MAGYAR NEMZETI BANK

ANNUAL REPORT

2006

Annual Report

Business Report and Financial Statements of the Magyar Nemzeti Bank 2006

Published by the Magyar Nemzeti Bank

Publisher in charge: Judit Iglódi-Csató

Szabadság tér 8–9., H-1850 Budapest

www.mnb.hu

ISSN 1216-6197 (print)

ISSN 1585-4604 (online)

Contents

Part A

2006 Business Report of the Magyar Nemzeti Bank

1. The Governor's foreword

In terms of inflation, 2006 was an unfavourable year. The year-on-year inflation rate of 6.5 per cent in December exceeded the year-end target of 3.5 per cent, and fell outside the ±1 per cent tolerance band as well. Thus, due mainly to factors beyond the control of monetary policy, the central bank's inflation target was not met in 2006. Instead of the earlier year-end targets, starting from 2007 the central bank has been pursuing a medium-term objective, which is currently set at 3 per cent.

As a result of the effect of factors which determine inflation, the rate of price increases almost reached the level corresponding to price stability at the beginning of the year, but in mid-2006 there was a turning point, and inflationary pressures started to grow in a wide range of products. As a consequence of the Government's measures, regulated prices increased significantly, and the increase in indirect taxes also affected a wide range of products. To a large extent, these measures contributed to the fact that the rate of year-on-year inflation was three percentage points higher than the target in December. During the year, the Monetary Council raised the central bank base rate in five steps by a total of 2 percentage points in order to return inflation to the 3 per cent objective over the medium term.

The balance of the budget continued to deteriorate in 2006. The general government deficit stood at around 9 per cent of GDP, and government debt exceeded 60 per cent of GDP. Amongst the new EU Member States, the yield on 10-year government securities is the highest in Hungary, reflecting a high risk premium due to fiscal and external equilibrium problems. The Government abandoned the earlier target date of 2010 for adopting the euro, and did not determine a new one. The Government's fiscal consolidation measures mainly aimed at increasing revenues over the short term. As a result, the budget deficit is expected to significantly decline in the coming two years, but these measures also fuelled inflation and reduced the competitiveness of the economy over the short run.

The exceptionally high budget and current account deficits increased the vulnerability of forint assets. The increase in the expected premium during the first part of the year resulted in a considerable depreciation of the exchange rate. The Monetary Council's interest rate decisions played a role in restoring investors' confidence. The exchange rate appreciation and decline in yields during the second half of the year showed that in investors' view the short-term credibility of economic policy improved, compared to the low-point reached in the summer.

On 10 November 2006, the MNB announced that starting from 9 January 2007 it would issue MNB-bills with two-week maturity instead of the two-week central bank deposit used as a policy instrument up to then. The new instrument was intended to be introduced in order to facilitate credit institutions' efficient liquidity management and the development of financial markets.

In the course of 2006, official foreign exchange reserves increased from EUR 15.7 billion to EUR 16.4 billion. The level of reserves increased the most in the first quarter, when the ÁKK (the Government Debt Management Agency) issued as many as three foreign exchange bonds. The greatest decline was observed in the second quarter, on account of the repayment of a maturing dollar bond.

Foreign exchange market transactions related to the debt management activities of the ÁKK and the MNB increased reserves by a total of more than EUR 1 billion, and transfers from the European Union added another approximately EUR 1 billion, while the pre-announced euro sales intended to offset the forint liquidity expanding effect of the above amounts resulted in a decline of slightly more than EUR 1 billion.

Compared to previous years, there was no important change in the structure and quality of foreign exchange reserves. On the basis of the indicators most often used to determine the optimum size of reserves, their current level can be considered as adequate.

In 2006 several important decrees of the Governor of the MNB regarding payment and clearing transactions entered into force. Decrees were issued on the requirements related to the regulations and statutes of organisations performing clearing-house activities and of clearing houses for credit institutions according to the Act on the Capital Market, and these decrees meet internationally accepted requirements.

In order to facilitate the formulation of the national changeover programme, the MNB prepared comprehensive working materials on the main practical tasks involved in adopting the euro in Hungary. The Bank initiated professional consultations related to preparations for the practical introduction of the euro. Accordingly, the MNB and the Ministry of Finance established a joint expert working group.

In order to increase the security of the banknote series in circulation, 1,000 forint banknotes with new security features were put into circulation in April 2006. Beside developing the series in circulation, 15 million 500 forint circulation banknotes and 2 million 50 forint circulation coins were issued in commemorative versions on the occasion of the 50th anniversary of the revolution of 1956.

The wholesale character of the MNB's cash distribution was strengthened by a new regulation issued in 2006, which applies to all clients and cash transactions. An important part of the extended Business terms and conditions is the regulation of the exchange activity performed by the MNB.

Stemming from its responsibility for financial stability, the Magyar Nemzeti Bank took an active part in the analysis of the financial intermediary system, as well as in the exploration and extensive communication of risks. In 2006, the enhancement of households' financial knowledge was considered as a primary task, as – according to our surveys – the level of the financial culture of the Hungarian population, especially among the young, is very low. Since this entails the danger of incorrectly assessing risks and making wrong decisions, in co-operation with the competent organisations we initiated the inclusion of general financial knowledge in the national core curriculum, which should have a positive effect on financial stability over the longer term.

In addition to increasing the level of basic financial knowledge, we put great emphasis on the more extensive communication of financial stability messages to targeted professionals and readers who are interested in economics, but do not have deeper professional knowledge. Additionally, we took the initiative in financial regulatory works, primarily in the elaboration of the concepts related to the regulation of the pension fund system and creating the legal environment for securitisation, as well as in the preparation of the European and domestic adaptation of the new Basel capital regulation.

In 2006, the Magyar Nemzeti Bank earned a profit of HUF 14.6 billion, as opposed to the loss of HUF 21.4 billion in 2005. This improvement in profit is mainly attributable to an increase in the realised income from the exchange rate change. Due to the significant depreciation of the forint exchange rate during the year, the official exchange rate departed considerably from the average cost rate, which resulted in a HUF 66.4 billion gain as realised net income from exchange rate change, as opposed to the HUF 14.6 billion gain in the previous year.

The internal operations of the MNB continued to be characterised by cost-effectiveness, as operating costs remained within the planned budget, and their amounts were lower than in the previous year. In 2006, the volume of investment significantly exceeded those of previous years, mainly due to the implementation works of the Logistic Centre, which will be handed over at end-2007.

In 2005, in order to enhance the development and efficiency of operations, the MNB's management set the target of introducing a new, less hierarchical and regulated operational and management model based on a commonly accepted scale of values, standards, principles and empowerment, which – due to its flexibility – results in faster and less bureaucratic performance of work, consuming less resources and time. As a part of the measures aimed at operational development, the MNB's organisation became flatter, the head of department level ceased to exist in case of several organisational units, and the number of managerial positions also declined to two thirds. In 2006, the Bank's human resources management was characterised by organisational-operational rationalisation and improvement of efficiency, as well as measures related to the continuation of the operational development programme, which together resulted in a 13.8 per cent decline in the MNB's average number of employees and to a year-end number of 739.

2. A brief overview of the Magyar Nemzeti Bank

Company name: Magyar Nemzeti Bank
Registered office: 1054 Budapest, Szabadság tér 8-9.
Form of operation: Company limited by shares
Date of foundation: 1924
Owner (shareholder): Hungarian State, represented by the Minister of Finance
Basic tasks: As defined by the Act on the Magyar Nemzeti Bank
Share capital: HUF 10 billion

2.1. OBJECTIVES AND BASIC TASKS OF THE MNB

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

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

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

– it defines and implements monetary policy;

– it has the exclusive right to issue banknotes and coins, including commemorative banknotes and coins, qualifying as the legal tender of the Republic of Hungary;

– it forms and manages official reserves in foreign exchange and gold;

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

– it develops and regulates the domestic payment and settlement systems and securities settlement systems, and, as part of its oversight duties, monitors their operation in order to ensure their safe and efficient operation as well as smooth money circulation;

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

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

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

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

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

2.2. BODIES AND MANAGEMENT OF THE MNB

The various bodies of the Magyar Nemzeti Bank are governed by the MNB Act and Act IV of 2006 on Business Associations, except for issues where the MNB Act provides otherwise.

Pursuant to the aforementioned two Acts, despite its status as a single-member business organisation, the Bank has a **General Assembly**, at which the Hungarian State as a shareholder is represented by the Minister of Finance. The

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

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

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

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

Pursuant to the European Union's requirements, and as an additional guarantee of independence, in contrast to the practice of other companies limited by shares, remuneration of the Bank's executive officers, including the Governor, the Deputy Governors and the other members of the Monetary Council as well as the members of the Supervisory Board, are governed by the MNB Act and not by the General Assembly.

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

Each year – at the first meeting of the year – the Monetary Council elects a Deputy Chairperson who will substitute the Chairman if the latter is unable to attend. In 2006, Deputy Governor Henrik Auth was elected as Deputy Chairman.

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

The members of the **Monetary Council** in 2006 were:

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

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

– managing the implementation of the basic tasks;

– establishing limits on the assumption of market and credit risks and benchmarks in accordance with the basic principles determined by the Monetary Council as well as the methodology of determining partner limits and investment instruments;

– preparing the proposals to be submitted to the General Assembly on the MNB's balance sheet, profit and loss statement, allocation of profits, and approving the draft report to be submitted to the General Assembly on the business management, the financial situation of the MNB and the business policy;

– approving issues associated with the Bank's organisation and internal management, including the introduction of human resource management systems and modification thereof;

– approving business policies, professional plans and programmes in connection with the Bank's operation and performing its tasks as well as drafting of the development and operational budget;

– making decisions on the business and non-business-related matters set forth in its Rules of Procedures;

– approving the annual schedule of passing decrees of the Governor of the MNB (MNB decrees) and the texts of the MNB decrees in accordance with the decisions made by the Monetary Council, not including the MNB decrees on the central bank base rate and the minimum reserve ratio;

– in matters falling outside the Supervisory Board's competence, managing the internal audit system and discussing the results of the internal auditing and plans for internal audits;

– approving proposals for major amendments to the collective bargaining agreement;

– in the event of a credit institution crisis – in accordance with the fundamental principles determined by the Monetary Council:

  – with regard to emergency loans: determining credit rating limits related to eligible collateral, the currency and extent of acceptance of eligible collateral and the interest rate of the emergency loan;

  – regulating at all times the procedural issues of the decision on emergency measures to be taken in case of a credit institution crisis;

– establishing and operating committees, establishing their rules of procedure and approving their agenda;

– taking decisions on investments by the MNB;

– implementing strategic capital projects;

– appointing members to be delegated to the special committees of the ESCB and

– defining the policy on fees.

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

The Board of Directors, which functions as the MNB's operative management body, consists of at least four and at

Members of the Monetary Council of the Magyar Nemzeti Bank

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

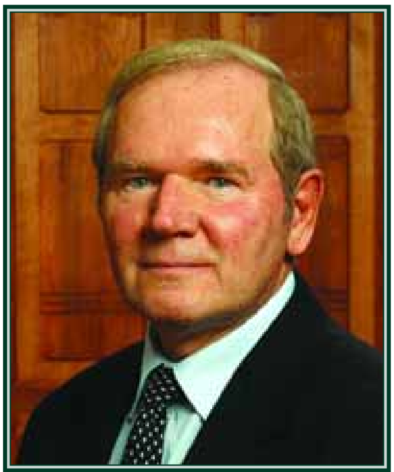
Péter Adamecz
Deputy Governor, member of the Monetary Council and the Board of Directors

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

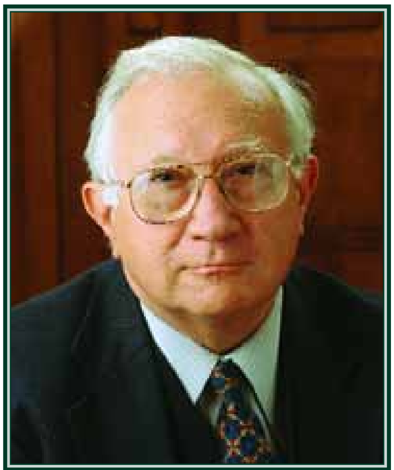
Dr. György Szapáry
Deputy Governor, member of the Monetary Council and the Board of Directors

Dr. Tamás Bánfi
member of the Monetary Council

Dr. Péter Bihari
member of the Monetary Council



Vilmos Bihari
member of the Monetary Council



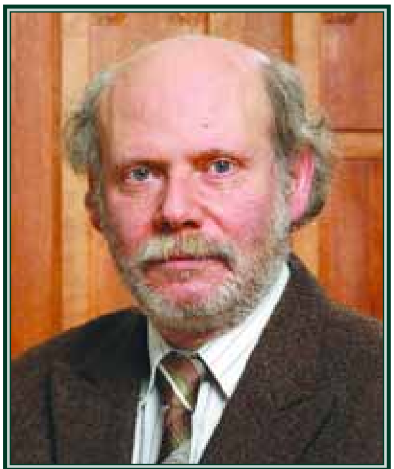
Dr. Csaba Csáki
member of the Monetary Council

Dr. Ilona Hardy
member of the Monetary Council

Dr. Béla Kádár
member of the Monetary Council

György Kopits
member of the Monetary Council

Judit Neményi
member of the Monetary Council



Dr. Gábor Oblath
member of the Monetary Council

most six members. Its members include the Governor, as the Chairman of the Board, and the Deputy Governors of the Bank.

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

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

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

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

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

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

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

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

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

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

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

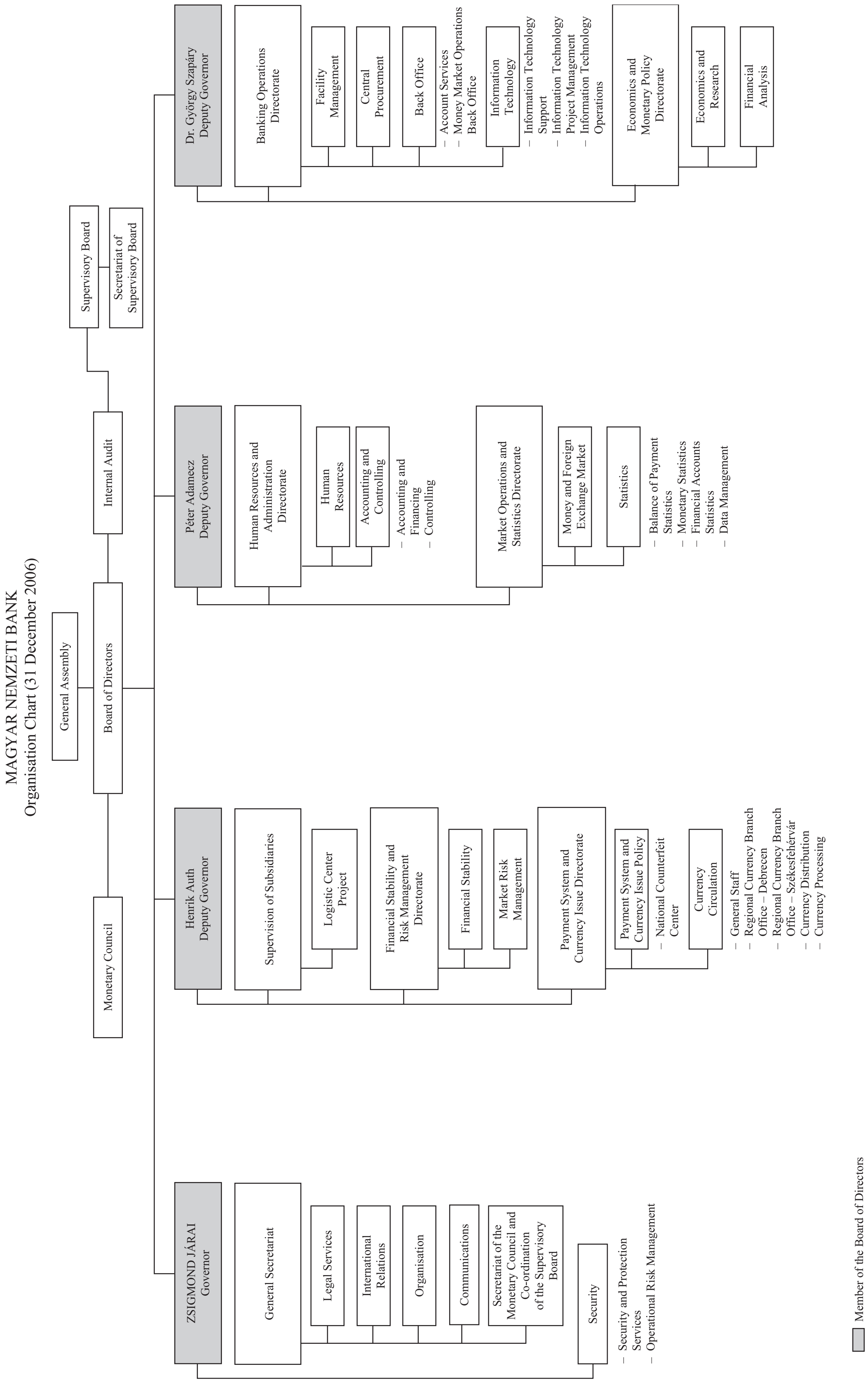
The supervisory competence of the State Audit Office in relation to the MNB is set forth in the Act on the State Audit Office. The State Audit Office supervises the financial management of the Magyar Nemzeti Bank and its activities under the MNB Act that are not included in its basic tasks. The State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

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

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

Of the six members of the Supervisory Board, four (including the Chairman) are appointed by the Parliament, one represents the Minister of Finance and one is a consultant commissioned by the Minister of Finance. Their respective terms of office coincide with the Parliament's mandate. The Supervisory Board remains in office until a new Parliament elects the new Supervisory Board members within three month from the Parliament's first convening. Should the new Parliament fail to elect the new Supervisory Board members within the aforementioned time-limit, the Supervisory Board remains in office until the new Parliament elects the Supervisory Board members.

Organisation chart



In 2006, the members of the Supervisory Board of the MNB were:

– László Akar, Chairman,
– Dr. Éva Várhegyi,
– László Baranyay,
– Dr. József Kajdi,
– Dr. László István Urbán,
– Dr. István Várfalvi (until 30 July 2006),
– Ferenc Pichler (from 31 July 2006).

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

2.3. ORGANISATIONAL STRUCTURE OF THE CENTRAL BANK

The Bank's aim is to belong to the most excellent central banks both in terms of professionalism and operational conditions. Accordingly, its organisation is undergoing continuous modernisation.

The efficiency enhancement measures implemented on the basis of the results of the benchmarking analysis performed in 2005 with the Sveriges Riksbank, which is considered to be one of the most efficient central banks in the European Union, has had an impact on the organisational structure as well.

From 10 January 2006, the Bank has simplified its organisational structure substantially. The new, empowerment-based working culture allowed a significant rationalisation of the organisational hierarchy.

While on 1 January 2005, there were 10 managing directors, 18 departments and 60 divisions, since 10 January 2006 there are 8 managing directors, 8 professional fields, 21 functions and 19 divisions.

The structure of the organisation in charge of performing the tasks stemming from central banking and banking operations is shown in the organisational chart dated 31 December 2006.

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

The directors controlling the activities of the organisational units assigned to them are responsible for the following areas: Economics and Monetary Policy, Market Operations and Statistics, Financial Stability and Risk Management, Payment System and Currency Issue, General Secretariat, Human Resources and Administration, Banking Operations, Owners' Representation. The directors report to the Governor or to the relevant Deputy Governors, in accordance with the division of tasks and in addition to their primary role as monetary policy-makers.

