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The development and the polarised spatial structure of the Hungarian banking system in a transforming economy

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1. Introduction

The creation of a two-tier banking system in 1987 “re-established” the modern Hungarian banking system. There can be no doubt that the Hungarian financial sector lagged significantly behind that of more developed countries in the 1990s even as regards territorial distribution. Nevertheless, it seems legitimate to refer to the ‘inherited backwardness’ of the banking sector only as far as the phases marked by the socialist period and the transition to market economy are concerned. This is because Hungary did actually have a European financial system and a dense banking network already by the end of the nineteenth century. In the socialist period when capital and financial markets were comprehensively dismantled, one attempted to compensate for the subordinate role of the credit system by current asset financing through the government budget. The key element of the system was the National Bank of Hungary that served not only as a central bank but also as a commercial bank taking on corporate financing as well. Until the end of the 1960s, the one-tier bank system of financing could be well accommodated with a mode of economic control in which credit demands of economic actors were determined by central planning. The weak and subordinate banking and credit system had no significant role to play in the territorial redistribution of resources.

In the period of socialist planned economy, there also existed a financial institution specialised in retail deposit services (OTP) as well as another bank responsible for the financing of foreign trade in addition to the central bank, already mentioned, which served both as a central bank and a commercial bank. Further banks had been established with mixed profiles already before the introduction of the full-blown two-tier banking system. The primary function of these was to assist foreign-owned companies. During the 1980s, other

'bank-like' financial institutions were established as a result of sectoral cooperation. These were later to become legal predecessors of future banks. The 1987 bank reform, however, radically transformed the function of the banking system.

2. The establishment of a two-tier banking system and its stages of development

The Hungarian bank reform preceded the change of political system by three years. It was to have pioneering significance in Eastern Europe. With the separation of central banking and commercial banking functions in 1987, a two-tier system was established. The political decision was taken in response to economic pressure. Hungarian financial institutions included at this point major *commercial banks* carved off the central bank. These were given access to significant state resources. In addition, this group also comprised *OTP Bank* which had been licensed as a commercial bank as well as other Hungarian-owned small and medium-sized financial institutions. Finally, there were also *Hungarian branches of major foreign banks* and *financial institutions formed from various organisations managing state development funds*. Accordingly, 5 commercial banks and 14 specialised financial institutions started to operate in 1988. The territorial structure of the branch network of commercial banks was set up following the organisation of former county offices and branches of the National Bank of Hungary (NBH). The branch network of the new banks was characterised by marked disparities at territorial and settlement levels. The central feature of their organisational and operational structure was strong centralisation (Lados 1992). A peculiarity of banking systems in transitional economies is that financial markets do not emerge as a result of organic development. The creation of the Hungarian two-tier banking system was an artificial measure supervised by a central authority. Already in the first years of its operation, therefore, this system operated in a highly centralised fashion with a considerable degree of territorial concentration. It must also be noted that this territorial concentration was entirely consonant with international trends, although of course it was not, as elsewhere, the outcome of the globalisation of financial markets starting in the 1970s.

The analysis of *the development of the Hungarian two-tier banking system in the last 15 years* shows five distinct stages (Gál 2000a):

1. The short period between 1988 and 1992 saw the creation of financial markets. It can be regarded as the period during which *the establishment of new banks* was most vigorously

pursued. By the end of this stage, 44 Budapest-seated banks were present on Hungarian financial markets. The first “greenfield” foreign banks also appeared on the Hungarian market. At the beginning of the 1990s, the Hungarian banking system – similarly to its Eastern and Central European counterparts – faced the problem of reintegration into international markets, while also witnessing the swift spread of foreign capital which was to play a leading role in accelerating modernisation and privatisation.

