**CENTRE FOR REGIONAL STUDIES
OF HUNGARIAN ACADEMY OF SCIENCES**

DISCUSSION PAPERS

No. 45

**Spatial Development and the Expanding
European Integration of the Hungarian
Banking System**

**by
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This paper was prepared for the "Economic Geography and European Finance"
European Science Foundation Exploratory Workshop
17–19 September 2004, Jesus College, Oxford

Series editor

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**Pécs
2004**

ISSN 0238–2008

2004 by Centre for Regional Studies of the Hungarian Academy of Sciences.
Technical editor: Ilona Csapó.
Printed in Hungary by Sümegi Nyomdaipari, Kereskedelmi és Szolgáltató Ltd., Pécs.

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Abstract

The paper is concerned with the development stages and the spatial transformation of the Hungarian banking system in the economic transition & post-transition periods. It gives an overview of the development tendencies of the financial re-integration into the global market and particularly concentrates on the spatial polarisation factors (concentration – de-concentration; centralisation – decentralisation) which affect banking. The paper explores the arguments behind the extremely high centralisation of headquarter functions in Budapest and the factors that have impact on the establishment of locally-regionally based banks. This is followed by an introduction of the different organisational (institutional) and territorial (location strategies) level of the Hungarian banking system, dealing with either the domestic or the international financial central-function of Budapest and the reorganisation of the bank network and with its social consequences (financial exclusion) in the regions. The paper argues that EU membership is not a dramatic event in the integration process of the Hungarian banking sector, partly due to its particular ownership structure, the integration of the banking sector has already taken place. The paper concludes that the EMU integration could have been affected more adversely the Hungarian regions already characterised by the endogenous disparities, which are to a large extent rooted in the deficiency of their financial base.

Keywords: Hungarian banking system, transition economy, financial market integration, structural and spatial polarisation, branch network reorganisation, uneven regional development, financial exclusion

JEL Codes: G 21, G 28, G 32

1 Introduction: the macro-economic environment

Financial Geography, regarded as a newly established sub-discipline of Economic Geography, deals with the flows and transformation of money, and the spatial, institutional and regulatory structure of financial capital (*Leyshon,* 1995; *Leyshon–Thrift*; 1997). The recent growth of interest in the Geography of money has been stimulated by an explosive growth in information technology and financial services and also by the profound changes, upheavals (crises) that have remapped, and are continuing to transform the financial landscape of the World (*Leyshon* et al. 1988). These changes are usually associated with a single word, globalisation. Globalisation refers to the increasing integration of financial markets, hybridisation, convergence and stretching of economic relationships across the space, regardless of national borders and institutions, and to the growth of „stateless monies" that move electronically around the globe at a very high speed, ignoring national borders and economic territories (*Martin,* 1999). *Financial globalisation* is inherently geographically constituted, the product of organisational, technological, regulatory and corporate strategies by individual firms, financial institutions and authorities in specific location. Divergent forces of *deconcentration/decentralisation and concentration/centralisation* are consistent with *financial globalisation,* which are shaping the evolving *geographies of the national, regional and global finance*. Different monetary spaces – national, global and local, regional – coexist, as it is recognised that globalisation of finance is a global-local process.

These changes have several effects on the emerging single European market, where finance with the European banking licence lies in the heart of the policy, and have huge effects on the emerging financial markets of Central and Eastern Europe. The emergence of the European Monetary Union encourages mergers and acquisition activity across the EU in order to strengthen the position of financial institutions to hold their own in increased competition. While cross-border acquisition has been limited, the emergence of new large national universal banks, as the amalgamation of several national or regional institutions, is bound to have important spatial consequences, as they are located in the existing financial centres. These banks will have even more power to dominate the European market (*Leyshon-Thrift,* 1997). Changes that are imposing a universal monetary space for Europe remove a significant element of national and regional autonomy concerning the monetary control over their economic territory. The consequences of financial integration will affect regional and local banks as well as different national banking systems. According to the predicted main trend for future organisational structure of the European banking the emerging predominance of the large multi-country banks and the locally based regional banks gaining strength will dominate the markets. Small and local banks might suffer a competitive disadvantage initially;

eventually a two-tier banking system would emerge with *one tier consisting of international banks* and the *second tier consisting of local banks* (where local banks include local, regional and national banks devoted to their domestic markets). The major losers of this segmentation process will be the medium size domestic banks without international scope of activity.

Study of banking history reveals a wide variety of the development of different national banking systems. Despite its increasingly transnationalised feature the banking system (even in the core regions) very much retained its national character. National banking systems experience also spatial diversity, arising from the particular location of a distinctive financial centre and from the differences in spatial structure and in the origins of particular national and regional banking (*Dow,* 1999). National borders that coincide with economic borders continue to play an important role and impose several difficulties on mergers and acquisition (M&A) activity and bank entries. National banking markets are still segmented even within the European Union and resulting in different stages of integration into the common market. However, recent moves, both towards supra-national economic, political and monetary unions and towards secession and regional autonomy, have tended to undermine the usefulness of the nation state and simultaneously strengthen the role of locally based regional units. In contrast to the concentration processes in the global markets the growing significance of European regionalism requires strengthening of the regional money markets and institutions financing regional policies. Globalisation and the emergence of global financial spaces may actually serve to open up opportunities for local-regional alternatives (*Lee,* 1999; *Porteous,* 1996).

2 Financial Integration of Central and Eastern Europe

The growing literature on regional finance suggests that credit allocation in regional banking systems and in the different national banking vary according to their stage of development, and frictions exist across regions within national economies, resulting in different availability of capital. Money flows between locations and regions raising the problems of integration between the global and local level, or between centre and periphery, which concerns an irregular financial division of labour between central and peripheral areas. Consequently capital is concentrated into the financial centres of the core areas, which can be resulted in regional inequalities within the single European markets as well (*Porteous,* 1996; *Leyshon–Thrift,* 1997). Less developed national banking systems – and peripheral

regions within – have a lesser capacity to promote their economic development and might experience certain disadvantages because of the financial integration in Europe. Despite the fact local banks can serve local economic interests better than financial-centre banks whose priorities relate more to the single European and global markets, less advanced banking systems can be controlled more easily by the large universal banks of the financial core areas.

This latter argument refers very much to the accessing countries (new EU member states) of Central and Eastern Europe. *Their transition period was characterised by the reintegration process into the world's financial market in the early 1990s* and where the banks have turned out to dominate the financial system. Countries of this region one and half decade ago began to dismantle the structure of the central planning and permitted their economies to be governed by market forces. The transition to the market economy was largely influenced by the expanding globalisation of the World's economy and it was a large extent determined by the very harsh international framework conditions in the early years of transition. These framework conditions rooted in the capital shortage followed by the debt crisis of the 1980s were at least so much a determining factor *(Table 1)*.

An important dimension of the transition to a market economy is the creation of efficient financial system since well-developed financial systems cause economic growth and faster transition. They not only had to adopt new technologies and the financial behaviour it accommodates, but also had to cope with a legacy of bad debts and a lack of experience in credit risk assessment. In the last 15 years post-communist countries of Central and Eastern Europe (CEECs) have moved a long way towards establishing market-based banking systems as well as reforming in wider economic sense (*Bonin* et al. 1998).

Most of these countries had a prior memory of being market economies with banking traditions of their own up to a mere 40 years before the collapse of the Communist regimes. However, it is important to note, that the establishment of the financial markets in the CEEC was not the consequence of natural evolution, but rather a creation of a framework structure from a top-down directed way by the new elites of the transition period (*Várhegyi,* 2002a). Despite the traditional legacy of the bank-based financial system in continental Europe the policy makers in the CEEC had a preference for market-based over bank-based financial systems at the beginning of transition which was closely related to the growth pressure and to the heavy burdens of the indebted banking sectors with the legacy of non-performing loans (*Budd,* 1997). Despite initial preference for capita market-based over the bank-based systems, banks have turned out to dominate CEEC financial systems *(Table 2)*.

Table 1

Changing of the structural characteristics of the Hungarian banking in the transition and post-transition period

Transition: reintegration into the world's financial markets	Post-transition: integration process into the EU & EMU
Macroeconomic framework conditions: globalisation, neo-liberal paradigm, monetarist approaches	
Unfavourable conditions: depth crisis, collapse of the 'old' economy, capital shortage, pressure for liberalisation	Same structural problems than in the EU-15, but different scales; Banking is considered one of the most integrated sector: 3/4th of the ownership structure dominated by global players (stable equity background)
Banking reform: shift from the mono-bank system to the two tier system: 'bank-based financial systems emerged through a non-natural evolution (top-down directed reforms)	Steady network expansion & spatial consolidation (centralisation of certain services, rationalisation of local branches, financial exclusion)
Bank failures, indebtedness, irrecoverable assets in the sector	Trading scandals & speculative shocks (K&H equities)
Restructuring & institutional development: banking sector re-capitalisation and supervisory regulation by the state	Growing financial disinter mediation: rise of non-banking institutions (pension and insurance funds), Strong competition in the retail market
Privatisation of the banking sector: privatisation = 'foreignerisation' 'Outer-directed capitalism')	Dual-economy: foreign versus domestic institutions (loss of monetary autonomy, increased volatility of capital flows, 'redlining' strategies)
Transformation & convergence: enormous progress in banking fosters its expansion and modernisation	Expansion abroad: banks are net external creditors in a capital-importing environment (foreign direct investment abroad by the OTP Bank)
Small size of the sector & low degree of intermediation	Enormous profit growth (ROE) in global context despite the lower productivity of banks (OTP is within the TOP 10 in the World)
More stages & more rapid pace of development during 1.5 decades than anywhere else in the developed World	"Over-banked sector in under banked market": many players, but lower penetration in the financial market (enterprises' strong direct & cross-border financing in corporate market)

Source: Edited by the author.

Table 2

Benchmarking of banking systems in the EU-15 and CEECs (EU-8), 2001

Benchmarking factors	EU-15	CEECs (EU-8)
Type of financial system	Bank and/or capital market based	Bank based
Aggregate size of banking systems	Large (40% of the global market share)	Small: 2.4% of the EU-15's balance sheet
Share of loans in the EU's single market	98.8%	1.2%
Average size of banks	Large	small
Ownership structure	Rather national	Trans-national
Share of foreign ownership	20%	70%
Degree of intermediation (Asstes/GDP)	Intense (transmission ratio average 200 %)	Shallow, low transmission ratio (transmission ratio average 75 %)
Disinter mediation	More modest relative to the US, but increasing rapidly	Less apparent, bank intermediation still expands
Consolidation	Increasing concentration & centralisation	Further de-concentration (cyclical) and centralisation
Density of Branch network (inhabitants per branch)	1,923	9,200 (average)
Expansion abroad	Significant	Recent phenomena (OTP Bank in Hungary)

Source: Edited by the author.

Since macroeconomic performance, the depth of liberalisation, enterprise restructuring, privatisation methods, and the legal framework of market economy varied from country to country in the early stages of transition, economic performance and the created banking systems have not been uniform across the region. Because of the different degrees of market liberalization, the solution and the duration of privatisation, following a series of severe banking crises, involving a collapse of both the confidence in banks and the injection of large amount of state funds, varies from country to country. Stability of the sector has been restored not only by prudential regulation, consolidation and by the liquidation of insolvent institutions, but to a large extent by the large–scale entry of foreign banks (*Ábel* et al. 1998). As European Union membership was approaching in the CEEC' more advanced economies, Western European banks were 'aggressively' moving to expand into what would soon be a home market for them. The result is an increasing

pressure on margins, as more banks compete for relatively little business. Following Hungary's pioneering path in the attraction of strategic foreign investors, by the early 21st century foreign banks own three-quarter of the banking sector in the eight (CEEC) new member states (This figure for the old-member states only one quarter.) (*Tálas,* 2004).

Central European countries have chosen the path of the "outer directed capitalism", which was strongly relied on FDI (*Szelényi* et al. 2000). The foreign direct investments did not but resulting in a more rapid modernization of the Hungarian economy. The advantage of foreign investors was that they not only helped a faster recovery from the economic crisis and injected capital into the transforming economies but also wealth of expertise into the banking sectors.

The transition period was followed by the integration into the market of the European Union during the post-transition period since the late 1990s (Table 1). Despite its expansion after the privatisation process banking sector remained small by Western European standards. This is true both for absolute and relative figures. In 2001, the aggregate total assets of banks in the accession countries of Central & Eastern Europe came to EUR 324 billion, thus reaching only 1.7% of total banking assets of the EMU (EU–12). The other Comparisons are particularly striking. The aggregate total banking assets of the accession countries roughly equal the size of a middle-large west West European bank, and much below the size of the large Pan-European banks. Eastern European banking market also remains underdeveloped with regard to financial intermediation, which is measured by assets- to-GDP (balance sheet-to-GDP). Economic crises and high inflation eroded banks' balance sheets, insufficient capital resources and bad loans triggered banking crises and restricted the lending capacity *(Table 3).*

Table 3

Size of the banking sectors in few CEEC countries and few European banks, 2000

	Transmission ratio: balance sheet total/GDP %	Total Balance sheet of banking system (in Billion EUR)	Number of banks
Hungary	68	50	42
Czech Republic	120	167	40
Poland	62,3	210	84
Deutsche Bank		940	
KBC Bank		165	
Raiffeisen Bank		36.5	

Source: Central Banks' publications.

However, the banking sectors in the CEECs for several reasons (to a large extent because of its international character) can be considered better integrated within the EU than most of the banking sectors in the older EU member states (Riess et al. 2002). Since most of the foreign banks dominate the CEECs' market residence in the EU, therefore the true size and the profitability of the financial sectors very much depend on the performance of their parent companies.

East Central European banking systems are accelerating through more of the stages of development within a relatively short period because of competition with more advanced systems and state encouragement of banking development. While in the West the processes of market concentration and the financial exclusion are the major characteristic, in the Eastern counterpart the growing number of institutions and the network expansion was observable in the first decade of transition (*Anderson-Kegels,* 1998). The foreign banks entering the region often boast deeper pockets, greater expertise and more solid reputation and making circumstances of competitions worse for the local players. Foreign banks not only contributed to the modernization and the expansion of the sector, but often argued their lack of commitment to the local economy, which reinforce its dual and segmented character causing less development prospective for the local firms. All these challenges, which are to be faced, are common in these countries, but what could be varied from country to country is the spatial (regional & settlement) and institutional structure of the national banking systems. The development of the spatial structure of the emerging banking sector in CEECs offers a view of rapidly transforming and converging structures and allows testing of several hypotheses of regional finance theory.

3 Stages of development of the Hungarian banking system

The first important step forward in the modernisation of the Hungarian financial sector was the creation of the two-tier banking system in 1987, which was more adapted to a market environment. Hungary started the modernization of banking first in the CEE region and Hungary already had for three years a two-tier banking system when the Berlin Wall came down.