On 31 December 2006 the directors of the Magyar Nemzeti Bank were:

– Dr. Katalin Barátossy, Payment System and Currency Issue,
– Dr. Zsuzsanna Arnold Csenterics, Human Resources and Administration,
– György Garancsi, Owners' Representation,
– Dr. Ferenc Gerhardt, Banking Operations,
– István Hamecz, Economics and Monetary Policy,
– Dr. Tamás Kálmán, Financial Stability and Risk Management,
– György Sándor, Market Operations and Statistics,
– Dr. László Urbán, General Secretariat.

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

Hungary's accession to the European Union also entailed the MNB's membership in the European System of Central Banks (ESCB). The ESCB comprises the European Central Bank and the respective national central banks of the EU. Its governing bodies are the Executive Board and the Governing Council, consisting of the members of the ECB's Executive Board and the governors of the central banks of those Member States that have adopted the euro. The General Council is the ECB's third decision-making body, members of which are the President and the Vice-President of the European Central Bank (ECB) and the respective governors of the central banks of all EU Member States. This latter body primarily addresses issues relevant to the ESCB as a whole and to the future expansion of the euro area, and it also has an advisory role and co-ordinating functions.

As of 1 January 2007, with the inclusion of Bulgaria and Rumania, the number of EU Member States – and thus ESCB Members – increased from 25 to 27, while the number of countries which have adopted the euro changed from 12 to 13 as Slovenia began using the euro.

ESCB members are also owners of the ECB. The share in the ECB's capital key is based on demographic and GDP data. Thus, Hungary's share in the ECB's subscribed capital was 1.3884 per cent until 31 December 2006. As Hungary has not adopted the euro yet, pursuant to the Statutes of the ECB, Hungary was required to contribute 7 per cent of its subscribed capital, i.e. EUR 5.4 million (HUF 1.4 billion), to the ECB's operational cost upon accession to the European Union on 1 May 2004. Following the accession of Bulgaria and Rumania to the EU, Hungary's key for subscription to the ECB's capital and its paid-up capital declined to 1.3141 per cent and EUR 5.3 million (HUF 1.37 billion), respectively.

The so-called ESCB Committees play an important role in the work of the ECB's decision-making bodies. The basic role of these committees is to prepare decisions and facilitate co-ordination regarding the various central bank duties, covering all areas of central banking operation, from monetary policy through communication to statistical data reporting. The experts of the central banks of Member States which have not yet adopted the euro are present at those committee meetings, where issues within the competence of the General Council are on the agenda (the activities of the currently working 12 ESCB Committees are presented in Chapter 3.10).

The committees meet and discuss current issues relevant to their professional areas 5–6 times a year on average, according to a schedule determined for a year in advance. The senior managers and competent experts of the MNB continue to play an active role in the activities of these committees and their working groups. ESCB committee work proved to be a very useful forum for the exchange of professional experience in 2006 as well, contributing to our preparations for joining the Eurosystem.

3. Review of the MNB's performance in 2006

3.1. MONETARY POLICY

Monetary policy framework

Pursuant to the MNB Act, the primary objective of the MNB is to achieve and maintain price stability. To this end, monetary policy is determined in the framework of inflation targeting, taking into account the ±15 per cent intervention band of the forint exchange rate against the euro. The Government and the Magyar Nemzeti Bank together set the end-2006 inflation target at the level of 3.5±1 per cent, while the valid medium-term inflation target is 3 per cent starting from 2007.

The meetings of the Monetary Council were held in accordance with its pre-determined schedule in 2006 as well. Accordingly, decisions on changing the central bank base rate were made only at the second meeting of each month.

Inflation developments

The year-on-year inflation rate of 6.5 per cent in December 2006 exceeded the inflation target of 3.5 per cent for end-2006, and was outside the ±1 per cent tolerance band as well. Thus, due mainly to factors beyond the control of monetary policy, the central bank's inflation target was not met in 2006. During 2006 the annual average consumer price index and annual average core inflation increased from the previous year's level of 3.6 per cent to 3.9 per cent and from 2.1 per cent to 2.3 per cent, respectively.

By the end of 2005 and early 2006, as a result of the favourable effect of factors determining inflation, the rate of price increases had reached a level close to price stability, against a background marked by serious equilibrium risks in the economy. Through to mid-2006, the macroeconomic picture was characterised by a split between favourable inflation developments, and the prospects and necessity of fiscal adjustment. The benign inflation performance was mainly attributable to the decline in the inflation of tradables, which was explained by a combination of global disinflation in these goods, EU accession and changes in the trade structure resulting to a certain degree from accession. Reaching a level close to price stability was also facilitated by the reduction in indirect taxes, which entered into force in January 2006, the stable, strong euro–forint exchange rate and wage inflation, which gradually came in line with price stability.

In mid-2006, inflation reached a turning point, and inflationary pressures started to increase in a wide range of products. One underlying reason was that the disinflationary effect of product market competition, which had become increasingly keen in previous years, started to decrease, and this was reflected in a rising core inflation as well. In mid-2006, signs already pointed to an even more significant acceleration of inflation than previously expected, due amongst other things to a salient increase in the price of unprocessed foods, growing wage inflation and a weakening forint exchange rate. As a consequence of the Government's measures, regulated prices increased significantly, and the increase in indirect taxes also affected a wide range of products. These measures contributed to a large extent to the fact that in December 2006 the year-on-year rate of inflation was three percentage points higher than the target.

In addition to the primary inflation-generating effects, the Government's measures may also cause changes in price-setting behaviour and wage agreements, while the growth-reducing effect of the measures – if it proves to be stronger than expected – may reduce the probability of potential second-round effects.

Table 1

The consumer price index and its components in 2006

(Percentage change, year on year)

	2004	2005 annual average	2006	2006 Q1	Q2	Q3	Q4	Dec.
Core inflation	5.8	2.1	2.3	0.6	1.0	2.8	4.7	5.0
Unprocessed food	6.6	4.3	17.8	15.3	18.0	17.7	20.3	19.1
Fuel and energy	6.6	8.6	7.8	8.4	9.5	8.7	4.8	5.5
Regulated prices	9.3	6.1	3.7	2.8	1.0	3.1	8.1	7.8
Consumer price index	6.8	3.6	3.9	2.5	2.6	4.1	6.4	6.5

Exchange rate and interest rates

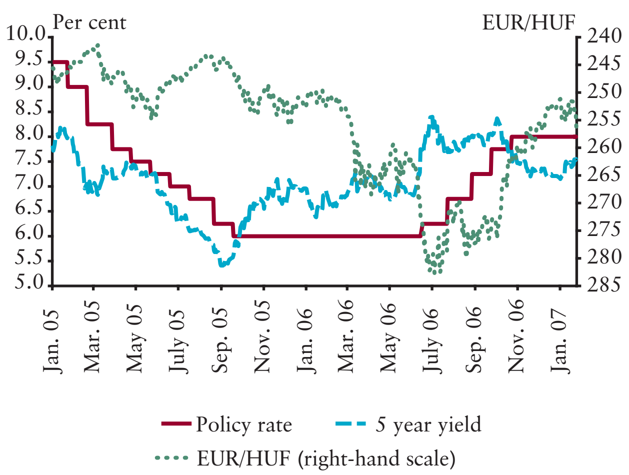
Despite the favourable global investment atmosphere and the steadily low risk premia, international financial markets were affected by several temporary shocks in 2006. Amidst these conditions, the strikingly high budget and current account deficits increased the vulnerability of forint assets. As a result, at the time of the decline in risk appetite in March and June, the exchange rate of the forint departed from that of the other currencies in the region, and followed the weakening of the asset prices of high-risk emerging countries. By July, the exchange rate weakened to the middle of the intervention band, i.e. it depreciated by 12 per cent compared to the beginning of the year. The yield of longer-maturity government securities increased considerably.

Due to the notable deterioration in the inflation outlook, which was in part a result of the fiscal adjustment measures announced in the middle of the year, and to a significant increase in the risk premium expected of forint assets, between June and October 2006 the Monetary Council raised the central bank base rate in five steps, by a total of 200 basis points, to 8 per cent. This monetary tightening was in conformity with market participants' expectations, and thus did not cause any surprise on the markets.

Interest rate hikes contributed to restoring market participants' confidence. In the second half of the year, the exchange rate gradually rose back to its level observed at the beginning of the year, while long yields declined, despite an increase in the short interest rate level. However, developments in long forward premia showed that – despite the short-term improvement in economic policy credibility – investors continue to see significant macroeconomic risks over the longer term.

Chart 1

Exchange rate and yield developments



New policy instrument: the MNB bill

On 10 November 2006, the MNB announced that as of 9 January 2007 it would issue MNB bills with two-week maturity instead of the two-week central bank deposit used as policy instrument up to that point.

The new instrument was introduced in order to facilitate credit institutions' efficient liquidity management and the development of financial markets. As opposed to the two-week central bank deposit, the MNB bill has the following advantages, amongst other things:

- The MNB's partners can use the MNB bill as collateral in intraday payment transactions, thus the new instrument contributes to safer operation of payment transactions.
- Within maturity, the MNB bill is freely transferable, thus credit institutions can better handle the fluctuations in their liquidity positions.
- The new instrument may also enhance the efficiency of the interbank market through a recovery of secondary market trading and repo activity.

From a monetary policy perspective, the change-over did not result in any change; the level of the central bank base rate and the maturity of the policy instrument remained unchanged. The yield of MNB bill with two-week maturity when issued is equal to the current central bank base rate.

The technical conditions of the new instrument changed slightly, but the most important terms and conditions of issuing and selling the MNB bonds are the same as those for the two-week central bank deposit. Thus, in terms of the policy instrument, the bidding time, the acceptance of submitted bids, the announcement of results and the date of financial realisation remained unchanged.

Changes in the conditions of the forint and foreign exchange market transactions

The trading time of the deposit standing facility and of the collateralised lending facility was modified in two steps: as a result, from end-2006 the MNB's partners can submit their bids for the aforementioned two types of transactions between 08:30 and 17:30.

On the one hand, the extension of trading times is explained by an adjustment to the ECB's set of instruments, and on the other hand – conforming to the longer VIBER operating hours – at the end of the settlement day, after the settlement of the interbank transactions the MNB's partners can place their respective excess liquidities with the MNB, or can take collateralised loans in case of a demand for liquidity.

Leading the state's foreign exchange funds to the market

As in previous years, foreign exchange assets of the Government were exchanged into forints by the MNB in 2006. In accordance with the practice of the past, in order to neutralise the liquidity effects of the Government's foreign exchange conversion, the MNB sold a part of the foreign exchange raised by the Government on the foreign exchange market.

In 2006, the Government's foreign-exchange funds entailed foreign exchange conversion with the MNB in a magnitude of approximately EUR 1.5 billion; this amount was further increased by a net conversion of around EUR 1 billion in transfers from the European Union. The MNB used a part of this approximately EUR 2.5 billion foreign exchange conversion to increase the level of foreign exchange reserves, while, in accordance with the practice established in 2004, it took the other part to the foreign exchange market in order to reduce excess liquidity. As the MNB continued to refrain from influencing developments in the forint exchange rate, in the course of the year, foreign exchange sales were carried out in the interbank foreign exchange market in a number of tranches, in small amounts and in a price-taking manner, in view of the market situation and OTC market practices. Domestic and foreign credit institutions with a foreign exchange market limit with the MNB were possible partners in these transactions.

3.2. STABILITY OF THE FINANCIAL INTERMEDIARY SYSTEM

Stemming from its responsibility for financial stability, the Magyar Nemzeti Bank took an active part in the analysis of the financial intermediary system and in the exploration and extensive communication of risks in 2006 again. The tools used in these activities included both the publication entitled *Report on Financial Stability* and numerous other professional analyses and publications on this topic, as well as the messages communicated to economic agents at scientific conferences and through various channels of the media.

The *Report on Financial Stability* was published in April 2006. It played a key role in identifying the risks stemming from macroeconomic imbalances and in analysing the possible consequences. The *Report* emphasised that due to the existence of significant general government and current account deficits for several years, a credible fiscal adjustment had become indispensable by the first part of 2006. Without the adjustment there would have been a danger of a market correction, which would have been much more costly for the Hungarian economy and the financial system, and would have caused a major shock to society. Significant imbalances entailed the risk of forint depreciation and a considerable increase in yields. All this would have had a particularly adverse effect on the SME and household sectors, which have debts unhedged against exchange rate risk due to foreign exchange loans: these debts have become widespread in recent years and are almost completely dominant among newly extended loans. An increase in forint yields, in turn, would have increased the repayment burdens of forint debtors considerably.

The temporary inflation-increasing and economic growth reducing effect of the Government's adjustment measures introduced in the course of the year will still have an unfavourable impact on the development of the financial system in the coming years, but over the longer term it may contribute to more balanced growth.

In addition to the analysis and assessment of domestic financial stability risks, the MNB's experts took an active part in international financial stability works as well. It is worth emphasising the professional assistance provided for the preparation of the publications of the European Central Bank (ECB) entitled 'Financial Stability Review', 'EU Banking Sector Stability' and 'EU Banking Structures' as well as other ECB analyses. We were initiators of the broad-ranging awareness-raising of the risks of lending in foreign currency observable in the new EU Member States and of elevating the subject to international level. In October 2006, with the participation of several foreign central bank experts, representatives of the IMF, domestic market participants and authorities the MNB organised a conference on this subject, which was met with great interest. One important message of the conference was that although domestic banks are aware of the risks of foreign currency lending, and pay increasing attention to these risks when developing their products and formulating risk management systems, on the whole, further significant work still needs to be done to strengthen clients' risk awareness and increase their experience in financial matters.

In 2006, the central bank considered it a primary task to strengthen the public's knowledge of financial matters. To this end, as a first step, it assessed the level of financial knowledge of secondary school students and of the young adult population. Then, based on these findings, it compiled a publication containing basic financial knowledge, which was forwarded to secondary school graduates. The most important conclusion of the survey is that the level of financial culture of the young is extremely low, which is an unfavourable phenomenon from the aspect of financial stability, as it may lead to incorrect assessment of risks and inadequate decisions.

Therefore, as a longer-term solution, in co-operation with the relevant organisations the central bank initiated the inclusion of general financial knowledge in the national core curriculum.

In addition to increasing the level of basic financial knowledge, the Bank also placed great emphasis on more extensive communication of financial stability messages to readers who are interested in economics but do not have deeper professional knowledge. To this end, as a new channel of communication, in 2006 the central bank launched a new publication entitled 'MNB Bulletin', which aims to inform the public about the research and analyses carried out in various professional fields in an easily understandable manner. Of the financial stability topics, the June and December issues of the publication included analyses related to the risks of foreign currency loans to domestic small and medium size enterprises, the efficiency of the banking system, the dynamic expansion of loans and the reform of insolvency regulations.

Within the scope of communication aimed at professionals, several important studies were published in the MNB's series of publications and in various trade papers. The research subjects cover a wide range of current issues involving the banking sector and the non-bank financial intermediary system. Noteworthy contributions included the research studies and analyses related to the management of concentrations in the banking book, the practice of the settlement of banks' loan losses, the exchange rate exposure of the corporate sector, the rapid credit expansion seen in East and Central European countries and the efficiency of the banking sectors of the European Union. In addition to the studies published, a part of the professional communication was the regular survey conducted among banks' senior loan officers, the findings of which are published by the central bank biannually. On the basis of the evaluation of the answers, market participants and the central bank receive important information on the expected developments in demand for and supply of loans as well as on banks' lending policies in the corporate and household markets.

An important element of supporting financial stability is the creation of an adequate operational environment, in which financial regulation plays a key role. In this field, elaboration of the concepts and carrying out the background analyses related to the regulation of the pension fund system and creating the legal environment for securitisation, as well as the participation in the works related to the European and domestic adaptation of the new Basel capital regulation are worth mentioning. Within this framework, a study on domestic collateral regulations was prepared, and the Bank also participated in elaborating the Validation handbook, which contains the conditions of supervisory acknowledgement of developed risk measuring methods, and in other related works.

On the international stage, highlights included the active participation in the Committee of European Banking Supervisors (CEBS), in the ECB's relevant committees and working groups (BSC, WGMA, WGDB etc.), in IMF programmes related to financial stability, as well as in the work of the Task Force on Crisis Management established by CEBS and the European Banking Supervisory Committee (BSC). In 2006, one of the major projects of BSC was to carry out an EU-level crisis simulation exercise; the MNB's experts played a key role in the preparation and professional control of this exercise. The aim of the exercise was to test the readiness and ability to co-operate of central banks, supervisory authorities and ministries of finance, as well as the efficiency of sharing information among the relevant institutions in a hypothetical crisis situation. In its international work and activities, the MNB always closely co-operated with the staff of the Ministry of Finance and the HFSA. In terms of financial stability issues, the highest-level domestic forum of co-operation among the three institutions is the Financial Stability Committee, which regularly discussed the current stability issues and dealt with certain strategic matters of the regulation of data provision and the financial sector in 2006 as well.

3.3. PAYMENT SYSTEMS AND SECURITIES SETTLEMENT SYSTEMS

In relation to payment and securities settlement systems, as service provider, the MNB manages credit institutions' accounts, on which the forint positions from interbank transactions are settled with finality, and operates the real time gross settlement system (VIBER). It is also a co-owner of GIRO Clearing House Limited (GIRO Zrt.) and the Central Clearing House and Depository Ltd. (KELER Zrt.), and is a participant in all three settlement systems.

In respect of the clearing and settlement infrastructure, the MNB fulfils regulatory, licensing and supervisory functions as an overseer. As a neutral partner from the point of view of market competition, the MNB is a catalyst for change in the development of infrastructure in areas requiring joint decision of stakeholders.

Regulatory activity

– In February 2006, Decree No. 2/2006 (II.15.) of the Governor of the MNB on the requirements of the Business Terms and Conditions and other regulations of organisations providing clearing house activities under the Act on Capital Markets was published. This decree supplements the provisions of the Act on Capital Markets regarding the business terms and conditions and operating rules of those entitled to perform clearing house activities and the guarantee and collateral system operated by such parties. It ensures the compliance of these rules with the relevant principles and requirements set forth in international recommendations ('Recommendations for securities settlement systems' issued by BIS CPSS–IOSCO in November 2001).

– Decree No. 11/2006 of the Governor of the MNB on the requirements for the Business Terms and Conditions and internal regulations of automated clearing houses was published on 1 August 2006. In compiling this decree, the principles and requirements worded in the relevant international recommendations (e.g. 'Core Principles for Systemically Important Payment Systems' published by the BIS in January 2001) and the ECB's guideline related to TARGET were taken into account.

– In accordance with the regulatory competences determined in the MNB Act, in November 2006 the new rules on payments, Government Decree 227/2006 (XI.20.) on payment services and electronic payment instruments and Decree No. 21/2006 (XI.24.) of the Governor of the MNB on carrying out payment transactions were published. The legislative work included a comprehensive revision and updating of the current regulations, with special attention to practical problems and proposals raised by market participants since the 2001 regulation, development in payment methods and means of payment, the aim of making it easier to change banks, as well as completing the legal harmonisation with the EU with regard to transactions executed by electronic means of payment.

Central bank inspection of payments

Based on the medium-term on-site inspection strategy, the MNB's on-site inspection tasks decreased, and at the same time more emphasis than earlier was put on the off-site inspection of payment data supplies.

In 2006, on-site inspections were carried out at five banks, four cash-in transit companies and two clearing houses (in the latter case participating in the supervision performed by the HFSA). In addition, in 37 cases the central bank sent letters to those obliged to report on payments, asking them to revise some of the data they had reported.

