



MAGYAR NEMZETI BANK

ANNUAL REPORT

2007

Annual Report

Business Report and Financial Statements of the Magyar Nemzeti Bank 2007



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Part A

**2007 Business Report
of the Magyar Nemzeti Bank**





1 The Governor's foreword

2007 saw unfavourable trends in inflation, with annual CPI varying within the range of 6.4%-9%. Following a peak in March, year-on-year inflation decreased steadily until October, when it again assumed an upward tendency. Inflation, which remained outside both the 3% medium-term target of the Magyar Nemzeti Bank and the $\pm 1\%$ tolerance band all through the year, can be attributed predominantly to factors beyond the central bank's control. In addition to tax and regulated price increases, which were part of fiscal adjustments, a rapid global rise in oil and food prices in the second half of the year also fuelled inflation.

In formulating its monetary policy, the Magyar Nemzeti Bank did not wish to respond directly to the one-off inflationary impact of either fiscal adjustments or global shocks. However, it paid close attention to counteracting all potential secondary effects exerted through heightened inflation expectations. In the Monetary Council's opinion, from a forward-looking perspective fiscal adjustments, which curbed demand, would at the same time lessen inflation risks; therefore, the Council saw room for cautious reduction of the key policy rate. In view of the above, in 2007 the Monetary Council reduced the central bank base rate by 25 basis points on two occasions, in June and September. In the fourth quarter of 2007, experiencing the upside risk that global shocks posed to inflation and reckoning with the increased investor uncertainty due to the financial turbulence caused by the US sub-prime market, the Monetary Council decided not to lower the central bank base rate any further.

The MNB strives to design monetary policy instruments in such a manner that these support the liquidity management of credit institutions as far as possible, thereby ultimately contributing to the reduction of interbank interest rate volatility within the interest rate corridor. The introduction of the MNB bill as a new policy instrument, the disclosure of data about monetary instruments and the transformation of the sanctionative system of minimum reserves were all constituents of the above efforts.

Central bank analyses reveal that in 2007, due to an adjustment in fiscal policy, both real economic and financial stability grew, despite a temporary increase in economic burdens. As regards international processes, although the crisis in the US sub-prime market did not affect the Hungarian financial system directly (owing to limited exposure), identifying and communicating risks is, due to the possible channels of contagion, a key responsibility of the central bank.

Showing virtually no change when compared with a year earlier, official foreign exchange reserves remained fundamentally constant at EUR 16.4 billion as at the end of 2007. The level of reserves rose temporarily in the first quarter in response to the Government Debt Management Agency (ÁKK) issuing foreign currency bonds in an amount of EUR 1 billion and with a maturity of 10 years, after which it declined gradually. Foreign exchange market transactions related to the debt management activities of the ÁKK and the MNB increased reserves by a total of approximately EUR 100 million, with transfers from the European Union adding over EUR 1 billion, while euro sales announced in advance and intended to offset the forint liquidity expanding effect of the above amounts resulted in a decline of more than half billion euros. In addition, payments in foreign exchange effected on behalf of budgetary institutions reduced reserves by EUR 1 billion. Compared to previous years, there was no important change in the structure and quality of foreign exchange reserves. Experience gained from the sub-prime crisis on the international market in 2007 reinforced the soundness of the adopted policy. On the basis of the indicators most often used to determine the optimum size of reserves, their current level can be considered adequate.

The real-time gross settlement system again operated reliably last year, against a background of rising turnover and decreasing fees. As a result of central bank supervision, legal compliance on the part of institutions conducting payment and settlement transactions and the quality of data supplied about payment transactions improved in 2007. Hungary's preparation for creating the Single Euro Payment Area (SEPA) gathered new momentum, and receiving assistance from and with the participation of the MNB, a National SEPA Committee was set up.

In 2007, the central bank initiated several major changes in order to enhance the quality and efficiency of money supply for the economy. Such changes included the withdrawal from circulation of the old 1000 forint banknotes with fewer and less sophisticated security features, with effect from 31 August 2007, and the preparatory work leading to the withdrawal of the 1 and 2 forint coins, with effect from 1 March 2008. In order for its money supply tasks to be streamlined, the MNB modified its business terms and logistics-related requirements. Based on an analysis of the efficiency of the central bank's regional cash distribution, the last two regional centres of the MNB (Székesfehérvár and Debrecen) were dissolved without causing any disturbance in the national cash turnover.

In order to offer higher quality statistical services, the central bank increased the range of its publications and further strengthened co-operation with national institutions which also provide such services. As regards the balance of payments statistics, in 2007 – following three years' preparation – the Bank, working in close co-operation with the economic actors affected, completed the process leading to the introduction of data collection based on direct surveys. The 2008 introduction of the new system of data collection at the level of the national economy will cut the costs of compiling the balance of payments statistics.

The development of financial literacy and raised financial awareness of the population, and within that, the younger generation in particular, contribute to the successful achievement of the strategic objectives of the central bank and the fulfilment of its fundamental duties. In respect of achieving the above objectives, one of the major results is that the National Core Curriculum now includes a syllabus covering general financial and economic knowledge as a school subject. Another milestone was the publication by the central bank of an information booklet about daily money matters, which reached as many as 120,000 secondary school students in their final year.

In order to determine the direction of its medium-term development, the Bank's management worked out the institution's medium-term strategy in 2007. This document provides guidance for the effective and efficient operation of the organisation in the years to come and enables the Bank to monitor and evaluate implementation consistently and objectively.

The Bank's human resources management, a key area for the central bank, adopted a job family-based pay structure, which enabled the Bank to create a more flexible and transparent basis by placing, in its decisions on wage scales and

remuneration, greater emphasis not only on job characteristics, but also on the differences in individual staff members' competences and contribution to the fulfilment of the Bank's objectives. The introduction of the new structure raised the number of career paths available for experts and made them more transparent and easier to plan, which, according to the Bank's expectations, will help motivate and retain talented high-achievers in the future.

In 2007, the Magyar Nemzeti Bank incurred a loss of HUF 16.6 billion as opposed to its HUF 14.6 billion profit in 2006. The change was mainly triggered by a fall from the Bank's outstandingly high HUF 66.4 billion gain as net income from exchange rate changes in 2006 to HUF 9 billion. In 2007, in contrast with previous years' losses, the Bank posted HUF 0.3 billion profit in interest and interest related income.

MNB's internal operation in 2007 continued to be characterised by efforts aimed at reasonable cost efficiency. As a result, its annual operating costs were not only lower than budgeted, but also remained below that of the preceding year. Compared to 2006, the 1.5% cost savings were due, in part, to conscious HR management streamlining measures, which led to a reduction in personnel costs against the background of a 7.5% lower average number of staff as opposed to the previous year. A decrease in the number of management levels and the profile cleaning, modernisation and centralisation of the activities related to cash logistics, including the shutting down of the regional currency issue centres in Debrecen and Székesfehérvár, facilitated improved operational efficiency to a large extent. On account of the further development of the methods used for supporting development and investment decisions, the size of completed investment projects also decreased. Due to lower investment activity, amortisation was lower than in the preceding year, which further reduced general operating costs.

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 responsible for public finances

Basic tasks: As defined by the Act on the Magyar Nemzeti Bank

Subscribed 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: 'The primary objective of the MNB shall be to achieve and maintain price stability. Without prejudice to its primary objective, the MNB shall support the economic policy of the Government using the monetary policy instruments at its disposal.'

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

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

– it develops and regulates the domestic payment and settlement systems and securities settlement systems, and, 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 the restrictions set forth in the Act, lending against adequate collateral; buying, selling and mediating securities in open market transactions and under repurchase agreements in the spot and derivatives market; issuing its own securities; influencing and setting exchange rates and interest rates, discounting (rediscounting) securities and regulating minimum reserves.

The Bank's account management services are restricted to the entities defined by law. Thus, for instance, the Bank manages the single Treasury account, the current accounts of the Hungarian Privatisation and State Holding Company (ÁPV), the Government Debt Management Agency 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. With respect to the MNB the rules of Act IV of 2006 on Business Associations shall apply except for issues where the MNB Act provides otherwise.

The MNB operates as a single-member business entity. The Hungarian State as shareholder is represented by the minister responsible for public finances. Pursuant to Act LXXXV of 2007 amending the MNB Act, which entered into force on 3 July 2007, the MNB has neither a general assembly, nor a board of directors. With effect from the date of the amendment, **the shareholder** is entitled to make decisions, by way of a shareholder's resolution, about the establishment and modification of the Statutes, approval of the balance sheet and the profit and loss account, dividend payment from the profit for the reference year or from the accumulated profit reserve, and the election, dismissal and remuneration of the auditor, who guarantees lawful operation. 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 shareholder are separated. As regards the financial statements, the shareholder 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.

In line with the European Union's requirements, and as an additional guarantee of independence, in contrast with the practice of other companies limited by shares, the remuneration of the Bank's Governor, the Deputy Governors and the other members of the Monetary Council as well as the members of the Supervisory Board, are determined by the MNB Act rather than the shareholder.

In matters related to the performance of the MNB's basic tasks, the exchange rate regime and all the characteristics thereof and issues related to its role as lender of the last resort, the MNB's supreme decision-making body is the **Monetary Council**. Pursuant to the above amendment of the law, the members of the Monetary Council include the Governor of the MNB, who acts as Chairman of the Council, its Deputy Governors and a further, at most 4 members appointed by the President of the Republic of Hungary for a period of six years. The Monetary Council has at least five and at most seven members. However, the number of MC members may exceed seven as long as the number of members who already had MC membership at the time when the aforementioned amendment came into force remains above four, exclusive of the Governor and Deputy Governors of the MNB.

Each year – at the first meeting of the year – the Monetary Council elects a Deputy Chairman who substitutes the

Chairman if the latter is unable to attend. In 2007, Deputy Governor Ferenc Karvalits was elected as Deputy Chairman.

In addition to MC members, a representative of the Government as a permanent attendee must also be invited to MC meetings. However, such representative shall not have a voting right, as, in accordance with the European Union directives, the MNB Act stipulates that 'The Government shall not instruct the MNB regarding its duties set forth herein.'

The members of the Monetary Council in 2007 were:

- András Simor, Governor – Chairman of the Monetary Council (from 3 March 2007),
- Zsigmond Járai, Governor – Chairman of the Monetary Council (until 2 March 2007),
- Ferenc Karvalits, Deputy Governor – Deputy Chairman of the Monetary Council (from 27 March 2007 a member of the MC),
- Júlia Király, Deputy Governor – member of the Monetary Council (from 3 July 2007),
- Henrik Auth, Deputy Governor – Deputy Chairman of the Monetary Council (until 2 July 2007 a member of the MC),
- Péter Adamecz, Deputy Governor – member of the Monetary Council (until 2 July 2007),
- Dr. György Szapáry, Deputy Governor – member of the Monetary Council (until 21 February 2007),
- 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 Governor of the MNB**. His competences include, *inter alia*,

- managing the implementation of the basic tasks;
- in respect of tasks other than those falling within the Supervisory Board's competence, the management of the internal audit unit of the MNB;
- exercising employer's rights over the employees of the MNB other than the non-deputy governor members of the Monetary Council, except the powers related to the appointment and dismissal of the Deputy Governors;

– taking all other decisions related to the operation of the MNB that do not fall under the competence of the Monetary Council.

Provisions relating to the legal status, powers, functions and operating procedures of the Monetary Council are set forth in the MNB Act, the Bank's Statutes, its Organisational and Operational Procedures, as well as the rules of procedures it has formulated.

In order to provide assistance for the MNB in managing its operation and attaining the objectives and fulfilling the duties defined in the MNB Act, the Bank operates **special committees** in charge of discussing issues that fall within the competence of the Governor, Deputy Governors and the Executive Director, and of supporting the pertaining decision-making process.

The **Management Committee** is a consultative body providing assistance with the operative management of the Bank. It supports the Governor responsible for managing the operation of the Bank in decision-making, thereby ensuring the transparency of the Governor's decisions.

The **Implementation Committee**, through doing the necessary preparatory work and putting forward proposals and opinions, facilitates decision-making related to the implementation of the Monetary Council's decisions.

The **Financial System Overseeing Committee** provides assistance with central bank decisions concerning financial stability, including the operation of the financial institutions, financial markets and financial infrastructure, through doing the necessary preparatory work and putting forward proposals and opinions.

The **Investment and Cost Management Committee** facilitates decision-making by doing the necessary preparatory work and putting forward proposals and opinions related to fixed investment and cost management.

The **Assets-Liabilities Committee (ALCO)**, through doing the necessary preparatory work and putting forward proposals and opinions, supports decision-making related to the Bank's activities performed in foreign exchange, affecting the Bank's balance sheet.

The **Operative Crisis Management Committee** supports decision-making related to the emergence of potential crises of credit institutions, and discusses the results and experience of crisis simulation exercises.

In addition to the auditor appointed by the shareholder, 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 shareholder's resolutions.

Prior to putting forward a proposal for the election and dismissal of the MNB's **auditor**, the opinion of the President of the State Audit Office must be sought.

The supervisory competence of the **Supervisory Board** as defined by the MNB Act excludes supervision of the Bank's performance of its core duties 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.

Prior to the entry into force of the above amendment of the MNB Act, members of the Supervisory Board included a chairman appointed by Parliament, a further three members elected by Parliament, a representative of the Finance Minister and an expert appointed by the Finance Minister.

On 3 April 2007 the Chairman of the Supervisory Board resigned. With effect from 4 April 2007, Ms. Éva Várhegyi, a SB member assumed the office and the responsibilities of the Chairperson. On 3 July 2007, provisions governing the determination of the number and the appointment of SB members changed. As from this date, the aggregate number of the Chairman and members of the Supervisory Board must, at the date of the commencement of the procedure for their election, be determined in such a way that the number of members of the ruling parties and of the opposition parties in Parliament is taken into consideration. Ruling party members appoint the Chairman and half the members of the Supervisory Board, whereas the other half are appointed by members of the opposition parties.

The Parliament first elected members of the Supervisory Board in accordance with the new regulations on 3 December 2007. Since then, a newly elected Supervisory Board has been operating in the MNB.

Members of the Monetary Council of the Magyar Nemzeti Bank



András Simor

Governor,
Chairman of the Monetary Council



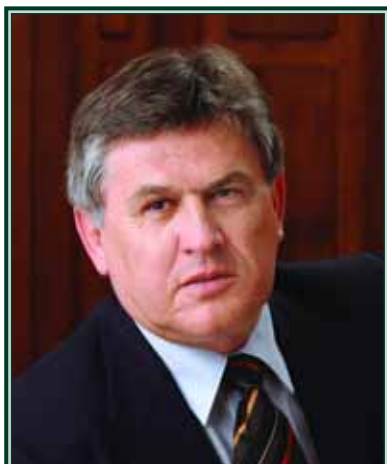
Ferenc Karvalits

Deputy Governor with general responsibilities,
Deputy Chairman of the Monetary Council



Júlia Király

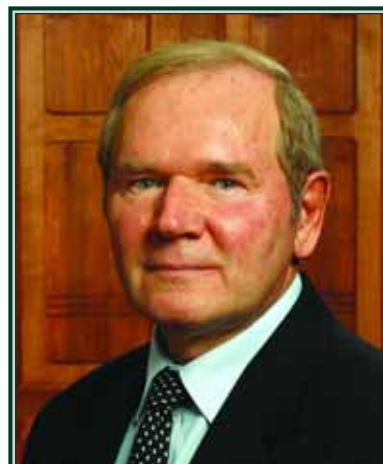
Deputy Governor,
member of the Monetary Council



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



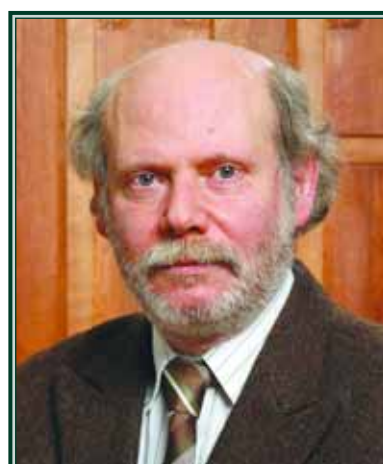
Dr. Béla Kádár
member of the Monetary Council



György Kopits
member of the Monetary Council



Judit Neményi
member of the Monetary Council



Dr. Gábor Oblath
member of the Monetary Council

The term of office of the members coincides with the Parliament's mandate. The Supervisory Board remains in office until a new Parliament elects new Supervisory Board members within three months from the date Parliament meets for the first time. Should the new Parliament fail to elect new Supervisory Board members within the aforementioned time-limit, the Supervisory Board remains in office until the new Parliament elects the Supervisory Board members.

In 2007, the members of the Supervisory Board of the MNB were:

- László Akar, (member and Chairman until 3 April 2007),
- Dr. Ákos Balassa, Chairman (from 3 December 2007),
- Dr. Éva Várhegyi (member, Acting Chairperson between 4 April and 3 December 2007),
- László Baranyay,
- Dr. Gábor Csányi (from 3 December 2007),
- Dr. József Kajdi,
- Ferenc Pichler (representative of the Finance Minister until 12 April 2007),
- Dr. Gábor András Szényei (from 3 December 2007),
- Dr. László Urbán (expert appointed by the Finance Minister), and
- Dr. István Várfalvi (representative of the Finance Minister from 13 April 2007),

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 fundamental aim is to count among the most excellent central banks in terms of both professionalism and operational conditions. The motto of its mission is: 'The Magyar Nemzeti Bank for Stability'. This motto reflects the cornerstone of the Bank's strategy, which is to ensure the stability required for the proper development of the economy in the domains of price stability, the stability of the financial intermediary system, the payment system and payment instrument alike.

In line with the management's intention, the organisational and management structure, transformed as a result of former streamlining measures and reviewed in the wake of the amendment of the MNB Act, which entered into force on 3 July 2007, serves the successful and cost-efficient attainment of the above objectives.

In the first half of 2007, the mandate of central bank Governor (Zsigmond Járαι) and his three Deputies (Dr. György Szapáry, Péter Adamecz and Henrik Auth) expired. Since the amended MNB Act sets the number of Deputy Governors at two, and as there is a lag between the expiry date of the mandates of Deputy Governors and the date of appointment of replacements, the specification of the areas supervised by the Governor and the Deputy Governors changed on several occasions.

The first major change affecting the Bank occurred on 12 April 2007, when the still functioning Board of Directors of the Bank terminated the operation of the General Secretariat as a supervisory unit, as well as two more organisational units with the simultaneous reassignment of their responsibilities.

The amendment of the MNB Act, which took effect on 3 July, led to significant organisational changes through its terminating the institution of the Board of Directors, transferring its powers and duties to the Governor.

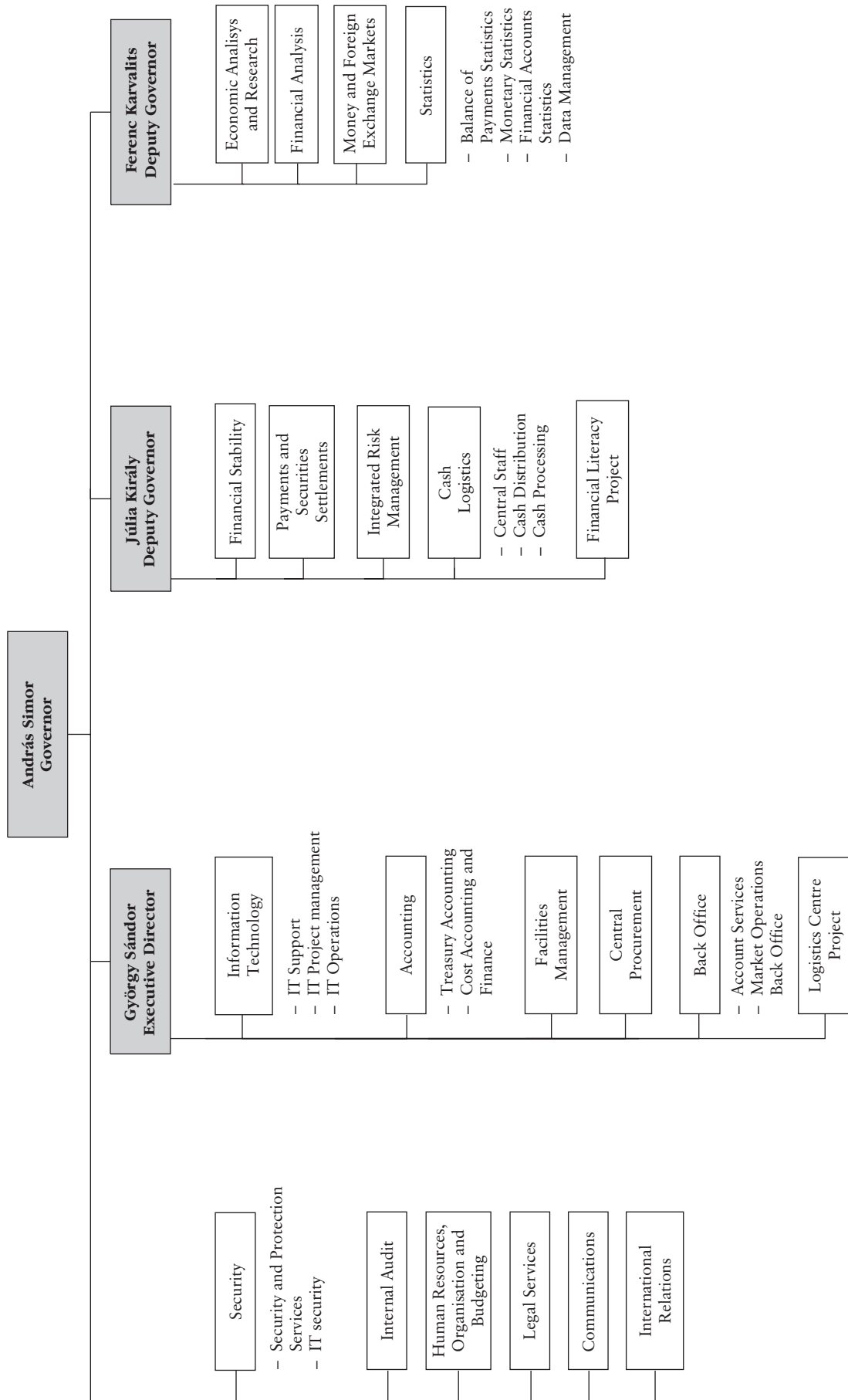
The amended MNB Act also generated modifications in the Bank's Organisational and Operational Procedures. With effect from 4 July, the supervisory units requiring director level management (Human Resources and Administration, Banking Operations, Market Operations and Statistics, Economics and Monetary Policy, Payment System and Currency Issue, Financial Stability and Risk Management) and hence the level of director control ceased to exist, similarly to independent shareholder's representation. From that date onward, the organisational units formerly organised into specialist areas have been directly supervised by the Governor, the Deputy Governors and the Executive Director, a recently created management level.