2. The period between 1992 and 1995 was characterised by *the extensive growth of the banking network*. This period involved bankruptcies and the regulation of the supervision of the banking sector as well as *bank and credit consolidation* with significant state participation. The latter measures served in the majority of cases to prepare *the ground for the privatisation* of financial institutions. The years 1991 and 1992 saw, first, the passing of the Act on the Regulation of Financial Institutions, second, the creation of a monitoring system for the banking sector, and third, the Act on the Central Bank. The latter laid down legal guarantees for the independence of the NBH (many regard this as the real starting point of the two-tier banking system). However, it is important to note that banks were established amidst the general recession of the early 1990s. The sudden onset of rapid growth, the amount of inherited bad and irrecoverable corporate credits and intensifying competition posed by foreign banks all led to a substantial worsening of the positions of state-owned banks and a shrinking of their market shares (Csáky 1997). Between 1992 and 1995, the state contributed 4 billion USD, i.e. 10% of the annual GDP, for the purposes of consolidating the banking system. This money was in part used for the re-capitalisation of banks in order to reduce a former 80% state ownership to 25%. However, consolidation of the banking system was crucial not only to avoiding a financial crisis and stabilising the budget, but was also a precondition of the large-scale involvement of foreign capital in the privatisation of the banking sector (Várhegyi 2002).

3. The period between 1995 and 1997 saw the peak of the highly successful privatisation of the banking sector. The most important result of this was the inflow of foreign banking capital into the domestic financial sector. The share of FDI into the banking sector was *high in European comparison at that time, although it is no longer outstanding in the region today (Table 1)*. The new ownership structure emerging by 1997 was dominated by foreign capital. Stabilisation of the banking system that had started in 1995 continued, while the safety reserves of financial institutions increased. 1997 marked the beginning of a slow expansion of

the banking system. The rapid “de-nationalisation” of the Hungarian banking system was unique in the region. It created a peculiar ownership structure, differing from the majority of developed countries as well, in which *the market share of the foreign-owned sector* reached around 75% by 2003. Today, *the banking sector has the highest ratio of foreign involvement* in Hungary. The rapid privatisation of the banking system without further state investments was possible only through the involvement of foreign capital (Várhegyi 1997). The inflow of foreign capital substantially contributed *to maintaining the international competitiveness of Hungarian banks* (Wachtel 1997). By 1995, *nearly 70% of all banking revenues were generated by foreign banks which claimed a 25% share of the market. Their profitability was twice as high as that of domestically owned banks* (Várhegyi-Gáspár 1997). Foreign banks are present as long-term strategic investors on the Hungarian market. This is indicated by the fact that profits are increasingly *ploughed back into the enlargement of their branch network*. By virtue of its multiplicative effect, capital flowing into the banking sector intensified direct capital investment in the whole economy.

Table 1: Assets of foreign-owned banks* as a percentage of the banking sector (2000)

	1995	1996	1997	1998	1999	2000
Hungary	41.8	46	61	64	66.4	68
Czech R.	10	12	15	16	28	54
Poland	4	14	16	17	49	70
Slovenia	-	5	5	5	5	5

*Foreign ownership above 50%

Source: Riess et. al, 2002

4. Following a significant restructuring of ownership, the period between 1997 and 2004 was characterised by a progressive adaptation to structures of the European banking system. At present, 80% of all banks are in majority foreign ownership. In accordance with international trends, these foreign-owned banks operate as integrated members of groups with significant capitalisation and a strong background in the international finance or insurance sectors. This can be regarded as a transitional period between the expansive development of the banking sector and the creation of mature banking structures. Nevertheless, the spectacular increase in the number of banks had come to a halt by the end of the 1990s. The establishment of foreign-based banks in Hungary is counterbalanced by mergers, liquidations and the general concentration of banking activities becoming more pronounced around the turn of the

millennium (Gál 1999). Some structural changes took place in the banking system as well. Specialised financial institutions (mortgage banks, building societies) appeared as new players on financial markets. This period witnessed the saturation of the corporate banking market and the growing interest of banks and specialised financial institutions in retail markets. At the same time, deconcentration, which is a natural concomitant of the evolution of the banking market, was accompanied by an accelerating process of concentration as well. Several mergers took place in the early 2000s (ABN Amro and K& H Bank, HVB and Bank Austria, Erste Bank and Postabank). The crucial feature of this period was an increasingly rapid drive towards the formation of 'universal banking institutions', i.e. the integration of investment and insurance activities previously functioning as separate units within banking groups.