The experience of the inspections is that payment rules were broadly obeyed by credit institutions, although the quality of reports on the number of banking accounts and the turnover thereof is still inadequate. The inspection of regulations regarding cash recycling highlighted the shortcomings of internal regulations of credit institutions.

At the majority of cash-in transit companies shortcomings were found both in the area of the prevention of money laundering and in the field of professional activity with regard to internal regulations, client identification, personnel and material conditions of performing the activity, the procedures of cash processing and the handling of presumably counterfeit banknotes.

In order to correct the mistakes found in the on-site inspections, the central bank ordered a total of 55 tasks to be completed, and for one clearing house it made 3 proposals to improve operational reliability. Off-site inspection established the necessity of data modifications in 32 cases. The MNB continuously monitored performance of the tasks ordered.

The operation and development of the VIBER

In 2006, the number of VIBER participants was 38, one more than at the end of the previous year. In terms of the value of the total turnover of the Interbank Clearing System (ICS) and VIBER, 91.4 per cent was settled by VIBER, while ICS accounted for a larger share in the volume of transactions, at 99.57 per cent. The total turnover of the two systems was 37.6 times as much as the projected GDP figure for the year, while this indicator was 29.8 in 2005.

Banks' average daily intraday credit line – which is provided by the MNB for carrying out payment transactions, against blocked securities held as collateral and which supplements the bank account balance – amounted to HUF 395.4 billion in 2006, exceeding the previous year's figure by 6.3 per cent.

Total available liquidity made it possible to settle the combined turnover of VIBER and ICS at an average daily value of HUF 3,490 billion, representing a 36.8 per cent increase on the daily turnover in the previous year. During the year, the average daily turnover was 3.7 times the daily liquidity, compared to the previous year's average of 3.0 times. In international comparison, the liquidity of VIBER as a whole can be considered high.

Last year, the availability of VIBER was 99.7 per cent, which corresponds to the level of previous years. Due to a late start and five intraday shutdowns, 5 operating hours were lost. There was no disruption exceeding two hours. In addition, there was a partial failure as well, which only resulted in a slowdown of the service (e.g. manual examination of cover at the cashier's counter). The contingency system was not used at all.

Extension of VIBER operating hours

Starting from 2 November 2006, the business hours of VIBER were extended: the time of opening remained unchanged, while the system closes at 17:00 hours, instead of the earlier 16:30. Within the business hours clients have half an hour more time to submit payment orders initiated by them (until 16:00 hours); the closing time of initiating DVP items was changed to 16:30 hours. The change was introduced in order to improve the service provided by the system.

MA-CUG with the ÁKK's participation

The development of SWIFT paved the way for the ÁKK to join its network, thus its message turnover could be directed from paper-based to electronic channel. The solution is based on the so-called MA-CUG (Member Administered Closed User Group) service. The MNB as a SWIFT member established a closed user group, the only member of which currently is the ÁKK. The service has been operating since May 2006.

Interbank co-operation

As part of the Payment System Forum (PSF), the elaboration of the tasks designated by the Payment System Council (PSC), the decision-making body of the organisation, continued in numerous working groups managed by the six committees.

Of the performance of these tasks, in the field of cashless payments, the work related to the modernisation of the 'direct debit method of payment', the situation of mobile payments and the renewal of ICS, while in the cash area the elaboration of the relevant cost and efficiency indicators were points of considerable importance during 2006.

The experts in the PSF played an important role in the development of the Hungarian opinion on the documents regarding the pan-European payment and settlement models elaborated by the EPC (European Payments Council), in relation to the implementation of the SEPA (Single Euro Payments Area).

The subject of the autumn conference was provided by the new EU directive on payment services. The new directive will have to be included in the national legislation irrespective of whether the given Member State is a member of the euro area or not. The directive is expected, inter alia, to lead to new types of service providers in the market, which will result in strengthening competition and cheaper payment services of improving quality. Basic and core payment services will become standardised, which will make it sufficient for each European citizen and enterprise to have only one banking account to be able to carry out payment transactions throughout the whole territory of the Union.

3.4. MANAGEMENT OF FOREIGN EXCHANGE RESERVES

Objectives of holding reserves

Like other central banks, one of the most important tasks of the Magyar Nemzeti Bank is the management of the country's foreign exchange reserves. The foreign exchange reserves contain the liquid foreign exchange assets of the central bank, which the monetary authority may directly use in the event of payment problems and which provide coverage for foreign exchange market intervention serving monetary policy objectives. A country's foreign exchange reserves may serve various purposes, the most important of which are worth underlining:

– supporting monetary policy (intervention carried out in order to keep the forint within the announced exchange rate band),

– transaction goals (supporting the management of government debt, satisfying the State's demand for foreign exchange and non-residents' claims in the event of a possible crisis),

– accumulation of wealth.

The primary aim of reserve management is to support monetary policy. One of the guarantees for the credibility of the exchange rate regime is an adequate level of reserves, which, if necessary, protects the intervention band in the form of interventions, and supports the fulfilment of the Maastricht exchange rate criterion on the way to joining the Economic and Monetary Union (EMU). In 2006, there was neither open intra-band intervention nor passive interventions at the edges of the band.

In terms of the transaction goals, supporting the management of government debt remained the most important objective last year. In 2006, the Hungarian State borrowed foreign exchange in the amount of approximately EUR 3 billion, which, even netted with the interest and principal repayments, added more than EUR 1 billion to the foreign exchange reserves, as the State converts its foreign exchange resources into forints at the MNB. Transfers received from the European Union increased the reserves by approximately EUR 1 billion.

The MNB still does not wish to maintain reserves solely for the purpose of accumulating wealth. At the same time, however, it aims to meet total return criteria when managing foreign exchange reserves in an amount necessary at all times, i.e. it intends to preserve their value as a responsible asset manager and achieve an additional return if possible. In

2006, the costs of maintaining the reserves increased – although not significantly – as a result of the expansion of the credit spreads of Hungarian bond issues.

Investment policy

In formulating the investment policy, the MNB strives to adopt the best practice followed by central banks in developed countries. Like the majority of central banks, the MNB also pursues a fundamentally conservative investment policy. In our case, the conservative investment policy, in respect of the classical investment triad of return–safety–liquidity means that the emphasis is on the latter two, and thus the aim of holding reserves is maximising the return, while maintaining safety and liquidity. Our investment universe is restricted in such a manner that the maximum maturity of bond market assets which can be purchased is 10.5 years, while their credit rating can be AA-AAA. Liquidity requirements, in addition to credit ratings, also allow only for purchase of securities issued by developed countries, large international financial institutions and government agencies, and rule out the purchase of securities with large price fluctuations.

The euro plays a key role in the foreign exchange structure of reserves. Its weight is justified by the exchange rate system of Hungary, the country's close economic integration with the euro area and the foreign exchange structure of the government debt. In addition, the MNB keeps US dollar reserves as well.

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

Size of reserves

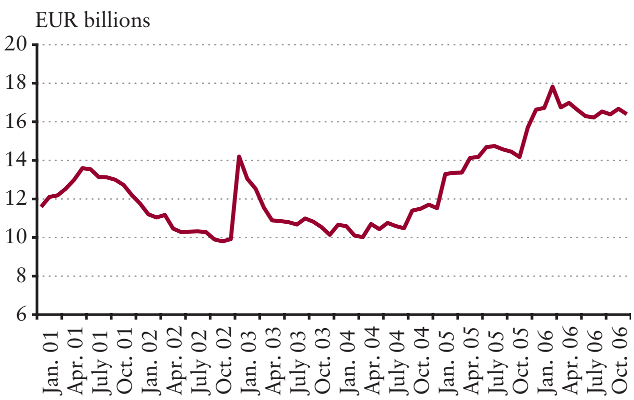
In the course of 2006, official foreign exchange reserves (which include accrued interests as well) rose from EUR 15.7 billion to EUR 16.4 billion. The level of reserves increased most strongly in the first quarter, when the ÁKK issued as many as three foreign exchange bonds. The greatest decline was observed in the second quarter, on account of the repayment of a maturing dollar bond. There was no considerable change in the second half of the year. On the basis of the indicators most often used to determine the optimum size of foreign exchange reserves, their current level can be considered as adequate.

The ÁKK's bond issues and borrowings mainly contributed to the increase in reserves. The euro bond (maturing in 2014) issued in January, the Japanese yen (maturing in 2013) and pound sterling (maturing in 2016) bonds issued in March, as well as the additional euro bond issue (maturing in 2012) in September added EUR 2.6 billion, while the loans extended by the European Investment Bank (EIB) added nearly EUR 0.4 billion to the reserves. At the same time, repayment of the dollar bonds maturing in April and December resulted in a decline of EUR 0.8 billion, while other foreign exchange transactions of the ÁKK and the MNB related to debt management (loan repayments, interest payments, interest and foreign exchange swaps) caused a total decline of nearly EUR 1 billion.

Transfers from the European Union resulted in a EUR 1 billion inflow. The return on foreign exchange reserves contributed by approximately EUR 0.4 billion to the increase. Sales of euro (rechannelling to the market) intended for offsetting the forint liquidity expanding effect of foreign currency borrowings and transfers reduced reserves by EUR 1.1 billion, while payments in foreign exchange effected on behalf of budgetary institutions reduced reserves by EUR 0.8 billion.

Chart 2

Developments in foreign exchange reserves from 2001



Managing financial risks at the MNB

In the course of conducting its core tasks, the MNB is necessarily confronted with financial risks. As a general principle, the degree of the risks assumed should be known, risk assumption should be conscious, and the degree of the risks in question should correspond to the targets of the core tasks. The

MNB mitigates financial risks related to the management of foreign exchange reserves by the use of limits. As a basis for comparison, it applies benchmarks in relation to investment portfolios which reflect the MNB's preferences with regard to the safety of the managed reserve's value, the liquidity of the reserves and the rate of yield expected on the reserves. The performance of the foreign exchange management activity is indicated in the context of these reference portfolios.

The framework of conscious risk-taking to be applied in 2006 was decided by the Monetary Council. It determined the basic principles of reserve and risk management, defining market, credit and liquidity risks as risks which are consciously taken, decided on the benchmark policy, establishing strategic benchmarks and defining the types of currencies to be held on the assets side in the gross reserve structure.

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

The two main pillars of the risk management policy are the two-tier benchmark system and the limit system partly attached to the benchmarks. A risk management organisational unit independent of the market area reviewed the benchmarks serving yield/risk preferences and the measurement of performance on a monthly basis. In September, a tactical benchmark was established with regard to the dollar portfolio. Maximum deviations from the benchmark were restricted by limits defined by the Board of Directors.

The Bank manages the investment and liquidity portfolios on the basis of separate strategies. In 2006, the benchmark of both the euro and the dollar investment portfolios contained high credit rating government securities, corporate bonds as well as money and capital market assets with a maximum remaining maturity of 10.5 years. The composition of the benchmark portfolios, by credit ratings of assets and remaining maturity, reflects a conservative risk appetite, which is typical of central banks in general.

The total return on the euro-denominated investment portfolio was 2.1 per cent in the 2006 calendar year, 0.21 percentage points higher than the relevant benchmark, while the total return on the US dollar-denominated portfolio was 4.76 per cent, outperforming the relevant benchmark by 0.35 percentage points. The annual total return on the euro-denominated liquidity portfolio was 2.86 per cent as opposed to the 2.65 per cent return on the benchmark, while the US dollar-denominated total return was 4.99 per cent compared to the 4.84 per cent for the benchmark.

On the last day of the year, the interest rate risk on the MNB's total balance of foreign exchange was EUR 46 million expressed by the value-at-risk (VaR) indicator (at a one-month time horizon and at a confidence level of 95 per cent), while the tracking error of investment portfolios to the benchmarks corresponded to EUR 6 million, also at a 95 per cent confidence level. At the same time, the value at risk of the net open currency position (measured to the euro, at a 1-day time horizon and a confidence level of 95 per cent) amounted to EUR 83,000. The magnitudes reflect the implementation of the conservative principles laid down in the risk-taking policy.

Managing operational risks

Based on previous years' experiences, in 2006 the MNB reformed its operational risk management system.

As a foundation for introduction of the new system, the 'Audit Committee' transformed into an 'Audit and Operational Risks Committee'; thus the committee became the number one reporting forum for operational risk management and an institution of central approval of risks.

The annual review and analysis system of operational risks changed, and, as a new method, the centralised collection and analysis of operational risk events and key risk factors was launched.

It was an important objective to have a new system which is simpler, but still capable of providing more information, and more useful information for the Bank's management on the Bank's situation in terms of operational risks, the risk events which took place, their effects as well as changes in the probability of risks' taking place.

As in the previous years, the Bank paid special attention to maintaining and improving the quality of its business continuity system.

3.5. CURRENCY ISSUING ACTIVITIES

One of the basic tasks of the Magyar Nemzeti Bank is to supply the national cash circulation with banknotes and coins of adequate quantity, quality and denomination. In the course of 2006 the central bank discharged this obligation completely.

In order to increase the security of the banknote series in circulation, in April 2006 the MNB issued 1,000 forint banknotes with new security features (copper-coloured, holographic-effect metal stripe, pearl-coloured iridescent stripe). Earlier versions of the 1,000 forint banknote also remained in circulation.

In October 2006, 15 million 500 forint circulation banknotes and 2 million 50 forint circulation coins were issued on the occasion of the 50th anniversary of the Revolution of 1956.

The central bank considered it necessary to create an adequate regulatory framework for all of its customers and all cash transactions. The extended Business Terms and Conditions entered into effect on 1 June 2006. To this end, it was an important step to regulate the exchange activity performed by the MNB in the Business Terms and Conditions. In the area of exchanging more than 100 pieces per denomination, wholesale service was attained, as for exchanging the MNB receives only cash pre-processed by a cash processing organisation. The MNB continues to be at the service of any customer if not more than 100 pieces per denomination are exchanged.

The central bank revised the role and operational efficiency of its regional network in cash distribution, and decided to close down the regional currency branch offices in Győr and Kecskemét. In addition to the Budapest headquarters, two branch offices (in Székesfehérvár and Debrecen) perform cash distribution tasks from the second quarter of 2006.

In 2006, the MNB regulated the reproduction of Hungarian legal tender and the euro in a decree (Decree No. 1/2006 (II.15.) of the Governor of the Magyar Nemzeti Bank on the reproduction of Hungarian legal tender and the euro), defining compliant reproductions which may be produced without or with authorisation, as well as prohibited reproductions.

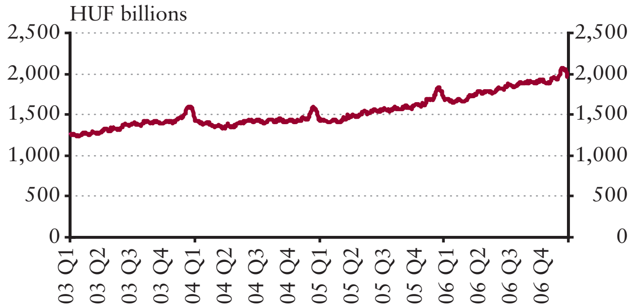
Currency in circulation

At the end of 2006, the value of cash in circulation was HUF 1,960 billion, up 15 per cent or HUF 254 billion compared to the end of the previous year. In 2006, the value of cash increased by an annual average of 18 per cent, significantly exceeding the 10 per cent growth rate recorded in 2005.

The difference between the changes in the value of cash in circulation during the year compared to previous years was that the annual peak due to the year-end holidays was less marked than in the previous years. Compared to end-November, the volume of cash in circulation increased by HUF 120 billion in mid-December, corresponding to 13 per cent growth compared to the same period of the previous year.

Chart 3

Value of cash in circulation 2003–2006



The ratio of average value of cash in circulation, in relation to GDP at current prices, rose from 7.1 per cent in the previous year to 7.8 per cent, as a result of higher growth rate in cash compared to that of GDP.

Chart 4

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

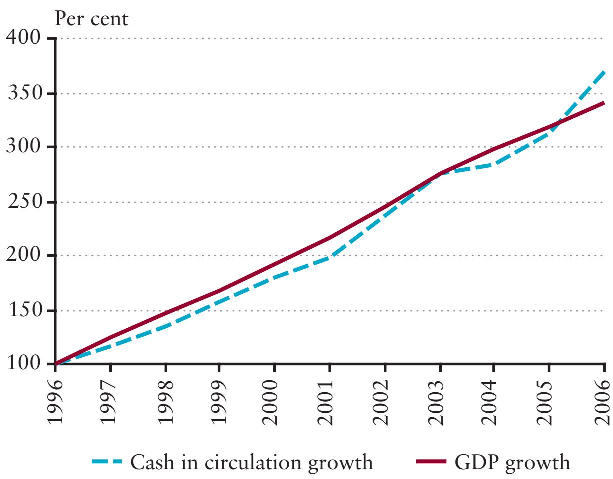


Table 2

Currency in circulation on the last day of the year

	2005	2006	Change	
	HUF billions			%
Banknotes	1,675.3	1,926.0	250.7	115.0
Coins	27.5	29.8	2.3	108.4
Cash for circulation	**1,702.8**	**1,955.8**	**253.0**	**114.9**
Collector notes and coins	3.2	4.0	0.8	125.0
Cash in circulation	**1,706.0**	**1,959.8**	**253.8**	**114.9**

Table 3

Banknotes in circulation on 31 December 2006

Denomination	Quantity	Value	Percentage share	
	Millions	HUF billions	Quantity	Value
20 000 forint	43.3	865.5	14.8	44.9
10 000 forint	83.7	836.7	28.6	43.5
5 000 forint	22.7	113.6	7.7	5.9
2 000 forint	18.1	36.3	6.2	1.9
1 000 forint	50.3	50.3	17.2	2.6
500 forint	28.5	14.3	9.7	0.7
200 forint	46.4	9.3	15.8	0.5
Total	**293.0**	**1,926.0**	**100.0**	**100.0**

Banknotes in circulation

In 2006, the value of banknotes in circulation increased by 15 per cent in comparison with end-2005, reaching HUF 1,926 billion by the end of the year. The number of banknotes in circulation grew at a more moderate rate of 11 per cent, due to a further increase in the number of banknotes with higher denominations. The quantity of all banknote denominations rose, with the number of 20,000 forint banknotes increasing at an above-average rate of 25 per cent. The number of 500 forint banknotes also increased considerably, by 17 per cent. The underlying reason was the issue of the commemorative version of the 500 forint circulation banknote, a part of which was probably set aside as a keepsake, thus removing it from daily circulation. The share of the new 1,000 forint banknote issued in April 2006 within the total quantity of 1,000 forint banknotes in circulation reached 40 per cent by the end of the year.

Coins in circulation

There were 2,801 million coins in circulation at the end of 2006, up 10 per cent or 256 million on a year earlier. Similarly to previous years, 67 per cent of the increase is related to the higher-than-average outflow of coins of small denomination (1 and 2 forint coins). In 2006, the increase in the number of 50 forint coins was the most dynamic, 13 per cent. The underlying reason was that in 2006 the MNB issued 2 million copies each of the commemorative versions of the 50 forint circulation coin on the occasion of the 125th anniversary of the existence of the Hungarian Red Cross and in commemoration of the 1956 Revolution, and, due to their special nature, most of them are out of circulation, being preserved as keepsakes. In 2006, the value of coins in circulation increased by 8.4 per cent (HUF 2.3 billion).

Cash distribution

In 2006, the MNB's cash turnover amounted to HUF 3,688 billion, which is 6.3 per cent less than in 2005. The turnover also declined in terms of numbers, as the MNB paid out 335 million banknotes, while banks paid 306 million banknotes to the central bank, which is 11 per cent and 3 per cent less, respectively, than the corresponding figures for the previous year.