In addition to the introduction of the new management model, primarily in the spirit of increasing efficiency and assigning closely related activities to the same organisational unit, several other organisational units saw changes in their activities, internal organisational structure and, for the above reasons, supervision in the course of the year. It was in 2007 that, as the completion of a process commenced earlier, the last two regional centres responsible for currency issue were terminated.

As at 1 January 2007, under the supervision of the Governor and the three Deputy Governors, 21 organisational units rendered to 7 specialist areas, and within 7 organisational units 17 departments were in operation. As at 31 December 2007, the Governor, the two Deputy Governors and a Managing Director supervised the functioning of 21

Organisation chart

WORK ORGANISATION OF MAGYAR NEMZETI BANK



organisational units and 16 sub-units under 6 organisational units therein. The organisational chart on page 15 shows the structure of the organisation (as at 31 December 2007) that emerged following the organisational changes and which was designed to ensure the fulfilment of the above duties.

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

Hungary's accession to the European Union also entailed MNB membership in the European System of Central Banks (ESCB). Founded in June 1998, ESCB comprises the European Central Bank (ECB) with its seat in Frankfurt and the national central banks (NCBs) of the Member States of the European Union (EU). Its governing bodies are the Executive Board and the Governing Council, the latter consisting of members of the Executive Board of the ECB and the governors of the NCBs of the Member States participating in the euro area. The General Council, the third decision-making body of the ECB is responsible for maintaining an institutional relationship between the Eurosystem and the NCBs of non-euro area Member States. Holding its meetings quarterly, the General Council comprises the President and the Vice-President of the ECB and the respective governors of the central banks of all EU Member States. The key responsibilities of the General Council include consultancy concerning preparation for joining the euro area, approval of the convergence reports stipulated by the EU Treaty and monitoring the operation of ERM II. Within the framework of this latter activity, it assesses the sustainability of the bilateral exchange rate of non-euro currencies in ERM II and the euro, and provides a forum for the alignment of monetary and exchange rate policy and the management of the intervention and financing mechanisms of ERM II. In addition, the General Council continually checks whether the NCBs of the EU Member States and the ECB observe the prohibition on monetary financing of the budget and privileged access of the public sector to financial institutions. The General Council also contributes to the ECB's advisory functions and to the collection of statistical information; its opinion concerning any changes in accounting and financial data supply and issues related to adjustment of the ECB's key for capital subscription must be requested. The mandate of the General Council will expire at the date when all Member States have adopted the euro.

As of 1 January 2007, with the accession of Bulgaria and Romania, the number of EU Member States – and thus ESCB

Members – increased from 25 to 27. The number of countries which have adopted the euro changed from 12 to 13 as Slovenia began using the euro, with Cyprus and Malta following suit on 1 January 2008. Thus, the number of the Member States participating in the euro area is now 15.

ESCB members are also owners of the ECB. Ownership share is based on demographic and GDP data. The NCBs of the Member States participating in the euro area subscribe to 70% of ECB's shareholder's equity, and the remaining 30% is held by non-euro area Member States. The NCBs of the non-participating countries pay 7% of their respective subscriptions to the ECB's capital as contribution to the operational costs of the ECB that are incurred in connection with their ESCB membership. Between 1 May 2004 and 31 December 2006 Hungary's ownership share in the ECB's capital amounted to 1.3884%. As Hungary has not yet adopted the euro, it was required to contribute 7% of its ownership share, i.e. EUR 5.4 million (HUF 1.36 billion), to the ECB's share capital upon accession to the European Union/ESCB on 1 May 2004. Following the accession of Bulgaria and Romania to the EU, Hungary's share in the ECB's capital and its paid-up capital fell to 1.3141% and to EUR 5.3 million (HUF 1.34 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 as per the division of the various central bank duties, covering all areas of central banking operation, from monetary policy through communication to statistical data reporting. Experts from the NCBs of non-euro area Member States may attend those committee meetings the agenda of which includes items affecting the ESCB as a whole and which fall under the competence of the General Council. (For a detailed description of the 13 ESCB Committees and the activities of other forums providing assistance for them, see Chapter 3.10.) The committees meet and discuss current issues relevant to their professional areas 4-5 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 continued to be a very useful forum for the exchange of professional experience in 2007, contributing to Hungary's preparations for joining the Eurosystem.

3 Review of the MNB's performance in 2007

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 within the framework of inflation targeting, taking into account the $\pm 15\%$ intervention band of the forint exchange rate against the euro. The Government and the MNB's Monetary Council set a 3% medium-term inflation target valid all through the period starting in 2007. This modifies earlier practice insofar as the Bank's inflation target is interpreted not only as end-of-the-year inflation, but also as a target valid throughout the year.

In 2007, the number of Monetary Council members decreased from 13 to 12. In keeping with the MNB Act enacted in 2007, this headcount fell to a maximum of 7 and a minimum of 5 members. This change in the number of MC members will be implemented in such a way that, following the expiry of the mandate of members, no new member will be appointed.

In 2007 the meetings of the Monetary Council were held in accordance with its pre-determined meeting schedule. Accordingly, decisions about changing the central bank base rate were made only at the second meeting of each month.

Trends in inflation in 2007

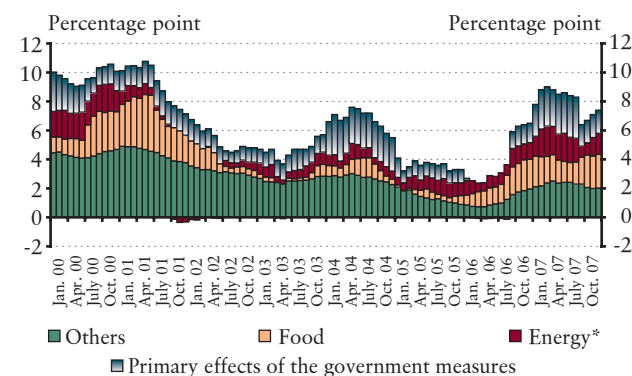
In 2007, the annual consumer price index varied in the range of 6.4%-9%. Following a peak in March, it decreased steadily until October, when it reversed and edged up consistently until the end of the year. Average annual inflation rose to 8% from 3.9% in the previous year, while average core inflation

increased from 2.3% to 5.3%. Thus, in the course of the year, year-on-year inflation exceeded the 3% inflation target significantly every month. As a result, the primary objective of the central bank could not be achieved in 2007.

The difference between actual inflation and the inflation target of the central bank is attributable predominantly to shocks beyond the control of monetary policy. Such shocks primarily originated from fiscal measures and trends in oil and food prices. In the summer of 2006, the Government announced the details of its austerity package. This also made it clear that fiscal adjustments would push inflation up significantly in 2007, mainly through a marked increase in income and social taxes, and regulated prices. Accelerating inflation was also engendered by increasing oil prices in the global markets and a sharp rise in the price of unprocessed food as from the summer of 2007. With the impact of the above shocks excluded, inflation in 2007 would have exceeded the mid-term inflation target to a much lesser degree.

Chart 1

Breakdown of inflation into components



* The direct effect and the indirect effect (transmitted by regulated prices) of energy prices on inflation.

Table 1

The consumer price index and its components

(Percentage change, year on year)

	2005	2006 annual average	2007	2007			
				Q1	Q2	Q3	Q4
Core inflation	2.1	2.3	5.3	5.8	5.8	5.1	4.6
Unprocessed food	4.3	17.8	13.7	16.1	9.3	12.3	17.0
Fuel and energy	8.6	7.8	2.2	2.4	0.9	-1.8	7.5
Regulated prices	6.1	3.7	14.7	15.3	17.6	15.6	10.1
Consumer price index	3.6	3.9	8.0	8.5	8.6	7.7	7.1

Monetary policy in 2007

As monetary policy affects consumer prices only indirectly and with a lag,¹ with the instruments at its disposal the central bank cannot influence the immediate and direct impact of shocks on inflation or it can do so only in a manner such that the national economy would incur high costs. Accordingly, as a rule, modern central banks pursuing an inflation targeting policy consider a 1 to 2 year horizon to be relevant in terms of the efficient operation of monetary policy. As regards temporary shocks that lead to a one-off rise in the price level, they only strive to contain their secondary effect exerted on inflation expectations.

Due to the lengthy process of monetary transmission, the central bank was able to influence trends in inflation in 2007 mainly in the course of 2005 and 2006. From the second half of 2005 to the summer of 2006, no risk to inflation to which monetary policy had to react emerged. Inflation reached historical lows and prospects were also favourable. The baseline scenario of the MNB's projection for inflation in 2007 assumed a 3% growth of CPI up to August 2006. There was no gainsaying the fact that fiscal adjustments were needed; however, no satisfactorily detailed information about the composition of the expected government measures and especially their impact on inflation was available. Therefore, the monetary policy of the time adopted a wait-and-see stance, opting for keeping the base rate unchanged month by month.

In the summer of 2006, details of the Government's austerity package were announced. A number of government measures were disclosed, which greatly modified the macroeconomic, inflationary and fiscal paths outlined by the central bank earlier. As a result, there was a shift in the baseline scenario of the MNB projection towards higher inflation, with upside risk to inflation looming over the entire forecast horizon. It is important to note that during the same period Hungary's risk rating deteriorated materially, which led to a significant weakening of the exchange rate of the forint vis-à-vis the euro. Both factors urged the Magyar Nemzeti Bank to cautiously embark on a tightening cycle, which led to an 8% rise in the central bank base rate in 2006. The Bank reiterated in its communication that, considering their temporary nature, it did not wish to neutralise the immediate impacts of the fiscal austerity measures; rather, it sought to dampen those secondary effects which could manifest themselves in heightened inflation expectations and could pose upside risk to inflation over the medium term.

The fundamental aim of Hungarian monetary policy was to prevent the feed-through of temporary inflationary shocks into inflation expectations, thereby avoiding the emergence of lasting inflation effects. The interest rate increasing cycle in 2006 was followed by significant uncertainties in 2007. The Government's measures engineered towards curbing demand improved the external balance, reduced fiscal deficit and the country's external borrowing requirement simultaneously and contributed to a better risk rating of the country. The negative impact of fiscal adjustments, however, left Hungarian monetary policy facing a dilemma. The underlying reason for this was that the austerity measures led to slowdown in economic growth, which could have justified a more lax monetary policy, and rising inflation, which called for a tighter policy. In the central bank's opinion, there was considerable uncertainty as to the impact of lower demand on inflation, the tapering off of the inflationary effect of one-off shocks and trends in inflation expectations. Data on private sector wages further intensified the perceived uncertainty, since it was not obvious whether high wage inflation in the private sector was the result of bleaker expectations or the whitening of the economy. Changes in labour market and tax regulations led to statistically evidenced growth in wage dynamics in some industries, which is not to be mistaken for an actual wage increase; rather, former untaxed income was recognised as wages.

After the second quarter in 2007, the MNB detected unmistakable improvement in the economic climate. Relying on its estimates, the central bank found that the impact of the whitening of the economy accounted for a large chunk of wage inflation; thus, if it was excluded, no rise could be experienced in wage dynamics. Short-based seasonally adjusted core inflation which captures underlying inflation subdued in the first half of 2007. Overall, the above factors mitigated the risk of persistently high inflation expectation; therefore, in June the Monetary Council decided to lower the base rate – which had by then remained unchanged for two months – by 25 basis points.

However, the Hungarian economy received new, mainly global shocks in August 2007, with their aftermaths hurting the economy until the end of the year. A rapid increase in food and oil prices weakened downside risks and strengthened upside risks to inflation.

Money market turbulences attributable to the US sub-prime crisis exerted their effect indirectly, through their impact on the forint's expected risk premium, ultimately leading to a

¹ See Várpalotai, V. (2005): 'An optimum horizon for inflation targeting in Hungary', MNB Occasional Papers, 45; and Vonnák, B (ed. 2006): 'The monetary transmission mechanism in Hungary', MNB Working Papers, 2007/3.

weaker HUF/EUR exchange rate. As the Hungarian banking system did not have any direct exposure to the US sub-prime market, capital market woes did not exert any substantial influence on the domestic markets and there were no major liquidity constraints. However, if, facing heavy losses, US and European banks become much less risk tolerant and tighten their lending terms, that may pose a risk to global growth in the longer run. Global slowdown may easily lead to a setback in domestic growth as well; nonetheless, it may also reduce global inflationary pressure. The November Report on Inflation already pinpointed the impacts of the global business conditions and inflation as a major alternative risk scenario.

With regard to the new shocks, in its communication the Monetary Council explained that, although it saw room for further rate cuts, higher uncertainty bids caution in monetary policy decisions. Thus, during the rest of the year, the Monetary Council lowered the central bank base rate on only one occasion, in September, by 25 basis points. It is important to note that, despite the rate cuts, in 2007 the central bank base rate consistently exceeded the expectations that market actors had already priced in.

In its November 2007 forecast, the Bank assumed an increasingly upside risk to inflation and a bleaker outlook on growth prospects. The marked rise first in the price of unprocessed food, then in the price of processed food proved to be more lasting than expected. The adverse shocks created a monetary policy environment where staving off secondary inflation effects and offsetting the upside risk to inflation posed through expectations became the Council's main concerns. In keeping with such concerns, the base rate was left unchanged in both November and December, which was a clear indication that the Monetary Council saw the situation differently. The Council made it clear that the only opportunity for further rate cuts was when the entailed upside risk to inflation expectations subsided and global financial markets picked up again.

Introduction of the MNB bill

In January 2007, the MNB introduced a new key policy instrument. Issued weekly and replacing the two-week deposit, the MNB bill is a dematerialised security with a maturity of two weeks. Its yield upon issuance is identical with the prevailing central bank base rate.

From a monetary perspective, the introduction of the new instrument does not mean any change compared to deposits with a maturity of two weeks; thus, neither the key policy rate, nor the maturity of the key policy instrument has been altered. Though the conditions of technical implementation have partly changed, credit institutions have adjusted to it

well. As a result, both the issuance and the distribution of the security have been smooth from the outset.

In line with earlier expectations, the introduction of the bill enables credit institutions to manage liquidity more efficiently, which, in turn, ensures that payment systems are safer; it also affects the operation of the interest rate transmission mechanism favourably.

In the first eight months of the year, trading in bills in the secondary market was allowed until the third day prior to maturity date. Then, following an IT version update at KELER Zrt. on 31 August, disbursement date, in the case of debt securities, was brought forward from the third to the second day before maturity. Thus, with effect from last September, trading in the secondary market is also allowed on the Monday before the maturity date on Wednesday. Accordingly, the MNB bill is accepted as central bank collateral until the Friday instead of the Thursday prior to the date of maturity.

Publication of data on the central bank's asset portfolio

From 2 October 2007 onward, the MNB has been publishing, on a daily basis, the aggregate net sum of overnight central bank deposits and overnight collateralised loans placed and taken out respectively by central bank counterparties on the preceding MNB business day.

The MNB expects that market actors, being familiar with the portfolio of the central bank's assets, will be able to forecast liquidity with higher accuracy, which will lead to a reduction in the use of the central bank's standing facilities and, hence, to lower volatility of interbank rates in the interest rate corridor.

Changes in the sanctionative system of minimum reserves

On 13 November 2007, the MNB announced that the system of the minimum reserve would be modified with effect from 1 January 2008. The primary objective of the changes was to make the sanctionative system of minimum reserves symmetric. Towards this end, as from 2008, the costs of under- and over-provisioning will be identical, and the penalty interest rate will be identical with the central bank base rate. Furthermore, the sanctionative system of minimum reserves will be simplified further, because, with effect from 2008, in the case of under-provisioning, the MNB will use one-off debits calculated on the basis of the penalty interest rate as a sanctionative measure, rather than holding deposits on separate non-interest-bearing accounts.

The purpose of the changes is that, simultaneously with making the sanctionative system of minimum reserves symmetric and more straightforward, the reserve management behaviour of credit institutions should also be made more symmetric, whereby their liquidity management becomes more effective. Ultimately, this also contributes to lower volatility of interbank rates in the interest rate corridor.

Channelling the state's foreign exchange funds to the market

Similarly to previous years, foreign exchange assets of the Government were exchanged into forints by the MNB in 2007. 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 in the foreign exchange market.

In 2007, the Government's foreign exchange funds entailed foreign exchange conversion with the MNB in a magnitude of approximately EUR 1.3 billion; this amount was further increased by a net conversion of around EUR 1.4 billion in transfers from the European Union. The MNB used a part of this approximately EUR 2.7 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 the exchange rate of the forint, in the course of the year sales occurred in small tranches in a price-taking manner in the interbank market, with the current market situation and OTC markets conventions taken into account. Domestic and foreign credit institutions with a foreign exchange market limit with the MNB were prospective partners in these transactions.

3.2 STABILITY OF THE FINANCIAL SYSTEM

Stemming from its responsibility for financial stability, the Magyar Nemzeti Bank took an active part in the analysis of the financial system and in the exploration and extensive communication of risks in 2007. In performing this duty in 2007, the MNB paid close attention to assessing the impacts of trends in the global financial markets on Hungary and identifying the possible risks.

The Bank published its *Report on Financial Stability* on 10 April 2007. The report dwelt on the likelihood and possible effects of emergence of risks in the external environment and the domestic operation of the financial system. In respect of

the external environment, the report stressed that, due to the shift in fiscal policy, both real economic and financial stability had strengthened. Nevertheless, the change in the macroeconomic environment had temporarily placed additional burdens on economic actors, thereby posing new risks to the domestic financial system. With this focus in mind, the report primarily investigated the credit demand and credit risk of households and companies, the two major borrowers of financial institutions. Financial intermediaries strive to maintain long-term profitability and as a consequence are faced with greater pressure to extend loans, to expand abroad and to economise on intra-group relations. The report highlighted the short and long-term advantages and risks these factors imply. Shortly after publication of the report, the MNB organised a public expert forum on the topic. Guest speakers gave their opinions from the perspective of commercial banks.

The second half of 2007 was a true global challenge for the financial system, the central banks and the supervisory authorities in terms of financial stability. The spill-over effects of the US sub-prime crisis led to liquidity problems in several markets, and the global confidence crisis was reflected in rising yields and significant exchange rate volatility. The MNB's key concerns were the assessment of the impacts of international trends on Hungary and the identification of possible risks.

The root cause of the crisis was the loosening of US lending standards in the first half of the decade. Such lax standards enabled an increasingly high number of people to borrow with a down payment of less than 10% of the loan, without verified income or, at least initially, at very low repayment rates. A rapid take-off in sub-prime lending was fuelled by high risk appetite and strong investor demand for higher-return instruments on a global scale, to which the market responded by heavy lending to sub-prime borrowers rather than by issuing new securities. As a result, the traditionally good quality portfolios of mortgage loans behind asset-backed securities (ABS) and collateralised debt obligation (CDO) were packed with sub-prime loans. By repackaging risky loans into a variety of complex investment vehicles (securitisation), the market distributed credit risk associated with sub-prime mortgage loans among (mainly institutional) investors with a different risk appetite.

The woes of the sub-prime market and the mispricing of risks started to emerge in the wake of a downturn in the US housing market in 2006. The price of mortgage backed ABSs and CDOs dropped as a result of plummeting demand and forced sales, with their secondary market practically vanishing into thin air. Faced with huge write-offs, in order to reduce further potential losses, banks heavily tightened the

financing terms of their leveraged clients. Such clients now included other banks due to a widespread confidence crisis. A sudden shortage in the supply of banks' funds sometimes led to a dry-up in the market, which spilled over to other markets.

