Annual Report

Business Report and Financial Statements of the Magyar Nemzeti Bank for 2002

Published by the Magyar Nemzeti Bank

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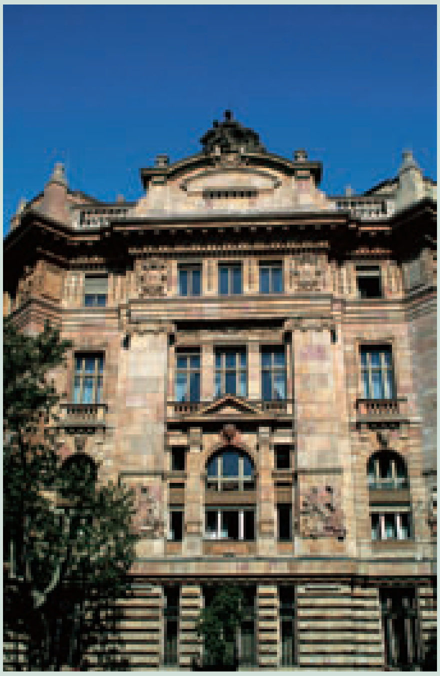


THE PRESIDENT'S FOREWORD

The process of disinflation, which commenced in mid-2001, continued in 2002. Inflation dropped to 4.8% in the final months of the year. Hence the MNB reached its inflation target in two successive years, i.e. in 2001 and 2002.

The appreciation of the forint against the euro and the carry over effect of the 2001 appreciation were key to declining inflation. General deceleration in global economic growth, which established a favourable disinflationary environment despite relatively low interest rates, also played a major role.

In stark contrast, with regard to inflation, domestic macroeconomic indicators changed for the worse. The economic situation was considerably influenced by politics and the fact that 2002 was an election year. A 25% increase in minimum wages in early 2002 and a 50% wage increase affecting approximately 600,000 employees in the public sector in September that same year resulted in wage inflation exceeding 19% on average. This dramatic increase in wages, which also materialised in certain parts of the private sector, and the rise in general government deficit from 4.1% of GDP in 2001 to 9.4% in 2002 exerted considerable inflationary pressure on the economy. The MNB was only able to contain such pressure through maintaining high interest rates and accommodating a strong exchange rate. Extraordinary wage increases in particular and, to a certain extent, a strong exchange rate affected economic competitiveness adversely.

In the second half of 2002 there evolved a debate with political overtones about monetary policy, which also added to uncertainty. All this, despite the well-known fact that the delivery of inflation targets rests on a concerted fiscal and monetary policy.

Hungary also took another step forward to EU membership in 2002. After the Irish referendum as well as the conclusion of accession negotiations in December, it became almost certain that Hungary and nine other candidate countries would accede to the European Union on 1 May 2004. The timing of the introduction of the euro became a priority. In the MNB's view, choosing the fast track of joining the euro area, for which the earliest possible date is 2007, could affect Hungary's economic growth favourably. A potencial annual growth of 0.6 to 0.9% could follow from enhanced stability, expanding foreign trade and declining real interest rates. However, in order for Hungary to be admitted to the euro area, it will have to meet the Maastricht criteria, which would

require profoundly disciplined and concerted fiscal and monetary policy in the years to come.

The Hungarian banking and financial intermediary system remained stable in 2002. Regulatory changes, the system of payments as well as the rules governing statistical service all had to comply with EU accession criteria. Currency issue and cash flow, too, were problem-free in 2002.

In 2002 the MNB's financial results hinged primarily on the financial impact of monetary processes (e.g. exchange rate changes affecting foreign exchange reserves). Owing to the upgrading and enhanced efficiency of organisational management and processes, operational costs fell by 15% in terms of real value on a year earlier.

I would like to conclude by stating that Hungary became a step nearer to EU membership in 2002, though in order for the euro changeover to occur, microeconomic processes will have to be substantially modified. The MNB performed its statutory duties successfully.

Zsigmond Járai, Governor of the Magyar Nemzeti Bank

A Brief Overview of the Magyar Nemzeti Bank

Corporate name: Magyar Nemzeti Bank

Registered office: 1054 Budapest, Szabadság tér 8–9.

Form of operation: company limited by shares

Date of foundation: 1924

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

Scope: as laid down in the Act on the National Bank of Hungary

Equity: HUF 10 billion

THE MNB'S KEY OBJECTIVES AND TASKS

The Magyar Nemzeti Bank is a legal entity operated as a special company limited by shares, which conducts its operations as provided for by Act LVIII of 2001 on the Magyar Nemzeti Bank.

The Act, effective from 13 July 2001, laid down the principles for the Bank's primary objectives, key functions, institutional, organisational, personnel and financial independence and operations, while also significantly restructuring its activity and profile. In accordance with Article 105 of the Treaty establishing the European Community, the Act declares the achievement and maintenance of price stability to be the primary goal of the Bank. In relation to autonomy, the Act provides that the central bank may only support the implementation of the government's economic policy using the monetary policy instruments at its disposal, if such support does not jeopardise the aforementioned goal.

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

- the Bank defines and implements monetary policy in the interests of maintaining the stability of the national currency;
- it has the exclusive right to issue banknotes and coins, which qualify 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 ensures the efficient and safe operation of such;
- in order to undertake its tasks, the Bank collects the necessary statistical information and publishes such;
- it promotes the stability of the financial system and the development and smooth conduct of policies related to the prudential supervision of the financial system.

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

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

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

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

BODIES AND MANAGEMENT OF THE BANK AND THE DECISION-MAKING PROCESS

The bodies of the Magyar Nemzeti Bank are governed by the Central Bank Act and by Act CXLIV of 1997 on Business Organisations, except for issues where the Central Bank Act provides otherwise.

Under the aforementioned two Acts, despite the fact that it is a single-member business organisation, the Bank shall hold **general meetings**, where the Hungarian State, as a shareholder, is represented by the Minister of Finance. The rules relating to the convening, quorum and powers of the general meeting are laid down in the Act on the MNB, the Act on Business Organisations and in the Bank's Statutes. The general meeting has the exclusive right to establish and amend the Statutes, to determine the equity of the Bank, to establish the balance sheet and profit and loss statement, to elect and dismiss the auditor, who functions as a safeguard of statutory operation, and to establish the remuneration of the auditor.

In accordance with European Union requirements and as an additional guarantee of autonomy, since it entered into force, Act LVIII of 2001 controls the remuneration of the highest ranking officials of the Bank (such as the President, Vice Presidents and other members of the Monetary Council) rather than the general meeting.

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

The members of the Monetary Council in 2002 were:

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

Responsibility for implementing Monetary Council decisions and managing the operations of the Magyar Nemzeti Bank rests with the **Board of Directors.** The Board of Directors now oversees performance of the Bank's core functions, the preparation of proposals to be put forward to the General Meeting about the balance sheet, profit and loss statement and assets of the Bank, as well as the distribution of income, the approval of the draft report on the Bank's business management, assets and business policy; the approval of issues associated with organisation and internal management, approval of professional plans and programmes; approval of the development and operating budget; discussing the results of and plans for internal audits, and passing proposals for significant amendments to the collective bargaining agreement.

The Board of Directors, acting as the operative executive body of the Bank, must have at least four but at most six members, comprising the President and Vice Presidents of the Bank.

Provisions relating to the legal status, powers, functions and operating procedures of the Monetary Council and the Board of Directors are set forth in Act LVIII of 2001 on the Magyar Nemzeti Bank, the Act on Business Organisations, the Bank's Statutes amended as of 11 October 2001, as well as the rules of procedures formulated by these bodies.

Under a Board of Directors decision, these bodies are supported in their work by special committees. The **ALCO (Assets/Liabilities Committee)** is responsible for preparing Monetary Council decisions on foreign exchange management, approving relevant briefing material and passing operative decisions under powers delegated by the Monetary Council and the Board of Directors. The **Audit Committee** responsibilities include the follow-up of the findings made in the course of the operation of the MNB's supervisory system (internal audit, the auditor, Board of Supervisors and State Audit Office), inviting opinions about supervision-related experience, the preliminary approval of the schedule of annual audit programmes, as well as monitoring of the implementation of such. The **Banking Committee** is in charge of central bank decision making on matters relating to the financial intermediary sector. The **Investment and Cost Management Committee** discharges its tasks within the framework of the budget approved by the Board of Directors. With regard to the Logistics Centre investment project, the **Committee of High-Profile Investment Projects** has the scope of authority and exercises the rights of the Investment and Cost Management Committee. Its responsibilities are Logistics Centre investment-related TOR and overseeing the investment project itself. The **Monetary Committee** supports monetary policy operations conducted by the Monetary Council, providing a regular review of the monetary situation by comparing the monetary programme with actual developments. In addition, this committee prepares operative policy decisions and co-ordinates domestic foreign exchange market and forint market operations The **Owners' Advisory Committee** lays the groundwork for and makes decisions about strategic and business policy matters.

The Magyar Nemzeti Bank is supervised by the **State Audit Office** and, as of 27 July 2002, the **Board of Supervisors**.

The **State Audit Office** examines whether the Bank complies with the relevant laws and regulations, the Statutes as well as the resolutions passed by the General Meeting. Its scope of supervisory authority encompasses the Bank's entire operation and management, as well as its fundamental tasks, except for the issue of banknotes and coins, and also their impact on the Bank's profit and loss account. The State Audit Office puts forward recommendations for the Bank's auditor and is also entitled to propose that the General Meeting consider the auditor's dismissal.

The scope of the supervisory authority resting with the **Board of Supervisors** is strictly confined to performing certain duties. Its scope of supervision does not include the Bank's fundamental tasks specified in the Act on the MNB (definition and implementation of monetary policy, issue of banknotes and coins, accumulation and management of foreign exchange and gold reserves, foreign exchange operations related to the management of foreign exchange reserves and to the implementation of exchange rate policy, establishment, regulation and assistance with the safe and efficient operation of the payment systems and settlement facilities in Hungary, collection and promulgation of statistical data required by the MNB, so that it can perform its duties, and promotion of the stability of the financial system, and adoption and effective pursuance of a policy related to the prudent supervision of the financial system) or the effects thereof on the MNB's profit and loss account.

Of the six members of the Board of Supervisors, four, including the Chairperson of the Board, are appointed by Parliament. One member represents the Minister of Finance, while another is an expert retained by the Minister of Finance. Their respective terms of office coincide with the mandate of the Parliament. The Board of Supervisors remains in office until a new Parliament appoints new board members within three months of its opening session. Should the new Parliament fail to appoint such members before the deadline expires, the Board of Supervisors continues to operate until new members are appointed by Parliament.

ORGANISATIONAL STRUCTURE

The process of organisational restructuring launched by the Bank in 2001 continued in 2002, due partly to the changing legal framework and partly to the need to enhance efficiency and rationalise activities.

In the interest of, among other things, facilitating preparation for EU accession and the changeover to the euro, the modernisation of the Bank's operations and organisational structure entailed the transformation of currency issue and payment systems. In order for the Bank's supervision to be re-focussed and its efficiency enhanced, certain changes were made in the division responsible for the Bank's supervision. In order that the risks inherent in the Bank's operations could be reduced, the transparency of various processes ensured and statistics-related duties, consistent with international methodology, performed, statistical operations had been overhauled. Back office work as well as operation, service and IT-related tasks had been centralised. As a result of organisational streamlining and the rationalisation of responsibilities, the old Secretariat discharging several duties had been turned into a secretariat in the traditional sense.

The restructuring of the past two years was aimed at enhanced efficiency, the termination of non-bank operations, the rationalisation of workflow and the exploration of inner resources. As a result, the Bank's organisation has been streamlined, processes are now more transparent and operational costs have also been reduced through headcount reduction. In order that smooth operation could be ensured, potential risks had been assessed and restructuring carefully staged, thus no hitch was experienced.

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

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

Managing Directors of the Magyar Nemzeti Bank, 31 December 2002:

Dr. Katalin Barátossy: Chief Cashier's Department, Payment System and Currency Issue Policy Department, Regional Branch Offices

Zsuzsanna Arnold-Csenterics: Human Resources Department, Communications and Information Department

György Garancsi: Department for Capital Projects

Éva Gyöngyösy: Accounting and Finance Department, Department of Management Accounting and Financial Reporting

István Hamecz: Economics Department, International Relations Department

Dr. Tamás Kálmán: Banking Department, Central Bank Supervision Department, Regulation Policy Department

Szilárd Király: Bank Security

Dr. Erika Kovács: Legal Department, Secretariat

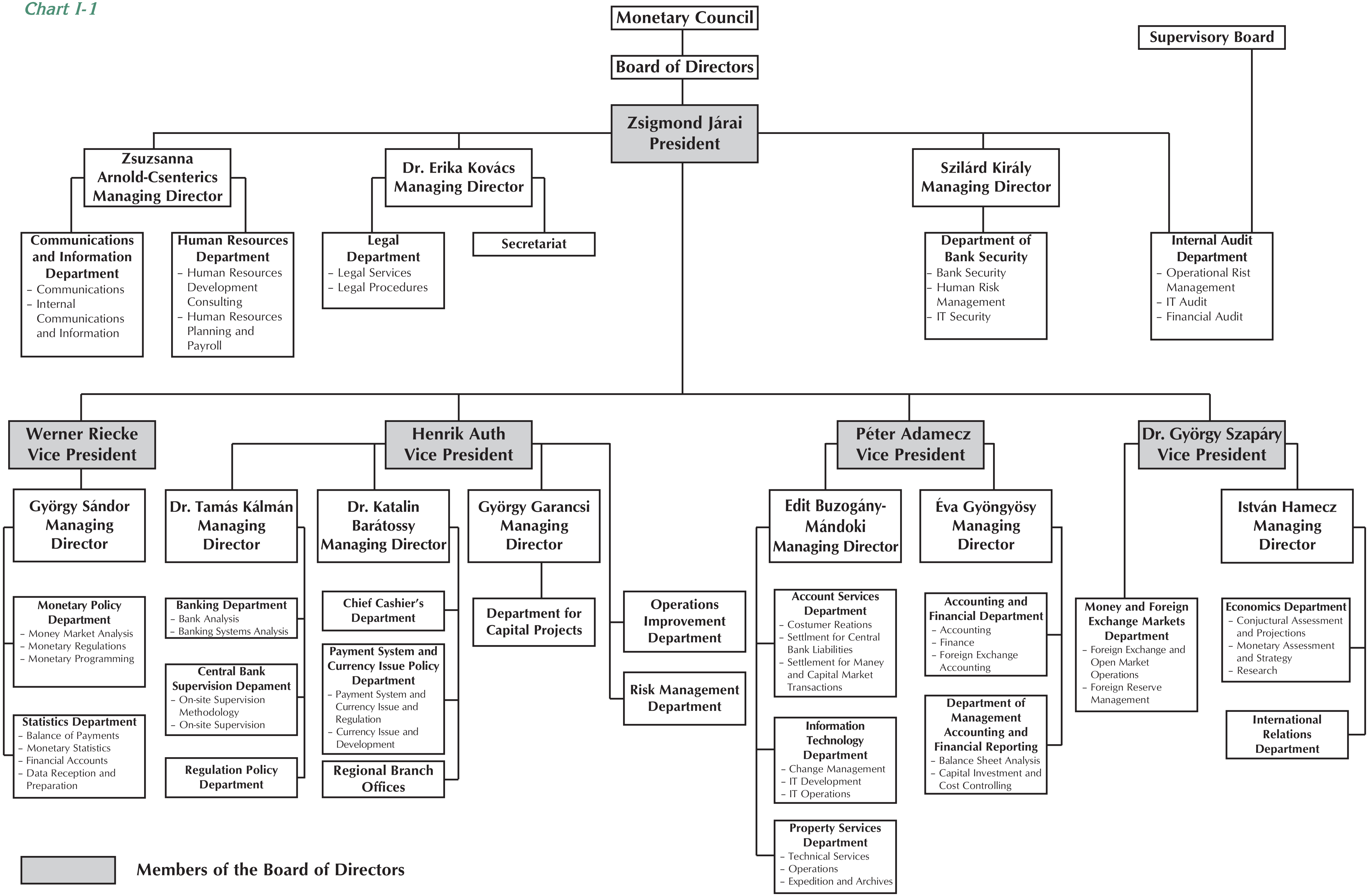
Edit Buzogány-Mándoki: Account Services Department, Information Technology Department, Property Services Department

György Sándor: Monetary Policy Department, Statistics Department

The Bank's organisational structure as of 31 December 2002, divided into departments and their sub-units called divisions, required for the performance of the Bank's functions, is presented in an organisational chart *(see Chart I-1).*

Organisation Chart of the Magyar Nemzeti Bank (31 December 2002)

Chart I-1



REVIEW OF THE MNB'S ACTIVITIES IN 2002 (EXECUTIVE SUMMARY)

MONETARY POLICY IN 2002

In 2002 the Magyar Nemzeti Bank met the inflation target, set jointly with the Government, for the second consecutive year. As a result, inflation in Hungary fell from 6.8% in December 2001 to 4.8% at end-2002.

Monetary policy was tightened gradually in the course of the year under review, as carry-over effects from 2002 to 2003 and excessive wage growth relative to the country's economic performance added to risks that inflation would rise above the target toward end-2003.

The Bank continued to harmonise its monetary policy instruments with those of the ECB in 2002. As part of this process, the MNB adjusted the reserve base to the ECB's monetary policy rules. With the reduction in the *reserve rate* from 6% to 5% and the increase in the interest rate remunerated on required reserves in August 2002, the tax on banks was more than halved in one year. In order to adopt the ECB's practices, the MNB reduced the width of the interest rate corridor from ±1.5% to ±1% in September 2002.

The easing of surplus liquidity in the course of the year made it unnecessary for the Bank to continue issuing MNB bills. Since May the Bank has only been available in transactions denominated in euro.

STABILITY OF THE FINANCIAL INTERMEDIARY SYSTEM

In 2002, the Magyar Nemzeti Bank continued its attempts aimed at supporting financial system stability at a high standard. The Bank's most important observations about the Hungarian financial intermediary system are published in the *Report on Financial Stability*, which has been published in a new structure since 2002, consistent with the best international practice.

The operation of the Hungarian financial intermediary system continued to be stable and reliable in the year under review – the stress tests performed showed solid results in respect of stability. Once again in 2002, profitability indicators of the banking sector were evidence of very good performance, following the previous year's record profits.

Analytical work aimed at evaluating banks' risk awareness and risk management systems continued. Of the risks facings banks, operating and liquidity risks were assessed in the year under review.

Building on results of the analyses of systemic risks and challenges, as well as the related regulatory issues, a number of background papers and publicly available analyses were prepared in 2002. The Bank participated actively in drafting financial legal regulations, in order to ensure that macroprudential considerations were also taken into account.

In 2002, the MNB carried out on-site examinations at 213 institutions, in areas of its competence as a regulatory authority – among credit institutions, clearing houses, money processing firms, non-financial corporations, foreign exchange offices and one money market fund. On the whole, the inspections provided evidence that the institutions' compliance with the relevant legal rules improved and the data reports in general met the required standards.

PAYMENT SYSTEMS

In 2002 the domestic payment and securities settlement systems operated smoothly and efficiently.

Preparations for meeting the requirements of accession to the EU and strengthening operational reliability were in the focus of the MNB's activities.

The international institutions assessing Hungary's payment and settlement systems in 2002 have come to the conclusion that the country's systems are robust and meet the international requirements.

The MNB examined thoroughly the risk management procedures as well as the operational reliability of the systems operated by GIRO Elszámolásforgalmi Rt. and KELER Rt. On the basis of the statements of the inspection the clearing houses have improved further their already high-level services.

Turnover in VIBER continued to rise robustly, without any liquidity problems or operational failures at all. The reliability of VIBER has improved further. Using the remote hot back-up system developed in the course of the year, the MNB is able to handle even such emergency situations which would have caused a longer interruption in the operation earlier.

The international bank account number was introduced and the conditions for using it were created with the co-ordination of the MNB. This was an important precondition for improving the efficiency and speed of executing cross-border transfers, particularly those with EU member states.

FOREIGN EXCHANGE RESERVE MANAGEMENT, RISK MANAGEMENT

The MNB's reserve management policy is determined by the Monetary Council. In May and August 2002, the Council reviewed whether the level of reserves was consistent with the underlying principles of holding reserves. Since, in the circumstances, the amount of reserves was above the EUR 9 billion threshold level, considered as safe from the perspective of conducting monetary policy, there was no need to raise funds for the purposes of building reserves. Moreover, with the Government discontinuing its foreign currency borrowing programme in 2002, the Bank had the opportunity to lower the amount of reserves. Generally, the Bank's main principle in compiling investment guidelines is to adopt the best practice followed by developed-country central banks, and particularly those of the European Union. Accordingly, the Bank only invests in highly liquid, AA-AAA-rated securities. These comprise government bonds and securities issues by large international financial institutions and government agencies. There were no substantial changes to the Bank's investment guidelines in the year under review.

In the course of 2002, the Bank's foreign exchange reserves fell from EUR 11.7 billion to EUR 9.9 billion by end-December. The main reason for this was that the Hungarian Government did not enter the international capital market with new bond issues. Meanwhile, however, the repayment of existing debt against foreign exchange reserves continued uninterrupted.

The European Central Bank and the central banks of countries aspiring to join the euro area in the future established formal connections in 2002. On this occasion, the ECB assessed the level of preparedness of the central banks involved. It found that the preparations by the MNB, together with the majority of central banks wishing to join, were adequate in terms of meeting the time schedule.

CURRENCY ISSUING ACTIVITIES

One of the fundamental tasks of the Magyar Nemzeti Bank is to provide banknotes and coins in adequate quantity, in proper quality and in suitable denominations for the national cash turnover. The Bank performed this task both at the Main Cashier's Desk in Budapest and at cash desks in its four regional directorates to full extent in 2002.

In 2002, the Magyar Nemzeti Bank's cash desks conducted cash turnover in the amount of HUF 3,521 billion. This was 3% higher than the value of cash turnover in the previous year. Processing the banknotes and coins lodged in the Bank's cash desks continued to be carried out by state-of-the-art processing equipment and in accordance with standard rules.

The number of detected counterfeits was insignificant, and it did not jeopardise the security of cash turnover.

Issuing commemorative coins is a traditional activity of the Bank and has a long history. In 2002, the Magyar Nemzeti Bank issued four silver, three base metal commemorative coins, and one jubilee circulation coin.