The increase in efficiency of the cash market is indicated by a further decline in the MNB's role in cash distribution in

Table 4

Coins in circulation on 31 December 2006

Denomination	Quantity	Value	Percentage share	
	Millions	HUF millions	Quantity	Value
100 forint	146.3	14,631	5.2	49.1
50 forint	98.6	4,931	3.5	16.6
20 forint	187.8	3,757	6.7	12.6
10 forint	223.6	2,236	8.0	7.5
5 forint	307.2	1,536	11.0	5.2
2 forint	846.3	1,692	30.2	5.7
1 forint	990.8	991	35.4	3.3
Total	**2,800.6**	**29,774.0**	**100.0**	**100.0**

2006. The frequency of banknotes' appearance at the central bank (banknotes processed by the MNB/banknotes in circulation) declined to 1.1 in 2006, down from the rate of 1.3 measured in 2005.

In parallel with this, in 2006, the MNB continued to strengthen the inspection of cash processing activity outside of the central bank. In order to provide for the adequate quality of banknotes in circulation, it continued the new inspection activity introduced in the previous year. In the presence of the processing organisation, it regularly examined the quality of the cash paid into the central bank.

In order to provide stronger support for market participants' mechanisation, the MNB institutionalised the co-operation between the MNB and cash-processing organisations. Within the scope of this work, the MNB provides continuous technical support for the installation of banknote processing machines used outside the central bank.

Prevention and reduction of counterfeiting

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

In 2006, the activity of the National Counterfeit Centre, established in the spirit of EU accession, focused on strengthening the co-operation with institutions, primarily with the ORFK (National Police Headquarters), ensuring efficient and co-ordinated action against counterfeiting at the national level.

Following a slight rise observed in the previous years, in 2006 the magnitude of forging forint banknotes did not increase any further, but stopped at the level of the year 2005. Last year, the experts of the Magyar Nemzeti Bank registered 10,507 counterfeit forint banknotes withdrawn from circulation in a total 9,809 cases. The 1,000 forint banknote was counterfeited most often, accounting for a share of 79 per cent. In order to reduce the counterfeiting of this denomination, 1,000 forint banknotes with new security elements started to be issued in April 2006. Banknotes were still not counterfeited using printing-house methods; all seized counterfeits were produced with office reproduction equipment (colour photocopier, printer). The rate of counterfeits did not jeopardise the safety of cash circulation. In 2006, the average number of counterfeit banknotes per one million banknotes in circulation was 38, a ratio which is more favourable than that of the euro area.

Compared to the previous year, the number of foreign currency counterfeits seized from circulation remained at a favourable level, although it increased slightly. Within this, the occurrence of counterfeit euro banknotes declined by 15 per cent, and overall it is insignificant. Our experts analysed a total of only 691 counterfeit euro banknotes withdrawn from circulation in 2006.

Issue of commemorative coins

In 2006, the Magyar Nemzeti Bank issued eight commemorative coins, two circulation coins and a commemorative version of a circulation banknote. Demand for commemorative coins increased significantly in 2006.

The MNB issued a cupronickel commemorative coin about the Ford T-model with a face value of 1,000 forints and silver commemorative coins with a face value of 5,000 forints for the 125th anniversary of the birth of Béla Bartók, about the fortress in Munkács (Mukachevo), the Fertő cultural landscape, the 550th anniversary of the victory at Nándorfehérvár (Belgrade) and the Esztergom basilica. The Bank issued the commemorative version of the 50 forint coin on the occasion of the 125th anniversary of the existence of the Hungarian Red Cross. On the occasion of the 50th anniversary of the Hungarian Revolution of 1956 the central bank issued four types of commemorative money: in addition to the aforementioned 50 forint circulation coin and the commemorative version of the 500 forint banknote, gold and silver commemorative coins with face values of 100,000 forints and 5,000 forints, respectively, were also issued.

3.6. STATISTICAL SERVICES

The MNB's statistical activity

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

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

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

The MNB revises the collection of statistical data once every year, and specifies the reporting obligations for a calendar year. The MNB specified the 2007 data provision obligations in its Decree No. 22/2006 (XI.24.) and within the framework of the National Programme for Statistical Data Collection (OSAP) for 2007. Following a definite schedule, the MNB decree also includes data collections which were required earlier within the framework of the OSAP.

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

Monetary statistics provide information on the developments in credit portfolios and monetary aggregates and changes in the position of the individual sectors vis-à-vis monetary financial institutions on the basis of the processed balance sheet data of monetary financial institutions (i.e. credit institutions, money market funds and the central bank). Monetary statistics also include market (i.e. non-financial corporate, household and interbank) interest rate statistics.

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

The financial accounts provide information on the financial assets and liabilities in the Hungarian economy, and the elements of the changes in such. The financial accounts form an integral part of the system of national accounts, and are a useful contribution to the analysis of the development and level of financial mediation, as well as the financing relations between various economic agents. Securities statistics, which are closely related to the financial accounts, are based on reports by securities custodians, and provide information on government securities, investment fund units and quoted shares as well as their distribution between economic agents. Since 2004 the MNB has been participating in the compilation of the excessive deficit procedure (EDP) report related to the financing of the general government and government debt. Hungary is required to prepare this report on the basis of its obligations stemming from its EU membership. The report, which the MNB compiles together with the Central Statistical Office and the Ministry of Finance, contains the most important indicators of general government deficit and government debt.

Changes in 2006

In the field of balance of payments statistics, in the first quarter of 2006, the Magyar Nemzeti Bank issued a new methodological publication entitled 'External accounts statistics, Hungary'. With the intention of providing extensive information to users, this publication summarises the international methodology of compiling balance of payments statistics and the international investment position, as well as the practice applied in Hungary. The publication presents the main data of the balance of payments statistics and the developments in Hungary's assets and liabilities starting from 1995. The tables in the publication show annual data in a harmonised, time series format.

An important change in the methodology of balance of payments statistics is that on 31 December 2005, as a result of changes in the relevant legislation, previously established special-purpose off-shore companies ceased to exist. From the beginning of 2006, in accordance with international statistical methodological standards, the MNB also compiles the balance of payments and position statistics which completely contain the data of special-purpose companies (SPC), so that the data calculated in this manner allow for the international comparison of statistics and the preparation of mirror statistical analyses. From the aspect of the Hungarian economy, the MNB considers the statistics which do not contain the special-purpose companies' transactions and positions as relevant; therefore, this is what it communicates to users. In determining the scope of special-purpose companies the MNB co-operates with the CSO.

In line with European practice, in 2008 the MNB will introduce a new data collection regime, based exclusively on direct questioning. The adoption of the new questioning system requires a long time of preparation; as an important phase of this, in 2006 the questionnaire-based asking of goods turnover and services was completed in co-operation with the CSO. Test questionnaires with regard to the other items of the balance of payments and the international investment position were formulated and tested by the MNB with the involvement of 30 experimental data suppliers. Taking account of the experience gained in the tests, the final questionnaires were prepared and the draft MNB decree regarding the new data collection was formulated. It is expected to be published at the end of February 2007. The changeover will be preceded by extensive communication with the expected data suppliers. Accordingly, in November 2006, the MNB issued a newsletter about the changes, and held informative lectures for the potential data suppliers.

In respect of financial accounts statistics, in order to satisfy users' needs as fully as possible, in February 2006, the Magyar Nemzeti Bank began compiling and publishing households' preliminary financial accounts with a processing time of one and a half months following the relevant period, in addition to releasing the normal financial accounts data with a processing time of a quarter of a year. After the addition of households' financial accounts, in May 2006 the MNB also launched a preliminary data release on the general government sector as well. Another change compared to the earlier practice is that, in addition to data release on the

Internet, comments are also prepared about both the preliminary and normal financial accounts.

In 2006, there were changes in monetary statistics publications as well. The data release related to the consolidated balance sheet of monetary financial institutions expanded: from November 2006, in respect of certain important balance sheet items the MNB releases the transaction data as well, and it also publishes the accrued interest on loans and deposits.

International reporting

The MNB complied with all the reporting obligations pertaining to EU Member States in 2006. Accordingly, it supplied the statistical office of the European Union (Eurostat) and the European Central Bank with data on a regular basis.

Stemming from its status and in accordance with the expectations resulting from international co-operation, as well as in line with its membership obligations, in addition to Eurostat and the ECB's institutions, the MNB supplies the following international organisations with data and information: the International Monetary Fund (IMF), the World Bank, the Organisation for Economic Co-operation and Development (OECD) and the Central European Statistical Co-operation (CANSTAT). Data provision by the MNB meets the high-standard requirements of SDDS (Special Data Dissemination Standard) and relies on the methodology recommended by various international organisations. The MNB also provides data to the Bank for International Settlements (BIS) on a regular basis, with continuously expanded content.

Co-operation with domestic institutions

In addition to international institutions, statistical activities require the MNB to co-operate closely with domestic partner institutions, primarily the Central Statistical Office, the Ministry of Finance and the Hungarian Financial Supervisory Authority.

The framework of professional co-operation between the MNB and the CSO is defined in an agreement concluded on 8 February 2002 by the Governor of the MNB and the President of the CSO. The two institutions determine the fields of co-operation and the specific tasks in itemised working plans for calendar years. Similarly to the previous year, in 2006 as well, further development of the methodology related to the balance of payments, broadening of co-operation and harmonisation of the methodology of general government statistical records constituted a prominent part of the working plan. Another important area of co-operation is that through the two institutions' close co-operation, Hungary can completely fulfil its statistical data reporting obligations towards EU institutions, the European Central Bank and Eurostat.

In the field of monetary statistics, since early 1998 the MNB and the HFSA have required a jointly compiled balance sheet report from credit institutions. These two institutions also manage their co-operation in annually updated agreements.

3.7. PREPARATIONS AND PRACTICAL TASKS FOR THE ADOPTION OF THE EURO

Last year, the Board of Directors of the Magyar Nemzeti Bank discussed and approved a detailed working material which took account of the most important practical tasks related to the adoption of the euro in Hungary. The document summarised the national-level practical tasks which, in parallel with the future fulfilment of macroeconomic criteria, will have to be completed in Hungary as well in order to join the euro area and adopt the euro as the new currency. The schedule and action plan of meeting the convergence criteria in their own right are insufficient to create the conditions for adopting the euro. In fact, there are two parallel tracks of preparation for joining the euro area: implementation of the convergence programme (which requires meeting the macroeconomic criteria in a sustainable manner) on the one hand and the compilation and implementation of a broad-ranging series of practical preparatory tasks, i.e. the national changeover plan, which will allow a smooth and trouble-free currency changeover at all levels of society, on the other hand.

Upon accession to the European Union, a temporary derogation was granted to Hungary (together with the other nine countries which joined in 2004) regarding the adoption of the euro. Consequently, the adoption of the euro and the thorough preparation for such constitute a strict and equal obligation for Hungary both in a macroeconomic and a practical sense.

Almost all of the EU Members States which intend to join the euro area have already prepared or are compiling a comprehensive euro changeover scenario, which takes account of the practical tasks involved in adopting the new currency, designates the time requirements of individual phases of preparation, defines the institutional framework of preparation and future changeover, and specifies the specific preparatory tasks of individual players (central administration, local governments, credit institutions and corporations, etc.). Even countries where the adoption of the euro is not yet on the agenda, such as the United Kingdom and Sweden, have elaborated their respective national changeover plans. The preparation, adoption and continuous maintenance of a national practical preparatory programme is important because its implementation may require at least four, or – optimally – five years. Obviously, it is not sufficient to determine practical preparations when the macroeconomic criteria have already been met, because the lack of relative preparedness may again lead to a significant delay in the adoption of the euro.

The material attempts to clarify the main principles which have to be clear for everybody in the course of the changeover to the euro, at the very beginning of the process. For example, one of these principles is that each player concerned has to bear the cost burdens related to the euro changeover itself. It is also an important requirement that the cash changeover itself may not contribute to an increase in inflation. Half a year before the actual changeover all market participants have to start to apply dual prices in shop-windows, catalogues and on invoices. The legal continuity of contracts will remain in place. Precursory determination and announcement of these and similar rules and principles greatly contributes to the success of the changeover.

The MNB's working material also examines the national institutional framework of the changeover. It is essential for the elaboration of the national euro changeover plan to depart from the traditional domestic frameworks of public administration and be distinguished from the daily routine procedures, but at the same time to rely on the expertise and proficiency of ministries and other government agencies. A body comprising prepared, competent representatives of the central bank, the Government and business circles should co-ordinate the large-scale changes covering the whole economy, determine – on the basis of common interests – the initial steps of practical preparation, monitor the implementation of plans and fine-tune the latter. It assumes the establishment of a national-level committee structure which covers all segments of society and the economy, and allows the maximum involvement of the business sector in the preparations, active development of solutions and monitoring of the preparation in its own fields.

The material takes account of the tasks to be performed in the fields of public administration, large distribution systems, the competitive sector and households, but also touches on issues to be dealt with regarding legislation, the financial sector, consumer protection, IT changeover and communication. The MNB plays a leading role in the tasks related to money circulation and the cash changeover, as well as the broad-based communication on the subject.

Taking the European framework conditions into account, the institutional structures regarding practical preparation must be established, and the national changeover plans must be elaborated and made public in Hungary as soon as possible. This assists economic agents in planning their own euro changeover, taking account of the national plan and in contributing to the fine-tuning of the national euro changeover plan in the form of practical proposals. National, regional, sectoral and corporate euro changeover plans must be implemented in close interaction with one another. The preparation involving the whole society will have to be started and implemented in a very intensive co-operation. Meanwhile, it will be absolutely indispensable that economic agents start the preparation of their own euro changeover in due course, although actual investment can be expected of the private sector only when it accepts the euro area accession programme as credible.

The completed working material contains proposals not only for the major tasks to be performed with regard to the national euro changeover programme, but also for their possible scheduling and institutional solutions as well. In order to facilitate the compilation of the national changeover programme, at the beginning of August the MNB forwarded its comprehensive working material to the Ministry of Finance and to the Prime Minister's Office, initiating professional consultations related to the preparation of the practical adoption of the euro. After accepting this proposal, the Ministry of Finance set up a joint working group with the MNB to elaborate a joint proposal.

3.8. FACTORS SHAPING THE COMMUNICATIONS OF THE MNB IN 2006, TARGETS AND RESULTS

The communication activity of the MNB is built on three closely related pillars:

The first one is the support of communication following the Monetary Council's decisions and monitoring news on the events which appear in the press. By means of the press conferences after the meetings of the Monetary Council, the central bank can relay quick, direct messages to the outside world.

The second pillar is providing information on the results of the research activities in the fields of analysis, the release of publications prepared therein and converting professional analyses into easily intelligible messages.

The central bank's communication with the public is the third area which has been marked by greater initiative and wider scope in recent years. In this regard, the central bank has undertaken a wide range of communication campaigns aimed at the largest and at the same time most complex audience. The MNB Visitor Centre continues to be one of the most efficient means of enhancing the MNB's image and reputation as well as functioning as a channel for relaying central bank messages. It contributes to the development of the public's knowledge of financial matters and helps boost the public's familiarity with the Bank and its activities. The exhibitions and lectures received more than 40,000 visitors in 2006. With its open-house days and by organising museum programmes (conference, picnic in May, café) the Visitor Centre has succeeded in establishing a good relationship with the museum profession as well. The 'Stúdium' programme for students in higher education and the successful 'Monetary' quiz series has served to increase the financial knowledge of several thousand students.

The efficiency of communication with the public is confirmed by the public-opinion polls which are carried out every year. According to a survey carried out among the public, confidence in the Bank increased from 29 per cent in 2003 to 68 per cent in 2006.

Overall, similarly to modern central banks, the MNB treats communication as a matter of strategy, the main characteristic features of which are openness, pro-activity and an approach in line with the needs of those concerned and interested in the central bank's activity. This allows complex tasks and professional messages to reach the desired target groups with a suitable level of efficiency.

In 2006, relations with the press, regular information supply, publications for professionals and the general public, modern communication interfaces, on-line tools and co-operation with the media also contributed to increasing the public image of the MNB, which occupied the second place in institutions' confidence ranking.

3.9. FINANCIAL PERFORMANCE OF THE MNB

The MNB's income in 2006

In 2006, the Magyar Nemzeti Bank earned a profit of HUF 14.6 billion. The financial result and balance sheet structure of the Bank are primarily determined by the macroeconomic developments of recent years and measures implemented for monetary policy purposes. The major events determining changes in the balance sheet and the income statement in 2006 were as follows:

– a significant depreciation of the exchange rate of the forint against the euro in the course of the year,

– an increase in the central bank base rate predominantly in the second half of the year,

– the sale to the MNB of foreign currency from the issue of foreign currency bonds by the Republic of Hungary,

– an increase in foreign exchange interest rate levels.

In the first part of the year, following a continuous trend of depreciation, the forint exchange rate crossed the middle of the intervention band, thus weakening by 11.9 per cent (to HUF 282.69), before rebounding in the second half of the year (mainly in the fourth quarter) back to the level observed early in the year.

Table 5

Abbreviated income statement of the MNB

HUF billions

	Description (P/L line)	2005	2006	Change
	1	2	3	3-2
1	Net interest and interest related income (I+II)-(X+XI)	–17.7	–15.2	2.5
2	*– net forint interest and interest related income (I–X)*	*–116.9*	*–131.6*	*–14.7*
3	*– net foreign exchange interest and interest related income (II–XI)*	*99.2*	*116.4*	*17.2*
4	Realised gains/losses arising from financial operations (IV–XIV)	–1.3	–15.4	–14.1
5	Income arising from exchange rate changes (III–XII)	14.6	66.4	51.8
6	Other constituents of net income[1] (V+...+VIII)–(XIII+XV+...+XVIII)	–17.0	–21.2	–4.2
7	**Profit/loss for the year (1+4+5+6)**	**–21.4**	**14.6**	**36.0**
	Revaluation reserves in the balance sheet			
8	*– due to unrealised foreign exchange gain/loss*	*106.0*	*49.6*	
9	*– due to changes in the market value of hte foreign currency securities*	*–14.8*	*–20.6*	

[1] *Other constituents of net income consists of cost issuing banknotes and coins, net expenses of money circulations, net provision, and other income/expenses.*

Due to the significant depreciation of the forint exchange rate the course of the year, the official exchange rate departed considerably from the average cost rate, which resulted in a HUF 66.4 billion gain as realised net income from exchange rate change, as opposed to the HUF 14.6 billion gain in the previous year. Accordingly, the realised income from the exchange rate change had the greatest impact on income in fiscal 2006.

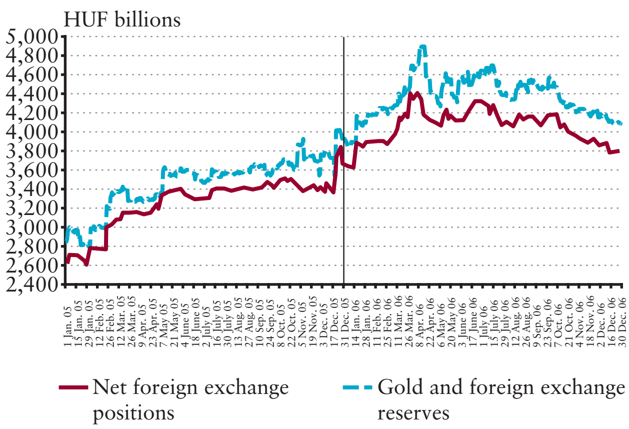
As a total result of conversion, changes in the forint exchange rate and the pre-announced foreign exchange sales in the market:

– the MNB's net foreign exchange position increased by EUR 0.5 billion to EUR 15.0 billion (HUF 3,780.5 billion),

– the foreign exchange reserves excluding accrued interest grew by EUR 0.6 billion (HUF 151.2 billion) to EUR 16.2 billion (HUF 4,082.3 billion) in 2006.