Despite the fact that the Hungarian banking system is to some extent still lagging behind western countries, we cannot say that there is a huge inherited gap between Hungary and Western Europe because despite some delay, already at the turn of the 19/20th century, the Hungarian banking system was well developed in comparison to international standards. Moreover, it became one of the most rapidly

growing sectors of the domestic economy of that time[1]. The historical evolution of the Hungarian banking system, despite it has developed in a latecomer country with regards to the phases of industrialisation, has gone through the similar development stages of the modern financial system than the more advanced economies (*Martin,* 1994). With the earliest stage of industrialisation the *"regionally-locally based, bank-oriented system"* operated in Hungary until the end of WWI, based on the extensive network of locally based banks using local sources of capital accumulation *(Table 4)*. During the interwar period it was replaced by the *"national or capital market-oriented"* stage, in which the banking system became more centralised into the capital city of Budapest and the national market incorporated the local, regional banks setting up the centralised national branch network (*Gál,* 2001). The post-war history of the Hungarian financial sector is a history of nationalization and the introduction of a centrally planned economy, which resulted in Hungary turning aside from the world's development mainstream. By 1948, the whole financial sector was nationalized, and the introduced one-tier mono-banking system was characterised by a monopoly of the *National Bank of Hungary (NBH).* This meant a direct line to the monetarisation of the economy that was financed through an oversized redistribution.

Despite the NBH monopoly few off-shore and joint-venture banks were established until the middle of the 1980s, representing not only the reform endeavour rather the capital (foreign currency) shortage during the communist period. By the early 1980s a particular contradiction evolved between the already existing small-scale enterprises wanting to finance their functioning and the one-level financial system based on the credit monopoly of the National Bank.

Hungary was the first in the region to repair the mistakes of the early transition years and opened the doors very early to the foreign strategic investors, as the trust slowly grew for foreign investors due to political transformation and new legislation, serving the market economy. The country was at the forefront of creating a market-driven bank sector. This act provided legal base for the institutional transformation in banking. The National Bank of Hungary started to perform primarily central bank's functions and the new commercial banks were set up from the for-

[1] Were someone to compare the state of our recent banking system with the banking sector of the turn of the century, one can find many similarities between them. Both were created following a change of regime (1867: Austrian-Hungarian Compromise; 1990: the fall of the Communism) and coincided with the early stages of modernisation that were characterised by an original accumulation of capital, by an early foundation of credit institutions, by a mass inflow of foreign capital (although its share was much smaller in 1910 amounting to 11%), by the foundation of joint-venture banks and by bankruptcies that demanded new legislation on banks and the creation of the public supervision of banking in both eras. The predominant position of Budapest in the money market and in banking is as important as it was 100 years ago. Budapest became the national centre of Hungary with intense international relations (*Gál,* 2001).

mer lending departments of NBH in January, 1987. Commercial banks that originally had corporate clientele were admitted to the retail market, while financial institutions were given commercial banking licenses. In contrast to Hungarian traditions, a specialised rather than universal banking system has been created in 1987, sorting different types of banks by functions (34 commercial banks, 8 specialised banks, mortgage banks and building societies, 236 co-operative savings banks) (*Lengyel,* 1994).

Table 4

The evolution of the modern financial system

Regional and bank-oriented	National and capital market-oriented	Transnational and securitized form
Associated with industrialization phase of economic development	Characteristics of industrial maturity phase of economic development	Associated with post-industrial and transnational phase of economic development
Banks main source of external funds needed by private sector firms	Capital markets main source of funds, using savings of private investors	Bulk of funds obtained through capital and credit markets, using mainly resources of institutional investors
Industrial growth financed by loans, risk capital and profits	Capital markets channel personal and other savings into industry; risk spread across shareholders	Separation of capital and money markets from industry and commodification of money; proliferation of monetary products
Local-regional and national banking system; local sources of capital important	Concentration and centralisation towards national banking and capital markets; loss of local-regional financial autonomy; emergence of internationalization	Development of globally integrated system of world financial centres; loss of national financial autonomy to supranational economy of stateless monies

Source: Martin, 1994.

Since the reintroduction of two-tier banking (after 40 years discontinuity) the banking system was opened up to the world as a competitive and rapidly growing sector. The transformation into a market economy, the radical diminution of the state's role in the business sector, privatisation, and foreign capital inflow, a more intensive participation in the international division of labour and European integration all provided new opportunities and challenges for banking. Hungary's financial sector after 40 years of discontinuity was reintegrated into the world's financial system and entered the *stage of "transnational" and "securitised" financial world.* The recovering financial sector in Hungary, besides the heavy burden inherited

from the centrally planned economy, had to cope with the unfavourable framework conditions of the increasingly globalized financial markets.

The last 15 years of development in the banking system can be divided into different periods. The comprehensive periodisation of different development phases of the development of the Hungarian banking system is closely related to the political-economic-legislative transformation of the country during the transition period, lasting till the late 1990s and to the expanded integration of banking into the international financial markets *(Table 5).* The *short period between 1989 and 1992* was *the boom for foundation of new banks, following the steady increase of financial institutions during the 1980s.* Competition was also increased by the entrance of the new foreign-owned and joint venture banks, founding their own subsidiary banks in Budapest (*Bácskai,* 1997).

After the period of rapid and extensive expansion between 1992 and 1995 the banking system was characterised by the *first bankruptcies, failures and bank consolidation.* The legislative action regulating the booming market came into force with a certain delays. The Act on Credit Institutions passed in 1991, and the first bankruptcies were followed by the Act on Bankruptcies and Banking Supervision. In 1991, soon after its ratification, the bankruptcy act was enforced during the first bankruptcies. The strong wave of establishment and expansion of banks coincided with a period of general economic recession following the economic transition in the early 1990s. Over-geared expansion of balance-sheets and increasing risk-taking stood in contrast with the low level of financial standing and the huge sum of inherited debts (non-performing loans). This automatically led to the loss of market shares of the Hungarian owned banks and strengthened the position of foreign banks. Pecuniary difficulties of the mainly state-owned banks made inevitable the restructuring of the Hungarian banking sector, together with the loan, bank and debtor consolidation. This has contributed to the evolution of a market economy, particularly in bringing about important structural changes through the privatisation of banking to develop a modern financial system. Banks showing deficits gained huge amounts of capital from the state, which imposed a substantial burden on state finances and thus on society as well (the state spending on bank consolidation between 1992 and 1995 exceeded the four Billion USD accounted for the 10% of the annual GDP). The purpose of bank consolidation and privatisation was to decrease the percentage of state ownership in the banking sector (*Várhegyi,* 2002a).

In the third period after the reconstruction (between 1995 and 1997), a stabilised and a more competitive banking system emerged, characterised by *successful privatisation* of the banking system resulting in a slower expansion in the banking from 1996 onward. The number of banks grew dynamically during this expansion period (with 40% between 1990 and 1997) and parallel to this the concentration (measured by the Herfindhal-Hirshman index of the total assets) decreased (*Móré–Nagy,* 2004). The period of "reduction versus expansion", as Jöns (2001) calls it,

Table 5

Development stages of the Hungarian banking system, 1980–2004

Institutional development	*Decentralisation of mono-bank system*	*Rapid expansion*		*Steady expansion and diversification*	*Concentration and institutional reorganisation*
	Slow growth in joint-venture banks	‘Boom’in bank establishment	Privatisation and “foreignisation”	De-concentration-de-centralisation	Further consolidation, Institutional centralisation, Dual economy bias
		Bankruptcies & liquidations	Bank-Consolidation process	Adaptation of western (universal) banking structure Network expansion	Decrease in the no. of banks: M&A, Competition of non-banking intermediaries, Cross-border branching, De-intermediation
Legislation	Liberalisation of the one-tier banking system	Formation of the two-tier banking system Act on credit institutions ’91		Harmonisation with EU regulations Acts: amendments, Single Financial Supervisory unit,	Harmonisation with Basle II, EMU’s criteria, Act on money laundering Structural & spatial inequalities in dual economy
Economic policy	Market-orientated reforms within the centrally planned economy *Push factor*: Debt crisis, capital shortage	Economic & political transformation: creation of a market economy during transition period *Push factor:* general economic crises versus modernisation			EU accession, Preparation for the EMU’s criteria, *Push factor:* cost saving, Increasing competition

Year 1980 87 1990 91 92 94 96 97 2000 2004 →

Source: Edited by the author and Jöns (2001).

was a transitional period in network building, as parallel processes had overlapped each other: reductions of branches of (former) Hungarian owned banks (OTP Bank), mergers and liquidation processes, and finally the steady opening of branches of foreign owned banks.

During this period, foreign investors successfully privatised a few big banks while a few smaller banks went into bankruptcy and were liquidated. One of the most important alterations in the Hungarian banking system was that the *role of foreign capital in ownership* was determined. As the consequence of foreign capital inflow into Hungarian banking, the structure of ownership was entirely transformed; parallel with the process of the significant decrease in state ownership,[2] the foreign market shares as a proportion of registered capital attained 78% of the banking system in 2002 (91% in terms of banking assets) , gaining a majority of market shares within a short time *(Table 6)*. FDI (Foreign Direct Investment) became a salient feature of the Hungarian banking sector early in the transition process. Of the banks in Hungary, 80% are foreign owned. The Hungarian proportion of foreign capital was the highest in CEECs context until the late 1990s, but other countries in the region have now opted to follow Hungary's pioneering path gaining even larger share of foreign capital. With the exception of Slovenia, the banking sectors of the CEEC countries are now dominated by foreign banks. Despite this self-explanatory nature of this ownership structure, the role of foreign banks is much less dominant in the EU–15 countries and foreign penetration only in emerging regions has reached unprecedented levels.[3]

To summarise the role of foreign capital in the Hungarian banking system it can be said that such a rapid process of privatisation of banking without foreign capital inflow would have been impossible. Foreign capital inflow into the banking system together with the foreign ownership shares of privatisation, comprising a total of 1,1 Billion USD, was directly invested into banks headquartered in Budapest. Already in 1995, foreign banks, occupying one fourth of the total market, accounted for 70 % of profit returns due to their high profitability, which was twice as much as in the Hungarian owned banks. Foreign capital investment has contributed significantly to the growth of international competitiveness of Hungarian banking (*Wachtel,* 1997). The main motivation of foreign banks' entry into the CEE region is the existence of host country opportunities provided by the competitive advantages of non-saturated and rapidly expanding markets (*Clarke* et al. 2001). More-

[2] The state ownership decreased from 74% in 1990 to 20% recently.

[3] As a result of foreign capital inflow, foreign investors own about three-quarters of banking industry assets in the new member states of the CEE region, compared with about 20% in the Eurozone (The Banker, May 2004). The main investors are in Hungary, according to the portion of invested capital, still the leading German and Austrian entrepreneurs, followed by the Belgian, American, Italian, French, Japanese, Dutch and Korean investors. British banks are conspicuous by their absence (*Várhegyi,* 1997).

over, foreign banks played a multiplication role as they attracted other foreign investors in the non-banking sector. Nevertheless, opening up the banking market was not decided upon after careful consideration of the advantages and disadvantages. Rather it was the direct response to the capital shortage and the demand for sophisticated services. During the turbulent years, foreign banks could also provide a "safe heaven" for depositors and stable source of funds compared to domestic banks, which latter ones needed time to mature. Only handful local banks, such as OTP Bank, were able to compete very successfully without the benefit of foreign banks' backing and experience, their risk-management systems, and their product range. On the other hand, one of the typical disadvantages of market opening is cherry picking: powerful foreign banks, selling services that are more sophisticated and often unburdened by non-performing loans, can easily acquire the best clients with the lowest risks. This also might be one reason why the foreign banks have reached exceptionally high shares in the market.

Table 6

Assets of foreign owned bank as a percentage of the banking sector, 2000*

CEECs	1995	1996	1997	1998	1999	2000	2002 Foreign banks' assets as % of Commercial banks' assets
Hungary	41.8	46	61	64	66,4	68	90.7
Czech Republic	10	12	15	16	28	54	85.8
Poland	4	14	16	17	49	70	70.9
Slovenia	–	5	5	5	5	5	16.9
Slovakia	–	–	–	–	25	76	95.6
UK			52.1				
Spain			11.7				
Germany			4.3				
Sweden			1.6				

* The foreign share in ownership being more than 50%.
Source: Riess et al., 2002.

The period between 1997 and 2004 after the major transformation in the ownership structure was characterised by the adjustment to the European banking structure. The majority of Hungarian banks by the Millennium became integrated into large European banking groups, which created the conditions for sustainable development conditions for them (*Várhegyi,* 2002a). This period was a transition from the extensive market expansion (accompanied by the acceleration of an extensive branch network expansion) towards the formation of more mature market

structures. In the earlier stage of development the branch network expansion was one of the major phenomena. The growing retail market from the mid–1990s has urged banks to establish their extensive nation-wide network of local branches. The rapid growth in the number of banks had stopped by the end of the period, and the mergers and acquisitions strengthening the market concentration counterbalanced the new establishment. New players such as mortgage banks and building societies have entered to the market. In this period, the banks became increasingly universal (all-finance), as they integrated the previously separately conducted intermediary, insurance and capital investment services. After the years of dynamic growth, the leading bank (OTP-Bank, during the state-socialist period a savings bank with a monopoly of retail market) has thrived thanks to its good Hungarian management, and found the Hungarian market too small and has started foreign expansion within the CEE region.

With the EU membership, achieved *in 2004, a new period has commenced* in the banking system. The structure of the Hungarian banking sector will continue to change – without and even more so with the EU accession. With the accession, the process of integration can be expected to proceed smoothly not least because EU financial institutions have taken large stakes in the Hungarian banking system and since the integration of the banking system has already taken place by the end of the 1990s. Hungary was at the forefront of creating a market-driven bank sector, therefore the structure of bank balance sheets and portfolio is similar to that found in the EU. However, the accession should further enhance the integration and the slower accommodation of the banking sector (EU regulation, Basle II principles). Considering the size of the banking system, it is still small; the total banks assets to the GDP are only 78%. The still "under-banked" nature (in terms of accessibility of services) of the country, particularly in consumer finance, offers huge potential for further growth. On the other hand, the CEEC banking, the Hungarian Banking system in particular, mobilises more funds than banks can lend domestically, which effectively makes them net external creditor in a capital importing environment. European integration increases the competition due to the opportunity of cross-border bank branching of foreign banks currently not operating in Hungary (*Riess* et al. 2002). EU accession influences the new foreign banks entry branching out without the commitment to establish subsidiaries; therefore resident banks might face up to stronger competition. Nevertheless, mass entry of foreign branches is not expected since new players might face strong competition in the market. There is also a potential for resident banks to benefit from local information and increase lending to borrowers and they may exploit their knowledge of local conditions and existing client relations. In regional context, resident banks have the best chance to raise their market share. The macroeconomic and institutional environment of banking seems to be conductive for future development and further expansion (*Várhegyi,* 2002b).