The sub-prime crisis, through a widespread and marked loss in risk appetite, led to the re-pricing of risks in other credit markets as well. The losses and financing problems of not adequately transparent financial institutions (mainly hedge funds and venture capital funds) investing into positions that were first hit by losses generated fire sales of assets in large quantities, further increasing market volatility and liquidity crunches, which now started to feed through to the markets of good quality products. These processes occurred when the transparency of financial markets was limited, which significantly hindered the satisfactory pricing of risks and the assessment of credit market exposures linked directly or indirectly to sub-prime lending.

For the time being, the increase in risks generated by the sub-prime crisis is moderate in Hungary. Although the crisis has fed through to the European banking system, it has so far had a limited impact on the operation of the domestic one. High uncertainty may, however, also result in permanent volatility in the global financial markets in the future. The abundant global liquidity of recent years is expected to dry up in the medium and long run, which may adversely hit the domestic banking sector mainly through an increase in borrowing costs and lower lending limits towards subsidiaries due to tighter availability of external funds, an increasing risk avoidance of parent banks and stricter lending conditions. Although domestic banks tend to respond to increasingly tough competition by loosening certain lending conditions, based on the current situation no credit crunch is to be expected in Hungary. The central bank continues to monitor market trends and the channels of contagion and to identify possible risks and their impact on the stability of the national financial system.

At the quarterly meetings of the Financial Stability Committee, representatives of the MNB provide information for counterparty authorities on the major risks affecting the financial system. In the second half of 2007, the MNB assumed a major role in communicating the lessons from the US sub-prime crisis. In addition, it pointed out the risks implied in JPY-based lending, the most recent product of Hungarian banks. There was a general consensus among the attendees that JPY-based lending raised the issue of increased systemic risks and they all agreed that the situation should be studied more closely.

Through its presence in international forums, the MNB plays an active role in ECB working groups dealing with financial

stability. The MNB contributed to the publication of 'EU Banking Structures', 'EU Banking Sector Stability' and 'Financial Stability Review' by supplying data and giving an opinion about them. It also participated in the compilation of the IMF's financial stability indicators on Hungary.

Two years after the first simulation exercise held in 2005 with the participation of the MNB and the HFSA, with the Ministry of Finance as an observer, another simulation exercise testing the cooperation among authorities in a crisis situation took place on 21 February 2007 with the participation of the MNB, HFSA and the Ministry of Finance now also as a participant. In addition to testing cooperation between the three institutions and the way they share information, this exercise also focused on testing the external communication strategy of these authorities and, with the involvement of the Ministry of Finance, possible crisis solutions. The executives of all three organisations agreed that the exercise had been successful and useful. In keeping with its objective, the simulation exercise shed light on the areas where the efficiency of cooperation has to be improved further.

An important element of supporting financial stability is the creation of a satisfactory operational environment, in which financial regulation plays a key role. Within the framework of the MNB's regulation policy, the bank gave an opinion on the draft statutory regulations required for the legal implementation of the new European capital requirement directive (CRD). The MNB also participated in the implementation of the EU directive on investment services provision, gave an opinion on the new Civil Code and participated actively in the Pension Working Group of the State Reform Committee.

Development of financial literacy

The indebtedness of households has also been on the rise in Hungary. Experience and surveys reveal that Hungarian households do not have the necessary financial knowledge: they cannot assess their risk tolerance or the benefits and risks associated with individual financial services. As a result, they either assume too much risk (e.g. long-term foreign currency-denominated debt) or avoid any investment product or service that is slightly more complicated than traditional low-risk investments. International experience has proven that the low level of households' financial literacy is detrimental to the development of the market of retail financial services; unaffordable and rushed risk assumption also threatens, through deterioration in the loan portfolios of banks, the stability of the financial intermediary system.

By contrast, well-informed finance-savvy clients handpicking service providers and products push financial actors to

compete with each other more strongly; stronger competition encourages innovation in and improves the efficiency of the operation of the financial sector. Efficient dissemination and training programmes help make the most of welfare opportunities. In a number of countries central banks consider the development of the financial literacy of the population to be part of their core duties and take an active part in it.

The Magyar Nemzeti Bank launched a project aimed at the development of financial literacy in 2006. Professional support for the development of general financial literacy was among the bank's key objectives in 2007. In order for the key strategic objectives of the MNB to be realised (achieving and maintaining price stability, encouraging sophisticated means of payment, etc.), the contribution of both the professional community and the wider public is needed. Therefore, the management of the central bank launched an independent financial literacy project in October 2007 in order to reinforce and integrate all the activities aimed at developing financial literacy and create and implement uniform programmes.

In the area of the development of financial literacy the most important result in 2007 was the publication of *Money talks. Do you understand?*, identified by a Commission survey as a noteworthy initiative. The booklet sent out to 120,000 secondary school students in their last year at school provides essential information in an easy-to-understand form about the financial products and services that young persons, whether taking up employment or going on to universities, will inevitably 'encounter'. The Ministry of Education and Culture, the Ministry of Finance, the Student Loan Centre and the Hungarian Financial Supervisory Authority also provided assistance with the publication of the booklet. The bank intends to reprint the booklet until financial knowledge and skills as a school subject are taught as part of school curricula.

A further success in 2007 was that, on the initiative of the central bank and several other authorities and organisations, economic and financial basics became, as part of the revision of the National Core Curriculum in 2007, a school subject. In order for basic financial skills to be acquired and for economic and financial knowledge to be mastered, further steps will have to be taken, which the central bank will also actively facilitate in the future.

On the initiative of the central bank, in order to bring the activities of state, non-profit and civil organisations with a stake in the development of financial literacy in line with each other, quarterly forums are held, which provide an excellent basis for working out forms of further cooperation between the organisations affected.

3.3 PAYMENT SYSTEMS AND SECURITIES SETTLEMENT SYSTEMS

The MNB plays several roles in the payment systems and securities settlement systems. As a service provider it manages the accounts of credit institutions, on which payments related to interbank transactions are settled with finality. It operates a Real Time Gross Settlement System (Hungarian abbreviation: VIBER). It is a co-owner of GIRO Clearing House Limited (GIRO Zrt.) and the Central Clearing House and Depository Ltd (KELER Zrt.). It is also a participant in all three settlement systems. As an overseer, in respect of the clearing and settlement infrastructure, the MNB fulfils regulatory, licensing and supervisory functions. 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. In 2007 its functions as an operator, overseer and catalyst were of key importance.

The operation and development of VIBER

In 2007 the number of VIBER members was 42, four members more than at the end of the previous year. 92.5% of the total turnover value of 984.1 thousand billion forints of the Interbank Clearing System (ICS) (Hungarian abbreviation: BKR) and VIBER was processed in VIBER, while the share of BKR in the volume of transactions was highest (99.5%). The total turnover of the two systems was 38.6 times the projected GDP figure for the year, slightly exceeding the 37.6 ratio in 2006.

VIBER conducted a total of 892.4 thousand payments in an amount of HUF 910.6 billion. The value of transactions grew by 16.8%, while the number of transactions was 10.6% higher compared with the preceding year. In 2007, the average value per item amounted to HUF 1020.5 million, i.e. 5.6% higher than the average of the previous year. In 2007 the average daily volume of transactions was 3,555, while the average daily VIBER turnover amounted to HUF 3,628 billion. The largest daily turnover in terms of volume was 6,151 transactions settled on 30 March 2007. The peak value HUF 7,598 billion was settled on 21 March 2007.

In international comparison, the liquidity available for payments of participants in VIBER is high. Banks' average daily intraday credit line – which is provided by the MNB for the purposes of settling payments against blocked securities held as collateral and which supplements the bank account balance – amounted to HUF 537.8 billion in 2007, which was 36% higher than the figure for 2006. Compared with the previous year, the combined average daily balance available on banks' accounts increased by 10.2%, reaching HUF 591.3

billion. Total liquidity for settlements – arising from the two aforementioned sources – rendered it possible to settle the combined turnover of VIBER and ICS at an average daily value of HUF 3,924 billion, representing a 12.4% increase on the daily turnover in the previous year. During the year, the average daily turnover was 3.5 times the daily liquidity, compared to the previous year's average of 3.7 times. VIBER's availability was 99.43% in 2007, down from the previous year's figure, and the internationally expected level. The total loss of operating time was 13 hours. There was only one disruption longer than two hours (3.5 hours). The MNB considers it to be one of its key duties to improve the availability and stability of VIBER in order to meet or even exceed international standards in respect of availability indicators.

The MNB reviews the fees it charges for the payment services that it provides. Relative to 2006, the fee per VIBER item decreased further to HUF 350 in 2007, which was in line with the steady decrease in fees experienced for years. Except for the fee, no other costs are imposed on VIBER members.

There was a switchover, a development affecting each direct VIBER member, from bilateral key exchange to public key infrastructure (PKI), which was due, in the second phase of the migration to SWIFTNet, by 30 April 2007. The MNB and other domestic users implemented, in accordance with their original commitment, the technical up-grade of their systems for the introduction of PKI and the application based on it. The aim was to filter undesirable messages and guarantee the encryption and electronic signing of messages, replacing bilateral key exchange, which had been used for a long time prior to the switchover. Due to this development, the security and efficiency of message turnover further improved.

Central bank inspection of payments

The Bank draws on its experiences gained in central bank supervision, oversight and developing the payment systems and securities settlement systems, regulating payments and developing data collection concerning payments, and applies them for the prevention of money laundering and the financing of terrorism.

During the on-site audit of various institutions (e.g. credit institutions, companies engaged in cash processing, clearing houses and two major entities engaged in the intermediation of payment transactions) the bank stipulated, in order for the deficiencies identified during the audit to be eliminated, a total of 39 tasks, the fulfilment of which it monitored closely. Except for one cash processing company, where a follow-up is justified, the audited organisations had all taken the

prescribed measures by the set deadline. In the case of several audits, the deadline for the implementation of the corrective actions is due in 2008.

The experience gained during the audits can be summed up as follows: credit institutions executed the majority of bulk payment transaction orders in accordance with the central bank's stipulations; nevertheless, all of them committed material breaches, identified by central bank audits, which had implications for the reliability and safety of payments. Some of the breaches also concerned the payment regulations already in force. Containing stipulations materially different from earlier payment regulations, an MNB decree on the implementation of payments went into force in 2007. Experience gained from the audits revealed that some of the credit institutions failed to fully comply with the new requirements.

The quality of payment data fell short of the expected standards; errors leading to significant bias were detected in the data provided by all audited institutions. The majority of the errors also caused significant differences in the aggregate national data.

We detected shortcomings concerning the prevention of money laundering (verification of client identity) and the material and personnel conditions bearing relevance to professional work during the audit of the majority of cash processing companies. Shortcomings were sometimes also identified in connection with internal regulations. In the case of cash recirculation, inspectors found that competent bank staff members failed to adequately manage banknotes suspected to be counterfeits.

Interbank co-operation

Meetings of the Payment System Council

The Payment System Council held two ordinary meetings and one extraordinary meeting. Major decisions made at the meetings were as follows:

- The working group studying direct debits examined the experiences concerning this payment instrument and found that neither payees nor the payers monitor or comply with the deadlines and the rules specified in the requisite procedural rules. In the light of the above, the working group proposed new rules and reworded the Rule Book (RB). Subsequently, it submitted an application for the standardisation of what is stipulated in the RB to the Hungarian Standardisation Office. The working group also checked the extent to which the new RB complied with the requirements laid down in the Payment

Services Directive (PSD) published in the fourth quarter of 2007. It was found that the legal environment, transformed in response to the above directive, would fundamentally alter the responsibilities of those participating in collection and the risks to be borne by the parties, which urges the banking community to adopt the direct debit scheme designed within the framework of the implementation of the Single Euro Payment Area (SEPA). With the participation of GIRO Zrt., the working group commenced a study of the feasibility of the central mandate handling system.

– An important goal and result of the extraordinary meeting in autumn was the establishment of a body that was entrusted with the task of supervising SEPA in Hungary. A National SEPA Committee was set up with support from and participation of the MNB. The committee is co-chaired by the MNB and Bankszövetség (Banking Association). The following banks, each playing a major role in the domestic payments system, joined the committee: Budapest Bank, CIB Bank, Citibank, ERSTE Bank, ING Bank, K&H Bank, MKB Bank, OTP Bank, Raiffeisen Bank, Takarékbank and UniCredit Bank. These banks agreed that their experts would compile a national changeover plan, aimed at the introduction in Hungary of the SEPA payment schemes developed by the European Payments Council (EPC) and approved by European regulators, by end-2007.

Within the National SEPA Committee a National Adherence Support Organisation (NASO), a group providing assistance for domestic banks to adhere to SEPA schemes, was set up, and a decision was made on the establishment of an organisational unit in charge of all communication related to the implementation of the Single Euro Payment Area.

SWIFT information campaign

In the first half of 2007, with active support from the MNB, representatives of SWIFT held presentations for the payment experts of the entire Hungarian banking community. The subject of the presentations was the testing programme that SWIFT had developed to facilitate the earliest possible successful introduction of SEPA schemes and the related payment and settlement mechanism, and which it was presenting within the framework of a road-show in all EU Member States.

Conference on payments

The topic addressed at the 6th International Autumn Conference on Payments was business continuity, since the smooth and reliable operation of payment and settlement

systems and improving their resilience against various shocks are of key importance.

Experts from the ECB, SWIFT and three national central banks were invited as speakers to the conference. The ECB representative presented a project whose objective is to develop a supranational pan-European business continuity methodology and information basis. The speaker from SWIFT outlined the applications which are intended to enable a unique global financial messages forwarding system to operate at a consistently high standard and perform self-repairs. NCB representatives all agreed on and highlighted the importance of the availability of national business continuity plans, which they had worked out in close cooperation with other national authorities, such as supervisory authorities and finance ministries. They all emphasised the need for the regular incorporation of plans, even if staff members have gathered adequate experience in it, and the development and continual improvement of a set of tools commensurate with threats.

3.4 MANAGEMENT OF FOREIGN EXCHANGE RESERVES

Objectives of holding reserves

Similarly to other central banks, one of the most important tasks of the Magyar Nemzeti Bank is the management of the country's foreign exchange reserves. The foreign exchange reserves contain the liquid foreign exchange assets of the central bank, which the monetary authority may directly use in the event of payment problems, and which provide coverage for foreign exchange market intervention serving monetary policy objectives. 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 support the HUF exchange rate),
- 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 exchange rate in the form of interventions, and supports the fulfilment of the Maastricht exchange rate criterion in relation to joining the Economic

and Monetary Union (EMU). In 2007, there were no (open) intra-band interventions, nor (passive) interventions at the edge of the band. (Under the new exchange rate regime, since 26 February 2008 there has been no obligation for passive intervention to maintain any band.)

In terms of the transaction goals, supporting the management of government debt remained the most important objective last year. In 2007, the Hungarian State borrowed foreign exchange in an amount exceeding EUR 1.5 billion, which, even when netted with the interest and principal repayments, added more than EUR 600 million to the foreign exchange reserves, since the State converts its foreign exchange resources into forints at the MNB. Transfers received from the European Union increased the reserves by more than EUR 1 billion.

The MNB 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, achieving an additional return if possible. In 2007, the cost 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 its investment policy, the MNB strives to adopt the best practice followed by central banks in developed countries. Similarly to the majority of central banks, the MNB 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. We have restricted our investment universe so that the maturity of purchased bond market assets may be a maximum of 10.5 years, while their credit rating may fall within the top two investment categories (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 experiences of the sub-prime crisis of 2007 justified the legitimacy of this policy.

The euro continues to play a key role in the foreign exchange structure of reserves. Its weight is justified by the exchange rate system of Hungary, the country's economic integration into the euro area and the foreign exchange structure of the

government debt. In addition, the MNB also keeps US dollar reserves.

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 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% of the reserves in liquidity and 80% of the reserves in investment portfolios.

Size of reserves

At the end of 2007 the amount of official foreign exchange reserves remained largely the same as in the same period of the previous year, EUR 16.4 billion, and was in balance throughout the year. In the first quarter the level of reserves increased temporarily when the ÁKK (the Government Debt Management Agency) issued a euro bond with a 10-year maturity. However, this was followed by a gradual decline. Based on the indicators most often used to determine the optimum size of reserves, i.e. those linked to short-term debts and cash amounts, the current level of foreign exchange reserves can be considered adequate.

The level of reserves was mainly influenced by the bond issues and borrowings of the Government Debt Management Agency. The euro bond (maturing in 2017) issued in February and the Japanese yen bond (maturing in 2017) issued in October added nearly EUR 1.15 billion, while the loans extended by the European Investment Bank (EIB) added nearly EUR 0.5 billion to the reserves. At the same time other, debt management-related foreign exchange transactions performed by the ÁKK and the MNB (loan repayments, interest payments, interest rate and foreign exchange swaps) resulted in a decline of nearly EUR 1 billion.

Transfers from the European Union resulted in an inflow of approximately EUR 1.3 billion. The return of foreign exchange reserves contributed to the increase by nearly EUR 0.6 billion. Transfers from the European Union and sales of euro (re-channelling to the market) intended to offset the

Chart 2**Developments in foreign exchange reserves, 2001-2007**

forint liquidity-expanding effect of foreign currency borrowings, foreign exchange payments performed on behalf of budgetary institutions, and payments related to the debt service of MNB itself reduced reserves by EUR 596 million, EUR 1.1 billion, and EUR 0.6 billion, respectively.

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 2007 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 were taken intentionally; it 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. On a monthly basis, the risk management organisational unit independent of the business area reviewed the reference portfolios or so-called 'benchmarks', which are indicative of the yield/risk preferences of the institution and are used for performance measurement. For the purpose of increasing the duration, a tactical benchmark was established in September 2006 with respect to the dollar portfolio. In accordance with the decision made by the Board of Directors in April 2007, the strategic duration changed to the level of the former tactical duration, thus the tactical position, as such, ceased to exist during the year. 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 2007, 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.

Thanks to the conservative risk-taking policy of the MNB, the secondary mortgage market crisis that exploded in the summer of 2007 did not directly affect the portfolio of the bank. Due to the decline in market yields the performance of the reserve portfolios of the MNB was relatively high in absolute value, compared to previous years: the average performance of the portfolios was higher by more than 1 percentage point than in the previous year, while the performance of partial portfolios exceeded the average of the last three years by 1-3 percentage points. However, albeit to a lesser degree, the effects of the mortgage market turbulence have rippled through other markets, and the yield spreads of corporate securities, which increased relative to the benchmark, resulted in varying return levels. The total return on the euro-denominated investment portfolio was 3.51% in the calendar year of 2007, compared to the 3.62% return of the corresponding benchmark, while the total return on the dollar-denominated portfolio was 6.01% compared to the 6.54% return of the corresponding benchmark. The annual total return on the euro-denominated liquidity portfolio was 3.98%, 12 basis points higher than the corresponding benchmark, while the dollar-denominated liquidity portfolio reached 5.35% compared to its 5.27% benchmark.

On the last day of the year, the interest rate risk on the MNB's total balance of foreign exchange was EUR 48 million expressed by the value-at-risk (VaR) indicator (with a one-month time horizon and on a confidence level of 95%), while the tracking error of investment portfolios to the benchmarks corresponded to EUR 12 million, also on a 95% confidence level. At the same time, the value at risk of the net open currency position (measured to the euro, with a 1-day time horizon and a confidence level of 95%) amounted to EUR 1.3 billion. The magnitudes reflect the implementation of the conservative principles laid down in the risk-taking policy.

Managing operational risks

The Bank attaches great importance to fortifying its activity related to operational risk management. For this reason, this activity was removed from the organisation of banking security as of October 2007, and simultaneously, through a merger with Market Risk Management, the institutional unit of Integrated Risk Management was established.

Due to the reorganisation of the existing committee structure of the MNB, the Audit and Operational Risks Committee was discontinued, and all reports and propositions regarding operational risk management are now directly discussed by the Steering Committee.

The annual review and analysis of operational risks focused on expressly high profile or high financial risk activities, and we continued the centralised collection of key risk factors regarding these activities.

Throughout the year of 2007 the Bank continued to maintain an up-to-date business-continuity system. The Bank considered the availability of human resources a priority, and ensured that personnel was assigned to key positions.

3.5 CASH LOGISTICS ACTIVITIES

One of the key tasks of the Magyar Nemzeti Bank is to provide citizens and the economy with a cash supply of adequate quantity, quality and denomination. For this purpose several important steps were taken during the year of 2007.

On 31 August 2007 the Magyar Nemzeti Bank withdrew the earlier version of the 1000 forint denomination banknotes issued between 1998 and 2006. As of 1 September 2007, only those 1000 forint banknotes qualify as legal tender which were first issued on 10 April 2006 with the new security elements of a holographic-effect metal stripe and a pearl-coloured iridescent stripe. The withdrawal of the earlier version of the 1000 forint banknotes and the exclusive

circulation of the new version banknotes had a favourable influence in relation to counterfeiting. The older types of 1000 forint banknotes still in circulation can be exchanged at the cash counters of the central bank for another twenty years.

As 1 and 2 forint coins have no significant purchasing power in themselves, they have been used less and less frequently for quite some time now. A large part of the coins produced are lost or misplaced, consequently these coins are not in active circulation. In addition, the world market price of metal has soared in recent years, and the production of coins causes a significant amount of extra expenditure not only for the Magyar Nemzeti Bank operating with public funds, but also for the whole country. As a result, at the end of September 2007, the Magyar Nemzeti Bank announced the withdrawal of 1 and 2 forint coins from circulation as of 1 March 2008.