STATISTICAL SERVICE

The Central Bank Act and the Statistical Act provide the regulatory background for the Magyar Nemzeti Bank to perform its statistical activities. Arrangements for joining the EU constituted a priority task in 2002. Adopting the statistical systems recommended by the EU and meeting the requirements related to the dissemination of data and information are important preconditions for accession. The Bank has been gradually bringing the reporting requirements for its own data providers into harmony with the ECB's regulations. As part of this process, in 2002 the Bank took important steps to reform its data collection system.

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

In the framework of reforming its publication policy, in 2002 the Bank ceased to publish its *Monthly Report*. Since July 2002, the Internet has been the major channel for publishing statistical data, in addition to statistical press releases.

Effective from 2 December 2002, the Board of Directors decided to reorganise the Statistics Department, in order for the Bank to be able to better perform its statistical duties.

In the area of *monetary statistics*, the EU accession and obligations to report data to the ECB made it necessary to overhaul the balance sheet and interest rate statistics. As regards *balance of payments statistics*, in accordance with the decision taken by the Monetary Council, the preparations were made for the necessary methodological changes to be implemented as of 2003, such as incorporating customs statistics, harmonising travel data with the national accounts and recording reinvested earnings.

In addition to international co-operation, statistical work performed at the MNB makes it indispensable to maintain close co-operation with domestic institutions. The co-operation between the MNB and the Hungarian Central Statistics Office is documented by the agreement concluded by the presidents of the two institutions on 8 February 2002. A priority task of the work schedule for 2002 was modernising the methodology of balance of payments and financial accounts statistics, and expanding co-operation between the two institutions in various other areas.

FINANCIAL RESULTS OF THE MNB

In 2002, the Bank had a loss of HUF 4.9 billion and a balance sheet total of HUF 4,232 billion. Under Article 78 of the Central Bank Act, the MNB was required to make a dividend payment of HUF 23.3 billion in the year under review. As the financial results for the year did not provide cover for the dividend payment, the Bank used HUF 23.3 billion of its retained earnings, as stipulated by the Act.

The Bank's financial results in 2002 featured higher interest income, lower gains from exchange rate movements, calculated on the basis of a different method due to a change in legal regulations, and lower operating costs in nominal terms. The improvement in interest income was the result of a fall in the outstanding stock of, and the interest rates on, liquidity-absorbing instruments with higher unit costs of funds.

Accounting for gains or losses arising from movements in exchange rates was changed substantially. Under the Central Bank Act in effect from 1 January 2002, realised gains from changes in the forint exchange rate were recorded under profits and unrealised gains under the equalisation reserve, a constituent of equity.

Under articles 17 (4) and 72 (3) of the Central Bank Act, by 31 March 2003 the central government settled the Bank's HUF 82.9 billion negative equalisation balance arising from exchange rate changes. This occurred in the form of a financial settlement that (i) did not affect the budgetary estimates for 2002 and (ii) was offset by a reduction of a similar size in forint terms in public sector foreign currency debt.

The Bank's operations were characterised by the gradual modernisation of activities and processes, and improving their efficiency. The most important instruments of this were saving on labour thorough reorganisation and increasing cost efficiency through the generalised use of invitations for tender. As a result of all these, the Bank's operating costs fell relative to 2001.

REVIEW OF PERFORMANCE

I.

MONETARY POLICY IN 2002

The new Central Bank Act, in force since July 2001, sets delivering and maintaining price stability as the Bank's primary objective. The MNB has developed its new monetary policy instruments consistent with the primary objective. These include a ±15% wide intervention band, harmonising with the EU's exchange rate mechanism (ERM II).

At the time of implementing the new system, in June 2001, the Bank and the Government set the objectives for end-2002 and 2003 jointly. In line with the two-year central budget, approved by Parliament, a 4.5% inflation target was set for end-2002 and one of 3.5% with a ±1% tolerance band for end-2004. In the summer of 2002, the end-2003 target was revised jointly with the Government – a below 4.5% inflation target was set, the 3.5% target with a ±1% tolerance band for end-2004 remaining unchanged. Meanwhile, the Government committed itself in its Medium-Term Economic Policy Programme approved in 2002 to implementing significant fiscal restriction. The Government's commitment included the reduction in the central budget deficit to 4.5% of GDP in 2003 and to 3% in 2004, meeting the Maastricht fiscal criteria. After consideration of the fiscal path announced in the Medium-Term Economic Policy Programme, the Monetary Council judged the set inflation targets as achievable, even in the face of the exchange rate hurdle imposed by the upper edge of the intervention band.

In the first year of implementation, however, fiscal policy departed from the path envisaged in the Medium-Term Economic Policy Programme, which caused difficulties to monetary policy implementation – the budget deficit amounted to 9.4% in 2002 instead of the target of 5.5%. Fiscal expansion gave a direct boost to household demand. In addition, rapid wage growth in the public sector slowed the rate of wage adjustment in the private sector. Under the circumstances, the Monetary Council responded by tightening monetary conditions, in order to meet the jointly set targets. But the proximity of the upper edge of the intervention band and the

Table I-1 **CPI inflation and its components in 2002 (Percentage changes on a year earlier)**

	Weight 2002	2000 Annual average	2001 Annual average	2002 Annual average	2002 Q1	2002 Q2	2002 Q3	2002 Q4	2001 Dec.	2002 Dec.
Food	19.0	10.0	15.1	4.7	8.5	5.9	2.0	2.4	9.9	2.4
unprocessed	6.2	14.0	15.5	2.4	9.5	5.1	−4.3	−1.0	5.8	−0.3
processed	12.8	8.2	15.0	5.8	7.9	6.1	5.1	4.0	11.8	3.7
Tradables	27.0	5.0	4.7	2.5	3.3	2.6	2.3	2.0	3.7	1.7
durables	7.0	1.7	1.0	−1.6	−1.2	−2.0	−2.0	−1.3	−0.7	−1.2
non durables	19.9	6.0	5.9	4.0	4.9	4.3	3.8	3.1	5.3	2.8
Market services	19.4	10.9	12.0	8.3	9.3	9.0	7.5	7.5	10.5	7.1
Market-priced energy	1.5	21.3	17.6	2.0	0.0	1.9	2.3	4.1	−0.7	5.0
Motor fuels	5.2	28.1	−2.3	−1.6	−9.1	−7.3	1.8	8.2	−13.9	9.6
Alcohol and tobacco	9.1	11.0	11.2	9.7	9.4	9.1	9.3	11.0	10.3	11.8
Regulated prices	18.9	9.0	8.5	6.2	7.7	7.0	5.4	4.5	8.9	4.5
CPI	**100.0**	**9.8**	**9.2**	**5.3**	**6.2**	**5.5**	**4.6**	**4.8**	**6.8**	**4.8**
Core inflation	68.2	8.1	9.3	6.0	6.7	5.9	5.7	5.7	8.0	5.6

real economic costs of real appreciation restrained the Bank's room for manoeuvre in implementing the inflation path.

Inflation developments

2002 marked the first full economic year in the inflation targeting system. Disinflation, which resumed after a two-and-a-half year pause in the second half of 2001, continued virtually uninterrupted in the year under review – the Bank met the inflation target set jointly with the Government for the second successive year.

Annual inflation in December 2002 was lower than a year earlier in all price categories, with the exceptions of power and fuel, alcoholic drinks and motor fuel prices. *(Table I-1)*

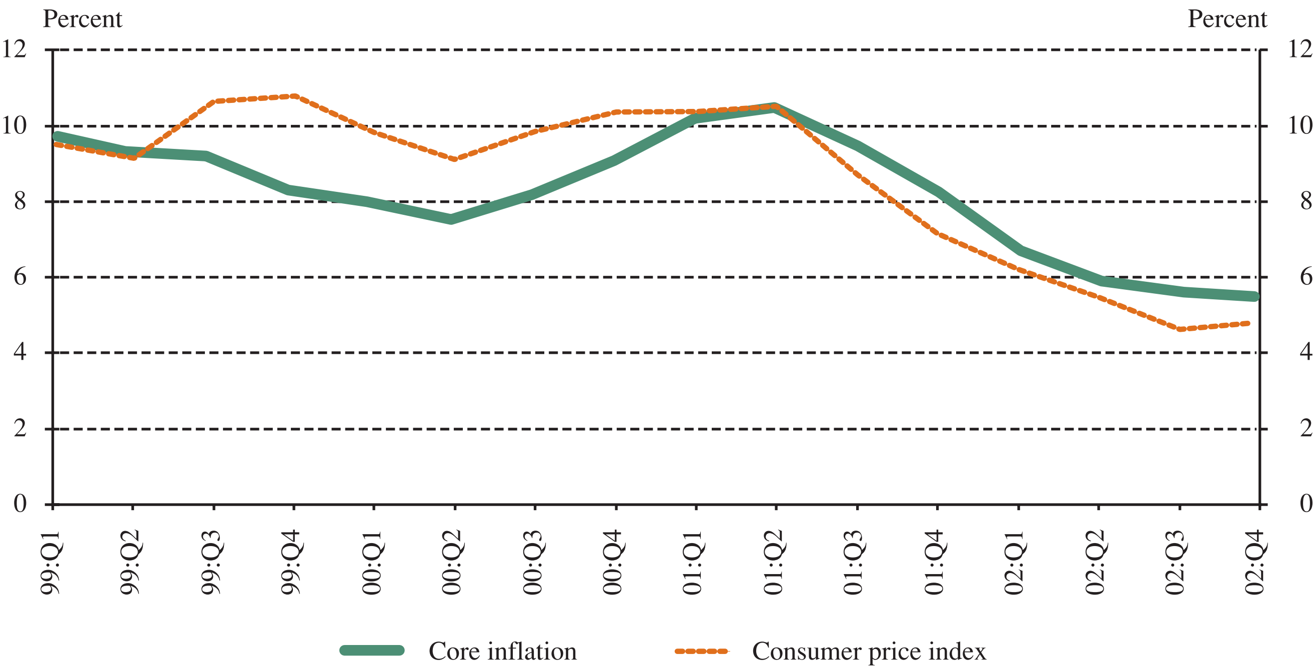
The fall in unprocessed food prices and the postponement of increases in regulated prices definitely played a role in the decline in consumer prices. Nevertheless, the tightening of monetary conditions played the most dominant role. The core inflation indicator, which does not include unprocessed food prices (for which weather conditions are important and which often move erratically), changes in motor fuel and household energy prices as well as goods with regulated prices, is evidence of this. Core inflation fell practically as a trend from mid-2001 – the consumer price index declined from 10.8% to 4.8% and core inflation from 10.1% to 5.6% in the period May 2001–December 2002. *(see Chart I-2)*

The fall in inflation was uninterrupted, despite the significant fiscal expansion of 2001–2002, stimulating domestic demand. The expansionary effect of general government on demand amounted to 1.8% in 2001 and to 4.3% in 2002. Another factor slowing disinflation was the unprecedented rate of real wage growth, which led to an increase in household disposable income. In spite of continued disinflation, private sector wage inflation fell only slightly in the course of 2002 – the 12.9% rate of wage growth was considerably higher than the sum of 5.3% average rate of inflation plus the 2.2%–2.6% annual gain in productivity. Consumer demand rising in excess of GDP growth jeopardised the disinflation process, which was reflected not only in the tentative slowdown in services price inflation, it also slowed down the rate at which durables prices fell in the second half. Rising oil prices also retarded disinflation in the period.

Monetary conditions

As the instruments available to the Bank are only capable of influencing inflation with a time lag of 1 to 2 years, it is indispensable for monetary policy to have a reliable forecast for the likely developments in inflation and to make its decisions in a forward-looking manner. For this reason the forecasts prepared by the Bank's analysts and published in the *Quarterly Report on Inflation* play the role of an intermediate target in the monetary policy system. Incorporating all available information, the forecast defines the inflation path expected on the forecast horizon, based on the assumption that monetary

Chart I-2 **Consumer price index and core inflation (Annual average rates)**



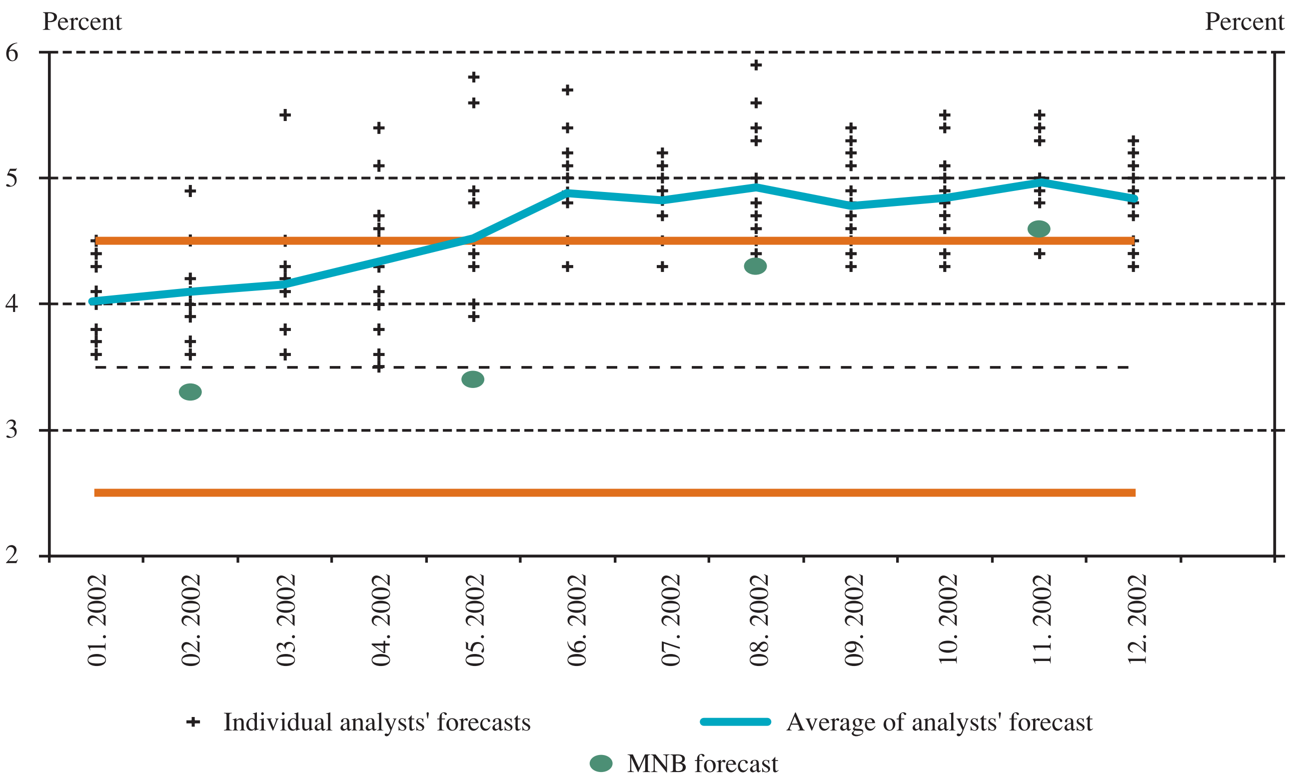
policy remains unaltered. The Monetary Council compares the forecast with its pre-announced target, and, depending on the outcome, it decides whether or not it should alter the current monetary conditions. *(see Chart I-3)*

Up to November 2002, the projection had been for inflation to remain within the target range for 2003. However, the forecast departed from the tolerance band in November. During the year, the global economic recovery, expected by both the Bank and market analysts, failed to get underway. Consequently, the Bank continuously revised downwards its forecasts for both export demand and manufacturing fixed investment closely related to the former. This meant a downward revision to the expected level of inflation. In contrast with this, other factors, such as the steady rise in oil prices throughout the year and the upward revision to forecasts for private sector wage growth, as well as the much higher central budget deficit relative to the statutory limit, forced the Bank to raise its inflation projection. Meeting the 2002 target was not jeopardised by developments in the economic variables, but their carry-over effects for 2003 questioned whether the set target could be met.

By raising or lowering its major policy rate, the Bank influences movements in the exchange rate and short-term interest rates. Under the current economic conditions, interest rates only have a limited direct impact on inflation. By contrast, the exchange rate determines inflation developments both directly and indirectly – through influencing import prices and through the contractionary impact of the real exchange rate on demand. Consequently, the Bank is currently able to meet its inflation target via influencing the exchange rate.

As the inflation projection had been for inflation to remain within the target band up to November 2002, the focus of monetary policy actions was on stabilising the exchange rate within a range of HUF 240–245 vis-à-vis the euro, consistent with the inflation targets. Falling risk premia contributed to keeping the exchange rate stable with lower interest rates in early 2002. However, in order to counterbalance the negative effects of the rise in risk premia caused by the worsening economic outlook and the increases in the budget and current account deficits, in May and July 2002 the Monetary Council raised official interest rates. By raising interest rates in May, the Council was able to counteract a further decline in the exchange rate. Nevertheless, a worsening of economic prospects led to a renewed sharp fall in the exchange rate. Finally, the announcement by the Government of its Medium-Term Economic Programme helped stabilise the exchange rate. In this, the Government reinforced its commitment towards fiscal convergence and a fast track to joining the euro area. Previously, market analysts increasingly inferred from the deteriorating budget position that the Government

Chart I-3 **Reuters' survey of analysts' inflation expectations and the MNB's inflation forecast for end-2003**



may have relaxed its resolve to adopt the euro, which, due to the delay in the expected date of accession, triggered a rise in risk premia, putting strong downward pressure on the exchange rate.

Increasing risks to inflation made it necessary to tighten monetary conditions further towards end-2002, in order to meet the set target. For this reason, the Bank (i) lowered its major policy rate by less (by 100 basis points altogether) than it would have been legitimate in the face of the positive effects of the Irish referendum on risk premia and the date of accession set for May 2004 and (ii) it attempted to maintain the exchange rate of the forint vis-à-vis the euro within a band of HUF 238–242. *(see Chart I-4.)*

Changes to monetary policy instruments

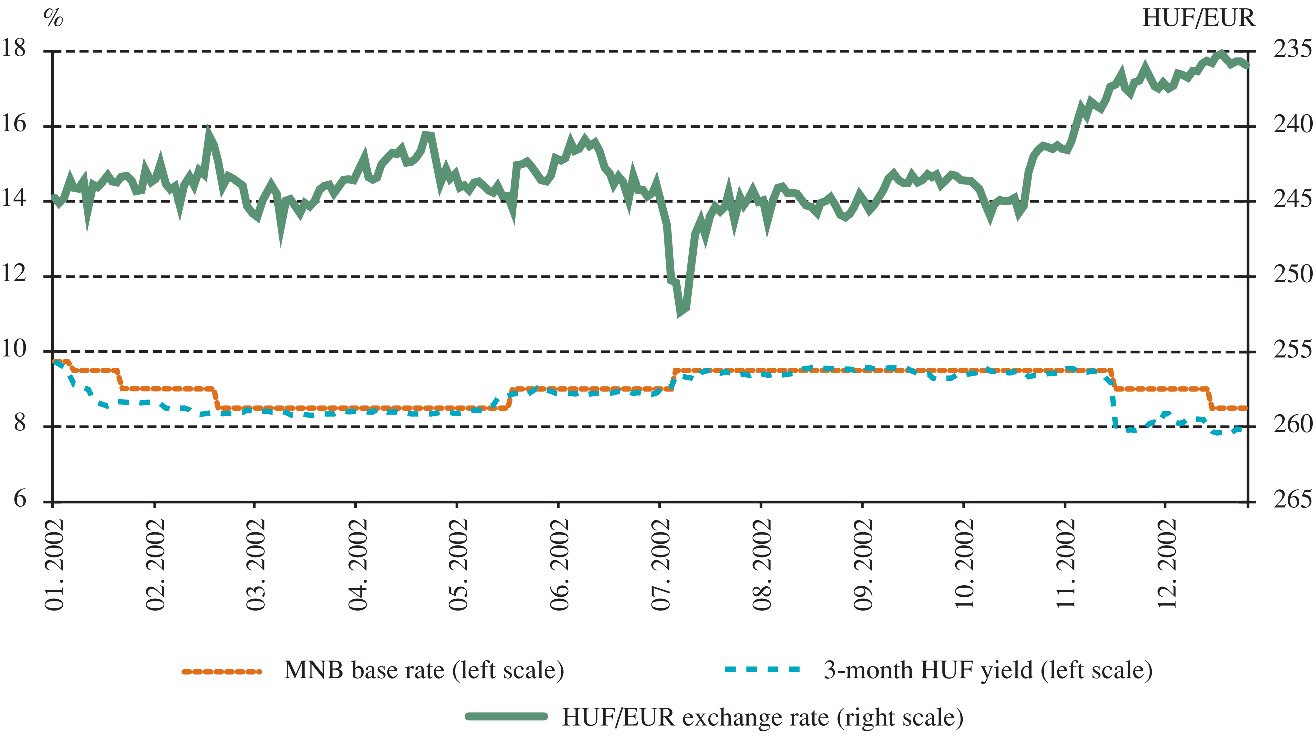
In 2002, the changes to the Bank's monetary policy instruments were determined by harmonisation with the regulations of the European Central Bank; furthermore, cost efficiency considerations and efforts to simplify the instruments also played a role.

Reserve requirement regulation

The reserve requirement system saw the most significant changes. In the course of 2002, the Bank narrowed the *range of liabilities subject to reserve requirements* several times – as of February, forint-denominated foreign liabilities with remaining maturity over 2 years and securities issued by credit institutions with maturity over 2 years were exempted from the reserve requirement. As of August, funds obtained via repo transactions and deferred liabilities were also exempted from the reserve requirement. With these changes, only deposits with maturity over 2 years remain to be exempted in order for the reserve base to comply fully with the ECB's regulations.

The *reserve rate* fell from 6% to 5% in August, approaching the 2% reserve rate applied by the ECB. The Bank raised the interest rate remunerated on required reserves in two steps, by a total of 1 percentage point, from 4.25% to 5.25%. Raising the remuneration was justified by the effort to lower the burden on banks, and to contribute to improving the banking system's efficiency and competitiveness. The implicit tax on banks (the cost of maintaining reserves expressed as a percentage of bank liabilities) fell to less than a half in one year – it was only 17 basis points at end-2002. Beyond the raise of remuner-

Chart I-4 **Exchange rate and interest rate movements in 2002**



tion an aggregate 125 basis point cut in the base rate also contributed to it. The Bank's objective is to eliminate gradually this tax on banks in the period remaining until Hungary's accession to the EU. In order to achieve this goal, the rate remunerated on reserves will be raised to the level of the key policy rate.