5. The next stage in the development of the banking system began with Hungary's accession to the European Union in 2004. No dramatic changes are expected in this period given that the integration of the Hungarian banking system had been essentially complete by the beginning of this decade. At the same time, due to rapid global developments in financial services, the Hungarian banking system is still to face a substantial process of re-adjustment. Today, Hungary possesses one of the most developed banking systems in the region. The advantages of the transition to a two-tier banking system are still evident. Capital stability of Hungarian banks is good, although the banking system itself is quite small. *Total bank assets amount to 70% of the total GDP* which is a relatively low ratio according to European standards. In sum, there is still room for development.

Following accession to the European Union, it is not expected that new banks would enter the Hungarian market with the sole purpose of opening new branches since they would have to face keen competition on what is an already saturated banking market. Apart from its somewhat protracted development and certain domestic peculiarities, the whole of the banking system clearly faces the same structural challenges and problems as banks in Western European countries. This is of course partly due to the high share of foreign ownership. The number of banks has stopped growing. In fact, a slight decrease has been registered. This is to be attributed to the shrinking role of banking mediation (disintermediation, no dynamic increase in the ratio of capitalisation relative to the GDP), competition posed by non-banking financial intermediaries, the spread of universal (all-finance) type of banking, concentration (mergers & acquisitions) generated by intensified market competition, the introduction of ITC

technologies, increasing operational efficiency through cutbacks in the number of employees and the rationalisation of the branch network (centralisation of structural and territorial activities in back offices). At the same time, although more slowly than before, the development of branch networks continues.

3. Territorial characteristics of the development of the banking network

Advanced financial services became such crucial elements in the development and competitiveness of regional economies that they can in the long run seriously impact on the *emergence of territorial disparities* (Mazucca 1993). The territorial location and *regional expansion* of bank branches reflect economic developments in Hungary of the 1990s. Following the economic-political transition, commercial banks embarked on a rapid development of their branch networks in Hungary's western counties. These areas had been neglected in the period of socialist industrialisation. As a result of these developments, *disparities among branch networks of regions disappeared by 1990*. The previous disadvantage of western parts of the country could be eliminated. The aim of domestic financial institutions was to cover with an evenly distributed branch network what was at the time a relatively small banking market. Branch developments in the 1990s worked towards restoring the balance between western and eastern parts of the country. Having reached a relative saturation of western regions from the mid-1990s onward, the main targets were major towns of eastern and southern Hungary.

Although the territorial enlargement of the branch network has improved the accessibility of banks, the country's backwardness in terms of network density is still conspicuous, especially in comparison to the EU-15 average (1923 persons/branch), but even in comparison to the same figures in the Czech Republic and Slovenia. Even though the number of banks is high relative to the overall size of the Hungarian market, branch density is still quite low. Despite a 22% increase of the density indicator between 1998 and 2004, the current figure of 8561 persons/branch reveals that the country is still insufficiently covered by existing branches (*Table 2*). Financial services accessibility¹ indicators still show considerable differences between western and eastern parts of the country. There are inner, disadvantaged peripheries to be found at micro-regional level in the region of Transdanubia as well. Moreover, such

¹ This compound indicator is generated using the following formula: population/number of bank branches + number of branches of mutual savings banks + number of ATMs.

areas can be said to dominate in the regions of the Great Plain and Northern Hungary. The ratio of bank branches per capita clearly ranks the region of Transdanubia first. As a consequence of the intense development of the branch network in Budapest, the capital further increased its share in the network. While in 1997, 11% of all branches operated in Budapest, this figure was already at 34% in 2001. Here the density of the network doubles the national average of 4700 persons/branch. By contrast, the region of Central Hungary, regarded as Budapest's 'hinterland', has a lower network density. However, the poorest density and service figures are recorded in the regions of the Northern Great Plain and Northern Hungary. The territorial distribution of banks clearly points to a more intense financial intermediary activity that correlates strongly with economic development.