In 2007 additional steps were taken to strengthen the wholesale character of central bank cash distribution. In order to increase the efficiency of incoming and outgoing payments of the central bank, several points of the business terms and conditions regulating the cash transactions performed by the MNB were modified. One of the most important changes is the fact that cash distribution is now performed at batch level only (1,000 pieces of banknotes per denomination) for wholesale cash distributors. Under the Business Terms and Conditions comprehensive regulations were introduced regarding the central bank acceptance of damaged or incomplete banknotes.

The central bank continued the work it started 15 years ago to streamline its regional network. Considering the role and business efficiency of its network units at cash distribution, the MNB decided to close down the regional currency branch offices in Székesfehérvár and Debrecen as of 1 November 2007. As the regional branches served the post office and the same national credit institutions, which primarily use the logistics services of MNB Budapest anyway, the number of regional branches has declined in recent years. These organisations adapted well to the regional changes of central bank cash distribution. With the closure of the last two regional branches all regional currency branch offices of the central bank ceased to exist.

Currency in circulation

At the end of 2007, the value of cash in circulation was HUF 2,189 billion, up 12% or HUF 229 billion compared to the end of the previous year. In 2007, the value of cash increased by an annual average of 10%, which falls significantly behind the 18% growth rate recorded in 2006.

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

	2006	2007	Change	
	billion forints		%	
Banknotes	1,926.0	2,153.2	227.2	11.8
Coins	29.8	31.1	1.3	4.3
Stock of circulation cash	1,955.8	2,184.3	228.5	11.7
Collector coins and banknotes	4.0	4.7	0.7	17.5
Cash in circulation	1,959.8	2,189.0	229.2	11.7

The ratio of the average value of currency in circulation during the year in relation to GDP remained largely the same as that of the previous year, 7.9%.

Chart 3**Ratio of currency in circulation to GDP****Banknotes in circulation**

In 2007 the value of banknotes in circulation increased by 12% compared to the end of 2006, and by the end of the year it exceeded HUF 2,153 billion. The number of

banknotes in circulation increased at a more moderate rate of 5%, owing to the sustained increase in the number of banknotes with higher denomination. While the quantity of all banknote denominations increased, the number of 20,000 forint banknotes increased at an above-average rate of 20%. The demand for all other banknote denominations increased by 3%-8%.

Coins in circulation

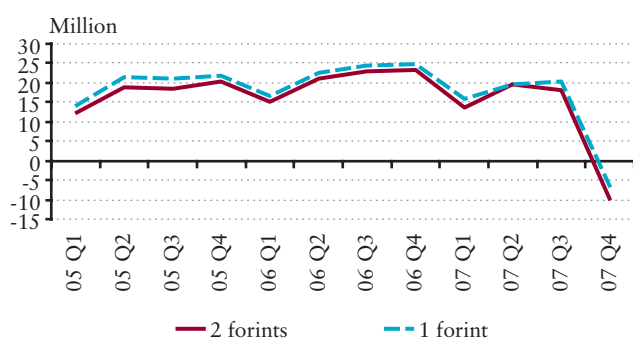
At the end of 2007 the number of coins in circulation was 2,937 million, representing a 5% increase in the demand for coins, which is considerably lower than the 9%-10% growth of previous years. In September 2007 the Bank announced the withdrawal of the 1 and 2 forint coins as of 1 March 2008, which resulted in a slower growth of demand for coins, as coins resting in piggy banks and drawers found their way back to the central bank. The inflow of 1 and 2 forint coins hit the highest level; incoming payments of these coins have multiplied and, as a result, for the first time since their issue in 1993 the values of incoming payments of the 1 and 2 forint coins exceeded those of the outgoing payments. Incoming payments of other coin denominations grew significantly as well.

Table 3**Banknotes in circulation on 31 December 2007**

Denominations	Quantity	Value	Distribution (%)	
	million		quantity	value
20,000 forints	52.2	1,043.8	17.0	48.5
10,000 forints	88.7	886.8	28.9	41.2
5,000 forints	23.1	115.6	7.5	5.4
2,000 forints	18.7	37.3	6.1	1.7
1,000 forints	44.5	44.5	14.5	2.0
500 forints	30.8	15.4	10.1	0.7
200 forints	48.8	9.8	15.9	0.5
Total	306.8	2,153.2	100.0	100.0

Table 4**Coins in circulation on 31 December 2007**

Denominations	Quantity	Value	Distribution (%)	
	million		quantity	value
100 forints	150.6	15,061.6	5.1	48.4
50 forints	106.7	5,333.9	3.6	17.2
20 forints	196.7	3,933.2	6.7	12.7
10 forints	234.2	2,341.7	8.0	7.5
5 forints	320.0	1,600.0	10.9	5.1
2 forints	887.5	1,775.0	30.2	5.7
1 forints	1,041.5	1,041.5	35.5	3.4
Total	2,937.2	31,086.9	100.0	100.0

Chart 4**The net circulation of 1 and 2 forint coins by the central bank****Cash distribution**

In 2007, the cash turnover of the MNB amounted to HUF 3,641 billion, an amount similar to that of the previous year.

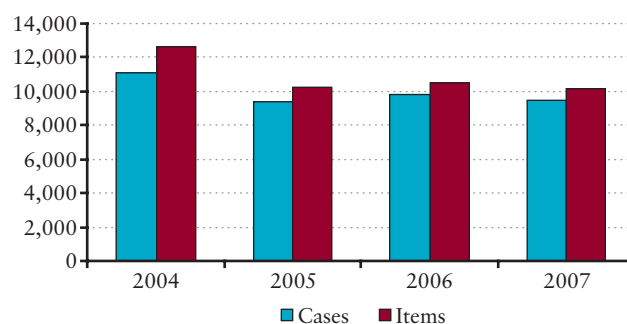
The amount of incoming and outgoing banknotes did not change significantly compared to 2006. The MNB paid out 329 million banknotes last year, while banks paid 309 million banknotes to the central bank in 2007. The frequency of the appearance of banknotes at the central bank (i.e. banknotes processed by the MNB/banknotes in circulation) was 1.1; this rate did not change compared to 2006.

The number of coins paid to the central bank increased by more than one third, i.e. 62 million coins, primarily due to the inflow of 1 and 2 forint coins and, to a lesser degree, the inflow of other coins. Charity collections had an important role in the collection of coins held in the households of citizens. Due to the inflow of dormant coins a considerable amount of other coin denominations returned to the day-to-day cash circulation, decreasing the amount of outgoing

central bank payments of each coin denomination. The total number of coins paid out by the central bank in 2007 was 57 million coins less than in the previous year, which represents a 13% decline.

Prevention and reduction of counterfeiting

In 2007 the counterfeiting of forint banknotes decreased to some extent compared to 2006. Last year the experts of the Magyar Nemzeti Bank registered 10,139 forint counterfeit withdrawn from circulation in a total of 9,487 cases. With a share of 77% the 1 forint banknote was counterfeited most often until the end of August, when the central bank withdrew from circulation the old, less secure version of the 1,000 forint banknotes. Only the hologram-protected, hard-to-counterfeit 1000 forint banknotes have been in circulation since September, which, according to the initial signs observed during the last month of the year, had a favourable impact in relation to counterfeiting.

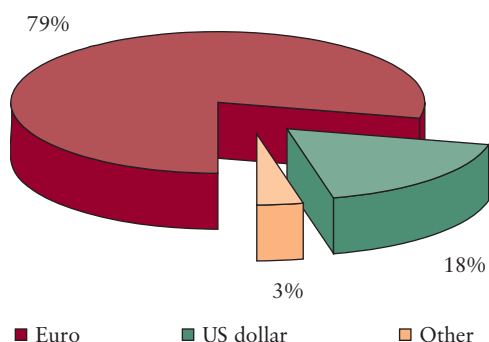
Chart 5**Counterfeiting of forint banknotes, 2004-2007**

All seized counterfeitings were produced by means of simple office reproduction equipment (colour photocopier, printer). The ratio of counterfeiting does not jeopardise the safety of cash circulation – in 2007 the average number of counterfeit

banknotes was 33 per one million banknotes in circulation, as opposed to the earlier figure of 38 counterfeits.

Even though the number of foreign currency counterfeits slightly increased during the year, the number of seized counterfeits decreased; our experts examined a total of 1,946 different currency counterfeits. The number of euro counterfeits is relatively moderate; a total of 1,528 euro counterfeits were examined and withdrawn from circulation.

Chart 6
Currencies seized from circulation in 2007



Issue of commemorative coins

The Magyar Nemzeti Bank issued seven commemorative coins in 2007.

The MNB issued 'Libelle aeroplane', a cupronickel collector coin with a face value of HUF 1,000, and the following silver collector coins with a face value of HUF 5,000: 'Bicentenary of the birth of Lajos Batthyány', 'the 125th anniversary of the birth of Zoltán Kodály', 'Gyula Castle', 'Great Reformed Church of Debrecen', 'the 800th anniversary of the birth of St. Elisabeth of the House of Arpad'. The Bank issued a commemorative version of the 50 forint coin to mark the 50th anniversary of the signing of the Treaty of Rome.

The commemorative version of the 50 forint coin issued in 2006 to mark the 50th anniversary of the 1956 Hungarian Revolution and War of Independence earned prestigious international recognition by winning the public's award of the 'Coin of the Year' competition.

3.6 STATISTICAL SERVICES

The MNB's statistical activity

Article 4 of Act LVIII of 2001 on the Magyar Nemzeti Bank defines the collection and publishing of statistical information required for carrying out its tasks and the

operation of the information system 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 statistical activity of the MNB includes the collection, use and processing of data required for performing its duties, the installation and operation of its information systems, the analysis and publication of the compiled statistics, and activities required to meet its international data reporting obligations.

The MNB revises the collection of statistical data once every year, and specifies the reporting obligations for one 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.

The purpose of the statistical work performed by the MNB is to support the monetary policy decision-making process, the money market operations, and the stability and payment system activities of the MNB. In addition, as an institution of the National Statistical Service, the MNB is responsible for the compilation and publication of monetary and balance of payments statistics, and 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 the balance sheet statistics of non-monetary financial institutions, and the compilation of market (i.e. non-financial corporations sector, household and inter-bank) interest rate statistics.

Balance of payments and related international investment position statistics record economic transactions of an economy with the rest of the world, that is residents and non-residents, and their financial assets and liabilities, as well as 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 the 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 Hungarian Central Statistical Office and the Ministry of Finance, contains the most important indicators of general government deficit and government debt.

Changes in 2007

In the field of the *balance of payments statistics*, the former system, which was primarily based on settlement transactions reported by credit institutions using transaction codes, was replaced. With effect from 1 January 2008, the Magyar Nemzeti Bank, in cooperation with the Hungarian Central Statistical Office, has introduced a new data collection system, which, in line with the best European practice, is based exclusively on the direct reporting of economic entities. The adoption of the new data collection system required three years of preparation. The new reporting obligations are imposed by an MNB Decree (No. 3/2007 (II. 21.)) that was issued on 21 February 2007. The early publication of the decree was intended to ensure that data suppliers had sufficient time for preparation. The adoption of the new data collection system was preceded by continuous communications addressed to potential data suppliers. During 2007 the MNB delivered several informative presentations, sent out newsletters and made all the necessary information accessible on a separate sub-page on its home page.

Previously the statistics compiled in the field of *financial accounts statistics* did not include data related to special purpose entities (former off-shore enterprises). As of 1 October 2007, in line with the balance of payment statistics, these companies are also included in the statistics. By means of expert estimations a complete retrospective data revision was performed, which now allows the Bank to comply with international methodological standards in its financial accounts statistical data reporting towards international institutions. With respect to *securities statistics*, which constitute a part of financial accounts, the MNB discontinued the semi-annual publication of 'Investments into securities by holding sectors', and simultaneously launched the quarterly press release of 'Distribution of securities holdings by

sectors'. New information was added to the list of instruments in the publication, including data related to the holders of mortgage bonds and bonds issued by domestic sectors other than the central government.

In the area of *monetary statistics*, in 2007 the MNB expanded its data release related to the balance sheet information of monetary financial institutions. Since June 2007 the Bank has published the components of flows, and in addition to transaction data it also indicates the effects of price and exchange rate changes and that of changes in other volumes. The newly published charts indicate the components of the M3 monetary index, and those of the aggregates of external assets and liabilities, starting from January 2005. In addition, the new, expanded press release includes a year-on-year growth index for the M1, M2 and M3 monetary aggregates, which filters out the impact of all inflation-related price level changes, and takes into account flows caused by transactions only. The new index provides a more precise indication of the changes than the former index, which simply indicated values relative to the same month of the previous year. During the course of 2007 the time series of the statistical balance sheets of insurance companies were also published, indicating end-of-quarter figures starting from the first quarter of 2004.

In the autumn of 2007, for the third time, the MNB sent out questionnaires to conduct a user satisfaction survey with regard to the statistical publications posted on the home page of the Bank. In the course of developing the revised statistical publications, the MNB will consider the user opinions and requirements expressed via the returned questionnaires.

International reporting

The MNB complied with all the reporting obligations pertaining to the Member States of the European Union. Accordingly, it provided regular data reporting services to Eurostat, the statistical office of the EU, and to the European Central Bank (ECB). The MNB also provides data to the Bank for International Settlements (BIS) on a regular basis, with continuously expanded content. Since the ECB requests a significant amount of data from the database of BIS, rather than from central banks directly, co-operation with BIS is particularly important.

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, the MNB supplies data and information to the International Monetary Fund (IMF), the World Bank and the Organisation for Economic Co-operation and Development (OECD). Data provision by the

MNB meets the high standard requirements defined by the International Monetary Fund.

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 Hungarian Central Statistical Office, the Ministry of Finance and the Hungarian Financial Supervisory Authority. Co-operation between the MNB and the Hungarian Central Statistical Office is regulated by the provisions of the agreement signed by the Governor of the MNB and the President of the HCSO. The fields of co-operation and the specific tasks are defined in the annual work programme.

3.7 STARTING THE PRACTICAL PREPARATIONS FOR EURO ADOPTION

As early as the end of 2006, the Magyar Nemzeti Bank and the Ministry of Finance set up a joint team of experts to elaborate a proposal for the Government to launch the practical and technical preparations required for the adoption of the euro. The event leading to the establishment of the joint team took place in the summer of 2006, when the Board of Directors of the MNB approved the detailed working document specifying the practical tasks needed for the adoption of the euro in Hungary. Consequently, the MNB initiated professional consultations with the relevant government agencies, primarily with the Ministry of Finance, on the subject of the practical preparations for the introduction of the euro.

Through the joint effort of experts of the bank and the ministry most practical tasks have been identified which need to be accomplished across the country in order to join the euro area, and to adopt the euro as the new currency. These tasks have to be executed simultaneously with the ongoing process of fulfilling the macroeconomic criteria. Meeting convergence criteria by itself is not sufficient to establish the conditions required for the adoption of the euro. Obviously, it will not suffice to define the list of technical preparation tasks only when the macroeconomic criteria are already met, because this would lead to further delays in the adoption of the euro. For the preparation to join the euro area it is crucial to identify, and compile into a national changeover plan, the diverse practical tasks the precise execution of which will ensure a smooth currency changeover at all levels of society.

As a result of the joint efforts of the MNB and the Ministry of Finance, a proposal was submitted to the Government for the beginning of practical preparations without having set the target date euro adoption. The proposal suggested that the

Government establish the institutional structures required for this wide spectrum of work which is to be realised at all levels of the society. Consequently, in September 2007 the Government announced its decision to establish the National Euro Co-ordination Committee (NEC) in its Decree 1071/2007 (IX. 21.). The MNB will have a particularly important role at national level in the definition and execution of preparations for the adoption of the euro. This is demonstrated and at the same time recognised by the fact that the Government invited the Governor of the MNB to co-chair the NEC along with the Minister of Finance.

The Government defined the responsibilities of the NEC as follows:

- to elaborate a national changeover plan required for the adoption of the euro with the involvement of all relevant parties, which outlines the practical tasks and time schedules related to the changeover of the financial, corporate and public sectors, the legislative and information technology areas, as well as consumer protection, accounting and statistics; to review the plan on a regular basis but at least once a year, and to monitor its completion on a continuous basis;
- to actively support the preparations of the public and private sectors for the adoption of the euro by means of non-mandatory, professional recommendations, particularly in respect of the information, price display and accounting systems and the cash and non-cash changeover;
- to identify the costs of the changeover in the public sector;
- to provide guidance and information in relation to the preparatory phase for the actual preparations of the euro changeover through efficient communication methods;
- to elaborate proposals regarding the development of a legal framework to support the changeover, and initiate the required legislation.

As early as during the year 2008 the Government expects the NEC to develop a detailed proposal for the first draft of the national euro changeover plan.

Getting prepared for the introduction of the euro has been recognised as an item of special significance in the mid-term strategy of the MNB.

– ‘Changeover to the euro is a significant milestone in the European integration process of the Hungarian national economy. Based on the core responsibilities of the MNB as defined by the Act on the MNB, as well as its role in the

European System of Central Banks, it is the primary objective and interest of the MNB to ensure that the Hungarian financial system be prepared for the adoption of the euro, regardless of the actual date of the changeover'.

- 'In the course of preparations for the adoption of the euro the Magyar Nemzeti Bank plays a role in analysing and monitoring the macroeconomic conditions of the changeover and in supporting its macroeconomic foundation on the one hand; and in preparing the domestic payments and securities settlement systems and the participants therein on the other.
- 'The Magyar Nemzeti Bank intends to play a key leading role at national level in practical preparations for the introduction of the euro, and in the preparation of domestic payments and securities settlement systems, as well as the participants therein, to facilitate the smooth implementation of the carefully planned and developed action plan'.

Following its foundation in November 2007, the NEC shared the work load among seven sub-committees, with the MNB being invited to chair two of these: the Financial Sector Sub-Committee (FSSC) and the Communications Sub-Committee (CSC).

The well-prepared financial sector will have a decisive role in preparing the economy and society as a whole for membership in the euro area, and in their entire preparation process. Introduction of the new currency will be a major step. The financial sector will be in the front line during the changeover process and will have an important role regarding initiation, awareness-raising and information. The conversion of bank accounts, loans and other financial products into euro, the transformation of insurance products, the adjustment of retirement account services and the securities market to the future currency, furthermore the provision of information technology and infrastructure support for the euro changeover involves tasks directly affecting society as a whole. The identification and scheduling of tasks, the recognition of problem areas and issues, and the elaboration of a preliminary action plan may pose a huge challenge for the financial sector, but their accomplishment will produce major benefits and opportunities.

3.8 FACTORS SHAPING THE COMMUNICATION OF THE MNB IN 2007, OBJECTIVES AND RESULTS

The activities of the communications area were similarly defined by changes in the organisation and changes in the

external environment. In addition to the basic and traditionally well functioning external communication tasks, in the first half of the year the main focus of central bank communications was information exchange targeting the introduction of the new management and structure, their acceptance, and the development of the financial culture. In the second half of 2007, however, in addition to communications conveying information about decisions made by the Monetary Council and the findings of the research areas, announcements from the cash logistics and statistical areas came into focus.

Efficient press relations, analytical publications and publications intended for the general public, modern on-line tools, forums and co-operation with the media – all these elements contributed significantly to a better understanding and recognition of the activities of the MNB by both the general and the professional public. This is confirmed by the annual, representative central bank confidence index of 64%, reconfirmed by a national level survey seeking input from the general public.

For the purpose of improving Hungarian financial culture several services offered by the Visitor Centre of the MNB were renewed. New programme packages were launched with the purpose of communicating and supporting the understanding of central bank announcements and information; the Bank developed visitor information pages on its website, demos and on-line games illustrating the decision-making mechanism of monetary policy, as well as educational films and newsletters.

Through the quiz show 'Monetary', the number of high school students becoming acquainted with the activities of the central bank, monetary policy and other terms related to economy and finance, increased by 22% compared to the previous year. The educational competition 'Studium' was also renewed, contributing to the better understanding of finance among college and university students.

A new, informational publication was launched for all Hungarian students facing high school graduation, called *Money talks – Do you understand?* This full colour information booklet contains a great deal of important financial information that students will necessarily face once they step out to the real world (including the use of bank accounts and bankcards, savings, loans, retirement pre-savings, etc). The publication received a positive feedback from teachers and students alike.

The announcement of and preparations for the withdrawal of the 1 and 2 forint coins were successfully supported by the informational public web page designed by the Bank for this

purpose, and also by the call centre service, the informative publications, active press relations, and the continuous dialogue and co-operation with consumer interest protection groups, as well as commercial organisations, credit institutions and partner authorities. A general attitude of support was expressed by both the general public and all the relevant partner organisations regarding the decision of the central bank, and the volume of coin inflow increased considerably.

During the preparatory communication phase of the new project introducing direct corporate questioning in balance of payments reporting, all relevant economic organisations were able to receive information about and successfully prepare for the new type of reporting by means of a web page designed for data suppliers, and via several events, newsletters and incentive programmes for testing.