Interest rate corridor

As of September 2002, the Bank reduced the width of the interest rate corridor from ±1.5% to ±1%. This meant that the difference between the interest rates on the overnight loan and the overnight deposit narrowed – the conditions of the overnight standing facilities remaining unchanged. This modification took place in order to reduce fluctuations in interbank rates and adopt the ECB's practices. Volatility of interbank rates fell within the narrower interest rate corridor, and recourse by banks to standing facilities increased only slightly.

MNB bill

With the decrease in the banking system's structural liquidity surpluses, it became unnecessary for the MNB to use two sterilisation instruments simultaneously. For this reason, a decision was made in 2001 to reduce to zero the outstanding stock of three-month MNB bills. The last issue of bills took place in April 2002. As a result, in three months the stock of MNB bills fell to zero in the Bank's balance sheet. Having abandoned the three-month bill, the Bank contributed to the success of Government securities issues in excess of the planned amounts.

Foreign exchange market instruments

Earlier, the Bank was available to banks in both US dollar and euro at the upper and lower extremes of the intervention band. However, from May 2002 the Bank has ceased the standing facility in dollars. After the implementation of foreign exchange liberalisation, the development of the domestic foreign exchange market and the increase in the share of the euro no longer justified maintaining the possibility of intervention at the extremes of the band in the HUF/USD market. Nevertheless, the Bank did not conduct any foreign exchange intervention in 2002.

STABILITY OF THE FINANCIAL INTERMEDIARY SYSTEM

The Act on the Magyar Nemzeti Bank defines promoting the stability of the financial intermediary system as one of the Bank's basic duties. In order to be able to discharge this role, the Bank continuously monitors developments in the financial sector, analyses the sector's stability and vulnerability, participates in developing the regulatory concepts relating to the sector and in drafting standard rules, in addition to performing on-site inspections.

Analysis of the financial intermediary sector's stability

The Bank publishes its most important observations about the stability of the domestic financial intermediary system in the *Report on Financial Stability*, a semi-annual publication issued since August 2000. The *Report* greatly contributes to the developing expert thinking about financial stability and to increasing the transparency of issues and views related to stability.

The Report found that the domestic banking sector's operations were characterised by stability and profitability in 2002, despite an increase in activities carrying lending risks. As a positive development, the combined market share of loss-making banks fell. The slowdown in business activity was instrumental in lending to the corporate sector remaining modest. However, due to the changes in the income position of households, the extension of the housing subsidy scheme and the shift in banks' focus toward the retail market, growth in outstanding household borrowing was very robust. Nevertheless, the lending expansion was not followed by a rise in real property prices. This helped prevent property market price bubbles from developing.

The studies analysing the medium-term trends of banking sector developments sought to answer three questions – (i) what would be the sector's state and the directions in which it would develop at the time of Hungary's joining the European Union; (ii) would the sector be competitive in the single European market and (iii) what processes should take place in order for the sector to become competitive?

In 2002, the Bank continued to survey banks' specific risk taking and their risk perceptions and risk management systems relating to those risks. The studies foster financial stability by contributing to a higher level of awareness in taking risks. Within the various types of risk, the Bank assessed operating risks and liquidity risks in 2002. Taking the Hungarian banking sector as a whole, it is a positive development that the banks accounting for a dominant share of the market plan to develop their operating risk management systems in the future. However, small and medium-sized banks are still faced with a huge deficit in terms of preparedness. In assessing the imperfections in the area, it should be taken into account that standard methodologies and regulatory guidance are now being formulated internationally. Based on the survey of their liquidity risk management practices, banks mainly tend to adopt their parent's risk management methods; liquidity risk management meeting the basic principles of international organisations and banks' preparedness to face new challenges are excellent.

In analysing financial stability, the Bank continues to maintain close working relations with international and domestic fellow institutions whose activities are related to the issue. The Bank's most important partners in Hungary are the HFSA, the Ministry of Finance and, abroad, the IMF, the World Bank, the ECB and the Commission of the European Union.

Drafting legal regulations and developing regulatory policy

In order to ensure the enforcement of macroprudential issues, the MNB is a regular participant in the efforts aimed at drafting and modifying financial acts and regulations.

With the adoption of the amendments to the Credit Institutions Act and the Capital Market Act, the MNB's oversight functions related to securities settlement systems and clearing houses became more accentuated. In addition, the Bank expounded its views mainly in respect of the harmonisation of rules and regulations with EU law, the prudent operations of the institutional system and the improvement of the efficiency of financial markets in the preparatory phases of amending laws.

In addition to participating in the process of drafting financial laws, the Bank constantly analyses the stability and efficiency of the financial intermediary system. In 2002, two important analyses were published which presented the challenges facing the financial intermediary system and the related regulatory issues: one about the *procyclical behaviour of the banking sector* (MNB Occasional Papers, No. 23) and another discussing the *risks and regulation of financial groups and conglomerates* (MNB Occasional Papers, No. 23). The research activity and the analytical work play an important role in identifying the main regulatory challenges and exploring the possible solutions, and provide a background for the decision-making bodies to formulate a unified view for the central bank and to support the decision-making process.

On-site inspections

The Bank carried out 213 on-site inspections in 2002, comprising 32 full-scope and 181 project examinations and involving 7 banks, 2 clearing houses, 34 co-operative credit institutions and 26 non-financial corporations. In addition, the Bank inspected 3 money processing firms, 1 money market fund and, commissioned by the HFSA, 140 foreign exchange offices.

The priority issues of the 2002 inspections were the on-site examination of the adequacy of the various data reports sent to the Bank, tracing the adoption of European Union requirements in the reports and other issues supporting the MNB's payment system oversight role, in addition to controlling the compliance with payment transactions regulations. The range of institutions and the activities to be examined were determined by an MNB-specific risk classification system, on the basis of which a great number of credit institutions and non-financial corporations were examined. The major issue of the year involved examining the data reports related to the balance of payments, in addition to money transfers and banks' monetary reports.

During the on-site inspections, the Bank examines compliance by banks with regulations on money circulation, with the objective of discovering factors slowing or hampering payment turnover on the side of credit institutions, and encouraging and obliging the members of the payment system under examination to eliminate those obstacles. During the inspections, special attention was paid to meeting the deadlines related to the execution of transactions, the practice of executing pre-authorised collection orders to be ranked favourably and to examining the bank card business, as well as the system of postal transfers. In respect of money processing and cash circulation activities, the main emphasis was placed on examining internal regulations and the suitability of banknotes placed back into circulation. In general, observance by institutions of legal regulations improved in these areas. In the framework of the Bank's payment system oversight role the examinations of the clearing houses were aimed at discovering the risks inherent in clearing and settlement activities. Experience with the examinations was positive.

During the examinations of data reporting in a systems approach, the major emphasis was put on organisation of the data supply, completeness, sector classification and the conformity of the various reports in terms of content. A part of data reporting errors also had an effect on the compulsory reserve base. The on-site inspections provided the Bank with useful information for evaluating the reliability of statistical data; however, the institutions examined received feed-back on the quality of their reports and guidance for preparing data reports in conformity with the existing rules. The errors discovered necessitated some retroactive corrections in Hungary's balance of payments and monetary statistics.

PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

The MNB's core duties

The Central Bank Act defines promoting the smooth and efficient operation of the domestic payment and settlement systems as well as regulating payment services among the core tasks of the Magyar Nemzeti Bank. Many of the MNB's functions are closely related to this role.

In the framework of its business services, the MNB operates the Real-Time Gross Settlement System (VIBER), which is the central infrastructure of the domestic payment system.

As a majority shareholder, the MNB has a controlling influence on the activities of KELER Rt., which operates the domestic securities settlement system. In addition, as a minority shareholder it is involved in the corporate governance of Giro Rt., the automated clearing house for retail payments which operates the Interbank Clearing System.

A new definition – oversight – has appeared in the international literature. This involves central banks' tasks with regard to the payment systems, i.e. data collecting, analysing, regulating and controlling activities in order to ensure the smooth and efficient operation of payment systems.

The MNB promotes co-operation between market participants and plays a proactive role in achieving the objectives set by the interested parties.

Two important issues, namely preparing for accession to the EU and examining the operational reliability of the systems, were in the focus of the MNB's activities in 2002.

Accession to the EU

The MNB considers it extremely important that the operation of the systems overseen by it should be in full compliance with international requirements and standards. Examinations carried out by various international institutions in 2002 provided excellent opportunities to assess the adequacy of the domestic systems' operations.

At the request of the EU Commission, the European Central Bank examined the Hungarian payment and settlement systems, prior to closing of the country's accession negotiations. The analysis, prepared in co-operation with the MNB, came to the conclusion that the Hungarian payment infrastructure is safe and adequately efficient. It does not constitute any obstacle to close the accession negotiations.

Although it is not related to the EU accession, it is worth mentioning that in 2002 the IMF updated its 'Report on observance of standards and codes', issued two years earlier, in relation to its Financial Sector Assessment Program. The paper discussed the transparency of central bank activities and the compliance with the core principles[1] for systemically important payment systems issued by the BIS CPSS in 2001. According to the report there was significant improvement over the years in making the MNB's role, tasks and policy more transparent and the systemically important Hungarian systems (VIBER, ICS and KELER) are to a great extent in compliance with the core principles.

In 2002 the ECB issued its Blue Book presenting comprehensively the payment and securities settlement systems of accession countries. The chapter describing the Hungarian systems, including the relevant statistical data, was prepared by the MNB.

An international conference, organised by the MNB, was held in November. At the conference experts from the EU Commission, the ECB and a number of EU member states gave presentations to Hungarian financial experts concerning challenges facing the national payment systems and their participants in connection with the accession to the EU and EMU.

In compliance with the European legislation, significant progress has been made in order to be prepared for the efficient execution of cross-border retail transfers. Order No. 9/2001 of the President of the MNB stipulated that by 31 December 2002 Hungarian banks have to implement the International Bank Account Number (IBAN) introduced already by the member states of the European Union. For this purpose by the end of December commercial banks introduced the same structure of account numbers in respect of foreign currency accounts as is already used in relation to domestic accounts. In addition, they issued an international bank account number for all accounts of their clients and prepared their systems for executing payment orders identified by such bank account numbers.

Operational reliability

In accordance with international requirements and recommendations, in 2002 the MNB installed VIBER's new remote hot back-up system, in order to increase the safety of the operation of the domestic large-value pay-

[1] The governing bodies of the ECB, a number of European central banks and the MNB adopted these core principles in 2001 as minimum requirements in respect of the operation of the payment systems.

ment system. The MNB previously also had a back-up facility; the improvement is, however, that the new back-up facility is located in a physically remote area from the main operation site.

At the request of the Supervisory Board of KELER Rt., the MNB delegated experts to assess the operations of the securities clearing and settlement system operated by KELER Rt., with special emphasis on the adequacy of risk management procedures and operational reliability. According to the findings of the report there were no serious problems requiring immediate intervention in the systems' operation. An action plan has been elaborated in order to eliminate the minor deficiencies discovered.

The one-site inspection of the Interbank Clearing System also took place in 2002. During the examination, the MNB's experts paid particular attention to evaluating the system's IT infrastructure, its legal soundness, the physical safety and its operational reliability. The recommendations and tasks drawn up as a consequence of the inspection have been integrated into the internal procedures of the company in accordance with the relevant schedule.

VIBER's operations

The number of VIBER participants was 38 at the end of 2002, one participant less than in the previous year.

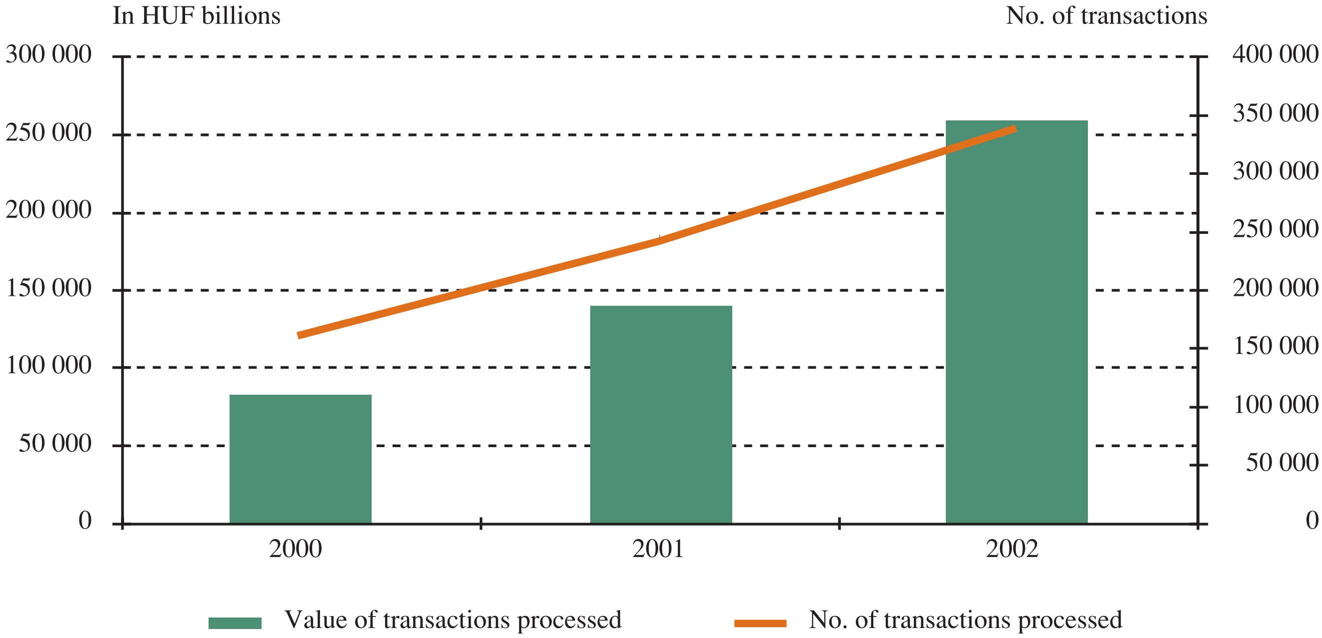
In the system executing basically interbank and large-value, urgent transfers, 337,000 payment orders were recorded in 2002, amounting to HUF 259 thousand billion. This was a significant increase compared to 2001 as the volume and value of transactions rose by 40% and 85% respectively. The average value of one transaction was HUF 768 million[2] in 2002, 32% more than in the previous year. *(see Chart I-5)*

Daily average turnover was HUF 1,032 billion with the average number of payment orders being 1,343. The peak day in terms of volume was 4 October with 2,339 transactions, while in terms of value it was 28 February, which witnessed the processing of more than HUF 2,797 billion.

Considering the types of transactions, the number of bank-to-bank transfers increased the most dynamically, reflecting the intensification of market activities of foreign banks' having accounts with domestic financial institutions. The robust increase in the average value of transactions also indicates the increasing proportion of bank-to bank transfers. The share of customer payments remained unchanged in comparison with the previous year (15%); however, their value fell from 6% in 2001 to 3% in 2002.

The availability of VIBER has improved in recent years. On a monthly average, it operated without any failure in 99.8% of its total operating time in 2002, compared to 99.59% in 2001 and 99.03% in 2000. In 2002 the length of failure was 18–66 minutes per occasion.

Chart I-5 **VIBER turnover in 2000–2002**



[2] The average value of large-value transactions between EU member states in TARGET was EUR 6 million in 2002 (HUF 1,470 million), whereas in the EURO 1 system, operated by the EBA, it was EUR 1.4 million (HUF 343 million).

Taking into consideration the expected changes in monetary conditions, the MNB and KELER Rt. have launched a joint project to modify the central bank's collateral management system, including the implementation of pooled collateral management and the daily valuation.

Securities settlement system

The MNB is highly interested in the smooth and efficient operation of the domestic securities settlement system for a number of reasons. Potential financial problems or operational failures may endanger the operation of the entire payment system and the efficient conduct of monetary policy. Moreover, the MNB is interested in the smooth operation of the system as an owner. The Capital Market Act has granted rights to the MNB to oversee the system in respect of systemic risk.

In 2002 several new functions were added to the securities settlement system, which reduce the risks of the participants, increase market liquidity.

An internationally recognised high-level application is available to settle government securities transactions in Hungary, since the real-time settlement systems of the MNB and KELER Rt. have been connected, making possible delivery versus payment (DVP) settlements in real time and in central bank money.

In May KELER extended its central counterparty (CCP) service, provided earlier only in the derivatives market, to include spot market transactions. KELER interposes itself in transactions by becoming the seller to every buyer and the buyer to every seller, and it guarantees the settlement. KELER has developed a multi-level risk management system in order to ensure the smooth operation of the securities settlement system.

KELER reduced the settlement cycle of the Stock Exchange spot market from T+5 to T+3 days from 18 November 2002.

FOREIGN EXCHANGE RESERVE MANAGEMENT, RISK MANAGEMENT

Objectives of holding reserves

The Central Bank Act states that managing Hungary's foreign exchange reserves is one of the Magyar Nemzeti Bank's core duties.

The basic objectives of managing foreign exchange reserves remained unchanged in 2002, as follows:

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

In recent years, the direct transaction goals, such as supporting debt repayment, have lost their importance with the country's economic development and the improvement in its credit rating and debt service indicators. Nevertheless, these goals are still important. This is indicated by the fact that debt servicing by the Bank and the Hungarian State amounted to some EUR 2 billion in 2002. Debt servicing will continue to be above EUR 1 billion in the coming years. This amount includes repayments of principal and interest payments, as well as prepayments.

Simultaneously with the transaction purpose becoming a secondary goal, supporting the implementation of monetary policy was made the primary objective of reserve management. An adequate level of reserves is one of the guarantees for the credibility of the exchange rate regime, which, if necessary, supports the system of inflation targeting in the form of interventions, and the fulfilment of the Maastricht exchange rate criteria on the way to joining the EMU. Within the framework of supporting monetary policy implementation, the Bank did not conduct interventions in the interbank foreign exchange market in 2002.

Although the costs of holding reserves have fallen significantly with the improvement in Hungary's credit rating, the Bank still does not wish to maintain reserves purely for the purposes of accumulating wealth.

Investment policy

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

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

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

Within its foreign exchange reserves, the Bank distinguishes between liquidity and investment portfolios, in accordance with international practice. Its aim with holding a liquidity portfolio is to ensure daily liquidity, such as actual repayments of interest and principal and foreign exchange market intervention, and specific transactions and transfers. This portfolio can be characterised by low interest rate risk and a short-term investment horizon. The investment portfolio, accounting for a higher share of total reserves, is that part of reserves which is intended to be held stable over the long term; therefore, it is related to more pronounced return requirements than the liquidity portfolio of reserves. Although it is a basic requirement of the investment portfolio that securities should be easily marketable, its stable composition makes it possible to invest for longer average durations, depending on market outlook.

Optimising the percentage shares of the two portfolios, the Bank held 20% of its reserves in the liquidity portfolio and 80% in the investment portfolio in 2002.

Preparations for EMU membership

Since the late 1990s, the MNB has been developing its foreign exchange reserve management activity in preparation for joining the European Monetary Union. In 2002, the European Central Bank established formal contacts with the central banks of central European countries aspiring for EMU membership and, as a first step, it assessed the preparedness of the institutions involved. The ECB's examination covered domestic open market operations and the related settlement and risk management activities, in addition to reserves management. According to the findings of the survey, the MNB, together with the majority of accession-country central banks, is adequately prepared, and there are no backlogs in any of the major areas. During 2003, the MNB's representatives have been attending the work of the ECB's Market Operations Committee as well, in the framework of an increasingly close co-operation.

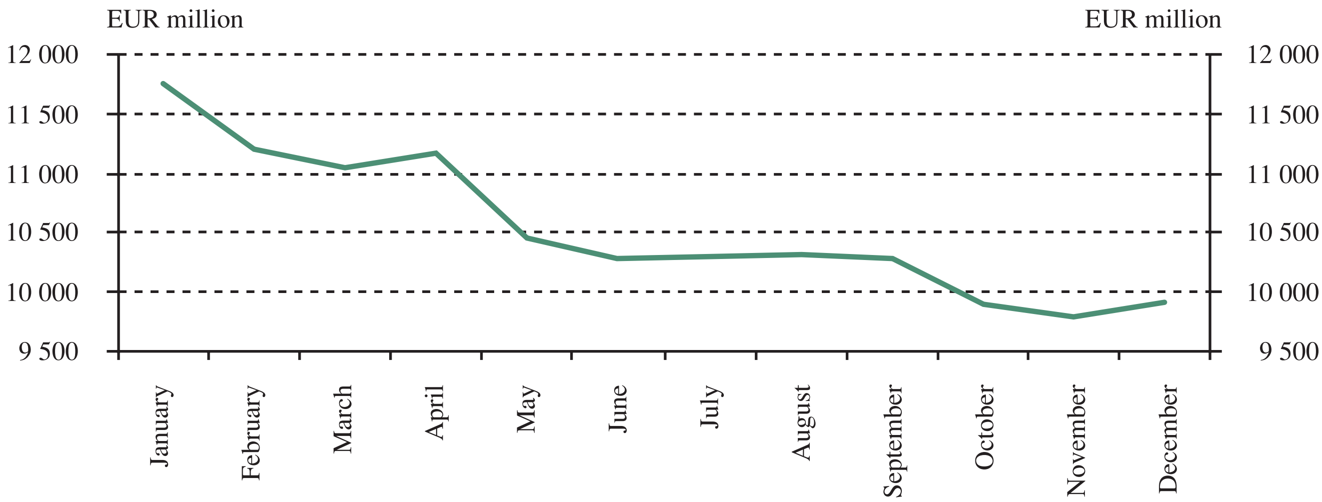
Adequacy of reserves

Consistent with the Bank's strategy formulated early in the year, foreign exchange reserves fell almost continuously, declining from EUR 11.7 billion in early 2002 to EUR 9.9 billion towards year-end. *(see Chart I-6)*

The following capital flows shaped movements in foreign exchange reserves in the year under review. The repayment of nearly EUR 2 billion medium and long-term loans jointly by the state and the Bank was the major cause of the decrease in reserves. Contributing to this was a EUR 400 million fall arising from marking-to-market the derivative transactions (swaps) related to debt servicing by the Hungarian State and the MNB. Increasing reserves were the EUR 500 million return earned on the Bank's portfolio and drawings by the State from the EIB in the amount of nearly EUR 150 million. The more than 15% strengthening of the single European currency against the US dollar reduced the euro equivalent of foreign exchange reserves by around EUR 200 million.