Table 2: Territorial distribution of bank branch networks and branch density, 1998-2004

Regions	No. of bank branches 1998	No. of bank branches 2004	Ratio of bank branches 1998	Ratio of bank branches 2004	Branch density (population per branch) 1998	Branch density (population per branch) 2004
Central Hungary	304	441	32	38	9434	6417
<i>Out of which:</i>	<i>253</i>	<i>358</i>	<i>16</i>	<i>31</i>	<i>7356</i>	<i>4762</i>
<i>Budapest</i>						
Central Transdanubia	96	109	10	9	11594	10211
Western Transdanubia	114	127	12	11	8711	7897
Southern Transdanubia	101	111	11	9	9762	8865
Northern Hungary	88	110	9	9	14591	11636
Northern Great Plain	109	147	12	12	14073	10524
Southern Great Plain	132	155	14	13	10295	8774
Hungary	944	1170	100	100	10736	8.647

Source: Based on yearbooks of the Hungarian Financial Sector and Stock Exchange

From the banks' perspective, the development of networks is not driven primarily by regional preferences. It was to proceed instead in accordance with the urban hierarchy. That is to say, in the early stage of network-building, banks tried to cover the country while following the hierarchy of settlements, i.e. starting with regional centres and county seats proceeding subsequently to smaller urban centres. Given that by the early 1990s the number of bank branches had equalled the number of major towns, financial institutions turned their attention to towns with smaller populations. The former 50% share of large towns in the branch network (60% including Budapest) fell to 22% due to the opening of branches in smaller towns. Today, the bulk of the branch network (41.5%) is located in towns with 10 to 25 thousand inhabitants. At the same time, the accessibility of services corresponds to the economic prosperity of individual towns. The relative positions of larger towns are best characterised by reference to range of financial services offered and the intensifying competition among banks rather than the mere enlargement of branch networks. In terms of these indicators, *some major towns (Pécs, Győr, Debrecen, Miskolc, Szeged) can be said to*

have started to assume the status of financial centres. In settlements with populations between 5 to 50 thousand, branch networks have slightly increased, while in settlements with populations of 2 to 5 thousand, the number of branches has decreased (Figure 1).

Within the services sector itself, business and financial services have the greatest potential to shape space. In addition to manufacturing, business and financial services were responsible for generating the most significant regional disparities during the phase of economic transition (Gál *et. al* 2002). There is evidence today of a new, intensive phase of development in the financial sector. Thus in Transdanubian regions showing the most rapid industrial growth industrial development could provide an impetus to the financial sector as well. The GDP of financial services in many counties increased at a rate that approximated or even exceeded that of industrial growth. In the sector of financial services, the highest increase in generic investment volumes was realised in central and western regions of the country, a fact that can be explained by the more intensive *concentration* of services in economically dynamic regions. With respect to regional differences, there exists a strong correlation between economic activity, income structures and the distribution of financial services. At the regional level, higher income levels strengthen the position of Budapest and that of western regions which is also reflected in the greater density of the bank network. The correlation is even stronger between the location of financial services providers and relative levels occupied in the urban hierarchy.

4. The territorial polarisation of the Hungarian banking system

While at a global level capital often moves independently from economic processes, uneven *capital flows* among regions are typically caused by *inequalities* in economic potential. Financial centres of economic core areas located at the top of the urban hierarchy concentrate the greatest amounts of capital. This results in significant regional disparities (Porteous 1995, Leyshon-Thrift 1997). With the formation of global financial markets and the strengthening of supranational organisations (EMU), the pressure on local and regional financial markets has intensified. This foreshadows the growing dependence of local economies on global (trans-national) organisations. Governments of nation-states – especially those of *emerging economies* – are faced with the unenviable task of having to decide whether to assist local economic actors or to support multinational organisations. The real challenge is to find the optimal balance between these two economic domains.

Business finance markets are geographically and organisationally centralised in Hungary. Among Hungary's economic sectors, territorial concentration and polarisation is the highest in the banking and insurance sectors. An analysis of the polarised territorial structure of the Hungarian banking system yields the following conclusions (*Gál 2000a*):

- The Budapest-based organisational-administrative structure of the banking sector is of crucial significance. The Hungarian banking system is organisationally centralised. *33 commercial banks and specialised financial institutions are located in Budapest (the only exceptions are the Austrian-owned Sopron Bank and the Budaörs-based Opel Bank founded in 2003)*. This means in practice that 94% of banking capital stock and 86% of those employed in the financial sector (those registered at company headquarters) are concentrated in Budapest. Foreign bank capital and its organisations focus on Budapest due to its *geographical location which is of strategic importance*.