Banking in Hungary is recently facing to similar structural problems as the more mature banking of the older EU members since it has already come over the earlier stages of development by the Millennium, which is characterized by the more mature stage of banking: dez-intermediation, increasing competition, employment loss subsequent to IT development and financial exclusion. Structural adjustment will continue. This will influence both the institutional and the spatial structure of banking since on the one hand the number of banks licensed is likely to decrease and the number of non-financial institutions may rise, but on the other hand, further expansion of branches due to the lower branch density and unexploited markets potential especially in retail banking continues. Following the M&A activities taken place in the last years the market concentration is increasing, which accelerated by the introduction of IT technologies and operation cost efficiency. Banks react to these challenges with the reorganization of their organisational structure gaining ground for the centralisation of the organizational structure, which results in a growing spatial concentration in the market.

4 Structural and spatial polarity of the Hungarian banking system in the 1990s

Money flows on global level are often independent from the real economic processes at the same time uneven capital flows among the regions and the deficiencies in accessibility to the financial institutions caused by the spatial inequalities in the economic potentials. The presence of high level services and the location of the head offices, and also the absence of bank branches express territorial disparities in economic development (*Jöns,* 2001). Financial services became the key sector in the processes of economic transformation and differentiated by uneven regional and urban development. The market of the financial and business services in Hungary is very much centralised by geographically and organizationally. Several factors underpin this argument:

1) The spatial structure of the banking sector is characterised by a large-scale concentration in Budapest. The Budapest-centred organisational control in the banking sector is predominant. The extremely high centralisation of headquarter functions in Budapest is illustrated by the fact that all the 38 banks, except one[4], have head-offices in Budapest. Banking in Hungary is still the most centralised branch of economy with a definite centre in Budapest. The leading position of Budapest in the financial sectors, especially in banking and insurance, is more striking than in any other sectors. This can be indicated by the 94% of the total banking

[4] Sopron Bank Rt. established by the Bank Burgenland of Austria in Sopron.

assets and the 86% of employees (registered according to the headquarters) are concentrated into Budapest, which is the major strategic geographical location and financial core of the country.

2) The Hungarian banking system is characterised by the lack of strong locally and regionally based banks. The marginal pole of the national banking system is the dense network of the locally-based co-operative savings banks scattered throughout the countryside. The most important fundamentals of these are the weak financial standing (accounting for only 6% of the total balance sheet of banking) and lack of strong centres of their headquarters[5]. Despite the number of co-operative savings banks being 1,700, thereby accounting for 58 % of the total national network, most of these small credit institutions are situated in the smaller towns and villages having a very low capital circulation and can supply only a narrow range of services.

3) The third reason of polarity lies on their governance structure. Branches of banks with the headquarters in Budapest have much less room for making independent decisions than the branches in county seats during the communist period. Since the Hungarian banking system is characterised by an over-centralised management, controlling and structural system, branches are not in a real decision-making position, partly because they have got only limited information (information asymmetry). Most of the banks offer the same services all over the country and do not have local advertising strategy.

4) Lower density of the network compared to the European average means both a lower level of availability of branch offices and higher spatial polarisation of the branch network. Despite the rapid expansion of branches, banking services are still missing from the lower hierarchical levels of settlements and their presence is low in certain micro-regions, which is accompanied by a spatial-regional asymmetry (*Gál,* 1998).

In the case of financial services the dual and the segmented feature of the transition economies is observable. The dual term can be applied to both the structural and the spatial segmentation of economic development during the transition period. The financial sector of the transition economies is on one hand dominated by the large foreign (transnational) institutions owning the lion's share of the market, on the other hand domestic players facing them do not stand for significant market force. The dual character does not imply only the structural peculiarities but increase the spatial segmentation as exists between the large financial firms almost exclusively concentrated in Budapest and the local service providers of the countryside (*Nagy,* 2002).

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[5] Until the early 1990s savings co-operatives located exclusively in villages and were not allowed to open urban branches.

There are several arguments concerning the predominant position Budapest plays within the Hungarian economy and the lack of the self-autonomous locally embedded financial centres (*Jöns,* 2001). The five main reasons that have been responsible for the centrally organised financial system in Hungary are:

– The historical dominance of Budapest within the country (path dependence);
– The inherited centrally managed feature of the state socialist economy, making centralisation in decision-making;
– Transition processes was largely influenced by the framework conditions of the global economy;
– The key role of Budapest as the centre of innovation in economic transformation (bridgehead of FDI in service sector);
– Inefficient level of capital accumulation outside Budapest.

The strongly centralised structure, as one can argue, is more in line with the contemporary international tendencies, which prefers larger concentration at the global level. Most countries typically have a single national financial centre, even in those countries that have a number of major regional centres. However, the financial centre do not need to be the largest city of the country in terms of population, but in financial centres have to be an intensive economy activity, providing high-level services which are in demand over a larger area possibly the nation and even the global economy (*Porteous,* 1999). The large scale concentration of the financial sector in the capital city is explainable partly with the adjustment not only to the more concentrated international banking structures, but as Bellon (1998) argues, the result of the small size of the Hungarian economy and territorially restricted preconditions of capital accumulation within the country. Others add to this (*Beluszky,* 1998; *Gál,* 1998) the path dependence factors and the traditional agglomeration of key economic sectors in Budapest since the first wave of modernization in the 19th century.[6] A common characteristic regarding the spatial organisation of the Hungarian banking system before and after the political transformation in 1990 has been an extremely high centralisation of headquarter functions in the capital city.

[6] Although regions were important territorial element of the financial space in the late 19th early 20th century Hungary, when banks closely connected to regional economic structures, their significance is much less clear in the era of globalisation. The spatial structure of banking system is more centralised compared to the network which existed at the turn of the 19/20th century. That time the number of independent banks scattered throughout the countryside was overshadowed within the banking network. Consequently there were proportionally few branches in banking before World War I, consequently only 5.7% of the banks were concentrated in Budapest (*Gál,* 1999a).

The establishment of financial markets in the early transition years in the CEECs was not the consequence of natural evolution, but rather a creation of a very much centralised framework structure from the top-down directed way by the reform elite. The introduced two-tier banking system more or less remapped the over-centralised and Budapest dominated nature of the state-socialist monobank structure. Nevertheless, the rapid foreign bank penetration in the early transition year has placed the strategic decision-making, including the location of the headquarters into market base, and all the privatised banks and so the new green-field establishment selected the capital city as their strategic location. This meant that the total amount of capital inflow invested into the Hungarian banking sector was concentrated in Budapest. In other CEECs, part of the early bank establishment by governmental policy makers considering the historical traditions, has taken place outside the capital cities creating a more even spatial structure of the headquarter locations. It is also due to the fact that, at least in e.g. Poland and Slovakia, the dominance of the capital city is much smaller than in Hungary, consequently there are more big cities besides the capital city. Nevertheless, the constraints of the decentralization have reduced the number of bank headquarters in the Czech Republic and Poland by the end of the transition, and resulting in a stronger correlation between the existing regional bank centres and the local economic performance (*Blažek,* 1997).

Besides the previously mentioned factors, the very much centralised spatial structure of banking system and the uneven spatial distribution of capital sources within the country was large extent determined by the international and local framework conditions in the early years of transition. The transition to the market economy was largely influenced by two main processes of the World's economy, namely by *globalisation and the neo-liberal change in economic* paradigm. These processes were not only conductive to the collapse of the communist regimes, but created very harsh framework condition for the transforming economies. The new market economies had to adapt themselves to the disadvantageous framework conditions of the very volatile global economy facing global crises. One solution to avoid the debt crises was the full market liberalization and the promotion of the mass influx of foreign capital inflows. Hungary has chosen the path of the "outer directed capitalism", which was strongly relied on FDI (*Szelényi* et al. 2000). The foreign direct investments did not only help a faster recovery from the economic crisis but resulting in a more rapid modernization of the Hungarian economy. Among the disadvantages, there are several arguments with spatial and structural implications. Foreign banks not only contributed to the modernization and the expansion of the sector but often argued their lack of commitment to the local economy, which reinforce its dual character. As Claessen (et al. 2001) argued the loss of monetary autonomy and increased volatility of capital flows might cause capital outflow from certain regions, resulting in spatial and structural segmentation of the

peripheral areas. There are also concerns that foreign banks ignore certain markets segment small and medium sized enterprises or propagate shocks originating from their home country (*Mérő-Valentiny,* 2003). These disadvantages became observable as the economic pressure diminished by the end of the transition process.

In the consequence of the diminishing financial role of the state, the growing importance of the integrated markets both at global and *supranational level* goes parallel with the strenuous effort being made to build up *sustainable national financial markets* in the "new" market economies of Central and Eastern Europe. The market concentration in European finance led to domination by large financial firms situated in few financial centres located in the core regions. The increasing role of global and other foreign players imposes a heavy burden on the government of the emerging economies facing dependence from the global actors, whether to promote the scope of action of the local firms or the multinationals instead. The big question is to find the optimal equilibrium between the two ones.

5 Spatial development of the Hungarian banking network

Developed financial services became determinant factors of the economic development and competitiveness of the region, which in the longer run might have influenced the emergence of territorial differences (*Mazucca,* 1993). In regards to the diffusion of the banking network, it is very important to survey the geographical location and the different hierarchical types of settlements where banks are located. The expansion of the banking network was determined very much by a huge inherited debt imposing a large burden on the smaller state owned banks, limiting their ability to build an extensive branch network. Large banks re-scheduled their policy of network building and few of them closed some of their branch offices. Foreign owned banks started to expand their branch network more cautiously only after the mid–1990s. There are different reasons for this more cautious policy. On the one hand, these banks were strong enough in terms of capital intensity, so that they could adjust the pace of their network building to their own pace of development. On the other hand, foreign owned banks were interested first in corporate banking, and only afterwards the saturation of this segment has shifted to the retail market. Several banks reformulated their strategies and intended to increase their presence in the retail markets as well as to lending to creditworthy medium-sized enterprises (*Jöns,* 2001).

The geographical distribution and the regional diffusion of the new branches strongly correlated to the Hungarian economic processes in the 1990s. At the birth of the two-tier banking system, the network was characterised by a certain spatial

balance due to evenly allocated branches of the OTP Bank. After the foundation of the new commercial banks significant spatial asymmetry occurred within the country since certain banks were missing from particular regions. This was especially so because some of the newly formed banks did not have representation in 10 counties and the others had strong sectoral affiliation dominating in particular regions (*Lados,* 1991).

Significant spatial differences emerged in the network building process. Slight west-east disparities were preserved from the pre-socialist times. Pre-war disparities in banking continued to exist in socialist times – though smaller extent – because of nationalisation of banks, resulting in an extensive branch reduction. The structure of diffusion of the banking network had followed this spatial pattern for the first time by the beginning of the 1990s. This was evident because the largest unexploited territories of financial services were situated in Western Hungary due to the committed economic development policies during the socialist era, which had the preference to transfer state fund to the east and especially the north-east, and to areas alongside the southwest – northeast industrial axes. The reason behind the policy in favouring of the development of the eastern regions was the priority of the stronger economic collaboration with the Soviet Union (*Lados,* 1991; *Lengyel,* 1994).

After the political change the prevailing majority of economic associations, within it the joint-venture companies and the accumulated capital outside Budapest flowed into the north-western regions, which were less-frequented in locating industries during the socialist period, indicating the new direction of economic relations. Significant differences among the greater regions had practically evened out, except in Northern Hungary, by 1990, and the disadvantage of the Transdanubian region came to an end. From the mid–1990s, after saturation of Transdanubia, the larger cities of Eastern and Southern Hungary became the main targets of branch network expansion (*Gál,* 2000).

A general characteristic of the early transition period was the growing importance of the national financial centre in the branch network expansion. All banks have started to open their first branches in the capital city. Within Budapest most of the head offices of banks are based in the inner districts. The spatial concentration of the institutions gives a strong impetus to the formation of the central business district, where the office buildings of banks became an important functional-morphological element of the urban landscape. The number of banks has grown by 18-fold between 1987 and 2001, increasing the capital's share within the national network, with regarding to the network expansion, from 11% to 38% (with 358 bank offices). The expansion of branches has increased the density of network in Budapest, resulting in that the ratio of one office per 25,000 inhabitants changed to 4,700. These figures demonstrate the high level of extension of the banking network within the capital city.

Despite that spectacular progress has been made in the field of financial services the accessibility to banks and the network density is still much lower than in the Western counterparts (In the EU–12 [EMU members] there is the average of 1,923 inhabitants per branch). Hungary is lagging behind, in terms of the size of the network, being low comparing not only to the EU average but also to the Slovenian and the Czech figures. The smaller size of the banking network is highlighted by European comparisons *(Table 7).* In countries with smaller territories, such as Belgium and The Netherlands there are seven times more branch offices and less densely populated Finland has twice as much offices than in Hungary (*Gál,* 2000).

