasingly unsatisfactory equilibrium position. On the one hand, the likelihood of the fiscal deficit remaining below the 2003 target declined; on the other, the steady monthly deterioration of the current account deficit gave rise to major concerns. In late October, the exchange rate of the forint began to depreciate again, with the government bond market suffering liquidity shortages, which could be interpreted as a temporary market hitch. The MNB conducted open market operations in order to alleviate the liquidity shortage and to promote the earliest possible consolidation of the government bond market.

Although money markets temporarily stabilised as a result of the bond purchases by the MNB, the exchange rate depreciated significantly and yields rose again in late November. The risk assessment of forint investments deteriorated considerably, with required risk premia increasing as a response to growing uncertainties. The Monetary Council raised the key policy rate by 3 percentage points to 12.5% in order to offset the increasing risk premia and stop the forint from depreciating further, the latter representing a threat to the inflation target. The final month of the year saw a few instances of minor correction in the money markets, with the exchange rate of the forint further appreciating, and short-term yields stabilising at a lower level after a sudden increase.

IV. 1. 3. Changes to monetary policy instruments

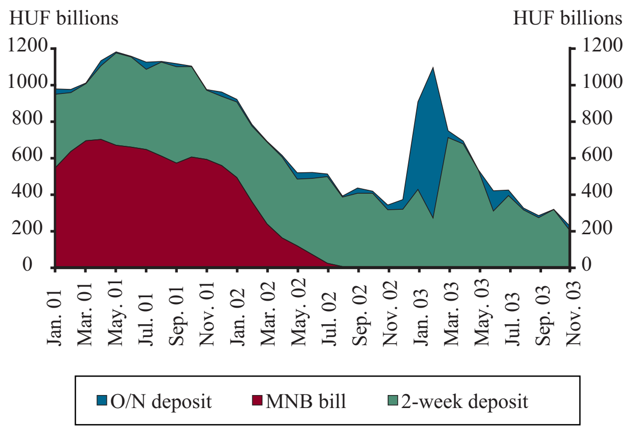
Essentially, changes to monetary policy instruments in 2003 were determined by two factors. One was significant, albeit temporary, changes by the MNB in order to tackle currency appreciation speculation. The other was bringing instruments in line with ECB regulations, which was an on-going process during the rest of the year. As a result, the instruments of the MNB approximated to those of the ECB to a great degree.

Temporary changes to monetary policy instruments

One crucial element in repelling the speculative attack against the forint's band was that the MNB, simultaneously to lowering its key rate twice by 100 basis points on both occasions, temporarily suspended the provision of the intermittently available standing facility of its main policy instrument in mid-January 2003. From that time on, banks could only place a maximum of HUF 100 billion in two-week deposits every week. Concurrently with the imposition of quantity restrictions on deposits, the MNB increased the width of its O/N interest rate corridor from ±1 to ±3 percentage points. Due to these measures and interventions conducted at the lower edge of the intervention band, interbank overnight rates stayed close to the lower edge of the interest rate corridor. Excess liquidity in the banking system was sterilised by the O/N rather than the two-week deposit. The central bank O/N deposit rate became the effective interest rate. Having taken these measures, the MNB succeeded in separating the temporary impacts of lowering interest rates from the lasting ones. The aim of the central bank measures was to urge foreign investors, who had suffered exchange rate losses, to close their long forint/foreign exchange positions. Changes to the monetary policy instruments provided for the possibility that the hot capital could exit in a steady, controlled manner, without jeopardising the stability of the banking system.

Chart IV. 1-5

Changes in the average monthly quantity of sterilisation instruments



Owing to the quantity restrictions imposed on deposits, banks oversubscribed the two-week deposit facility. As a result, the MNB changed its allocation procedure, allocating bids in proportion to the average amounts of earlier reserve requirements. This method prioritised domestic deposit-taking banks, providing for the possibility of earning higher rates of return on deposits. Speculative capital was, however, forced to suffice with lower rates.

By late February, the bulk of the hot capital that had flowed in had exited the domestic banking system. Thus, the MNB was able to restore the arrangement of its monetary policy instruments to the structure in use prior to the speculative attack. The MNB continued to provide the intermittent availability of the two-week deposit facility without any quantity restrictions. It reduced the width of the interest rate corridor to ±1 percentage point, in accordance with ECB's practice. The temporary effects of the MNB measures were also reflected in the stock of sterilisation instruments. From mid-2003, excess liquidity in the banking system continued to decline (see Chart IV 1.5).

The collateral assessment system

Following a period of meticulous preparation, in May 2003, the MNB introduced a pooling system for and a system of daily cover assessment related to covered central bank lending transactions. Compliance with ECB principles applied to collateral assessment and more efficient management of the risks inherent in central bank lending were major considerations in formulating these systems.

Pooling system for collateral assessment means that customers are not required to earmark specific securities with individual lending transactions, rather it is the entire securities portfolio blocked in favour of the central bank that is used as collateral for all customer loans. Thus, a jointly managed securities portfolio serves as collateral for intraday, overnight and longer-term credit.

Depending on changes in the market price of securities, the collateral value of the securities portfolio blocked in the course of daily collateral assessment and that of central bank loans are re-valued and compared on a daily basis. Should it be found in the course of matching that the rate of undercoverage falls outside the acceptable range, the MNB requests additional collateral. One definite advantage of the daily collateral assessment is the fact that the risk arising from the term of a loan becomes marginal, thus borrowers can obtain larger loans for the same collateral than they were able to under the previous system. Under the old system, the collateral values set upon contracting did not change during the term of the loan.

Eligible collateral

In 2003, the MNB expanded the list of securities eligible as collateral for central bank lending transactions. In addition to the need to comply with ECB instruments, the aim of the expansion was to foster the development of the Hungarian capital market. To this end, the central bank now accepts as collateral the widest possible range of safe securities available in the domestic capital market. Only government securities and MNB bills were formerly regarded as such. As of November 2003, this group also includes public issues of mortgage bonds and traded domestic forint bonds issued by low-risk companies (with at least an 'A' rating), banks and international institutions. In order to reduce lending risks, however, the central bank refuses to accept as eligible collateral bonds issued by its counterparties or by any other entity with which the counterparty has close links.

Central bank counterparties

Since last November, the range of eligible counterparties of the MNB's forint instruments has widened. The aims of modifications included harmonisation and compliance with the principle of fair market competition. Another justification for raising the number of counterparties was for the MNB to offer the widest possible selection of payment transaction services for its customers.

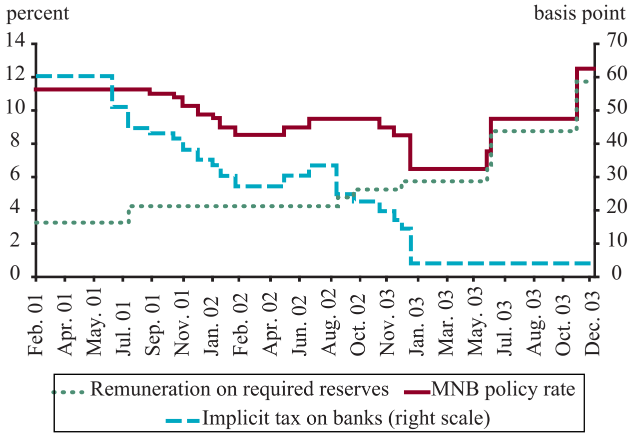
Potential MNB counterparties include all financial institutions with reserve requirements, provided that they are members of VIBER or the Interbank Clearing and Settlement System. A further eligibility requirement for collateralised central bank loans is the holding of a securities account kept with KELER Rt. As a result of the changes, potential customers now also include lending and savings societies which meet eligibility criteria. Potential counterparties conducting spot securities transactions now include specialised credit institutions and except primary dealers.

Reserve requirement regulations

As of 1 January 2003, the interest rate on required reserves increased by 0.5% to 5.75%. This, combined

Chart IV. 1-6

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



with a cut in the central bank base rate in January, reduced the implicit tax on the banking system to 4 basis points, compared to the average 30 basis points in 2002. During the rest of the year, the interest rate compensation remunerated on required reserves rose in conjunction with the increase in the base rate. As a result, the implicit tax on the banking system continued to be low and thus no longer has an adverse effect on the competitiveness of the individual banks.

Changes in business hours

Foreign exchange interventions at the edges of the intervention band have been available for an extra 1 hour since February, with the central bank accepting HUF/EUR bids at the edges of the band from 09:00 to 16:00 hours. Business hours for spot securities transactions have also been longer since November. Previously, such transactions, announced occasionally, could only be conducted in the morning and during a predetermined period in the afternoon. These changes may enable the central bank to influence trends in the money market in a more efficient manner.

IV. 2. STABILITY OF THE FINANCIAL INTERMEDIARY SYSTEM

The MNB continues to publish its key statements on the stability of the financial intermediary system in its Report on Financial Stability. Published semi-annually, the reports issued in 2003 highlighted the extraordinary events in the money market and the unprecedented increase in subsidised housing loans. The Bank also continued to analyse banks' risk awareness and risk management systems. In 2003, a survey was conducted on banking groups' risk management and on the risks implied in the housing loan activity.

IV. 2. 1. An analysis of the stability of the financial intermediary system

In 2003, bank intermediation deepened considerably. Despite a downturn in the economy, the profitability of the banking system improved significantly, even compared to its exceptionally good performance in the preceding year. Dynamic growth in subsidised housing loans played a major role in the marked improvement of the profitability of the banking system. Due to a take-off in lending, the quality of banks' improved. The growth dynamics of deposits, however, lagged behind the increase in lending, thereby exacerbating liquidity risks.

One major risk identified by the MNB was that the slowdown in household income growth, accompanied by a broad expansion of consumer and housing loans, reduced households' net financing capacity. The sharp rise in households' indebtedness in 2003 can be attributed to the availability of subsidised loans and demand for such loans brought forward because of continuous expectations of tighter regulation of the housing subsidy scheme. It is important to note that, in addition to a jump in housing loans, there was a significant increase in loans extended to households by leasing firms and also in consumer loans.

The MNB paid special attention to changes to the housing subsidy system, i.e. the tightening of conditions, in June and December 2003, analysing, in particular, changes in the growth rate of the housing loans extended by major participants in the banking system, margins on products and lending risks.

The MNB closely monitored the extraordinary events in 2003, including the handling of the speculative attack in January and the analysis of the impacts of changes in the exchange rate of the forint and in the base rate.

There was a major rearrangement of the participants in financial intermediation. Bank privatisation was completed in 2003. As a result, foreign ownership share now exceeds 80%, one of the highest among CEE countries. State ownership share fell to 1.1%. With brokerage firms merged, universal banks dominate the market. Currently, there are only three bank-owned brokerage firms in the market.

In 2003, the MNB continued to examine banks' specific risk tolerance and related risk awareness and risk management. In 2003, an analysis of risk management by banking groups was performed. The topicality of the issue was underscored by the fact that new members had been integrated into the various banking groups, and that the activity of these new members had been rather dynamic prior to the survey. The objectives of the survey included a check on whether there had been any improvement in group risk management, relative to 1998 and 1999, studying the activity of the individual members and identifying the extent to which intra-group transactions added to group risks. It is safe to say that, owing to the stipulations of the provision of regular group-level reports, more efficient supervision of foreign owners and the heightened risk awareness of the Hungarian management; group risk management has improved considerably.

In 2003 H2, the MNB also analysed the practice of providing housing loans, related risks and their management. In the course of this analysis, the Bank studied the extent to which the explosive expansion in the provision of housing loans affected market participants' lending, market and operational risk exposure. What adds to risks in this business line is that most banks still lack sophisticated risk management, which would enable them to tackle the issue of clients facing loan repayment problems. Currently, banks' risk management is primarily confined to collateral assessment.

IV. 2. 2. Drafting regulations and developing regulatory policy

In 2003, the MNB also actively participated in the process of legal harmonisation in relation to EU membership as well as in the drafting and amending of regulations related to the financial system.

The Insurance Act as well as the Act implementing consolidated supervision and amending the Act on credit institutions and capital markets, both complying with EU requirements, were passed in the summer of 2003. Related lower-level regulations (e.g. Government and Ministry of Finance decrees) were drawn up in the second half of 2003. Of such regulations, Decree 23/2003 (X. 3.) of the Ministry of Finance on the calculation of consolidated regulatory capital and consolidated solvency ratio is of key importance. It sets forth regulations governing implementation, thereby enabling the amendments of the relevant acts to achieve their original goals. In order to ensure the comprehensive application of consolidated supervision, in the government decree on trading books, the regulations were elaborated concerning the group-level assessment and management of market risks. Furthermore, the related decree on data provision for the supervisory authority was also put to practice.

Owing to the above regulatory developments, the system of financial regulations now nearly fully complies with EU requirements. Obviously, the MNB provided expert assistance in the preparation of the above regulations, and played an active role in their drafting.

Furthermore, the MNB also participated in the consultative process related to the New Basel Capital Accord (Basel II) and the EU directive with identical content, and commenced preparation for the adoption of such in Hungary. MNB experts performed several complex regulatory analyses and prepared a series of background studies on this topic (e.g. a volume of studies on Basel II), which also served as the basis for the formulation of the common Hungarian position.

IV. 2. 3. On-site inspections

Like in previous years, in 2003, on-site inspections carried out by the central bank – representing an integral aspect of financial stability – continued to play an important role in the supervision of the activities[1] and organisations[2] falling within the MNB's competence. Last year, a total of 115 on-site inspections were performed. Summarising last year's experience, it can be stated that credit institutions' reports are essentially reliable in terms of data supply. In respect of reports on monetary data, the inspections mainly identified shortcomings in the adoption of the changes to MNB guidelines. Among monetary statistics, interest rate reports were of the least acceptable quality. With respect to balance of payment statistics, banks had difficulties complying with the regulations governing the preparation of reports on HUF and derivatives transactions with non-resident customers.

As to the findings of on-site inspections on money circulation, it can generally be stated that compliance with legal regulations has improved, even though inspections of payment transactions did reveal deficiencies at all credit institutions, mainly in the field of the acceptance, filing and performance of orders, executing pre-authorised collection orders ranked favourably and data supply on payment transactions.

The Bank continued to examine the data supply from non-financial companies and from other financial institutions. The so-called first round of on-site inspections of non-financial institutions, which are the most important in respect of balance of payment purposes, was completed. The inspections identified errors similar to those discovered at companies inspected during the previous year. Such problems were mainly related to the reports providing data used directly in the compilation of balance of payment statistics and to the lack of comprehensiveness of the data reported. Although awareness of reporting obligations has improved, some companies were still completely unaware that they were required to provide data on their rest-of-the world transactions for the MNB without being specifically requested to do so.

MNB continuously updated the balance of payment data based on the measures related to inspections.

The findings of inspections of cash processing activity in 2003 at credit institutions differed from those at money processing companies. Essentially, in performing their cash circulation-related tasks, the inspected credit institutions complied with the central bank's decrees on payment transactions, as in previous years. In the course of its inspection of money processing firms, the Bank found serious deficiencies at half of the inspected companies. These failed to examine or only partially examined the authenticity of banknotes and coins and their eligibility for circulation. In the case of seven units examined, it was found that already pro-

[1] Data supply, compliance with regulations on money circulation, on money processing and cash circulation activity, on compulsory reserve requirements.
[2] Credit institutions, other financial organisations, non-financial corporations and money processing firms.

cessed banknotes included some banknotes which were unsuitable for circulation.

In 2003, the Bank placed a great emphasis on monitoring the resolution of deficiencies identified by the previous inspections, and some 200 measures related to these inspections were prescribed. In order to check whether or not the measures required by the Bank had been carried out, the Bank conducted 15 post-inspections. The results of these post-inspections were not favourable at all institutions: not all the institutions inspected had performed all of the measures stipulated by the MNB.

Emphasising that in the course of on-site inspections the MNB examines all activities taking into consideration the entire scope of central bank expectations, it published the main priorities of the inspections to be carried out in 2004 as an appendix to its on-site inspection policy. Public disclosure of these priorities is intended to facilitate institutions in complying with legal regulations and ensuring that data meet the standards stipulated by the central bank.

IV. 3. PAYMENT SYSTEMS AND SECURITIES SETTLEMENT SYSTEMS

In 2003, the MNB's major objectives included EU accession-related legal harmonisation and infrastructure preparation as well as deepening of the co-operation among the participants of the payments system. The MNB and the major players in the payment business set up the Payment System Forum, which co-ordinates the rapid and concerted development of payment and securities settlement systems and payment services.

IV. 3. 1. Operations of VIBER (RTGS system of Hungary)

At year-end 2003, there were 36 VIBER participants, two less than at end-2002.