- The Hungarian banking sector is characterised by the lack of locally founded banks. Only mutual savings banks ('cooperatives') have their headquarters in the countryside. These mutual savings 'cooperatives' operate with more branches than bank networks (accounting for 58% of financial institutional networks), but with a lower capitalisation (6% of total national assets). They lack strong centres and usually have their headquarters in smaller settlements. In recent years, several dynamically developing mutual savings 'cooperatives' were able to meet the requirements for banking operations. These have become significant financial institutions at the regional level.

- The main cause of polarisation is the *strongly centralised hierarchical control of the branch network*. Due to this structure, competencies of countryside branches are restricted. In some cases, even their access to information is limited (informational asymmetry). Today, banks offer the same services throughout the country, i.e. products tailored to regional demands are missing. Strategic decisions concerning future development are taken at Budapest headquarters.

- A further cause of polarisation is the relatively low level of access to services throughout the country. This is manifest in the highly uneven territorial distribution of branch networks in terms of both urban hierarchy and regional levels.

As regards financial services, one can speak of the *dual nature and fragmentation* of the sector *both in organisational and geographical respects*.² The banking and insurance sectors are characterised by the concentration of large companies (large banks) in predominantly transnational ownership. By contrast, domestic providers of financial services (e.g. mutual savings banks) are not significant players on the market. This intensifies the duality of not only the organisational but also that of the spatial division existing between Budapest-based financial services providers and those outside Budapest that are to struggle with manifold competitive disadvantages. The emerging *dual structure* of financial services, which has also become manifest in spatial terms, is consonant with the centralisation and concentration characterising the transformation of the entire spatial structure of the Hungarian economy. This structure can be best observed in connection with the strengthening of Budapest's "*filtering*" functions (the capital occupying a key position in controlling the flow of information). Globalisation, adjustment to international financial structures, rational constraints on decentralisation and the small size of the Hungarian banking market can only partially explain why banking services are centred in *Budapest* to this extent. In order to account for this phenomenon, many refer to historical factors as well such as the traditional Budapest-centred character of key sectors of the economy (Beluszky 1998). In addition to the factors listed above and the uneven distribution of capital concentration, structural features of the banking sector are primarily determined by market structures at the outset of economic transition and the international economic environment of the time.

The international situation in the context of which system change was to take place in Hungary was crucially shaped by two major currents of the twentieth century, namely *globalisation and a (neoliberal) economic paradigm change*. These developments contributed not only to the fall of the Soviet block. They also created rather strict economic conditions for post-communist Hungary about to reintegrate into the international market economy. In the course of this transition, Hungary had to adjust to a world economy fraught by shocks and uncertainties (debt crisis, money market and currency crises), i.e. among competitive conditions that had become extremely disadvantageous. As a country in the forefront of economic transition, Hungary was exceptionally vulnerable and was also to act as an

² The term 'dual economy' can stand for characteristics caused by *organisational and structural differences among economic actors (large and small enterprises)*. In Hungary's case, these are embodied in differences between foreign-owned large enterprises, on the one hand, and Hungarian SMEs, on the other. One can also speak, however, of a *dual regional economy*. This term points to a developmental gap between dynamic centre(s) and peripheries.

experimental ground for dominant interests of foreign capital (Gazsó-Laki 2004). The only available solution to set off the loss of capital caused by the debt crisis and to avoid an even deeper economic recession was to permit the unconstrained inflow of foreign capital and to liberalise markets far beyond what was accepted in more developed countries. As a result, the chief characteristics of this blend of “imported capitalism” included a relatively fast recovery from economic crisis but also the dominant role of foreign capital in the process of stabilisation. However, foreign investments not only contributed to the modernisation of the economy, but also increased its structural and spatial segmentation (Szelényi et al 2000). This, of course, has seriously reduced opportunities for capital accumulation in countryside regions. Disadvantages created by the “dual economy” are increasingly palpable in the area of financial services now that economic transition processes have come to an end and economic constraints have gradually disappeared.