In 2002, the MNB continued to make attempts to maintain reserves at a level adequate for efficiently supporting the set monetary policy objectives, while meeting

***Chart I-6* Official foreign exchange reserves in 2002**



the requirements of debt servicing. The calculations reviewed by the Monetary Council showed that, considering the 2002 circumstances, the safe level of foreign exchange reserves should be at least EUR 9 billion to ensure the safe conduct of monetary policy. The actual level of reserves fulfilled this condition throughout the whole year.

CURRENCY ISSUING ACTIVITIES IN 2002

One of the fundamental tasks of the Magyar Nemzeti Bank is to provide banknotes and coins in a satisfactory amount, quality and composition of denominations for the national cash turnover. The Bank performed this task both at the Main Cashier's Desk in Budapest and at the cashiers' desks in the regional directorates to the full extent in 2002.

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

Cash turnover and processing activity

In 2002, the Main Cashier's Desk of the Magyar Nemzeti Bank, together with the cashiers' desks in the regional directorates, registered a turnover of HUF 3,521 billion. This was 3% higher than turnover in 2001. The rise in the value of the cash in circulation was not accompanied by a similar rise in that of central bank cash turnover, the reason for that being that participants in cash turnover traded cash among themselves to an increasing extent.

In 2002, including exchange transactions, customers paid 343 million banknotes into the cash desks of the Bank, in a total value of HUF 1,680 billion. This was 3% and 4% higher, respectively, in terms of quantity and value than in the previous year.

In 2002, including exchange transactions, 353 million banknotes entered circulation, in a total value of HUF 1,819 billion. This represented an approximately 3% increase in terms of both quantity and value relative to the previous year.

Each banknote passed through the Bank's processing units 1.6 times on average in 2002, which represents a slight decline relative to the corresponding figure of the previous year. Given this fact, as well as the rise in the volume of banknotes in circulation, the proportion of cash processing outside the Bank rose from 77% in 2001 to 81% in 2002. The new series of banknotes are of good quality and properly protected against counterfeiting. Cash processing outside the Bank (subject to oversight by the Bank) and cash processing inside the Bank jointly guaranteed satisfactory quality and the authenticity of the banknotes in circulation.

Currency in circulation

The total value of currency in circulation was HUF 1,270.9 billion at the end of 2002, up 12.5% on the previous year's end. The annual average growth of currency in circulation amounted to 20%, the rate of growth being 9 percentage points higher than in 2001. Such vigorous growth was brought about by a similar rate of increase in net wages, as well as a pick up in housing construction and in the number of real property purchases. Government measures to abolish anonymous deposits and falling inflation also have a likely effect on the increase in the amount of currency in circulation.

The average amount of banknotes and coins in circulation, over the year, as a percentage of GDP at current prices, rose from 6.7% in 2001 to 7.3% in 2002, owing to the considerable cash outflows. In 2002 the growth rate of currency in circulation exceeded that of GDP at current prices by nearly 10 percentage points, whereas it was down 2 percentage points in the preceding year. (This ratio was between 3% and 7% in the majority of EU member states prior to cash changeover.)

During the year changes in the value of banknotes and coins in circulation showed similar seasonal fluctuations as in the previous few years – the lowest values were measured in late January, the highest ones in December, prior to the Christmas holiday. A share of currency that entered circulation because of early month wage outflows returned to the Bank by the middle of month. The growth rate of currency in circulation, at 24%, was the highest in August. Compared to late November figures, cash turnover increased by HUF 115 billion in December, owing to the approaching Christmas holiday.

In 2002, the average amount of forint cash per capita was HUF 119 thousand, the number of banknotes and coins being 22 and 183 respectively. The value of banknotes and coins per capita rose by 20% relative to the previous year, the number of banknotes and coins increasing by 2 and 18, respectively. (At the end of 2002, the number of euro banknotes per capita in the euro area was nearly 27, that of euro coins being around 130.)

Within cash for circulation, banknotes and coins accounted for 98% and 2%, respectively in 2002, broadly comparably with earlier years. *(see Chart I-7 and Chart I-8; Table I-2)*

Banknotes in circulation

The average value of banknotes in circulation amounted to HUF 1,162 billion over the year and it showed a

Chart I-7 **Annual average amount of banknotes and coins as a percentage of GDP at current prices**

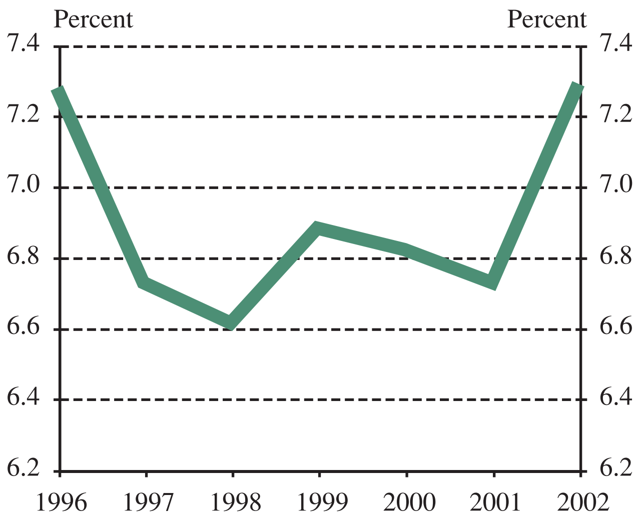
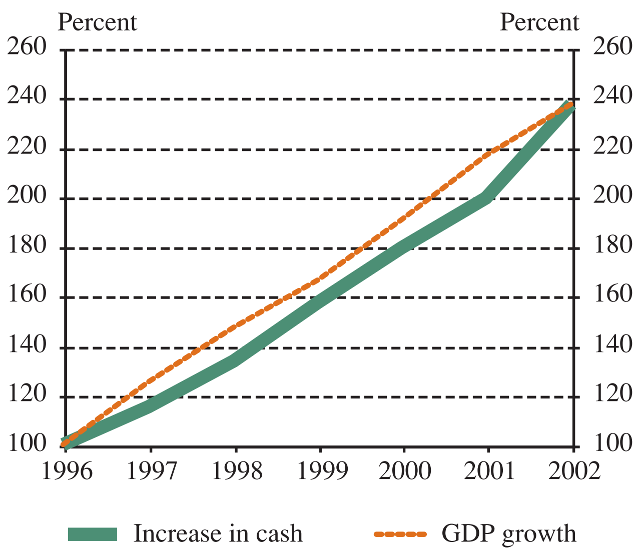


Chart I-8 **Increases in GDP at current prices and the annual average amount of banknotes and coins on a 1996 base**



19.9% increase relative to 2001. The average number of banknotes increased by only 9.3% – due to the higher percentage share of the 20,000 forint banknote, the use of which continued to gain ground in 2002. Its percentage share within the total number of banknotes rose from 4.3% at year-end 2001 to 6.7% at year-end 2002, while its percentage share within the total value during the same period rose from 16.8% to 24.3%. As regards the number and value of notes in circulation, the 10,000 forint banknote continued to account for the highest percentage share, although its percentage share with respect to the values diminished relative to a year earlier.

The average value of denomination (i.e. the value of the banknotes in circulation/the number of the banknotes in circulation) of the banknotes in circulation at year-end 2002 was HUF 5,504 representing an 8% increase from a year earlier. The average value of denomination of the euro banknotes in circulation at year-end 2002 was EUR 44 (HUF 10,384). *(see Table I-3)*

Coins in circulation

The number of coins in circulation was 1933 million, and this indicates a rise by 192 million or 11% at end-2002 in comparison to the end of the previous year. 70% of the increase was accounted for by the stronger-than-average rise in the number of coins with small (1 or 2-forint) denominations. The value of coin in circulation was HUF 1.9 billion, or 9% higher in 2002 relative to the previous year, the rate of increase slightly exceeding the previous year's.

The breakdown of coins in circulation by denomination showed no significant changes with respect to the number and the value in 2002 in comparison with 2001. *(see Table I-4)*

Table I-2 **Banknotes and coins in circulation on the last business day of 2002**

	2001	2002	Change	
	HUF billions			%
Banknotes	1105.8	1245.4	139.6	112.6
Coins	21.1	23.0	1.9	109.0
Cash for circulation	1126.9	1268.4	141.5	112.6
Commemorative notes and coins	2.3	2.5	0.2	108.7
Cash circulation	1129.2	1270.9	141.7	112.5

I.

Table I-3 Banknotes in circulation on 31 December 2002

Denomination	Quantity	Value	Percentage share	
	millions	HUF millions	Quantity	Value
20 000 forint	15.2	303 121	6.7	24.3
10 000 forint	72.1	721 160	31.9	57.9
5 000 forint	26.1	130 524	11.5	10.5
2 000 forint	15.6	31 217	6.9	2.5
1 000 forint	42.1	42 073	18.6	3.4
500 forint	20.9	10 444	9.2	0.8
200 forint	34.3	6 865	15.2	0.6
Total	**226.3**	**1 245 404**	**100.0**	**100.0**

Table I-4 Coins in circulation on 31 December 2002

Denomination	Quantity	Value	Percentage share	
	millions	HUF millions	Quantity	Value
100 forint	123.9	12 393	6.4	53.9
50 forint	67.3	3 364	3.5	14.6
20 forint	136.4	2 729	7.1	11.9
10 forint	166.3	1 663	8.6	7.2
5 forint	209.1	1 046	10.8	4.6
2 forint	561.6	1 123	29.0	4.9
1 forint	668.7	669	34.6	2.9
Total	**1933.3**	**22 987**	**100.0**	**100.0**

Chart I-9 Forint counterfeits: number of cases and quantity

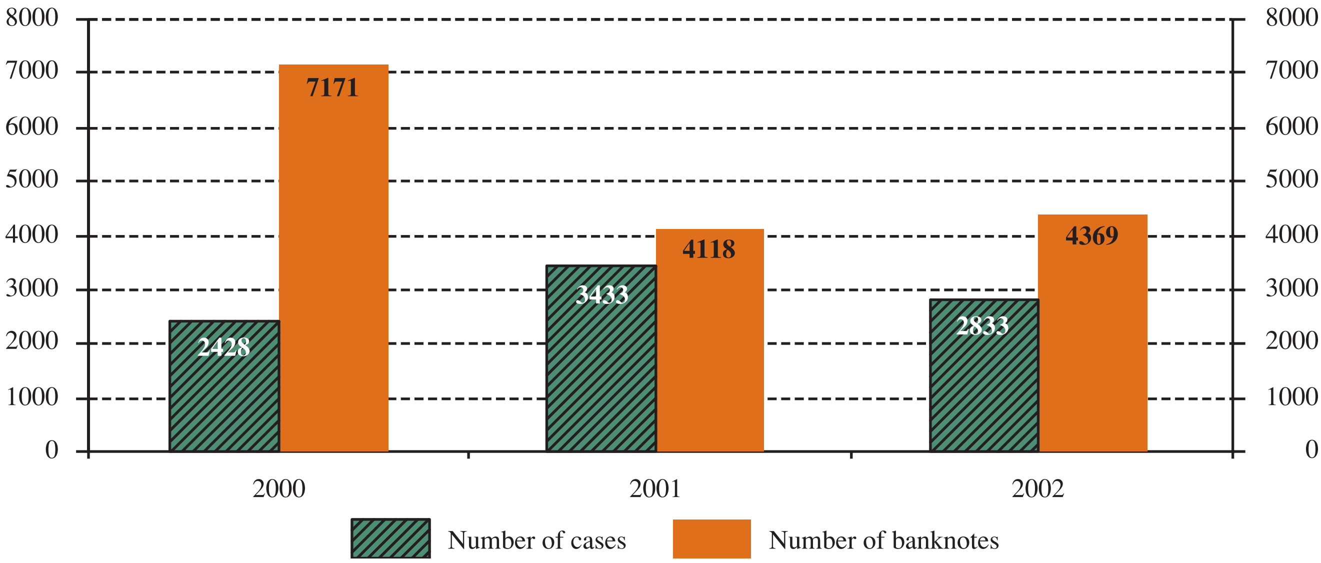
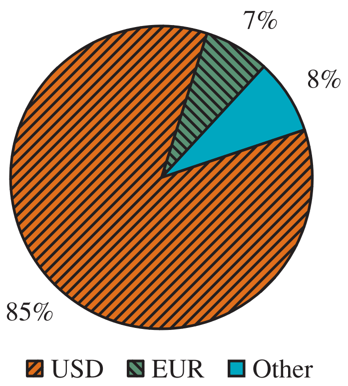


Chart I-10 **Foreign currency breakdown of counterfeits seized in Hungary in 2002**



Since the beginning of the launch of the new forint banknote series in 1997, 2002 was the third year when the banknotes of the old series were no longer involved in cash turnover. Owing to the new series with state-of-the-art security features and the developments implemented in due time, the number of counterfeits fell by nearly 40% in 2001 relative to the previous year. This level seems to have persisted, though by end-2002 the number of counterfeits slightly increased, while that of cases decreased.

The number of counterfeits in 2002 was 20 per 1 million banknotes in circulation, which is favourable even by European comparisons and which does not pose a threat to the security of currency turnover. This reflects the individual and unorganised nature of counterfeiting.

Table I-5

Commemorative coins issued in 2002	Face value HUF	Date of issue	Material	Issue limit in pieces
"200th Anniversary of Birth of Lajos Kossuth" jubilee circulation coin	100	1 February	steel	1 million
"The Hortobágy National Park"	3000	1 March	silver	10 thousand
"200th Anniversary of Establishing the National Széchényi Library"	3000	11 June	silver	6 thousand
"200th Anniversary of Birth of János Bolyai"	3000	5 July	silver	6 thousand
"The Chess"	500	20 September	base metal	10 thousand
"Message"	1000	21 October	base metal	15 thousand
"Rubik's Cube"	500	5 November	base metal	10 thousand
"100th Anniversary of Birth of Margit Kovács"	3000	29 November	silver	8 thousand

Analysing and development activities concerning banknotes and coins

The Bank performs across-the-country analysis and special investigation of suspected forint counterfeits and various foreign banknotes and coins. The legal basis for such activity is the 1929 Geneva Convention for the Suppression of Counterfeiting Currency, which entered into effect in Hungary in 1933. In 2002, in compliance with EU expectations, the Bank, through setting up a national unit of EUROPOL in Hungary, duly authorised by the ECB, established channels of information concerning euro counterfeiting. Preparation for creating a direct relationship following EU accession has also started.

In 2002, too, the Bank continued to carry out further development of the security features of banknotes. As a result of this work, the 2,000 forint note was printed with a feature fluorescing when exposed to ultra-violet light.

Compared to previous years, the number of counterfeit foreign currencies declined. However, that of seized counterfeits, due, mainly, to USD counterfeiting, increased by more than twice. Not surprisingly, the number of euro counterfeits rose following the introduction of the euro. Nevertheless, it was considerably lower in Hungary than that of legacy currencies, a fact that corresponded to the ECB's experience. Only 7% of all counterfeit foreign currencies seized in Hungary (i.e. 522 items) were euro counterfeits. In 2002, a total of

167 thousand euro counterfeits were seized, which was less than a quarter of the quantity of 12 legacy currencies seized by the relevant central banks in the euro area in 2001. *(see Chart I-9 and I-10)*

Issue of commemorative coins

In 2002, the Magyar Nemzeti Bank issued four silver, three base metal commemorative coins and one jubilee circulation coin. *(see Table I-5)*

STATISTICAL SERVICE

Legal background of the Bank's statistical activities

Act LVIII of 2001 on the Magyar Nemzeti Bank defines the collection of statistical information and the operation of an appropriate information system as one of the Bank's core duties. § 28 Chapter II of the Act also defines the range of institutions providing financial services that the Bank may directly mandate to report data. The MNB regulates the data reporting obligations of such institutions through passing resolutions.

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

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

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

Preparation for EU accession

Two important preconditions for joining the European Union are to adopt the statistical methodology recommended by the Union and to fulfil obligations related to data reporting and the provision of statistical information. In its statistical reports, the Bank endeavours to follow the harmonised methodological principles of international institutions. Meeting the data reporting requirements applied to EU Accession Countries, statistical reports are submitted regularly to EUROSTAT, and since 2002 the Bank has been reporting regularly to the European Central Bank (ECB). The range of these reports has been expanding continuously.

As regards the data disclosed, the fulfilment of data provision obligations necessitates the Bank's meeting the methodological requirements of the relevant institutions. Data providers' reports have been harmonised gradually with the requirements of the ECB since early 1999. Consistent with such efforts, in 2002 the Bank took further important measures to transform data collection.

In order to be able to consider and accept international recommendations and meet the requirements related to accession, the Bank ensures continuous presence at the various fora of EU institutions which affect the Bank's statistical activity and participates in the meetings of various international organisations such as the OECD, EUROSTAT and the ECB.

Statistical activity

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

The MNB's Statistics Department is responsible for the collection, processing and disclosure of the data pertaining to monetary and balance of payment statistics and financial accounts (a system of accounts recording the financial instruments and obligations, as well as any change in them, of the individual economic players) and the fulfilment of its obligation to disclose such data. In 2002 the Statistics Department issued press releases in the field of monetary statistics and Hungary's balance of payments on a monthly basis (similarly to the order of publications that was in effect in 2001). These included releases on the MNB's statistical balance sheet, on the consolidated balance sheet of monetary institutions and the developments in monetary aggregates, on forint interest rates of the non-financial corporate and household sectors and the money market, as well as on Hungary's balance of payments. In addition to those noted above, monthly press releases about the financial savings of households and quarterly releases on the distribution of securities holdings by sector were issued. These data are all required for the compilation of the financial accounts. The Bank is to launch the publication of a complete range of financial accounts in April 2003.

As part of its endeavours to bring its publication policy up-to-date, the Bank stopped issuing its *Monthly Report* in 2002. The Internet has become a primary vehicle for the publication of statistical data since July 2002. This has entailed widening the scope of the time series data on the Bank's website. The time series of monetary statistics, balance of payments statistics and household and securities data related to financial accounts, price and exchange rate data as well as all the press releases are accessible for users on the Internet.

Besides adapting EU requirements and to assist data providers in performing their duties, the Bank, while reviewing the reporting requirements in 2003, sought to provide a more straightforward structure for its reports. Furthermore, it also compiled reference tables displaying the interrelationships to be adhered to in the reports. In order to facilitate more understandable data reporting, the Bank provides practical guidelines in its manuals.

Effective from 2 December 2002, the Board of Directors decided on the restructuring of the Statistics Department in order that the Bank could perform its duties more efficiently. The essence of the organisational transformation is that, as part of the department, a separate unit is responsible for the entire process of data reception, processing and analysis-preparation related to statistical activity.

Major events affecting various areas of statistics in 2002

In the field of *monetary statistics*, a major overhaul of balance sheet and interest rate statistics was necessitated by pending EU accession. The transformation of the system of data reporting required by the MNB already commenced in 2001. The Bank has fully integrated ECB requirements concerning balance sheet statistics from 2003 onwards. In accordance with the relevant provisions of the ECB, the methodology of the collection of statistical data on interest rates has also been completely revised.

In *balance of payments statistics*, in line with the decision of the Monetary Council of the MNB and in co-operation with the Central Statistical Office, the preparation of the methodological changes necessitated by the inclusion of customs statistics, bringing travel accounts in line with national accounts as well as accounting for reinvested earnings got underway.

The Monetary Council also approved a new publication and data revision schedule for balance of payments statistics effective from 2003. The underlying reasons for the adoption of such a new schedule include compliance with international methodological standards on the one hand, and consistency with macro-economic statistical data, on the other. Accordingly, publications are to focus on quarterly rather than monthly data from 2003 onwards. Only data on international reserves and the balance of payments comprising the major aggregates will be published monthly; accordingly, stock data will no longer be provided. A detailed balance of payments as well as data on non-resident assets and liabilities will be compiled and published in an unchanged format on a quarterly and annual basis. The new schedule for publication goes hand in hand with changes in data revision. The Bank held a press conference on the methodological changes as well as the new publication schedule in November 2002.

The MNB deems the compilation of *financial accounts* fitting in the system of national accounts and the launch of regular data provision to be high-profile strategic tasks within its statistical activity. The compilation and publication of financial accounts as per international methodologies are also among the Bank's obligations stipulated by the statistical service. The methodology applied in and the schedule for the compilation of the accounts were finalised last year. As a result, the holding of unquoted shares and the breakdown of any change in such will be recorded as separate entries among the financial assets of the individual sectors. Moreover, the data reporting of financial and investment enterprises needed for the compilation of financial accounts has already commenced.

Though the accounts are to be published first in April 2003, other statistical service providing organisations were advised of the introduction of new types of statistics and related discussions were held with them as early as the second half of 2002.

As regards *statistics on securities holdings*, in order to enhance the reliability of the figures to be included in financial accounts, the recording of core data in the securities register on instruments unpublished in press releases on statistics on securities holdings was completed, and the manner in which the content of related reports is checked was established in 2002.

International data provision

In accordance with its position and the requirements arising from international co-operation as well as its membership obligations, the Bank provides regular data reports to the following international organisations, in addition to EUROSTAT and the ECB: International Monetary Fund (IMF), World Bank, Organisation for Economic Co-operation and Development (OECD) and the Central European Statistical Co-operation (CESTAT). The Bank provides data meeting the high-standard requirements of SDDS (Special Data Dissemination Standard) and applying the methodology recommended by various international organisations. In 2001, the Bank joined the database of the Bank for International Settlements. The preparation for data provision had been completed by the final months of 2002. Regular data provision for BIS is to commence in 2003. The adaptation of various applications (e.g. EDIFACT and GESMES) that will forward messages to ECB, EUROSTAT and BIS continued in 2002.

Co-operation with domestic institutions

In addition to the international organisations, statistical work in the Bank makes it indispensable to have close co-operation with domestic fellow institutions, particularly with the Central Statistical Office, the Ministry of Finance and the Hungarian Financial Supervisory Authority. Co-operation between the Bank and the CSO is based on an agreement concluded by the respective presidents of the two institutions on 8 February 2002. The two institutions define the areas of co-operation and actual tasks in an itemised agenda which is updated annually. Some of the high-profile items on the 2002 agenda were the additional elaboration of the methodology applied for the balance of payments and widening co-operation.

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

As far as monetary statistics is concerned, both the Bank and the Hungarian Financial Supervisory Authority request financial institutions to submit joint balance sheet reports as of early 1998. The co-operation agreement concluded by the Bank and the Hungarian Financial Supervisory Authority also covers information exchange and the co-ordination of other tasks.