Chart 5

Net foreign exchange position and foreign exchange reserves (2005-2006)



Overall, in line with the changes in the foreign exchange position, net forint liabilities increased in 2006 compared to the previous year. The sum total of the forint deposits of the central government, required reserves of credit institutions and liquidity absorbing instruments (money market deposits placed on one's own decision, forint bonds issued by the MNB) declined by HUF 92.8 billion to HUF 1,915.2 billion by 31 December 2006, while the annual average amount of these instruments rose.

Net interest and interest related income improved by HUF 2.5 billion, as a result of an improvement in the net foreign exchange interest and interest related income, which exceeded the deterioration in the net forint interest and interest related income.

Developments in the interest balance were mainly determined by the following factors:

– The central bank base rate, which stood at 9.5 per cent on 1 January 2005, first declined to 6 per cent in several steps, followed by an increase again in several steps starting from 20 June 2006 to the current level of 8 per cent. As a result, forint interest expenses on forint liabilities increased.

– The change in the foreign exchange interest income is partly attributable to the increase in the foreign exchange reserves by EUR 0.6 billion (HUF 151.2 billion) and partly to the rising foreign exchange yields (EUR and USD foreign exchange market yields increased at all maturities during 2006).

Compared to the previous year, the realised loss from financial operations increased by HUF 14.1 billion to HUF 15.4 billion in 2006. The deterioration of income was a result of higher realised losses on the maturities and sales of foreign exchange securities.

The revaluation reserves due to the forint exchange rate fell from HUF 106.0 billion at the beginning of the year to HUF 49.6 billion, mainly as a result of a steady increase in the average cost rate during the year.

The revaluation reserves of foreign exchange securities showed a negative balance of HUF 20.6 billion on 31 December 2006. Based on the MNB Act, a negative level of revaluation reserves entails reimbursement from the central government by 31 March 2007.

As a consequence of the changes in the forint exchange rate, the total net revaluation effect was a profit of HUF 10 billion. From this amount, due to sales, the Bank realised a gain of HUF 66.4 billion, while the forint revaluation reserves (unrealised exchange rate income) declined by HUF 56.4 billion to HUF 49.6 billion.

Internal operations of the Magyar Nemzeti Bank in 2006

The internal operations of the Bank are essentially aimed at providing the resources required for the efficient discharge of the duties stipulated by the MNB Act and facilitating risk-free operations in the most cost-effective manner. Upon inspection of the operation of the Magyar Nemzeti Bank, the State Audit Office (SAO) reviews compliance of the institutional management with the statutory regulations and internal rules, and checks if the requirement of cost-effectiveness has been applied with regard to operating costs and investment. The SAO made no remarks or recommendations on these issues following the audit of the year 2005.

Table 6

2006 operating costs of the MNB

1	2	3	4	5	6
Description	Actual data for 2005	Budget for 2006	Actual data for 2006	Index (2006 actual/2006 budgeted)	Index (2006 actual/2005 actual)
	HUF millions			4 ÷ 3	4 ÷ 2
1. Personnel expenses	9,501	8,710	8,562	98.3%	90.1%
2. General operation costs	5,382	6,609	6,232	94.3%	115.8%
Total	**14,883**	**15,319**	**14,794**	**96.6%**	**99.4%**

The nearly 10 per cent decline in personnel costs in 2006 resulted primarily from the operational development programme, and was mainly due to the significant decrease in the average number of employees. General operating costs were up by a total of nearly 16 per cent, mainly due to the increase in depreciation resulting from an increase in the volume of investment.

The financially realised value of investment implemented in 2006 was HUF 6,494 million, a much higher amount than the figures of previous years. The underlying reason is that the construction of the Logistic Centre arrived at a phase of execution which required more funding. Some of the works and payments planned for 2006 were rescheduled; the investment is expected to be completed in December 2007. In addition, modernisation of the IT infrastructure and enhanced integration of systems continued. Amongst these development projects, the implementation of the medium-term statistical IT programme is of key importance, and major projects were completed in 2006 in this field. Another highlight amongst investment activities in 2006 was the new Conference Centre constructed in the building at Szabadság tér 8.

Operating costs

The Board of Directors had approved an operating cost budget of HUF 15,548 million for 2006 (including central reserves in the amount of HUF 229 million), whereas actual costs amounted to HUF 14,794 million.

Personnel costs

In 2006, personnel costs (HUF 8,562 million) declined by 9.9 per cent in comparison to 2005, basically as a joint effect of the factors listed below:

– implementation of the operational development programme launched in 2005 – i.e. the increase in efficiency and the rationalisation of the operation of the organisation – resulted in a 13.8 per cent decline in the average number of employees (2005: 896 employees, 2006: 773 employees);

– declining costs related to termination of employment and to changes in scope of activities compared to the previous year resulted in lower personnel costs;

– in 2006, base wages increased by 3.5 per cent on average.

General operating costs

In 2006, general operating costs (HUF 6,232 million) rose by 15.8 per cent in comparison to 2005.

In 2006, the amount of IT costs (HUF 1,296 million) exceeded the figure for 2005 by 11.6 per cent. This increase is primarily related to the measures begun in accordance with the principles defined in the MNB's approved medium-term IT strategy and the new and expanded software support and consulting services used for the operation of the IT systems.

In terms of its magnitude, the total amount of operating costs (HUF 1,554 million) corresponds to that of the previous year, in accordance with the planned target, related to maintaining the level of reliable operation reached in the previous years.

Depreciation charges on tangible assets and intangible assets in 2006 (HUF 2,375 million, which corresponds to the plan) were 28.0 per cent higher than in the previous year, because the volume of investment in recent years significantly exceeded the level from the preceding years. Within the completed investment, the proportion of IT developments (which amortise faster), with higher depreciation rates, increased.

In 2006, the total amount of other costs was HUF 1,007 million, up 22.9 per cent on 2005. This is primarily related to the implementation of a more efficient and intensive external communication strategy, both with regard to the Bank and the MNB Visitor Centre. In addition, the increase in other costs was also attributable to the fact that due to a growing demand for commemorative coins, the amount of the related costs exceeded that of the previous year.

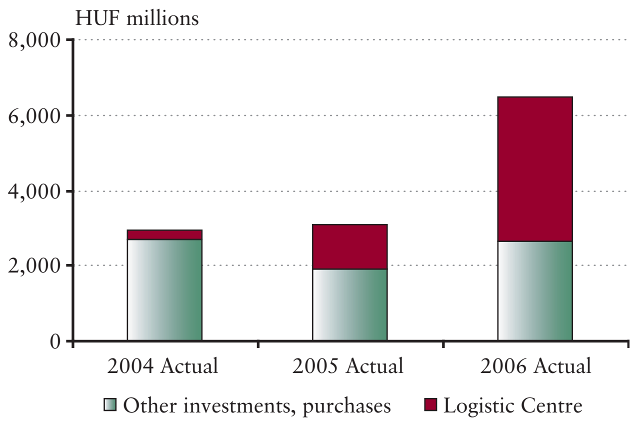
Capital expenditure

In 2006, the planning and monitoring method of capital expenditure was renewed. In the plan, for investment projects extending over several years, allocations covering the complete time horizon of implementation were determined, while regular, repeated investment with similar content continued to be planned only for a year in advance. From 2006 no central reserves are included in the investment plan. The plan compiled in this manner is updated every year.

Accordingly, the Board of Directors approved the plan of investment launched in 2006 for the period 2006 to 2008 (in the amount of HUF 4,095 million, including modifications in the course of the year), of which the amount envisaged for 2006 was HUF 2,259 million. In addition, it also took notice of the total sum allocated for investments in progress (HUF 15,034 million), which included the actual expenditure up to 2005 and expenditure planned for the following years. Three-quarters of this is related to the implementation of the Logistic Centre.

Chart 6

Investments of the MNB (2004–2006)



Establishment of the Logistic Centre

The MNB will relocate the issue of banknotes and coins, along with its IT support and the Magyar Pénzverő Zrt., to a new, well-equipped logistic centre. The Board of Directors approved the complete (projected) financial plan of the facility in 2003, and has continued to monitor the progress of works on a regular basis.

In 2006, the structural works of the buildings of the Logistic Centre and the outdoor parking lots were fully completed, while the on-site and off-site utilities as well as the high- and low-current networks were mostly completed. The level of completeness allowed the heating and lighting of indoor spaces, and thus finishing and installation works became possible in the winter. The route development works which ensure convenient access to the facility were also completed.

Compared to the preliminary schedule, the implementation had to be postponed due to the weather, which was less favourable than expected, and other technical problems, and the final deadline for the turn-key handover of the facility changed to 15 December 2007. Accordingly, delivery times of individual technological suppliers and payment schedules were also modified, which entailed changes in the annual distribution of financial allocations in the 3-year investment plan.

Additional investment

In 2006, the majority of the planned new investment was launched. On the whole, 56.3 per cent of the investment was completed and/or put into operation during the year, and the rest will continue in 2007.

The aim of the conference centre investment was to create a conference venue which meets international standards. The new conference centre also allows the organisation of meetings of international scientific and professional organisations for a large number of participants. The implementation was a result of converting parts of the building which previously had had other functions. The general contracting works were finished during the year, and the facility was occupied.

The quality of the information system supporting central bank statistics is of crucial importance, and an essential aspect of this activity is IT support with an adequate level of quality. The Integrated Statistical System began to be implemented in 2004; a medium-term programme for building up the new system was determined, including the related investment. In 2006, the functions supporting the primary processing, central registration and electronic submission of statistical reports, as well as the systems processing securities statistics were developed and installed, successfully migrating from the earlier systems. In addition, the system performing the corporate balance calculations of financial statistics was also completed.

During the year, the licence structure, platform and version replacement of the corporate management system of the internal operations was realised. The project aimed at increasing the efficiency of processes was also launched, which creates the IT background for the revised processes of internal operations. As a part of the re-organisation, the IT support for the administrative processes of organising business trips was already completed in October 2006. The task for next year will be to change the processes of undertaking obligations, account management, petty cash and administration of assets. The new processes of financial planning will also be elaborated in 2007.

The objective of the server consolidation investment according to the medium-term IT strategy is to replace the 'one system – one server' operating practice with the implementation of efficient management of IT resources, in parallel with the replacement of partly outdated technical facilities and the improvement of operating safety. Following the purchase of equipment, architecture planning was carried out in 2006, and the implementation of the application consolidation phase also started. On the basis of the means obtained and the architecture plan, its task is to adjust the set of tools supporting banking operations to the new environment planned to be used in the future.

Upon creation of the IT processes, the ITIL (IT Infrastructure Library: the methodology and internationally accepted operational standard of information supply), which is accepted as an international standard, was considered to be the basic example. Its gradual introduction started in 2006. Based on process describing documents, IT activity is becoming more understandable and transparent.

There was further IT investment in order to support administrative processes (development and modifications of user systems) and to provide for a high-level, continuous availability of the technical infrastructure and systems.

Other investment and procurements in 2006 were mainly related to real estate maintenance and technological modernisation as well as currency issue and security developments.

Human resources management of the MNB

The main objectives of human resources management in 2006 included the further development and a more active use in day-to-day management activities of the modern human resources systems created in the previous years, simplification and development of organisational development activities aiming at deregulation, which facilitates more efficient operation, and of the related administrative tasks. The direction of the further development of human resources systems was determined by the 3-year human resources strategy prepared in 2005 and approved by the Board of Directors.

Support of the new operational–management model, which facilitates more flexible and efficient operation and is based on deregulation

In 2005, in order to enhance the development and efficiency of operations, the Bank's management set as a target the introduction of a new, less hierarchical and regulated operational and management model based on a commonly accepted scale of values, standards, principles and empowerment, which – due to its flexibility – results in faster and less bureaucratic performance of work, consuming less resources and time. The changeover started in January 2006, supported by a multi-directional, appropriate and intensive training and communication programme. Joint programmes were organised for the employees of the organisational units, aimed at providing information about the new operational model, the formulation of the principles of the new operations, determination of roles and laying the foundations of standards and processes. Training programmes were organised for the managers, team leaders and staff and supported learning about the management style and set of tools supporting operations on the basis of the philosophy of empowerment, the acceptance of fundamental values of empowerment (self-reliance, taking responsibility, initiative) and acting in line with these values.

Competence-based performance management, development, selection

In 2005, as a first step, the Bank determined the competences which result in effective work and good performance. These were continuously incorporated into the HR systems in 2006. In the performances appraisals in 2006, the managers who carried out the appraisals assessed the existence of competences, behaviours and skills necessary for the achievement of a good performance and their forms of appearance. The results of evaluations of competences directly influence the extent of individual performance bonuses and individuals' pay rises. The evaluation of competences assists in determining the directions of trainings and development, and also constitutes the basis for decisions on promotion and career development. In 2006, the development of the means and methods of competence-based selection started, while they will be introduced in 2007.

Employee resourcing

In 2006, the Bank advertised 68 vacant or new positions, 31 of which (46 per cent) were awarded to the Bank's employees within the internal application system, while the rest were filled through external competition.

In 2006, 12 employees worked for a period of 3–11 months at the European Central Bank or in staff exchange programmes, which, in addition to participants' professional and personal development, significantly contributes to the Bank's integration and development of professional relations in the European System of Central Banks. As part of the Visiting Researcher Programme, in 2006 the Bank received 13 PhD students, researchers and scientific lecturers, who took an active part in the work of the MNB's research workshop for one to three months.

Salary-system, incentives

The Bank's salary structure was simplified in 2006 by terminating fix bonuses and the simultaneous adjustment of the magnitudes of the performance bonus to market ratios. The simplification of the salary structure reduced the great differences between managerial and non-managerial bonuses, thus supporting simplification of the organisational structure and the change in the management model. As a result of the changes, the ratio of fixed to variable payment within total income matches the reference market ratios better.

Training, development

In 2006, training programmes were greatly influenced by the empowerment-based operations. Empowerment determined the main direction of executive training, while in respect of personal skills development training, certain previously-prepared training curricula were revised in order to further strengthen empowerment-based operation and form the staff's relevant attitudes. Similarly to previous years, professional training in Hungary and abroad, as well as management training and skills development programmes constituted the major thrusts in the Bank's training activities. In order to support employees' conscious career planning, a new type of training was offered to key personnel. In the identification of development needs, as a starting point, managers could already rely on those competence expectations identified at the beginning of the year.

Number of employees

In 2006, the human resources management of the MNB was characterised by organisational and operational rationalisation and the measures related to the continuation of the operations improvement programme launched by the Bank's management in 2005. Together these resulted in a 13.8 per cent decline in the MNB's average number of employees. As a continuation of the operational development measures, two regional currency branch offices were closed down, and activities which do not match the Bank's profile or cyclical activities (translation, loans to employees, application development activity) were partly or completely outsourced.

The number of employees at end-2006 was 739. As a result of the measures implemented, the number of employees was 70 persons (8.7 per cent) lower than the number at end-2005. In 2006, the employment of 132 employees was terminated. Termination was initiated by the employer in 74 cases, by the employees in 37 cases, while the employment of 21 people was terminated due to retirement and other reasons (e.g. expiry of fixed-term contracts).

As a part of the measures aiming at operational development, the MNB's organisation became flatter, the head of department level ceased to exist for several organisational units, and the number of managerial positions declined by one-third. Accordingly, the number of employees in managerial positions was 34 persons lower at end-2006, compared to 2005.

In 2006, the ratio of employees with higher education was 1.3 per cent higher than in the previous year. The composition by age is advantageous at the MNB; the average age of those employed grew only by 0.22 year to 41 years. The average employment time at the Bank is 12.6 years.

3.10. INTRODUCTION OF THE ESCB COMMITTEES

Since Hungary's accession to the European Union, the MNB's management and experts have been participating in the work of the ESCB committees and their working groups as full members. The fields of activity (mandate) of the individual ESCB committees can briefly be summarised as follows:

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

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

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

Eurosystem/ESCB Communications Committee (ECCO): Contributes to the development of the external communications policy of the Eurosystem, the ESCB and the ECB, in order to make the defined objectives more transparent and clearer and to inform the public about the tasks and activities of the Eurosystem and the ESCB.

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

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

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

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

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

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

Payment and Settlement Systems Committee (PSSC): Assists the ESCB in the smooth operation of the payment system, also giving advice on the cross-border use of collaterals in respect of the operation of TARGET (Trans-European Automated Real-time Gross Settlement Express Transfer System) and the CCBM (Correspondent Central Banking Model). In addition, it supports the ESCB in general and in 'oversight' issues related to payment systems, as well as in issues concerning central banks with regard to securities clearing and settlement systems.

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

3.11. PUBLICATIONS, CONFERENCES ORGANISED BY THE MNB IN 2006

Publications

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

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

Quarterly Report on the MNB's activities: This quarterly publication briefly reports on the activities of central banking professional areas in the previous quarter (monetary policy, overview of the financial system, foreign exchange reserves, payment transactions, currency issuing activity, statistical changes). Available only in Hungarian.

Annual Report: This publication contains the central bank's business report on the previous year and its audited financial statements.

Report on Convergence: This publication was first issued by the Magyar Nemzeti Bank in 2005, to be issued annually in November. With this publication the MNB wishes to provide information to decision-makers, experts and the wider public to improve their knowledge of the rather complex issues related to membership of the monetary union.

MNB Occasional Papers: In this series economic analyses related to monetary decision-making by the Magyar Nemzeti Bank are published. The series aims at increasing the transparency of monetary policy. Thus, in addition to studies also describing technical details of forecasting, economic issues arising during decision-making are published as well.

MNB Working Papers: These publications contain the results of analyses and research work conducted at the Magyar Nemzeti Bank. The analyses reflect the opinions of the authors, and may not necessarily coincide with the official stance of the MNB. Since the autumn of 2005 the series has been available only in English.

MNB Bulletin: It was first published in 2006, and is issued biannually. The aim of the short articles published in this volume is to inform the wider public in an easily intelligible manner about the central banking aspects of economic developments and the findings of research carried out at the central bank.

Other publications: The new, revised version of the volume entitled *Monetary Policy in Hungary* was published in the autumn of 2006. It highlights the fundamental concepts and framework of monetary policy, and provides an insight to recent developments in the Hungarian monetary policy. The volume entitled *Monetary Transmission in Hungary,* which examines the monetary transmission mechanism and summarises the results of several years of central bank research, was published in English as well in 2006.

All publications of the Magyar Nemzeti Bank are available on its website (http://english.mnb.hu).