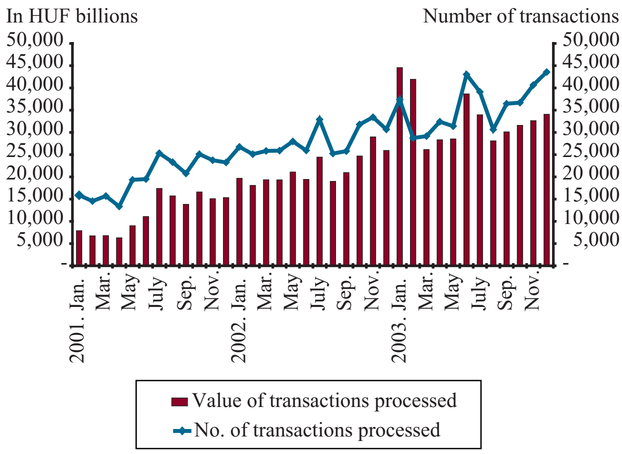
The proportion of VIBER transactions within the entire turnover of inter-bank forint payment transactions (comprising payment orders settled either in the ACH system or VIBER), exceeded 89% in 2003, compared to 85% in 2002. The combined turnover of the two systems was HUF 445 trillion, i.e. 24 times the amount of Hungary's annual GDP. As a rule, in the case of EU Member States, this indicator varies from 25 to 100.

The chart below plots monthly developments in payment turnover over the past 3 years.

In 2003, turnover in payment transactions accurately reflected the higher volatility of the money market.

Chart IV. 3-1

VIBER turnover in 2001–2003



While earlier years experienced broadly flat, steady monthly growth, January 2003 saw a jump, in mainly the amount of the turnover, owing to speculation about the appreciation of the exchange rate of the forint. In mid-2003, turnover peaked again, due to decisions affecting the exchange rate of the forint, manifesting itself in a sudden rise in the number of transactions, with turnover edging up moderately. In the final months of last year, again due to fluctuations in the exchange rate, turnover broke interim records and increased consistently from one month to the next, with the value of transactions also on the rise.

In 2003, 429,000 payment orders, representing HUF 397 trillion, were settled in VIBER. Relative to the preceding year (337,000 transactions), the number of transactions grew by 27%, with the value of transactions rising 53% (from HUF 259 trillion in 2002).

The average amount of a payment transaction has also continued to grow from year to year. In 2003, the average amount of a payment transaction was HUF 924 million, a 20% increase on the previous year's average figure (HUF 768 million). The volume and value of customer orders, representing smaller amounts as a rule, grew less spectacularly than interbank turnover.

In 2003, the average number of daily transactions amounted to 1,697, with an average daily turnover of HUF 1,568 billion. Turnover set a record on 21 January, when 5,221 transactions were settled, with a total value of HUF 6,043 billion.

The average monthly availability of VIBER was 99.22% in 2003, falling slightly short of the 99.77% average rate in 2002. In 2003, there were 18 system failures, owing almost invariably to breakdowns in the SWIFT connection and upgrades of related systems. The length of failure ranged from 4 to 69 minutes.

A sharp drop in charges by the MNB for payment transactions

Based on the policy on fees and charges approved by the MNB's Board of Directors in 2002, charges for payment transactions declined significantly. The principle underlying the new policy is to ensure that charges sufficiently cover the costs related to the account-keeping services provided by the Bank. VIBER members, for instance, were charged only HUF 750 per transaction in 2003, compared to an earlier amount of HUF 1,200. Lower fees allow VIBER members to reduce the VIBER charges that they debit to their customers.

Modifications of VIBER operating hours

As of 1 February 2003, business hours for the acceptance of payment orders initiated by the customers of VIBER members are an hour longer, with closing time at 15.30. This move was warranted by the needs of banks, mainly their non-resident clients. Longer business hours enable banks to extend their cut-off times for customers, providing for the possibility of longer daily disposability of the account balances. This has had a particularly benign impact on the liquidity of the securities market. It also allows for banks to arrange their own positions as late as 1 hour prior to the end-of-the day closing, as opposed to the 2 hours specified earlier. The amendment conforms with the practice typical in EU Member States (e.g. TARGET). With the new operating hours, an additional hour is no longer available for back-transferring erroneous items. The deadline for such back-transfers remains unchanged, i.e. 15.30 hours.

IV. 3. 2. Changes in legal regulations

On 28 April 2003, the Parliament passed the Act on the Finality of Settlements in the Payment and Securities Settlement Systems, which took effect upon Hungary's accession to the European Union. The Act is in keeping with Directive 98/26/EC, with an identical title, of the European Parliament and Council. The objective of the Act is to solidify the legal basis for the safe operation of payment and settlement systems and to meet Hungary's obligations arising from EU membership. Collateral pledged by members of the systems cannot be jeopardised by liquidation even if actions to impose solvency procedures are taken against the member that initiated payment transactions and pledged the relevant collateral. The law grants the MNB the powers of an authority of designation and notification. Central bank responsibilities include designation and public filings with the European Commission of systems under the scope of the Act and, in emergencies, the receipt and dispatch of notifications from and to authorities in a similar capacity in other member countries in the event of the insolvency of a member.

Act CXV of 2003, passed in December 2003, vested the MNB with the responsibility for enhancing the safe and efficient operation of securities settlement systems. Based on its powers, the MNB is authorised to regulate and oversee the operation of securities settlement systems in order to maintain financial stability.

Government Decree 256/2001 (XII.18.) on the transaction titles for international payments was also modified at year-end 2003. As a result, the system for coding forint payments between residents and non-residents became more regulated. Amendments to the Government Decree also warranted the amendment of MNB Decree 9/2001 (MK 147.) on the rules governing payment services and cash processing. With the addition of new fields for data entry, the PF1 form used for transfers is now suitable for the uniform recording of transaction and country codes.

IV. 3. 3. A comprehensive assessment of the Hungarian securities settlement system (KELER) in the light of ESCB user standards

The development of payment and securities settlement systems is a time consuming and capital intensive process. Therefore, planning ahead is essential lest these systems hamper the safe and efficient use of the monetary policy instruments of the central bank in the course of introducing the euro. Pursuant to a decision of the ECB's Governing Council passed in September 2002, the ECB provided assistance to the accession countries' national central banks in assessing their securities settlement systems in the light of the user standards for securities settlement systems involved in Eurosystem credit operations. The objective of the evaluation was to pinpoint any potential deficiencies in the systems and resolve them in a timely manner. In the course of the assessment process, the MNB reviewed the self-evaluation prepared by KELER, while conducting on-going consultations with the Central Bank of Luxembourg participating as a second assessor as well as the ECB, which compiled the final report.

The report approved by the ECB's Governing Council stated that KELER is essentially eligible for use in Eurosystem lending transactions. However, it also proposed a few recommendations, which KELER should take into consideration in the course of its future operations.

IV. 3. 4. Assessment of participation in TARGET[3]

Pursuant to the decision of the ECB's Governing Council passed in October 2002, the new member states may join TARGET1 (i.e. TARGET currently in place) from the date of their EU accession, i.e. prior to their EMU entry. Following prior consultations with domestic banks, the MNB decided not to establish a euro RTGS system and not to join TARGET1. Payment transactions in euro will continue to rely on correspondent banking services. The MNB intends to provide settlement services for banks in Hungary in TARGET2 (replacing TARGET1 currently in place) as soon as it starts operating.

IV. 3. 5. Establishment of the Payment System Forum

The Payment System Forum (PSF) was set up in June 2003 at the initiative of the MNB, under the aegis of the Hungarian Banking Association. Upon the joint invitation of the MNB and the Hungarian Banking Association, senior executives of 10 banks (the most important players in the payment system), and the Hungarian State Treasury attended the founding session held at the MNB. The MNB wishes to establish a consultative organisation, which is capable of responding flexibly to the challenges facing payment systems in terms of efficiency, transparency and security in the context of integration into the EU and EMU. The responsibility of the Forum is to analyse all issues that cannot be addressed without the co-ordinated activities of the participants. Several working groups comprising experts from the MNB and the commercial banks will elaborate potential solutions for open issues. The Forum was established along the lines of the European Payments Council founded by European banks, under the aegis of European central banks.

IV. 3. 6. International payment system conference

The MNB considers it important to provide Hungarian market participants with up-to-date information on international trends, development models and consolidation processes in payment systems. At its second international conference held in October 2003, internationally recognised experts delivered lectures on the most topical issues. Representatives of domestic banks attended lectures on CLS Bank, which was founded to reduce foreign exchange settlement risk, on the further development of the TARGET system in which urgent, large value payments are effected and settled and on EBA STEP2, the first pan-European system to handle bulk payments. The presentations provided a good overview about the establishment and operation of the aforementioned systems.

IV. 4. MANAGEMENT OF FOREIGN EXCHANGE RESERVES AND RISK MANAGEMENT

IV. 4. 1. Objectives of holding reserves

The MNB Act states that management of Hungary's foreign exchange reserves is a core duty of the Magyar Nemzeti Bank. The basic objectives of managing foreign exchange reserves remained unchanged in 2003 and were the following:

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

The primary aim of reserve management is to support monetary policy. 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 interventions, and fulfilment of the Maastricht exchange rate criteria on the way to joining the EMU.

In 2003, the MNB intervened strongly in the foreign exchange market both as a seller and a buyer, thereby significantly influencing the level of the foreign exchange reserves. In January 2003, owing to the Bank's intervention at the strong edge of the band, reserves rose sharply, and then in the second half of 2003 they returned to the EUR 10-11 billion level seen at year-end 2002.

Recent years have seen immediate transaction objectives, i.e. supporting the servicing of debts, take an increasingly low profile. The reasons for this include Hungary's economic development, its improving credit ratings and debt service indicators, and the resulting increased interest in foreign exchange bonds issued by Hungary as well as an increase in the number of investors. This trend is clearly reflected by the fact that the credit spread of FX-denominated Hungarian government debt has remained fairly stable recently, with risk premia gradually narrowing. Nevertheless, as attested by the cash movements last year, the importance of the transaction objective should not be underestimated. The joint debt service by the MNB and the Government in 2003 amounted to approximately EUR 3.5 billion, which comprises repayment of principal, interest payments and prepayments. In 2004, approximately EUR 2.2 billion will be paid out in debt service.

[3] TARGET is a payment system established by connecting RTGS systems, which arranges euro payments within and between EU-member countries.

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While the costs of holding reserves have fallen considerably (owing to Hungary's improved credit ratings and yield convergence related to EMU entry), the MNB still does not wish to maintain reserves purely for the purposes of accumulating wealth.

IV. 4. 2. Investment policy

In respect of the classical investment triad of return-safety-liquidity, the Bank's investment philosophy is to maximise profit on a given portfolio, while complying with high-level safety and daily liquidity requirements. The Bank's principal idea behind the compilation of the investment guidelines is to adopt the best practices followed by the central banks of developed countries. As all other central banks, the Magyar Nemzeti Bank also pursues a fundamentally conservative investment policy.

This means that it avoids trading in securities with strong fluctuations in prices, and thus it does not invest in equities. The maximum allowed maturity of bonds 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 developed countries, large international financial institutions and government agencies.

Since the forint exchange was pegged to the euro basket, the euro has played a decisive role in the composition of foreign exchange reserves. Beyond this, the direction of Hungary's economic integration, the composition of its foreign exchange debt and the fact that the euro is the number one intervention currency for the Bank all justify the significant weight of the euro.

Within its foreign exchange reserves, the Bank distinguishes between liquidity and investment portfolios, in accordance with international practice. Its aim in holding a liquidity portfolio is to ensure daily liquidity, such as on-going repayments of interest and principal and foreign exchange market intervention, and specific transactions and transfers. This portfolio can be characterised by low interest rate risk and a short-term investment horizon.

The investment portfolio, accounting for a higher share of total reserves, is that part of reserves which is intended to be held stable over the long term; therefore, it is subject to more pronounced return requirements than the liquidity portfolio. Although it is a basic requirement of the investment portfolio that securities should be easily marketable, its stable composition makes it possible to invest in bonds with longer average durations, depending on market outlook.

The structure of in- and outflows of the past years and their average amount compared to the level of reserves reveals that in order to optimise the relative weight of the two portfolios, the MNB should continue to keep 20% and 80% of its reserves in liquidity and investment portfolios, respectively.

IV. 4. 3. Adequacy of reserves

Reserves rose from EUR 9.9 billion at end-2002 to EUR 10.1 billion in 2003. Nevertheless, the amount of reserves fluctuated significantly during the year. Massive intervention at the edge of the fluctuation band on 15 and 16 January 2003 significantly increased reserves to EUR 14.2 billion. Declining steadily all through the year, they stood at EUR 10.1 billion at year-end 2003. Underlying the latter development was the fact that the MNB's measures of 16 January (when the MNB widened the O/N interest rate corridor, in addition to lowering interest rates) marked the start of an outflow of speculative capital. This initially took the form of open interventions, and then later the Bank used foreign exchange auctions and other foreign exchange instruments to provide for euro outflows. The Government's two bond issues worth EUR 1 billion each, its receipt of EUR 500 million in syndicated loans coupled with an additional EUR 200 million in other loans, and the settlement of Russia's government debt of USD 82 million to Hungary also resulted in an upsurge in reserves. The return earned on the portfolio amounted to EUR 300 million. Mark-to-market hedging transactions and the weakening of the dollar caused euro-denominated reserves to drop by EUR 460 million and EUR 210 million, respectively. Changes in the total outstanding holdings of foreign exchange deposits with the MNB brought about a decrease of EUR 180 million. The items stemming from the MNB's debt service (interest burden, repayment and pre-repayment) were high, reducing foreign exchange reserves by around EUR 3.5 billion.

IV. 5. CURRENCY ISSUING ACTIVITIES

One of the fundamental tasks of the Magyar Nemzeti Bank is to provide banknotes and coins in the appropriate amount, quality and denomination for Hungary's currency circulation. The Bank discharged this task in full at the Main Cashier's Desk in Budapest and at the cashiers' desks at the regional directorates in 2003.

Banknotes and coins needed for the national cash turnover are manufactured by Pénzjegynyomda Rt and Magyar Pénzverő Rt, both in the Bank's ownership.

IV. 5. 1. Cash turnover and processing activity

In 2003, the Main Cashier's Desk of the Magyar Nemzeti Bank, together with the cashiers' desks at the regional directorates, registered a turnover of HUF 3,610 billion, which was 2.5% higher than a year earlier, but was lower than the growth rate of cash in circulation. The reason for this was the fact that participants in cash payment transactions meet each other's cash requirements to an increasing degree every year.

The Bank charges cash handling and exchanging fees to its customers for cash turnover on their bank accounts kept with the Bank and exchange where the number of the banknotes and coins exchanged exceeds one hundred per denomination (HUF 0.8 per banknote and HUF 0.1 per coin). In May 2003, in order to facilitate the circulation of small-denomination (i.e. 1-, 2- and 5-forint) coins, the Bank waived its cash handling and exchanging fees to be paid upon the payment or exchange of these denominations.

In the course of 2003, customers paid 331 million banknotes into the MNB's cash desks. These banknotes were also examined for authenticity and suitability for circulation. Each banknote in circulation was processed 1.4 times on average in 2003, which represents a slight decline relative to the corresponding figure of the previous year.

IV. 5. 2. Cash in circulation

On 31 December 2003, currency in circulation amounted to HUF 1,458 billion, up 15% (HUF 188 billion) on end-2002. Compared to the first half-year, the growth rate in the second half-year fell by 3%. (The spillover effect into 2003 of wage corrections in 2002 and wage raises in early 2003 led to a significant increase in the first half-year.)

The average amount of banknotes and coins in circulation over the year as a percentage of GDP at current prices, rose from 7.1% in 2002 to 7.3% in 2003, owing to a higher-than-GDP growth rate of cash. The average growth rate of cash in circulation was 16% in 2003, exceeding the growth rate of GDP by 4% at current prices.