FINANCIAL RESULT OF THE MAGYAR NEMZETI BANK AND ITS FINANCIAL MANAGEMENT

The Bank's income in a breakdown by functions*

The financial result of the MNB for 2002 amounted to a loss of HUF 4.9 billion and the balance sheet total stood at HUF 4,232 billion.

The financial statements of the Magyar Nemzeti Bank are primarily influenced by the objectives and instruments of monetary policy. Furthermore, management of the country's foreign currency reserves - with a view to increasing their value as part of the Bank's functions defined by law - also has a significant impact on the balance sheet and income of the central bank. As the rules on calculating exchange rate related profit were significantly changed in 2002, the following analysis gives revised values for 2001 to facilitate comparison. (For a detailed description of the change in regulations, see Notes to financial statements.)

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

Central bank seigniorage must cover the Bank's operating costs. The seigniorage adjusted for currency issue and banking operations costs amounted to a **profit of HUF 110.6 billion in 2002,** down by HUF 8.1 billion on a year earlier. The average stock of notes and coin in circulation increased by 13.2%, exerting upward pressure on the profit from seigniorage in contrast to the 2-percentage-point fall in forint interest rates on average, which exerted downward pressure. *(see Table I-6)*

Table I-6 **Profit of the MNB in a breakdown by function**

HUF billions

No.	Description	2001 adjusted	2002	Change
	(1)	(3)	(4)	(5) = (4)–(3)
1	Seigniorage	137.7	125.3	–12.4
2	Cost of currency issue	–4.4	–2.1	2.3
3	Net operating expenses**	–14.6	–12.6	2.0
4	**Adjusted seigniorage (1+2+3)**	**118.7**	**110.6**	**–8.1**
5	**Cost of fiscal activity undertaken on behalf the government**	**–2.0**	**–1.3**	**0.7**
6	**Cost of foreign currency reserves and liquidity management**	**–168.0**	**–103.0**	**65.0**
7	**Other (primarily revaluation reserves and capital)**	**–20.2**	**–11.2**	**9.0**
8	**Accounting profit** (4+5+6+7)	**–71.5**	**–4.9**	**66.6**

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

** *'Operating income' less 'Operating cost and expences' in the Profit and Loss Account.*

The impact of non-central bank functions on the balance sheet and the profit and loss account has steadily declined, due partly to the revision and elimination of the Bank's activities of this nature. The HUF 1.3 billion charge incurred on the Bank's participation in state financing is due to the fact that the Bank previously actively participated in providing development credit to the economy via lending to financial institutions and the Budget. The source of the forint loans was foreign currency borrowing from abroad. In 2002 the Bank continued the transfer of non-central-bank activities and the existing loans to the Hungarian Development Bank (MFB), which started in 2001.

The Bank incurred a total loss of **HUF 103.0 billion in connection with its functions of foreign exchange reserves management and liquidity regulation** (associated with the central bank monetary policy) *(see Line 6, Table I-6)*.

The loss primarily occurred because, due to previous interventions and sterilisation, the Bank's balance sheet began to include increasing amounts of market interest bearing forint liabilities against the country's growing foreign exchange reserves. This implies that the central bank was persistently forced to finance its lower interest bearing foreign exchange assets with higher interest bearing liabilities denominated in forint.

The Bank did not have to intervene in 2002. Debt servicing reduced the amount of foreign exchange reserves and, simultaneously, liquidity absorbing liabilities. This process gained further momentum from a drop in the interest rate spread, when the yield on the foreign exchange reserves fell by 0.7 of a percentage point while the average interest rate on counterpart forint liabilities fell by 1.9 percentage points.

The HUF 11.2 billion relative cost incurred on **other items** *(Line 7, Table I-6.)* was due to missing interest income on non-interest bearing assets.

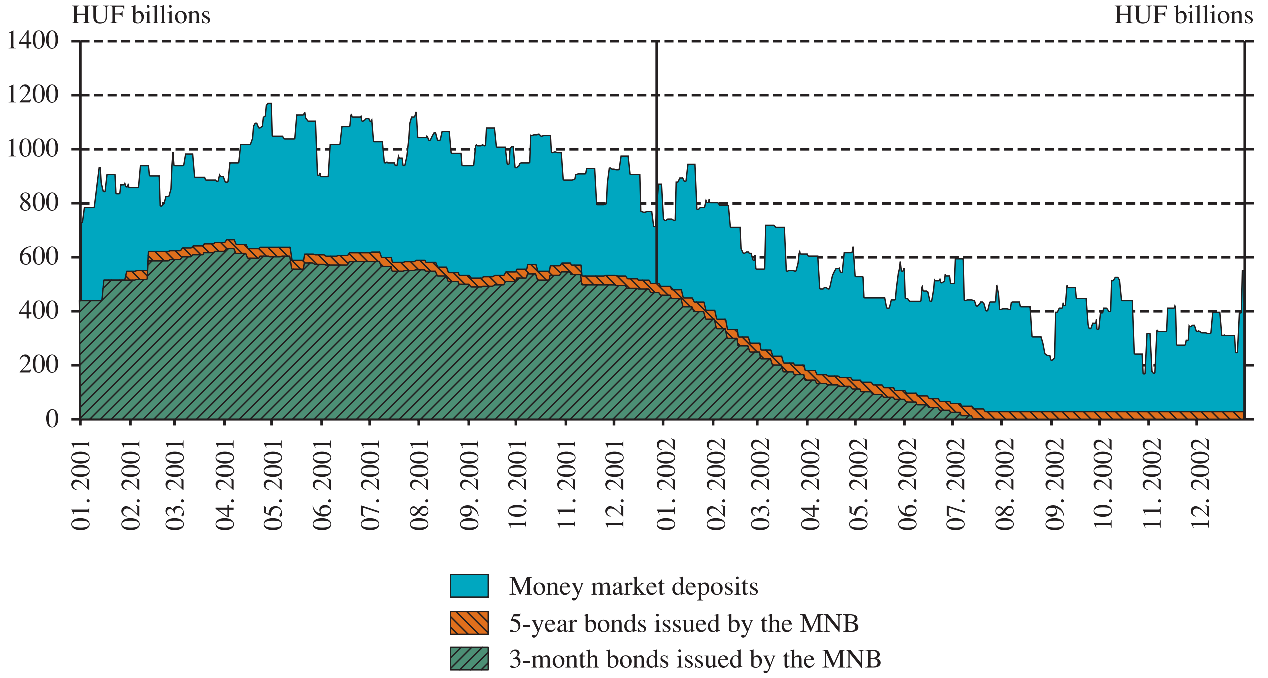
I.

Measures and events affecting items on the balance sheet

The structure of the Bank's balance sheet was shaped essentially by macroeconomic developments and monetary policy measures implemented over the past few years. The key factors affecting the balance sheet in 2002 were as follows:

- Changes in the exchange rate of the forint,
- Financing the government's foreign exchange liabilities to the MNB by forint funds, converted to foreign currency at the MNB,
- Repayment by the Budget of the MNB's negative balance of equalisation reserve of HUF 250 billion for 2001,
- maturity of the foreign currency debt that was transferred partially to the state,
- reduction in the rate of credit institutions' mandatory reserves, and

Chart I-11 **Sterilisation instruments in 2001 and 2002**



I.

– assumption of a certain portion of the refinancing credit by the Hungarian Development Bank (MFB).

The exchange rate of the forint strengthened by 4.2% in the course of 2002, reducing the value of each foreign currency item in the balance sheet in terms of forint. This led to an non-realised revaluation loss of HUF 82.9 billion. This was reimbursed by the Budget to the MNB before 31 March 2003. Under the MNB Act, this reimbursement must be recorded in the balance sheet for 2002. Accordingly, the sum must be stated among the receivables from the central government.

Another key factor affecting the balance sheet in 2002 was an agreement between the MNB and the Budget on the forint renewal of a large portion of the government's maturing foreign currency debt. Thus, the central Budget used forint funds to finance the larger portion of its matured foreign currency debt, for which it purchased most of the foreign currency required for debt servicing and interest payments from the MNB. The Budget's foreign currency purchases and the change in exchange rates caused net foreign currency liabilities, derived as on-balance-sheet foreign exchange assets less foreign exchange liabilities, to fall by HUF 222 billion to HUF 1,844 billion (EUR 7.8 billion), relative to the end of the previous year.

In addition to the said foreign currency purchase, the Budget also had to finance the budgetary reimbursement arising from the MNB's HUF 250 billion negative balance of equalisation reserves for 2000 via an issue of forint-denominated government securities. This caused a drop in forint liquidity in the market, resulting in a reduction of HUF 323 billion in the Bank's liquidity regulating instruments. *(see Chart I-11)*

The stock of foreign currency receivables from the Budget fell by HUF 315 billion, due to maturities and the strengthening of the forint. On the liabilities side, there was a drop of HUF 679 billion in net foreign currency liabilities. In addition to the noted factors, this was caused by a change in net mark-to-market deposit accounts[3].

Repayment of foreign debt, foreign currency purchases by the Budget and mark-to-market deposits, together with exchange rate changes, caused foreign exchange reserves to fall by HUF 664 billion to HUF 2,340 billion (EUR 9.9 billion) at the year-end. *(see Table I-7)*

Currency in circulation grew by an annual average of 12.5% in 2002. The total value of currency in circulation amounted to HUF 1,271 billion at the year-end.

In addition to debt servicing, receivables from credit institutions were also reduced by the transfer of development

Table I-7

HUF billions

No.	Receivables	2001	2002	No.	Liabilities	2001	2002
1	Forint receivables from the government	389	394	7	Notes and coins in circulation	1 129	1 271
				8	Bank Account Deposits	421	366
	of which: receivables due to the forint exchange rate revaluaion reserve		83	9	Sterilisation instruments	878	555
				10	Forint deposits by central government	345	51
2	Foreign currency receivables from the government	1 167	852	11	Foreign currency liabilities to government and credit institutions	367	126
3	Refinancing credits	44	21	12	Foreign and other foreign currency liabilities	2 356	1 677
4	Foreign currency reserves	3 004	2 340				
5	Operating and ohter assets	849	625	13	Operating and other liabilities	204	166
				14	Equalisation reserves	–247	20
6	**Total assets (1+2+3+4+5)**	**5 453**	**4 232**	**16**	**Total liabilities (7+8+9+10+11+12+13+14)**	**5 453**	**4 232**

[3] Mark-to-market deposit accounts are associated with the change in the market value of certain derivative transactions, and are aimed at reducing credit risk. The fall of HUF 115 billion meant that due to various changes in exchange rates, the market value of such transactions conducted by the MNB fell relative to the end of last year. As a consequence, the counterparties had to maintain a smaller amount of deposits as collateral at the MNB.

refinancing loans to the MFB (by HUF 7 billion). The related assumption of foreign credit also pushed down foreign liabilities. Loans of this type are being gradually removed from the MNB's balance sheet as part of eliminating non-central-bank functions.

The change in the rules on the reserve requirement in August also affected the balance sheet of the MNB. The reserve ratio was reduced to 5% and part of the bank liabilities was removed from the reserve base, which caused a drop of HUF 55 billion in the reserves, relative to a year earlier.

Between December 2002 and balance sheet date, the most significant impact on the MNB's balance sheet and profit was associated with the reverberations of the speculative attack against the exchange rate of the forint in mid-January. The speculative pressure forced the MNB to buy euros at a rate at the stronger edge of the exchange rate band, which it sold in the most part in the course of January, February and March. The Bank made two cuts in the central bank base rate of 1 percentage point each, in addition to widening the interest rate corridor from 2% to 6%. As a result, the overnight deposit rate was lowered to 3.5%, and that on the two-week deposit and the Treasury Account (KESZ) to 6.5%.

Factors affecting profit and loss

Due to the changes in balance sheet items outlined above and forint and foreign currency interest rates, the **financial result recorded by the Bank for the year 2002 was a loss of HUF 4.9 billion, an improvement of HUF 66.6 billion** relative to the corrected result for the previous year.

The analysis of the financial result for 2002 required an adjustment in the base data on account of a change in evaluation and profit accounting rules. The legal amendment which entered into force on 1 January 2002 affected the allocation of the revaluation effects, arising from changes in the exchange rate of the forint, between profit and loss account and equalisation reserves. Furthermore, the amendment introduced the market revaluation of foreign exchange securities not included within the foreign exchange reserves. (Notes to financial statements presents the amendment to the legal provision and its impact at more length.)

This regulatory change had a major impact on net income: while representing a worsening of HUF 8.5 billion relative to the official figure for the previous year, it was an improvement of HUF 66.6 billion relative to the data for 2001 adjusted for the effect of the amendment. The following analysis presents the MNB's profit and loss with the adjusted data for 2001, in order to facilitate comparison. *(see Table I-8)*

The most important constituent of the income change was the improvement in interest income, arising primarily from a drop in the stock and interest rate level of instruments that absorb liquidity.

The Bank incurred a net **loss** of HUF 16.1 billion **on interest and interest related income in 2002,** relative to a loss of HUF 31.6 billion in the previous year.

The great volume of market interest bearing forint liabilities (such as instruments of liquidity regulation and government deposit accounts) and the fact that the interest on such liabilities far exceeded the average

Table I-8

HUF billions

	Description (P/L lines)	**2001.** I–XII	**2001.** adjusted*	**2002.** I–XII
1	Net interest and interest related income (I+II)–(X+XI)	–31.6	–31.6	16.1
2	Income arising from exchange rate changes (III–XII)	55.1	–20.0	–3.4
3	Other constituents of net income** (IV+...+VIII)-(XIII+...+XVII)	–19.9	–19.9	–17.6
4	**Profit for the year (1+2+3)**	3.6	–71.5	–4.9
	Equalisation reserve in the balance sheet			
5	*of which:*			
	– due to changes in foreign currency and precious metal prices (2001)	–250.2		
6	*– due to non-realized foreign exchange gain/loss*		–175.1	–82.9
7	*– due to changes in the market value of foreign currency securities*	2.8	16.6	20.0

* *Adjusted due to the changes in the rules of foreign excange revaluation from 1st January 2002.*

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

yield on counterpart foreign currency assets has resulted in negative interest income in net terms in the past few years. In 2002, the interest rate spread between foreign exchange reserves and market interest bearing forint liabilities significantly narrowed (by 1.2% to 5.2%), as forint interest rates fell considerably faster than international market rates. Due to factors presented in more detail in the section on balance sheet changes, the average level of market interest bearing forint liabilities fell (by almost HUF 493 billion) to nearly two-thirds of its previous level. As a combined result of all these developments the net interest income improved by HUF 47.7 billion, becoming positive.

In the course of the year, apart from the first three months, EUR foreign exchange market yields followed a downward trend, as in the previous year, causing the equalisation reserve to increase by HUF 5.6 billion, due to the higher market value of *foreign currency securities stated within foreign exchange reserves*. As of 1 January 2002, *MNB bonds* issued abroad and then *repurchased* had to be recorded in the balance sheet at market value, and the market value differential had to be recorded within the equalisation reserve. As a result, the equalisation reserve increased by HUF 11.6 billion in 2002, or, relative to the adjusted base, fell by HUF 2.2 billion. The equalisation reserve of foreign currency securities increased by a total of HUF 17.2 billion (or by HUF 3.4 billion relative to the adjusted base) to HUF 20.0 billion at end-December.

The income arising from exchange rate changes also improved relative to the adjusted income for 2001, thanks to changes in the forint exchange rate being more balanced than in the previous year.

The exchange rate of the forint against the euro strengthened by 4.2% during the year, to a rate 14.56% stronger than central parity. The MNB Act in force provided that, as of 1 January 2002, realised gain and loss arising from changes in the forint exchange rate had to be recorded under profit and loss, while the non-realised income had to be stated under the equalisation reserve component of equity.

Realised exchange rate loss amounted to HUF 3.4 billion, while calculated in accordance with the accounting rules effective this year, realised income for 2001 would have amounted to a loss of HUF 20.0 billion.

Due to a non-realised loss arising from foreign currency exchange rate change, the net equalisation reserve was a negative value of HUF 82.9 billion. The net balance of the equalisation reserve at end-2002 implied that under the terms of the MNB Act, the central government would have to reimburse this amount by 31 March 2003. Therefore, this item was recorded among the receivables from central government in the annual balance sheet. (This claim was settled by the central government in March 2003.)

Net expenses arising from **other factors of income** amounted to HUF 17.6 billion, down by HUF 2.3 billion on the previous year. In particular, the operating costs of banking operations moderated by HUF 1.8 billion, due primarily to stringent management of operating expenses.

General information concerning internal operations in 2002

The internal operations of the Bank are essentially aimed at providing the resources required for high quality fulfilment of the responsibilities as prescribed by the MNB Act and facilitating risk-free operations in the most cost-effective manner.

In the area of *operating costs,* rationalisation of the organisational structure and procedures launched in 2001 and continued in 2002 brought about significant savings. Calculated at 2000 prices, operating costs were nearly 25% lower than in 2000. *(see Table I-9)*

While the economising in 2001 was primarily implemented through eliminating non-central-bank operations and organisational units, 2002 was characterised by efforts to modernise procedures and improve efficiency.

The efforts taken to improve efficiency were as follows:

- Reorganising procedures modernising technologies in order to economise on live labour,

Table I-9

Description	2000	2001	2002
Operation costs (million HUF)	15 220	15 196	13 507
Nominal index (previous year = 100%)	111%	100%	89%
Inflation (yearly average)	110%	109%	105%
Change in real terms (previous year = 100%)	101%	92%	85%
Change (2000 = 100%)	100%	92%	77%

Table I-10

Description	Actual data for 2001	Budget for 2002	Actual data for 2002	Index (2002 actual/ 2002 plan)	Index (2002 actual/ 2001 plan)
	(1)	(2)	(3)	(3)/(2)	(3)/(1)
1. Personnel expenses	9 837	9 794	9 057	92%	92%
2. General operation costs	5 359	4 948	4 450	90%	83%
Total	**15 196**	**14 742**	**13 507**	**92%**	**89%**
Change in real terms					***85%***

- Curbing current costs of operations via implementing various development projects,
- Increasing price efficiency via applying modern procurement procedures.

The budget for *investment projects* to be implemented in the course of 2002 amounted to HUF 3,036 million. A number of comprehensive and large-scale projects were launched, mostly for terms longer than one year. Consequently, the majority of related financial settlements were carried over to the year 2003.

Thanks to competition in procurement, the Bank also economised on suppliers' costs, relative to the budgeted amounts.

Operating costs

The operating budget for 2002, approved by the Board of Directors, amounted to HUF 14,455 million, in addition to a central reserve of HUF 1,000 million to cover unforeseeable expenses. The budgeted amount was later revised up to HUF 14,742 million, with the rise covered from the reserve.

The actual operating costs amounted to HUF 13,507 million in 2002. Thanks to the modernisation of procedures, costs were curbed significantly, falling by 15% in real terms compared with 2001. *(see Table I-10)*

The savings affected each major cost category:

- Staff-related costs were curbed through a reduction in numbers employed,
- The savings on general operating costs (such as IT and operations) were achieved primarily through redefining the service levels required for operations and the general adoption of competition in procurement.

Personnel costs

In 2002, annual personnel costs (HUF 9,057 million) decreased altogether by 8% relative to 2001 as a result of two factors at work within this cost group as a whole:

- a fall in average numbers employed exceeding 15% owing to streamlining and rationalisation and
- an average rise of 8% in basic wages, implemented in 2002. *(see Table I-11)*

The number of the persons in employment at the Bank dropped from 1,163 to 984 in 2002. As a result of the measures taken, the average headcount fell by 15.1%. There were 179 fewer persons in employment than at end-2001. Interdepartmental transfers were considerable (18.4%) because of organisational upgrading and task rationalisation.

Table I-11

Description	2000	2001	2002	Difference (2002/2001)	
	(persons)	(persons)	(persons)	(persons)	(%)
Closing headcount	1 316	1 163	984	–179	–15
Average headcount	1 361	1 246	1 058	–188	–15

In 2002, the employment of 237 persons was terminated, with 184 initiated by the employer. Of the instances of termination initiated by the employer, 141(76.6%) were redundancies related to restructuring. The remaining 43 had to do with either measures to improve efficiency or replacement with better qualified staff members. The Bank entered into employment contract with 70 new employees in 2002 in order to either replace those whose employment had been terminated or – in some cases – satisfy increased demand for manpower in certain areas.

The number of high-ranking officials fell by 133 in 2002, which was mainly (112 persons, i.e. 84%) attributable to the changeover to HAY. As a result of this changeover, positions such as independent head of department and head division were abolished and various others (e.g. consultancy) were also excluded from the category of executives.

There was no material change in the composition of employees in terms of their academic background. Fluctuation led to a slight decrease in the number of employees with primary and/or secondary education. There was a minor shift in the composition of the MNB's manpower towards higher HAY levels. The average length of employment dropped by 0.5 of a year to 11.8 years.

As a result of headcount reduction, the costs (HUF 9,163.8) included in the HR's budget decreased by nearly 7% in 2002 relative to 2001.

General banking operation costs

In 2002, general banking operation costs (HUF 4,450 million) fell by a total of 17%, relative to 2001.

This included a 21% drop in IT costs (to HUF 751 million). The levels of IT services having been redefined, such drop was discernible in each cost component. Redefining the levels of IT services, which followed organisational and task rationalisation, entailed a survey of user demand, on the one hand, and a survey-based revision of the required level of service provided by supplier, on the other.

Operating costs fell by HUF 318 million (18%) compared with the previous year. This decrease was due to the restructuring of the Bank's operation, the divesting of unnecessary banking functions, resulting headcount reduction and the introduction of announcing calls for applications. As a result,

– property-related costs fell by nearly 19%,

– costs of stationery for and repair of machines and equipment (e.g. copiers, fax machines and other office equipment) by nearly 17%,

– vehicle maintenance costs by 26%,

– telephone and postal service fees by 28%,

– office stationery costs by nearly 30%.

Depreciation (HUF 1,865 million) decreased by 22% in 2002, compared with the previous year. The reason for this is that tangible and intangible fixed assets are depreciated evenly on an ongoing basis. At the same time, the number of capital investments dwindled in 2002 and the period leading to it.

Other costs (e.g. fees charged by authorities, membership fees, legal costs, auditing, economic counselling, communication, entertainment costs, business trips, etc) amounted to HUF 626 million in 2002, which is approximately the same as the corresponding figures for 2001.