Events, lectures

Conferences

1 June Currency issuance conference

19–22 June International Users Group (IUG) conference

1 August Forint commemorative conference

16 October Foreign currency lending workshop

26–27 October 5th Macroeconomic Policy Research Workshop on Micro Behaviour and Monetary Policy

8 November Financial Markets Conference

8 November Visitor centres and museums in education

17 November International Payment System Conference

22 November Inflation, growth, equilibrium – economic outlook

Committee/working group meetings organised by the European Central Bank at the MNB

18–19 May ECB PSPWG Conference, Payment System Policy Working Group

22–24 June ECB IRC Conference, International Relations Committee

29–30 June ECB WGMA Conference, Working Group Macroprudential Analyses

7–8 September ECB WGEM, Working Group on Econometric Modelling

23–24 November ECB WGGES, Working Group on General Economic Statistics

Lectures

17 January Dániel Holló-Márton Nagy: Bank Efficiency in the Enlarged European Union

25 January Ceyhun Bora Durdu: Are Indexed Bonds a Remedy for Sudden Stops?

9 February Ádám Reiff: Costs of investment

10 February Ana Maria Oviedo: Doing Business in Developing Economies: The Effect of Regulation and Institutional Quality on the Productivity Distribution

15 February Lajos Ódor: Beyond the flat tax: fiscal consolidation strategy in Slovakia

11 April Frank Smets: Inflation persistence and price setting behaviour in the euro area - A summary of the IPN Evidence

5 May Gergely Kiss-Márton Nagy-Balázs Vonnák: Credit Growth in Central and Eastern Europe: Trend, Cycle or Boom?

11 May Elod Takáts: A Theory of 'Crying Wolf': The Economics of Money Laundering Enforcement

17 May János Hidi: Monetary policy evaluation for Hungary using Taylor rules

19 May Ádám Reiff: Firm-level Adjustment Costs and Aggregate Investment Dynamics - Estimation on Hungarian data

26 May BESS at MNB: Robert H. Rasche: Inflation: Do Expectations Trump the Gap?

15 June BESS at MNB: Russell Cooper: Is it is or is it Ain't my Obligation? Regional Debt in a Fiscal Federation

22 June Klaus Schmidt-Hebbel D.: Does Inflation Targeting Make a Difference?

23 June Balázs Vonnák: Transmission of Hungarian Monetary Policy

3 August Béla Személy: Trade Induced Factor Reallocations and Productivity Improvements

6 September Mirco Tonin: Did the Minimum Wage Increase in 2001 Reduce Tax Evasion in Hungary? Some interim results

19 September Michael Frömmel: Bank lending and asset prices

4 October BESS at MNB: Péter Benczúr-István Kónya: Nominal growth of a small open economy

12 October BESS at MNB: Jin-Chuan Duan and András Fülöp: How Frequently Does the Stock Price Jump? An Analysis of High-Frequency Data with Microstructure Noises

16 October BESS at MNB: Helge Berger, Michael Ehrmann and Marcel Fratzscher: Forecasting monetary policy decisions: What determines the accuracy of forecasts by central bank watchers?

18 October Anna Naszódi: Are The Exchange Rates Of The EMU Accession Countries Anchored by Their Expected Euro-Locking Rates?

25 October Cecília Hornok-Zoltán M. Jakab-Barnabás Máté Tóth: Consequences of global imbalance corrections for Hungary

27 November BESS at MNB: Maarten Dossche-Freddy Heylen-Dirk Van den Poel: The kinked demand curve and price rigidity: evidence from scanner data

11 December BESS at MNB: Reint Gropp, Christoffer Kok Sørensen and Jung-Duk Lichtenberger: The dynamics of bank spreads and financial structure

20 December BESS at MNB: Jirka Slacalek: What Drives Personal Consumption? The Role of Housing and Financial Wealth

3.12. EXPLANATION OF ABBREVIATIONS AND TERMS SPECIFIC TO CENTRAL BANKING

Abbreviations

ÁKK: Government Debt Management Agency Ltd.

ALCO: Asset-Liability Committee.

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

BANCO: Banknote Committee (an ESCB committee).

BIS: Bank for International Settlements.

BSC: Banking Supervision Committee (an ESCB committee).

BUCO: Budget Committee.

CANSTAT: Central European Statistical Co-operation.

CEBS: Committee of European Banking Supervisors.

CSO: Central Statistical Office.

DRC: Disaster Recovery Centre.

DVP: Delivery Versus Payment.

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

ECB: European Central Bank.

ECCO: Eurosystem/ESCB communications committee.

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

EIB: European Investment Bank.

EMU: Economic and Monetary Union.

EPC: European Payments Council.

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

ESCB: European System of Central Banks.

EUROSTAT: the statistical office of the European Union.

GDP: gross domestic product.

GIRO: Giro Clearing House Limited.

HFSA: Hungarian Financial Supervisory Authority.

IAC: Internal Auditors Committee (an ESCB committee).

ICS: Interbank Clearing System.

IMF: International Monetary Fund.

IRC: International Relations Committee (an ESCB committee).

ITC: Information Technology Committee (an ESCB committee).

ITIL: IT Infrastructure Library, the methodology and internationally accepted operational standard of information supply.

KELER: Central Clearing House and Depository Ltd.

LEGCO: Legal Committee (an ESCB committee).

MC: Monetary Council.

MOC: Market Operations Committee (an ESCB committee).

MPC: Monetary Policy Committee (an ESCB committee).

O/N, overnight (deposit/loan).

OECD: Organisation for Economic Co-operation and Development.

ORFK: National Police Headquarters.

OSAP: National Statistical Data Collection Programme.

OTC: Over the counter (market).

PSC: Payment System Council.

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

SAO: State Audit Office.

SDDS: Special Data Dissemination Standard.

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

STC: Statistics Committee (an ESCB committee).

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

SWIFTnet: the IP-based closed network of SWIFT.

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

VIBER: real-time gross settlement system, a payment system operated by the MNB.

Explanation of terms

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

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

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

Delivery Versus Payment: Connecting securities and money transfer in a way that the securities are delivered only after the money has been paid.

EDP report: A report containing indicators compiled according to EU methodology regarding general government deficit and public debt, prepared jointly by the MNB, the CSO and the Ministry of Finance.

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

Interest rate futures: Interest rate futures is a stock exchange transaction where the basis of future settlement is a determined amount of standardised (expressed-in-contract) deposits with interest determined when making the deal.

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

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

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

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

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

Monetary financial institutions: The central bank, financial institutions and money market funds together form this institutional category within financial corporations.

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

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

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

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

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

Part B

Audited Financial Statements of the Magyar Nemzeti Bank

1. Independent auditor's report

ERNST & YOUNG

■ Ernst & Young Kft.
H-1132 Budapest, Váci út 20.
1399 Budapest 62 Pf. 632
Hungary

■ Tel: +36 1 451-8100
Fax: +36 1 451-8199
E-mail: mailbox.ey@hu.ey.com
www.ey.com
Cg. 01-09-267553

This is a translation of the Hungarian Report

Independent Auditors' Report

To the Shareholder of Magyar Nemzeti Bank

1.) We have audited the accompanying 2006 annual financial statements of Magyar Nemzeti Bank ("the National Bank"), which comprises the balance sheet as at 31 December 2006 - showing a balance sheet total of HUF 4,843,554 millions and a profit for the year of HUF 14,571 millions -, the related profit and loss account for the year then ended and the summary of significant accounting policies and other explanatory notes.

2.) We issued an unqualified opinion on 21 March, 2006 on the National Bank's annual financial statements as at 31 December, 2005.

Management's Responsibility for the Financial Statements

3.) Management is responsible for the preparation and fair presentation of these financial statements in accordance with the Hungarian Accounting Law and generally accepted accounting principles in Hungary. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

4.) Our responsibility is to express an opinion on these financial statements based on the audit and to assess whether the business report is consistent with the financial statements. We conducted our audit in accordance with Hungarian National Auditing Standards and with applicable laws and regulations in Hungary. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

5.) An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. Our work regarding the business report is restricted to assessing whether the business report is consistent with the financial statements and does not include reviewing other information originated from non-audited financial records.

6.) We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

ERNST & YOUNG

Opinion

7.) We have audited the elements of and disclosures in the annual financial statements, along with underlying records and supporting documentation, of Magyar Nemzeti Bank in accordance with Hungarian National Auditing 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, with the government decree of 221/2000 (XII.19.) regulating the accounting and preparation of the annual financial statements of the National Bank, with the Hungarian Accounting Law and with generally accepted accounting principles in Hungary. In our opinion the annual financial statements give a true and fair view of the equity and financial position of Magyar Nemzeti Bank as at 31 December 2006 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 11, 2007

Ernst & Young Kft.
Registration No. 001165

Mariann Hergovits
Registered Auditor
Chamber membership No.: 004648

A member of Ernst & Young Global

2. Balance sheet of the Magyar Nemzeti Bank

HUF millions

Note	ASSETS	31. 12. 2005	31. 12. 2006	Change
	1	2	3	3–2
	I. RECEIVABLES DENOMINATED IN FORINT	**174,139**	**171,619**	**–2,520**
4.3.	1. Receivables from the central government	169,528	171,313	1,785
4.14.	of which: receivables to refund the revaluation reserve of foreign currency securities*	14,816	20,600	5,784
4.7.	2. Receivables from credit institutions	3,924	303	–3,621
	3. Other receivables	687	3	–684
	II. RECEIVABLES DENOMINATED IN FOREIGN CURRENCY	**4,432,773**	**4,558,183**	**125,410**
4.9.	1. Gold and foreign currency reserves	3,931,059	4,082,279	151,220
4.4.	2. Receivables from the central government	117,253	102,852	–14,401
	3. Receivables from credit institutions	114	0	–114
4.10.	4. Other receivables	384,347	373,052	–11,295
	III. BANKING ASSETS	**30,915**	**32,637**	**1,722**
4.12.	of which: invested assets	29,644	32,398	2,754
4.15.	**IV. PREPAID EXPENSES/ACCRUED INCOME**	**73,211**	**81,115**	**7,904**
	V. TOTAL ASSETS (I+II+III+IV)	**4,711,038**	**4,843,554**	**132,516**

Note	LIABILITIES AND EQUITY	31. 12. 2005	31. 12. 2006	Change
	1	2	3	3–2
	VI. LIABILITIES DENOMINATED IN FORINT	**3,716,843**	**3,878,063**	**161,220**
4.5.	1. Central government deposits	175,039	280,447	105,408
4.8.	2. Deposits by credit institutions	1,799,180	1,634,681	–164,499
	3. Banknotes and coins in circulation	1,705,998	1,959,817	253,819
	4. Other deposits and liabilities	36,626	3,118	–33,508
	VII. LIABILITIES DENOMINATED IN FOREIGN CURRENCY	**817,220**	**834,653**	**17,433**
4.5.	1. Central government deposits	108,476	92,736	–15,740
	2. Deposits by credit institutions	4,319	54,881	50,562
4.11.	3. Other deposits and liabilities	704,425	687,036	–17,389
4.13.	**VIII. PROVISIONS**	**62**	**57**	**–5**
	IX. OTHER BANKING LIABILITIES	**10,796**	**10,656**	**–140**
4.15.	**X. ACCRUED EXPENSES/DEFERRED INCOME**	**33,216**	**29,023**	**–4,193**
4.16.	**XI. EQUITY**	**132,901**	**91,102**	**–41,799**
	1. Share capital	10,000	10,000	0
	2. Retained earnings	38,357	16,936	–21,421
	3. Valuation reserves	0	0	0
4.14.	4. Revaluation reserves due to exchange rate changes	105,965	49,595	–56,370
4.14.	5. Revaluation reserves of foreign currency securities	0	0	0
	6. Profit/Loss for the year	–21,421	14,571	35,992
	XII. TOTAL EQUITY AND LIABILITIES (VI+VII+VIII+IX+X+XI)	**4,711,038**	**4,843,554**	**132,516**

* *Pursuant to the Article 17, paragraph (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.*

11 April 2007

András Simor,
Governor of the Magyar Nemzeti Bank

Péter Adamecz,
Deputy Governor of the Magyar Nemzeti Bank

3. Income statement of the Magyar Nemzeti Bank

HUF millions

Note	INCOME	2005	2006	Difference
	1	2	3	3–2
4.18.	**I. INTEREST AND INTEREST RELATED INCOME DENOMINATED IN FORINT**	**15,687**	**10,801**	**–4,886**
	1. Interest on receivables from the central government	15,013	10,324	–4,689
	2. Interest on receivables from credit institutions	638	464	–174
	3. Interest on other receivables	29	4	–25
	4. Interest related income	7	9	2
4.18.	**II. INTEREST AND INTEREST RELATED INCOME DENOMINATED IN FOREIGN CURRENCY**	**218,278**	**202,079**	**–16,199**
	1. Interest on foreign currency reserves	101,550	145,291	43,741
	2. Interest on receivables from the central government	16,240	6,130	–10,110
	3. Interest on receivables from credit institutions	18	9	–9
	4. Interest on other receivables	3,827	3,385	–442
	5. Interest related income	96,643	47,264	–49,379
4.19.	**III. INCOME ARISING FROM EXCHANGE RATE CHANGES**	**21,147**	**68,545**	**47,398**
4.18.	**IV. REALIZED GAINS ARISING FROM FINANCIAL OPERATIONS**	**11,499**	**1,261**	**–10,238**
4.21.	**V. OTHER INCOME**	**3,560**	**5,362**	**1,802**
	1. Fees and commissions	1,166	1,098	–68
	2. Income other than fees and commissions	2,394	4,264	1,870
4.13.	**VI. PROVISIONS RELEASED**	**51**	**62**	**11**
4.13.	**VII. IMPAIRMENT RELEASED**	**43**	**608**	**565**
4.23.	**VIII. OPERATING INCOME**	**743**	**319**	**–424**
	IX. TOTAL INCOME (I+II+III+IV+V+VI+VII+VIII)	**271,008**	**289,037**	**18,029**

Note	EXPENSES	2005	2006	Difference
	1	2	3	3–2
4.18.	**X. INTEREST AND INTEREST RELATED EXPENSE DENOMINATED IN FORINT**	**132,503**	**142,405**	**9,902**
	1. Interest on central government deposits	28,940	25,938	–3,002
	2. Interest on deposits by credit institutions	100,476	116,094	15,618
	3. Interest on other deposits	3,087	373	–2,714
	4. Interest related expenses	0	0	0
4.18.	**XI. INTEREST AND INTEREST RELATED EXPENSES DENOMINATED IN FOREIGN CURRENCY**	**119,089**	**85,677**	**–33,412**
	1. Interest on government deposits	1,462	2,555	1,093
	2. Interest on deposits of credit institutions	285	389	104
	3. Interest on other liabilities	27,293	20,679	–6,614
	4. Interest related expenses	90,049	62,054	–27,995
4.19.	**XII. EXPENSES RESULTING FROM EXCHANGE RATE CHANGES**	**6,590**	**2,167**	**–4,423**
4.20.	**XIII. COST OF ISSUING BANKNOTES AND COINS**	**5,349**	**8,648**	**3,299**
4.18.	**XIV. REALIZED LOSSES ARISING FROM FINANCIAL OPERATIONS**	**12,836**	**16,706**	**3,870**
4.21.	**XV. OTHER EXPENSES**	**892**	**3,875**	**2,983**
	1. Fees and commissions	503	568	65
	2. Expenses other than fees and commissions	389	3,307	2,918
4.13.	**XVI. PROVISIONS CHARGED**	**103**	**57**	**–46**
4.13.	**XVII. IMPAIRMENT**	**0**	**0**	**0**
4.23.	**XVIII. OPERATING COSTS AND EXPENSES**	**15,067**	**14,931**	**–136**
	XIX. TOTAL EXPENSES (X+XI+XII+XIII+XIV+XV+XVI+XVII+XVIII)	**292,429**	**274,466**	**–17,963**
	XX. PROFIT/LOSS BEFORE DIVIDENDS	**–21,421**	**14,571**	**35,992**
	XXI. Dividends from retained earnings	**0**	**0**	**0**
	XXII. Dividends	**0**	**0**	**0**
	XXIII. PROFIT/LOSS FOR THE YEAR (XX+XXI-XXII)	**–21,421**	**14,571**	**35,992**

11 April 2007

András Simor,
Governor of the Magyar Nemzeti Bank

Péter Adamecz,
Deputy Governor of the Magyar Nemzeti Bank

4. Notes to the financial statements

4.1. THE BANK'S ACCOUNTING POLICY

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

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

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

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

4.1.1. The MNB's accounting framework

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

On a daily basis the MNB records:

- the exchange rate difference arising from the revaluation of its foreign assets and liabilities and derivative transactions for hedging purposes recorded off-balance sheet, and

- the accrued/deferred interest arising on in- and off-balance sheet assets and liabilities from hedging transactions.

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

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

- market valuation of foreign currency securities, with the exception of foreign currency bonds issued and repurchased by the Bank,

- allocation and recording of realised and unrealised parts of foreign exchange gains and losses arising on the daily revaluation, and

- charging depreciation.

Upon the quarterly closing of accounts, the MNB qualifies its contingent liabilities and claims, commitments and future receivables originating from derivative transactions for other purposes stated among off-balance sheet assets and liabilities, at the end of the year the invested assets, claims and other off-balance sheet liabilities. It then recognises impairment losses as necessary and makes provisions for liabilities and for expected losses.

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

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

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

The financial statements of MNB must be audited by the statutory auditor in compliance with Act C of 2000.

The persons authorised to sign the Annual Report are:

András Simor[1], Governor of Magyar Nemzeti Bank,
Péter Adamecz, Deputy Governor of Magyar Nemzeti Bank.

The person responsible for accounting services is Éva Gyöngyösy, MKVK membership number: 005792.

4.1.2. Major principles of valuation

Receivables from the central government

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

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

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

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

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

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

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

[1] András Simor, the present Governor, replaced Zsigmond Járai from 3 March 2007.

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

Of the foreign exchange gains and losses arising in the course of the daily revaluation, realised exchange rate gain can be stated as a profit item, while unrealised income is stated under equity, in the item ‘Revaluation reserve due to exchange rate changes’.

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

Foreign currency securities

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

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

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

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

Accounting rules relating to the IMF quota

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

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

Accounting rules relating to derivatives

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

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

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

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

Banking assets and liabilities

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

- assets and liabilities not directly related to central bank functions and bank operations (such as settlements relating to taxes, contributions, payments to personnel, creditors, precious metals unsold held for non-central bank purposes), as well as

- liabilities arising from banknotes no longer accepted as legal tender but not yet exchanged,

- investments, and

- assets required for operating the organisation (such as intangibles, tangibles, inventories).

Depreciation rates applied by the Magyar Nemzeti Bank

Description	31. 12. 2006
Rights on assets	17.0%
Intellectual property	20.0–50.0%
Foundation-restructuring (maximum)	20.0%
Buildings	3.0%
Vehicles	12.0–20.0%
Telecommunication devices, office equipment, machines	9.0–33.0%
Computer hardware	14.5–33.0%
Emissions machinery	20.0–50.0%
Instruments	14.5–33.0%
Bank security devices	9.5–33.0%
Other not specified devices*	14.5–33.0%

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

The above listed percentage ranges of depreciation rates are reference values based on estimated useful life. Deviation from the reference values is allowed depending on the actual time of use.

Depreciation is charged on a straight line basis in every case.

The MNB's balance sheet does not state cash among liquid assets. The central bank is the exclusive issuer of banknotes and coins. Notes and coins held at the Cashier and the Depository are not in circulation and therefore are deducted from banknotes and coins on the liabilities side of the balance sheet.

4.2. EFFECTS OF MACROECONOMIC TRENDS ON THE 2006 BALANCE SHEET AND INCOME STATEMENT OF THE MAGYAR NEMZETI BANK

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

Due to changes in the forint exchange rate, the total net revaluation effect was a gain of HUF 10 billion. During 2006 the official exchange rate of the forint against the EUR weakened considerably, resulting a gain of HUF 66.4 billion in net realised income arising from exchange rate fluctuation. This represented an increase of HUF 51.8 billion in the amount of gain compared to 2005.

The revaluation reserve due to exchange rate changes decreased by HUF 56.4 billion to HUF 49.6 billion.

In 2006, the bank recorded a net interest and interest related loss of HUF 15.2 billion, down HUF 2.5 billion on the previous year.

In the second half of the year, the central bank base rate was raised by 175 basis points, causing growth in forint interest expenses on forint deposits, which worsened the net interest income. This was, however, overbalanced by an increase in foreign currency interest income due to a rise in foreign exchange yields. The rise of HUF 151.2 billion in volume of the gold and foreign currency reserves (not included accrued interest) contributed to growth of foreign currency interest income.