Table 7

Indicators of access to banking service in selected CEEC countries, 2000

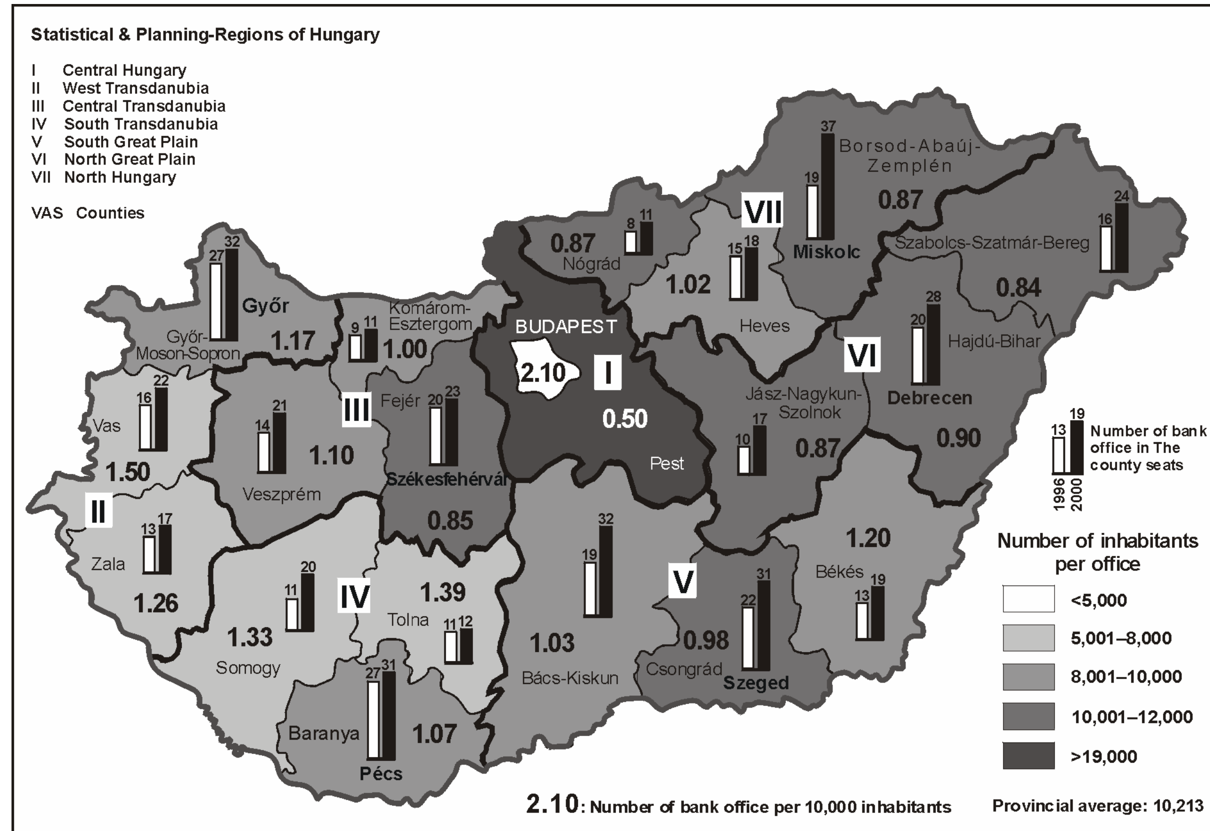
Country	Number of banks	Inhabitants per bank	Number of branch	Inhabitants per branch	Employee	Inhab. per employee	ATMs per 1 million inhabitants	Assets (in mill. Eur) per employee
Hungary	42	238,876	1,116	9,091	26,668	379	250	1,2
Czech Republic	40	255,608	1,840	5,556	46,000	222	160	1,7
Poland	84	522,220	2,323	16,667	139,280	278	100	0,7
Slovenia	25	79,640	571	3,448	10,883	181	430	1,4
EU–12	4,700	78,663	197,607	1,923	2,968 750	128	540	6,6

Source: Own calculation and Riess et al. (2002).

In Hungary the number of branches accounted for 1170 by 2003. The population per branch, despite its constant improvement (with 22% 1998–2004), is still amounting to 8561, indicating the insufficient accessibility to banking services. Surveying the spatial distribution of banking services, measured by the *financial supply index*, we can find significant geographical differences between the western and the eastern parts of the country. Spatial differences can be surveyed more thoroughly at micro-regional level than simply applying it to the macro-regions *(Figure 1, Table 8).* Even more so, from the mid–1990s a shift has taken place, levelling out the expansion of the banking network in favour of the eastern parts of the country.

Figure 1

Density of the Hungarian bank branch network and the distribution of branches in the cities with county seats functions, 2000



Source: Edited by the author and Handbook of the Hungarian Financial and Capital Markets.

Table 8

Regional distribution of the Hungarian banking network, 1998–2004

Regions	No. of banks 1998	No. of banks 2004	Territorial ratio of branches 1998	Territorial ratio of branches 2004	Network density (Inhabitants per branch) 1998	Network density (Inhabitants per branch) 2004
Central Hungary	304	441	32	38	9,434	6,417
From which Budapest	*253*	*358*	*27*	*31*	*7,356*	*4,762*
Central Transdanubia	96	109	10	9	11,594	10,211
West Transdanubia	114	127	12	11	8,711	7,897
South Transdanubia	101	111	11	9	9,762	8,865
North Hungary	88	110	9	9	14,591	11,636
North Great Plain	109	147	12	12	14,073	10,524
South Great Plain	132	155	14	13	10,295	8,774
Hungary	944	1,170	100	100	10,736	8,647

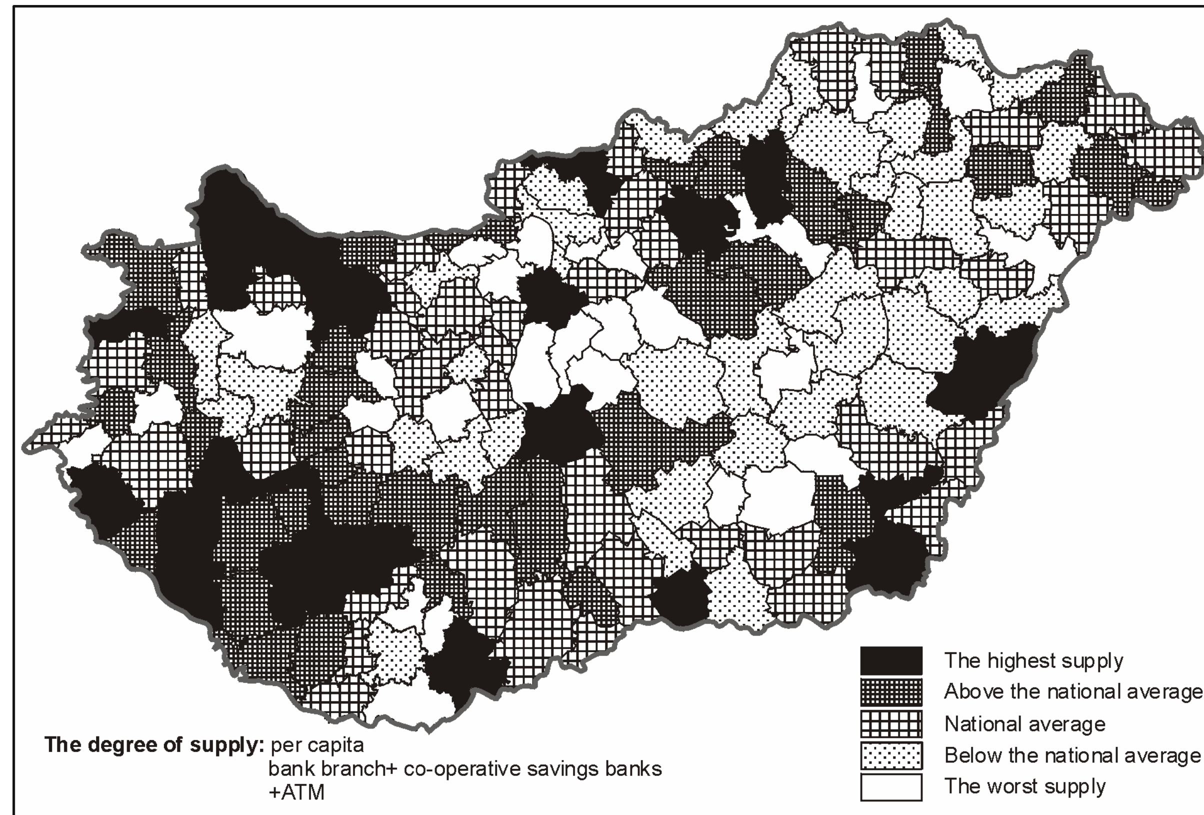
Source: Handbook of the Hungarian Financial & Capital Markets.

During these years the number of branches in the cities of Eastern and Southern Hungary increased more rapidly than in the western counterparts which previously were the target regions. According to the recent micro-regional survey *(see Figure 2)* there are internal peripheries even in the western regions, however these are prevailing in the eastern and the north-eastern parts of the country. The lowest density of branches can be found in the North Great Plain and North Hungarian regions, followed by the developed Central Hungary, in which the service supply concentrating in Budapest explains the contradictions. In the regions with lower density the economic activity of entrepreneurs, the low level of foreign capital inflow etc. could be the explanation of the smaller interest of banks.

The spatial distribution of banks strongly correlates with the state of territorial economic development. It can be said that the network expansion of branches initially followed the pattern of the spatial-economic division of the country, as banks were mainly opening branches in the rapidly developing regions. Nevertheless, surveying the distribution of the banking network according to the settlement types is more expedient than investigating at territorial level; all the more so as banking institutions have more links to the cities and towns, therefore capital flows is an important indicator of the different urban processes. The branch network building reveals a hierarchical top-down diffusion *(Figure 3)*. The Hungarian banks, in the early period of network building, aimed at covering the relatively small banking market alongside the settlement hierarchy, starting their expansion first in the

Figure 2

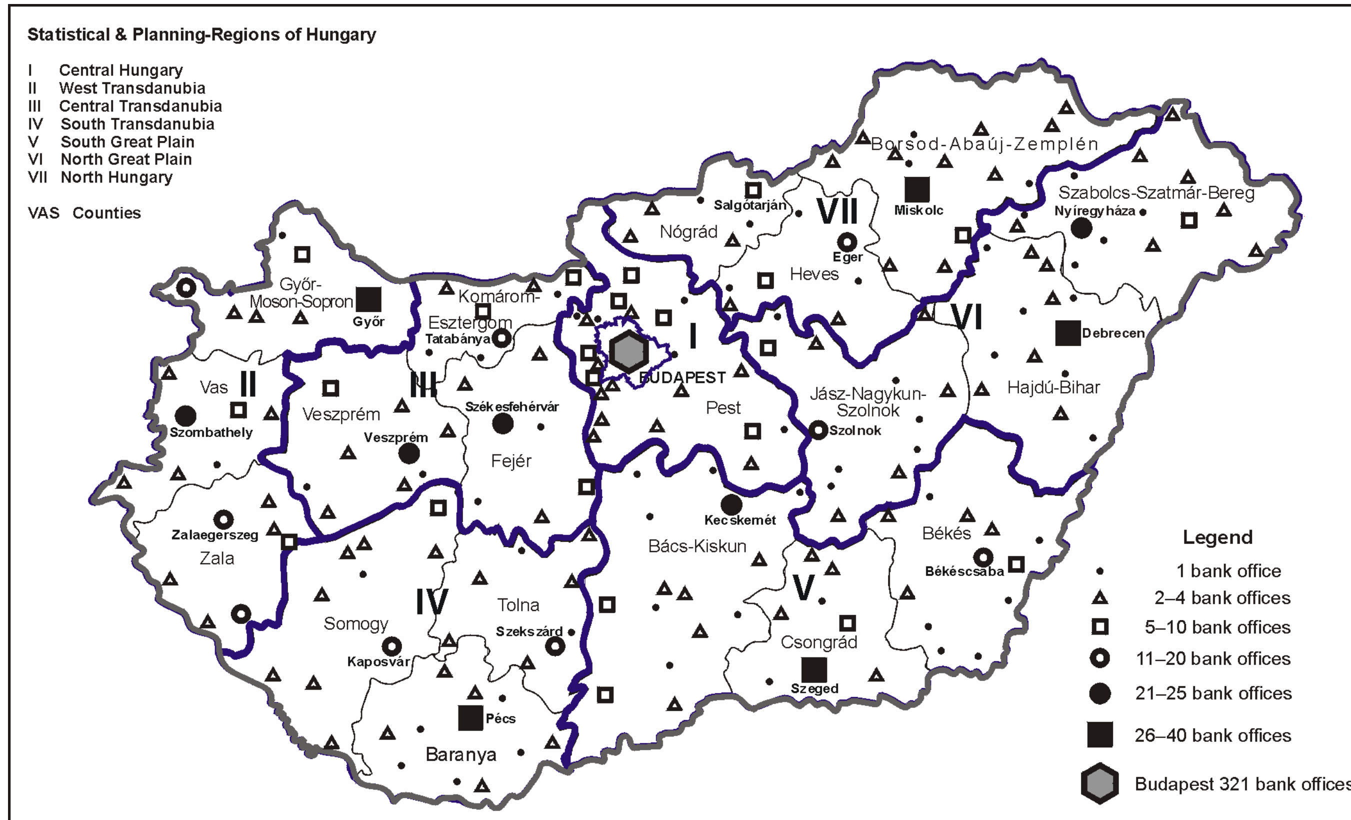
The degree of banking supply in the Hungarian micro regions, 2004 (Measured by no. of bank branch + no. savings co-operatives + no. of ATMs to population)



Source: Edited by the author based on VÁTI's calculation.

Figure 3

Regional distribution of branch network in the Hungarian towns, 2000
(included banks headquartered in Budapest, excluded cooperative savings banks)



Source: Edited by the author based on Bankinfo database.

larger cities. The first branches in villages were also opened. As the number of branches exceeded the number of larger cities the interest of banks turned towards the medium-sized towns. The share of larger cities from banking network decreased from 50% (with Budapest 66%) in the early 1990s to 22% between 1998 and 2004 owing to the network expansion targeting the smaller towns *(Table 9).* Bankruptcies and the rationalisation policy of network development in the early transition period mainly affected the larger cities, being the major beneficiaries of the earlier boom in banking expansion. Recently the largest share (41.5%) of the network can be found in the settlements between 10 and 50 thousand inhabitants. In the settlement categories with less than 5 and over 50 thousand inhabitants, networks expanded only to a smaller extent, while the number of branches has decreased in the smaller settlements. Population per branch ratio also shows that disparities between different settlement categories considerably decreased during the transition period, but since the end of the 1990s differences has been starting to grow.

Table 9

Distribution of branch network in Hungary on basis of settlement categories, 1998–2004

Settlement category by size of population	No. of settlements	Ratio of population	Territorial ratio of branches 1998	Territorial ratio of branches 2004	Network density (Inhabitants per branch) 1998	Network density (Inhabitants per branch) 2004
1,000 – 1,999	641	9	0.6	0.2	230,771	461,543
2,000 – 4,999	505	14.8	7.3	6.2	29,826	29,252
5,000 – 9,999	136	9.2	13.0	12.0	10,408	9,378
10,000 – 49,999	122	22.6	36.9	41.5	8,961	6,612
50,000 – 99,999	12	7.5	17.8	17.9	6,109	5,057
100,000 –	8	11.4	24.4	22.2	6,807	6,192

Source: Handbook of the Hungarian Financial & Capital Markets & VÁTI (2004).

Certain larger cities (Pécs, Győr, Szeged, Székesfehérvár), despite not being seats of a regional bank, have been started to play significant roles in the agglomeration of financial services in which different organisations of the financial sector (banks, insurance companies, consulting) attract each other mutually *(Figure 1).* This also induces increased competition in the local-regional market. In the beginning of the transition, West Hungarian cities, such as Győr, Pécs, and Székesfehérvár were considered the largest financial centres outside Budapest, while recently Miskolc gained the leading position in the number of bank and co-operative savings bank branches (37), followed by Győr and Kecskemét (each with 32 branch offices), then Pécs and Szeged (31–31), and finally by Debrecen (28) (*Gál,*

1999). The main targets were the large cities in East and South Hungary, and Miskolc, Szeged, Debrecen, Nyíregyháza gained a temporary leading position in size of the local network. However, differences occurring in the number of branches do not mean differences in the quality of banking services. This latter one is much more dependent upon the territorial embedded ness and local economic development, which can induce mutual attractiveness toward the other types of financial, and business services. This is better highlighted by the territorial differences in credit supply. Branches in the eastern regions, in general, concentrated on mobilising savings, while credit allocation is more restrictive there. Consequently banks transfer their deposit via the Budapest head office to branches in Budapest and the Central region, and the northwestern part of the country (*Wágner,* 2004; *Jöns,* 2001).