Chart IV. 5-2

Increase in GDP at current prices and the annual average value of cash in circulation on a 1996 base

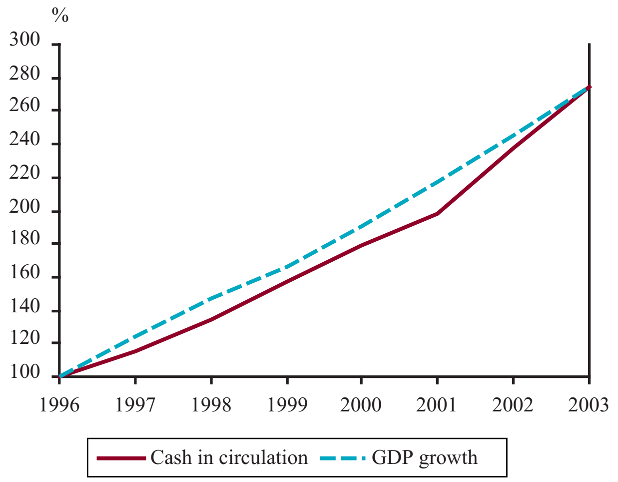

Chart IV. 5-3

Cash in circulation

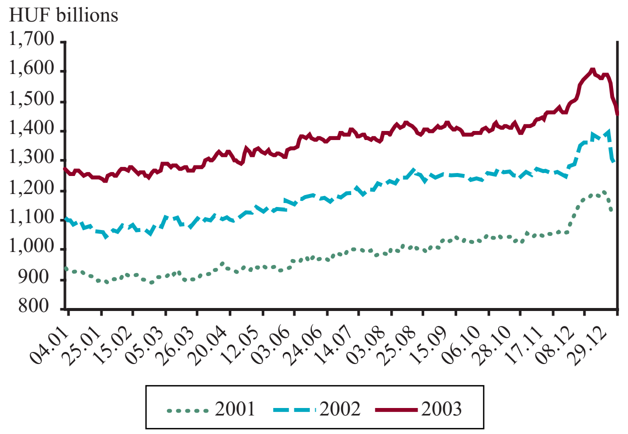

Table IV. 5-1

Cash in circulation on the last business day of 2002 and 2003

	2002	2003	Change	
	HUF billions			%
Banknotes	1,245.4	1,431.3	185.9	114.9
Coins	23.0	24.5	1.5	106.5
Cash for circulation	1,268.4	1,455.8	187.4	114.8
Commemorative notes and coins	2.5	2.6	0.1	104.0
Cash in circulation	1,270.9	1,458.4	187.5	114.8

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During the year changes in the value of banknotes and coins in circulation showed seasonal fluctuations similar to the previous few years – the lowest values were measured in late January, the highest ones in December, prior to the Christmas holiday. A share of currency that entered circulation because of early month wage outflows returned to the Bank by the middle of month. The growth rate of cash in circulation peaked at 19% in April, then slowed in the second half of 2003. Compared to late November figures, cash turnover increased by HUF 107 billion in December, owing to the approaching Christmas holiday.

In 2003, the average amount of forint cash per capita was HUF 135,000, the number of banknotes and coins being 23 and 200, respectively. The value of banknotes and coins per capita rose by 14% relative to the previous year, while the number of banknotes and coins increased by 1 and 17, respectively. (In the euro zone, the number of euro banknotes and coins per person was 29 and 159, respectively, at year-end 2003.)

Within cash for circulation, banknotes and coins accounted for 98% and 2%, respectively, in 2003, broadly comparable with earlier years.

Table IV. 5-4

Banknotes in circulation on 31 December 2003

Denomination	Quantity	Value	Percentage share	
	millions	HUF millions	Quantity	Value
20 000 forint	22.6	450,941	9.2	31.5
10 000 forint	75.8	757,843	31.0	52.9
5 000 forint	25.1	125,665	10.3	8.8
2 000 forint	17.1	34,242	7.0	2.4
1 000 forint	43.8	43,836	17.9	3.1
500 forint	22.4	11,197	9.2	0.8
200 forint	37.7	7,535	15.4	0.5
Total	**244.5**	**1,431,259**	**100.0**	**100.0**

Table IV. 5-5

Coins in circulation on 31 December 2003

Denomination	Quantity	Value	Percentage share	
	millions	HUF millions	Quantity	Value
100 forint	129.3	12,931	6.0	52.8
50 forint	73.2	3,658	3.4	14.9
20 forint	147.3	2,946	6.9	12.0
10 forint	179.1	1,791	8.4	7.3
5 forint	231.5	1,157	10.8	4.7
2 forint	628.7	1,258	29.4	5.2
1 forint	750.2	750	35.1	3.1
Total	**2,139.3**	**24,491**	**100.0**	**100.0**

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IV. 5. 3. Banknotes in circulation

The total value of banknotes in circulation was HUF 1,431 billion at end-2003, up 15% on end-2002. By contrast, owing to a significant increase in the proportion of 20,000-forint banknotes, the number of banknotes in circulation increased by a mere 8%.

The average face value (i.e. the value of banknotes in circulation/the number of the banknotes in circulation) of the banknotes in circulation at year-end 2003 was HUF 5,854 representing a 6% increase on a year earlier. The average face value of euro banknotes in circulation at year-end 2003 was EUR 48 (HUF 12,587).

IV. 5. 4. Coins in circulation

The number of coins in circulation was 2,139 million at end-2003, representing an increase of 206 million or 11% on the previous year. More than 70% of the increase was accounted for by the stronger-than-average rise in the number of small-denomination coins (1- and 2-forint coins). The value of coins in circulation rose by 7%, or HUF 2 billion, relative to a year earlier.

The breakdown of coins in circulation by denomination showed no significant changes with respect to number and value in 2003 as compared with 2002.

IV. 5. 5. Expert analysis and development activities concerning banknotes and coins

The Bank performs expert analysis and special inspection of suspected forint counterfeits and various foreign banknotes and coins throughout the Republic of Hungary. In 2003, this activity was focused on preparation for Hungary's EU accession. The president of the ECB and the governor of the MNB signed an agreement to combat euro counterfeiting. The preparation of the establishment the National Counterfeit Centre was completed, and the development of the technical background, according to EU requirements, commenced.

Chart IV. 5-6

Forint counterfeits: number of cases and quantity

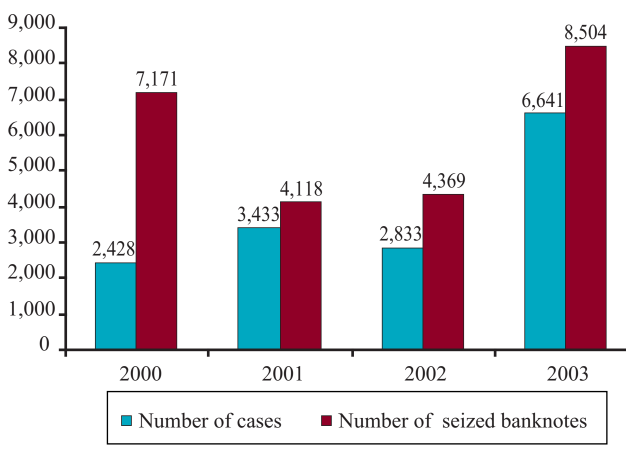
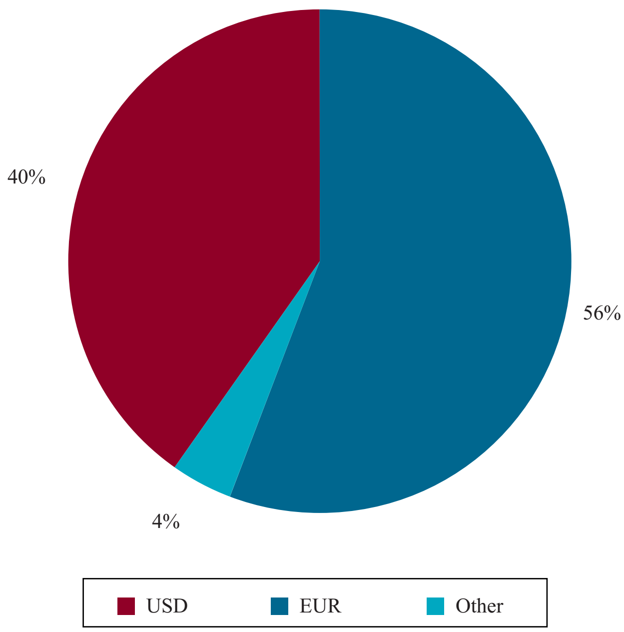


Chart IV. 5-7

Breakdown of foreign currency counterfeits seized in Hungary in 2003



Following a period of stagnation in the counterfeiting of the new series of banknotes since 2001, the number of counterfeit forint banknotes nearly doubled in 2003 relative to a year earlier. In 2003, the MNB's banknote experts identified 8,504 counterfeit forint banknotes, stemming from 6,641 cases of counterfeiting. The increase relative to a year earlier can be attributed to the higher number of colour printed counterfeits of the 1,000-forint note.

Despite the significant increase, the extent of counterfeiting did not pose any danger to the security of cash turnover. In 2003, out of 1 million banknotes in circulation, 36 were counterfeits, which can be regarded as average by European standards.

Compared to a year earlier, the number of foreign currency counterfeiting cases declined slightly. Understandably, within this, the proportion of euro counterfeits grew in the second year of issuance. Fifty-six per cent of the foreign currency seized in Hungary were euro counterfeits.

IV. 5. 6. Issue of commemorative coins

In 2003, the Magyar Nemzeti Bank issued four silver commemorative coins and one jubilee circulation coin.

IV. 6. STATISTICAL SERVICES

IV. 6. 1. Legal background of the Bank's statistical activities

Article 4 of Act LVIII of 2001 on the Magyar Nemzeti Bank defines the collection of statistical information and the operation of an appropriate information system as a core duty of the MNB. Article 28 in Chapter II of the Act also defines the range of institutions providing financial services that the Bank may directly mandate to report data.

In order to fulfil all its statistics-related tasks, the Bank collects data from a broader range of institutions than that defined by the MNB Act. Such data collection is carried out within the framework of the National Statistical Data Collection Programme (OSAP).

In line with Act LXIII of 1992 on the Protection of Personal Data and Disclosure of Information of Public Interest, the statistics-related activities of the Bank (as a member of the National Statistical Service) are governed by Act XLVI of 1993 on Statistics, also.

Inviting the respective opinions of the Ministry of Finance and the Hungarian Financial Supervisory Authority and working in close co-operation with the Central Statistical Office, the Bank devises the methodology that forms the basis of data collection as well as the operation of its information system.

IV. 6. 2. Preparation for EU accession

The key requirements of EU accession include the adoption of statutory and recommended EU methods and compliance with data and information disclosure obligations. In compiling its statistical data the MNB attempts to employ the methodological principles already harmonised by international institutions. The MNB complied with all the data disclosure obligations pertaining to accession countries in 2003. Accordingly, it regularly provided data to Eurostat, the EU's statistical office, and the European Central Bank (ECB).

The national central banks are responsible for the provision of statistical data, as stipulated in a statutory obligation by the ECB for member states. These duties warranted the preparation of new statistics and the introduction of data collection needed for such statistics; furthermore, the existing form of data collection as well as available statistics and their publication schedule had to be modified. Working in co-operation with ECB experts, the Statistics Department began preparation in 1999. As a result, statistical activity at the Bank was fundamentally harmonised with ECB requirements by 2003.

IV. 6. 3. Statistical activity

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

The MNB's Statistics Department is responsible for collecting, processing and disseminating data related to monetary, balance of payments and financial accounts statistics, as well as for discharging the tasks linked to the Bank's data reporting obligations.

As regards data collection, monetary statistics was the field in which the most important changes were made. This was due, on the one hand, to the adoption of the ECB's requirements, and, on the other, to the fact that the Bank required new data collections for the compilation of the financial accounts.

2003 saw significant changes in data provision related to statistical activities.

The introduction of regular data releases on the financial accounts as of 1 April 2003 was a milestone in the MNB's statistical activities.

In keeping with the new publication schedule effective from 2003, the MNB first published detailed balance of payments statistics based on quarterly data and the related press release on 30 June 2003.

From June 2003, the MNB's data releases via the Internet have included further statistics. Since 16 June 2003, the MNB has been publishing monthly securities issue statistics, in line with the ECB's recommendations and expectations.

The Internet is the primary channel for the release of statistical data, and processed data published as long time series on the Bank's website. Currently, under the menu 'Statistical time series', the MNB publishes monetary and balance of payments, financial account, price and exchange rate statistical and money and capital market time series.

In addition to the publication of time series, on dates set 6 months ahead in the publication timetable, the MNB also publishes monthly and quarterly press releases on certain topics, including monetary and balance of payments statistics and the ownership distribution of securities.

In 2003, the MNB conducted a survey on user satisfaction regarding its statistics-related releases on its website. The objective of the survey was to better understand users' opinions and needs, which the Bank's Statistics Department could take into consideration in its future development projects.

To improve the quality of the statistics, in 2003, the Bank all statistical areas were integrated in its quality assessment system. In order to be able to monitor the risk level of statistical data processing, the Bank worked out checklists and specified their contents, structural principles and risk limits. It also defined the areas to be audited and the scope of such audits.

Monetary statistics

Processing the balance sheet data of monetary financial institutions (i.e. credit institutions, money market funds and the central bank), the monetary statistics prepared by the MNB provide information on trends in credit portfolios and cash flows and changes in the positions of the individual sectors vis-à-vis monetary financial institutions. Monetary statistics also include market (i.e. non-financial corporation, household and interbank) rate statistics.

Major changes in the MNB's monetary statistical activities in 2003 included the following:

• With respect to monetary statistics, the MNB switched to the preparation and publication of monetary aggregates calculated according to the methodology employed by the ECB. Furthermore, also in compliance with ECB's stipulations, the data content of press releases on market rates also changed.

• In the interest of compliance with EU practice and international comparability, the MNB also revamped its publications. It standardised the structure of the monetary balances published, expanded the range of the data released and began publishing seasonally adjusted data on monetary aggregates.

• As regards data collection in 2003, a material change occurred in the area of supervisory balance statistics. The reason underlying this change was the fact that the MNB, in keeping with the project it announced in May 2000, fully integrated ECB criteria for monetary statistics into its 2003 guidelines.

Balance of payments statistics

Balance of payments and international investment position statistics record economic transactions between residents and non-residents as well as the actual balances of and movements in assets and liabilities.

Major events in the area of balance of payments statistics were as follows in 2003:

• In the interest of adjustment to international methodological standards and compliance with macro-economic statistical data, major methodological changes occurred. This meant that for trade in goods the MNB replaced the settlements data with customs statistics, and brought touristic data in line with the national accounts. The MNB published the balance of payments statistics compiled on the basis of the new methodology for the first time on 25 February.

• Concurrently, a new publication and data revision schedule was introduced as of January 2003. The publication focused on quarterly rather than on monthly data. In addition to publishing statistics on international reserves, the MNB publishes only the balance of payments comprising major aggregates on a monthly basis. It prepares and publishes a detailed balance of payments statistics and data on assets and liabilities vis-à-vis the rest of the world only on a quarterly basis and annually.

• As a result of a close co-operation between the MNB and the Central Statistical Office (CSO), in the areas of customs statistics and foreign direct investment statistics, a new set of questionnaires on trade in services has been introduced.

Financial accounts

The compilation of financial accounts and the launch of related regular data provision have recently been key strategic issues at the MNB. Financial accounts statistics as an integral part of the system of national accounts, showing the financial assets and liabilities of the Hungarian economy as well as the components of changes in financial wealth, are instrumental for examining the development and the state of the system of financial intermediation and analysing the financial relationship among players of the economy. In compiling and publishing financial accounts, the MNB fully complies with ECB requirements. As regards the content of statistics, the frequency of their publication and the breakdown of the data published, the financial accounts statistics prepared by the MNB can be considered top-notch by European standards. The regime of regular quarterly releases was introduced on 1 April 2003.

Securities statistics closely linked with financial accounts are based on reports by securities custodians, and provide information on stock of government securities, investment fund units and quoted shares as well as their distribution between economic participants. In 2003, further data were included in securities statistics. As of 16 June 2003 the MNB, in keeping with ECB recommendations and expectations, publishes aggregate data on securities issuance in a breakdown of issuers.

IV. 6. 4. International data provision

In accordance with its position and the requirements arising from international co-operation 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 (IMF), World Bank, Organisation for Economic Co-operation and Development (OECD) and the Central European Statistical Co-operation (CESTAT). The Bank provides data meeting the high-standard requirements of SDDS (Special Data Dissemination Standard) and applying the methodology recommended by various international organisations. In 2001, the Bank joined the database of the Bank for International Settlements (BIS). The preparation of data provision was completed by year-end 2002, with regular data provision for BIS launched in 2003.

IV. 6. 5. Co-operation with domestic institutions

Statistical work in the MNB makes it indispensable to maintain close co-operation with domestic fellow institutions, mainly the CSO, the Ministry of Finance and the Hungarian Financial Supervisory Authority (HFSA), in addition to international institutions.

A framework for professional co-operation between the MNB and the CSO was established in an agreement signed by the governors on 8 February 2002. The two institutions specify the areas of co-operation and actual tasks in an annually updated itemised agenda. Some of the high-profile items on the 2003 agenda were the additional elaboration of the methodology applied for the balance of payments and widening co-operation.