For more details on the impacts on net income, see the Business Report, Section 3.9.

4.3. FORINT RECEIVABLES FROM THE CENTRAL GOVERNMENT

HUF millions

B/S line	Terms to maturity	Balance		Change
		31. 12. 2005	31. 12. 2006	
	Government bonds maturing within one year	4,000	4,000	0
	Government bonds maturing within one to five years	8,302	5,729	–2,573
	Government bonds maturing over five years	142,410	140,984	–1,426
	Securities	**154,712**	**150,713**	**–3,999**
	Revaluation reserves of foreign exchange securities	**14,816**	**20,600**	**5,784**
I.1.	**Total receivables from central government**	**169,528**	**171,313**	**1,785**

The decrease of HUF 4 billion in the portfolio of government securities in 2006 was due to a scheduled repayment related to an amortising bond (to be repaid annually over five years) totalling HUF 4 billion.

Receivables due to a negative balance of the revaluation reserve at the end of 2006 related to the market valuation of foreign currency securities amounting to HUF 20.6 billion, which is to be obligatory reimbursed by the central government by 31 March 2007 (based on the MNB Act), and which thus must be stated under Receivables from the central government in the year-end balance sheet.

In 2006, there was no profit from the withdrawal of notes and coins; therefore there was no change in the related receivables from the central government. (Pursuant to the MNB Act, the profit from the withdrawal of notes and coins should not be stated in the income statement of the MNB but rather should be used for a repayment the central government’s outstanding debt to the MNB.)

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

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
	Receivables from central government due to debt swap	91,931	81,890	–10,041
	Swap transactions with maturity over 1 year	25,322	20,962	–4,360
II.2.	**Foreign currency receivables from the central government**	**117,253**	**102,852**	**–14,401**

Foreign currency credits vis-à-vis the central government originate from the debt exchange conducted in 1997. The amount of foreign currency receivables from the central government decreased by HUF 14.4 billion to HUF 102.9 billion. This decrease is primarily related to revaluation of foreign currency credits to the central government denominated in dollar and yen, due to exchange rate changes. The forint exchange rate against the dollar and yen, strengthened significantly in the fourth quarter of 2006.

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

Foreign currency receivables from the central government by remaining maturity

HUF millions

B/S line	Remaining maturity	Balance		Change
		31. 12. 2005	31. 12. 2006	
	– within 1 year	17,364	1,629	–15,735
	– within 1 to 5 years	3,183	52,278	49,095
	– over five years	96,706	48,945	–47,761
II.2.	**Foreign currency receivables from the central government**	**117,253**	**102,852**	**–14,401**

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

HUF millions

Nr	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
1.	– USD	42,716	38,324	–4,392
2.	– JPY	49,215	43,566	–5,649
3.	**Foreign currency receivables from the central government**	**91,931**	**81,890**	**–10,041**

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

HUF millions

Nr	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
1.	– USD	0	0	0
2.	– EUR currency group*	322,371	138,983	–183,388
3.	– JPY	0	0	0
4.	**Swap receivables (1+2+3)**	**322,371**	**138,983**	**–183,388**
5.	– USD	235,751	62,769	–172,982
6.	– EUR currency group*	12,084	11,686	–398
7.	– JPY	49,214	43,566	–5,648
8.	**Swap payables (5+6+7)**	**297,049**	**118,021**	**–179,028**
9.	**Net swap receivables (4–8)**	**25,322**	**20,962**	**–4,360**

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

4.5. FORINT AND FOREIGN CURRENCY DEPOSITS OF THE CENTRAL GOVERNMENT

Forint deposits of the central government

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
	Single Treasury Account (KESZ)	33,290	270,797	237,507
	Deposit by State Privatisation and Holding Co. (ÁPV Zrt.)	141,429	9,306	–132,123
	Deposit by Government Debt Management Agency (ÁKK Zrt.)	256	280	24
	Other	64	64	0
VI.1.	**Central government deposits (total)**	**175,039**	**280,447**	**105,408**

Foreign currency deposits of the central government

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
	Foreign currency deposits of the central government	108,473	92,736	–15,737
	Foreign currency deposits of the Hungarian State Treasury	0	0	0
	Other than money market deposits of the central government	3	0	–3
	Short-term derivatives	0	0	0
VII.1.	**Central government deposits**	**108,476**	**92,736**	**–15,740**

The dates of maturity of foreign currency deposits of the central government are within one year. The balance decreased by HUF 15.7 billion compared to the total amount at last year-end.

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

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
I.1–VI.1.	Net forint position	–5,511	–109,134	–103,623
II.2–VII.1.	Net foreign currency position	8,777	10,116	1,339
	Total	**3,266**	**–99,018**	**–102,284**

4.7. FORINT RECEIVABLES FROM CREDIT INSTITUTIONS

Forint receivables from credit institutions by original maturity

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
	Security-backed loans	2,622	0	–2,622
	Refinancing credit to credit institutions in liquidation/pending liquidation	1,764	1,575	–189
	Loans granted for foreign currency deposits	1,040	303	–737
	Long-term refinancing credit	262	0	–262
	Receivables from credit institutions in gross value (total)	**5,688**	**1,878**	**–3,810**
	Impairment provision for claims on credit institutions	–1,764	–1,575	189
I.2.	**Receivables from credit institutions (total)**	**3,924**	**303**	**–3,621**

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

Domestic credit institutions use the facility of security-backed overnight loans, primarily in order to fulfil their minimum reserve requirement. This item in the set of monetary policy instruments was not applied by credit institutions on 31 December 2006.

HUF millions

Nr	Remaining maturity	Balance		Change
		31. 12. 2005	31. 12. 2006	
	– within 1 year	5,385	1,878	–3,507
	– within 1 to 5 years	303	0	–303
	– over five years	0	0	0
1.	**Receivables from credit institutions (total)**	**5,688**	**1,878**	**–3,810**

4.8. NET POSITIONS VIS-À-VIS CREDIT INSTITUTIONS

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
I.2–VI.2.	Net forint position	–1,795,256	–1,634,378	160,878
II.3–VII.2.	Net foreign exchange position	–4,205	–54,881	–50,676
	Total	**–1,799,461**	**–1,689,259**	**110,202**

Net liabilities to credit institutions decreased by HUF 110.2 billion at the end of 2006. The change was mainly caused by the HUF 164.5 billion decrease in forint deposits placed by credit institutions, and the HUF 50.6 billion growth in their foreign currency deposits.

4.9. GOLD AND FOREIGN EXCHANGE RESERVES OF THE CENTRAL BANK

Balances in forint

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
	Gold reserve	10,840	12,014	1,174
	Reserve position in the IMF	41,072	26,227	–14,845
	Foreign currency deposits	550,863	267,902	–282,961
	Foreign currency securities	3,150,888	3,688,228	537,340
	Foreign currency repo transactions	177,396	87,908	–89,488
II.1.	**Gold and foreign currency reserves (total)**	**3,931,059**	**4,082,279**	**151,220**

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

Foreign exchange reserves without the accrued interest rose by HUF 151.2 billion to HUF 4,082.3 billion.

Balances in euro

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
	Gold reserve	43	48	5
	Reserve position in the IMF	162	104	–58
	Foreign currency deposits	2,180	1,062	–1,118
	Foreign currency securities	12,467	14,618	2,151
	Foreign currency repo transactions	702	348	–354
II.1.	**Gold and foreign currency reserves (total)**	**15,554**	**16,180**	**626**

The amount of the gold and foreign exchange reserves was mainly increased by the conversion of foreign currencies arising from the issuing of Hungarian government securities, into forint, and by market yields of the reserves.

Sales of foreign currency linked to the matured government securities denominated in American dollar reduced the level of the gold and foreign exchange reserves, as did sales of euro in a price-taking manner (re-channelling) and foreign exchange payments made on behalf of central government institutions during the year. The aforementioned effects altogether increased the gold and foreign exchange reserves by EUR 0.6 billion to EUR 16.2 billion in 2006.

4.10. OTHER FOREIGN CURRENCY RECEIVABLES

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
	Forint payment of IMF quota	275,876	272,869	–3,007
	Repurchased bonds	108,283	99,812	–8,471
	Foreign hedging transactions*	0	55	55
	Other	188	316	128
II.4.	**Other foreign currency receivables**	**384,347**	**373,052**	**–11,295**

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

The amount of repurchased bonds issued abroad by the bank, denominated in forint decreased by HUF 8.5 billion because of the stronger forint exchange rate against the American dollar and the Japanese yen.

4.11. OTHER LIABILITIES IN FOREIGN CURRENCY

Other foreign currency liabilities at the end of the period

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
	Bonds	315,716	279,989	–35,727
	Repo transactions	51,031	62,979	11,948
	IMF forint deposit	275,876	272,870	–3,006
	Foreign deposits and loans	9,513	9,778	265
	Hedging transactions	46,006	56,093	10,087
	Other liabilities	6,283	5,327	–956
VII.3.	**Other foreign currency liabilities**	**704,425**	**687,036**	**–17,389**

The amount of the foreign currency denominated securities issued by the Bank decreased due to the stronger forint exchange rate against the American dollar and the Japanese yen. The line “Hedging transaction” mainly consists of net receivable of currency swap transactions with non-resident counterparts.

Other foreign currency receivables in a breakdown of remaining maturity

HUF millions

B/S line	Remaining maturity	Balance		Change
		31. 12. 2005	31. 12. 2006	
	– within one year	365,425	478,825	113,400
	– within one to five years	201,239	143,155	–58,084
	– over five years	137,761	65,056	–72,705
VII.3.	**Other foreign currency liabilities**	**704,425**	**687,036**	**–17,389**

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

HUF millions

Nr	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
1.	– USD	51,879	39,352	–12,527
2.	– EUR currency group*	57,662	77,057	19,395
3.	– JPY	273,000	241,664	–31,336
4.	– Other	275,877	272,870	–3,007
5.	**Other foreign currency liabilities**	**658,418**	**630,943**	**–27,475**

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

Other foreign currency liabilities include a HUF 272.9 billion deposit by the IMF.

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

HUF millions

Nr	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
1.	– USD	308,509	123,256	–185,253
2.	– EUR currency group*	453,918	15,190	–438,728
3.	– JPY	227,500	201,387	–26,113
4.	**Hedging transactions receivables (1+2+3)**	**989,927**	**339,833**	**–650,094**
5.	– USD	470,263	60,899	–409,364
6.	– EUR currency group*	530,140	331,806	–198,334
7.	– JPY	35,530	3,221	–32,309
8.	**Hedging transactions payables (5+6+7)**	**1,035,933**	**395,926**	**–640,007**
9.	**Net hedging transactions payables (8–4)**	**46,006**	**56,093**	**10,087**

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

4.12. INVESTED ASSETS

In addition to intangibles, tangibles and capital expenditure (HUF 14.9 billion), invested assets include share in investments (HUF 17.5 billion).

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

HUF millions

	Assets							
	Immaterial goods		Buildings	Equipment	Assets of banknote and coin	Tangible assets of MNB, total	Capital expenditure and advances given	Intangibles, tangibles and capital expenditure, total
	Intangible assets	Software under development						
Gross value								
31. 12. 2005	**6,863**	**219**	**8,290**	**8,612**	**206**	**17,108**	**1,731**	**25,921**
Installation	1,253	25	561	702	5	**1,268**	3,956	**6,502**
Other addition	0	0	0	0	0	**0**	0	**0**
Scrapping	–3	–4	–1	–125	0	**–126**	–4	**–137**
Selling	0	0	0	–232	0	**–232**	0	**–232**
Transfer free of charge	0	0	–1,613	–858	0	**–2,471**	0	**–2,471**
Other disposal	–219	0	0	–299	0	**–299**	0	**–518**
31. 12. 2006	**7,894**	**240**	**7,237**	**7,800**	**211**	**15,248**	**5,683**	**29,065**
Details of depreciation								
31.12.2005	**5,279**	**0**	**2,397**	**6,331**	**0**	**8,728**	**0**	**14,007**
Planned depreciation	1,064	0	231	1,107	0	**1,338**	0	**2,402**
Extraordinary depreciation	0	0	0	0	0	0	0	**0**
Depreciation due to damage	0	0	0	0	0	0	0	**0**
Increase due to reclassification	0	0	0	0	0	0	0	**0**
Interim increase due to removal from the account	–123	0	–553	–1,213	0	**–1,766**	0	**–1,889**
Decrease due to reclassification	–97	0	0	–272	0	**–272**	0	**–369**
31. 12. 2006	**6,123**	**0**	**2,075**	**5,953**	**0**	**8,028**	**0**	**14,151**
Closing net value								
31. 12. 2005	**1,584**	**219**	**5,893**	**2,281**	**206**	**8,380**	**1,731**	**11,914**
31. 12. 2006	**1,771**	**240**	**5,162**	**1,847**	**211**	**7,220**	**5,683**	**14,914**
Change	**187**	**21**	**–731**	**–434**	**5**	**–1,160**	**3,952**	**3,000**

Investments and dividends from investments

HUF millions

Description	Ownership share (%)		Book value		Dividends received*	
	31. 12. 2005	31. 12. 2006	31. 12. 2005	31. 12. 2006	2005	2006
BIS (HUF millions, SDR millions, CHF millions)	1.43	1.43	5,247 10 13	5,004 10 13	562	686
European Central Bank (HUF millions, thousand EUR)	1.39	1.39	1,367 5,408	1,364 5,408	0	0
SWIFT (HUF millions, thousand EUR)	0.02	0.02	2 9	2 9	0	0
Pénzjegynyomda Zrt.	100.00	100.00	8,927	8,927	288	500
MNB Üdültetési és Jóléti Szolg. Kft.	100.00	100.00	602	602	0	0
Magyar Pénzverő Zrt.	100.00	100.00	575	575	125	194
KELER Zrt.	53.30	53.30	643	643	1,067	1,120
GIRO Elszámolásforgalmi Zrt.	7.30	7.30	46	46	134	153
Budapesti Értéktőzsde Zrt.	6.90	6.90	321	321	0	164
Total investments			**17,730**	**17,484**	**2,176**	**2,817**

** Dividends financially settled in the given year.*

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

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

Ownership distribution in the ECB as of 1 May 2004

National Central Banks (NCBs)	Subscribed capital	Paid-up capital	Capital key
	EUR thousands		%
Nationale Bank van België / Banque Nationale de Belgique	141,910	141,910	2.5502
Deutsche Bundesbank	1,176,171	1,176,171	21.1364
Bank of Greece	105,584	105,584	1.8974
Banco de España	432,698	432,698	7.7758
Banque de France	827,533	827,533	14.8712
Central Bank and Financial Services Authority of Ireland	51,301	51,301	0.9219
Banca d'Italia	726,278	726,278	13.0516
Banque centrale du Luxemburg	8,725	8,725	0.1568
De Nederlandsche Bank	222,336	222,336	3.9955
Österreichische Nationalbank	115,745	115,745	2.0800
Banco de Portugal	98,233	98,233	1.7653
Suomen Pankki-Finlands Bank	71,712	71,712	1.2887
Total euro area NCBs	**3,978,226**	**3,978,226**	**71.4908**
Danmarks Nationalbank	87,159	6,101	1.5663
Sveriges Riksbank	134,292	9, 400	2.4133
Bank of England	800,322	56,023	14.3822
Česká národní banka	81,155	5,681	1.4584
Eesti Pank	9,927	695	0.1784
Central Bank of Cyprus	7,234	506	0.1300
Latvijas Banka	16,572	1,160	0.2978
Lietuvos bankas	24,624	1,724	0.4425
Magyar Nemzeti Bank	77,260	5,408	1.3884
Central Bank of Malta / Bank Centrali ta' Malta	3,600	252	0.0647
Narodowy Bank Polski	285,913	20,014	5.1380
Banka Slovenije	18,614	1,303	0.3345
Národná banka Slovenska	39,771	2,784	0.7147
Total non-euro area NCBs	**1,586,443**	**111,051**	**28.5092**
Total euro area and non-euro area NCBs	**5,564,669**	**4,089,277**	**100.0000**

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

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

At 1 January, 2007 Bulgaria and Rumania joined to the EU. As a consequence of this, the central banks of these countries take ownership of the subscribed capital of the ECB, and the total subscribed capital increased to EUR 5.761 billion in which the capital key of the MNB fell to 1.3141% (EUR 75,700,733).

On 1 July 2004, the Magyar Nemzeti Bank undertook participation in the London-based CEBS Secretariat Ltd. established under UK law to provide, pursuant to its deed of foundation, administrative services to the Committee of European Banking

Supervisors. Every year members contribute their respective quotas to its operating costs according to an annual payment schedule. As membership required the investment of a mere GBP 1, it is not recorded in the MNB's books.

Key indicators of domestic investments (preliminary data)

HUF millions

Investment	Equity	Share capital	Reserves	Profit/loss for the year after taxation	Profit/loss for the year after taxation
	31. 12. 2006	31. 12. 2006	31. 12. 2006	2005	2006 preliminary
Pénzjegynyomda Zrt. 1055 Budapest, Markó utca 13–17.	9,335	8,927	408	679	830
MNB Üdültetési és Jóléti Szolgáltató Kft. 1054 Budapest, Szabadság tér 8–9.	761	602	159	37	–29
Magyar Pénzverő Zrt. 1089 Budapest, Könyves Kálmán krt. 38.	1,082	575	507	194	270
KELER Zrt. 1075 Budapest, Asbóth utca 9–11.	14,637	4,500	10,137	2,350	2,021
GIRO Elszámolásforgalmi Zrt. 1054 Budapest, Vadász utca 31.	5,160	2,496	2,664	2,487	2,251
Budapesti Értéktőzsde Zrt. 1052 Budapest, Deák Ferenc u. 5.	7,791	541	7,250	2,364	2,400

HUF millions

Investment	Net sales revenue		Financial income		Other income		Extraordinary income	
	2005	2006	2005	2006	2005	2006	2005	2006
Pénzjegynyomda Zrt. 1055 Budapest, Markó utca 13–17.	6,904	7,797	137	97	42	128	0	0
MNB Üdültetési és Jóléti Szolgáltató Kft. 1054 Budapest, Szabadság tér 8–9.	5	4	13	10	190	0	0	0
Magyar Pénzverő Zrt. 1089 Budapest, Könyves Kálmán krt. 38.	1,903	3,630	52	52	25	9	0	0
KELER Zrt. 1075 Budapest, Asbóth utca 9–11.	n/a	n/a	5,473	5,941	11	12	0	0
GIRO Elszámolásforgalmi Zrt. 1054 Budapest, Vadász utca 31.	n/a	n/a	1,131	808	367	512	0	0
Budapesti Értéktőzsde Zrt. 1052 Budapest, Deák Ferenc u. 5.	2,614*	3,294*	1,171	680	23	276	0	106

n/a: not applicable data.

** Income from Stock Exchange related activities.*

Investment	Average number of staff	
	31. 12. 2005	31. 12. 2006
Pénzjegynyomda Zrt. 1055 Budapest, Markó utca 13–17.	477	463
MNB Üdültetési és Jóléti Szolgáltató Kft. 1054 Budapest, Szabadság tér 8–9.	0	0
Magyar Pénzverő Zrt. 1089 Budapest, Könyves Kálmán krt. 38.	69	70
KELER Zrt. 1075 Budapest, Asbóth utca 9–11.	104	105
GIRO Elszámolásforgalmi Zrt. 1054 Budapest, Vadász utca 31.	128	128
Budapesti Értéktőzsde Zrt. 1052 Budapest, Deák Ferenc u. 5.	64	66

The MNB's receivables from and liabilities to affiliated companies

HUF millions

Investment	Receivables	Liabilities
Pénzjegynyomda Zrt.	0.0	190.9
MNB Üdültetési és Jóléti Szolg. Kft.	0.0	0.0
Magyar Pénzverő Zrt.	0.8	2.3
KELER Zrt.	0.0	1.5
GIRO Elszámolásforgalmi Zrt.	0.0	4.3
Budapesti Értéktőzsde Zrt.	0.0	0.0
Total	**0.8**	**199.0**

The above table presents short-term liabilities.