Capital investments

The management approved the investment budget for 2002 in an amount of HUF 3,036 million, which also included interim modifications. *(see Table I-12)*

The total amount of development expenditure in 2002

Table I-12

Investment programmes	Budget for 2002	Development expenditures			Difference
		Actual data for 2002	Re-scheduled to 2003	Total	
	HUF millions				
	(1)	(2)	(3)	(4)=(2)+(3)	(5)=(4)–(1)
Modernisation of information technology	1 276	528	567	1 095	–181
Logistics and other investment and acquisitions	1 760	445	1 168	1 613	–147
Investment programmes, total	**3 036**	**973**	**1 735**	**2 708**	**–328**

was HUF 2,708 million, of which HUF 973 million had been paid prior year-end 2002. The remaining amount is to be paid in 2003 for capital investments launched in 2002 and to be completed in 2003.

Savings can be attributed partly to favourable prices bargained in tendering processes and partly to cancelling minor investment projects rendered unnecessary by enhancing the functions of the projects in progress.

Modernisation of information technology

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

Of *the tasks aimed at developing IT infrastructure*, the switchover to a new version of the operating system that runs PC work stations to be completed early in 2003 was crucial. The next major task is *enhancing IT system surveillance* (the establishment of an internal firewall system and the procurement of equipment that can signal illegal intrusion to the system and analyse vulnerability).

Top priorities in *the development of integrated operating systems* include

- revamping the system of international payments (to be completed in the first half of 2003) and

- the replacement of obsolete system components and changeover to a new version of the business information system in the dealing room.

Other IT projects also include the establishment of the Bank's electronic filing system. In the first stage of this project in 2002, a filing office was put in place. The IT system will be set up in 2003.

Logistics and other investments and procurements

Similarly to the past years, the majority of the capital projects aimed at *the preservation of the general repair and the technologically upgrading of property*. In 2002, the following high-profile investment projects were completed:

- the establishment of an entry system that also doubles as a record-keeping system of working hours on the central premises,

- the upgrading of various bank security systems (e.g. fire protection, break-in signals and video surveillance) and

- the replacement of the air-conditioning system in the central computer room.

The capital projects launched in 2002 also included the establishment of a visitors' centre in the old cashier's room. The current reference library as well as the numismatic museum and show room will also be housed in the visitors' centre. This project is to be concluded in 2003.

2002 was the year of preparation as regards the establishment of the Bank's new Logistics Centre. The building site was selected and preparations were made to buy it. Relying on a feasibility study covering the entire scope of the project, the Bank's management will decide on its implementation and schedule in the first half of 2003.

Human resources management

The HR management policies and systems introduced in 2002 were significantly influenced by the following factors: the Bank's medium-term institutional objectives, desirable organisational features and values (respect for the individual and expertise, striving for excellence, open-mindedness and co-operation in the interest of common objectives) defined in the course of the development of the Bank's organisational culture and by cutting-edge HR management policies adopted by central banks in the EU.

The vacancies attributable to the Bank's recruitment policy in 2002 were filled with Bank employees rather than candidates from the external labour market. The main criteria of selection included suitability for the job, excellent academic and professional track records and experience.

In 2002, a new system of work performance management was adopted, the objectives of which are more efficient management of work performance, enhancing employee incentives and an objective and work performance-based system of remuneration.

The Human Resources Department worked out the Bank's career management system in 2002. As a result, career development committees responsible for top and mid-management recruitment are already in place. Numerous bank employees participated in what is called career development interviews aimed at mapping personal ambitions, career orientation and long-term Bank-related visions. Certain top management promotions in 2002 were based on the principle according to which mid- and top management vacancies should be filled with talented top-notch employees who are spurred by personal ambitions and are committed to the Bank's objectives.

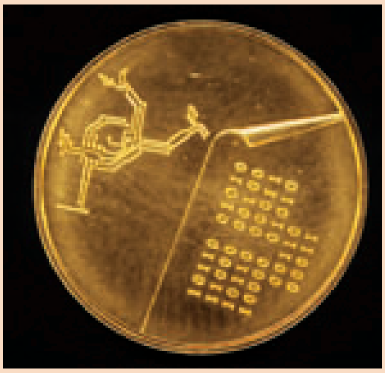
In addition to the system training that had been in place prior to 2002, management training and 'custom made' courses aimed at developing individual skills were new features last year. Revamped language and IT courses remained popular. Conferences and seminars organised by various central banks continued to attract a vast audience. At the same time, domestic fora were also popular with the staff. The 'custom made' courses aimed at developing individual skills were based on the personal goals included in the individual annual work performance schedule.

2002 was the first year in the history of the Bank when employee satisfaction was surveyed. Based on the results of the survey, mainly HR-related management actions to be taken at a 2-3-year horizon were worked out in order that desirable working environment features could be established and employee satisfaction boosted. Such surveys will be the order of the day in the future so that working environment-related opinions can be invited and the success of accomplished actions evaluated.

The Bank provided its outplacement services and financial support for those affected by compulsory redundancy made in the interest of streamlining and enhanced efficiency, on the one hand, and owing to activities that had been phasing out, on the other.

Part II.

Audited Financial Statements of the Magyar Nemzeti Bank


MAGYAR KÖZTÁRSASÁG
1000
Forint
BP.
2002


MAGYAR
KÖZTÁRSASÁG
3000
FORINT
2002


200

KOSSUTH
LAJOS
1802
1894

KOVÁCS MARGIT
1902-2002

MAGYAR
KÖZTÁR
-SASÁG
500
FORINT


KEMPELEN FARKAS SAKKAUTOMATÁJA
1 7
6 9

200 ÉVES AZ ORSZÁGOS SZÉCHÉNYI KÖNYVTÁR

MAGYAR KÖZTÁRSASÁG
3000 FORINT

MAGYAR
KÖZTÁRSASÁG
500
FORINT
2002·BP.
A B C D E F G H

Independent Auditor's Report

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This is a translation of the Hungarian report

Independent Auditors' Report

To the Shareholder of Magyar Nemzeti Bank

We have audited the accompanying balance sheet of Magyar Nemzeti Bank ("the National Bank") as at December 31, 2002, which shows a balance sheet total of HUF 4,231,926 million and a loss for the year of HUF 4,886 million, the related profit and loss account for the year then ended and the notes included in the National Bank's 2002 annual financial statements. The annual financial statements are the responsibility of the National Bank's management. The auditor's responsibility is to express an opinion on the financial statements based on the audit and to assess whether the business report is consistent with that presented in the financial statements.

The financial statements of the National Bank as of 31 December 2001 were audited by PricewaterhouseCoopers Kft whose report dated 22 April 2002, expressed an unqualified opinion on those statements.

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

We have audited the elements of and disclosures in the annual financial statements, along with underlying records and supporting documentation, of Magyar Nemzeti Bank in accordance with national audit standards and have gained sufficient and appropriate evidence that the annual financial statements have been prepared in accordance with the Act of LVIII of 2001, regulating the operations of the National Bank, and with the government decree of 221/2000 (XII.19.) regulating the accounting and preparation of the annual financial statements of the National Bank, and with the Hungarian accounting law and with generally accepted accounting principles. In our opinion, the annual financial statements give a true and fair view of the equity and financial position of Magyar Nemzeti Bank in accordance with the relevant regulations as at December 31, 2002 and of the results of its operations for the year then ended. The business report corresponds to the disclosures in the financial statements.

Budapest, April 17, 2003

Ernst & Young Kft.
Registration No. 001165

Mariann Hergovits
Registered Auditor
Chamber membership No.: 004648

Balance Sheet of the Magyar Nemzeti Bank, 2002

HUF millions

Note	ASSETS	31. 12. 2001	31. 12. 2002	Changes
	1	2	3	3–2
	I. RECEIVABLES IN FORINT	**430 369**	**413 420**	**–16 949**
V.3.	1. Receivables from the central government of which: receivables	389 458	393 970	4 512
V.14.	to refund the equalisation reserves due of the exchange rate changes*	0	82 890	82 890
V.7.	2. Receivables from credit institutions	40 186	18 697	–21 489
	3. Receivables from money issue and circulation	0	0	0
	a) Receivables from the Hungarian Post Administration	0	0	0
	b) Items in transit	0	0	0
	4. Other receivables	725	753	28
	II. RECEIVABLES IN FOREIGN CURRENCY	**4 789 003**	**3 644 566**	**–1 144 437**
V.9.	1. Gold and foreign currency reserves	3 004 098	2 340 223	–663 875
V.4.	2. Receivables from the central government	1 166 917	851 814	–315 103
	3. Receivables from credit institutions	4 202	2 148	–2 054
V.10.	4. Other foreign currency receivables	613 786	450 381	–163 405
	III. BANKING ASSETS	**24 504**	**23 652**	**–852**
V.12.	1. Fixed assets, intangibles, investments	23 500	22 828	–672
	2. Value adjustment	0	0	0
	3. Liquid assets	6	1	–5
	4. Other assets	998	823	–175
V.15.	**IV. PREPAID EXPENSES/ACCRUED INCOME**	**209 488**	**150 288**	**–59 200**
	V. TOTAL ASSETS (I+II+III+IV)	**5 453 364**	**4 231 926**	**–1 221 438**
Note	**LIABILITIES AND SHAREHOLDERS'S EQUITY**	**31. 12. 2001**	**31. 12. 2002**	**Changes**
1	2	3	3–2	
	VI. LIABILITIES IN FORINT	**2 791 898**	**2 284 171**	**–507 727**
V.5.	1. Central government deposits	344 752	50 862	–293 890
	2. Deposits by credit institutions	788 716	921 280	132 564
	3. Liabilities from money issue and circulation	1 130 314	1 271 081	140 767
	a) Notes and coin in circulation	1 129 247	1 270 851	141 604
	b) Items in transit	1 067	230	–837
	4. Other deposits and liabilities	528 116	40 948	–487 168
	VII. LIABILITIES IN FOREIGN CURRENCY	**2 722 819**	**1 803 360**	**–919 459**
V.5.	1. Central government deposits	208 057	33 538	–174 519
	2. Deposits by credit institutions	159 238	93 002	–66 236
V.11.	3. Other foreign currency liabilities	2 355 524	1 676 820	–678 704
	V.13. VIII. PROVISIONS	**0**	**0**	**0**
	a) For liabilities	0	0	0
	b) Other	0	0	0
	IX. OTHER BANKING LIABILITIES	**–237 396**	**9 479**	**246 875**
	Of which: – equalisation reserve due to exchange rate changes of FX and precious metals	–250 180	0	250 180
	– equalisation reserves due to market value changes of foreign currency securities	2 831	0	–2 831
V.15.	**X. ACCRUED EXPENSES/DEFERRED INCOME**	**135 181**	**102 280**	**–32 901**
V.16.	**XI. EQUITY**	**40 862**	**32 636**	**–8 226**
	1. Share capital	10 000	10 000	0
	2. Retained earnings	30 862	7 546	–23 316
	3. Valuation reserve	0	0	0
	4. Equalisation reserves of Forint exchange rates*	0	0	0
	5. Equalisation reserves of foreign exchange securities	0	19 976	19 976
	6. Profit per balance sheet	0	–4 886	–4 886
	XII. TOTAL LIABILITIES AND SHAREHOLDERS'S EQUITY (VI+VII+VIII+IX+X+XI)	**5 453 364**	**4 231 926**	**–1 221 438**

*Note: *Pursuant to the Act on the NBH, Section 17, par. (4) in the case of a negative balance the central balance refunds the negative balance by March 31 of the year following the year related, which is to be booked in the balance sheet of the year related.*

17 April 2003

Zsigmond Járai

Profit and Loss Account of the Magyar Nemzeti Bank

HUF millions

Note	INCOME	2001	2002	Difference
	1	2	3	3–2
V.18.	**I. FORINT INTEREST AND INTEREST RELATED INCOME**	**47 279**	**32 020**	**–15 259**
	1. Interest income on receivables from the central government	40 028	29 008	–11 020
	2. Interest income on receivables from credit institutions	6 384	2 785	–3 599
	3. Interest income on other receivables	201	225	24
	4. Interest related income in forint	666	2	–664
V.18.	**II. FOREIGN CURRENCY INTEREST AND INTEREST RELATED INCOME**	**548 271**	**377 731**	**–170 540**
	1. Interest income on foreign currency reserves	158 250	108 796	–49 454
	2. Interest income on receivables from the central government	93 573	65 365	–28 208
	3. Interest income on receivables from credit institutions	198	128	–70
	4. Interest income on other receivables	10 500	10 861	361
	5. Interest related income in foreign currency	285 750	192 581	–93 169
V.19.	**III. INCOME ARISING FROM EXCHANGE RATE CHANGES**	**59 361**	**6 245**	**–53 116**
	IV.INCOME FROM MONEY CIRCULATION	**1 407**	**1 497**	**90**
	V. OTHER INCOME	**2 131**	**1 943**	**–188**
	1. Commission and fees received in forint	186	166	–20
	2. Commission and fees received in foreign currency	1 638	1 015	–623
V.22.	3. Ordinary and extraordinary income not included above	307	762	455
	VI. PROVISIONS RELEASED/USED	**21**	**0**	**–21**
	VII. DEPRECIATION	**10 893**	**886**	**–10 007**
V.23.	**VIII. OPERATING INCOME**	**853**	**1 020**	**167**
	IX. TOTAL INCOME (I+II+III+IV+V+VI+VII+VIII)	**670 216**	**421 342**	**–248 874**
Note	**EXPENSES**	**2001**	**2002**	**Difference**
	1	2	3	3–2
V.18.	**X. FORINT INTEREST AND INTEREST RELATED EXPENSES**	**161 578**	**93 228**	**–68 350**
	1. Interest expenses on central government deposits	35 309	27 051	–8 258
	2. Interest expenses on deposits by credit institutions	60 972	51 863	–9 109
	3. Interest expenses on other deposits	65 297	14 314	–50 983
	4. Interest related expenses in forint	0	0	0
V.18.	**XI. FOREIGN CURRENCY INTEREST AND INTEREST RELATED EXPENSES**	**465 558**	**300 436**	**–165 122**
	1. Interest expenses on central government deposits	6 309	4 012	–2 297
	2. Interest expenses on deposits by credit institutions	9 027	1 973	–7 054
	3. Interest expenses on other liabilities	153 551	97 766	–55 785
	4. Interest related expenses in foreign currency	296 671	196 685	–99 986
V.19.	**XII. EXPENSES RESULTING FROM EXCHANGE RATE CHANGES**	**4 239**	**9 600**	**5 361**
	XIII. EXPENSES RELATED TO MONEY CIRCULATION	**5 803**	**3 549**	**–2 254**
	XIV. OTHER EXPENSES	**13 479**	**5 270**	**–8 209**
	1. Commissions and costs recorded in forint	57	28	–29
	2. Commissions and costs recorded in foreign currency	3 298	3 802	504
V.22.	3. Ordinary and extraordinary expenses not included above	10 124	1 440	–8 684
	XV. PROVISIONS	**14**	**0**	**–14**
	XVI. DEPRECIATION	**485**	**489**	**4**
V.23.	**XVII. OPERATING COSTS AND EXPENSES**	**15 418**	**13 656**	**–1 762**
	XVIII. TOTAL EXPENSES (X+XI+XII+XIII+XIV+XV+XVI+XVII)	**666 574**	**426 228**	**–240 346**
	XIX. PROFIT FOR THE YEAR	**3 642**	**-4 886**	**–8 528**
	XX. Dividend payment from retained earnings	**24 090**	**23 316**	**–774**
	XXI. DIVIDEND PAID	**27 732**	**23 316**	**–4 416**
	XXII. PROFIT PER BALANCE SHEET (XIX+XX-XXI)	**0**	**-4 886**	**–4 886**

17 April 2003

Zsigmond Járai

Cash flow Statement

HUF millions

	Denomination	2001	2002
I.	**Cash flow arising from banking operations**		
1.	Net income before dividend payment (+profit/-loss)	3 642	–4 886
2.	Amortisation charge	2 324	1865
3.	Difference between provisions made and used (+making/-release)	–5 214	–398
4.	Change in accruals related to foreign currency and forint transactions (+increase/-decrease of receivables)	18 790	26 225
5.	Change in other assets and liabilities net of issued NBH securities and equalisation reserves (+net increase in assets)	–33 285	–24 393
6.	Dividend payable (-dividend payment obligation)	–27 732	–23 316
7.	Dividend payment from retained earnings	24 090	23 316
	Total operating cash flow	**–17 385**	**–1 586**
II.	**Cash flow from financial activities**		
1.	Change in forint receivables (-increase/+decrease)	325 672	100 299
2.	Change in forint liabilities (net of other liabilities, including NBH bonds) (+increase/-decrease)	128 924	–508 096
3.	Change in other foreign currency receivables (-increase/+decrease)	493 017	480 532
4.	Change in foreign currency liabilities / (+increase/-decrease)	–920 797	–919 459
5.	Change in equalisation reserves (+increase/-decrease)	–202 676	184 435
	Total cash flow from financial activities	**–175 860**	**–662 289**
I.+II.	**Change in foreign currency reserves (+increase/-decrease)**	**–193 245**	**–663 875**

NOTES TO FINANCIAL STATEMENTS

THE BANK'S ACCOUNTING POLICY

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

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

The following section is a short description of the accounting framework of the MNB, the valuation and profit recognition rules whenever different from general rules, as well as the impact of changes in legal provisions on the balance sheet and the profit and loss account.

Features of the MNB's accounting framework

One of the key principles of book-keeping at the MNB is that transactions initiated before the end of the current year are recorded at the point in time when they occur. This is especially important in view of the accurate determination of foreign currency gains and losses (see valuation rules), with special regard to foreign currency sales and purchases. Spot foreign currency transactions, involving translation of foreign currency, are stated in the balance sheet on the day of trade, and the receivables and liabilities arising from such transactions between the dates of trade and financial settlement are stated by the MNB as foreign currency assets. The same procedure is applied in recording the translation differential in the balance sheet relating to forward transactions for hedging purposes.

The MNB maintains daily accounting of

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

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

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

- a market revaluation of foreign currency securities,

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

- the recording of the amortisation charge.

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

Balance sheet date is 31 January 2003.

Under the law it is the MNB's duty to report to Parliament. The MNB submits one single report to both Parliament and the Ministry of Finance, which exercises the rights of ownership as laid down in the MNB Act. This is in the form of an *Annual Report*, which contains the MNB's annual financial statements as prescribed by the Accounting Act, and the business report describing the MNB's organisation, management and operations in the reviewed year. The *Annual Report* is published in full length both in printed format and on the Internet.

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

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

Major principles of valuation

Receivables from the central government

The securities stated among the receivables from central government are recorded in the balance sheet at purchase price less interest. The difference between the purchase price excluding interest and face value is stated in the MNB profit and loss account as exchange rate gain or loss in proportion to the time elapsed.

The receivables from central government also include receivables associated with the reimbursement of equalisation reserves. (For more on this, see the section on regulatory changes.)

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

Valuation of foreign currency assets and liabilities, and accounting for exchange rate gains

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

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

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

The daily accounting for accrued income is preceded by re-entering the accrued income of the previous day. This implies that foreign currency accruals are recorded in the balance sheet at the official exchange rate even without revaluation.

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

The realised income is created as a result of selling or buying foreign currency. The latter happens when the assets subject to translation are exceeded by counterpart liabilities in respect of a currency involved. The realised income arises as the difference between the value of the traded foreign currency at the official exchange rate and the average acquisition price.

Foreign currency securities

Foreign currency securities are stated at market price. The difference between the market value on translation day and book value is recorded in the equalisation reserve of foreign currency securities. The gain or loss realised on selling the securities is stated as interest-related income.

Securities issued by the MNB abroad and subsequently repurchased must be recognised at gross market value in the line of other foreign currency assets. The related interest is recorded under both income and expenses.

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

Accounting rules relating to the IMF quota

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

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

Accounting rules relating to derivative transactions

The MNB divides derivative transactions into two groups on the basis of transaction purpose, namely hedging transactions and derivative transactions for other purposes.

Hedging transactions are defined as those transactions that are aimed at reducing the the exchange and market rate risk of a specific asset or liability or position, are directly related to such and are marked 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 translation difference of foreign currency assets and liabilities arising from hedging transactions must be stated in the balance sheet (depending on their sign either in the line of other foreign currency receivables or liabilities, or foreign currency receivables from or liabilities to the central government), together with their interest in proportion to time (as accrued income or accrued expenses).

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

Banking assets and liabilities

The Banking assets and liabilities are stated in the balance sheet, including

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

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

- investments,

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

Depreciation rates applied by the Magyar Nemzeti Bank:

Description	31. 12. 2002
Intangible assets (excluding funding-restructuring)	33.0%
Funding-restructuring (maximal)	20.0%
Buildings	3–5%
Vehicles	20.0%
Telecommunication devices*	14.5%
Computer equipment	33.0%
Emission machinery	20.0%
Instruments	33.0%
Bank security devices**	33.0%

* *excluding mobile phones* *33%*
** *excluding guns, bullet-proof waistcoat, fire-extinguishers* *14.5%*

The table does not show the depreciation rates for rights representing money or money's worth, or rights associated with real property. This is because the Bank sets the depreciation rate applied on the basis of useful lifetime, or sets the same rate as that applying to the property involved or in terms of a contract. The depreciation rate for other unspecified assets is 14.5%. The Bank applies linear depreciation for each item.

The depreciation rates applied did not change relative to 2001.

The financial assets line of the MNB's balance sheet only includes the account balance related to employers' housing loans to employees by the National Savings Bank (OTP). The central bank is the issuer of notes and coin. Being not in circulation, the notes and coins stored in the Bank's teller office and depository are subtracted from the stock of banknotes and coins on the liabilities side ('Notes and coins in circulation').

Effect of changes in the legal framework on the profit and loss and the balance sheet

The MNB Act provisions entering into force on 1 January 2002, and the amendment to the MNB Decree led to the following regulatory changes in 2002:

– the methodology of calculating foreign exchange rate gains and losses, and of the related equalisation reserve,

– valuation of securities stated under the item called other foreign currency receivables, and consequently the composition of equalisation reserves for foreign currency securities,

– the presentation of equalisation reserves in the balance sheet, and

– the receivables from central government arising from the negative balance of the equalisation reserves.

Methodology to calculate exchange rate gains and losses and the relating equalisation reserve

In line with the harmonisation effort with the accounting rules applied by the EMU member countries, there was a change in the method of calculating 'the equalisation reserve arising from changes in the exchange rate and the price of precious metals'. In addition, the calculation of exchange rate gains and losses was also modified.