On the whole, by utilising the latest tools of strategic communication the MNB strives to ensure that all the complex activities it performs in the interest of the public good are transparent and effective, and that its messages reach the target audiences efficiently.

3.9 FINANCIAL PERFORMANCE OF THE MNB

The MNB's income in 2007

In 2007, the Magyar Nemzeti Bank incurred a loss of HUF 16.6 billion. The financial result and balance sheet structure of the Bank are primarily determined by domestic and international macroeconomic developments, along with the objectives and selected measures of monetary policy.

In 2007 the major processes determining the changes in the balance sheet and the income statement were as follows:

- The level and composition of foreign exchange reserves defined by the monetary policy, and foreign exchange purchases and sales affecting the level of reserves: foreign exchange inflow deriving from bonds issued by the Government Debt Management Agency and from EU transfers, and the foreign exchange conversions performed by the Hungarian Treasury for purposes not related to debt-financing;
- changes in the level of liquidity absorbing instruments, which is connected to the change of foreign exchange reserves;
- changes in forint interest rates and international foreign exchange interest rates, and
- forint exchange rate changes, which, in view of the foreign exchange structure of the balance sheet, may become a decisive factor in the total result of the profit and loss account.

Year 2007 was free of any extraordinary events, which would have had a significant impact on the financial result.

The change of the total profit/loss of the Bank compared to 2006 amounted to HUF 31.2 billion, and the loss is predominantly due to the fact that in 2006 an exceptionally high, HUF 66.4 billion profit was realised from foreign exchange rate changes, while in 2007 profits from foreign exchange rate changes were considerably lower, i.e. HUF 9.0

Table 5

Abbreviated income statement and individual balance sheet items of the MNB

HUF billions

	Description	2006	2007	Change
	1	2	3	3-2
1	Net interest and interest related income (I+II)-(X+XI)	-15.2	0.3	15.5
2	– net forint interest and interest related income (I-X)	-131.6	-149.6	-18.0
3	– net foreign exchange interest and interest related income (II-XI)	116.4	149.9	33.5
4	Realised gains/losses arising from financial operations (IV-XIV)	-15.4	-4.5	10.9
5	Income arising from exchange rate changes (III-XII)	66.4	9.0	-57.4
6	Other constituents of net income ¹ (V+...+VIII)-(XIII+XV+...+XVIII)	-21.2	-21.4	-0.2
7	Profit/loss for the year (1+4+5+6)	14.6	-16.6	-31.2
	Revaluation reserves in the balance sheet			
8	– due to unrealised foreign exchange gain/loss	49.6	49.9	0.3
9	– due to changes in the market value of the foreign currency securities ²	-20.6	-2.8	17.8

¹ Other constituents of net income consist of net expenses of money circulation and operations, net provision, and other income/expenses.

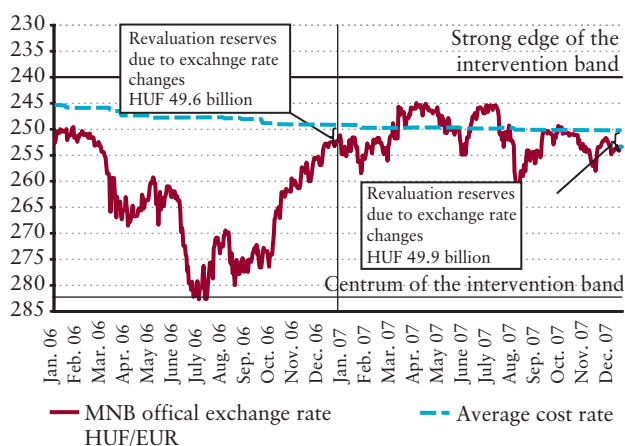
² Under receivables from the central government in the year-end balance sheet.

billion. The HUF 57.4 billion decline in the income arising from exchange rate changes was only partially compensated by the improved net interest and interest related income, and the lower amount of total losses realised on financial operations.

The net income arising from exchange rate changes reached HUF 9.0 billion, due to the more stable position of the official forint exchange rate compared to the previous year. The annual average HUF/EUR exchange rate in 2007 was HUF 251.3 compared to HUF 264.2 in 2006, due to the significant depreciation of the forint exchange rate against the euro, which took place during the year. In the first half of the year the official forint exchange rate appreciated, while in the second half, with fluctuations, it depreciated. On the whole, during the course of the year the forint depreciated slightly (by 0.42%) until it finally reached the HUF/EUR exchange rate of HUF 253.35 by 31 December.

The revaluation reserves due to exchange rate changes did not show notable changes compared to the end of 2006 because neither the revaluated foreign exchange amounts, nor the difference between the official forint exchange rate and the average cost rate showed significant changes compared to the end of the previous year. On 31 December 2007, the amount of the revaluation reserves was HUF 49.9 billion, which represents only a slight increase of HUF 0.3 billion compared to the end of 2006.

Chart 7
Changes in the forint exchange rate (1 January 2006–31 December 2007)



The revaluation reserves of foreign currency securities showed a negative balance of HUF 2.8 billion on 31

December 2007. Pursuant to the Act on MNB the central government has an obligation to reimburse the negative amount of revaluation reserves by 31 March 2008, thus this item is recorded in the balance sheet as an amount receivable from the central government.

By 31 December 2007, the retained earnings of the MNB increased to HUF 31.5 billion after the reclassification of the total profit for the year of 2006, which covers the losses of 2007.

It is still a characteristic of the balance sheet of the MNB that against the national foreign exchange reserves it shows interest-free banknote and coin totals on the one hand, and forint liabilities bearing an interest at the central bank base rate on the other, i.e. the central bank is compelled to finance its lower interest rate foreign exchange assets by higher interest rate forint liabilities. Due to the margin between the average forint interest rate and the average foreign exchange interest market rate, and in view of the current proportion of interest free and interest-bearing liabilities, the net interest and interest related income of the MNB is typically negative.

In 2007 the net interest and interest related income turned positive, earning a profit of HUF 0.3 billion, which is primarily due to a single transaction: on 29 December the central government pre-paid its existing (dollar- and yen-denominated) foreign exchange loans and the related currency swaps at market value, which resulted in an interest related income of HUF 6.5 billion. With this transaction the MNB's foreign exchange loan receivables to the central government irrevocably ceased to exist, and there will be neither similar loans, nor related pre-payments in the future.

The MNB may not pre-pay its foreign debts and swaps related to prepaid debts, which otherwise have an interest rate exceeding the (market) yield of foreign exchange reserves. Thus the MNB will continue to produce interest losses until these mature.² The pre-payment of loans and swaps at market value was intended to compensate for the losses described above. Without pre-payment the interest and interest related income would have indicated a net loss, even though the interest total would have still indicated an improvement by HUF 9 billion compared to the previous year.

In 2007 the net forint interest and interest related losses increased to HUF 149.6 billion from a loss of HUF 131.6 billion in 2006. While the forint interest income increased by HUF 1.4 billion, the net forint interest balance deteriorated by HUF 18 billion, which was due to the HUF 19.4 billion

² Interest revenues from the central government will no longer cover the foreign interest expenses of the MNB for the specific debt items.

Table 6**Operating costs of the MNB in 2007**

Description	Actual data for 2006	Budget for 2007	Actual data 2007	Index (2007 actual / 2007 budgeted)	Index (2007 actual / 2006 actual)
	HUF millions			%	
1. Personnel expenses	8,562	9,019	8,464	93.8	98.9
2. General operation costs	6,232	7,083	6,112	86.3	98.1
Total	14,794	16,102	14,576	90.5	98.5

(13.6%) increase in interest and interest related forint expenditure. The increased interest expenditure on forint liabilities bearing a central bank base rate interest (forint deposits by the central government, required reserves, sterilisation instruments) is predominantly due to the 1.1 percentage point rise in the average central bank base rate level.

In 2007 the net foreign exchange interest and interest related income showed a profit of HUF 149.9 billion, which represents a HUF 33.5 billion increase compared to the year 2006.

The level of foreign exchange reserves, which is a significant factor impacting the total income figure, is fundamentally determined by foreign exchange conversions. As a total result of conversions, changes in the forint exchange rate and the pre-announced foreign exchange sales in the market:

- the net foreign exchange position of the MNB increased by EUR 0.4 billion (HUF 132 billion) reaching EUR 15.4 billion during the year, and by 31 December 2007, a figure of HUF 3,912.7 billion;
- the amount of foreign exchange reserves excluding accrued interest was EUR 16.2 billion, which represents no notable change compared to the end of the previous year: calculated in forint it increased by a mere HUF 9.3 billion to HUF 4,091.6 billion.

The change in the net foreign exchange interest and interest related income is largely attributable to the increase in the interest income on foreign exchange reserves by HUF 18.8 billion, the HUF 6.5 billion related to debt prepayment posted as foreign exchange interest related income, and the HUF 4.2 billion increase of the net interest income of other foreign exchange receivables and liabilities.

Total losses realised arising from financial operations amounted to HUF 4.5 billion. Total losses realised on the maturity and sale of foreign exchange securities decreased by HUF 10.9 billion in 2007.

Internal operations of the Magyar Nemzeti Bank in 2007

The internal operations of the Bank are essentially aimed at providing the resources required for the efficient discharge of the duties stipulated by the Act on MNB 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 whether 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 2006.

The nearly 1% decline in personnel costs in 2007 resulted predominantly from the decline in managerial positions and the significantly smaller average staff number induced by the organisational changes. On the whole, general operating costs were nearly 2% lower than in 2006, which, while representing the balance of the positive and negative changes of the related cost groups, is primarily due to the decreasing depreciation in connection with the investment projects re-scheduled, cancelled or implemented later than planned.

The financially realised value of investment projects implemented in 2007 was HUF 6,282 million, which slightly falls behind the figure of the previous year in magnitude. More than one half of development costs is related to the implementation of the Logistics Centre. A part of the works and payments budgeted for 2007 were re-scheduled, and the investment is expected to be completed in the first quarter of 2008. In addition, modernisation of the information technology infrastructure, the set of user tools and the enhancement of system integration continued. Of these development projects the implementation of the medium-term statistical IT programme is of key importance, and major projects continued to be completed in this field in 2007. Regarding the investment projects of 2007, the purchase of an integrated banknote processing system, the re-organisation of the corporate management (SAP) system, and

the establishment of a modern, independent switchboard sub-centre are also of primary importance.

Operating costs

The approved operating cost budget for 2007 was HUF 16,344 million (including central reserves in the amount of HUF 242 million), whereas actual costs amounted to HUF 14,576 million.

Personnel costs

In 2007, personnel costs (HUF 8,464 million) fell by a total of 1.1% compared to 2006. This decline in personnel costs resulted predominantly from the 7.5% decline of the Bank's average staff number (which was 773 and 715 persons in 2006 and 2007, respectively), the change in employee composition, and the closure of the regional currency branch offices.

With respect to personnel costs, the only item that increased compared to 2006 were expenses related to the termination of employment (rising by more than 70%), which is largely attributable to the measures referred to above-mentioned arrangements and the notice periods carried forward from last year.

General operating costs

In 2007, general operating costs (HUF 6,112 million) fell by a total of 1.9% compared to 2006.

In 2007, the amount of IT costs incurred (HUF 1,305 million) exceeded the figure of 2006 by 0.7%. The majority of these expenses are software operating costs (monitoring, support, maintenance and consulting costs), which guarantee the continuous and safe maintenance of infrastructural and data processing systems supporting the core business of the Bank.

In terms of magnitude, the total amount of operating costs (HUF 1,548 million) corresponded with that of the previous year, and was in line with the planned target related to maintaining the level of reliable operation reached in the previous years.

The amount of the depreciation of tangible and intangible assets in 2007 (HUF 2,291 million) was 3.5 % lower than in 2006, due to the volume of fixed investment in 2007 without the Logistics Centre being lower than in the previous year.

In 2007 the total amount of other costs was HUF 968 million, 3.8% lower than in 2006. Among other items, expenses related to foreign travel and the cost of data purchases supporting the economic research of the Bank

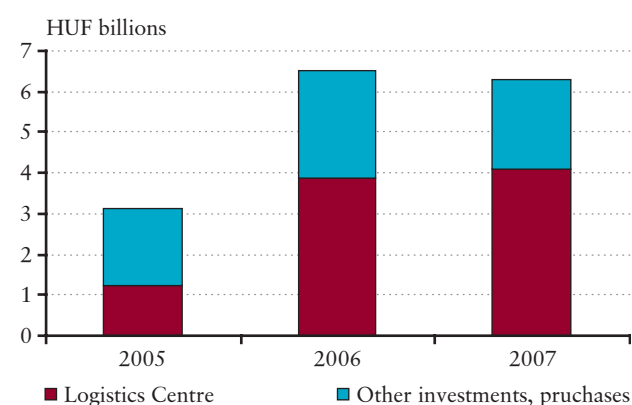
decreased significantly, and some surveys regarding the latter were re-scheduled to 2008. On the other hand, communication expenses, which constitute approximately 40% of such costs, increased, mainly as a result of the communication strategy of the MNB, which facilitates communication activities for the purpose of shaping professional opinion, and serving the education of the public in general and that of students in particular.

Capital expenditure

For new investment launched in 2007 and for re-scheduled and value-updated, ongoing investment projects the Board of Directors approved an investment plan in the amount of HUF 6,970 million for the period of 2007-2009, of which the amount projected for 2007 was HUF 5,067 million. In addition, it also took notice of the total sum allocated for investment in progress (HUF 13,003 million), which included the actual expenditure up to 2006 and expenditure planned for the following years. More than three-quarters of this is related to the implementation of the Logistics Centre.

The investment outlined in the plan for a central corporate data storage was conditionally approved, and on the basis of expert testing during the year the contents and the budget for the investment were revised. Accordingly, and particularly to cover the items carried forward, the plan was revised during the year and as a result, the budget for new investment projects to be launched in 2007 was modified to HUF 5,968 million (of which HUF 4,057 million represents expenses incurred in 2007), and the budget for the ongoing investment projects was modified to a total of HUF 13,129 million.

Chart 8
Investment of the MNB, 2005-2007



Establishment of the Logistics Centre

The MNB decided to build a Logistics Centre, a sophisticated, efficiently and securely operating facility of European quality, one that would also establish proper

conditions for the future introduction of the euro. The Board of Directors approved the complete (projected) financial plan of the facility in 2003 (with a total budget of HUF 11.4 billion). The implementation of the facility was based on this concept, and also exploited the technical developments of recent years. The investment is expected to be completed in the first quarter of 2008.

In 2007 the computer room was completed, bringing the building of the Logistics Centre to a 95% completion level by the end of the year. Test operations were completed for some technological units, and procedures for obtaining the occupancy permit have commenced. During the course of 2008 the user organisational units will start the gradual occupation of the new centre together with Magyar Pénzverő Zrt. (Hungarian Mint, Ltd.).

Additional investment

The majority of new investment originally planned for 2007 have commenced. 67% of the projects were completed, and/or put into operation during the year. In addition, the commencement of several investment projects was re-scheduled in the course of the year, some of which were (or are to be) implemented in the year(s) to come.

In order to meet the highest standards of banknote processing, the Bank obtained several high performance and low performance integrated banknote processing machines, to be installed in the new Logistics Centre.

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 implementation of the Integrated Statistical System began in 2004; a medium-term programme was developed for building up the new system, which also included all related investment. In order to provide IT support to the procedures required for the collection of balance of payments data and for the compilation of balance of payments statistics, a new system was installed for balance of payments processing in 2007. An interface to the central securities database of the European Central Bank was installed and as a result, the MNB will now be able to download data from the ECB database, and also to provide its regulatory reporting through the system. The enhancement of the data storage was intended to support the new requirements, which have arisen since the first installation of the system. The new developments supported the review and logging of reports received, the definition of data-market algorithms for the monetary statistics, and the generation of time series analyses and reports.

In the course of the year the Bank completed its project aimed at increasing the efficiency of the processes of operations, which also provided an IT background for the revised processes of internal operations. As part of the SAP reorganisation the Bank completed the transformation of the processes related to commitments, account management, petty cash and asset management, and in accordance with the public procurement plan automated the processes of financial planning.

A larger-scale investment affecting the head office buildings of the MNB was the establishment of a switchboard sub-centre with sufficient operations and information security. The flooring of the second floor of the central building was replaced by one that is befitting for a prestigious historic monument. The canteen was remodelled to become a sophisticated, upscale facility with properly separated areas for preparation, service and consumption, an establishment harmonising with the characteristics of the Bank's building. In order to achieve increased operating safety and reduced operating costs, the Bank completed the installation of a uniform cooling system, which required the transformation of the Bank's existing, non-uniform units and equipment producing cooling-energy.

The Bank also remodelled certain parts of the strategic cash storage unit in order to satisfy the requirements of appropriate cash storage and work performance.

Additional IT investment took place in order to support administrative processes (development and modifications of user systems), and to ensure the high-level, continuous availability of the technical infrastructure and systems. Other investment and purchases in 2007 were primarily related to real estate maintenance and technological modernisation, as well as security developments.

Human resources management of the MNB

Staff number and personnel costs

At the end of 2007 the MNB's total staff number was 690 persons; the number of employees was lower by 49 persons (6.6%) than at the end of 2006. In 2007, the employment status of 124 employees was terminated; termination was initiated by the employer in 67 cases, by employees in 34 cases, while the employment of 23 people was terminated due to retirement and other reasons (e.g. expiry of fixed-term contracts).

In 2007 the staff number of the MNB was predominantly influenced by the following measures:

- The Logistics Centre commenced operations, which resulted in an increase in personnel due to the additional staff required to provide armed security and guard services, building and IT operation and maintenance.
- In 2007 the MNB streamlined its organisation; the director management level was terminated.
- The regional currency branch offices in Debrecen and Székesfehérvár started to close down in 2007, their complete closure was set to be accomplished in January 2008.
- There was a decline in staff as a result of measures passed by the management in order to improve efficiency and rationalise operations.

As a result of the termination of the director management level, at the end of 2007 the number of employees filling top managerial positions was 9 persons less than in 2006.

In 2007, the ratio of employees with higher education was 2.1% higher than in the previous year. The composition by age of the MNB personnel is still favourable; the average age of those employed (41) did not change in 2007. In 2007 the average employment period at the Bank remained unchanged at 12.6 years.

Introduction of a new grading system

Based on a job family approach, the MNB introduced a new grading system, which aims to give a higher appreciation to individual skills competencies and performance, not only the tasks and characteristics requirements of the job. The new grading system better supports decisions concerning promotions, and makes the job structure, the considerations involved in job evaluation and grading more transparent and easy-to-understand for employees. Local characteristics of operations, individual qualities and skills resulting in higher quality and better performance were given an enhanced role in the new system than in the previous, more general, more abstract job evaluation system, which was based on the Hay methodology. Instead of grouping jobs by business areas, a uniform framework system was established across the Bank. As a result of the new grading system, more expert career opportunities have opened up for the Bank's employees, providing them more transparent and more predictable potential promotion options and career paths. The new grading system supports the appreciation of individual development and the recognition of individual efforts that contribute to the success of the Bank.

Developing a new mid-term strategy

The executive management of the Bank developed a new mid-term strategy, which will determine the direction of progress for the next five years. As a starting point in the process of designing the strategy, the executives of the Bank identified the mission and the vision of the Bank. Next, based on the vision defined for the Bank and the findings of the diagnoses (SWOT analysis, stakeholder analysis) the new strategic directions and the new organisational values were identified with the assistance of the heads of institutional units.

Development of managerial potential

Within the framework of the career management programme, by means of the selection method of the Development Centre and based on the recommendations of the management, in the last two years 7 additional individuals were added to the list of persons identified as employees with managerial potential, increasing the number of management potentials participating in the career management programme to 9 persons. In 2007 the Bank organised two, 2-day training programmes for these individuals, which targeted the development of their managerial skills and their preparation for future managerial roles.

Improving the efficiency and quality of recruiting

For the purpose of improving the success and efficiency of selection decisions, the Bank has designed new, competence-based selection methods and tools. These new tools are supported by tests and software, and they will allow the Bank to assess the personal qualities and suitability of candidates for the job with focus on the main competency requirements of the jobs. The recruiting and selection processes are supported by a new, sophisticated electronic recruiting system, which not only reduces administrative tasks, but also ensures the monitoring of the selection process and real-time communication with the candidates.

Revision of salary market positioning

The salary level applied by the Magyar Nemzeti Bank is determined by two basic factors: on the one hand, the goal is to offer salaries which allow the Bank to recruit and retain a good, high-quality workforce, and, on the other, the Bank has to be cost efficient. Based on market comparisons and the level of fluctuation, in 2007 the Bank introduced a differentiated salary market positioning by job groups: the

Bank defines a higher market salary level for those jobs where recruitment and retaining are critical for the Bank, and it defines lower market salaries in areas where the salaries offered by the Bank have been exceptionally competitive, based on the experiences of the past few years.

Developments in operations

Amendments to the MNB Act in 2007 required the introduction of a new governance system. The operational procedures for the consultative forum supporting the operative management of the Bank, the Steering Committee, have been developed, and the organisational and operational procedures of the Magyar Nemzeti Bank have been modified. Reflecting the new, high priority strategic objectives, a comprehensive plan was developed for the purpose of improving efficiency and profitability. In consideration of the organisational changes and the developments regarding operations, the activities and processes of certain business areas (including statistics, controlling and library services) have been reviewed and their operations have been re-designed.