As already mentioned, financial markets of system changing Eastern and Central European countries were not outcomes of organic growth. In the early stages of transition, Hungary’s two-tier banking system was created from above and was already strongly centralised with Budapest at the centre. In this sense, the two-tier banking system introduced in 1987 virtually reproduced the earlier Budapest-centred, over-centralised state-socialist single-bank structure, even if more financial institutions existed after this point. In Hungary, early privatisation dominated by foreign capital led banks to make their strategic decisions about organisation and development, including their choice of headquarters, entirely on a market-oriented basis.

Since banks available for privatisation were exclusively located in Budapest and so were greenfield banking investments, in effect 100% of capital invested in the sector was concentrated here. In several surrounding countries (Poland, Czech Republic), economic policy decisions ensured early on that banks would be established in a decentralised manner by also locating headquarters in the countryside. Nevertheless, the limits of decentralisation in terms of economies of scale manifested themselves in the fact that, by the end of transition, the number of Czech and Polish banks with countryside headquarters decreased. Consequently, there is a stronger correlation today between existing regional bank centres and the performance of local economies.

5. Territorial and organisational levels of the Hungarian banking system

Modern business and financial services are dominant factors in the economic development and competitiveness of territorial units and regions with a strong impact on the formation of long-term territorial disparities. It follows that different operative levels of the Hungarian banking system are informed by a combination of factors such as the concentration and differentiation of institutions in the financial sector, division of labour necessitated by market conditions as well as organisational-administrative structures of control at financial intermediaries. In developed countries, basic financial services and institutional forms (banks, building societies) are, geographically speaking, more evenly distributed in economic space than other, more specialised finance institutions (stock exchanges, pension funds, bank headquarters, venture companies). Those belonging to the latter group tend to be more concentrated spatially. Agglomeration and special traditions of development can also influence the financial sector. One can also observe historically-rooted clustering processes in certain urban centres and regions. Consequently, urban hierarchy overlaps with the financial hierarchy to a large degree as a result of which even larger economies typically have only one financial centre.

Budapest's position on national and international financial markets: prospects for the creation of a regional financial centre in Eastern and Central Europe

The traditional dominance of Budapest in the past 150 years in the economic and cultural life of the country has not weakened since the change of system. On the contrary, it has even strengthened due to the emergence of a market economy. Particularly significant is the concentration of *business and financial services in the capital*. As the centre of national economy, Budapest is also *the country's financial centre*. *International relations of the financial sector are also administered via the capital*. All institutions and functions associated with these roles can be found here. Budapest has the only capital market in the country. It concentrates the head offices of banks, insurance companies, specialised credit institutions, building societies, mortgage banks and lease companies. Organisational units performing national functions (treasury, call-centre) are also to be found in Budapest. The significance of the capital's special strategic geographical location in the national financial system also derives from the fact that important, so-called "critical information" (i.e. preparation of bank strategies, central data provision, access to the giro-system and stock-exchange listings) flows

exclusively via the centre. Institutions for maintaining contact with international financial centres are also to be found here. The number of financial sector employees is over 26 thousand in Budapest accounting for 37% of the total workforce in the financial sector.

What is at stake in the ongoing race among metropolises in Eastern and Central Europe is in part *whether Budapest can become a regional business and financial centre with international functions* (Enyedi 1992). *Nevertheless, contradicting former optimistic expectations, Budapest has not yet become such a regional financial and business centre, the “Singapore of the region of Central Europe”.* At the same time, the Hungarian capital does have the potential to acquire competitive advantages in certain areas of the financial sector in the early 2000s. *Such advantages* could stem from its central location and its bridging role within the region. In other respects, however, the size of the capital and its surroundings, its proximity to the region of Southeastern Europe, its stable economic environment with favourable infrastructural conditions all constitute features that are *not* unique in comparison with other regional capitals.