Previously, the exchange rate gain arising from official devaluation (that is the change in the central parity of the intervention band) had been stated in the income and the remainder of the exchange rate differential arising from foreign currency translation was stated in the equalisation reserve. Under the new rules, the gains and losses realised on the specific currencies are stated in the items constituting income, while non-realised income is stated in the equalisation reserve, which is a constituent of equity. Accordingly, the exchange rate gains and losses arising as a result of the daily translation are divided into realised and non-realised components. The breakdown is done on the basis of the average purchase price, which has to be determined with a daily frequency for each currency.

The difference between the change in the sum of foreign currency assets and liabilities revalued at the official exchange rate and their value calculated at the acquisition exchange rate is qualified as non-realised income. Such difference is therefore stated among the items constituting equity, more specifically the equalisation reserve of the forint exchange rate, rather than as income.

The realised income arises when the net foreign exchange position decreases (foreign currency is sold in net terms, or in the case of a negative net position, foreign currency is purchased in net terms) as the spread between the values of the currency sold (or purchased if the net position is negative) calculated at the official exchange rate of the transaction day of the transaction and the acquisition exchange rate.

Changes in the valuation of securities stated among the items constituting other foreign currency assets

While previously only the securities included within the foreign exchange reserves were stated in the balance sheet at market value, from 1 January 2002 all kinds of foreign currency securities are stated at market value. Consequently, the equalisation reserve relating to foreign currency securities also includes the differential between the market value and acquisition value of securities not included within foreign exchange reserves.

The position in the balance sheet of equalisation reserves and receivables linked to the reimbursement of equalisation reserves

In 2001, the equalisation reserves arising from changes in exchange rates and the market price of securities were stated in the line of other banking liabilities. In contrast, under the rules adopted in 2002 they are stated among the items constituting equity.

Pursuant to the MNB Act, the negative balance of the equalisation reserves are reimbursed by the central government by 31 March of the year following the reviewed year, and this has to be stated accordingly in the balance sheet for the reviewed year. In view of the fact that under the accounting rules the cash flow can only be accounted for in the year following the reviewed year, the derecognition of the negative balance of the equalisation reserve is only possible via stating it as a receivable from the central government.

As for recording negative equalisation reserves for 2001, based on an alternative offered by the amendment to the MNB Decree, the MNB stated the equalisation reserves as a negative liability. With this alternative terminated in 2002, the equalisation reserves were stated in the balance sheet line of receivables from the central government.

The effect of regulatory changes on income is illustrated in the table below, containing adjusted data for 2001 to facilitate comparison.

HUF billions

	Description (Profit/Loss line)	**Jan.–Dec. 2001**	**2001 adjusted***	**Jan.–Dec. 2002**
1	Net interest and interest related income (I+II)-(X+XI)	–31.6	–31.6	16.1
2	Income arising from exchange rate changes (III-XII)	55.1	–20.0	–3.4
3	Other constituents of net income** (IV+...+VIII)-(XIII+...+XVII)	–19.9	–19.9	–17.6
4	**Profit for the year (1+2+3)**	**3.6**	**–71.5**	**–4.9**
	Equalisation reserve in the balance sheet			
5	*of which: – due to changes in foreign currency and precius metal price (2001)*	–250.2		
6	*– due to non-realized foreign exchange gain/loss*		–175.1	–82.9
7	*– due to changes in the market value of foreign currency securities*	2.8	16.6	20.0

* *Adjusted due to the changes in the rules of foreign exchange revaluation from 1st January 2002.*

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

Had the rules effective in 2002 been applied in 2001, the net financial result of the MNB would have been a loss of HUF 71.5 billion instead of a profit of HUF 3.6 billion, while the deficit in the equalisation reserves would have been HUF 75.1 billion lower, that is a total of HUF 175.1 billion.

EFFECTS OF MACROECONOMIC TRENDS ON THE BALANCE SHEET AND PROFIT AND LOSS ACCOUNT OF THE MAGYAR NEMZETI BANK

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

A fall in the rate of interest on forint instruments reduces both the Bank's interest income and expenses. As interest-bearing liabilities denominated in forint exceed forint assets substantially, the effect of the reduction in the level of interest rates caused an improvement of HUF 18 billion in the Bank's income.

Due to a 4.2% strengthening of the forint, the value of foreign currency receivables and liabilities fell in forint terms. Consequently, the forint value of the foreign currency position fell by HUF 86.2 billion. Of this, the realised exchange rate loss of HUF 3.3 billion is stated in the profit and loss account, and the remainder is recorded, in accordance with the changes noted above, among the receivables from the central government in the balance sheet.

International interest rate levels at the maturities corresponding to those of the securities contained in the Bank's foreign exchange reserves fell overall in 2002, causing the interest income arising from foreign exchange reserves to fall by HUF 17.7 billion on the one hand, and the realised income of mark-to-market revaluation of foreign currency securities to improve by HUF 5.6 billion on the other. In accordance with the section on accounting policy, HUF 2.3 billion of the latter amount is stated as an improvement in the profit and HUF 3.3 billion in the balance sheet as an increase in the equalisation reserve.

RECEIVABLES FROM THE CENTRAL GOVERNMENT

HUF millions

B/S line	Term to maturity	31. 12. 2001	31. 12. 2002	Change
	Government bonds maturing within one year	5 053	361	–4 692
	Government bonds maturing within one to five years	361	20 000	19 639
	Government bonds maturing within five years	166 689	146 689	–20 000
	Securities	**172 103**	**167 050**	**–5 053**
	Loans maturing within one year	73 325	72 806	–519
	Loans maturing within one to five years	143 478	71 224	–72 254
	Loans maturing within over five years	552	0	–552
	Loans	**217 355**	**144 030**	**–73 325**
	Due to exchange rate changes*		**82 890**	**82 890**
I.1.	**Total**	**389 458**	**393 970**	**4 512**

** In line with the 2002-year rules*

The stock of government securities and loans to the government declined in accordance with the progress of debt servicing.

The receivables arising from the negative balance of the equalisation reserve of the forint exchange rate caused an increase of HUF 82.9 billion.

In 2002, there was no income from withdrawal of notes and coins, which caused related receivables from the central government to fall. (Under the MNB Act, the profit from withdrawal of notes and coins shall not be stated in the profit and loss account of the MNB. Instead, it shall be used for servicing the government's outstanding debt to the MNB.)

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

Maturity structure of foreign currency credits to the central government

HUF millions

Description	31. 12. 2001	31. 12. 2002	Change
Foreign currency receivables from the central government	**1 166 917**	**851 814**	**–315 103**
within one year	221 096	202 535	–18 561
within one to five years	624 377	480 968	–143 409
over five years	321 444	168 311	–153 133

The stock of foreign currency loans granted to the central government, related to the 'debt swap' implemented in 1997, decreased, due to repayments and the appreciation of the forint.

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

HUF millions

	Description	31. 12. 2001	31. 12. 2002	Change
1	**Foreign currency receivables from the central government (B/S line II.2.) (2+3+4)**	**1 166 917**	**851 814**	**–315 103**
2	USD currency group	167 418	33 182	–134 236
3	EUR currency group	330 092	334 999	4 907
4	JPY	669 407	483 633	–185 774

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

HUF millions

	Description	31. 12. 2001	31. 12. 2002	Change
1	**Swap receivables (2+3+4)**	**1 470 772**	**1 121 948**	**–348 824**
2	USD currency group	428 222	275 624	–152 598
3	EUR currency group	1 042 550	846 324	–196 226
4	JPY	0	0	0
5	**Swap payables (6+7+8)**	**1 594 953**	**1 127 984**	**–466 969**
6	USD currency group	885 131	590 297	–294 834
7	EUR currency group	40 415	54 054	13 639
8	JPY	669 407	483 633	–185 774
9	**Net swap receivables (1–5) (B/S line VII.1.)**	**–124 181**	**–6 036**	**118 145**

The hedging transactions with the central government are stated on either the assets or liabilities side of the balance sheet, depending on whether they have a debit or credit balance. In 2001 and 2002, long-term currency swaps were stated on the liabilities side in the line of foreign currency deposits by the central government (VII. 1). Short-term forward transactions were stated in the line of foreign currency receivables from the central government (II. 2).

FORINT AND FOREIGN CURRENCY DEPOSITS BY THE CENTRAL GOVERNMENT

Forint deposits by the central government

HUF millions

B/S line	Description	31. 12. 2001	31. 12. 2002	Change
	Single Treasury Account (KESZ)	328 860	35 737	–293 123
	Deposit by State Privatisation and Holding Co. (ÁPV Rt.)	15 508	14 523	–985
	Deposit by Government Debt Management Agency	296	339	43
	Hungarian State Treasury	263	175	
VI/1	**Total deposits**	**344 752**	**50 862**	**–293 890**

Foreign currency deposits by the central government

HUF millions

B/S line	Description	31. 12. 2001	31. 12. 2002	Change
	Short-term deposits	22 128	26 927	4 800
	Long-term special deposits	61 749	574	–61 175
	Long-term currency swap transactions	124 180	6 037	–118 144
VII/1	**Total deposits**	**208 057**	**33 538**	**–174 519**

Foreign currency deposits by central government in a breakdown by time to maturity

HUF millions

B/S line	Description	31. 12. 2001	31. 12. 2002	Change
	Within one year	46 334	14 017	–32 317
	Within one to five years	89 254	3 137	–86 117
	Over five years	72 469	16 384	–56 085
VII/1	**Total deposits**	**208 057**	**33 538**	**–174 519**

The foreign currency deposits by the central government comprise World Bank and other loans borrowed by the government from abroad and maintained in the form of a blocked deposit at the MNB, as well as the net debit balance of currency swaps linked to government loans.

Foreign currency deposits by the central government fell by HUF 174.5 billion. This is partly accounted for by the termination of a HUF 40 billion deposit associated with the EFSAL credit to the central government, which was converted into a forint deposit by the MNB in terms of an agreement between the Government Debt Management Agency (ÁKK) and the MNB.

The balance of the currency swaps linked to the credits to the central government fell by HUF 118 billion, due to changes in maturities and exchange rates.

NET POSITION VIS-À-VIS THE CENTRAL GOVERNMENT

HUF millions

B/S line	Description			Change
		31. 12. 2001	31. 12. 2002	
I/1–VI/1	Net forint position	44 706	343 108	298 402
II/2–VII/1	Net foreign currency position	958 860	818 276	–140 584
	Total	**1 003 566**	**1 161 384**	**157 818**

FORINT RECEIVABLES FROM CREDIT INSTITUTIONS

Forint receivables from credit institutions in a breakdown by original maturity

HUF millions

B/S line	Description			Change
		31. 12. 2001	31. 12. 2002	
	Receivables maturing within one year	**7 378**	**1 571**	**–5 807**
	Credit to Hungarian Development Bank	5 362	0	–5 362
	Liqudity refinancing credit on credit institutions	2 016	1 571	–445
	Receivables maturing over one year	**35 271**	**19 129**	**–16 142**
	Credit against foreign currency deposits	20 942	14 707	–6 235
	E-loans	224	224	0
	Refinancing loans from EXIM bank	1 164	546	–618
	ESOP* refinancing credit	38	32	–6
	START loans	7 628	207	–7 421
	Other priority loans 115	13	–102	
	World bank loans 1 530	757	–773	
	Other loans	3 630	2 643	–987
	Impairment prov. for claims on credit institutions	**–2 463**	**–2 003**	**460**
I/2	**Total receivables**	**40 186**	**18 697**	**–21 489**

** Employees Share Ownership Programme*

The receivables from credit institutions largely comprise preferential loans associated with the implementation of the government's former economic policy. They therefore are not linked to any of the central bank functions. This is why the MNB has made efforts since 2001 to wind up such loans, primarily through transferring these assets to the Hungarian Development Bank (MFB) and encouraging the prepayment of the loans involved.

In the course of 2002, the MNB's stock of forint receivables from the credit institutions fell by HUF 21.5 billion. HUF 7 billion of the reduction is accounted for by the transfer of credits to the MFB, and a further HUF 5.4 billion by the termination of the claims associated with refinancing loans assumed by the MFB in 2001. The remainder of the fall in forint receivables from credit institutions was due to repayments and debt servicing.

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

HUF millions

B/S line	Remaining maturity	31. 12. 2001	31. 12. 2002	Change
	Within one year	11 556	9 828	–1 728
	1–5 years	23 129	9 188	–13 941
	Over 5 years	586	113	–473
I/2	**Long-term receivables**	**35 271**	**19 129**	**–16 142**

NET POSITION VIS-À-VIS CREDIT INSTITUTIONS

HUF millions

B/S line	Description	31. 12. 2001	31. 12. 2002	Change
I/2–VI/2	Net forint position	–748 530	–902 583	–154 053
II/3–VII/2	Net foreign currency position	–155 036	–90, 854	64 182
	Total	**–903 566**	**–993 437**	**–89 871**

Net forint liabilities to credit institutions increased by HUF 154 billion by end-2002, due to a drop of HUF 21.5 billion in assets and an increase of HUF 132 billion in deposits by credit institutions. The latter was due to an increase of HUF 187 billion in two-week and overnight money market deposits and a fall of HUF 54 billion in required reserves. Although money market deposits increased, there was a drop of HUF 487 billion in the other instrument of liquidity regulation, namely the three-month MNB bills, stated in the line of Other deposits and liabilities (VI.4.), due to maturity.

GOLD AND FOREIGN CURRENCY RESERVES OF THE CENTRAL BANK

Forint balances

HUF millions

B/S line	Description	Balance 31. 12. 2001	Balance 31. 12. 2002	Change
	Gold reserve	7 813	7 787	–26
	Reserve position in the IMF	112 695	133 428	20 733
	Convertible foreign currency cash on hand	402	0	–402
	Foreign currency deposits	194 040	212 921	18 881
	of this: SDR	5 726	7 340	1 614
	Foreign currency securities	2 595 643	1 956 269	–639 374
	Foreign currency repo transactions	93 505	29 818	–63 687
II.1.	**Total gold and foreign currency reserves**	**3 004 098**	**2 340 223**	**–663 875**

The decline in foreign currency reserves can be attributed to the Budget's foreign currency purchases required for debt servicing and the appreciation of the forint. The increase in the IMF quota was primarily due to the IMF drawing SDR 115.5 million from the forint quota, slightly dampened by the 13% fall in the exchange rate of the SDR in 2002.

Euro balances

EUR millions

B/S line	Description	Balance		Change
		31. 12. 2001	31. 12. 2002	
	Gold reserve	32	33	1
	Reserve position in the IMF	457	566	109
	Convertible foreign currency cash on hand	2	0	–2
	Foreign currency deposits	788	903	115
	of this: SDR	23	31	8
	Foreign currency securities	10 537	8 293	–2 244
	Foreign currency repo transactions	380	126	–254
II.1.	**Total gold and foreign currency reserves**	**12 196**	**9 921**	**–2 275**

OTHER FOREIGN CURRENCY RECEIVABLES

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2001	31. 12. 2002	
	Forint payment of IMF quota	250 781	183 281	-67 500
	Total foreign credits and deposits	6 461	492	–5 969
	Repurchased bonds	236 944	256 290	19 346
	Foreign hedging transactions*	115 662	4 853	–110 809
	Other	3 938	5 465	1 527
II.4.	**Other foreign currency receivables, total**	**613 786**	**450 381**	**–163 405**

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

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

The line for foreign credits and deposits includes foreign currency claims on CW AG, which fell from HUF 6.5 billion at end-2001 to HUF 945 million at end-2002, due to debt servicing and exchange rate changes in 2002. Yet CW AG is liable to service a debt of only HUF 492 million in 2003 under the terms of the CW AG report of 30 September 2002. The rest of the amount is accounted for by a package of shares held by CW AG for some years. These shares, which previous years' reports had valued at stock exchange quoted prices, were stated at zero value in the report issued on 30 September 2002. This was because the offer of these shares for sale drew attention to the lack of genuine demand, which in turn made their market valuation impossible. This amount was cancelled under an agreement signed by the parties on 7 March 2003. Following the signing of the contract an amount of EUR 1,457,076 was repaid. Once the remaining EUR 630,000 is repaid, the parties will have no claims on or liabilities to each other in relation to any potential further losses incurred by CW AG. The MNB made a maximum provision for the loss in value of 31 December 2002 in accordance with the agreement signed and the principle of prudence.

II.

OTHER LIABILITIES IN FOREIGN CURRENCY

End-period level of other foreign currency liabilities in a breakdown by remaining maturity

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2001	31. 12. 2002	
	Short-term liabilities	265 124	123 915	–141 209
	Long-term liabilities	2 090 400	1 552 905	–537 495
	– Bonds	1 766 690	1 350 865	–415 825
	– Credits payable	68 002	14 041	–53 961
	– IMF forint deposit	250 781	183 281	–67 500
	– Other liabilities	4 927	4 718	–209
VII.3.	**Other foreign currency liabilities**	**2 355 524**	**1 676 820**	**–678 704**

The drop in short-term liabilities was largely due to the fall in the balance of marked-to-market deposits associated with changes in the market value of derivative transactions.

Foreign currency bonds included with long-term liabilities declined due to debt servicing and the strengthening of the forint's exchange rate. Borrowing also declined as financial loans from abroad matured. The forint deposit of the IMF also fell in value because of the aforementioned drawing by the IMF and the strengthening of the forint (see section on the MNB's accounting policy).

Maturity structure of other long-term foreign currency liabilities

HUF millions

Description	Balance		Change
	31. 12. 2001	31. 12. 2002	
Long-term liabilities	**2 090 400**	**1 552 905**	**–537 495**
–within one year	277 888	506 811	228 923
–within one to five years	1 175 828	646 177	–529 651
–within one to five years	636 684	399 917	–236 767

Currency composition of other foreign currency liabilities

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2001	31. 12. 2002	
	USD	666 987	357 497	–309 490
	EUR currency group	645 043	506 363	–138 680
	JPY	790 906	628 167	–162 739
	Other	252 588	184 793	–67 795
VII/3	**Other foreign currency liabilities**	**2 355 524**	**1 676 820**	**–678 704**

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

Other foreign currency liabilities include the HUF 183.3 billion deposit by the IMF.

INVESTED ASSETS

The category of invested assets comprises shareholdings (HUF 12.7 billion) in addition to intangibles, tangibles and work in progress (HUF 9.9 billion).

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

HUF millions

	Assets							
	Immaterial goods		Intangibles	Equipment	Assets of bank note and coin collection	Tangible assets of NBH, total	Work in progress	Immaterial goods, tangible assets and investments together
	Intangible assets	Software under development						
Gross value								
31. 12. 2001	**4912**	**11**	**9 344**	**8 102**	**141**	**17 587**	**81**	**22 591**
Installation	197	233	81	382	18	481	632	1 543
Other	0	0	0	102	0	102	92	194
Disposal	0	0	0	–4	0	–4	0	–4
Selling	0	0	–3	–96	0	–99	0	–99
Transfer free of charge	0	0	–89	–11	0	–100	0	–100
Other deduction	–381	–197	0	–394	0	–394	–464	–1 436
31. 12. 2002	**4 728**	**47**	**9 333**	**8 081**	**159**	**17 573**	**341**	**22 689**
Details of depreciation								
31. 12. 2001	**3 347**	**0**	**1 952**	**6 520**	**0**	**8 472**	**0**	**11 819**
Planned depreciation	913	0	280	672	0	952	0	1 865
Extraordinary depreciat.	0	0	0	0	0	0	0	0
Deprec. due to damage	0	0	0	0	0	0	0	0
Increase due to reclassif.	0	0	0	0	0	0	0	0
Interim decrease due to removal from the account	–377	0	–24	–482	0	–506	0	–883
Decrease due to reclass.	–3	0	0	0	0	0	0	–3
31. 12. 2002	**3 880**	**0**	**2 208**	**6 710**	**0**	**8 918**	**0**	**12 798**
Closing net value								
31. 12. 2001	**1 565**	**11**	**7392**	**1 582**	**141**	**9 115**	**81**	**10 772**
31. 12. 2002	**848**	**47**	**7125**	**1 371**	**159**	**8 655**	**341**	**9891**
Change	**–717**	**36**	**–267**	**–211**	**18**	**–460**	**260**	**–881**

Investments and dividends from investments

Under the MNB's investment strategy and the relating provisions of the MNB Act, the Bank intends to sell its share in all business undertakings whose operations are unrelated to those of the Bank.

HUF millions

Description		Ownership share (%)		Book value		Dividend received	
		31. 12. 2001	31. 12. 2002	31. 12. 2001	31. 12. 2002	2001.	2002.
BIS	(HUF millions,	–	–	2 225	2 173	461	509
	gold millions CHF)			6.7	6.7	–	–
SWIFT	(HUF millions,	–	–	0.4	0.4	–	–
	thousand EUR)			2	2	–	–
Pénzjegynyomda Rt.		100.0	100.0	8 927	8 927	–	99
Magyar Pénzverő Rt.		100.0	100.0	575	575	9	–
MNB Érmekereskedelmi Rt.*		–	–	–	–	65	–
KELER Rt.		50.0	50.0	250	250	–	118
GIRO Elszámolásforgalmi Rt.		15.0	14.6	91	91	73	91
Nemzetközi Bankárképző Központ Rt.		13.0	14.6	31	31	–	3
Bankjóléti Kft.		100.0	100.0	602	602	–	
Budapesti Értéktőzsde		5.8	6.8	30	321	–	–
Total investments				**12 731**	**12 970**	**608**	**820**

*Note: * MNB Érmekereskedelmi Rt. merge to Magyar Pénzverő Rt. in 2001.*

Some key indicators relating to the Bank's domestic investments (preliminary data)

HUF millions

Investment	Equity excl. income of the year related	Share capital	Reserves	Balance sheet income	Balance sheet income
	31. 12. 2002	31. 12. 2002	31. 12. 2002	2001	Premilinary 2002
Budapesti Értéktőzsde Rt. 1052 Budapest, Deák Ferenc u. 5.	4 695	550	4145	0	–62
GIRO Elszámolásforgalmi Rt. 1054 Budapest, Vadász utca 31.	6 925	2496	4429	373	1486
KELER Rt. 1052 Budapest, Deák Ferenc u. 5.	10 409	4500	5909	707	889
Nemzetközi Bankárképző Rt. 1022 Budapest, Csopaki út 6–8.	517	210	307	2	3
Magyar Pénzverő Rt. 1089 Budapest, Könyves K. krt. 38.	1 082	575	507	75	169
Pénzjegynyomda Rt. 1055 Budapest, Markó utca 17.	9 289	8927	362	0	219
MNB Üdültetési és Jóléti Szolgáltató Kft. 1054 Budapest, Vadász utca 16.	614	602	12	0	–46

The MNB's receivables from and liabilities to the affiliated investments

HUF millions

Investment	Receivables	Liabilities
GIRO Elszámolásforgalmi Rt.	–	0.50
KELER Rt.	–	1.44
Magyar Pénzverő Rt.	0.04	2.32
Pénzjegynyomda Rt.	–	8.07
Nemzetközi Bankárképző Központ	–	0.26
Budapesti Értéktőzsde Rt.	–	–
MNB Bankjóléti Kft.	–	–
Total investment	**0.04**	**12.59**

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

The management of the MNB has passed a decision about selling the company in the medium term for two reasons. First, the adoption of the euro will terminate the production of forint notes. Second, the income from banknote production has already sunk below 50% of the earnings of the company. The MNB will incur a potential loss on the sale of the company, as part of its assets are only suitable for banknote production, and it is not guaranteed that this can be recovered in the price. As, however, the size of this prospective loss cannot be quantified as yet, no provision for loss in value is stated on this account.