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. Within the committees and working groups, the central banks of different nations have the opportunity to work together and formulate joint positions, and this co-operation allows the representatives of individual national banks to obtain information about the work of the ECB on a regular basis.

The fields of activity (mandate) of the individual ESCB committees can be briefly 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, and the methodology of the preparation of regular financial reports, facilitating their co-ordination at an international level. Monitors the calculation of monetary income in accordance with the risk management process developed by the security framework system of accounting.

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 effect of developments in economic 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 jointly represents Hungary in the committee with the Hungarian Financial Supervisory Authority.

Committee on Cost Methodology (COMCO): COMCO is one of the new ESCB committees established in July 2007. It contributes to the application and enhancement of the Common Eurosystem Cost Methodology used by the Eurosystem, and it prepares analyses on the cost data and cost structure of certain functions and products of the Eurosystem/ESCB. In the area of management information systems, the organisation serves as an important forum for co-operation and information exchange on issues concerning the ESCB as a whole.

Eurosystem/ESCB Communications Committee (ECCO): Contributes to the development of the external communications policy of the Eurosystem, the ESCB and the ECB for the purpose of making the objectives defined by the Eurosystem/ESCB more transparent and understandable, and to providing information to 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 in carrying out the tasks of the ESCB related to international co-operation. It contributes to the forming of the common 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 development of the information technology policy and strategy of the Eurosystem and the ESCB, develops related guidelines, with special regard to security concerns, and provides technical advice to other committees. In addition, it initiates and executes Eurosystem and ESCB level developments and independent projects.

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 operation, in the management of the reserves of the ECB and in the appropriate 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 operation and cross-border use of collaterals of TARGET (Trans-European Automated Real-Time Gross Settlement Express Transfer System), TARGET2, TARGET2-Securities, the SEPA (Single Euro Payment Area), 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.

Other committees assisting the work of the ESCB:

Budget Committee (BUCO): Provides assistance to the Governing Council of the ECB on issues concerning the

budget of the ECB; its members comprise the central banks of the euro area member states.

Human Resources Conference (HRC): The committee was established in 2005, and its objective is to serve as a forum for the central banks of the Eurosystem/ESCB in the exchange of information, opinion and experiences on issues concerning the management of human resources.

3.11 PUBLICATIONS, CONFERENCES ORGANISED BY THE MNB IN 2007

Publications

Quarterly Report on Inflation

Published four times a year, in order to enable the public to understand and clearly follow the policy of the central bank. In this publication the MNB regularly reports on past and expected developments in inflation, and evaluates the macroeconomic trends affecting 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.

Report on the activity of the MNB

This quarterly publication briefly reports on the activities of the professional areas of the central bank in the previous quarter (monetary policy, overview of the financial system, foreign exchange reserves, payment transactions, currency issuing activity, statistical changes). Published only in Hungarian.

Annual Report

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

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 describing technical details of forecasting, economic issues arising during decision-making are also covered.

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

The second issue of the Bulletin was published in 2007, and is issued biannually. The short articles published in this volume are intended to inform the general population in a comprehensible format about the processes of economic development and the findings of research conducted by the central bank.

Other publications

In the winter of 2007 a volume titled ‘Temporary measures and off-budget activities’ was published in English, containing the papers of the Public Finance conference held in Hungary. For the first time in 2007 an information booklet, ‘Money talks – do you understand?’, was designed and issued primarily targeting the age group of 17-18 as part of the efforts exerted by the Magyar Nemzeti Bank to enrich the Hungarian financial culture, and to contribute to the improvement of financial intelligence. The Magyar Nemzeti Bank intends to issue this publication on an annual basis.

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

Conferences and presentations

Conferences

19 January 2007: Conference on Inflation Targeting – International Conference in English

19 April 2007: On the Road to the Euro: Good Governance and Effective Partnership – International Conference

10-12 May 2007: Frontiers in Central Banking Conference

20-23 May 2007: Central Bankers’ Club

14-15 September 2007: 3rd Annual Central Bank Workshop on the Microstructure of Financial Markets – International Conference

14 November 2007: International Payment System Conference

29-30 November 2007: 6th Macroeconomic Policy Research Workshop on Labour Markets, Wage Behaviour and Inflation Dynamics – International Conference

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

21-22 June 2007: ECB WGPF, Working Group on Public Finance

26-28 September 2007: ECB STC, Statistics Committee Meeting

29 November 2007: ECB WDN, World Dynamic Network, temporary work group

Lectures

29 January 2007: Budapest Economic Seminar Series (BESS) at MNB – László Halpern–Miklós Koren–Ádám Szeidl: Import and Productivity

8 February 2007: BESS at MNB – Alessia Campolmi: Which Inflation to Target? A small open economy with sticky wages indexed to past inflation

9 February 2007: BESS at MNB – Zeno Enders: S-Curve Redux: On the International Transmission of Technology Shocks

19 February 2007: BESS at MNB – Lawrence Christiano–Roberto Motto–Massimo Rostagno: Shocks, Structures, or Monetary Policies? The Euro Area and the United States After 2001

7 March 2007: BESS at MNB – Jaume Ventura: Sovereign Risk and Secondary Markets

21 March 2007: BESS at MNB – Veronica Guerrieri–Péter Kondor: Emerging Markets and Financial Intermediaries

2 April 2007: BESS at MNB – Ákos Valentinyi: Which Sectors Make the Poor Countries so Unproductive?

10 April 2007: BESS at MNB – Victor Bystrov: Forecasting Emerging Market Indicators: Brazil and Russia

7 May 2007: BESS at MNB – Tommy Sveen: Firm-Specific Capital and Welfare

14 May 2007: BESS at MNB – Jarkko Turunen: The Interaction of Labour Markets and Inflation: Micro Evidence from the International Wage Flexibility Project

14 June 2007: Gábor Vadas: Wealth Portfolio Of Hungarian Households – Urban Legends and Facts

21 June 2007: BESS at MNB – Andri Chassamboulli: Job Competition over the Business Cycle: Implications for Labour Productivity and Unemployment Rates by Skill

27 June 2007: Mihai Copaciu: Survey Evidence on Price Setting Patterns of Romanian Firms

25 July 2007: Judit Krekó–Gábor P. Kiss: From Tax Optimisation to Optimal Taxes – The First Step, Tax Evasion and the Hungarian Tax System

19 September 2007: BESS at MNB – Zsolt Darvas: Forecasting Exchange Rates of Major Currencies with Long Maturity Forward Rates

21 November 2007: BESS at MNB – Martin Evans: Understanding Exchange Rates: Economic Fundamentals v. Market Microstructure

6 December 2007: BESS at MNB – Olivier Blanchard: Adjustment Within the Euro. The Difficult Case of Portugal; and Christopher Pissarides: Employment Outcomes in the Welfare State

3.12 EXPLANATION OF ABBREVIATIONS AND TERMS SPECIFIC TO CENTRAL BANKING

Abbreviations

ALCO: Asset-Liability Committee

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

BANCO: Banknote Committee (an ESCB committee)

BIS: Bank for International Settlements

BSC: Banking Supervision Committee (ESCB committee)

BUCO: Budget Committee

CANSTAT: Central European Statistical Co-operation

CEBS: Committee of European Banking Supervisors

CSC: Communications Sub-Committee (a NEC sub-committee)

CSDB: European Central Bank Central Securities Database

CSO: Central Statistical Office

ECB: European Central Bank

ECCO: External Communications Committee (an ESCB committee)

EIB: European Investment Bank

EMU: Economic and Monetary Union

EPT: 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

FSSC: Financial Sector Sub-Committee (a NEC sub-committee)

GIRO: Giro Clearing House Limited

HFSA: Hungarian Financial Supervisory Authority

HRC: Human Resources Conference

IAC: Internal Audit Committee (an ESCB committee)

ICS: Interbank Clearing System

IMF: International Monetary Fund

IRC: International Relations Committee (an ESCB committee)

ITC: Information Technology Committee (an ESCB committee)

KELER: Central Clearing House and Depository Ltd

LEGCO: Legal Committee (an ESCB committee)

MOC: Market Operations Committee (an ESCB committee)

MPC: Monetary Policy Committee (an ESCB committee)

NEC: National Euro Co-ordination Committee

NSC: National SEPA Committee (see also: SEPA)

O/N, overnight (deposit/loan)

OECD: Organisation for Economic Cooperation and Development

OSAP: National Statistical Data Collection Programme

PSD: Payment Services Directive

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: Statistical 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

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

Duration: average remaining maturity of bonds. An index number used to indicate the risk level attached to a bond portfolio.

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.

ERM-II, Exchange Rate Mechanism II: an exchange rate mechanism for creating the basis of exchange rate policy co-operation between the euro area states and Member States not participating in the third stage of EMU. The ERM-II is a multilateral system of fixed but adjustable exchange rates, where the mid-rate is surrounded by a normal, $\pm 15\%$ fluctuation band. All decisions in relation to the mid-rate and, as the case may be, a narrower fluctuation band, are made on the basis of a joint agreement between the specific Member State, the euro area states, the ECB and the other Member States participating in the mechanism.

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.

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

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

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% 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.

Option transaction: For the owner of the foreign exchange option this 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.

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).

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. The amount of the reimbursement is recorded in the balance sheet of the year as receivable from the central government.

Revaluation reserve due to exchange rate changes: Non-realised exchange rate gains and losses on the forint exchange rate changes of foreign exchange assets and liabilities are to be indicated in the forint exchange rate revaluation reserve, which constitutes a part of the 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.

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

Part B

Audited Financial Statements of the Magyar Nemzeti Bank







1 Independent auditor's report



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This is an English translation of the Independent Auditor's Report on the 2007 statutory Annual Report of Magyar Nemzeti Bank issued in Hungarian. If there are any differences, the Hungarian language original prevails. This report should be read in conjunction with the complete statutory Annual Report it refers to.

Independent Auditor's Report

To the shareholder of Magyar Nemzeti Bank

We have audited the accompanying 2007 annual report of Magyar Nemzeti Bank (hereinafter referred to as "the Bank"), which comprises the balance sheet as at 31 December 2007, which shows total assets of million HUF 4,704,096 and retained loss for the year of million HUF 16,582, and the income statement for the year then ended, and the supplementary notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of the annual report in accordance with the provisions of the Act on Accounting and accounting principles generally accepted 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

Our responsibility is to express an opinion on the annual report based on the audit and to assess whether the business report is consistent with the annual report.

The 2006 annual report of the Bank was audited by another auditor, who issued an unqualified opinion in its Auditor's Report dated 11 April, 2007.

We conducted our audit in accordance with the Hungarian National Standards on Auditing and applicable laws and regulations in Hungary. Those standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

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 principles used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. Our work with respect to the business report was limited to the assessment of the consistency of the business report with the annual report and did not include a review of any information other than that drawn from the audited accounting records of the Bank.

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

KPMG Hungária Kft., a Hungarian limited liability company
and a member firm of the KPMG network of independent member
firms affiliated with KPMG International, a Swiss cooperative.
Address: 1139 Budapest, Váci út 99.
Company registration: Budapest, Fővárosi Bíróság, no: 01-09-063183



Opinion

We have audited the annual report of Magyar Nemzeti Bank, its components and elements and their accounting and documentary support in accordance with Hungarian National Standards on Auditing and gained sufficient and appropriate evidence that the annual report has been prepared in accordance with the provisions of the Act on Accounting and accounting principles generally accepted in Hungary. In our opinion, the annual report gives a true and fair view of the financial position of Magyar Nemzeti Bank as of 31 December 2007, and of its financial performance and of the result of its operations for the year then ended. The business report is consistent with the disclosures in the annual report.

Budapest, 03 April, 2008

KPMG Hungária Kft.
1139 Budapest, Váci út 99.
Chamber registration number: 000202

Henye István
Henye István
Partner, Registered Auditor
Identification number: 005674

2 Balance sheet of the Magyar Nemzeti Bank

HUF millions

Note	ASSETS	31. 12. 2006	31. 12. 2007	Change
	1	2	3	3-2
	I. RECEIVABLES DENOMINATED IN FORINT	171,619	149,512	-22,107
4.3.	1. Receivables from the central government	171,313	149,511	-21,802
4.14.	of which: receivables to refund the revaluation reserve of foreign currency securities*	20,600	2,799	-17,801
4.7.	2. Receivables from credit institutions	303	0	-303
	3. Other receivables	3	1	-2
	II. RECEIVABLES DENOMINATED IN FOREIGN CURRENCY	4,558,183	4,436,866	-121,317
4.9.	1. Gold and foreign currency reserves	4,082,279	4,091,604	9,325
4.4.	2. Receivables from the central government	102,852	7,583	-95,269
	3. Receivables from credit institutions	0	0	0
4.10.	4. Other receivables	373,052	337,679	-35,373
	III. BANKING ASSETS	32,637	36,764	4 127
4.12.	of which: invested assets	32,398	36,101	3,703
4.15.	IV. PREPAID EXPENSES/ACCRUED INCOME	81,115	80,954	-161
	V. TOTAL ASSETS (I+II+III+IV)	4,843,554	4,704,096	-139,458
Note	LIABILITIES AND EQUITY	31. 12. 2006	31. 12. 2007	Change
	1	2	3	3-2
	VI. LIABILITIES DENOMINATED IN FORINT	3,878,063	4,005,524	127,461
4.5.	1. Central government deposits	280,447	196,816	-83,631
4.8.	2. Deposits by credit institutions	1,634,681	1,062,380	-572,301
	3. Banknotes and coins in circulation	1,959,817	2,188,951	229,134
4.11.	4. Other deposits and liabilities	3,118	557,377	554,259
	VII. LIABILITIES DENOMINATED IN FOREIGN CURRENCY	834,653	583,067	-251,586
4.5.	1. Central government deposits	92,736	58,130	-34,606
4.8.	2. Deposits by credit institutions	54,881	1,086	-53,795
4.11.	3. Other deposits and liabilities	687,036	523,851	-163,185
4.13.	VIII. PROVISIONS	57	1,740	1,683
	IX. OTHER BANKING LIABILITIES	10,656	15,999	5,343
4.15.	X. ACCRUED EXPENSES/DEFERRED INCOME	29,023	22,984	-6,039
4.16.	XI. EQUITY	91,102	74,782	-16,320
	1. Share capital	10,000	10,000	0
	2. Retained earnings	16,936	31,507	14,571
	3. Valuation reserves	0	0	0
4.14.	4. Revaluation reserves due to exchange rate changes	49,595	49,857	262
4.14.	5. Revaluation reserves of foreign currency securities	0	0	0
	6. Profit/Loss for the year	14,571	-16,582	-31,153
	XII. TOTAL EQUITY AND LIABILITIES (VI+VII+VIII+IX+X+XI)	4,843,554	4,704,096	-139,458

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

3 April 2008



András Simor
Governor of the Magyar Nemzeti Bank

3 Income statement of the Magyar Nemzeti Bank

HUF millions

Note	INCOME	2006	2007	Change
	1	2	3	3-2
4.18.	I. INTEREST AND INTEREST RELATED INCOME DENOMINATED IN FORINT	10,801	12,167	1,366
	1. Interest on receivables from the central government	10,324	11,886	1,562
	2. Interest on receivables from credit institutions	464	271	-193
	3. Interest on other receivables	4	0	-4
	4. Interest related income	9	10	1
4.18.	II. INTEREST AND INTEREST RELATED INCOME DENOMINATED IN FOREIGN CURRENCY	202,079	209,002	6,923
	1. Interest on foreign currency reserves	145,291	164,082	18,791
	2. Interest on receivables from the central government	6,130	5,199	-931
	3. Interest on receivables from credit institutions	9	6	-3
	4. Interest on other receivables	3,385	3,169	-216
	5. Interest related income	47,264	36,546	-10,718
4.19.	III. INCOME ARISING FROM EXCHANGE RATE CHANGES	68,545	13,482	-55,063
4.18.	IV. REALISED GAINS ARISING FROM FINANCIAL OPERATIONS	1,261	2,298	1,037
4.21.	V. OTHER INCOME	5,362	5,182	-180
	1. Fees and commissions	1,098	981	-117
4.22.	2. Income other than fees and commissions	4,264	4,201	-63
4.13.	VI. PROVISIONS RELEASED	62	57	-5
4.13.	VII. IMPAIRMENT RELEASED	608	192	-416
4.23.	VIII. OPERATING INCOME	319	275	-44
	IX. TOTAL INCOME (I+II+III+IV+V+VI+VII+VIII)	289,037	242,655	-46,382
Note	EXPENSES	31. 12. 2006	31. 12. 2007	Change
	1	2	3	3-2
4.18.	X. INTEREST AND INTEREST RELATED EXPENSES DENOMINATED IN FORINT	142,405	161,781	19,376
	1. Interest on central government deposits	25,938	31,163	5,225
	2. Interest on deposits of credit institutions	116,094	55,326	-60,768
	3. Interest on other deposits	373	75,292	74,919
	4. Interest related expenses	0	0	0
4.18.	XI. INTEREST AND INTEREST RELATED EXPENSES DENOMINATED IN FOREIGN CURRENCY	85,677	59,067	-26 610
	1. Interest on central government deposits	2,555	2,910	355
	2. Interest on deposits of credit institutions	389	446	57
	3. Interest on other liabilities	20,679	16,277	-4,402
	4. Interest related expenses	62,054	39,434	-22,620
4.19.	XII. EXPENSES RESULTING FROM EXCHANGE RATE CHANGES	2,167	4,470	2,303
4.20.	XIII. COST OF ISSUING BANKNOTES AND COINS	8,648	9,047	399
4.18.	XIV. REALISED LOSSES ARISING FROM FINANCIAL OPERATIONS	16,706	6,805	-9,901
4.21.	XV. OTHER EXPENSES	3,875	1,630	-2,245
	1. Fees and commissions	568	511	-57
4.22.	2. Expenses other than fees and commissions	3,307	1,119	-2,188
4.13.	XVI. PROVISIONS CHARGED	57	1,740	1,683
4.13.	XVII. IMPAIRMENT	0	0	0
4.23.	XVIII. OPERATING COSTS AND EXPENSES	14,931	14,697	-234
	XIX. TOTAL EXPENSES (X+XI+XII+XIII+XIV+XV+XVI+XVII+XVIII)	274,466	259,237	-15,229
	XX. PROFIT/LOSS BEFORE DIVIDENDS (IX-XIX)	14,571	-16,582	-31,153
	XXI. Dividends from retained earnings	0	0	0
	XXII. Dividends	0	0	0
	XXIII. PROFIT/LOSS FOR THE YEAR (XX+XXI-XXII)	14,571	-16,582	-31,153

3 April 2008



András Simor
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 in charge of public finances (hereinafter referred to as shareholder).

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

The 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, being in charge of public finances, exercises the rights of ownership as laid down in the MNB Act. This is in the form of an Annual Report, which contains a business report describing the MNB's structure, operations and state of affairs in the reporting year and the MNB's annual financial statements as defined by the Accounting Act and adopted by the shareholder's resolution. The Annual Report is published unabridged both in print and on the Internet. The website is available at: <http://english.mnb.hu>.

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

The financial statements of the MNB must be audited by statutory auditor in compliance with Act C of 2000. The registered auditor of the MNB is István Henye (KPMG Hungária Kft), Chamber membership number: 005674.

The person authorised to sign the Annual Report is: András Simor, Governor of the Magyar Nemzeti Bank.

The person responsible for the accounting services is Katalin Horkai, Finance Ministry registration number: 159822.

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.

The MNB carries out a daily revaluation of 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 converted at the official exchange rate prevailing on 31 December (fixing). The banking assets and banking liabilities in foreign currencies (with the exception of foreign investments) and the derivative transactions for purposes other than hedging do not form part of revaluation.

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

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

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

Realised income is created as a result of selling and buying foreign currency. The latter occurs when the assets in a given currency are exceeded by counterpart liabilities. Realised income arises as the difference between the value of the traded foreign currency at the official exchange rate and the average cost 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 and maturing securities are stated within 'Realised gains/losses arising from financial operations'.

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

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

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

Accounting rules relating to the IMF quota

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

The other part of the quota, which does not have to be transferred to the IMF, is presented 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 announced as hedging transactions at the start of a deal. Derivative transactions with the government or non-resident counterparts on behalf of the government are also regarded as hedging transactions.

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

When derivative transactions for purposes other than hedging are closed, the income from such transactions must be stated in the lines of income and expenses arising from exchange rate changes when foreign exchange transactions are involved, and in the lines of interest income and interest expenses in the case of transactions linked to interest rate changes. While such transactions are not revalued, 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. 2007
Rights on assets	17.0%
Intellectual property	20.0–50.0%
Foundation-restructuring (maximum)	20.0%
Buildings	3.0%
Vehicles	12.0–25.0%
Telecommunication devices, office equipment, machines	9.0–33.0%
Computer hardware	14.5–33.0%
Emission 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%

* For example: office equipment, other equipment and devices.

The above listed ranges of depreciation rates are reference values based on estimated useful life. Deviation from the reference values is a must 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 2007 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 9.3 billion. In 2007 the official exchange rate of the forint against the EUR was more stable than that of the preceding year. As a result, the net income arising from exchange rate changes was a gain of HUF 9 billion, a decrease of HUF 57.4 billion compared to the income in 2006. The revaluation reserve due to exchange rate changes increased by HUF 0.3 billion to HUF 49.9 billion.