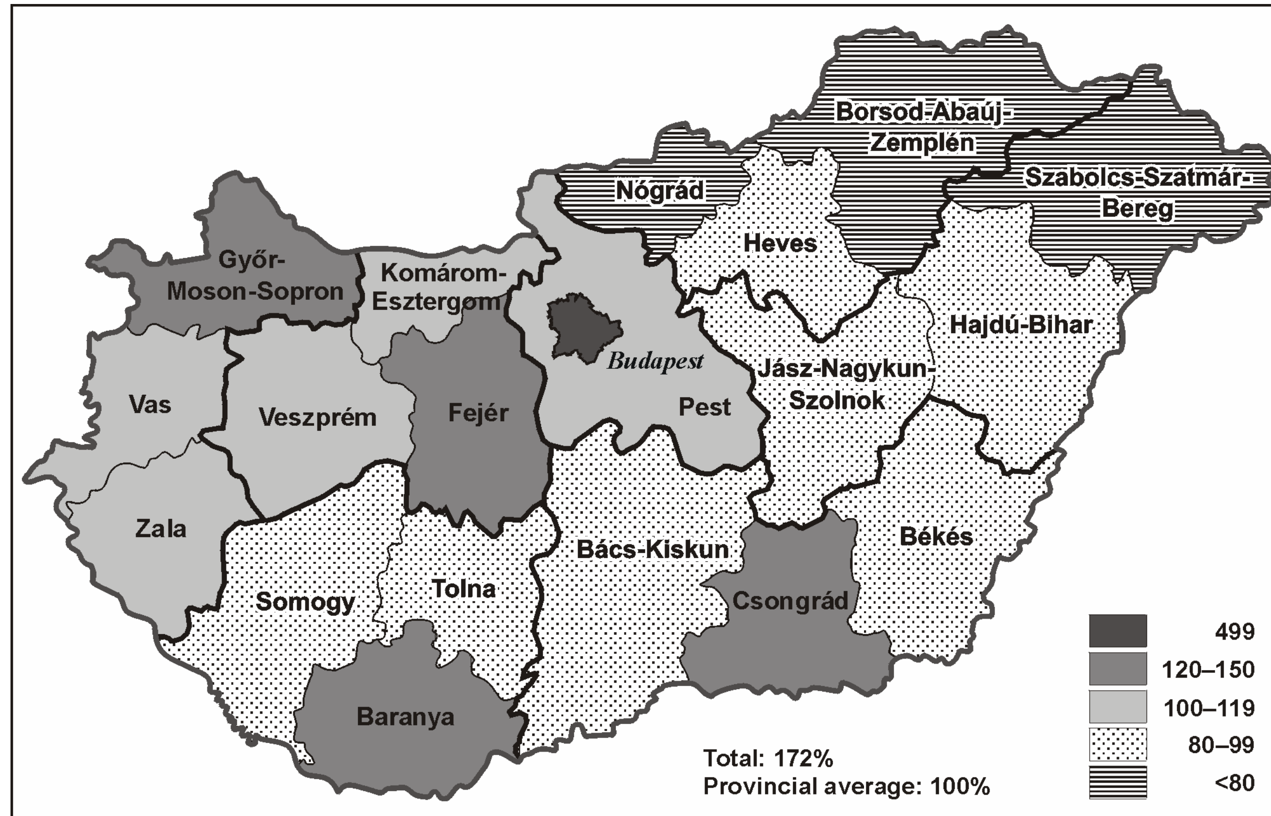
In the 1990s, which is considered to be the *transition period* in Hungary, new trends emerged in the national economy that stimulated the rise and expansion of the new "core" regions and also reinforced spatial disparities inherited from the former state-socialist system. In the early years of transition, regional differentiation was spurred by the factors of economic crisis and the consequent decline however, since 1996 the spatial structure has been formed chiefly by the factors of dynamics that rested on economic restructuring. The main spatial consequence of the transition was the deepening of the Budapest-countryside spatial-economic gap, although it has existed in similar dimension in the communist era as well. What was a real peculiarity of the economic transformation in the 1990s was the rapid growth of interregional differences, measured by the Hoover-index, growing from 1.7 to 2.6 times between the most advanced and the less advanced regions (*Nagy,* 2002).

Besides the role of industrial restructuring in spatial development, advanced business and financial services were to a large extent responsible for spatial differentiations, although banking in the peak period of its network expansion phase polarised economic space to a lesser extent than FDI-related industrial developments. Recently, advanced industrial development has stimulated the *agglomeration of financial services* besides Budapest into the more rapidly growing western and central regions *(see Figure 4).*

The growth rate of the financial sector and the growth of per capita investment volume in the financial sector came close to those of the industry in the West Hungarian counties and exceeded the industrial investment growth in Budapest, Fejér and Csongrád Counties *(Figure 5).* Concerning the spatial diffusion of financial services there is a strong correlation between the economic activities, income patterns and the agglomeration of financial service providers (*Nagy,* 2002). Spatial patterns of consumers' income reinforce the position of Budapest and the larger cities of the urban hierarchy.

Figure 4

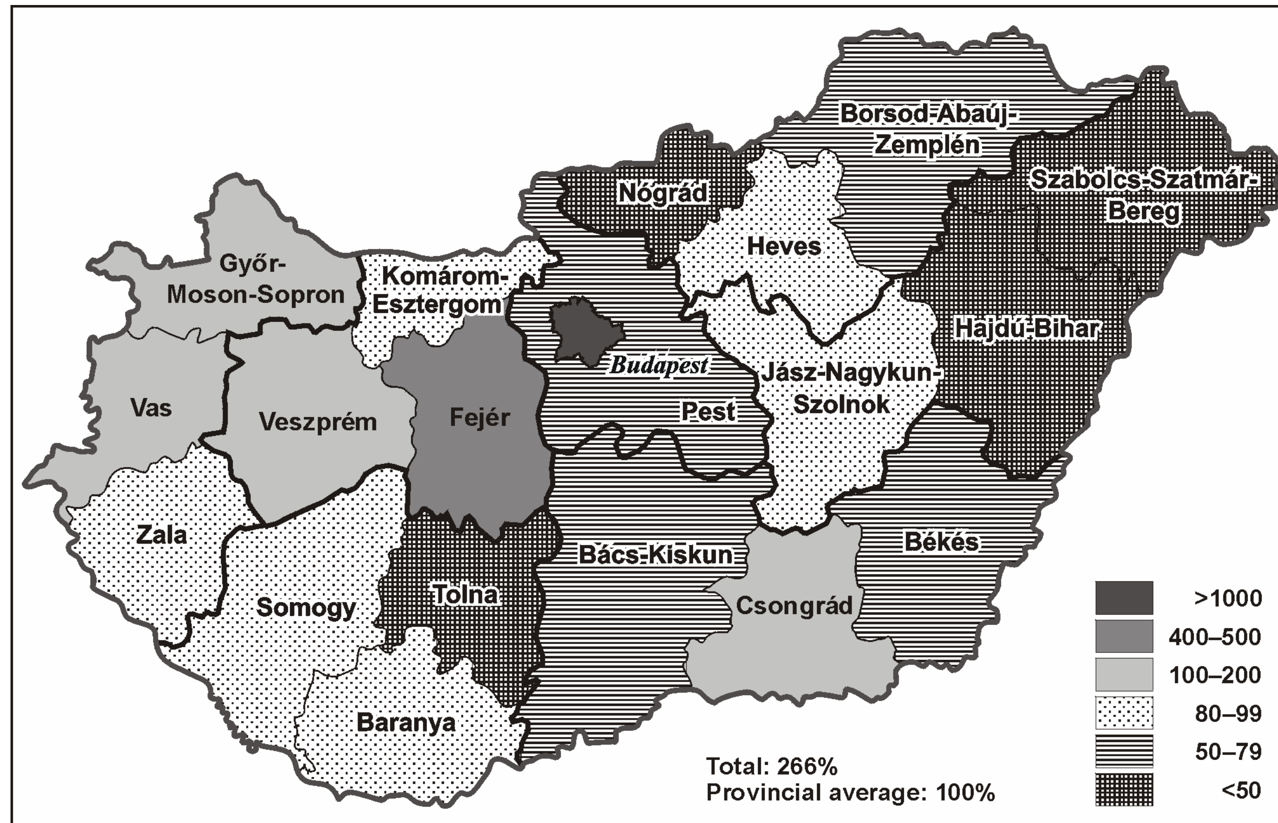
GDP per capita as a percentage of the provincial average in Financial & Business services, 1999



Source: Edited by the author based on Central Statistical Office data.

Figure 5

Per capita investment volume of enterprises & public organizations as a percentage of the provincial average in Financial & Business services 1996–1999



Source: Edited by the author based on Central Statistical Office data.

6 Territorial and organisational levels of the Hungarian banking system

Advanced business and financial services became determining factors of the economic competitiveness of the regions, and influence the emergence of territorial differences. Consequently, the differentiation of financial institutions according to the market division of labour and the organisational structures determine both the different organisational (institutional) and the territorial (location strategies) level of the Hungarian banking system. In any developed economy certain basic financial functions and the related institutions are widely distributed geographically (retail banking and building societies), corresponding to the distribution of population, other more specialised functions and institutions (such as stock exchange, pension fund houses, bank headquarters, investment banks, venture capital companies) are much more concentrated spatially. Like other industries, financial services are also characterised by economies of agglomeration, path-dependence and location lock in, and tended to cluster geographically in particular urban centres and regions (*Martin,* 1999). Indeed urban hierarchy, as Martin argues, is largely, financial hierarchy. Most countries have a number of financial centres and typically a single national centre.

6.1 Budapest: the national financial centre with international aspirations within the CEE region

Budapest as the single national financial centre of Hungary laid the foundation more than 150 years ago when the significant stock of original capital accumulation and foreign investments particularly in banking flowed into the city in the era of the early industrialization. The traditional predominance of Budapest in the economy has not diminished, quite the contrary, significantly it has been growing since the change of regime. The leading position of Budapest in finance, especially in banking and insurance, is more striking than in any other sectors that are characterised by strong spatial concentration. This considerable degree of concentration implies a 95% of foreign capital investments, joint-venture banks and bank transactions. Since the establishment of the Budapest Stock Exchange in 1990, the centre of capital markets is concentrated in the capital city. Budapest not only serves and controls its own domestic finance, but it also has a role in carrying international relations. In the capital city are all the specialised functions and institutions of the financial sectors concentrated: the location of the stock exchange, headquarters of banks, mortgage banks, insurance and leasing companies, and centres of the

specialised units of banks (treasury, call-centres). The advantageous position of the city arises from its strategic location function, which acquires and manages the critical information flows (institutional strategies, central data supply, connection with the clearing houses, and stock exchange dealings) and the international relations (*Wágner,* 2004; *Porteous,* 1999). The share of Budapest in the employment of the financial sector exceeds 37% compared to its 18% share of the national population. This share can be much higher if we take the financial employees registered by the headquarters into consideration (86% of financial employees belong to companies with headquarter in Budapest). Despite banking is still the most centralised branch of economy the leading role of Budapest is not a peculiarity in European context. In fact, the share of financial employees within the total employees (3.5 %) is lower than in other nearby cities (Vienna 5.6%, Munich 9.8%).

Recently, large cities and different regions rather than simply different nations are in competition with each other in the field of the global world economy in order to gain investment capital, and to connect with the sources of information. The prototype of the future city will not be an industrial one, not even a place of exchange of services, but will be the city of money and knowledge. Budapest nowadays is quite far away from the role of an internationally economically controlling position in world economy, but it is plain that in the East Central European region there is a lack of regional economic managing, financial, communication, service and financial centres (*Enyedi,* 1992). There is a commonly quoted issue namely the role of Budapest as a potential financial centre of the CEE region (it was a policy issue already in the early 20th century) and the question is whether Budapest may become a real financial centre by international standard (*Szabadföldi,* 2001). One of the stakes of the recently ongoing competition among the East Central European metropolises is which capital city in the CEE region can become the regional financial centre of the CEE region with significant international scope? Despite some envisaged governmental expectations, Budapest has not become the "Singapore of Central Europe" during the 1990s. Nevertheless by the end of first decade of the 21st century Budapest might have chance to gain competitive advantage in certain fields of the financial sector. In general, Budapest has favourable conditions in terms of its gateway location between West and Southeast Europe. The size of its urban agglomeration, favourable infrastructural conditions together with the stable economic environment provide advantages, although not peculiar ones in CEEC context. Communications and infrastructure are comprehensive and well developed; the work force is highly skilled and reasonably priced. The competitive advantages of the Hungarian financial sector centralised in Budapest can be underpinned by several factors:

- Budapest and Hungary have the best legal and financial infrastructure in the region. The international competitiveness of the successfully privatised, predominantly foreign owned Hungarian financial sector is considered to be the

most advanced in the CEE region (*Szabadföldi,* 2001). Although, competitive advantage of the financial sector decreased in the last years, but the sector still keeps the competitiveness concerning the legal and supervisory framework conditions.

- Because of the rapid restructuring and modernisation of Hungary's economy, the capital city has become one of the most important innovation-centres of the region, which might play an important bridgehead in foreign capital inflow and investment within Central and East European countries, although the pioneering role in the attraction of FDI recently has diminished. Foreign capital flew into the financial sector was directly invested into banks and other financial institutions having headquarters in Budapest.
- Budapest has a metropolitan townscape, adequate infrastructural background and stable economic environment, which are quite important attractive factors for the investment of the multinational companies. The fact that a growing number of multinational corporations have chosen Budapest for some of their business and financial centres forms a certain basis of this expectation. There are few financial institutions that have yet explored some benefits of centralising infrastructure (usually back-office functions, call-centres) on regional basis as bridgeheads facing Eastern Europe (Citibank, GE).
- The stock market in Hungary is developing quickly, although capitalization of the Budapest Stock Exchange (BÉT) is still considered low even to compare with the Warsaw Stock Exchange. Nevertheless, the BÉT recently is one of the most rapidly growing stock exchange of the world (in 2002 the BUX (BÉT's index) was the fourth fastest growing index and it was the third most advanced according to the liquidity). The traditional Viennese Exchange, once the leading exchange in the region, in co-operation with the HVB banking group has purchased the majority of shares of the BÉT in 2004 intending to create, with further acquisitions, a leading regional exchange within the CEE region. This raises the important question, that if further development of capital markets in the CEECs is necessary, does each country have to go its own way creating parallel and fragmented financial structures or should countries try to team-up to create a "pan Central-European capital market" instead, which services the specific needs of the region and headquartered in a particular location?
- After years of dynamic growth within Hungary, some of the leading local banks have started their foreign expansion and looking for investment opportunities especially within the region. The Hungarian economy has again a pioneering role within the CEE region in the capital export attaining the three Billion USD by 2003. The financial sector itself became the second most expansive sector in direct investment abroad, comprising 25% of the total capital export. OTP Bank, the largest Hungarian bank, as a pioneer in foreign

investment, purchased Slovakian, Bulgarian, Romanian and recently Serbian banks. The fact that the Hungarian banking sector has become capital exporter increased the international activity of the Hungarian banks, which can be regarded as an important function of a financial centre.