In preparing general whole-of-government sector accounts, which are integral to financial accounts, the Bank also works in close co-operation with the Ministry of Finance.

As regards monetary statistics, the MNB and the Hungarian Supervisory Financial Authority (HFSA) have required credit institutions to submit joint balance sheet reports since early 1998. The co-operation agreement signed between MNB and the HFSA and updated annually, also covers information exchange and co-ordination of other tasks.

IV. 7. FINANCIAL RESULT OF THE MAGYAR NEMZETI BANK AND ITS FINANCIAL MANAGEMENT

The MNB's profit in 2003 amounted to HUF 78.5 billion, up HUF 83.4 billion on the previous year. This increase in profit can primarily be ascribed to exchange rate gains generated by the sale of the foreign currency bought by the MNB as part of the intervention.

The financial result of the Magyar Nemzeti Bank is primarily influenced by the objectives and instruments of monetary policy. The implications of such activities on the financial result may not prejudice the performance of the MNB's key tasks as defined in the MNB Act; as a result in its business activities the MNB focuses mainly on reasonable and cost-efficient operations.

The following section outlines core central bank tasks, the impact of economic events and measures in 2003 on the Bank's results as well as the internal operations of the Bank in 2003.

IV. 7. 1. The MNB's results in a breakdown by function

As well as return on equity, seigniorage - a special source of income for central banks - also contributes to covering the operational costs of central banks. Seigniorage arises from the Bank's monopoly on issuing notes and coins and its authority to set compulsory reserve requirements for credit institutions: the resulting interest-free or below-market rated funds generate significant income compared to the raising of market-rated funds.

The MNB's balance sheet reflects the structure of assets and liabilities arising from central bank operations. Most of the assets and liabilities cannot be matched with certainty; thus for instance, there is no way of knowing which assets are financed by banknotes and coins in circulation. By contrast, the contribution of seigniorage can be defined, relative to market-rated funds and the central bank base rate; furthermore, comparing the base rate to rates on assets and liabilities, one can gain an insight into the use of seigniorage, the Bank's main source of income. The following provides an outline of the activities that affected developments in the MNB's results in 2003.

Seigniorage not only provides the financial background for the Bank to perform its tasks as a central bank, but is also closely linked to two core central bank tasks, i.e. banknote issue and activities related to credit institutions. Seigniorage adjusted for currency issue and banking operations costs resulted in a profit of HUF 104.6 billion in 2003, down HUF 6.0 billion on the previous year. This can be attributed to several, mutually opposing developments:

• the average stock of banknotes and coins in circulation rose by 15.7% in the year under review, representing an increase of HUF 15.7 billion;

• reduction in the base rate resulted in a decrease in profit amounting to HUF 6.8 billion;

• owing to higher interest on the minimum reserves of credit institutions and a drop in the average stock of deposits, additional interest expenses reduced the

Table IV. 7-1

Breakdown of the profit of the MNB by functions

HUF billions

No.	Description	2002	2003	Change
(1)	*(2)*	*(3)*	*(4)*	*(5)=(4)-(3)*
1	*Seigniorage*	*125.3*	*119.4*	*-5.9*
2	*Cost of currency issue*	*-2.1*	*-4.1*	*-2.0*
3	*Net operating expenses**	*-12.6*	*-10.7*	*1.9*
4	Adjusted seigniorage (1+2+3)	110.6	104.6	-6.0
5	Cost of fisical activity undertaken on behalf of the government	-1.3	-0.9	0.4
6	Cost of foreign currency reserves and liquidity management	-103.0	-39.8	63.2
7	Other (primarily revaluation reserves and capital)	-11.2	14.6	25.8
8	**Accounting profit (4+5+6+7)**	**-4.9**	**78.5**	**83.4**

** „Operating income” less „Operating cost and expenses” in the Profit and Loss Account.*

amount of seigniorage by HUF 14.9 billion compared to the previous year.

The Bank's activities related to fiscal activity undertaken on behalf the government include the economic policy-related refinancing of credit institutions and earlier lending to the general government (Table IV 7.1 Line 5). The impact of the Bank's economic policy-related refinancing lending activity on the balance sheet and on the profit has been diminishing , which can be attributed to rationalisation and to phasing out activities. Refinancing loans, owing to rationalisation in earlier years and repayments, no longer exert a significant impact on the Bank's profit. The HUF 0.9 billion cost recorded as 'Cost of fiscal activity' assumed on behalf of the government arises from non-market interest on loans to the government.

A loss of HUF 39.8 billion incurred on foreign exchange reserve and liquidity management functions performed as part of the central bank's monetary policy activities (Table IV 7.1 Line 6). The cause of the incurrence of this loss is a considerably lower level of foreign exchange market rates, relative to the central bank base rate.[4] In addition to the interest differential, another important factor is the exchange rate gain or loss arising from foreign exchange reserve management. The decrease of HUF 63.2 billion in the cost of implementing monetary policy can be traced mainly to this very factor.

The profit of HUF 14.6 billion recorded under 'Other items' (Table IV 7.1 line 7.) can be attributed to equity, including primarily revaluation reserves that do not bear a significant amount of interest; i.e. similarly to what could be seen in the case of monetary policy, this factor was also exposed to changes in the exchange rate of the forint.

IV. 7. 2. Major events and measures determining the balance sheet and income statement

The structure of the Bank's balance sheet has essentially been shaped by macroeconomic developments and monetary policy measures implemented over the past few years. Major events that determined the balance sheet and income statement in 2003 were as follows:

• foreign exchange market intervention in January 2003 and the resultant sale of foreign exchange purchased during the intervention to credit institutions and to government;

• the maturity of forint receivables from the government and that of foreign exchange debts transferred partially to the government;

• changes in the exchange rate of the forint;

• changes in the central bank base rate;

• adjustment of the interest on credit institutions' minimum reserves to the central bank base rate; and

• increase in the number of banknotes and coins in circulation.

Due to the speculative attack against the forint's exchange rate band in mid-January 2003, the exchan-

[4] As seigniorage is defined relative to the central bank base rate, a similar method should be applied to its appropriation.

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ge rate of the forint reached the strong edge of the band. As a result, the MNB was forced to intervene in the foreign exchange market. In the course of this intervention the MNB purchased foreign exchange in the value of EUR 5.3 billion, of which it sold EUR 4.4 billion in the foreign exchange market and the central government over the rest of the year. Sales were a response to the considerable weakening of the exchange rate of the forint, with the combined effect of changes in the exchange rate and massive sales of foreign exchange being HUF 88.8 billion in realised exchange rate gains.

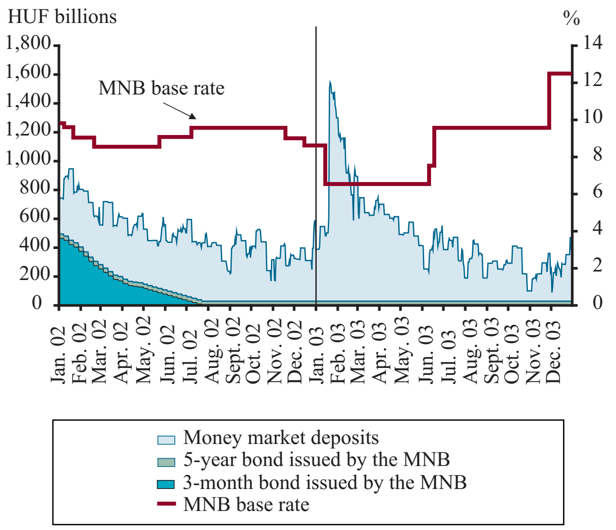
Owing to purchases and sales, the net foreign exchange position rose by EUR 0.9 billion relative to late December 2002. Consequently, it amounted to EUR 8.7 billion, or HUF 2,279.3 billion in late December 2003. The increase in the net foreign exchange position was reflected in falling foreign exchange debts and an increase of EUR 0.2 billion in foreign exchange reserves. As a result, foreign exchange reserves amounted to EUR 10.1 billion (HUF 2,659.5 billion) at year-end 2003. Despite a rise in foreign exchange balances, interest revenues fell by HUF 2.6 billion, the reason for this being that FX interest rates were, on average, lower than the year before.

In 2003, the official exchange rate of the forint weakened by 11.2%. A weaker forint exchange rate led to an increase in the forint-denominated value of the foreign exchange reserves and all FX-denominated items. The overall revaluation impact in 2003 was a gain of HUF 288 billion. Of this, the MNB realised HUF 88.8 billion in profit, while revaluation reserves, an equity component, rose by HUF 199.2 billion.

Simultaneously with FX purchases and sales, changes occurred in the Bank's forint liabilities as well, as is best illustrated by changes in liquidity-absorbing instruments.

Chart IV. 7-2

Liquidity management in 2002–2003



Liquidity-absorbing instruments were affected by changes in the FX position and changes in the structure of forint receivables and liabilities. Key components included a decrease of HUF 125 billion, owing to the maturity of receivables from the central government and an increase of HUF 187 billion in the value of banknotes and coins in circulation. Overall, changes in forint-denominated balances reduced liquidity in the forint market. As a result, the balance of the MNB's

Table IV. 7-3

Consolidated balance sheet of the MNB

HUF billions

No.	Receivables	2002	2003	No.	Liabilities	2002	2003
1	Forint receivables from the government	394	269	7	Bank notes and coins in circulation	1 271	1 458
	of which: receivables because of the forint exchange rate equalisation reserve	83	0	8	Bank Account Deposit	366	303
2	Foreign currency receivables from the government	852	623	9	Liquidity absorbing instruments	555	445
3	Refinancing credits	21	12	10	Forint desposit by central government	51	94
4	Foreign currency reserves	2 340	2 659	11	Foreign currency liabilities to government and credit institutions	126	182
5	Operating and other assets	625	616	12	Foreign and other foreign currency liabilities	1 677	1 305
				13	Operating and other liabilities	166	189
				14	Revaluation reserves	20	203
6	**Total assets (1+2+3+4+5)**	**4 232**	**4 179**	**15**	**Total liabilities (7+8+9+10+11+12+13+14)**	**4 232**	**4 179**

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Table IV. 7-4

Income statement of the MNB

HUF billions

	Description (P&L Lines)	2002	2003
1	Net interest and interest related income (I+II)-(X+XI)	16.1	7.6
2	Income arising from exchange rate changes (III-XII)	-3.4	88.8
3	Other constituents of net income* (IV+...+VIII)-(XIII+...+XVII)	-17.6	-17.9
4	**Profit for the year (1+2+3)**	-4.9	78.5
5	Revaluation reserve in the balance sheet		
6	*- due to non-realized foreign exchange gain/loss*	0.0	199.2
7	*- due to changes in the market value of foreign currency securities*	20.0	4.2

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

liquidity-absorbing instruments fell by an annual amount of HUF 110 billion.

The Bank's forint interest income was affected favourably by the structural rearrangement of stocks, mainly the rise of cash in circulation, which can be considered as interest-free funds. However, the forint-denominated interest balance dropped by HUF 5.9 billion as a combined effect of the factors described below:

• compared to a year earlier, the central bank base rate, in terms of weighted average, was 0.6% lower; accordingly, interest expenses incurred by liquidity absorption fell by HUF 11.1 billion;[5]

• also due to the lower level of interest rates, interest remunerated on the Treasury Account fell by HUF 1.4 billion relative to the previous year;

• interest on minimum reserves increased significantly, by an annual average of 3.1%, to 7.7%; as a result, interest expenses rose by HUF 11.8 billion; and

• the aforementioned decline in forint receivables from the central government reduced interest income by HUF 6.2 billion; a gradual decrease in the stock of refinancing loans resulted in interest income being HUF 0.7 billion lower than a year earlier.

On the whole, as a result of stock and interest impacts, interest income declined by HUF 8.5 billion in 2003. By contrast, income from changes in the exchange rate of the forint rose by HUF 92.2 billion. Along with a modest rise in expenses arising from other factors, the MNB's profit rose HUF 83.4 billion on the previous year.[6]

IV. 7. 3. General information on internal operations in 2003

The internal operations of the Bank are essentially aimed at (i) providing the resources required for the efficient discharge of the duties stipulated by the MNB Act and (ii) facilitating risk-free operations in the most cost-effective manner.

Regarding operating costs, rationalisation of the organisational structure and processes was launched in 2001 and continued in 2002, resulting in significant savings. Calculated at 2000 prices, operating costs in 2003 were nearly 30% lower than in 2000. As compared with 2002, annual operating costs in 2003 dropped

Table IV. 7-5

Changes in the costs of operation between 2000-2003

Description	2000	2001	2002	2003
Operation costs (HUF million)	15220	15196	13507	12700
Nominal index (previous year = 100%)	111%	100%	89%	94%
Inflation (yearly average)	110%	109%	105%	105%
Change in real terms (previous year = 100%)	101%	92%	85%	90%
Change (2000 = 100%)		92%	78%	70%
Change (2001 = 100%)			85%	76%
Change (2002 = 100%)				90%

[5] In early 2003, when the stock of money market deposits was high, the prevailing interest rate was 6.5%.
[6] For a detailed list of the developments in other factors of income, see the relevant sections of the Notes.

6% (over HUF 800 million) in nominal terms, and 10% in real terms.

Savings in 2002 were mainly attributable to the rationalisation of operations and to the upgrading and streamlining of processes in the previous year. In 2003, additional costs incurred in connection with restructuring decreased, and the organisational and the operational structure became more stable.

HUF 3,919 million was approved for capital expenditures in 2003, modified by the individual departments in the course of the year; of this, HUF 3,280 million (84%) was actually spent. Some capital expenditure projects were not completed prior to year-end 2003, owing partly to the fact that their completion was, ab ovo, expected to take longer than one year, and partly to the rescheduling of deadlines. Thanks to competition in procurement, suppliers' costs decreased, in comparison with the budgeted amounts.

Operating costs

In 2003, HUF 13,970 million was approved by the Board of Directors for operating costs, of which central reserves amounted to HUF 665 million. No additional spending from the central reserves was requested or approved during the year. HUF 15 million was credited to reserves from the financial budgets at cost managers' disposal.

Pursuant to a decision passed by the Board of Directors on 2 September 2003, there were no further (optional) wage raises in 2003. As a result, central reserves, hence the total amount of operating costs, fell by HUF 155 million.

The actual amount of operating costs amounted to HUF 12,700 million in 2003, which was HUF 807 million less than in 2002. (Reduction in costs in real value amounted to 10%.) Overall, expenses were 4% lower than what had been budgeted for 2003.

Reduction in costs can be attributed primarily to two factors:

• with respect to personnel costs, a significant reduction in costs incurred from the termination of employment, and

• with respect to banking operating costs, depreciation decreased considerably, owing to a decreasing number of capital investments from the previous years.

Personnel costs

Personnel costs amounted to HUF 8,418 million in 2003, representing a 7% decline over 2002. Essentially, three factors had an impact on costs:

• a 9.5% decline in the average number of employees;

• an average increase of 6% in basic wages, implemented in 2003; and

• an approximately 75% decline in costs incurred from the termination of employment.

The number of staff employed at the Bank fell from 984 to 946 in 2003. The average number of employees fell by 9.5%, primarily as a result of the carry-over effect of the measures taken at 2002. Balanced personnel

Table IV. 7-6

Operating costs

(1) Description	(2) Actual data for 2002	(3) Budget for 2003	(4) Actual data for 2003	(4)/(3) Index (2003 actual/ 2003 budgeted)	(4)/(2) Index (2003 actual/ 2002 actual)
			HUF millions	%	%
1. Personnel expenses	9057	8265	8418	102	93
2. General operation costs	4450	5025	4282	85	96
Total	13507	13290	12700	96	94
Changes in real term					90

Table IV. 7-7

Changes in the average number of employees

Description	2001	2002	2003	Difference (2003 / 2002)	
	(persons)	(persons)	(persons)	(persons)	(%)
Closing number of employees	1163	984	946	-38	-4
Average number of employees	1246	1058	958	-100	-9

management resulted in interdepartmental transfers representing 4.9%.

In 2003, 125 contracts of employment were terminated, 79% at the initiation of the employer and 21% at the initiation of the employee. The MNB entered into 69 new employment contracts to replace staff who left the Bank and to meet the labour demand arising from new tasks. There were also instances of replacement with more highly qualified staff members.

There was one person fewer in an executive position in 2003 than in 2002, which was the result of vacant executive positions.

In 2003, the proportion of the employees holding a college or university degree was 2% higher than at year-end 2002; it amounted to 81% in the case of new employees.

The actual total amount of personnel costs exceeded the approved 2003 budget by 2%, which can be attributed to the full-year effect of the 2002 measures as well as payments related to extraordinary assignments and events.