In 2007, the bank recorded a HUF 0.3 billion net interest and interest related gain, which was an increase of HUF 15.5 billion relative to the previous year. The change occurred partly because of the HUF 6.5 billion interest related income arising from the prepayment of the central government foreign exchange debt and connected currency swaps made at market value. An increase of interest on foreign currency reserves caused by exchange rate and interest rate changes also boosted the net interest

income. On the other hand, the 2007 average of the central bank base rate was higher by 110 basis points than that of the preceding year, which worsened the net interest income causing growth of the forint interest expenses.

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

4.3 FORINT RECEIVABLES FROM THE CENTRAL GOVERNMENT

HUF millions

B/S line	Remaining maturity	Balance		Change
		31. 12. 2006	31. 12. 2007	
	Government bonds maturing within one year	4,000	1,449	-2,551
	Government bonds maturing within one to five years	5,729	5,706	-23
	Government bonds maturing over five years	140,984	139,557	-1,427
	Securities	150,713	146,712	-4,001
	Revaluation reserves of foreign exchange securities	20,600	2,799	-17,801
I.1.	Total receivables from central government	171,313	149,511	-21,802

The decrease of HUF 4 billion in the portfolio of government securities in 2007 was due to a repayment of an amortising bond (to be repaid annually) totalling HUF 4 billion.

Receivables due to a negative balance of the revaluation reserve at the end of 2007 related to the market valuation of foreign currency securities amounted to HUF 2.8 billion, which the central government is obliged to reimburse by 31 March 2008 (based on the MNB Act), and which thus must be stated under Receivables from the central government in the year-end balance sheet.

In 2007, 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 Article 18 of 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 designated as repayment of 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. 2006	31. 12. 2007	
	Receivables from central government due to debt swap	81,890	0	-81,890
	Swap transactions with maturity over 1 year	20,962	7,583	-13,379
II.2.	Foreign currency receivables from the central government	102,852	7,583	-95,269

The amount of foreign currency receivables from the central government decreased by HUF 95.3 billion. At the end of December 2007 the central government prepaid its foreign exchange debt and connected currency swaps denominated in dollar and yen originating from the debt exchange. With this transaction all foreign currency credits vis-à-vis the central government originating from the debt exchange conducted in 1997 were repaid. The remaining amount of HUF 7.6 billion contains currency swaps concluded with the ÁKK before June 2002 for adjusting the foreign currency and interest structure of the foreign debt.

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. 2006	31. 12. 2007	
	– within 1 year	1,629	2,607	978
	– within 1 to 5 years	52,278	4,589	-47,689
	– over five years	48,945	387	-48,558
II.2.	Foreign currency receivables from the central government	102,852	7,583	-95,269

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. 2006	31. 12. 2007	
1.	– USD	38,324	0	-38,324
2.	– JPY	43,566	0	-43,566
3.	Foreign currency receivables from the central government	81,890	0	-81,890

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

HUF millions

Nr	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
1.	– USD	0	0	0
2.	– EUR currency group*	138,983	31,848	-107,135
3.	– JPY	0	0	0
4.	Swap receivables (1+2+3)	138,983	31,848	-107,135
5.	– USD	62,769	17,492	-45,277
6.	– EUR currency group*	11,686	6,773	-4,913
7.	– JPY	43,566	0	-43,566
8.	Swap payables (5+6+7)	118,021	24,265	-93,756
9.	Net swap receivables (4–8)	20,962	7,583	-13,379

* 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. 2006	31. 12. 2007	
	Single Treasury Account (KESZ)	270,797	196,401	-74,396
	Deposit by Hungarian Privatisation and State Holding Co. (ÁPV Zrt.)	9,306	0	-9,306
	Deposit by Government Debt Management Agency (ÁKK Zrt.)	280	351	71
	Other	64	64	0
VI.1.	Central government deposits (total)	280,447	196,816	-83,631

Foreign currency deposits of the central government

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
	Foreign currency deposits of the central government	92,736	58,130	-34,606
	Foreign currency deposits of the Hungarian State Treasury	0	0	0
	Other than money market deposits of the central government	0	0	0
	Short-term derivatives	0	0	0
VII.1.	Central government deposits	92,736	58,130	-34,606

The dates of maturity of foreign currency deposits of the central government are within a year. The balance decreased by HUF 34.6 billion compared to the total amount of the previous year-end.

4.6 NET POSITIONS VIS-À-VIS THE CENTRAL GOVERNMENT

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
I.1–VI.1.	Net forint position	-109,134	-47,305	61,829
II.2–VII.1.	Net foreign currency position	10,116	-50,547	-60,663
	Total	-99,018	-97,852	1,166

4.7 FORINT RECEIVABLES FROM CREDIT INSTITUTIONS**Forint receivables from credit institutions**

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
	Security-backed loans	0	0	0
	Refinancing credit to credit institutions in liquidation/pending liquidation	1,575	1,384	-191
	Loans granted for foreign currency deposits	303	0	-303
	Total receivables from credit institutions in gross value	1,878	1,384	-494
	Impairment provision for claims on credit institutions	-1,575	-1,384	191
I.2.	Total receivables from credit institutions	303	0	-303

Parts of the receivables from credit institutions were preferential loans associated with the earlier role of the MNB in the implementation of the government's economic policy and thus were not linked with any of the central bank functions. Consequently, since 2001 the Bank has made efforts to reduce such outstanding loans. Therefore, the refinancing loans granted for foreign currency deposits amounting to HUF 0.3 million were removed from the books of the MNB in March 2007.

The balance of receivables from credit institutions in gross value amounting to HUF 1.4 billion at the end of 2007 was caused by receivables from a liquidated credit institution. The liquidation process was determined during the period and the receiving date of final decree was 30 January 2008.

Domestic credit institutions use the facility of security-backed overnight loans, primarily in order to fulfil their reserve requirement liabilities. This item of the set of monetary policy instruments was applied occasionally in 2007. The balance in this line was zero, both on 31 December 2006 and on 31 December 2007.

HUF millions

Nr	Remaining maturity	Balance		Change
		31. 12. 2006	31. 12. 2007	
	- within 1 year	1,878	1,384	-494
	- within 1 to 5 years	0	0	0
	- over five years	0	0	0
1.	Total receivables from credit institutions	1,878	1,384	-494

4.8 NET POSITIONS VIS-À-VIS CREDIT INSTITUTIONS

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
I.2-VI.2.	Net forint position	-1,634,378	-1,062,380	571,998
II.3-VII.2.	Net foreign currency position	-54,881	-1,086	53,795
	Total	-1,689,259	-1,063,466	625,793

Net liabilities to credit institutions decreased by HUF 625.8 billion at the end of 2007.

Forint deposits within the net forint position declined by HUF 572 billion in consequence of restructuring of liquidity-absorbing instruments early on in the year. The two-week central bank deposits stated among the forint deposits of credit institutions were replaced by MNB bills with same maturity shown in the Other forint deposits and liabilities line.

The change of net foreign currency position was caused by the HUF 53.8 billion decrease of foreign currency deposits of credit institutions. The underlying reason, on the one hand, was that domestic credit institutions placed short-term money market deposits with the MNB in the amount of HUF 53.2 billion at the end of 2006, while on 31 December 2007 there was no deposit like this. On the other hand, the HUF 0.3 billion balance of fixed non money market foreign currency deposits was removed from the books of MNB, in accordance with a foreign currency deposit swap agreement related to ceasing of loans granted for foreign currency deposits, as was mentioned in Section 4.7.

4.9 GOLD AND FOREIGN EXCHANGE RESERVES OF THE CENTRAL BANK

Forint balances

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
	Gold reserve	12,014	14,136	2,122
	Reserve position in the IMF	26,227	19,391	-6,836
	Foreign currency deposits	267,902	349,889	81,987
	Foreign currency securities	3,688,228	3,608,796	-79,432
	Foreign currency repo transactions	87,908	99,392	11,484
II.1.	Gold and foreign currency reserves (total)	4,082,279	4,091,604	9,325

For statistical purposes, the MNB publishes the amount of 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 not including accrued interest rose by HUF 9.3 billion to HUF 4,091.6 billion.

Euro balances

EUR millions

B/S line	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
	Gold reserve	48	56	8
	Reserve position in the IMF	104	77	-27
	Foreign currency deposits	1,062	1,381	319
	Foreign currency securities	14,618	14,244	-374
	Foreign currency repo transactions	348	392	44
II.1.	Gold and foreign currency reserves (total)	16,180	16,150	-30

The official exchange rate of the forint was 252.3 forint/euro on 31 December 2006 and 253.35 forint/euro on 31 December 2007.

The amount of gold and foreign exchange reserves was mainly increased by the conversion of foreign currencies (into forint) arising from the issuing twice of Hungarian government securities in 2007, by net EU-transfers and by market yields of the reserves.

Sales of euro in a price-taking manner (re-channelling) reduced the level of the gold and foreign exchange reserves, as did foreign currency conversion performed by the Hungarian State Treasury not related to debt-financing. As a consequence of the aforementioned effects, the stock of the gold and foreign exchange reserves denominated in euro barely changed, amounting to 16.2 billion EUR at the end of 2007.

4.10 OTHER FOREIGN CURRENCY RECEIVABLES

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
	Forint payment of IMF quota	272,869	261,523	-11,346
	Repurchased bonds	99,812	72,301	-27,511
	Foreign hedging transactions*	55	3,488	3,433
	Other	316	367	51
II.4.	Other foreign currency receivables	373,052	337,679	-35,373

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

The amount of repurchased bonds issued abroad by the MNB, denominated in forint, decreased by HUF 21 billion because of maturity and by HUF 6.5 billion because of the stronger forint exchange rate against the American dollar and the Japanese yen. The forint payment of IMF quota also decreased, mainly due to the appreciation of the forint exchange rate in comparison to SDR.

4.11 OTHER LIABILITIES**Other forint deposits and liabilities at the end of the period**

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
	Two-week MNB bills	0	550,464	550,464
	International financial institutions forint deposits	2,295	6,036	3,741
	Other liabilities	823	877	54
VI.4.	Other deposits and liabilities	3,118	557,377	554,259

The increase of other forint deposits and liabilities was caused largely by changing of the set of monetary policy instruments. From 9 January 2007 the two-week central bank deposits used as a key policy instrument were replaced by MNB bills also with two-week maturity. The key policy rate is permanently equal to the current central bank base rate.

Other foreign currency liabilities at the end of the period

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
	Bonds	279,989	171,718	-108,271
	Repo transactions	62,979	51,223	-11,756
	IMF forint deposit	272,870	261,524	-11,346
	Foreign deposits and loans	9,778	1,969	-7,809
	Hedging transactions	56,093	37,077	-19,016
	Other liabilities	5,327	340	-4,987
VII.3.	Other foreign currency liabilities	687,036	523,851	-163,185

The HUF 108.3 billion decrease of the foreign currency denominated bonds issued abroad by the Bank arose mainly from interim maturities. The line 'Hedging transactions' consists of net receivables of currency swap transactions with non-resident counterparties, which amount decreased by HUF 19 billion due to maturities and exchange rate changes.

Other foreign currency liabilities in a breakdown of remaining maturity

HUF millions

B/S line	Remaining maturity	Balance		Change
		31. 12. 2006	31. 12. 2007	
	- within one year	478,825	361,766	-117,059
	- within one to five years	143,155	97,961	-45,194
	- over five years	65,056	64,124	-932
VII.3.	Other foreign currency liabilities	687,036	523,851	-163,185

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

HUF millions

Nr	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
1.	- USD	39,352	35,230	-4,122
2.	- EUR currency group*	77,057	65,572	-11,485
3.	- JPY	241,664	126,306	-115,358
4.	- Other	272,870	259,666	-13,204
5.	Other foreign currency liabilities	630,943	486,774	-144,169

* 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.

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

HUF millions

Nr	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
1.	– USD	123,256	52,014	-71,242
2.	– EUR currency group*	15,190	10,293	-4,897
3.	– JPY	201,387	99,086	-102,301
4.	Hedging transactions receivables (1+2+3)	339,833	161,393	-178,440
5.	– USD	60,899	0	-60,899
6.	– EUR currency group*	331,806	195,421	-136,385
7.	– JPY	3,221	3,049	-172
8.	Hedging transactions payables (5+6+7)	395,926	198,470	-197,456
9.	Net hedging transactions payables (8-4)	56,093	37,077	-19,016

* 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 18.9 billion), invested assets include shares in investments (HUF 6.1 billion foreign investments and HUF 11.1 billion domestic investments).

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

HUF millions

	Assets						Intangibles, tangibles and capital expenditure, total
	Immaterial goods		Tangible assets			Capital expenditure and advances given	
	Intangible assets	Software under development	Buildings	Equipment	Assets of banknote and coin		
Gross value							
31. 12. 2006	7,894	240	7,237	7,800	211	5,683	29,065
Installation/Repurchases	1,115	323	448	1,008	14	3,372	6,280
Other addition	0	0	0	5	0	0	5
Scrapping	-398	0	0	-253	0	0	-651
Selling	0	0	0	-1	0	0	-1
Transfer free of charge	0	0	0	-385	0	0	-385
Other disposal	-1,117	0	-3	-41	0	-1	-1,162
31. 12. 2007	7,494	563	7,682	8,133	225	9,054	33,151
Details of depreciation							
31. 12. 2006	6,123	0	2,075	5,953	0	0	14,151
Planned depreciation	1,051	0	213	1,075	0	0	2,339
Extraordinary depreciation	0	0	0	0	0	0	0
Depreciation due to damage	0	0	0	0	0	0	0
Increase due to reclassification	0	0	0	1	0	0	1
Removal from the account	-399	0	0	-627	0	0	-1,026
Decrease due to reclassification	-1,150	0	-1	-39	0	0	-1,190
31. 12. 2007	5,625	0	2,287	6,363	0	0	14,275
Closing net value							
31. 12. 2006	1,771	240	5,162	1,847	211	5,683	14,914
31. 12. 2007	1,869	563	5,395	1,770	225	9,054	18,876
Change	98	323	233	-77	14	3,371	3,962

Foreign investments and dividends from investments

Description	Ownership share (%)		Book value		Dividends received*	
	31. 12. 2006	31. 12. 2007	31. 12. 2006	31. 12. 2007	2006	2007
BIS (HUF millions, SDR millions, CHF millions)	1.43	1.43	5,004 10 13	4,766 10 13	686	604
European Central Bank (HUF millions, EUR thousands)	1.39	1.31	1,364 5,408	1,343 5,299	0	0
SWIFT (HUF millions, EUR thousands)	0.02	0.02	2 9	2 9	0	0
Total investments			6,370	6,111	686	604

* Dividends financially settled in the given year.

On 1 May 2004 Hungary joined the European Union. Consequently, the MNB became a member of the European System of Central Banks (ESCB). The ESCB consists of the European Central Bank (ECB) and the national central banks of the 27 EU Member States. The Eurosystem comprises the ECB and the national central banks of Member States which have adopted the euro.

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

Ownership distribution in the ECB as of 31 December 2007

National Central Banks (NCBs)	Subscribed capital	Paid-up capital	Capital key (%)
	EUR thousands		
Nationale Bank van België / Banque Nationale de Belgique	142,334	142,334	2.4708
Deutsche Bundesbank	1,182,149	1,182,149	20.5211
Bank of Greece	104,660	104,660	1.8168
Banco de España	434,918	434,918	7.5498
Banque de France	828,814	828,814	14.3875
Central Bank and Financial Services Authority of Ireland	51,183	51,183	0.8885
Banca d'Italia	721,792	721,792	12.5297
Banque centrale du Luxembourg	9,073	9,073	0.1575
De Nederlandsche Bank	224,302	224,302	3.8937
Österreichische Nationalbank	116,129	116,129	2.0159
Banco de Portugal	98,720	98,720	1.7137
Banka Slovenije	18,400	18,400	0.3194
Suomen Pankki-Finlands Bank	71,709	71,709	1.2448
Subtotal for euro area NCBs	4,004,183	4,004,183	69.5092
Danmarks Nationalbank	87,205	6,104	1.5138
Sveriges Riksbank	134,298	9,401	2.3313
Bank of England	802,672	56,187	13.9337
Česká národní banka	79,958	5,597	1.3880
Eesti Pank	9,810	687	0.1703
Central Bank of Cyprus	7,195	504	0.1249
Latvijas Banka	16,205	1,134	0.2813
Lietuvos bankas	24,068	1,685	0.4178
Magyar Nemzeti Bank	75,701	5,299	1.3141
Central Bank of Malta / Bank Ċentrali ta' Malta	3,583	251	0.0622
Narodowy Bank Polski	280,820	19,657	4.8748
Národná banka Slovenska	38,971	2,728	0.6765
Bulgarian National Bank	50,884	3,562	0.8833
Banca Națională a României	145,099	10,157	2.5188
Subtotal for non-euro area NCBs	1,756,469	122,953	30.4908
Total NCBs	5,760,652	4,127,136	100.0000

The 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%. On 1 January 2007 Bulgaria and Rumania joined the EU. As a consequence of this the central banks of these countries assumed part ownership of the subscribed capital of the ECB, and the total subscribed capital increased to EUR 5,760.7 million, in which the capital key of the MNB fell to 1.3141% i.e. to EUR 75,701 thousand. Since there was no new accession to the European Union on 1 January 2008, the subscribed capital did not change, but the sum of the paid-up capital grew as a result of accession of Cyprus and Malta to the Eurosystem.

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 5.3 million (HUF 1.3 billion), to the ECB's share capital.

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.

Domestic investments and dividends from investments

HUF millions

Description	Ownership share (%)		Book value		Dividends received*	
	31. 12. 2006	31. 12. 2007	31. 12. 2006	31. 12. 2007	2006	2007
Pénzjegynyomda Zrt.	100.0	100.0	8,927	8,927	500	800
MNB Üdültetési és Jóléti Szolg. Kft.	100.0	100.0	602	602	0	0
Magyar Pénzverő Zrt.	100.0	100.0	575	575	194	270
KELER Zrt.	53.3	53.3	643	643	1,120	983
GIRO Elszámolásforgalmi Zrt.	7.3	7.3	46	46	153	160
Budapesti Értéktőzsde Zrt.	6.9	6.9	321	321	164	167
Total investments			11,114	11,114	2,131	2,380

* Dividends financially settled in the given year.

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. 2007	31. 12. 2007	31. 12. 2007	2006	2007
Pénzjegynyomda Zrt. 1055 Budapest, Markó utca 13–17.	9,386	8,927	459	836	796
MNB Üdültetési és Jóléti Szolgáltató Kft. 1054 Budapest, Szabadság tér 8–9.	748	602	146	-29	-19
Magyar Pénzverő Zrt. 1089 Budapest, Könyves Kálmán krt. 38.	1,398	575	823	270	316
KELER Zrt. 1075 Budapest, Asbóth utca 9–11.	15,144	4,500	10,644	2,048	2,323
GIRO Elszámolásforgalmi Zrt. 1054 Budapest, Vadász utca 31.	5,572	2,496	3,076	2,251	2,146
Budapesti Értéktőzsde Zrt. 1052 Budapest, Deák Ferenc u. 5.	7,979	541	7,438	2,400	2,586

HUF millions

Investment	Net sales revenue		Financial income		Other income		Extraordinary income	
	2006	2007	2006	2007	2006	2007	2006	2007
Pénzjegynyomda Zrt. 1055 Budapest, Markó utca 13–17.	7,948	7,884	97	175	128	127	0	2
MNB Üdültetési és Jóléti Szolgáltató Kft. 1054 Budapest, Szabadság tér 8–9.	4	3	10	11	0	0	0	0
Magyar Pénzverő Zrt. 1089 Budapest, Könyves Kálmán krt. 38.	3,630	4,427	52	93	9	5	0	2
KELER Zrt. 1075 Budapest, Asbóth utca 9–11.	n.a.	n.a.	6,152	7,107	12	31	0	0
GIRO Elszámolásforgalmi Zrt. 1054 Budapest, Vadász utca 31.	n.a.	n.a.	5,012	4,832	512	723	0	0
Budapesti Értéktőzsde Zrt. 1052 Budapest, Deák Ferenc u. 5.	3,294*	3,916*	680	1,066	276	31	106	0

n.a.: revenue is not applicable data.

* Income from Stock Exchange related activities.

Investment	Average number of staff	
	2006	2007
Pénzjegynyomda Zrt. 1055 Budapest, Markó utca 13–17.	463	458
MNB Üdültetési és Jóléti Szolgáltató Kft. 1054 Budapest, Szabadság tér 8–9.	0	0
Magyar Pénzverő Zrt. 1089 Budapest, Könyves Kálmán krt. 38.	70	70
KELER Zrt. 1075 Budapest, Asbóth utca 9–11.	105	115
GIRO Elszámolásforgalmi Zrt. 1054 Budapest, Vadász utca 31.	128	128
Budapesti Értéktőzsde Zrt. 1052 Budapest, Deák Ferenc u. 5.	66	63

The MNB's receivables from and liabilities to affiliated companies

HUF millions

Investment	Receivables	Liabilities
Pénzjegynyomda Zrt.	0	98
MNB Üdültetési és Jóléti Szolg. Kft.	0	0
Magyar Pénzverő Zrt.	477	0
KELER Zrt.	0	1
GIRO Elszámolásforgalmi Zrt.	0	1
Budapesti Értéktőzsde Zrt.	0	2
Total	477	102

The above table presents short-term liabilities.