On the other hand, there are certain limits to the development of such an international financial centre in Budapest:

– The international financial centres do not need to be the largest cities in the region in terms of population, however their economic activity and size of their domestic market could provide higher level of financial functions than in the case of other cities. These centres not only serve the inhabitants of their agglomeration area, but the specialised services, which are in demand over a much larger area, covering a country, a large region and even global markets. Because of the small size of the Hungarian financial market, the smaller size of banks (smaller provisions for expected liabilities), and the lower level of financial intermediation, is it yet nowhere near the level needed to sustain a properly functioning economy.
– The lower cost of labour has historically guided companies in their Foreign Direct Investment decision in Hungary, although the importance of this is diminishing as labour cost-sensitive industrial investments are in the process of shifting further east. Hungary's skilled workforce and the well-trained management pool as a continuing competitive edge, albeit availability of qualified labour varied. Despite the supply of highly skilled labour, in certain fields of finance the practice-oriented qualification does not fulfil the requirement of international standard (accounting, cost management), which resulted in the employment of foreign managers in financial firms (*Pelly,* 2001).
– The strengthening of economic relations within the region slightly diminished by the parallel foreign direct investment activities within the financial sector deriving from the same ownership composition in each country. Foreign banks that opened their subsidiary banks in Hungary established branches and subsidiaries in other Central European countries parallel, which are governed from the headquarters of the parent companies. Consequently, foreign banks concentrate more on covering each national market rather than on establishing a single regional banking centre, for instance, in Budapest.
– Decentralization processes set up parallel with centralization in the recent development of global markets. Many global players have established their service centres and back-offices in Budapest demonstrating a strong tendency of the Hungarian subsidiaries of multinational companies to take on a regional role, although investment banks, as one of the indicator of the formation of regional centre are sill missing from there.

In the Central European region the important preconditions for the creation of a regional centre is still missing. Although global financial players built up their activities and institutional settings parallel throughout the CEECs there is little evidence of product standardization across CEE region, which is sometimes evidence for some regional focus (*Pelly,* 2001). There are other limits to the growth of such international financial functions in Budapest since telematically based concentration processes, which are characteristic of global money markets, could overcompensate the advantages of geographical proximity. Multinational companies are most likely to utilize only the simpler financial services in the Central European region, and the services requiring more resources will utilize in traditional Western European and overseas financial centers. On the other hand, the decision making on the strategic location of companies often prefers the establishment of decentralized sub-centres through geographical outsourcing, locating them with regard to the expected geographical direction of the future market expansion. The stability of competitive environment reinforced further by the EU accession makes Budapest an attractive location for servicing international back-office functions, or especially in consumer finance there is a good potential to concentrate the scattered functions throughout the region into a single back-office division of Budapest (*Bellon,* 1998). The size of domestic economy to some extent weakens the attraction of Budapest, which is counterbalanced by the good accessibility to the unexploited South Eastern European markets. However, one can argue that fundamentals of the surrounding capital cities are similar to that of Budapest, except Vienna where the wage-level is not competitive with the other locations. Achievement of this regional role depends on several global, macroeconomic factors and also on the competition between the capital cities (Warsaw, Prague, Vienna) similar in their financial standing. This raises another important question whether the CEECs need to develop their own capital markets, or they could instead of rely on existing (the fragmented and slowly integrating) EU markets (*Köke–Schröder,* 2002)?

Despite the chances of becoming regional centre have improved since the Millennium owing to the promising performance and the international expansion of the domestic economy, Budapest is still not suitable to develop as a major regional centre with full-scale international functions, rather it might become a back-office centre with distributive functions. Some experts argue, that Budapest could successfully apply only for the position of a subordinate *regional sub-centre* specialized in certain services. Subject to these conditions, services that require smaller amounts of capital and highly qualified employees will come into prominence. To carry out all these, it is necessary to strengthen the banking system with the business-like intervention of the state (*Bellon,* 1998).

6.2 Spatial (re)organisation of bank network in the regions

The number of actors in the banking sector varies parallel with the spatial concentration processes of banking and capital markets, which produces competition on the more and more expanding banking markets. *With the expansion of branch system, the deconcentration processes have strengthened.* In contrast with tendencies experienced in the EU, during the consolidation of the market the number of branches has not decreased. Moreover, currently the branch system increases in moderate speed. In spite of the expansion of branch system, the concentration of retail market is still bigger than the concentration of corporate banking, measured by the Herfindhal-Hirschman index, and the market share of the largest bank further increases it (*Móré-Nagy,* 2004). Primary tool of acquiring market share is the enlargement of branch network. The need for the presence in the local market (collecting sources and crediting) and the competition for retail banking market inspire for building the nation-wide network, in which financial institutions concentrate on collecting local sources. In the formation of the organizational and territorial frame of the development of branch network, the role of foreign capital is determinant. It determines not only the intercompany equity participation and the technological level but also the spatial dimension of market building strategy (in the case of bigger retail banks it would be optimal to form a network with 100 units) (*Várhegyi,* 2002b). The bank network building in the last 15 years of development of modern banking is *characterised by waves of network expansion–reduction, overlapped by the parallel organisational processes of decentralisation and centralisation of certain functions.*

Banks *in the expansion period of network building* partly contributed to diminish the earlier existing spatial differences, although with limited spatial scope. The positive effects of foreign direct investments in the countryside can be experienced in the enlargement of branch network and services with better quality. In the second half of 1990s banks with foreign owners enlarged the branch network intensively. Their roles in the enlargement of network, degree of supply of branches and thus reducing territorial differences were determinant. The population per branch ratio significantly decreased during the 1990s, as argued in section 5, indicating the evening up tendencies and the diminishing spatial disparities during the expansion period of banking *(see Table 6).*

In Hungary, more and more financial institution made steps towards the rationalisation of organisational structure, forming *regional control-offices* and decentralisation of controlling functions. Recently, commercial banks with larger networks have reorganised their institutional and managerial structure forming a hierarchically-built domestic network of branch offices, decentralising certain control functions. Banks are starting to pay much closer attention to the geography of their distribution networks. In 2002, 6 of 13 banks possessing nation-wide branch net-

work were having an organisational structure with at least three hierarchical levels. The majority of the banks with foreign owners also represented this conception; the foreign owners transplanted their own tried and tested management and controlling practice into Hungarian banks. A bank with a more extended network builds up a more decentralised organization structure with a greater probability than a bank with smaller network. Establishing territorially deconcentrated organisational units does not mean reduction in decision-making competences of the centre in the capital city. Strategic developmental decisions are made further on *in the headquarters situating in the primary financial centre* or headquarters of the foreign parent bank *(McKillop-Hutchinson,* 1991*).*

The decentralisation of a bank, of course, has rational (economies of scale) limits. At the same time, Western examples show that certain financial service providers can have a decentralised organisational structure on a regional level, which does not call in doubt the role of the national banking and can contribute to a more effective operation of the network. Today the organisational decentralisation in Hungary is formal in many cases. It means that not only the decision-making competences are limited outside the centre but also banking services are developed nation widely, so there are no specific local services or goods in the banking sector in Hungary. Different characteristics and development levels of the regions can make the elaboration of certain specific services reasonable.

Besides the head office the next managerial level of a bank system in spatial terms is represented by the *regional centres and sub-centres*. For making the first steps of decentralisation, banks establish their regional control offices and give new management functions to local branches. Regional control offices play the role of intermediate tiers between head office and local branches, having supervising authority over local branches in their geographic areas. These newly created regionally controlled territories of large banks are different from each other, and have not overlapped the territories of the statistical regions, but their regional control offices, in the most cases, have been concentrated usually in the largest cities of the regions with a potential becoming a regional centre. The existence of a financial centre can be defined by simultaneous presence of quantitative and qualitative indicators (the number of the banking headquarters and branches, position in the organisational hierarchy, existence of other financial institutions, the number, proportion and change of employment in the financial sector etc.) (*Wagner,* 2004). It can be stated that the financial role of five cities in the country (Pécs, Győr, Szeged, Debrecen, Miskolc) grows and they started to act as special regional financial sub-centres *(Table 10).*

Table 10

Potential regional banking centres in Hungary

Cities	No. of banks with network located	No. of headquarters of savings co-operatives	No. of non-banking financial intermediaries	No . of bank branch	No. of savings co-operatives	No. of financial employees	No. of regional control-offices of banks with Budapest HQ
	2002	2002	2002	2001	2002	2002	2002
Debrecen	13	0	22	25		1,632	4
Győr	13	1	36	27	1	2,073	5
Miskolc	13	0	40	24		2,108	5
Pécs	13	0	35	23	4	1,610	5
Szeged	13	3	37	25	3	1,573	4
Hungary	28	189	n.a	1168	1705	52,748	–

Source: Wágner (2004) and Handbook of the Hungarian Financial & Capital Markets, annual editions of the Regional Statistical Yearbook.

It is noticeable that the financial service providers agglomerate and more and more banks open their offices on the regional level. At the same time, they cannot be considered as real regional centres. International literature considers a geographical location as a regional centre only if it has an ability to produce and process independent information, and it has locally established banks, and has locally based branches or representative branches of foreign banks (*Tickell,* 1996; *Porteous,* 1999*).* In Hungary there are no real regional financial centres as the organisational system of banks is strongly centralized, so they produce only limited original information and information flow is directed mainly towards bank centres. The decision-making competences of centres are restricted and limited in sum of money.

On the other hand, differences occurring in the number of branches among different cities and regions do not mean differences in the quality of banking services and do not obviously constitute a regional financial centre. The territorial embedded ness and local-regional economic development, which can induce mutual attractiveness towards the other types of financial and business services. In the Hungarian regions, the agglomeration of financial services *(Table 11)* is based almost exclusively on the employment and information basis of the regional centres (and on its regional monopoly in many cases), and on the competition among banks competing for the local market, which in many cases is independent from the economic performance of the region.

Table 11

Agglomeration of other financial services in the potential regional banking centres (No.), 2002

Cities	Leasing companies	Financial services	Insurance, insurance brokers	Companies listed on the Budapest Stock Exchange
Debrecen	2	2	8	2
Győr	2	2	16	4
Miskolc	2	15	12	1
Pécs	3	6	13	2
Szeged	3	4	15	1

Source: Handbook of the Hungarian Financial & Capital Markets, annual editions of the Regional Statistical Handbook (based on Wágner's calculation, 2004).

Banks founded with FDI from the late 1990s, with the *spatial and organisational reorganisation of their network* largely *contributed more to a deepening of uneven regional development.* However building branch networks is based strictly on business and profitability aspects, so these are also the priorities in strategies of network building banks on either regional or settlement level. Differences in the financial service supply in certain territorial and settlement levels contribute to the growth in regional disparities. *The most determinant spatial characteristics of banking supply,* after the extensive network expansion has declined, *is the almost total lack of bank presence from villages even from the bigger ones.* At present, branches are situated in 223 settlements (of which 99% is town), so there is no bank network in villages, which constitute 93% of all settlements. Only 13 % of the 3,145 Hungarian settlements in 1998 had at least one bank branch or main office of the co-operative savings bank. In some of the other 87% of municipal branches of co-operative savings banks or alternative financial infrastructure such as ATMs, post offices might have been available, providing only a basic level of services.

Thus, disparities between rural and urban areas are among the most important disparities emerged in the geographies of banking at the turn of the 20th and the 21st centuries. While between 1998 and 2004 the population per branch has increased in Hungary by 18%, in micro-regions with the lowest degree of branch supply this indicator has decreased by 5.3%, and the number of micro-regions with the degree of branch supply under the national average of the country has increased from 97 to 102 *(Figure 2).* Banks continue their so-called 'redlining strategy' not only in the network building but also in certain service segments. Commercial banks are not interested in these less profitable and prudent businesses as they have different orientation of profile and tasks. The *majority of banks still do not finance very often agricultural investments, SMEs and regional developments*. Currently some

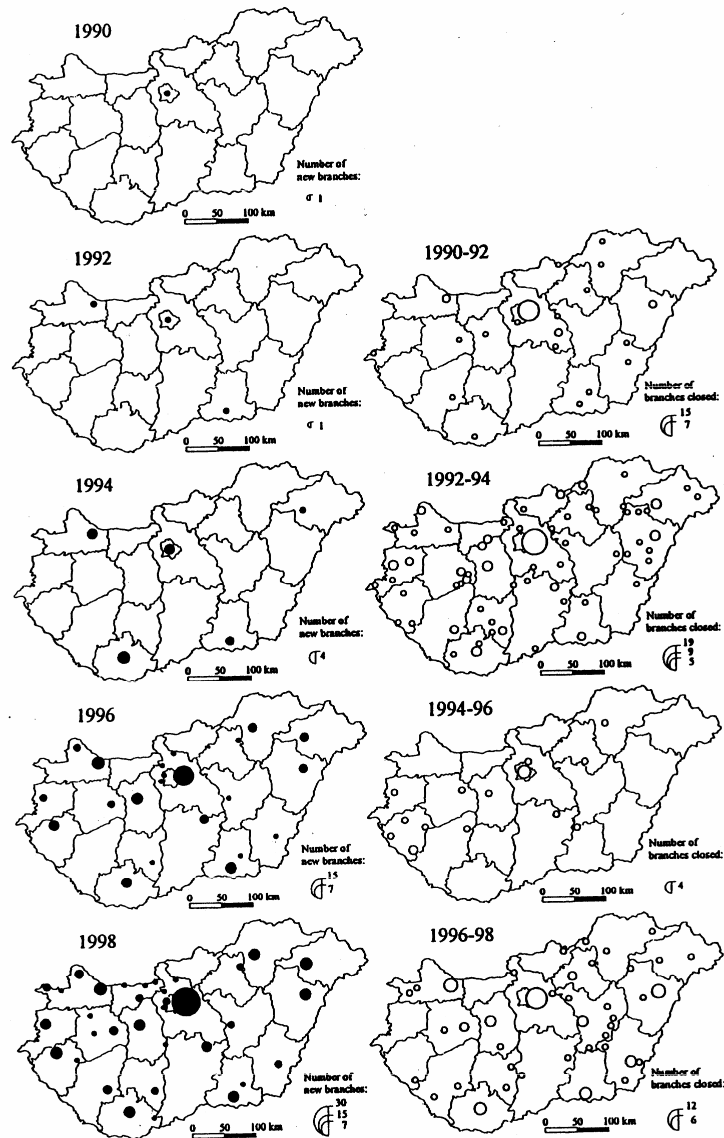
of the banks strengthen their competitive positions in these markets too. Because of the spatial structure of the sectors mentioned above, primarily the degree of banking supply of rural areas worsens. Therefore they often seem to discriminate against particular regions, although the building banking network in the transition period has significantly moderated the territorial differences. However, nowadays territorial differences are increased by slowing down the deconcentration of the network and closing down of branches *(Figure 6).* In Hungary there is a danger of "financial exclusion" in certain rural regions, in many small towns, small villages, in one word, the economically disadvantageous areas. Furthermore, there is also a great inequality in the accessibility to banks within cities or communities differentiated by social positions.