General banking operation costs

General banking operating costs amounted to HUF 4,282 million in 2003, representing a 4% decline over 2002. This can be ascribed to the fact that the proportion of declining costs within the cost components exceeded expenses that were higher than a year earlier in a manner described below.

IT costs in 2003 - amounted to HUF 755 million - were broadly the same as in 2002.

Within this cost category, the costs of material, maintenance and repairs related to hardware and telecommunications increased by over 27% relative to a year earlier. The underlying reasons for this increase include higher demand for accessories arising from a switch to a state-of-the-art data saving procedure and more comprehensive use of the services needed for the smooth operation of hardware systems in 2003 than in 2002.

Operating costs in 2003 (HUF 1,418 million) were broadly the same as in 2002. The decline in the real value of costs can be ascribed to the following factors:

• improved price efficiency in procurement procedures mainly through issuing invitation for new tenders for the engineering and electrical maintenance of buildings,

• economical management and use of material through widespread cost-saving solutions.

The amount of depreciation in 2003 (HUF 1,368 million) was 17% lower than a year earlier, fundamentally for two reasons:

• a lower number of investment projects in 2003 than in the years before, with constant, evenly distributed recording of the depreciation of the value of existing equipment;

• no depreciation was recorded in connection with the Logistics Centre, representing a large portion from the Bank's capital project-related expenses in 2003. The project is planned as a process scheduled to take several years.

Other costs amounted to HUF 957 million in 2003, representing an increase of over 30% compared to 2002. The underlying reason for this was that costs related to the establishment of a new system of services and foreign trade data collection, serving the needs of the CSO and the Bank, were first incurred in 2003. Furthermore, costs related to communications and travel abroad, owing mainly to the increased intensity of EU-EMU working relationships as well as an increase in the number of assignments related to the new strategy of pro-active communications, increased.

Investments

The Board of Directors approved the capital project budget for 2003 in an amount of HUF 4,195 million, which also included interim modifications. (Of this,

Table IV. 7-8

Investment programmes budgeted during 2003

(1)	(2)	(3)	(3)/(2)
Description	Rescheduled budget to 2003	Actual data for 2003	Index
	HUF millions		%
Modernisation of information technology	2005	1515	76
Logistics and other investment and acquisitions	654	669	102
Other investments, purchases	1260	1096	87
Total	**3919**	**3280**	**84**

A

itemised investment projects and central reserves amounted to HUF 3,919 and 276 million, respectively.)

Of the budget for investment projects in 2003, HUF 3,280 million was actually spent, representing 84% completion.

The 84% completion of the investment projects scheduled for 2003 can be attributed to three factors:

• the Bank was able to save on some investment projects, owing mainly to the tender procedure adopted;

• some capital expenditure projects were not completed prior to year-end 2003, owing partly to the fact that their completion was, ab ovo, expected to take longer than one year, and partly to the rescheduling of deadlines;

• some planned purchases did not need to be made, due to their relationship with other projects.

IT investments

In the interest of the continuous technical maintenance and development of IT equipment and business applications, HUF 1,515 million was spent on IT investment projects in 2003. Within this,

• *as part of the upgrading of IT infrastructure*

- new hardware (e.g. work stations, monitors and printers etc.) to replace obsolete, and partly incompatible, user hardware was purchased

- the IT system surveillance (the establishment of an internal firewall system and wider coverage of the equipment that can signal illegal intrusion to the system, etc.) was enhanced;

- the 2003 stage of the two-year development of the system of centralised data storage, saving and archiving was completed.

• *within the development of the integrated operating systems,* the version updates of the accounting subsystem (SAP) and the Kondor+ (within the transaction and payment subsystem) were completed; as were the establishment of new international payment subsystem, begun in 2002, and bringing it into line with the Bank's IT system.

• a large proportion of the development of *central bank statistics systems* was linked up with the Data Warehouse Project, which supports MNB analysis and publications and will continue also in 2004.

• *within the framework of supporting operative tasks,* a data recording system was set up, an IT environment needed for the introduction of teleworking was created, PC installation and logistics assignments related to the upgrading of technical infrastructure were implemented and carried out respectively and IT support was provided for process organisation and regulation.

Logistics Centre

The MNB intends to relocate the issue of banknotes and coins, one of its core activities, along with IT support and Hungarian Mint Ltd, to a new sophisticated logistics centre. Execution of the 2003 stage of this multi-year project cost HUF 668 million. The Board of Directors approved the implementation plan of the project in June 2003. With the architect selected, the process of planning gathered momentum. Permit plans were completed by year-end 2003, and purchase of the building site proceeded as planned.

Other investment projects and purchases

Approximately 60% of the remaining projects and purchases, amounting to HUF 1,096 million, were related to the preservation and technical upgrading of the buildings, close to 30% to the modernisation of cash processing equipment and approximately 10% to the purchase of equipment of a lesser proportion. Major assignments and purchases included

• *complete modernisation* of 3 BPS 3000 *banknote processing machines* in order to ensure smooth and safe operation;

• *establishment of a Visitor Centre* that houses the reference library, a numismatic museum and an exhibition room in the old cashier's room;

• *renovation* of one of the Bank's own buildings at Soroksári út to replace a rented record-keeping facility.

IV. 7. 4. Human resources management

In 2003, the MNB continued to pursue, even more vigorously than in the past, the human resources policy according to which the Bank supports interdepartmental transfers, and that vacancies and new positions should be filled by staff members. Accordingly, relative to a year earlier, the number of interdepartmental transfers and instances of promotion were higher and more numerous, respectively. This resulted in a higher mobility of the Bank's internal labour market.

In order to provide a more solid basis for its decisions in the process of employee selection and enhance the objectivity of such decisions, the Bank adopted additional methods for employee selection. The Bank now relies on interviews, tests and essays in assessing candidates' professional skills, and competence tests to identify personal skills. Executive feedback unequivocally proves the increased efficiency of the decision-making process.

In 2003, a new focal point in assisting new employees with orientation was that, in addition to programmes providing general information, each organisational unit implemented a job-specific training programme.

The objectives of the Pillér Project set for 2003 were achieved, including the employee opinion-based revision of the Code of Conduct, establishment of a new system of knowledge management (KM) and further development of the post-graduate training system. The fact that great emphasis is placed on the organisational values specified in 2002 is reflected in a shift in the executive focus, according to which continuous further education of employees is of key importance. This is further substantiated by the fact that participation in educational programmes more than doubled in 2003, compared to the previous year.

The objective of the establishment of a uniform knowledge-sharing system (KSS) is to ensure that the information and knowledge needed for work and work-related co-operation are available when appropriate, in a proper structure and within the framework of permanent knowledge maintenance. 2003 saw the establishment of the conceptual framework of the system, with its implementation carried over into the year to come.

The Bank participated in the 'Best Workplace' survey also in 2003. The survey examined employee satisfaction. Results indicate significant improvement over the previous year in terms of both satisfaction and commitment. Based on the results, feedback on the success of programmes implemented earlier was obtained. Furthermore, new programmes aiming at enhancing employee satisfaction were launched.

Within the framework of career management, staff members suitable, either immediately or over the short term, for the fulfilment of top and mid-management positions were identified. Staff members exhibiting top executive skills participated in specialised programmes for executives, the objective being to enable them, through the provision of efficient and targeted preparation, to fill top executive positions. Following the preparatory programme, a number of heads of division and heads of department positions were filled by staff members included in the above category.

The aforementioned system has become an integral part of the Bank; it supports the consistent implementation of the Bank's remuneration strategy successfully; furthermore, it serves as a basis for the majority of human resources systems (e.g. recruitment, educational programmes, career development and performance management etc.). In 2003, continually maintaining the system, the Bank managed to bring job descriptions fully in line with its Organisational and Operational Procedures, whereby they became more specific in terms of requirements.

As regards performance management, the Bank continued to co-ordinate the process of the breakdown and the interim monitoring of objectives in 2003. Involving executives, the Bank conducted a survey on the operation of the system, on the basis of which it carried out a few modifications in order to fine-tune and perfect applications.

As regards the system of remuneration, in 2003, the selection of optional benefits was further adjusted to employee demand and expanded in a manner that all opportunities provided by effective tax regulations could be economised on (e.g. Internet and holiday vouchers, etc.).

PART B

AUDITED FINANCIAL STATEMENTS

OF THE MAGYAR NEMZETI BANK


MAGYAR
KÖZTÁRSASÁG
5000
FORINT
2003
BP.
A·RÁKÓCZI-
SZABADSÁG-
HARC·300.
·ÉVFORDULÓJA
1703


HOLLÓKŐ
BP
MAGYAR
KÖZTÁRSASÁG
5000
FORINT
2003


MAGYAR
KÖZTÁRSASÁG
5000
FORINT
2003 BP.
1 0 0 0 1 0
1 1 0 1
Neumann János · 1903-1957


150 ÉVES A BUDAPESTI FILHARMONIAI TÁRSASÁG
MAGYAR KÖZTÁRSASÁG
1853
BP.
2003
5000 FORINT

B

I. Independent Auditor's Report

ERNST & YOUNG

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This is a translation of the Hungarian report

Independent Auditors' Report

To the Shareholder of Magyar Nemzeti Bank

We have audited the accompanying balance sheet of Magyar Nemzeti Bank ("the National Bank") as at December 31, 2003, which shows a balance sheet total of HUF 4,178,530 million and a profit for the year of HUF 78,464 million, the related profit and loss account for the year then ended and the notes included in the National Bank's 2003 annual financial statements. The annual financial statements are the responsibility of the National Bank's management. The auditor's responsibility is to express an opinion on the financial statements based on the audit and to assess whether the business report is consistent with that presented in the financial statements.

We issued an unqualified opinion on 17 April 2003 on the National Bank's annual financial statements as at 31 December, 2002.

We conducted our audit in accordance with Hungarian National Audit Standards and with applicable laws and regulations in Hungary. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our work in respect to the business report was limited to the above-mentioned procedures, and did not include the review of other information derived from records of the National Bank not audited by us.

We have audited the elements of and disclosures in the annual financial statements, along with underlying records and supporting documentation, of Magyar Nemzeti Bank in accordance with national audit standards and have gained sufficient and appropriate evidence that the annual financial statements have been prepared in accordance with the Act of LVIII of 2001, regulating the operations of the National Bank, and with the government decree of 221/2000 (XII.19.) regulating the accounting and preparation of the annual financial statements of the National Bank, and with the Hungarian accounting law and with generally accepted accounting principles. In our opinion, the annual financial statements give a true and fair view of the equity and financial position of Magyar Nemzeti Bank in accordance with the relevant regulations as at December 31, 2003 and of the results of its operations for the year then ended. The business report corresponds to the disclosures in the financial statements.

Budapest, April 5, 2004

Ernst & Young Kft.
Registration No. 001165

Mariann Hergovits
Registered Auditor
Chamber membership No.: 004648

B

II. Balance Sheet of the Magyar Nemzeti Bank, 2003

HUF millions

Note	ASSETS	31.12.2002	31.12.2003	Change
	1	2	3	3-2
	I. RECEIVABLES IN FORINT	**413 420**	**281 163**	**-132 257**
V.3.	1. Receivables from the central government	393 970	269 293	-124 677
V.14.	of which: receivables to refund the equalisation reserve due to exchange rate changes*	82 890	0	-82 890
V.7.	2. Receivables from credit institutions	18 697	10 424	-8 273
	3. Receivables from money issue and circulation	0	0	0
	a) Receivables from the Hungarian Post Administration	0	0	0
	b) Items by transit	0	0	0
	4. Other receivables	753	1 446	693
	II. RECEIVABLES IN FOREIGN CURRENCY	**3 644 566**	**3 763 029**	**118 463**
V.9.	1. Gold and foreign currency reserves	2 340 223	2 659 072	318 849
V.4.	2. Receivables from the central government	851 814	622 609	-229 205
	3. Receivables from credit institutions	2 148	2 027	-121
V.10.	4. Other foreign currency receivables	450 381	479 321	28 940
	III. BANKING ASSETS	**23 652**	**23 719**	**67**
V.12.	1. Fixed assets, intangibles, investments	22 828	23 270	442
	2. Value adjustment	0	0	0
	3. Liquid assets	1	0	-1
	4. Other assets	823	449	-374
V.15.	**IV. PREPAID EXPENSES/ACCRUED INCOME**	**150 288**	**110 619**	**-39 669**
	V. TOTAL ASSETS (I+II+III+IV)	**4 231 926**	**4 178 530**	**-53 396**

Note	LIABILITIES AND SHAREHOLDER'S EQUITY	31. 12. 2002	31. 12. 2003	Change
	1	2	3	3-2
	VI. LIABILITIES IN FORINT	**2 284 171**	**2 306 129**	**21 958**
V.5.	1. Central government deposits	50 862	94 139	43 277
	2. Deposits by credit institutions	921 280	712 298	-208 982
	3. Liabilities from money issue and circulation	1 271 081	1 458 719	187 638
	a) Notes and coin in circulation	1 270 851	1 458 371	187 520
	b) Items in transit	230	348	118
	4. Other deposits and liabilities	40 948	40 973	25
	VII. LIABILITIES IN FOREIGN CURRENCY	**1 803 360**	**1 486 950**	**-316 410**
V.5.	1. Central government deposits	33 538	160 204	126 666
	2. Deposits by credit institutions	93 002	21 653	-71 349
V.11.	3. Other foreign currency liabilities	1 676 820	1 305 093	-371 727
	VIII. PROVISIONS	**0**	**0**	**0**
	a) For liabilities	0	0	0
	b) Other	0	0	0
	IX. OTHER BANKING LIABILITIES	**9 479**	**10 137**	**658**
V.15.	**X. ACCRUED EXPENSES/DEFERRED INCOME**	**102 280**	**80 753**	**-21 527**
V.16.	**XI. EQUITY**	**32 636**	**294 561**	**261 925**
	1. Share capital	10 000	10 000	0
	2. Retained earnings	7 546	2 659	-4 887
	3. Valuation reserve	0	0	0
V.14.	4. Revaluation reserve due to exchange rates changes*	0	199 240	199 240
V.14.	5. Revaluation reserve due to changes in the market value of securities denominated in foreign currency	19 976	4 198	-15 778
	6. Profit/loss per balance sheet	-4 886	78 464	83 350
	XII. TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY (VI+VII+VIII+IX+X+XI)	**4 231 926**	**4 178 530**	**-53 396**

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

5 April 2004

Zsigmond Járai

B

III. Income statement of the Magyar Nemzeti Bank

HUF millions

Note	INCOME	2002	2003	Difference
	1	2	3	3-2
V.18.	**I. FORINT INTEREST AND INTEREST RELATED INCOME**	**32 020**	**24 999**	**-7 021**
	1. Interest income on receivables from the central government	29 008	22 776	-6 232
	2. Interest income on receivables from credit institutions	2 785	2 085	-700
	3. Interest income on other receivables	225	41	-184
	4. Interest related income in forint	2	97	95
V.18.	**II. FOREIGN CURRENCY INTEREST AND INTEREST RELATED INCOME**	**377 731**	**328 496**	**-49 235**
	1. Interest income on foreign currency reserves	108 796	101 079	-7 717
	2. Interest income on receivables from the central government	65 365	44 978	-20 387
	3. Interest income on receivables from credit institutions	128	94	-34
	4. Interest income on other receivables	10 861	8 082	-2 779
	5. Interest related income in foreign currency	192 581	174 263	-18 318
V.19.	**III. INCOME ARISING FROM EXCHANGE RATE CHANGES**	**6 245**	**97 643**	**91 398**
V.20.	**IV. INCOME FROM MONEY CIRCULATION**	**1 497**	**956**	**-541**
V.21.	**V. OTHER INCOME**	**1 943**	**1 456**	**-487**
	1. Commission and fees received in forint	166	84	-82
	2. Commission and fees received in foreign currency	1 015	1 321	306
V.22.	3. Ordinary and extraordinary income not included above	762	51	-711
	VI. PROVISIONS RELEASED/USED	**0**	**0**	**0**
V.13.	**VII. DEPRECIATION**	**886**	**1 201**	**315**
V.23.	**VIII. OPERATING INCOME**	**1 020**	**2 588**	**1 568**
	IX. TOTAL INCOME (I+II+III+IV+V+VI+VII+VIII)	**421 342**	**457 339**	**35 997**
Note	**EXPENSES**	**2002**	**2003**	**Difference**
	1	2	3	3-2
V.18.	**X. FORINT INTEREST AND INTEREST RELATED EXPENSES**	**93 228**	**92 107**	**-1 121**
	1. Interest expenses on central government deposits	27 051	25 643	-1 408
	2. Interest expenses on deposits by credit institutions	51 863	62 245	10 382
	3. Interest expenses on other deposits	14 314	4 219	-10 095
	4. Interest related expenses in forint	0	0	0
V.18.	**XI. FOREIGN CURRENCY INTEREST AND INTEREST RELATED EXPENSES**	**300 436**	**253 825**	**-46 611**
	1. Interest expenses on central government deposits	4 012	1 998	-2 014
	2. Interest expenses on deposits by credit institutions	1 973	775	-1 198
	3. Interest expenses on other liabilities	97 766	70 269	-27 497
	4. Interest related expenses in foreign currency	196 685	180 783	-15 902
V.19.	**XII. EXPENSES RESULTING FROM EXCHANGE RATE CHANGES**	**9 600**	**8 856**	**-744**
V.20.	**XIII. EXPENSES RELATED TO MONEY CIRCULATION**	**3 549**	**5 048**	**1 499**
V.21.	**XIV. OTHER EXPENSES**	**5 270**	**5 829**	**559**
	1. Commissions and costs recorded in forint	28	17	-11
	2. Commissions and costs recorded in foreign currency	3 802	2 561	-1 241
V.22.	3. Ordinary and extraordinary expenses not included above	1 440	3 251	1 811
	XV. PROVISIONS	**0**	**0**	**0**
V.13.	**XVI. DEPRECIATION**	**489**	**-32**	**-521**
V.23.	**XVII. OPERATING COSTS AND EXPENSES**	**13 656**	**13 242**	**-414**
	XVIII. TOTAL EXPENSES (X+XI+XII+XIII+XIV+XV+XVI+XVII)	**426 228**	**378 875**	**-47 353**
	XIX. PROFIT/LOSS FOR THE YEAR	**-4 886**	**78 464**	**83 350**
	XX. Dividend payment from retained earnings	**23 316**	**0**	**-23 316**
	XXI. DIVIDEND PAID	**23 316**	**0**	**-23 316**
	XXII. PROFIT/LOSS PER BALANCE SHEET (XIX+XX-XXI)	**-4 886**	**78 464**	**83 350**