In addition to banknotes, **Pénzjegynyomda Zrt.** produces documents, tax stamps and securities, primarily for institutional users. 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. In line with a decision of the MNB, Pénzjegynyomda Zrt. will not produce euro banknotes. As this may incur potential but presently unquantifiable losses for the MNB, the Bank has not recognised an impairment loss on the investment.

Magyar Pénzverő Zrt. produces circulation and commemorative coins pursuant to MNB's order. When capacity allows, it performs contract work for foreign markets and also produces non-legal tender precious metal coins on the basis of its own coin programme. The company also sells commemorative coins constituting legal tender and issued by the MNB, both internationally and locally. As part of the revision of the aforementioned function, Magyar Pénzverő Zrt., as a sub-selling organisation, bought the stock of the previously emitted commemorative coins and numismatic value from the MNB in the second half of 2007. In favour of stricter and overall more effective direct proprietary control, the MNB liquidated the Supervisory Board of Magyar Pénzverő Zrt. in December 2007. Magyar Pénzverő Zrt. will move to MNB's Logistic Centre during 2008.

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

The General Meeting of **Központi Elszámolóház és Értéktár Zrt.** (KELER Zrt.) on 25 April 2007 made a decision about segregation of the central counterparty (central guaranteeing) function of KELER Zrt. The decision – linked to an ECB recommendation – was justified to release the operation of central depository from those risks which arrive from the central counterparty function. In the case of non-performance of systems' members, the central counterparty guarantees fulfilment or is even liable to the extent of equity. Under such extreme market circumstances the central depository operation could be

jeopardised. The legal conditions are now secured and the work related to segregation is in progress. The transformation should be complete by 31 December 2008.

4.13 IMPAIRMENT LOSS AND PROVISIONS

HUF millions

B/S line	Description	31. 12. 2006	Interim changes in 2007			31. 12. 2007
		Impairment loss / Provisions	Increase (+)	Reversal (-)	Interim exchange rate effect due to Increase / Reversal	Total impairment loss / provisions (3+4+5)
1	2	3	4	5	6	7
from I.2	Forint receivables from credit institutions	1,575	0	-191	0	1,384
from II.3	Foreign currency receivables from credit institutions	0	0	0	0	0
from II.4	Other foreign currency receivables	0	0	0	0	0
from III.	Invested assets	0	0	0	0	0
from III.	Other assets	24	0	-1	0	23
VIII.	Liabilities	57	1,892	-209	0	1,740
	– derivatives	57	585	-209	0	433
	– bond lending	0	1,307	0	0	1,307
	Total	1,656	1,892	-401	0	3,147

Impairment loss and provisions increased by a HUF 1,491 billion in 2007.

The HUF 191 million previously recorded impairment loss for forint receivables from credit institutions was reversed, because the liquidation process against two credit institutions was concluded during the year and the institutions ceased to exist. The claim against one of them became irrecoverable so the reversal of the impairment loss compensated the credit loss recorded under other expenses (see section 4.22). On 31 December 2007, HUF 1.4 billion outstanding amount of total impairment loss for forint receivables from credit institutions was recorded as a 100% impairment loss for a claim on a credit institution under liquidation. The liquidation process is now closed. The expected receiving date of final judgement was 30 January 2008. 2.9216% of the claim will probably be repaid.

Provision for the negative market value of derivatives held for non-hedging purposes, shown in the liabilities line, resulted in an increase of HUF 376 million comparing to end-2006. At end-2007 a HUF 1,307 million provision became necessary because of MNB security lending activity. According to the security lending contracts, the potential risks of the investments – made by agents – of the obtained collaterals are undertaken by the MNB. For this loss as a contingent liability a provision was built up based on the principle of prudence.

4.14 REVALUATION RESERVES

HUF millions

B/S line	Description	31. 12. 2006	31. 12. 2007	Change
XI.4.	Revaluation reserves of forint exchange rate	49,595	49,857	262
XI.5.	Revaluation reserves of foreign exchange securities*	0	0	0
	Total revaluation reserves	49,595	49,857	262

* The end-2007 balance on the revaluation reserves of foreign currency securities indicated a loss of HUF 2.8 billion, which the central government is obliged to reimburse by 31 March 2008, and thus is no longer included among revaluation reserves but in the line 'Receivables from the central government'. (For the same reason the loss of the revaluation reserves in the year 2006 was included in the aforementioned line.)

The official forint exchange rate against the euro was more stable in 2007. At the end of the year the official exchange rate of forint was weaker by HUF 1.05 than a year before. As a result of a significant fluctuation of the forint exchange rate during the year, the average purchase forint exchange rate rose by HUF 1.03 to HUF 250.1, so the revaluation reserves due to exchange rate changes, calculated as a difference of foreign exchange items converted to forint by official and average purchased exchange rate, increased by HUF 0.3 billion to HUF 49.9 billion in 2007.

Annual changes in the forint exchange rate, 2006-2007

forint/euro

Date	MNB official exchange rate	Average cost rate
31. 12. 2006	252.30	249.07
31. 12. 2007	253.35	250.10
Annual appreciation(+)/ depreciation(-)		
In 2006	+0.2%	
In 2007	-0.4%	

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

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
	Due to banking transactions	81,008	80,851	-157
	Due to internal operation	107	103	-4
IV.	Prepaid expenses/accrued income	81,115	80,954	-161
	Due to banking transactions	28,864	22,659	-6,205
	Due to internal operation	159	325	166
X.	Accrued expenses/deferred income	29,023	22,984	-6,039

Prepaid expenses and accrued income and accrued expenses and deferred income include interest received/charged and interest related income/charges and expenses incurred in the reporting period, independently the date of the financial settlement.

4.16 CHANGES IN EQUITY

HUF millions

B/S line	Description	31. 12. 2006	Interim changes	31. 12. 2007
XI.1.	Share capital	10,000	0	10,000
XI.2.	Retained earnings	16,936	14,571	31,507
XI.3.	Valuation reserves	0	0	0
XI.4.	Revaluation reserves due to exchange rate changes	49,595	262	49,857
XI.5.	Revaluation reserves of foreign currency securities	0	0	0
XI.6.	Profit/Loss for the year	14,571	-31,153	-16,582
XI.	Equity	91,102	-16,320	74,782

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 shareholder. According to the decision of the shareholder, in 2008 the MNB will not pay dividend from the retained earnings for the year 2007.

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

4.17 OFF-BALANCE SHEET LIABILITIES OF THE MNB

Liabilities arising from hedging transaction and receivables

HUF millions

Nr	Description	31. 12. 2006		31. 12. 2007		
		Receivables	Liabilities	Receivables	Liabilities	Net market value
1.	Interest rate swap transaction	434,377	434,377	366,855	366,855	5,898
2.	CDS transaction	0	0	2,533	2,533	12
3.	Total hedging transaction (1+2)	434,377	434,377	369,388	369,388	5,910

The aim of the hedging interest rate swap transactions linked to the given bond issuing is to set the desirable interest structure.

Among the interest rate swap transactions there are some made with ÁKK, which serve to limit the interest rate risks of foreign exchange debt. These are hedged by the MNB through reverse transactions on the capital market.

Under the line 'CDS transaction' (Credit Default Swap) one transaction is recorded, the aim of which is to decrease the credit risk of a security. The transaction will mature in 2009.

Liabilities arising from other forward transactions

HUF millions

Nr	Description	Balance		Market value
		31. 12. 2006	31. 12. 2007	
1.	Options	0	7,489	-38
2.	Future transaction	0	2,325	28
3.	Total other forward transactions (1+2)	0	9,814	-10

Breakdown of options

HUF millions

Nr	Description	Market value	
		31. 12. 2006	31. 12. 2007
1.	Long call option	0	0
2.	Long put option	0	7
3.	Short call option	0	-44
4.	Short put option	0	-1
5.	Total (1+2+3+4)	0	-38

Structure of liabilities arising from derivative transactions by remaining maturity

HUF millions

Nr	Remaining maturity	Balance		Change
		31. 12. 2006	31. 12. 2007	
	– within 1 year	1,985	51,983	49,998
	– within 1 to 5 years	284,336	199,126	-85,210
	– over five years	148,056	118,279	-29,777
1.	Hedging transactions	434,377	369,388	-64,989
	– within 1 year	0	9,814	9,814
	– within 1 to 5 years	0	0	0
	– over five years	0	0	0
2.	Other forward transactions	0	9,814	9,814
3.	Total (1+2)	434,377	379,202	-55,175

Other off-balance sheet liabilities

HUF millions

Nr	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
1.	Liabilities from two-week MNB bills	0	382,764	382,764
2.	Guarantees	10,739	1,934	-8,805
3.	Other off-balance sheet liabilities	3,082	2	-3,080
4.	Total	13,821	384,700	370,879

The liabilities of the MNB related to two-week bill issuing are off-balance sheet items for a short (generally one day) period. The subscribed amount of HUF 382.8 billion on 29 December 2007 was recorded as an off-balance sheet item at the end of 2007. On 2 January 2008, when the aforementioned two-week bills were being issued, the total sum was already recorded under other forint liabilities in the balance sheet.

The line 'Guarantees' consists of export and import guarantees, to which is always linked any 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. In 2007, 5 guarantees ceased to exist, the amount of guarantees decreasing by HUF 8.8 billion.

The decrease in the amount of other off-balance sheet liabilities was caused almost entirely (HUF 3,079 million) by the earlier issued import letters of credit which were connected to reducing the Russian government debt and which closed in 2007.

Structure of other off-balance sheet liabilities by remaining maturity

HUF millions

Nr	Remaining maturity	Balance		Change
		31. 12. 2006	31. 12. 2007	
	– within 1 year	13,792	384,674	370,882
	– within 1 to 5 years	29	26	-3
	– over five years	0	0	0
1.	Total other liabilities	13,821	384,700	370,879

Recording of off-balance sheet security transactions

HUF millions

Nr	Description	Balance		Change
		31. 12. 2006	31. 12. 2007	
1.	Face value of securities lent	879,298	757,793	-121,505
2.	Face value of investment arising from security lending transactions	795,626	753,367	-42,259
3.	Face value of securities bought under repo transactions	85,355	100,601	15,246
4.	Face value of securities sold under reverse repo transactions	63,075	50,670	-12,405

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	2006	2007	Change
1	2	3	4	4-3
(I.1.+II.2.)-(X.1.+XI.1.)	Central government	-12,039	-16,988	-4,949
(I.2.+II.3.)-(X.2.+XI.2.)	Credit institutions	-116,010	-55,495	60,515
(I.3.+II.1.+II.4.)-(X.3.+XI.3.)	Other	127,628	75,682	-51,946
	Net profit from interest	-421	3,199	3,620
	Forint securities	9	10	1
	Derivative transactions for hedging and other purposes*	-13,733	-1,892	11,841
	Other	-1,057	-996	61
(I.4.+II.5.)-(X.4.+XI.4.)	Net interest related profit	-14,781	-2,878	11,903
(I.+II.)-(X.+XI.)	Net interest and interest related income	-15,202	321	15,523

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

In 2007 the Bank recorded a HUF 0.3 billion net interest and interest related gain, an improvement of HUF 15.5 compared to the figure for end-2006, which amounted to a HUF 15.2 billion loss.

Net interest income was higher by HUF 3.6 billion in comparison with end-2006.

The net interest income was increased by the following factors:

- an increase of the interest income on foreign exchange reserves by HUF 18.8 billion in 2007,
- a decline of the interest expenses on foreign currency denominated securities issued by the Bank by HUF 4.4 billion in 2007 relative to 2006.

The net interest income was decreased by the following factors:

- an increase of the interest expenses on government deposits denominated in forint by HUF 5.2 billion in 2007 compared to the preceding year,
- an increase of the interest expenses on credit institutions' deposits and on the two-week MNB bills by HUF 14.5 billion.

The net interest related income increased by HUF 11.9 billion in 2007. The change occurred partly because of the HUF 6.5 billion interest related income arising from the prepayment of the central government foreign exchange debt and connected currency swaps 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.

Realised loss from financial operations

HUF millions

P/L line	Description	2006	2007	Change
IV.	Realised gains from financial operations	1,261	2,298	1,037
XIV.	Realised losses from financial operations	16,706	6,805	-9,901
IV.-XIV.	Net financial losses	-15,445	-4,507	10,938

Realised gains and loss from financial operations include gains and losses arising from sales and maturities of securities.

The net realised loss decreased by HUF 10.9 billion in 2007, because of the lower loss realised on sales and maturities of securities in comparison to 2006.

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

HUF millions

Nr	Description	2006	2007	Change
1.	- interest income on currency swaps	39,039	24,725	-14,314
2.	- income like interest margin on over one year interest rate swaps	5,327	2,855	-2,472
3.	- interest gains on hedge FX swaps	1,402	1,393	-9
4.	- FX gains on derivative transactions	633	6,495	5,862
5.	- interest income on other transactions	642	554	-88
6.	Income from derivative transactions (1+2+3+4+5)	47,043	36,022	-11,021
7.	- interest expenses on currency swaps	47,070	30,584	-16,486
8.	- expenses like interest margin on over one year interest rate swaps	3,804	1,983	-1,821
9.	- interest loss on hedge FX swaps	8,926	4,544	-4,382
10.	- FX losses on derivative transactions	199	0	-199
11.	- interest expenses on other transactions	777	803	26
12.	Expenses on derivative transactions (7+8+9+10+11)	60,776	37,914	-22 862
13.	- net interest on currency swaps (1-7)	-8,031	-5,859	2,172
14.	- net interest on over one year interest rate swaps (2-8)	1,523	872	-651
15.	- net interest losses on hedge FX swaps (3-9)	-7,524	-3,151	4,373
16.	- net FX gains on derivative transactions (4-10)	434	6,495	6,061
17.	- net interest on other transactions (5-11)	-135	-249	-114
18.	Net income from derivative transactions (6-12)	-13,733	-1,892	11,841

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 in connection with the currency swaps are stated in the income statement in gross. The income from and expenses in connection with swaps vis-à-vis both non-residents and the ÁKK are recorded in the net interest related income more than once. On 29 December 2007 the central government prepaid the remaining amount of its foreign exchange debt and connected currency swaps. The prepayment made at market value resulted in HUF 6.5 billion interest related income (line 4 in table: FX gains on derivative transactions). The net effect of the currency swaps is HUF 5.9 billion loss, a decrease of HUF 2.2 billion compared to 2006, because of maturities of some foreign derivative transactions for hedging purposes.

4.19 COMPONENTS OF INCOME FROM THE REVALUATION OF FOREIGN EXCHANGE HOLDINGS

HUF millions

Description	2006	2007
Net income from exchange rate changes (realised and conversion spread)*	66,378	9,012
Change in revaluation reserves in the balance sheet** (due to unrealised revaluation net income)	-56,370	262
Total effect of exchange rate changes	10,008	9,274

* P/L line: III-XII.

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

The total exchange rate change effect was a gain of HUF 9.3 billion, of which the Bank realised HUF 9 billion, while the amount of the revaluation reserve due to exchange rate changes (unrealised gains) increased by HUF 0.3 billion during the year.

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

4.20 THE COST OF ISSUING BANKNOTE AND COIN

HUF millions

P/L line	Description	2006	2007	Change
	Cost of banknotes production	5,825	4,743	-1,082
	Cost of coins production	2,183	4,038	1,855
	Cost of production of commemorative and collector coins	640	266	-374
XIII.	Cost of issuing banknotes and coins	8,648	9,047	399

The cost of issuing banknotes and coins was HUF 9 billion in 2007, an increase of HUF 0.4 billion. The growth of the cost was mainly due to an increase in the cost of coins production, which itself was the result partly of greater a volume of production and partly of the higher cost per unit of the 100 forint coin.

4.21 OTHER INCOME/EXPENSES

HUF millions

P/L line	Description	2006	2007	Change
V.1.	Income from fees and commissions	1,098	981	-117
V.2.	Income from other than fees and commissions	4,264	4,201	-63
V.	Total other income	5,362	5,182	-180
XV.1.	Expenses of fees and commissions	568	511	-57
XV.2.	Expenses of other than fees and commissions	3,307	1,119	-2,188
XV.	Total other expenses	3,875	1,630	-2,245
V.-XV.	Other net results	1,487	3,552	2,065

Income from fees and commissions slightly decreased in 2007 in comparison with similar data in 2006.

For more details on income other than fees and commissions, see Section 4.22.

4.22 INCOME OTHER THAN FEES AND COMMISSIONS

HUF millions

Nr	Description	2006	2007	Change
1.	Dividends from investments	2,817	2,984	167
2.	Income related to coins and commemorative coins	900	1,213	313
3.	Income from sales transaction of employee loans	545	0	-545
4.	Paid-up bad debts	0	4	4
5.	Other income	2	0	-2
6.	Income from other than commissions and charges (1+2+3+4+5)	4,264	4,201	-63
7.	Losses from bad debts	0	174	174
8.	Expenses related to coins and commemorative coins	841	635	-206
9.	Expenses from sales transaction of employee loans	652	0	-652
10.	Final money transfer	288	277	-11
11.	Expenses from assets assigned free of charge	1,078	6	-1,072
12.	Other expenditures	448	27	-421
13.	Expenses from other than commissions and charges (7+8+9+10+11+12)	3,307	1,119	-2,188
14.	Net income/expenses from other than commissions and charges (6-13)	957	3,082	2,125

Income other than fees and commissions includes the following:

- Dividends received from investments increased by HUF 0.2 billion (for more details, see Section 4.12).
- The increase in income related to coins and commemorative coins occurred mainly because of the coin transfer to Magyar Pénzverő in November 2007. The transaction included transfers of commemorative coins, commemorative banknotes, coins withdrawn from circulation and plaster models. The net gain related to coins and commemorative coins increased by HUF 0.5 billion arising from the transfer.
- The line 'Losses from bad debts' includes write-off of receivables from a credit institution, liquidation of which was closed in 2007. The loss was covered by the impairment loss accounted in the previous years.
- The line 'Final money transfer' includes mainly donations to international and domestic organisations and to foundations.

4.23 OPERATING INCOME AND EXPENSES

HUF millions

P/L line	Description	2006	2007	Change
	Export sales	3	20	17
	Income from sales of assets and inventories	49	77	28
	Income from subcontracted services	53	41	-12
	Income from invoiced services	49	26	-23
	Other income	153	109	-44
	Extraordinary income	12	2	-10
VIII.	Total operating income	319	275	-44
	Cost of materials	4,025	3,969	-56
	Personnel-related costs	8,562	8,464	-98
	Depreciation	2,403	2,307	-96
	Transfer of costs of other activities	-196	-164	32
	Total operating costs	14,794	14,576	-218
	Expenses incurred on assets and inventories	91	97	6
	Expenses incurred on invoiced services	45	23	-22
	Income taxes	1	1	0
	Total operating expenses	137	121	-16
XVIII.	Total operating costs and expenses	14,931	14,697	-234

Operating costs and expenses in 2007 slightly decreased relative to 2006 by HUF 0.2 billion (1.6%) and amounted to HUF 14.7 billion.

Personnel-related costs decreased by HUF 98 million, caused mainly by the decline in managerial positions linked to organisational changes and a decrease in the average number of staff.

In addition, the cost of materials in the reporting year was HUF 56 million less relative to the previous year, due to several effects in contrary directions. An increase of costs was caused by the following:

- the implementation of a more efficient and more intensive communication strategy,
- the maintenance of banknote processing machines provided by an external service provider, and
- developments of the IT infrastructure linked to the measures taken in connection with medium-term IT strategy and connected to the enlarged software supporting and consulting services for operating IT systems.

This increase of costs was offset by the lower level of the following:

- syndicate fees,
- maintenance costs of real estate in connection with the closure of regional currency branch offices,
- the cost of delegations as a result of a decrease in the number of official journeys, and
- the cost of data purchases caused by cancelling and re-scheduling some surveys.

The volume of capital expenditures was similar to that of the previous year. Nevertheless, a decrease in depreciation by HUF 96 million was recorded, resulting from the high rate among the investments of the Logistics Centre, which was not put into operation in 2007.

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

Number of staff and payroll information

HUF millions

Description	2006	2007	Change (%)
Wage costs incurred on staff	4,952	4,745	-4
Other wage costs*	348	398	14
Wages	5,300	5,143	-3
Other personnel payments	1,252	1,342	7
Taxes on wages	2,010	1,979	-2
Total personnel expenditures	8,562	8,464	-1

* 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	2006	2007	Change (%)
Average number of staff	773	715	-8

Remuneration of executive officers

HUF millions

Bodies	Fees
Monetary Council*	277
Supervisory Board	50

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

Credits to executive officers

The senior officers, such as members of the Steering Committee and the Board of Supervisors, had no loan outstanding at 31 December 2007. The outstanding as at 31 December 2006 of HUF 1.6 million was repaid by 1 June 2007.

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

3 April 2008



András Simor
Governor of the Magyar Nemzeti Bank

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