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

In addition to banknotes, **Pénzjegynyomda Zrt.** produces documents, tax stamps and securities, primarily for institutional customers. Developments made at the company insure the secure production of the banknotes up to 2012-14. Over the longer term, after adoption of the euro, forint banknotes will no longer be issued. According to the MNB's decision, Pénzjegynyomda Zrt. will not produce euro banknotes. As this may incur potential but presently unquantifiable losses for MNB, the Bank has not recognised an impairment loss on the investment.

Magyar Pénzverő Zrt. produces circulation and commemorative coins. When capacity allows, it performs contract work for foreign markets and also produces non-legal tender precious metal coins. The company also sell precious and base metal coins constituting legal tender and issued by the MNB, both internationally and locally. The MNB's long-term strategy includes the preparation of Pénzverő Zrt. for the production of euro coins. As a result of the recent investments, based on the preliminary survey made by the ECB, the ECB declared the company as authorized producer of euro coins in the future. Magyar Pénzverő Zrt. will move to MNB's Logistic Centre by end-2007.

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

4.13. IMPAIRMENT LOSS AND PROVISIONS

HUF millions

B/S line	Description	31. 12. 2005	Interim changes in 2006			31. 12. 2006
		Loss in value/provisions	Increase (+)	Reversal (-)	Interim exchange rate effect due to Increase, Use/Release	Total loss in value/provisions (3+4+5)
1	2	3	4	5	6	7
from I.2.	Forint receivables from credit institutions	1,763.5	0.0	–188.2	0.0	1,575.3
from II.3.	Foreign currency receivables from credit institutions	0.0	0.0	0.0	0.0	0.0
from II.4.	Other foreign currency receivables	0.0	0.0	0.0	0.0	0.0
from III.	Invested assets	0.0	0.0	0.0	0.0	0.0
from III.	Other assets	443.2	0.0	–419.6	0.0	23.6
VIII.	Liabilities	62.2	266.6	–272.1	0.0	56.7
	Total	**2,268.9**	**266.6**	**–879.9**	**0.0**	**1,655.6**

The total amount of impairment loss and provisions decreased by a HUF 613.3 billion in 2006.

The Liabilities line of the table shows the provision for the negative market value of derivatives held for non-hedging purposes, which resulted a decrease of HUF 5.5 million compared to 2005.

The impairment of HUF 419.6 million made for doubtful claims from employees shown in the Other assets line was reversed compensating the write-off recorded among other expenses (See section 4.22.).

4.14. REVALUATION RESERVES

HUF millions

B/S line	Description	31. 12. 2005	31. 12. 2006	Change
XI.4.	Revaluation reserves of forint exchange rate	105,965	49,595	–56,370
XI.5.	Revaluation reserves of foreign exchange securities*	0	0	0
	Revaluation reserves (total)	**105,965**	**49,595**	**–56,370**

** The end-2006 balance on the revaluation reserves of foreign currency securities indicated a loss of HUF 20,600 million, which the central government is obliged to reimburse by 31 March 2007, and thus is no longer included among revaluations reserves but in the line 'Receivables from the central government'. (For the same reason the loss of the revaluation reserve in the year 2005 was included in the aforementioned line.)*

At the end of 2006, the official exchange rate of the forint was stronger by HUF 0.43 than a year before. As a result of a significant fluctuation in the forint exchange rate during the year, the average purchase forint exchange rate rose by HUF 3.7, and the revaluation reserves due to exchange rate changes – calculated as a difference of foreign exchange items converted in to forint by official and average cost exchange rate – decreased by HUF 56.4 billion to HUF 49.6 billion in 2006.

The net foreign currency positions increased by EUR 0.5 billion to EUR 15.0 billion (HUF 3,780.5 billion).

Annual changes in the forint exchange rate, 2005-2006 (+ appreciation / - depreciation)

	MNB official mid-exchange rate	Average cost rate
End-of-period exchange rate		
30. 12. 2005 (EUR)	252.73	245.39
31. 12. 2006 (EUR)	252.30	249.07
Annual appreciation/depreciation		
In 2005	–2.8%	
In 2006	0.2%	

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

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
	Due to banking transactions	73,120	81,008	7,888
	Due to internal operation	91	107	16
IV.	**Prepaid expenses/accrued income**	**73,211**	**81,115**	**7,904**
	Due to banking transactions	33,051	28,864	–4,187
	Due to internal operation	165	159	–6
X.	**Accrued expenses/deferred income**	**33,216**	**29,023**	**–4,193**

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

4.16. CHANGES IN EQUITY

HUF millions

B/S line	Description	31. 12. 2005	Interim changes	31. 12. 2006
XI.1.	Share capital	10,000	0	10,000
XI.2.	Retained earnings	38,357	–21,421	16,936
XI.3.	Valuation reserves	0	0	0
XI.4.	Revaluation reserves due to exchange rate changes	105,965	–56,370	49,595
XI.5.	Revaluation reserves of foreign currency securities	0	0	0
XI.6.	Profit/Loss for the year	–21,421	35,992	14,571
XI.	**Equity**	**132,901**	**–41,799**	**91,102**

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

Pursuant to the MNB Act, the MNB's dividend is specified by the General Meeting. According to the resolution of the General Meeting, in 2007 the MNB will not pay dividend from the retained earnings for the year and from the profit of 2006.

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

4.17. OFF-BALANCE SHEET LIABILITIES OF THE MNB

Liabilities arising from derivative transactions

HUF millions

Nr	Description	Balance		Net market value
		31. 12. 2005	31. 12. 2006	
1.	– FX forward transactions	0	0	0
2.	– FX swap transactions	445,687	402,089	–500
3.	– currency swap transactions	887,223	513,949	–61,496
4.	– interest rate swap transactions	442,256	434,377	–13,663
5.	**Hedging transactions (1+2+3+4)**	**1,775,166**	**1,350,415**	**–75,659**
6.	– options	0	0	0
7.	– future transactions	14,010	0	0
8.	**Other forward transactions (6+7)**	**14,010**	**0**	**0**
9.	**Total (5+8)**	**1,789,176**	**1,350,415**	**–75,659**

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

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

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

Structure of liabilities arising from derivative transactions by remaining maturity

HUF millions

Nr	Remaining maturity	Balance		Change
		31. 12. 2005	31. 12. 2006	
	– within 1 year	801,399	611,905	–189,494
	– within 1 to 5 years	369,234	498,175	128,941
	– over five years	604,533	240,335	–364,198
1.	**Hedging transactions**	**1,775,166**	**1,350,415**	**–424,751**
	– within 1 year	14,010	0	–14,010
	– within 1 to 5 years	0	0	0
	– over five years	0	0	0
2.	**Other forward transactions**	**14,010**	**0**	**–14,010**
3.	**Total (1+2)**	**1,789,176**	**1,350,415**	**–438,761**

Other off-balance sheet liabilities

HUF millions

Nr	Description	Balance		Change
		31. 12. 2005	31. 12. 2006	
1.	Liabilities from security repurchase transactions in foreign currency	50,546	63,075	12,529
2.	Guarantees	12,358	10,739	–1,619
3.	Other off-balance sheet liabilities	5,448	3,082	–2,366
4.	**Total**	**68,352**	**76,896**	**8,544**

Liabilities from security repurchase transaction in foreign currency increased by EUR 50 million in 2006.

The line 'Guarantees' comprises export and import guarantees, on to which always link irrevocable indemnity bond (without limitation of expiry date and amount) or government guarantee. When exercising a guarantee, the MNB has the right to a reverse guarantee if needed.

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

Structure of other off-balance sheet liabilities by remaining maturity

HUF millions

Nr	Remaining maturity	Balance		Change
		31. 12. 2005	31. 12. 2006	
	– within 1 year	62,906	76,867	13,961
	– within 1 to 5 years	5,446	29	–5,417
	– over five years	0	0	0
1.	**Total other liabilities**	**68,352**	**76,896**	**8,544**

Bond lending

The nominal value of securities lent under the general agreement on bond lending made between the MNB and its largest securities account managers amounted to HUF 879,3 billion at the end of 2006.

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

Net forint and foreign currency interest and interest related income

HUF millions

P/L line	Description	2005	2006	Change
1	2	3	4	4–3
(I.1.+II.2.)–(X.1.+XI.1.)	Central government	851	–12 039	–12,890
(I.2.+II.3.)–(X.2.+XI.2.)	Credit institutions	–100,105	–116 010	–15,905
(I.3.+II.1.+II.4.)–(X.3.+XI.3.)	Other	75,026	127,628	52,602
	Net profit from interest	**–24,228**	**–421**	**23,807**
	Forint securities	7	9	2
	Foreign currency securities	0	0	0
	Bonds issued abroad	0	0	0
	Derivative transactions for hedging and other purposes*	7,803	–13,733	–21,536
	Other	–1,209	–1,057	152
(I.4.+II.5.)–(X.4.+XI.4.)	**Net interest related profit**	**6,601**	**–14,781**	**–21,382**
(I.+II.)–(X.+XI.)	**Net interest and interest related income**	**–17,627**	**–15,202**	**2,425**

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

In 2006, the Bank recorded a net interest and interest related loss of HUF 15.2 billion, down HUF 2.4 billion on 2005.

Net interest income imporved by HUF 23.8 billion in comparison with 2005 due to the following factor:

– an increase in the interest income on foreign exchange reserves, which was up HUF 43.7 billion in 2006 compared to 2005.

The net interest income was decreased by the following factors:

– a decline of the interest income on government securities in 2006, because of a decrease in the outstanding amount of the securities due to sales in the second half of 2005,

– compared to the previous year less interest income was recorded in 2006, because of prepayment of the central government's foreign exchange debt vis-à-vis the MNB in end-2005 and,

– an increase in interest expenses, caused on the one hand by the growth in the yearly average of the credit institutions' deposits and on the other hand the rise of the central bank base rate compared to 2005.

Net interest related income fell by HUF 21,4 billion to a loss of HUF 14.8 billion in 2006. The change occurred mainly because of the HUF 15.2 billion gain realized in 2005 from the prepayment of the central government foreign exchange debt made at market value. In addition to the above mentioned item, the interest related profit includes the net gain or loss on derivative transactions that are not related to exchange rate changes, and the difference between the cost value and the face value of the securities recorded at cost, attributable to the reporting period.

Realized losses from financial operations

HUF millions

P/L line	Description	2005	2006	Change
IV.	Realized gains from financial operations	11,499	1,261	–10,238
XIV.	Realized losses from financial operations	12,836	16,706	3,870
IV.–XIV.	**Net financial losses**	**–1,337**	**–15,445**	**–14,108**

Realized gains and losses from financial operations mainly include gains and losses arising from sales of securities. Net realized losses increased by HUF 14.1 billion in 2006, because of the higher losses realized on sales and maturities of securities in comparison to 2005.

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

HUF millions

Nr	Description	2005	2006	Change
1.	– interest on currency swaps	76,021	39,039	–36,982
2.	– interest on over one year interest rate swaps	2,761	5,327	2,566
3.	– interest gains on hedge FX swaps	1,947	1,402	–545
4.	– FX gains on derivative transactions	15,235	633	–14,602
5.	– other transactions	564	642	78
6.	**Income from derivative transactions (1+2+3+4+5)**	**96,528**	**47,043**	**–49,485**
7.	– interest on currency swaps	78,651	47,070	–31,581
8.	– interest on over one year interest rate swaps	3,456	3,804	348
9.	– interest loss on hedge FX swaps	5,006	8,926	3,920
10.	– FX losses on derivative transactions	0	199	199
11.	– other transactions	1,612	777	–835
12.	**Expenses on derivative transactions (7+8+9+10+11)**	**88,725**	**60,776**	**–27,949**
13.	– interest on currency swaps (1–7)	–2,630	–8,031	–5,401
14.	– interest on over one year interest rate swaps (2–8)	–695	1,523	2,218
15.	– interest gains on hedge FX swaps (3–9)	–3,059	–7,524	–4,465
16.	– FX gains on derivative transactions (4–10)	15,235	434	–14,801
17.	– other transactions (5–11)	–1,048	–135	913
18.	**Net income from derivative transactions (6–12)**	**7,803**	**–13,733**	**–21,536**

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

Under the debt exchange implemented in 1997, the MNB converted a large part of its forint loans granted to the central government into foreign currency loans by making reverse transactions with the Government under same terms as those of the bonds issued by the MNB. The MNB has also concluded with the ÁKK the majority of the currency swaps linked to the bonds under nearly identical terms. Income from and expenses on the currency swaps are stated in the income statement in gross. The income from and expenses on swaps vis-à-vis both on non-residents and the ÁKK are recorded in the net interest related income more than once. The net profit and loss effect of the currency swaps was HUF 8.0 billion in 2006.

4.19. COMPONENTS OF INCOME FROM THE REVALUATION OF FOREIGN EXCHANGE HOLDINGS

HUF millions

Description	2005	2006
Net income from exchange rate changes (realised and conversion spread)	14,557	66,378
Change in revaluation reserve in the balance sheet* (due to unrealised revaluation net income)	86,459	–56,370
Total effect of exchange rate changes	**101,016**	**10,008**

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

The total effect of exchange rate changes was a gain of HUF 10 billion, of which the Bank realized HUF 66.4 billion while the amount of the revaluation reserves due to exchange rate changes (unrealized gains) decreased by HUF 56.4 billion during the year.

For more details on revaluation reserves, see Section 4.14.

4.20. COST OF ISSUING BANKNOTES AND COINS

HUF millions

P/L line	Description	2005	2006	Change
	Cost of banknotes production	3,512	5,825	2,31
	Cost of coins production	1,758	2,183	425
	Cost of production of commemorative and collector coins	79	640	561
XIII.	**Total**	**5,349**	**8,648**	**3,299**

Cost of issuing banknotes and coins was HUF 8.6 billion in 2006, up HUF 3.3 billion on the previous year. The higher cost was mainly due to the issuing of the new 1,000 banknotes from April 2006, prepared in the previous year, the different volumes of production, and due to the higher cost per unit. The main factor behind the growth in the cost of producing collector coins was the more than HUF 80,000 cost per unit of a gold commemorative coin, of which 5,000 copies were issued in 2006.

4.21. OTHER INCOME/EXPENSES

HUF millions

P/L line	Description	2005	2006	Change
1.	Income from fees and commissions	1,166	1,098	–68
2.	Income from other than fees and commissions	2,394	4,264	1,870
V.	**Total other income**	**3,560**	**5,362**	**1,802**
1.	Expenses of fees and commissions	503	568	65
2.	Expenses of other than fees and commissions	389	3,307	2,918
XV.	**Total other expenses**	**892**	**3,875**	**2,983**
V.–XV.	**Other net results**	**2,668**	**1,487**	**–1,181**

Income from fees and commissions slightly decreased in 2006 compared to the 2005 figures.

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

4.22. INCOME OTHER THAN FEES AND COMMISSIONS

HUF millions

Nr	Description	2005	2006	Change
1.	Dividends from investments	2,176	2,817	641
2.	Income related to coins and commemorative coins	199	900	701
3.	Income from sales transaction of employee loans	0	545	545
4.	Other income	19	2	–17
5.	**Income from other than commissions and charges (1+2+3+4)**	**2,394**	**4,264**	**1,870**
6.	Losses from bad debts	2	0	–2
7.	Expenses related to coins and commemorative coins	166	841	675
8.	Expenses from sales transaction of employee loans	0	652	652
9.	Final money transfer	132	288	156
10.	Expenses from assets assigned free of charge	58	1,078	1,020
11.	Other expenditures	31	448	417
12.	**Exepenses from other than commissions and charges (6+7+8+9+10+11)**	**389**	**3,307**	**2,918**

Income other than fees and commissions include the following:

• Dividends received from investments increased by HUF 0.6 billion (for more details, see Section 4.12.).

• The sale of the employee loans generated HUF 545 million in income and HUF 652 million in expenses in 2006.

• The line "Final money transfer" includes mainly donations to international and domestic organizations and to foundations.

• An increase in other expenses linked to an asset transfer free of charge by HUF 1,020 million occurred because of a property transfer (the building in the Vadász utca) on 31 December 2006 to the Hungarian State Treasury free of charge.

• The growth in other expenses was due to a write-off of HUF 420 million in doubtful claims from employees.

4.23. OPERATING INCOME AND EXPENSES

HUF millions

P/L line	Description	2005	2006	Change
	Export sales	6	3	–3
	Exchange gain from sales of investment	555	0	–555
	Income from sales of assets and inventories	39	49	10
	Income from subcontracted services	59	53	–6
	Income from invoiced services	62	49	–13
	Other income	21	153	132
	Extraordinary income	1	12	11
VIII.	**Total operating income**	**743**	**319**	**–424**
	Cost of materials	3,743	4,025	282
	Personnel-related costs	9,501	8,562	–939
	Depreciation	1,872	2,403	531
	Capitalised value of own-produced stocks	–38	0	38
	Transfer of costs of other activities	–195	–196	–1
	Total operating costs	**14,883**	**14,794**	**–89**
	Expenses incurred on assets and inventories	125	91	–34
	Expenses incurred on invoiced services	58	45	–13
	Income taxes	1	1	0
	Total operating expenses	**184**	**137**	**–47**
XVIII.	**Total operating costs and expenses**	**15,067**	**14,931**	**–136**

Operating costs slightly decreased by HUF 0.1 billion (0.6%) to HUF 14.8 billion, relative to 2005.

Personnel related costs decreased by HUF 0.9 billion, caused mainly by a decrease in average number of staff linked to the operational development programme set up in 2005, the average salary increase in 2006, and the more moderate costs related to the termination of employment in comparison to 2005. In addition, the cost of materials in the reporting year increased by HUF 0.3 billion relative to the previous year primarily due to the implementation of a more efficient communication strategy and developments of the IT infrastructure linked to the taken measures based on the medium-term IT strategy and linked to the expanded software support and consulting services for operating the IT systems.

The HUF 0.5 billion increase in depreciation is also associated with arise in the volume of capital expenditures of the previous years.

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

Number of staff and payroll information

HUF millions

Description	2005	2006	Change (%)
Wage costs incurred on staff	5,399	4,952	–8
Other wage costs*	414	348	–16
Wages	**5,813**	**5,300**	**–9**
Other personnel payments	**1,452**	**1,252**	**–14**
Taxes on wages	**2,236**	**2,010**	**–10**
Total personnel expenditures	**9,501**	**8,562**	**–10**

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

Description	2005	2006	Change (%)
Average number of staff	896	773	–14

Remuneration of executive officers

HUF millions

Bodies	Fees
Monetary Council*	260.4
Supervisory Board	53.7

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

Credits to executive officers

HUF millions

Bodies	Amount of loans	Outstanding as at 31. 12. 2006	Final maturity	Rate of interest
Board of Directors	8.0	1.6	01. 06. 2007	Floating*
Supervisory Board	–	–	–	–

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

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

11 April 2007

András Simor,
Governor of the Magyar Nemzeti Bank

Péter Adamecz,
Deputy Governor of the Magyar Nemzeti Bank

Annual Report 2006
Business Report and Financial Statements of the
Magyar Nemzeti Bank

Print: D-Plus
H–1037 Budapest, Csillaghegyi út 19–21.