5 April 2004

Zsigmond Járai

IV. Cash Flow Statement

HUF millions

		2002	2003
I.	**Cash flow arising from banking operations**		
1.	Net income before dividend payment (+profit/-loss)	-4 886	78 464
2.	Amortisation charge	1865	1574
3.	Difference between provisions made and used (+making/-release)	-398	-1 234
4.	Change in accruals related to foreign currency and forint transactions (+increase/-decrease of receivables)	26 225	18 234
5.	Change in other asstes and liabilities net of issued MNB securities and revaluation reserves (+net increase in assets)	-24 393	-1 019
6.	Dividend payable (-dividend payment obligation)	-23 316	0
7.	Dividend payment from retained earnings	23 316	0
	Total operating cash flow	**-1 586**	**96 019**
II.	Cash flow from financial activities		
1.	Change in forint receivables (-increase/+decrease)	100 299	132 442
2.	Change in forint liabilities (net of other liabilities, including MNB bonds) (+increase/-decrease)	-508 096	21 933
3.	Change in other foreign currency receivables (-increase/+decrease)	480 532	201 403
4.	Change in foreign currency liabilities / (+increase/-decrease)	-919 459	-316 410
5.	Change in revaluation reserves (+increase/-decrease)	184 435	183 462
	Total cash flow from financial activities	**-662 289**	**222 830**
I.+II.	**Change in foreign currency reserves (+increase/-decrease)**	**-663 875**	**318 849**

B

V. Notes to the financial statements

V. 1. THE BANK'S ACCOUNTING POLICY

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

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

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

V. 1. 1. Changes in the legal environment

There was only one major change in Hungarian accounting regulations and the Bank's accounting policy in 2003. Consistent with the amendment to the MNB Act in December 2003, from 2004 the Bank pays dividends from its profit for the year or its retained earnings on the basis of the decision taken by the General Meeting, rather than on the basis of a formula. This change is applicable to distributing the profit for 2003. The regulations governing the accounting policy of the Magyar Nemzeti Bank were modified on 1 January 2004.

V. 1. 2. Features of the MNB's accounting framework

One of the key principles of book-keeping at the MNB is that transactions are booked for the period when they occurred unless the financial year is already closed. This is especially important in view of the accurate determination of foreign currency gains and losses (see valuation rules), with special regard to foreign currency sales and purchases. Spot foreign currency transactions entailing exchange of foreign currencies are recorded in the balance sheet at their transaction dates. Assets and liabilities arising from such transactions alter the MNB's foreign currency position from the day of entering into a transaction. The same procedure is applied to recording the translation differential in the balance sheet relating to forward transactions for hedging purposes.

The MNB records daily

• the exchange rate differential arising from the revaluation of its foreign currency assets and liabilities and of derivatives transactions for hedging purposes recorded off balance sheet, and

• accrued interest on assets, liabilities and off-balance-sheet hedging transactions.

For the purpose of supporting the balance sheet and income statement drawn up for internal use, the MNB carries out on a monthly basis

• market revaluation of foreign currency-denominated securities,

• breakdown and recording of realised and non-realised portions of exchange rate gains and losses arising in the course of the daily revaluation, and

• recording of the amortisation charge.

Under the MNB Decree and for the purpose of reporting data to the owner, the MNB is required to close the accounts relating to its assets and liabilities as well as net income quarterly, and prepare a general ledger statement, following the procedure specified under its accounting policy. At the quarterly closing of accounts, the MNB states and records provision for loss in value of liabilities and expected losses.

Balance sheet date is 31 January 2004.

By law, MNB is also obliged to report to Parliament. The MNB submits one single report to Parliament and to the Ministry of Finance exercising the rights of ownership as laid down in the MNB Act. This is in the form of an Annual Report, which contains the MNB's annual financial statements as defined by the Accounting Act, and the business report describing the MNB's organisation, management and operations in the year under review. The Annual Report is published in full length both in printed format and on the Internet.

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

The person entitled to sign the Annual Report is the Governor of the Bank, Mr Zsigmond Járai, resident at Rózsahegy u. 1/b, 1024 Budapest.

V. 1. 3. Major principles of valuation

Receivables from the central government

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

The receivables from central government also include receivables associated with the reimbursement of revaluation reserves.

No provision for loss in value can be recorded in connection with receivables from the central government.

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

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

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

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

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

Of the foreign currency gains and losses arising in the course of the daily revaluation, realised exchange rate gain can be stated as a profit item, while non-realised income is stated under equity, in the item 'Revaluation reserve for the forint exchange rate'.

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

Foreign currency securities

Foreign currency securities are stated at market price. The difference between the market value on revaluation day and the book value is recorded in the revaluation reserve for foreign currency-denominated securities. Gains or losses realised on selling the securities are stated as interest-related income.

Securities issued by the MNB abroad and subsequently repurchased must be recognised at market value in the item 'Other foreign currency assets', i.e. with gross method. The related interest is recorded under both income and expenses.

Repos are reported under credit/deposit transactions and the related securities either as receivables or liabilities must be stated under off-balance-sheet items.

Accounting rules relating to the IMF quota

Part of the IMF quota subscribed in foreign currency and representing SDR claims is stated under foreign exchange reserves.

The other part of the quota, which does not have to be transferred to the IMF, is stated in the item 'Other foreign currency receivables' in the balance sheet. The counterpart liability is the IMF's forint deposit. It is the MNB's duty to ensure at least annually that the size of the IMF's forint deposit is identical to the forint equivalent of the SDR value of the unsubscribed part of the quota. As this deposit account is denominated in forint only nominally, it is stated in the item 'Other foreign currency assets' in the balance sheet.

Accounting rules relating to derivatives transactions

The MNB distinguishes derivative transactions to two groups on the basis of transaction purpose: hedging transactions and derivatives transactions for other purposes.

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

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

When derivative transactions for purposes other than hedging are closed, the income from such transactions must be stated in the items 'Receivables arising from exchange rate gain/loss' when foreign currency transactions are involved, and in the items 'Interest income' and 'Interest expenses' in the case of transactions linked to interest rate changes. While such transactions are not revalued, consistent with the principle of prudence, a provision shall be made equalling the negative market value of the transaction.

Banking assets and liabilities

Banking assets and liabilities are stated in the respective items of the balance sheet. These are the following:

• assets and liabilities not directly related to central bank functions and bank operations (such as settlements relating to taxes, contributions, employees, suppliers, precious metal yet unsold but held for non-central bank purposes), as well as

• liabilities arising from banknotes no longer accepted as legal tender but still not exchanged,

• investments,

• assets required for operating the organisation (such as intangibles, fixed assets, inventories).

B

Depreciation rates applied by the Magyar Nemzeti Bank

Description	31.12.2003.
Intangible assets (excluding funding-restructuring)	33.0%
Funding-restructuring (maximal)	20.0%
Buildings	3-5%
Vehicles	20.0%
Telecommunication devices*	14.5%
Computer equipment	33.0%
Emission machinery	20.0%
Instruments	33.0%
Bank security devices**	33.0%
** excluding mobile phones*	*33%*
*** excluding guns, bullet-proof waistcoat, fire-extinguishers*	*14.5%*

The table does not show the depreciation rates for rights representing money or money's worth, or rights associated with real property, as the Bank sets the depreciation rate applied on the basis of actual duration of use, or sets the same rate as that applying to the property involved or in terms of a contract. The depreciation rate for other unspecified assets is 14.5%. The percentage depreciation rate applied for properties, noted above, is the reference rate; any deviation from this is allowed depending on the period of use. The Bank applies linear depreciation for each item.

The depreciation rates applied did not change relative to 2002.

The 'Liquid assets' item of the MNB's balance sheet only includes the account balance related to employers' housing loans to employees by the OTP Bank. The central bank is the exclusive issuer of banknotes and coins. As they are not in circulation, notes and coins stored in the Cashier and Depository are subtracted from the stock of banknotes and coins on the liabilities side.

V. 2. EFFECTS OF ECONOMIC TRENDS ON THE BALANCE SHEET AND INCOME STATEMENT OF THE MAGYAR NEMZETI BANK

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

Changes in the central bank base rate had a strong influence on the Bank's forint interest income. On a weighted average basis, the interest rate was lower than in the previous year (early in 2003, when the stock of money market deposits was high, the base rate was relatively low, at 6.5%). As a consequence, interest expenses fell by HUF 11.1 billion compared with 2002. Also because of the lower level of interest rate, the interest remunerated on the Treasury Account fell by HUF 1.5 billion relative to the previous year.

Due to the 11.2% depreciation of the forint, the value of foreign currency receivables and liabilities declined in forint terms. Consequently, the forint equivalent of the foreign currency position was HUF 288 billion higher than in 2002. Of this, an exchange rate gain of HUF 88.8 billion was recognised in profit, the remaining part being recognised in the equalisation reserve for forint exchange rate changes, in accordance with the procedure discussed above.

International EUR and USD interest rates at maturities corresponding to those of securities held in the MNB's foreign exchange reserves were volatile in 2003. As a consequence, (i) interest income from foreign exchange reserves did not change significantly, and (ii) the realised exchange rate gain on foreign currency-denominated securities and the equalisation reserve due to foreign currency-denominated securities both fell.

V. 3. RECEIVABLES FROM THE CENTRAL GOVERNMENT

HUF millions

B/S line	Terms to maturity	Balance		Change
		31.12.2002	31.12.2003	
	Government bonds maturing within one year	361	4 000	3 639
	Government bonds maturing within one to five years	20 000	33 002	13 002
	Government bonds maturing over five years	146 689	161 067	14 378
	Securities	**167 050**	**198 069**	**31 019**
	Loans maturing within one year	72 806	43 335	-29 471
	Loans maturing within one to five years	71 224	27 889	-43 335
	Loans maturing over five years	0	0	0
	Loans	**144 030**	**71 224**	**-72 806**
	Due to exchange rate changes	82 890	0	-82 890
I.1.	**Total**	**393 970**	**269 293**	**-124 677**

Purchases by the MNB in the secondary market increased its holdings of government securities by HUF 35.4 billion, while scheduled repayments reduced the amount of holdings by HUF 4.4 billion.

The stock of loans to the central government decreased in accordance with the scheduled repayments.

Receivables due to the negative balance on the revaluation reserve arising from changes in the forint exchange rate at end-2002 amounted to HUF 82.9 billion, which the central government reimbursed in March 2003. As the balances on both revaluation reserves were positive on 31 December 2003, the central government did not have a reimbursement obligation.

In 2003, there was no income from withdrawal of notes and coins, therefore related receivables from the central government has not changed due to this. (Under the MNB Act, the profit from withdrawal of notes and coins shall not be stated in the income statement of the MNB. Instead, it shall be used for repaying the central government's outstanding debt to the MNB.)

V. 4. LONG-TERM FOREIGN CURRENCY CREDITS TO THE CENTRAL GOVERNMENT AND RELATED HEDGING TRANSACTIONS

HUF millions

B/S line	Description	Changes		Change
		12.31.2002	12.31.2003	
II.2.	**Foreign currency receivables from the central government**	**851 814**	**622 609**	**-229 205**
	Receivables from central government because of debt swap	851 191	537 381	-313 810
	Derivative transactions within one year	623	0	-623
	Swap transactions with maturity over 1 year	0	85 228	85 228

Hedging transactions with the central government are stated on either the assets or liabilities side of the balance sheet, depending on whether they have a debit or credit net balance. For 2002, long-term currency swaps are stated on the liabilities side, in item (VII.1.) Foreign currency deposits of the central government, while for 2003 they are stated in item (II.2.) Foreign currency receivables from the central government.

Foreign currency receivables from the central government by remaining maturity

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
II.2.	**Foreign currency receivables from the central government**	**851 814**	**622 609**	**-229 205**
	-within one year	202 535	121 906	-80 629
	-within one to five years	480 968	374 361	-106 607
	-over five years	168 311	126 342	-41 969

Foreign currency credits granted to the central government arose from the debt swap implemented in 1997. Its outstanding stock fell in 2003 due to repayments.

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

HUF millions

Nr	Description	Balance		Change
		31.12.2002	31.12.2003	
1	**Foreign currency receivables from the central government (B/S line II.2.) (2+3+4)**	**851 814**	**537 381**	**-314 433**
2	-USD	33 182	41 584	8 402
3	-EUR currency group*	334 999	0	-334 999
4	-JPY	483 633	495 797	12 164

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

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

HUF millions

Nr	Description	Balance		Change
		31.12.2002	31.12.2003	
1	**Swap receivables (2+3+4)**	**1 121 948**	**1 062 107**	**-59 841**
2	-USD	275 624	220 870	-54 754
3	-EUR currency group*	846 324	841 237	-5 087
4	-JPY	0	0	0
5	**Swap payables (6+7+8)**	**1 127 984**	**976 879**	**-151 105**
6	-USD	590 297	462 645	-127 652
7	-EUR currency group*	54 054	18 437	-35 617
8	-JPY	483 633	495 797	12 164
9	**Net swap receivables (1-5) (B/S line VII.1.)**	**-6 036**	**85 228**	**91 264**

** The euro currency group includes 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.*

V. 5. FORINT AND FOREIGN CURRENCY DEPOSITS OF THE CENTRAL GOVERNMENT

Forint deposits of the central government

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
	Single Treasury Account (KESZ)	35 737	44 199	8 462
	Deposit by State Privatisation and Holding Co.(ÁPV Rt.)	14 523	49 530	35 007
	Deposit by Government Debt Management Agency	339	319	-20
	Hungarian State Treasury	263	26	-237
	Other deposits	0	65	65
VI.1	**Total deposits**	**50 862**	**94 139**	**43 277**

Foreign currency deposits of the central government

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
	Short-term deposits	26 927	159 674	132 747
	Long-term special deposits	574	530	-44
	Long-term currency swap transactions	6 037	0	-6 037
VII.1	**Total deposits**	**33 538**	**160 204**	**126 666**

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

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
	- within one year	14 017	160 204	146 187
	- within one to five years	3 137	0	-3 137
	- over five years	16 384	0	-16 384
VII.1	**Total deposits**	**33 538**	**160 204**	**126 666**

Short-term foreign currency deposits of the central government increased by HUF 133 billion relative to 31 December 2002. This resulted from the obligation to repay a bond, with maturity in January 2004, two working days earlier, as agreed in the bond indenture, the same amount being recorded as a deposit for two days. As this bond was issued abroad and subsequently transferred to the central government, the same amount is stated on the assets side, as the foreign deposit of the MNB (see V.10.).

Currency swaps related to credit to the central government had a net credit balance in 2003; consequently, they are stated on the assets side of the balance sheet (see V.4.).