Since recently, banks are facing *structural challenges* of very competitive markets, which is characterised by increasing competition and de-intermediation. This will influence both the institutional and the spatial structure of banking. Following the M&A activities taken place in the last years the market concentration is increasing, which accelerated by the introduction of information technologies and operation cost efficiency. Banks react to these challenges with the reorganisation of their organisational structure gaining ground for the centralisation of the organisational structure, which resulted in a growing spatial concentration of the market. Banks after the period of rapid network expansion concern about network restructuring, merging certain functions into back-offices. *Network reorganisation is sensitive to geographical variation in profitability, risk, debt and social conditions in a particular area,* resulting in employment loss subsequent to IT-development and further deepens financial exclusion (*Geenhuizen,* 1999). Recently committed strategies of retail banks, with closing branches in rural and economically-socially depressed areas, especially in the eastern part of the country, contribute to increasing spatial *disparities (Figure 7).* Changes in the organisational system of branch network have also spatial implications as they are space sensitive. In banks' strategies elaborated at the turn of the millennium, *organisational centralisation* was strengthened, which reinforces the central role of Budapest.

The *over-centralised character of the financial market and the lack of decentralised regional financial system can restrain and slow down regional development in the long run.* Chance for foundations of banks with local residence, which is one of the criteria of a regional central function, is small in Hungary for simple reason. Apart from Budapest, especially in the undeveloped regions the conditions for capital accumulation needed for the establishment and operation of independent banks (with economies of scale) are very unfavourable. Studies by Nemes Nagy (1995, 1996) examined economic activity and capital accumulation possibilities of peripheral regions with the help of indicators of entrepreneurial activity, profitability of firms and territorial distribution of personal income tax. Budapest got bigger share from the dynamics supporting elements of the economic transition, as it

Figure 6

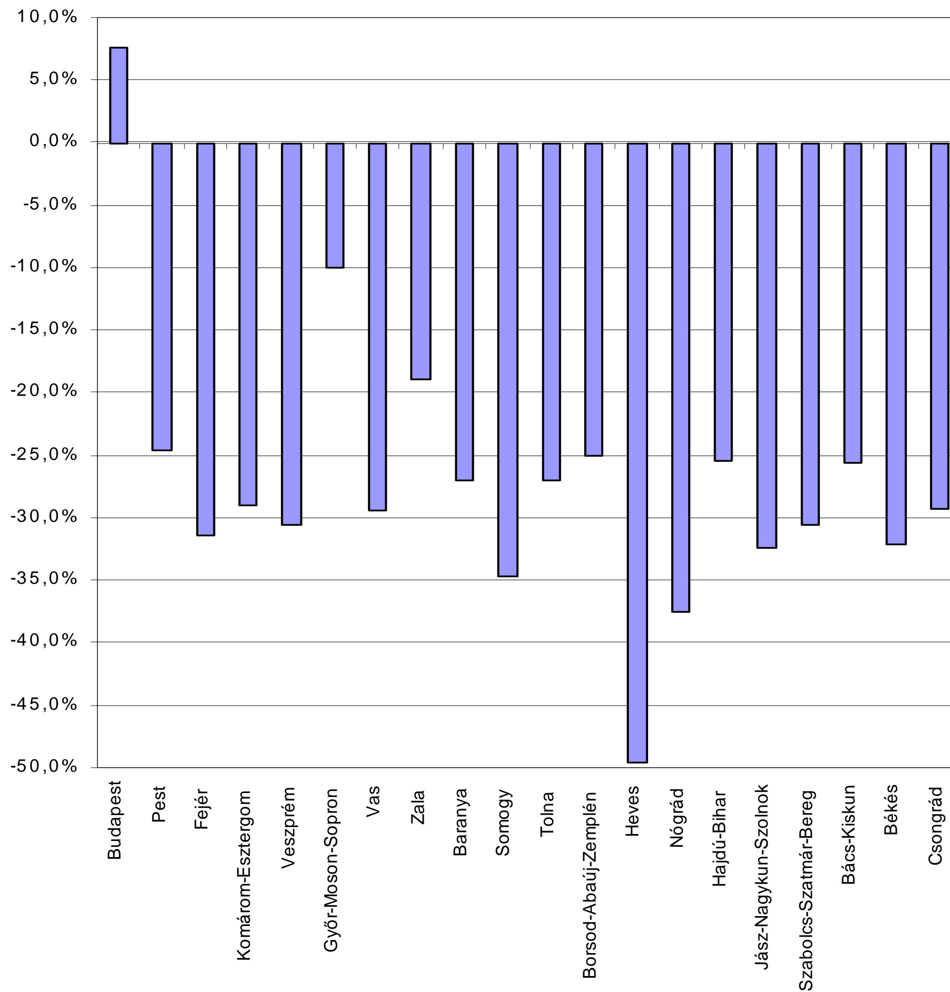
Expansion and financial exclusion: Bank branches opened by the foreign owned commercial banks (left) and branch closures by all commercial banks (right) between 1990 and 1998 in Hungary



Source: Jöns (2001).

Figure 7

Changes in financial sector employment in the Hungarian counties, in %, 1996–2002
(Average national decline 13.9%)



Source: Edited by Wágner 2004, based on data Regional Statistical Yearbook.

should have received proportionally to its population, such as from local capital accumulation, foreign capital investment and development of financial services. Besides the capital city, dynamic towns in the central and Western regions are the winners of capital accumulation, and centres of regions and county seats developing dynamically follow them.

At the same time in 80% of rural villages and in disadvantageous micro regions, the absence of capital that can be mobilised has become permanent. The low level of capital accumulation (concentration) in the disadvantageous regions, which shows the producing capacity of rural economy, is surely related to the lack of foundation of financial institutions with regional headquarters (*Nemes Nagy,* 1995). For the foundation of a savings bank, there is a requirement of registered capital 1 Million Euro but recently the majority of savings bank cannot fulfil this. The requirement of registered capital 10 Million Euro for founding a bank is even a bigger barrier to establish a financial institution in the regions. The changes that have been experienced in the last few years call attention to the possible danger that new interdependencies have been formed between the capital city and regions. The *'Filtering' role of Budapest* has been strengthened primarily by its key position in the information flow. The conditions of capital concentration are unfavourable outside Budapest and the most developed regions of the country. There is a threat of a new kind of dependence between the capital city and the regions. The Budapest orientated financial system filters (filtering-down) the most profitable financial services (firm banking, portfolio and risk management, private banking), making use of advantages of its location, and directs traditional and less profitable services to peripheries *(Figure 8).* Taking into account capital transfers among Budapest and the regions it can be said that capital transfers at the expense of the regions is negative.

Resident banks have the potential to build on their advantage in the regional (retail) markets where they do not face strong foreign competition and could exploit their knowledge of local conditions and existing client relations. In this area they have the best chance increasing their markets share due to increasing lending to borrowers, such as SMEs, that have been redlined in the past. This required a more comprehensive decentralized organizational structure of commercial banks and development strategies concerning expansion and to handle the parallel processes of financial exclusion with care. This implies the question how decentralization can contribute to a more efficient operation of the network.

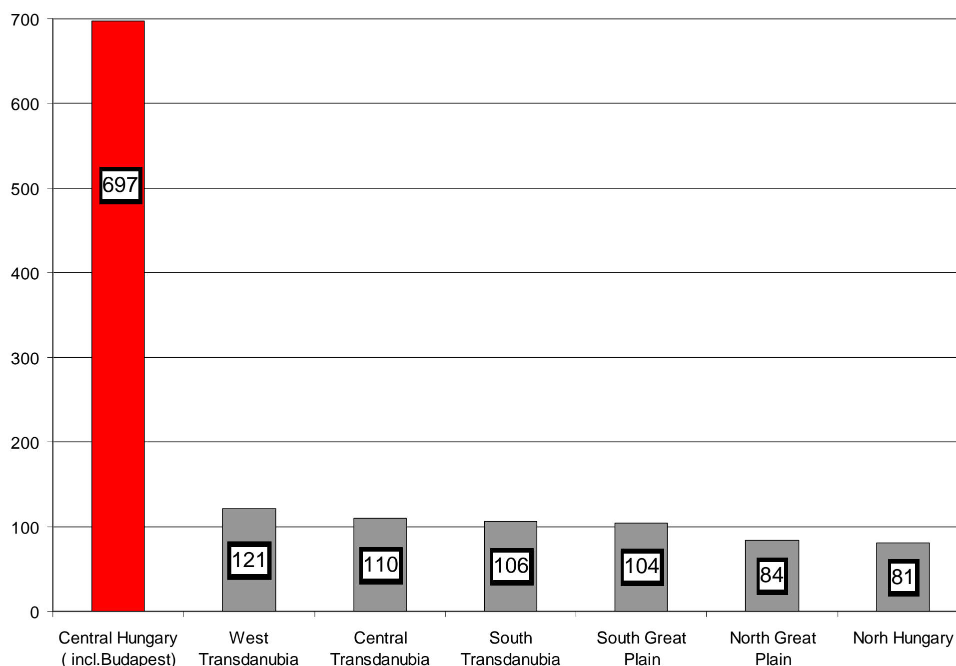
Researches made in the first part of the 1990s' suggested some possible ways of development of a more decentralised banking network: widening branch network of commercial banks, integration of savings banks, founding financial institutions of municipalities and forming regional development banks (*Illés,* 1993). Besides

the lack of equity capital, the sharp competitive situation (the Hungarian financial market is almost saturated if we consider the number of financial institutions) limits the entrance of new actors. Tendency in the future can be the growing concentration of the banking sector, *further decrease (at slow speed) in the number of independently operating financial institutions and exploitation of potential opportunities in the integration of the savings bank sector*.

In Hungary the local-regional credit supply operates through a centralised national branch-banking systems, and local savings banks operate in restricted rural and urban areas. The majority of banking system can be found in bigger or middle-sized towns. Co-operative savings bank can be regarded as alternative financial service providers, as they are the only credit institutions in certain areas.

Figure 8

Per capita GDP of the financial sectors as a percentage of the regional average (=100) in the Hungarian regions, 1997, %



Source: Central Statistical Office (edited by the author).

Alternative financial infrastructure can supply the basic banking facilities and low cost credit to households with lower incomes (*Leyshon–Thrift,* 1997). Thus, effects of commercial banking system on the smaller towns and bigger villages are small. (At the same time, 33% of money flows in 2000 occurred in villages, which do not have any branches.) Strengthening the market position of savings banks having an expanded rural network is the base for spreading financial services on the lower level. (In nearly 50% of all Hungarian settlements, in which 15% of the whole population lives, there are not any financial services). About 2.5–3 million people live in villages having only a single financial institution, like a savings bank. The presence of co-operative saving banks significantly improved the supply ratio in Hungary, which is much better than the average counted on the basis of commercial banks (3100 inhabitants per branch, it is 2.8 times better) *(see also Table 7).* The decentralised feature of savings banks could be a powerful competitive advantage in the local financial markets but only *savings banks' integration* co-ordinated by means of a central "umbrella" bank can produce profitable operating conditions for the excessively scattered savings banking system. Because of forming optimal bank size, 70–100 savings banks, instead of the 190 contemporary, could operate with economies of scale in Hungary *(Kiss,* 2000). With the balance-sheet footing of the integrated savings bank system, it can be the fifth largest bank in Hungary. Currently the regional performances of savings banks are the best in South-Transdanubia and the South Great Plain, where savings banks building on the strong agricultural basis could obtain powerful positions in the urban markets. Performance of savings banks in Budapest and the Central Region is poor, as commercial banks dominate here. For considering longer period, it is advisable to reduce the polarization of the Hungarian bank system by the co-operation between commercial banks having a smaller but spatially more concentrated network and savings banks possessing an expanded network in smaller towns and villages. The Hungarian banking market cannot be fully covered without the savings bank sector, as commercial banks would not like establishing branches in large numbers in smaller towns or villages and at the same time, the expansion of savings banks in towns can continue.

7 Impact of European integration on the Hungarian banking sector

Hungary has one of the best performing banking and financial systems in the post-communist CEEs region. The reasons behind this are the following (*Várhegyi,* 2002b):

– Hungary was the first to abandon the mono-bank system recreating a two-tier system (Hungary already had a two-tier banking system when the Berlin Wall came down);
– It was the first to repair the mistakes of the early transition years: loan & debtor consolidation and re-privatisation programme;
– By 1997 Hungary had opened the doors to a higher proportion of foreign banks than in any other post-communist country (the ratio of state owned shares had fallen to 11% by 1997).

Despite of its relative small size of economy, the banking sector dominates Hungary's financial system. The quality of the portfolio of the Hungarian bank sector improved much in the second half of the 1990s (bad debts have fallen to less than 3%) and the average capital adequacy has been around 15–17%, pointing to a well-capitalised banking sector. The structure of banks' balance sheets has become similar to it has been observed in the EU. Since foreign (mainly EU) investors dominate the banking sector (two-third of the total registered capital and 90% of the banking assets) they have contributed to a great extent to the modernisation of banking. Therefore the entry of foreign green-field banks, bank restructuring and bank privatisation to strategic foreign investors has strengthened the stability of the Hungarian banking sector (*Várhegyi,* 2002b). While Hungary has been successful in creating a functioning banking system, bank intermediation has not grown as fast as most observers predicted it in the early 1990s. The role and the capitalisation of the banking sector in the economy are rather limited and remain low by international standards. This is largely due to substantial competition from other foreign capital sources such as FDI, direct lending by non-resident banks, inter-company loans, and non-banking funds. Taking the example of the stock of cross-border loans to firms in Hungary, which amounted to 11.5 billion euro and it was almost as high as the amount of company debt owed to the Hungarian banks (12 billion euro).

In the advance assessment of the European integration we have seen that the Hungarian financial integration – comprising the activities of foreign investors and the availability of foreign finance for domestic borrowers – will have a significant impact on the Hungarian banking sector.