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

MNB Üdültetési és Jóléti Szolgáltató Kft. (Bankjóléti Kft.) was founded to attend to the Bank's social and welfare responsibilities. This limited liability company manages the vacation houses and sports facilities which were transferred into its ownership by the MNB as a contribution in kind. As the company had incurred substantial losses over the past few years, the management of the MNB passed a decision in 2002 on winding it up by 2004. For the loss in capital stated in the company's report on 31 December 2002, the MNB made a provision for loss in a value of HUF 32.5 million.

Budapest Stock Exchange was converted into a company limited by shares as of 30 June 2002. This involved the revaluation of the company's assets and liabilities. This and the increase from 5.8% to 6.8% of the MNB's stake caused the book value of the investment to rise from HUF 30 million to HUF 321 million.

PROVISIONS

HUF millions

B/S line	Description	31. 12. 2001	Interim changes in 2002			31. 12. 2002
		Loss in value/provisions	Increase (+)	Use/Release (–)	Interim exchange rate effect due to Increase, Use/Release	Total loss in value/ provisions
1	2	3	4	5	6	7
I/2	Forint receivables against credit institutions	2 462.6	2.8	–462.4	0.0	2 003.0
II/3	Foreign currency receivables against credit institutions	0.0			0.0	0.0
II/4	Other foreign currency rec.	987.1	453.4	–423.8	–55.3	1 016.7
III/1	Invested assets	0.0	32.5		0.0	32.5
III/4	Other assets	433.4			0.0	433.4
VIII	Liabilities	0.0			0.0	0.0
	Total	**3 883.1**	**488.7**	**–886.2**	**–55.3**	**3 485.6**

Provision for loss in value declined by HUF 398 million in 2002.

Of this amount, HUF 729 million was used to cover the loss relating to a credit institution and credit loss relating to another type of receivable.

For the receivables from CW AG, the MNB made a provision for loss in value of HUF 368 million before the end of 2002, in addition to the HUF 85 million made on 31 December 2001 (see other foreign currency receivables). Another provision for loss in value of HUF 32 million was made on account of the prospective loss in capital relating to Bankjóléti Ltd. The change in the amount of receivables from credit institutions and their rating, and the change in exchange rates led to the release of provisions for loss in a value of HUF 14 million and HUF 55 million respectively.

EQUALISATION RESERVES

HUF millions

	Description	31. 12. 2001 official	31. 12. 2001 corrected	31. 12. 2002	Change
1	Equalisation reserves of Forint exchange rate*	–250 180	–175 062	–82 890	167 290
2	Equalisation reserves of foreign exchange securities**	2 831	16 622	19 976	17 145
3	**Equalisation reserves (1+2)**	**–247 349**	**–158 440**	**–62 914**	**184 435**

* *Pursuant to legal changes the negative balance of equalisation reserves should be refunded by the central budget by March 2003.*

** *The equalisation reserves of foreign exchange securities includes the market value difference of repurchased MNB bonds denominated in foreign currencies.*

The official exchange rate of the forint against the euro appreciated by 4.2% in the course of 2002, leading to a net foreign currency position of HUF 1,844 billion (EUR 7.8 billion) at the year-end. Due to changes in the exchange rate and net position, there was a non-realised exchange rate loss of HUF 82.9 billion. This value is stated in the line of Receivables from the central government in the year-end balance sheet.

Size of annual changes in the forint exchange rate in 2001 and 2002

	NBH official mid-exchange rate
End-of-period exchange rate	
31. 12. 2000 (EUR)	264.94
31. 12. 2001 (EUR)	246.33
31. 12. 2002 (EUR)	235.90
Annual appreciation	
in 2001	7.0%
in 2002	4.2%

As of 4 May 2001, the Bank widened the fluctuation band of the forint's exchange rate around central parity to +/–15%.

PREPAID EXPENSES/ACCRUED INCOME AND ACCRUED EXPENSES/DEFERRED INCOME

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2001	31. 12. 2002	
	Due to banking transactions	209 398	150 190	–59 208
	Due to internal operation	90	98	8
IV.	**Prepaid expenses/accrued income**	**209 488**	**150 288**	**–59 200**
	Due to banking transactions	135 083	102 098	–32 985
	Due to internal operation	98	182	84
X.	**Accrued expenses/deferred income**	**135 181**	**102 280**	**–32 901**

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

CHANGES IN EQUITY

HUF millions

B/S line	Description	31. 12. 2001	Interim changes	31. 12. 2002
XI/1.	**Share capital**	**10 000**		**10 000**
XI/2.	**Retained earnings**	**30 862**		**7 546**
	Use of retained earnings for dividends		–23 316	
XI/3.	**Valuation reserves**	**0**		**0**
XI.4.	**Equalisation reserves of forint exchange rates**	**0**	**0**	**0**
	Due to changes in the HUF/EUR exchange rate in 2002		–82,890	
	Refunding of central budget until 31. March 2003		82 890	
XI.5.	**Equalisation reserves of securities denominated in foreign currency**	**0**	**19 976**	**19 976**
XI/6.	**Profit per balance sheet**	**0**	**–4 886**	**–4 886**
XI.	**Equity**	**40 862**	**–8 226**	**32 636**

Under the amended Act LVIII of 2001 on the Magyar Nemzeti Bank, the MNB was required to pay HUF 23.3 billion as dividend for 2002. As the profit obtained in the reviewed year did not provide cover for the dividend paid, the Bank drew HUF 23.3 billion, the full amount, from its retained earnings, as provided by the Act.

For more on the equalisation reserves, refer to Section V.14.

OFF-BALANCE SHEET LIABILITIES

Liabilities arising from derivative transactions

HUF millions

Nr.	Description	31. 12. 2001	31. 12. 2002	
		Book value of liabilities	Book value of liabilities	Net market value
1	Hedging transactions (2+3+4+5)	3 944 336	3 230 460	–7 326
2	– *FX forward transactions*	0	114 574	0
3	– *FX swap transactions*	92 092	100 333	1 845
4	– *currency swap transactions*	3 099 970	2 278 424	–7 549
5	– *interest rate swap transactions*	752 274	737 129	–1 622
6	Other forward transactions (7+8)	24 633	203	17
7	– *options*	24 633	0	0
8	– *interest rate future transactions*	0	203	17
9	**Total (1+6)**	**3 968 969**	**3 230 663**	**–7 309**

Hedging transactions (Lines 1–5) serve the purpose of reducing risk to the net foreign currency position, arising from cross exchange rate fluctuations and interest rate changes. They also facilitate establishing the benchmark foreign currency structure approved by the Bank's Board of Directors. They comprise predominantly transactions with or on behalf the Budget.

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

Interest rate swaps include the Bank's transactions with ÁKK, which serve to limit the interest rate risk of the debt denominated in foreign currencies and are hedged on the capital market with counterpart transactions.

Other off-balance-sheet liabilities

HUF millions

Nr.	Description	31. 12. 2001	31. 12. 2002
		Book value of liabilities	Book value of liabilities
1	Liabilities from foreign currency repos	22 909	0
2	Guarantees	160 851	149 588
3	Contingent liabilities	779	0
4	Credit line commitments	407	0
5	Other off-balance sheet liabilities	144	2
6	**Total (1+2+3+4+5)**	**185 090**	**149 590**

The line Guarantees comprises export and import guarantees, involving invariably some reversible contract or government guarantee. When exercising a guarantee, the MNB has the right to a reverse guarantee if need be.

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

CHANGES IN THE NET INTEREST INCOME BY SECTOR

Net forint and foreign currency interest and interest-related income

HUF millions

P/L line	Description	2001	2002	Change
(I/1+II/2)–(X/1+XI/1)	Central budget	91 983	63 310	–28 673
(I/2+II/3)–(X/2+XI/2)	Credit institutions	–63 417	–50 923	12 494
(I/3+II/4)–(X/3+XI/3)	Other	–49 897	7 802	57 699
	Net interest income	**–21 331**	**20 189**	**41 520**
	Forint interest related income	666	2	–664
	Foreign currency securities	–4 796	–2 429	2 367
	Bonds issued abroad	–812	20	832
	Derivatives transactions for hedging and other purposes*	–5 313	–1 695	3 618
	Other	0	0	0
(I/4+II/5)–(X/4+XI/4)	**Net interest related income**	**–10 255**	**–4 102**	**6 153**
(I+II)–(X+XI)	**Net interest and interest related income**	**–31 586**	**16 087**	**47 673**

* *For details on derivatives transactions for hedging and other purposes, see next table on Page 69.*

The interest income of HUF 10.9 billion arising from the securities issued by the MNB abroad and subsequently repurchased is included in the profit and loss account not as an item reducing expenses but as an item under other foreign currency income.

Interest-related income is comprised of:

– net income from derivative transactions that is not related to exchange rate changes;

– the difference between the purchase price and selling price of foreign currency denominated securities, and – in respect of securities held to maturity – the difference between the purchase price and notional value; and

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

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

HUF millions

Nr.	Description	2001	2002	Changes
1	**Income from derivative transactions (2+3+4+5+6)**	**266 187**	**177 392**	**–88 795**
2	– interest on currency swaps	263 559	173 300	–90 259
3	– interest on over one year interest rate swaps	1 742	3 310	1 568
4	– interest differential on hedge FX swaps	220	600	380
5	– exchange rate gains on derivative transactions	188	0	–188
6	– other transactions	478	182	–296
7	**Expenses for derivative transactions**	**271 500**	**179 087**	**–92 413**
8	– interest on currency swaps	265 539	175 173	–90 366
9	– interest on over one year interest rate swaps	1 088	1 670	582
10	– interest differential on hedge FX swaps	4 331	1 086	–3 245
11	– exchange rate gains on derivative transactions	0	972	972
12	– other transactions	542	186	–356
13	**Net income on derivative transactions (1–7)**	**–5 313**	**–1 695**	**3 618**
14	– interest on currency swaps (2–8)	–1 980	–1 873	107
15	– interest on over one year interest rate swaps (3–9)	654	1 640	986
16	– interest differential on hedge FX swaps (4–10)	–4 111	–486	3 625
17	– exchange rate gains on derivative transactions (5–11)	188	–972	–1 160
18	– other transactions (6–12)	–64	–4	60

The MNB hedged the risk arising from bonds issued abroad and interest rate risk by means of currency swaps (and other derivatives deals).

In the course of the debt swap in 1997, the MNB converted a large part of the forint credits to the central government into foreign currency credits via concluding counterpart transactions with the Budget under terms identical with those of the bonds issued abroad by the MNB. The MNB also concluded with the ÁKK the majority of the currency swaps linked to the bonds under nearly identical terms. Income and expenses arising on the currency swaps are stated in the profit and loss account in gross terms. As far as the swaps vis-à-vis both non-residents and the ÁKK are concerned, the income and the expenses are recorded in the interest income more than once. At the same time, their net impact on profit and loss amounts to HUF 1.9 billion, including currency swaps concluded by the MNB abroad on its own behalf.

COMPONENTS OF INCOME FROM THE TRANSLATION OF FOREIGN EXCHANGE HOLDINGS

HUF millions

	2001	2001 adjusted data*	2002
Income from exchange rate changes	55 123	–19 996	–3 355
Change of equalisation reserves in the balance sheet – due to differences in central and official exchange rates – due to non-realised revaluation income	 –211 899 	 –136 780	 –82 890
Total effect of exchange rate changes	**–156 776**	**–156 776**	**–86 245**

** Calculated in line with the regulation enacted in 2002.*

In the course of 2002, the official exchange rate of the forint strengthened by 4.2% relative to the euro, causing the net foreign currency position to fall by HUF 222 billion (EUR 0.6 billion). These two impacts combined led to HUF 3.4 billion and HUF 82.9 billion in realised and non-realised exchange rate loss respectively, bringing the total loss arising from changes in the forint's exchange rate to HUF 86.2 billion, taken in the economic sense.

Calculated on the basis of the new rules entering into effect in 2002, the realised loss in 2001 would have amounted to HUF 20.0 billion and the non-realised loss to HUF 136.8 billion.

On the equalisation reserve, see Page 65.

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

HUF millions

		2001	2002	Changes
1	Commission and fee income of credit institutions' deposit account turnover	613	707	94
2	Fee income of cash turnover	538	533	–5
3	Other commissions, fees	256	257	1
4	**Income related to payments**	**1 407**	**1 497**	**90**
5	Costs of bank note and coin production	5 107	3084	–2 023
6	Costs of production of commemorative coins	312	80	–232
7	Expenditures on VIBER (RTGS) transactions	316	331	15
10	Other expenditures related to payment turnover	68	54	–14
11	**Total expenditures related to payment turnover**	**5 803**	**3 549**	**–2 254**
12	**Income from payment turnover**	**–4 396**	**–2 052**	**2 344**

Income arising on commissions and fees in relation to credit institutions' forint deposit accounts rose slightly (by HUF 94 million) in 2002, due to an increase in the size and number of individual fee payments. By contrast, the value of commissions remained unchanged. Net expenditure arising on financial transactions and currency issue amounted to HUF 2.1 billion, down by HUF 2.3 billion on a year earlier.

The item called Costs of banknote and coin production changed significantly. The rise in the costs of banknote production was due to the introduction in 2001 of the 20,000 forint note. In line with the prospective adoption of the euro in Hungary, the stock of notes and coin declined in 2002, moderating both production needs and costs.

OTHER INCOME

HUF millions

	2001	2002	Changes
1 Commissions and fees received	442	292	–150
2 Bond lending fees received in foreign currency	782	533	–249
3 Costs of the central budget's FX loans	600	356	–244
4 Normal and extraordinary income not included in previous items	307	762	455
5 Total other income	**2 131**	**1 943**	**–188**
6 Expenditures related to EFSAL loans	0	1 636	1 636
7 Other commissions and costs	3 355	2 194	–1 161
8 Normal and extraordinary expenditures not included in previous items	10 124	1 440	–8 684
9 Total other expenditures	**13 479**	**5 270**	**–8 209**
10 Other results	**–11 348**	**–3 327**	**8 021**

The category of other income registered a loss of HUF 3.3 billion in 2002.

There was a decline in bond lending fees received in foreign currency in 2002. This income is due to the MNB under a general agreement on bond lending concluded between the Bank and its largest securities account manager. These fees are earned in accordance with the securities lent. The cost of foreign currency credit to the central government, that is the commissions relating to pre-payment of, and interest payment on, foreign currency loans declined relative to 2001. This was because the average stock of lending was smaller in 2002 and there was no early payment.

Costs incurred on the issue of foreign currency bonds fell by HUF 1 billion relative to 2001. As this type of cost is distributed evenly across a bond's time to maturity, it declined continuously with the maturing of bonds.

Under an agreement between the ÁKK and the MNB, the government pre-pays the EFSAL credit. Furthermore, half of the commission relating to the pre-payment is assumed by the MNB. This type of cost caused the MNB's balance sheet to fall by HUF 1.6 billion in 2002.

In 2001, HUF 6.4 billion of the HUF 10.1 billion in ordinary and extraordinary expenses not included among the above items was due to the sale of CW AG, in connection with winding up the owner's share and writing off the subordinated loan capital as credit loss. The release of the provision for loss in value made in previous years covered the extraordinary expenses. Another significant credit loss arose on writing off a receivable of HUF 2.7 billion, due to the assignment of the receivable. This was covered by an earlier provision for loss in value.

For a discussion of ordinary and extraordinary income for 2002 not included in the above items, see Page 72.

II.

BREAKDOWN OF ORDINARY AND EXTRAORDINARY INCOME NOT INCLUDED IN THE ABOVE ITEMS

HUF millions

Nr.	Description	2001	2002	Changes
	Ordinary and extraordinary income not included in previous items			
1	Due to invested financial assets	306	321	15
2	Other result-valuation	0	15	15
3	Settlement of refinancing loan ceded to Hungarian Development Bank	0	425	425
4	Other income	1	1	0
5	**Total (1+2+3+4)**	**307**	**762**	**455**
	Ordinary and extraordinary expenditures not included in previous items			
6	Loan and other losses exceeding normal extent	2 673	737	–1 936
7	Due to invested financial assets	6 481	30	–6 451
8	Final money transfer	919	39	–880
9	Settlement of refinancing loan ceded to Hungarian Development Bank	0	425	425
10	Other expenditures	51	209	158
11	**Total (6+7+8+9+10)**	**10 124**	**1 440**	**–8 684**

Components of ordinary and extraordinary income for 2002 are as follows:

- An amount of HUF 321 million in terms of ordinary and extraordinary income not included in the above items was associated with the conversion of the Budapest Stock Exchange (BÉT) on 30 June 2002 into a company limited by shares. Here, the derecognition of the previous book value resulted in an extraordinary expense of HUF 30 million.

- Furthermore, there arose an extraordinary income of HUF 15 million in 2002, due to the recovery of a credit loss written off.

- Losses on lending included the charge-off of HUF 737 million, which was covered by the provision for loss in value made earlier.

- The income and expenditure arising on the settlement of a transfer of refinancing loans to the MFB amounted to HUF 425 million.

- The line of Final money transfer among extraordinary expenditures includes predominantly support to international and domestic organisations and foundations.

- Derecognition of the book value of real property transferred free of charge to the ÁKK accounts for a large portion of other expenditure items (HUF 67 million).

OPERATING INCOMES AND EXPENSES

HUF millions

P/L. line	Description	2001	2002	Changes
	Dividend from investments	608	820	212
	Income from selling assets and inventories	121	84	-37
	Income from export sales	7	4	-3
	Income from mediated services	47	45	-2
	Income from invoiced services	52	58	6
	Other income	12	6	-6
	Extraordinary income	6	3	-3
VIII.	**Total operating income**	**853**	**1 020**	**167**
	Cost of materials, total	3 441	3 011	-430
	Personnel-related costs, total	9 837	9 057	-780
	Depreciation	2 323	1 865	-458
	Transfer of capitalised value of own-produced stocks	-39	-56	-17
	Transfer of costs of other activities	-366	-370	-4
	Total operating costs	**15 196**	**13 507**	**-1 689**
	Costs incurred on assets and inventories	155	114	-41
	Costs incurred on invoiced services	44	34	-10
	Taxes	23	1	-22
	Assets transferred free of charge	0	0	0
	Other costs	0	0	0
	Total operating expenses	**222**	**149**	**-73**
XVII.	**Total operating costs and expenses**	**15 418**	**13 656**	**-1 762**

In 2002, the operating costs of banking operations (HUF 13.5 billion) were HUF 1.7 billion lower than in 2001, due to a combination of factors.

Personnel-related costs declined by HUF 0.8 billion, due primarily to reduction in the number of staff in 2002. In addition, operating costs fell by HUF 0.9 billion, due primarily to economising on operating and IT costs. These savings were essentially due to redefining the kinds of services required and general adoption of a system of procurement competition.

In 2002, operating income amounted to a total of HUF 1.0 billion, largely accounted for by dividends from MNB undertakings (such as BIS, KELER Rt., GIRO Rt.).

II.

CHANGES IN DATA ON THE NUMBER OF EMPLOYEES, WAGES AND REMUNERATION OF EXECUTIVE OFFICERS OF THE BANK

Number of staff and wage information

HUF millions

Description	2001	2002	Change (%)
Wage costs incurred on staff	5287	4897	–7.4
Other wage costs*	539	486	–9.8
Wages	**5826**	**5383**	**–7.6**
Adjustments, total	26	–26	
– Deferred payments settled in 2002	26	–26	
Wages	**5852**	**5357**	**–8.5**
Other personnel payments	**1483**	**1509**	**1.7**
Taxes on wages	**2502**	**2191**	**–12.4**
Total personnel expenditures	**9837**	**9057**	**–7.9**

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

Denomination	2001	2002	Change (%)
Average number of staff	1246	1058	–15.1

Remuneration of executive officers

Bodies	Fees
Monetary Council	HUF 17 686 290
Supervisory Board	HUF 8 341 877

Credits to executive officers

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

Bodies	Amount of loans	Outstanding at 31. 12. 2002	Final maturity	Rate of interest
Board of Directors	71 590 572 Ft	56 844 941 Ft	15. 12. 2016	Floating (central bank base rate at 31 Dec. 2002. + 1% point)
Supervisory Board	2 000 000 Ft	895 350 Ft	15. 09. 2004	Floating (central bank base rate at 31 Dec. 2002. + 1% point)

17 April 2003

Zsigmond Járai

RESOLUTION

RESOLUTION 1/2003 (V.22.) PASSED BY THE ANNUAL GENERAL MEETING OF THE MAGYAR NEMZETI BANK HELD ON 22 MAY 2002

I. The 2003 Annual General Meeting of the Magyar Nemzeti Bank has approved
– the audited financial statements for the year ended 31 December 2002,
– and stated the Magyar Nemzeti Bank's

A. balance sheet total as at 31 December 2002
HUF 4,231,926 million,
that is, four trillion two hundred and thirty-one billion nine hundred and twenty-six million forints,

B. loss as at 31 December 2002
HUF 4,886 million,
that is, four billion eight hundred and eighty-six million forints.

II. Under Article 78 of Act LX of 1991 on the Magyar Nemzeti Bank, the General Meeting approved the settlement relating to the Bank's income in 2002 as follows

A. In 2002, the financial obligation of the Magyar Nemzeti Bank to its founder is the payment of a dividend amounting to
HUF 23,316 million,
that is, twenty-three billion three hundred and sixteen million forints,

B. The advance payment of dividend by the Bank in 2002
HUF 23,316 million,
that is, twenty-three billion three hundred and sixteen million forints.

Consequently, there is no amount due and payable between the Founder and the Bank.

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