V. 6. NET POSITION VIS-À-VIS THE CENTRAL GOVERNMENT

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
I.1-VI.1	Net forint position	343 108	175 154	-167 954
II.1-VI.1	Net foreign exchange position	818 276	462 405	-355 871
	Total	**1 161 384**	**637 559**	**-523 825**

V. 7. FORINT RECEIVABLES FROM CREDIT INSTITUTIONS

Forint receivables from credit institutions in a breakdown by original maturity

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
	Short-term receivables	**1 571**	**1 571**	**0**
	- Liquidity refinancing credit on credit institutions	1 571	1 571	0
	Long-term receivables	**19 129**	**10 671**	**-8 458**
	- Loans granted for foreign currency deposits	14 707	8 744	-5 963
	- "Existence" loan	224	58	-166
	- Refinancing loan received from EXIM Bank	546	237	-309
	- ESOP* refinancing loan	32	26	-6
	- "START" loan	207	170	-37
	- Other loans for special purposes	13	3	-10
	- World Bank loans	757	227	-530
	- Other loans	2 643	1 206	-1 437
	Impairment provision for claims on credit institutions	**-2 003**	**-1 818**	**185**
I.2	**Total receivables**	**18 697**	**10 424**	**-8 273**

** Employee Share Ownership Program*

Receivables from credit institutions mainly comprise preferential loans associated with the past role of the MNB in the implementation of the government's economic policy. They are therefore not linked to any of the central bank functions. Consequently, the Bank has made efforts to reduce the outstanding stock of such loans since 2001, primarily by transfer to the Hungarian Development Bank (MFB) and encouraging early repayment.

The outstanding stock of loans fell due to prepayments and repayments in 2003.

The table below lists long-term forint credits classified according to remaining maturity.

HUF millions

B/S line	Remaining maturity	Balance		Change
		31.12.2002	31.12.2003	
	-within one year	9 828	4 931	-4 897
	-within one to five years	9 188	5 732	-3 456
	-over five years	113	8	-105
I.2	**Long-term receivables**	**19 129**	**10 671**	**-8 458**

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V. 8. NET POSITION VIS-À-VIS CREDIT INSTITUTIONS

HUF millions

B/S line	Description	Balance		Change
		2002.12.31.	2003.12.31.	
I.2-VI.2	Net forint position	-902 583	-701 874	200 709
II.3-VII.2	Net foreign excahnge position	-90 854	-19 626	71 228
	Total	**-993 437**	**-721 500**	**271 937**

Net forint receivables from credit institutions had declined by HUF 201 billion by 31 December 2003, explained by the HUF 209 billion decrease in credit institutions' deposits. The latter was due to a decrease of HUF 146 billion in two-week and overnight money market deposits and a drop of HUF 63 billion in minimum reserves.

V. 9. GOLD AND FOREIGN CURRENCY RESERVES OF THE CENTRAL BANK

Forint balances

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
	Gold reserve	7 787	8 751	964
	Reserve position in the IMF	133 428	140 056	6 628
	Foreign currency deposits	212 921	235 549	22 628
	Foreign currency securities	1 956 269	2 149 394	193 125
	Foreign currency repo transactions	29 818	125 322	95 504
II.1.	**Total gold and foreign currency reserves**	**2 340 223**	**2 659 072**	**318 849**

Foreign exchange reserves increased by HUF 319 billion in one year, the major part of which (some HUF 267 billion) was accounted for by the 11.2% depreciation of the forint exchange rate. Foreign currency purchases for monetary purposes and sales of foreign currency to the market and the central government in the course of the year were also contributing factors. The maturity of a part of the MNB's bonds issued abroad reduced the stock of foreign exchange reserves.

Euro balances

EUR millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
	Gold reserve	33	33	0
	Reserve position in the IMF	566	534	-32
	Foreign currency deposits	903	898	-5
	Foreign currency securities	8 293	8 197	-96
	Foreign currency repo transactions	126	478	352
II.1.	**Total gold and foreign currency reserves**	**9 921**	**10 140**	**219**

V. 10. OTHER FOREIGN CURRENCY RECEIVABLES

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
	Forint payment of IMF quota	183 281	179 616	-3 665
	Total foreign credits and deposits	492	0	-492
	Repurchased bonds	256 290	172 780	-83 510
	Foreign hedging transactions*	4 853	6 830	1 977
	Other	5 465	120 095	114 630
II.4.	**Other foreign currency receivables**	**450 381**	**479 321**	**28 940**

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

The stock of bonds issued abroad and subsequently repurchased by the Bank decreased due to maturity.

The increase in Other items was caused by the repayment of a foreign currency-denominated bond at year-end; the Bank contracted to repay two days before maturity, at the same time it was stated in the balance sheet as an interest bearing deposit held in a foreign bank for two days (see also V.5.).

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V. 11. OTHER LIABILITIES IN FOREIGN CURRENCY

The level of other foreign currency liabilities in a breakdown by remaining maturity at year-end

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
	Short-term liabilities	123 915	149 184	25 269
	Long-term liabilities	1 552 905	1 155 909	-396 996
	- Bonds	1 350 865	884 317	-466 548
	- Credits payable	14 041	1 208	-12 833
	- IMF forint deposit	183 281	179 616	-3 665
	- Other liabilities	4 718	5 245	527
	- Foreign hedging transactions	0	85 523	85 523
VII.3.	**Other foreign currency liabilities**	**1 676 820**	**1 305 093**	**-371 727**

Deposit accounts (so-called mark-to-market deposits), related to changes in the market value of forwards, and liabilities arising from reverse repos are recorded in the item 'Short-term liabilities'.

The stock of foreign currency-denominated bonds, recorded under long-term liabilities, fell due to repayments. The net credit balance of long-term currency swaps with foreign counterparties is recorded in the item 'Foreign hedging transactions'.

Other foreign currency liabilities in a breakdown by remaining maturity

HUF millions

Description	Balance		Change
	31.12.2002	31.12.2003	
-within one year	630 726	503 499	-127 227
- within one to five years	646 177	446 285	-199 892
- over five years	399 917	355 309	-44 608
Long-term liabilities	**1 676 820**	**1 305 093**	**-371 727**

Foreign currency structure of other foreign currency liabilities (excluding swaps)

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
	USD	357 497	58 646	-298 851
	EUR currency group*	506 363	339 779	-166 584
	JPY	628 167	640 320	12 153
	Other	184 793	180 825	-3 968
VII.3.	**Other foreign currency liabilities**	**1 676 820**	**1 219 570**	**-457 250**

**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.*

Other foreign currency liabilities include the HUF 179.6 billion deposit of the IMF.

Foreign currency structure of currency swaps with foreign counterparties

HUF millions

Nr	Description	Balance		Change
		31.12.2002	31.12.2003	
1	**Swap receivables**	**1 153 460**	**995 045**	**-158 415**
2	USD	597 815	474 890	-122 925
3	EUR currency group	72 012	24 358	-47 654
4	JPY	483 633	495 797	12 164
5	**Swap payables**	**1 150 441**	**1 080 568**	**-69 873**
6	USD	272 851	218 310	-54 541
7	EUR currency group	872 848	857 397	-15 451
8	JPY	4 742	4 861	119
9	**Net swap payables**	**-3 019**	**85 523**	**-88 542**

** The euro currency group includes 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.*

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V. 12. FIXED ASSETS

The category of invested assets comprises shareholdings (HUF 13.8 billion), in addition to intangibles, tangibles and work in progress (HUF 9.4 billion).

Changes in the gross value, depreciation and net value of intangibles, tangibles and work in progress

HUF millions

	Assets							
	Immaterial goods							
	Intangible assets	Software under development	Buildings	Equipment	Assets of banknote and coin	Tangible assets of MNB, total	Work in progress and advances given	Intangibles, tangibles and investments, total
Gross value								
31.12.2002	**4 728**	**47**	**9 333**	**8 081**	**159**	**17 573**	**341**	**22 689**
Capitalisation	817	1 008	205	995	3	1 203	2 343	5 371
Other	0	0	11		0	11	0	11
Scrapping	0	0	0		0	0	-55	-55
Disposal	0	0	-8		0	-8	0	-8
Transfer free of charge	0	0	-2 629	-305	0	-2 934	0	-2 934
Other deduction	-126	-798	0	-285	0	-285	-1 291	-2 500
31.12.2003	**5 419**	**257**	**6 912**	**8 486**	**162**	**15 560**	**1 338**	**22 574**
Details of depreciation								
31.12.2002	**3 880**	**0**	**2 208**	**6 710**	**0**	**8 918**	**0**	**12 798**
Planned depreciation	629	0	272	673	0	945	0	1 574
Extraordinary depreciation	0	0	0	0	0	0	0	0
Depreciation due to damage	0	0	0	0	0	0	0	0
Increase due to reclassification	0	0	0	0	0	0	0	0
Interim decrease due to cancellation from the account	-123	0	-556	-543	0	-1 099	0	-1 222
Decrease due to reclassification		0	0	0	0	0	0	0
31.12.2003	**4 386**	**0**	**1 924**	**6 840**	**0**	**8 764**	**0**	**13 150**
Closing net value								
31.12.2002	**848**	**47**	**7 125**	**1 371**	**159**	**8 655**	**341**	**9 891**
31.12.2003	**1 033**	**257**	**4 988**	**1 646**	**162**	**6 796**	**1 338**	**9 424**
Changes	**185**	**210**	**-2 137**	**275**	**3**	**-1 859**	**997**	**-467**

Investments and dividends from investments

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

On 31 December 2003, the MNB had shares in 6 domestic companies. All of these companies closed the year under review with a profit, and paid significant dividends on profit earned in 2002.

HUF millions

Description	Ownership share %		Book value		Dividend received *	
	31.12.2002	31.12.2003	31.12.2002	31.12.2003	2002	2003
BIS (HUF millions,	1.33	1.33	2 173	3 079	509	543
gold millions CHF)			6.7	6.7		
SWIFT (HUF millions,	0.02	0.02	0.4	0.5	0	0
thousand EUR)			1.8	1.8		
Pénzjegynyomda Rt.	100.0	100.0	8 927	8 927	99	256
Magyar Pénzverő Rt.	100.0	100.0	575	575		138
KELER Rt.	50.0	50.0	250	250	118	150
GIRO Elszámolásforgalmi Rt.	14.6	14.6	91	91	91	406
Nemzetközi Bankárképző Központ Rt.	14.6	0.0	31	0	3	6
Bankjóléti Kft.	100.0	100.0	602	602		
Budapesti Értéktőzsde	6.8	6.9	321	321	0	4
Total investments			**12 970**	**13 846**	**820**	**1 503**

** Dividends financially settled in the given year.*

Key indicators of domestic investments (preliminary data)

HUF millions

Investment	Equity excl. income of the year under review	Share capital	Reserves	Balance sheet income	Balance sheet income
	31.12.2003	31.12.2003	31.12.2003	2002	preliminary 2003
Budapesti Értéktőzsde Rt. 1052 Budapest, Deák Ferenc u. 5.	4 572	541	4 031	58	129
GIRO Elszámolásforgalmi Rt. 1054 Budapest, Vadász utca 31.	5 266	2 496	2 770	0	0
KELER Rt. 1075 Asbóth u.9-11.	11 292	4 500	6 792	882	1 091
Magyar Pénzverő Rt. 1089 Budapest, Könyves Kálmán krt. 38.	1 082	575	507	0	238
Pénzjegynyomda Rt. 1055 Budapest, Markó utca 17.	9 289	8 927	362	160	259
MNB Üdültetési és Jóléti Szolgáltató Kft. 1054 Budapest, Vadász utca 16.	560	602	-42	-49	248

The MNB's receivables from and liabilities to affiliated companies

HUF millions

Investments	Receivables	Liabilities
GIRO Elszámolásforgalmi Rt.	-	1.8
KELER Rt.	-	1.7
Magyar Pénzverő Rt.	4.6	1.0
Pénzjegynyomda Rt.	-	136.4
Budapesti Értéktőzsde Rt.	-	0.1
MNB Bankjóléti Kft.	-	400.0
Total invesments	**4.6**	**541.0**

Pénzjegynyomda Rt. produces documents, tax stamps and securities, primarily for institutional users, in addition to banknotes. Over the longer term, with the adoption of the euro, forint banknotes will cease to be produced. According to the Bank's decision, Pénzjegynyomda Rt will not produce euro banknotes. Consequently, the MNB may realise potential losses, which cannot be quantified; therefore, the Bank did not generate any provision for loss.

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 foreign markets, in addition to producing precious metal coins which are not legal tender, within the framework of its own coin programme. In addition, the company sells precious metal and non-precious metal coins which are legal tender issued by the MNB, both in international and domestic markets. The MNB's long-term strategy includes the preparation of Pénzverő Rt for the production of euro coins.

Bankjóléti Kft. was founded to attend to the Bank's social and welfare responsibilities. This company manages the vacation houses and sports facilities which were transferred into its ownership by the MNB as a contribution in kind. As the company incurred substantial losses in previous years, the Bank's management decided in 2002 to liquidate the company. The liquidation procedure is likely to be completed in 2004. The company's liquidator expected the company to earn a profit in 2003. For this reason, the Bank released the provision for loss generated earlier. Charged against liquid assets arising from sales of real property, the company transferred HUF 400 million to the MNB as a dissolution advance.

The MNB's stake in the **Budapest Stock Exchange Ltd.** is 6.9%. The company's General Meeting passed a resolution to lower its registered share capital from HUF 550 million to HUF 541 million in September 2003.

In 2003, the MNB sold its 14.6% stake (nominal value of HUF 30.6 million) in the **International Training Centre for Bankers** for HUF 85 million.

B

V. 13. PROVISIONS

HUF millions

B/S line	Description	31.12.2002 Loss in value/provisions	Interim changes in 2003 Increase(+)	Use/Release(-)	Interim exchange rate effect due to Increase, Use/Release	31.12.2003 Total loss in value/ provisions
1	2	3	4	5	6	7
I.2	Forint receivables from credit institutions	2 003.0	0.0	-184.6	0.0	1 818.4
II.3	Foreign currency receivables from credit institutions	0.0	0.0	0.0	0.0	0.0
II.4	Other foreign currency receivables	1 016.7	0.0	-1 016.7	-20.9	0.0
III.1	Invested assets	32.5	4.6	-37.1	0.0	0.0
III.4	Other assets	433.4	0.0	0.0	0.0	433.4
VIII	Liabilities	0.0	0.0	0.0	0.0	0.0
	Total	**3 485.6**	**4.6**	**-1 238.4**	**-20.9**	**2 251.8**

Provisions for loss in value declined by HUF 1 234 million in 2003.

Of this amount, HUF 184.6 million was due to partial repayment of the Bank's receivables vis-à-vis two credit institutions.

The provision for loss in value of HUF 453.4 million, made by the Bank for the stock of receivables from CW AG as at 31 December 2002, fell by HUF 20.9 million due to exchange rate changes. Then, at end-July the remaining HUF 432.5 million was used due to the closure of settlements.

The release of another HUF 563.3 million was caused by the sale of a doubtful foreign currency claim.

V. 14. REVALUATION RESERVES

HUF millions

	Description	31.12.2002	31.12.2003	Change
1	Revaluation reserves of forint exchange rate*	0	199 240	199 240
2	Revaluation reserves of foreign exchange securities**	19 976	4 198	-15 778
3	**Revaluation reserves**	**19 976**	**203 438**	**183 462**

** Pursuant to legal changes the negative balance of revaluation (equalisation) reserves should be refunded by the central budget by 31 March 2004.*
*** The revaluation reserves of foreign exchange securities includes the market value difference of repurchased bonds denominated in foreign currencies.*

The official exchange rate of the forint against depreciated the euro by 11.2% in 2003, leading to a net foreign currency position of HUF 2,279 billion (EUR 8.7 billion) at the year-end. Due to changes in the exchange rate and the net position, there was a non-realised exchange rate gain of HUF 199.2 billion.

Size of annual changes in the forint exchange rate in 2002–2003

	MNB official mid-exchange rate
End-of-period exchange rate	
31.12.2002 (EUR)	235.90
31.12.2003 (EUR)	262.23
Annual appreciation	
In 2002	4.2%
In 2003	-11.2%

In agreement with the Government, on 4 June 2003 the Bank decided to adjust the central parity of the forint exchange rate, leaving the ±15% intervention band unchanged. Accordingly, the new central parity was set at HUF/EUR 282.36.