To assess the advantageous and disadvantageous impacts of the EU integration we have to face that the common monetary framework and the liberalised capital

flows will be beneficial only in the long run as they create more severe competition from the date of accession. EU accession may influence net capital inflow to Hungary, but the possible effects are ambiguous. On one hand, diminishing sovereign risk may raise inflows into the banking and corporate sector. On the other hand, Hungarian banks will be in a better position to diversify assets geographically and they will benefit from their local knowledge. It seems to be unlikely that Hungarian banks will target advanced EU markets, but it is possible that they will expand their market scope in other accession countries as a few examples already demonstrate this aspiration (*Várhegyi–Gáspár,* 1997).

The banking network will continue to change as the number of universal banks will decline, but on the other hand the number of specialised institutions may rise. The major effect of integration is that the number of current subsidiaries of foreign banks will be turned into foreign bank branches according to the non-discrimination principle of the place of origin of the capital and newcomers may open branches. This could further diminish the role of resident banks and decrease the bank capitalisation subsequent to EU accession. To open cross- border branches by foreign banks requires much lower capital adequacy ratios, which will be compensated for the unlimited liability of the foreign parent bank. The accession can be expected to promote further competition, resulting in a bank margin and operating cost decline. Competition will be stronger in corporate markets, where the competition has already driven down margins and where rivalry will certainly intensify after accession. However there is a good potential for resident banks to benefit from their local knowledge in the lending to the SME sector. In retail markets where resident banks already exploit their knowledge they do not face strong competition. Although in retail segments with the increasing numbers of non-banking actors, they may divert some resources from the established banking network (*Várhegyi,* 2002a).

Generally we conclude that one hand, accession should further enhance the integration of Hungary's banking system with those of the EU making the banking more stable and efficient. On the other hand, we have seen that the high spatial and structural polarity within the banking sector,[7] which in some remote provincial areas may have a lesser capacity to promote their economic development. These areas might experience certain disadvantages as a result of the financial integration in Europe. In the consequence of the European integration the Hungarian banking will face very similar structural issues as its Western counterparts, namely the widespread of universal banking, mergers & acquisition fostering by increasing competition not only within the banking sector but also from the side of non-banking players. Globalisation and integration of financial spaces open up oppor-

[7] Characterized by "redlining" policy of the recent years on the side of the SME segment especially in the periphery.

tunities for both local-regional and large pan-European financial alternatives (universal multi-country and global banks), and consequently the major losers of the integration will be the medium-sized domestic banks. All these challenges facing the Hungarian financial system require new structural and regional policy from the banking side and a more efficient co-ordination and supervision from the regulators' side.

8 Predictable regional impacts of financial integration

There is currently considerable interest in debate over the impact of increasing European economic and monetary integration on the regions of the EU. Opinion is sharply divided whether EMU is leading to regional economic convergence or regional economic divergence. Ron Martin's recent comprehensive paper examined the theoretical arguments and empirical evidence of these opposing views (*Martin,* 2001). Among these theories, the Optimum Currency Area (OCA) stresses the need for economic homogeneity across regions as a precondition for establishing a unified monetary space. Neoclassical models predict that the European currency area should lead to regional economic convergence of the sort implied by OCA theory (*Cohen–Wyplosz,* 1989). On the other hand, theories of regional growth based on localised increasing returns and endogenous growth, predict that EMU will lead to regional divergence, which is counter to the requirements of the OCA model. Recently, regional economies across the EU do not appear to have moved significantly nearer to those conditions. The empirical evidence on regional trends suggests that while "regional convergence took place some extent between 1950s and the mid–1970s, since then, as the process of European integration itself has deepened, regional convergence has slowed and ground to halt" (*Martin,* 2001).

In the mid–1990s, little argument predicted that the prospect of greater integration between Eastern Europe and Western Europe will be limited and may prove illusory (*Budd,* 1997). One of the major arguments of these critical outsider views is that the lack of properly functioning financial systems will be unlikely to serve and fulfil the wide range of economic and financial requirement (inherited bad debt issue, state budget constraint, risk-related capital adequacy ratios, and EMU's convergence criteria) before the integration takes place. The domestic capital markets in the CEE countries are unlikely either to develop sufficient maturity or to overcome considerable difficulties in the short to medium term to provide an adjustment role of the integration criteria (*Budd,* 1997). As we have seen in the previous chapter of this paper Hungary (and most of the other accession coun-

tries as well) very rapidly and successfully has overcome of structural adjustment problems of the financial, in particular banking sector at national level. Such an unpredictable rapid pace of successful privatisation and following modernization of the banking sector together with the appropriate adoption of the EU directions for the financial markets and state supervision surpassed even the most optimistic expectation of the observers.

However, this exaggerated pessimistic view of modernization prospect of the CEECs is acceptable in the case of regional impacts of the accession. That argument predicts that the fiscal adjustment to fulfil the EMU convergence criteria will have a greater impact on the regions of these accession economies, and may increase the regional differences and the economical vulnerability of the regions. The imposition of monetary and fiscal convergence criteria may put up a further barrier to the wider integration of Europe in the case of the too rapid accession process of CEECs to the EMU. This latter might reinforce the problem of uneven development and may strengthen the core-periphery regional structure within the new accession countries.

There is no doubt the main cost of joining the Union and later to the common currency area together with the loss of the national monetary instruments is that accession countries might experience certain disadvantages because of the financial integration. Several studies have examined an asymmetric monetary shock so far at national level (*Krugman,* 1992; *Eichengreen,* 1992; *Masson,* 1996; *Cohen–Wyplosz,* 1989; *Wyplosz,* 1997) but only very few have done at regional level and none of them surveyed the possible reaction of the financial sectors in the case of the accession countries' regions (De Nardis et al.. 1996; *Ramos* et al. 1999).

In the following, we analyse the possible macroeconomic effects of the EU and EMU integration at regional level in Hungary using national and Eurostat Databases. The methodological approach following some previous surveys' methods, based in the Theory of OCA, has consisted in comparing the values of correlation coefficients for different economic variables among every region, national and European aggregates (*Ramos* et al. 2001). The analysis of asymmetric shocks at a regional level is related with the degree of concentration of economic activity. The consideration of the fact that European regions did not have sovereignty to apply their own autonomous policy implies that inside every national state regions could have been adversely affected by the national single monetary policy in the emergence of the asymmetric shocks. In this sense, the consideration of the effects of accession into the European Union and the Economic & Monetary Union necessarily involves taking account to the relative situation of every region inside their own country. The methodology used in this section consists in comparing the value of the correlation coefficients between the growth rate of the same variable (GDP per capita growth rate) for four different territorial levels such as the Hungarian regions, the nation state level and the European level. Two different definitions of

the European aggregates are considered in the study: EU–15 and the EMU–12 levels. The comparison of these values permits to assess the advantages and disadvantages (the macroeconomic cost) for every Hungarian region, which will be participating in the EMU in the future. If the relationship between every region and the European aggregates are as intense as the relationship with the pervious national aggregate, the relative position of the region in this new macroeconomic framework will be similar to the previous one. The disadvantageous effects will be negligible and namely there will be no additional macroeconomic costs for the given region[8]. The previous surveys assessing the degree of symmetry of economic shocks experienced by the EU regions and states have focused on the evolution of GDP, prices and wages, which are strongly correlated to the objectives of the monetary policy (*Ramos* et al. 2001). We survey analyses the relationship among the growth rates of per capita GDP at market prices (PPP) in all Hungarian NUTS II-regions from the period 1996–2000.

In general, it can be said that most regions keep the same relative status inside the country when comparing the previous situation with the European aggregates *(Table 12).*

Table 12

Correlation coefficients among per capita GDP growth rates between 1996 and 2000 in Hungary

Regions	EU	EMU	HUN
Hungary	0,80	0,85	–
Central Hungary	0,89	0,90	0,92
Central Transdanubia	0,81	0,70	0,87
West Transdanubia	0,19	0,48	0,70
South Transdanubia	0,45	0,69	0,83
North Hungary	0,45	0,60	0,89
North Great Plain	0,81	0,75	0,91
South Great Plain	0,70	0,84	0,96
2/√(5)yr	0,89		

Source: Calculation by the author.

[8] To distinguish between the significant and non-significant correlation the *Brander and Neuser* (1992) model were used suggests that at a 5% level of significance the values obtained from the expression is $2/\sqrt{n}$, where n is the number of observation of the considered series.

Although in Hungary there are significant regional differences, the data of GDP per capita growth rate between 1996 and 2000 (in the period of economic recovery) represent slight spatial equalization within the country.

West Transdanubia was the only region, which in the consequence of the higher level of its state of development has differed from the more fluctuating general national and regional tendencies. However, it is important to remark that the average correlation with the national level is always higher than average correlation with the European aggregates, but correlation with EMU aggregates are usually expected to be higher than correlation with the EU aggregates.

In general terms the standard deviation of the correlation coefficients also increase when considering the European aggregates. In the case of our preliminary surveys we have to consider that in the period of examination Hungary was still not part of the EU and the optimal date of the accession to the EMU is still under debate. Therefore our survey has to be considered as a speculative prediction of the impact of integration. From this table we can conclude that:

- It is predictable that most Hungarian regions will keep the same relative status within the country after the European integration they had previously.
- Regions with low correlation with the national level might have still low correlation with the European aggregates. For example: the West and the South Transdanubian regions therefore demonstrate a more resistant position in terms of the integration.
- There are some regions with high correlation with the state level that show quite low values with the examined European aggregates (they demonstrate less significant correlation with the European aggregates. This means that the majority of the Hungarian regions might be the potential losers in the integration process (North Hungary, North-Great Plain and the South Great Plain regions respectively).
- The only regions which might keep its relatively stable and well developed situation is Central-Hungary with the metropolitan district of Budapest and the Central Transdanubian region might experience only a slight vulnerability after the integration.

Further research is required in order to analyse ex-post the consequences of the stable regional differences and the real impacts of the integration in the future. Although there are pessimistic arguments, which predict that the integration of the newly accession countries (with the incorporation of a 'new periphery') will distort the "prospects for a comprehensive Europe of the regions" (*Budd,* 1997), regional economies of the EU have shown large differences in the recent years and do not appear to have moved nearer to the monetary convergence conditions.

9 Conclusions

Economic changes are very much dependent on financial services, which reflect the nearly two decades of processes of the Hungarian economic transformation. Surveying the almost two decades of development of the Hungarian banking it can be concluded that financial services, including the banking sector, strongly influenced the spatial pattern of economic transformation. With the earliest establishment of the two-tier banking Hungary acquired considerable competitive advantage. The development of the banking system directed by the market requirement and the decision of foreign investors even in the early stage of transition due to the intense pressure of capital shortage in the post-socialist economy. The banking system is characterised by a strong centralisation in management and spatial polarization, which the most well known feature of Budapest's predominance. After the decade of spatial diffusion of the branch network resulting in not only the deconcentration of the service units, but the decentralization of certain management level, nowadays seems to the organizational centralization has been gaining strength again. The strong predominance of Budapest cannot be explained solely with the small size of the country and neither the adaptation to the global financial structures.

The framework conditions rooted in the debt crisis of the 1980s were at least so much a determining factor. The institutional and the legal frameworks of the overcentralized banking structure created by the reform elite, conducting the change of regime. It was based upon the principle of concentration of the economies of scale and its was largely determined by the economic crises accompanied by capital shortage, which did not encourage the formation of decentralized structures. In the partly ready-made banking structure obtained by foreign investors, the expansion of network has started from the mid–1990s. Banks struggled for larger shares of the expanding market and for new customers in order to channel resources through the bank intermediation. This required both the expansion of the banking network and the perpetual innovation of banking, which resulted in certain spatial levelling up.

Structural challenges characteristic of the global markets, such as the competition of the non-financial intermediaries, spread of the universal banking, M&A activities, introduction of IT and the requirement of cost-efficiency, resulting in organisational centralisation and the decline in employment, are having similar effects on the Hungarian banking system, which is almost fully integrated into the global financial markets. It has also significant impact on the growth of the spatial differences. The organisational centralisation of certain service functions accompanied by the branch closures, which is a more frequent phenomenon in peripheral areas, asserts the newly emerging tendency of financial exclusion. These processes not only deepen the gaps in territorial development but are reinforcing the tradi-

tionally centralised practices in credit granting. Branch closures and reductions of employees are mainly affecting the settlements with lower hierarchy, socially segregated residential areas, while organisational centralisation mainly having an effect on the regional control offices in the larger cities. These negative processes, comparing to their West European counterparts, had begun before the size of bank network would have been reached its maturity stage. Despite the general recovery of banking system, its organisational and territorial structure has remained polarised. The Hungarian banking exemplifies a predominant position of the national financial centre and the weakness of the regional economies. It seems plausible that there is no place for such strong regional financial centres in a small domestic market and the small geographical areas of the created regions. The presence of the centralised capital market and the lack of a decentralised regional financial (banking) system can restrain and slow down regional development in the long run.

In conclusion, it can be argued that the introduced bank strategies and the managerial decisions notably contributed to the growth of regional inequalities. Considering the low internal capital accumulation abilities of the regions, there is no early possibility to found well-equipped and locally based financial institutions outside Budapest and to establish functioning regional financial centres. Within the centralised banking structure, the regional decentralisation of certain commercial banking services might be possible, without questioning the pre-eminent role of the national banking centre and contributing to a more efficient operation of the network. Even in the centralised banking structure some regional decentralisation of certain banking functions is possible, without questioning the pre-eminent role of the national banking centre. The integrated network of co-operative savings banks might be one solution for the problem. The Hungarian banking market cannot be fully covered without the savings bank sector. The locally, regionally embedded co-operative savings banks with capital adequacy, meliorating both the local and the market principles, might perform as important role as its German counterparts in modernization. Branch network building of commercial banks will continue to grow, although less dynamically than previously. Especially in local retail markets, there is a good chance to raise further market share, if banks can exploit their knowledge of local conditions and the existing client relations.

Besides the endogenous disparities characterising the national banking system, Hungarian regions facing EMU integration within a decade could have been affected adversely by the by the adoption of the criteria of EMU's monetary policy. In the case of Hungary it can be said that the national monetary policy were not appropriate for most of the regions within the country. As we have seen the conditions of uneven capital concentration are unfavourable outside Budapest and the most developed regions of the country. There is a threat of a new kind of dependence on one hand between the national capital and the regions, and on the other hand between the Hungarian regions and the European financial space resulting in

capital drainage and net capital loss in most of the regions. With this background the adoption of the single currency and European monetary policy will change the relative situation of the regions. Nevertheless, these changes will not be equal for every region, and most of the Hungarian regions will be among the losers unless more active government participation in the support of local-regional finance might diminish the certain disadvantageous effects of integration on the regions.

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