B

V. 15. PREPAID EXPENSES/ACCRUED INCOME AND ACCRUED EXPENSES/DEFERRED INCOME

HUF millions

B/S line	Description	Balance		Change
		31.12.2002	31.12.2003	
	Due to banking transactions	150 189	110 519	-39 670
	Due to internal operation	99	100	1
IV.	**Prepaid expenses/accrued income**	**150 288**	**110 619**	**-39 669**
	Due to banking transactions	102 098	80 662	-21 436
	Due to internal operation	182	91	-91
X.	**Accrued expenses/deferred income**	**102 280**	**80 753**	**-21 527**

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.

V. 16. CHANGES IN EQUITY

HUF millions

B/S line	Description	31.12.2002	Interim changes	31.12.2003
XI.1.	Share capital	10 000	0	10 000
XI.2.	Retained earnings	7 546	-4 887	2 659
XI.3.	Valuation reserves	0	0	0
XI.4.	Revaluation reserve of forint exchange rates	0	199 240	199 240
XI.5.	Revaluation reserve of securities denominated in foreign currency	19 976	-15 778	4 198
XI.6.	Profit per balance sheet	-4 886	83 350	78 464
XI.	**Equity**	**32 636**	**261 925**	**294 561**

Pursuant to the December 2003 amendment to Act LVIII of 2001 on the Magyar Nemzeti Bank, the Bank's dividends for 2003 are defined by the General Meeting. For more details on the revaluation reserves, see Section V.14.

V. 17. OFF-BALANCE-SHEET LIABILITIES

Liabilities arising from derivative transactions

HUF millions

Nr	Description	31.12.2002	31.12.2003	
		Book value of liabilities	Book value of liabilities	Net market value
1	Hedging transactions (2+3+4+5)	3 230 460	3 473 006	-2 859
2	-FX forward transactions	114 574	5 246	-16
3	-FX swap transactions	100 333	492 789	3 957
4	-currency swap transactions	2 278 424	2 057 447	-3 399
5	-interest rate swap transactions	737 129	917 524	-3 401
6	Other forward transactions (7+8)	203	32 082	15
7	-options	0	32 082	15
8	-interest rate future transactions	203	0	0
9	**Total (1+6)**	**3 230 663**	**3 505 088**	**-2 844**

Hedging transactions (Lines 1–5) serve the purpose of reducing risks related 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. Such transactions predominantly consist of transactions with or on behalf of the Government Budget.

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

Interest rate swaps include the Bank's transactions with ÁKK (Government Debt Management Agency Ltd.), which serve to limit the interest rate risks carried by debt denominated in foreign currency and are hedged on the capital market through reverse transactions.

B

Breakdown of options

HUF millions

Nr	Description	Net market value	
		31.12.2002	31.12.2003
1	Long call option	0	28
2	Long put option	0	0
3	Short call option	0	-13
4	Short put option	0	0
5	**Total**	**0**	**15**

Other off-balance-sheet liabilities

HUF millions

Nr	Description	31.12.2002 Book value of liabilities	31.12.2003 Book value of liabilities
1	Liabilities from foreign currency repos	0	123 510
2	Guarantees	149 588	12 278
3	Contingent liabilities	0	0
4	Credit line commitments	0	0
5	Other off-balance sheet liabilities	2	2
6	**Total**	**149 590**	**135 790**

The item ‘Guarantees’ includes export and import guarantees, involving invariably some reverse contract or government guarantee. When exercising a guarantee, the MNB has the right to a reverse guarantee if needs be.

Other off-balance-sheet liabilities largely consists of liabilities arising from debt collection initiated or received by the MNB.

V. 18. NET INTEREST INCOME OF THE MNB BY INSTITUTIONAL SECTOR

Net forint and foreign currency interest and interest related income

HUF millions

P/L line	Description	2002	2003	Change
(I.1+II.2)-(X.1+XI.1)	Central government	63 310	40 113	-23 197
(I.2+II.3)-(X.2+XI.2)	Credit institutions	-50 923	-60 840	-9 917
(I.3+II.4)-(X.3+XI.3)	Other	7 802	34 714	26 912
	Net interest income	**20 189**	**13 987**	**-6 202**
	Forint interest related income	2	97	95
	Foreign currency securities	-2 429	-8 347	-5 918
	Bonds issued abroad	20	-1 513	-1 533
	Derivative transactions for hedging and other purposes*	-1 695	3 322	5 017
	Other	0	18	18
(I.4+II.5)-(X.4+XI.4)	**Net interest related income**	**-4 102**	**-6 423**	**-2 321**
(I+II)-(X+XI)	**Net interest and interest related income**	**16 087**	**7 564**	**-8 523**

** For details on derivative transactions for hedging and other purposes, see the next table.*

The interest income of HUF 8.1 billion stemming from securities issued by the MNB abroad and subsequently repurchased is included in the income statement not as an item reducing expenses but as an item under other foreign currency income.

Interest related income consists of:

• net income from derivative transactions that are 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 face value; and

• the difference between the face value and the acquisition value of bonds issued by the Bank abroad and repurchased at a later date, as calculated at maturity, or, if they are sold prior to maturity, the difference between the acquisition price and the selling price.

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

HUF millions

Nr.	Description	2002	2003	Change
1	**Income from derivative transactions (2+3+4+5+6)**	**177 392**	**160 061**	**-17 331**
2	- interest on currency swaps	173 300	151 303	-21 997
3	- interest on over one year interest rate swaps	3 310	2 359	-951
4	- interest differential on hedge FX swaps	600	6 295	5 695
5	- exchange rate gains on derivative transactions	0	0	0
6	- other transactions	182	104	-78
7	**Expenses for derivative transactions**	**179 087**	**156 739**	**-22 348**
8	- interest on currency swaps	175 173	152 947	-22 226
9	- interest on over one year interest rate swaps	1 670	2 530	860
10	- interest differential on hedge FX swaps	1 086	733	-353
11	- exchange rate gains on derivative transactions	972	0	-972
12	- other transactions	186	529	343
13	**Net income on derivative transactions (1-7)**	**-1 695**	**3 322**	**5 017**
14	- interest on currency swaps (2-8)	-1 873	-1 644	229
15	- interest on over one year interest rate swaps (3-9)	1 640	-171	-1 811
16	- interest differential on hedge FX swaps (4-10)	-486	5 562	6 048
17	- exchange rate gains on derivative transactions (5-11)	-972	0	972
18	- other transactions (6-12)	-4	-425	-421

The MNB hedged exchange rate and interest rate risk arising from bonds issued abroad by means of currency swaps (and other derivative transactions).

Under the debt swap implemented in 1997, the MNB converted a large part of its forint loans outstanding to the central government into foreign currency loans via concluding counterpart transactions with the Government under terms identical to those of the bonds issued by the MNB abroad. The MNB also concluded with the ÁKK the majority of the currency swaps linked to the bonds under nearly identical terms. Income and expenses accruing on the currency swaps are stated in the income statement in gross terms. As far as the swaps vis-à-vis both non-residents and the ÁKK are concerned, the income and the expenses are recorded in interest income more than once. At the same time, their net impact on profit and loss amounts to HUF 1.6 billion, including currency swaps concluded by the MNB abroad on its own behalf.

V. 19. COMPONENTS OF INCOME FROM THE TRANSLATION OF FOREIGN EXCHANGE HOLDINGS

HUF millions

Description	2002	2003
Income from exchange rate changes	-3 355	88 787
Change of revaluation reserves in the balance sheet*		
- due to non-realised revaluation gain/loss	-82 890	199 240
Total effect of exchange rate changes	**-86 245**	**288 027**

** Revaluation reserve for forint exchange rate changes (balance sheet line XI. 4).*

In 2003, the official exchange rate of the forint depreciated by 11.2% relative to the euro, causing the net foreign currency position to decrease by HUF 436 billion (EUR 0.9 billion). The Bank recorded an exchange rate gain of HUF 88.8 billion in 2003, mainly due to the sale of a large part of foreign currency, purchased in the course of the official interventions, at a much higher price than the purchase price.[7]

In addition, the non-realised exchange rate gain was HUF 199.2 billion. Consequently, total profit arising from changes in the forint exchange rate amounted to HUF 288 billion in 2003.

For more details on the revaluation reserve, see Section V.14.

[7] As, pursuant to the MNB Act, the Government reimbursed the negative revaluation reserve for 2002 by 31 March 2003, on 1 January 2003 the purchase prices of the individual currencies were changed to the exchange rate prevailing on 31 December 2002. This purchase price at end-December was adjusted by the exchange rate of euro purchased in the course of intervention conducted by the Bank at the upper extreme of the intervention band.

B

V. 20. NET FEE AND COMMISSION INCOME RELATED TO PAYMENTS AND COSTS OF ISSUING BANKNOTES AND COINS

HUF millions

Nr	Description	2002	2003	Change
1	Commission and fee income of credit institutions' deposit account turnover	707	318	-389
2	Fee income of cash turnover	533	483	-50
3	Other commissions, fees	257	155	-102
4	**Income related to payments (1+2+3)**	**1 497**	**956**	**-541**
5	Costs of banknotes and coins production	3 084	4 601	1 517
6	Costs of production of commemorative coins	80	100	20
7	Expenditures on VIBER (RTGS) transactions	331	336	5
8	Other expenditures related to payment turnover	54	11	-43
9	**Total expenditures related to payment turnover (5-6-7-8)**	**3 549**	**5 048**	**1 499**
10	**Income from payment turnover (4-9)**	**-2 052**	**-4 092**	**-2 040**

Revenues of the Bank related to payment transactions declined by HUF 541 million in 2003, due mainly to the decrease in fee income in relation to credit institutions' forint deposit accounts, which in turn was caused primarily by the reduction in commissions and fees and by the change in the calculation the base of the fee.

Net expenditure arising from payment transactions and currency issue amounted to HUF 5,048 billion, which was HUF 1,499 billion higher than in the previous year. The costs of banknotes and coins production changed significantly relative to 2002. This can be ascribed to the increase in the volume of purchases.

V. 21. OTHER INCOME

HUF millions

Nr	Description	2002	2003	Change
1	Commissions and fees received	292	166	-126
2	Bond lending fees received in foreign currency	533	403	-130
3	Costs of the central budget's FX loans	356	836	480
4	Normal and extraordinary income not included in previous items	762	51	-711
5	**Total other income (1+2+3+4)**	**1 943**	**1 456**	**-487**
6	Other commissions and costs	2 194	2 578	384
7	Normal and extraordinary expenditures not included in previous items	1 440	3 251	1 811
8	Expenditures related to EFSAL loans	1 636	0	-1 636
9	**Total other expenditure (6+7+8)**	**5 270**	**5 829**	**559**
10	**Other results (5-9)**	**-3 327**	**-4 373**	**-1 046**

A loss of HUF 4,373 billion was recorded under 'Other income' in 2003.

There was a decline in bond lending fees received in foreign currency in 2003. This revenue is due to a general agreement on bond lending concluded between the MNB and its largest securities account manager. The cost of the foreign currency loan to the central government, i.e. commission income related to the prepayment of and interest on foreign currency loans, increased relative to 2002, due to the repayments and prepayments of such loans at maturity.

Costs arising in relation to issues of foreign currency-denominated bonds fell by HUF 0.1 billion from 2002 to 2003. This type of cost is distributed evenly across the bond's time to maturity; therefore costs also decrease gradually as bonds mature (as shown in line 7).

With the aim of cleaning up its balance sheet and also on the basis of efficiency calculations, in 2003 the Bank repaid the loans granted by the EIB, the related costs amounting to HUF 498 million (as shown in line 7).

For a discussion of ordinary and extraordinary income/loss not included in the above items for 2003, see V.22.

V. 22. BREAKDOWN OF ORDINARY AND EXTRAORDINARY INCOME/EXPENDITURE NOT INCLUDED IN THE ABOVE ITEMS

HUF millions

Nr	Description	2002	2003	Change
	Ordinary and extraordinary income not included in previous items			
1	Due to invested financial assets	321	0	-321
2	Other income correction	15	50	35
3	Settlement of refinancing loan ceded to Hungarian Development Bank	425	0	-425
4	Other income	1	1	0
5	**Total (1+2+3+4)**	**762**	**51**	**-711**
	Ordinary and extraordinary expenditures not included in previous items			
6	Loan and other losses exceeding normal extent	737	975	238
7	Due to invested financial assets	30	0	-30
8	Final money transfer	39	141	102
9	Settlement of refinancing loan ceded to Hungarian Development Bank	425	0	-425
10	Other expenditures	209	2 135	1 926
11	**Total (6+7+8+9+10)**	**1 440**	**3 251**	**1 811**

Components of ordinary and extraordinary income and expenditure for 2003 are as follows:

• Cancellation of the book value of real property transferred free of charge to the ÁKK pursuant to a resolution taken by the Shareholder, accounts for a large portion of other expenditure items (HUF 2.1 billion).

• A credit loss of HUF 405.3 million was linked to the closure of settlements of MNB-MKK related to CW AG, for which the provisions for loss generated earlier provided full cover (see line 6).

• The MNB sold its receivables from a developing-country debtor, irrecoverable for decades. Consequently, the cancellation of the book value of receivables resulted in a HUF 570 million expenditure. The provision for loss, generated earlier, also provided cover for this item. The receipt of the HUF 50 million purchase price increased ordinary and extraordinary income not included in the above items (lines 2 and 6).

• The item ‘Final money transfer’ among extraordinary expenditures mainly includes support to international and domestic organisations and foundations.

V. 23. OPERATING INCOME AND EXPENSES

HUF millions

P/L line	Description	2002	2003	Change
	Dividend from investments	820	1 503	683
	Income from export sales	4	809	805
	Exchange gain from selling investment	0	55	55
	Income from selling assets and inventories	84	52	-32
	Income from mediated services	45	48	3
	Income from invoiced services	58	75	17
	Other income	6	45	39
	Extraordinary income	3	1	-2
VIII.	**Total operating income**	**1 020**	**2 588**	**1 568**
	Cost of materials, total	3 011	3 263	252
	Personnel-related costs, total	9 057	8 418	-639
	Depreciation	1 865	1 574	-291
	Transfer of capitalised value of own-produced stocks	-56	-147	-91
	Transfer of costs of other activities	-370	-409	-39
	Total operating costs	**13 507**	**12 699**	**-808**
	Loss on exchange from selling investment	0	0	0
	Expenses incurred on assets and inventories	114	469	355
	Expenses incurred on invoiced services	34	73	39
	Taxes	1	1	0
	Assets transferred free of charge	0	0	0
	Other expenses	0	0	0
	Total operating expenses	**149**	**543**	**394**
XVII.	**Total operating costs and expenses**	**13 656**	**13 242**	**-414**

Operating costs amounted to HUF 12.7 billion in 2003, which was HUF 0.8 billion lower than in the previous year. This decrease in operating costs was the result of numerous factors.

Personnel-related costs declined by HUF 0.6 billion, due primarily to reductions in severance pay. In addition, there was a considerable decline in amortisation charge, as an effect of the lower investment volume in earlier years.

The HUF 1.2 billion improvement in the balance of operating incomes and expenses resulted from the HUF 0.5 billion net profit on the sale of unnecessary non-monetary gold reserves and from the HUF 0.7 billion increase in dividend income.

V. 24. CHANGES IN DATA ON THE NUMBER OF EMPLOYEES, WAGES AND REMUNERATION OF EXECUTI-VE OFFICERS OF THE BANK

Staff and wage data

HUF millions

Description	2002	2003	Change (%)
Wage costs incurred on staff	4 897	4 867	-0.6
Other wage costs*	486	242	-50.2
Wages	**5 383**	**5 109**	**-5.1**
Adjustments, total	-26	0	-100.0
- Deferred payments settled in 2003	-26	0	-100.0
Wages	**5 357**	**5 109**	**-4.6**
Other personnel payments	**1 509**	**1 291**	**-14.4**
Taxes on wages	**2 191**	**2 018**	**-7.9**
Total personnel expenditures	**9 057**	**8 418**	**-7.1**

** Other wage costs include payments on dismissal and in exchange of vacation time not used and amounts paid to non-staff and non-NBH employees.*

Description	2002	2003	Change (%)
Average number of staff	1058	958	-9.5

Remuneration of executive officers

forints

Bodies	Fees
Monetary Council*	70 526 414
Supervisory Board	47 832 852

** Includes the saleries of external members of the Monetary Council in an employement relationship with the MNB.*

Credits to executive officers

Bodies	Amount of loans	Outstanding at 31.12.2003	Final maturity	Rate of interest
Board of Directors	67 090 572 Ft	39 513 864 Ft	15.12.2016	Floating *
Supervisory Board	2 000 000 Ft	401 383 Ft	15.09.2004	Floating *

** Central bank base rate at 31 Dec. 2003 +1% point*

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

5 April 2004

Zsigmond Járai

Annual report
Business report and financial statements of the Magyar Nemzeti Bank
2003

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