Meanwhile, several factors can be cited for a better assessment of the relative development of the financial sector and its competitive advantages in the region of Central and Eastern Europe:

- The international competitiveness of the Hungarian banking and insurance sector has improved. This sector was successfully privatised, it is dominated by foreign capital and has succeeded in complying with EU standards for a considerable amount of time now. It boasts some of the best quality indicators in the region. Although the country's previous competitive advantage in the financial sector has decreased, it is still leading in terms of available legal and monitoring background.
- Largely due to Budapest's excellent capital-absorption potential, the share of foreign investments remains high.
- The country's capital-attracting potential was also high, at least until the turn of the millennium, after which it has decreased dramatically.
- In the 1990s, several well-known international companies set up their Eastern European headquarters in Budapest. Others have followed this trend at the beginning of this decade.

- Recently, a number of financial services providers have moved their back offices to Budapest hoping to realise cost advantages (e.g. regional back offices of Citibank and KPMG as well as Exxon, the regional financial service centre of GE).

- The operation of the Budapest Stock Exchange (BSE), one of the most dynamically developing stock exchanges in the world, also indicates that investors generally prefer Budapest to Warsaw and Prague. However, competing stock exchanges have also become much more attractive by the early 2000s. Thus the Warsaw Stock Exchange, due to its larger capitalisation, poses serious competition to the Budapest Stock Exchange. With the acquisition of a significant share of BSE, the HVB Group, a part-owner of the traditionally strong Vienna Stock Exchange, plans to realise a Vienna-based regional integration of stock exchanges.

- Budapest's role as a financial centre could be strengthened by the fact that Hungary has become the region's largest capital-exporting economy by the end of the 1990s. Half of all Hungarian FDI has targeted the Southeast European region. In light of this export of capital, foreign interests at Budapest-based head offices of capital-exporting companies certainly strengthen the city's international financial positions. With a 25% share, the Hungarian financial sector is ranked second among Hungarian capital-exporting sectors. Capital export to Eastern and Central Europe is dominated by Slovakian, Romanian and Bulgarian bank acquisitions of OTP Bank. It is interesting to note in this connection that a few years back one of the main obstacles to Budapest's aspirations to become a financial centre was precisely that Hungary's banking system was fairly passive in the region.

However, there are still serious impediments to *Budapest's becoming an international financial centre*:

- International financial centres playing a key role in regional economies or the world economy as a whole are typically located in areas where the size of the host national economy is itself considerable. This is because such economies require extensive financial services. By contrast, as already noted, the size of both the domestic economy and that of the banking system is small in Hungary. Despite an expansion during the last few years, the financing role of the banking system is restricted and domestic banks remain small (although this disadvantage may be partly set off by the size of foreign 'mother banks').

- In Budapest, despite a suitable supply of highly qualified professionals, qualifications of the available workforce still fall short of international quality standards. In certain areas of finance (accounting, cost-management, marketing and sales) there are especially serious shortcomings. Consequently, financial services providers tend to employ foreign managers (*Pelly 2001*).
- Economic relations among countries of the region seem to have strengthened in recent years. At the same time, the intensity of these relations is weakened by parallel developments resulting from overlapping foreign ownership. In all countries of the region of Eastern and Central Europe, foreign banks established subsidiary banks and parallel networks controlled by managements of foreign 'mother banks' rather than regional financial centres proper.
- Organisational division of labour in the development of global financial markets lead to processes of decentralisation which run parallel to those of centralisation. Although in past years many global financial actors have moved their back offices to Budapest, investment banks are still missing. The presence of these is regarded as crucial to the creation of financial centres.

In sum, the likelihood of creating a relatively independent regional financial centre in Hungary is low. There is little evidence of regionalisation in banking markets of Central Europe. This is because regional product standardisation has not taken place, while capital markets and infrastructure have developed in parallel in the countries concerned. Beyond conditions specific to financial systems in Eastern Europe, the evident concentration of financial markets throughout the world also suggests that the largest companies in the region will continue to rely heavily on Western European and overseas financial markets in the future as well. At the same time, these processes of concentration are partly set off by the fact that financial services providers' location of branches leads more and more frequently to the establishment of decentralised (geographically outsourced) organisational units in the pursuit of economies of scale. This highlights the importance of locating sub-centres in accordance with the prospective directions of the spatial expansion of growing markets. EU accession guarantees the stability of the market environment thereby rendering Budapest an attractive location for international back office services. Budapest may have (in fact, it already has) good resources for the creation of a regional service centre catering for consumer needs and enabling the concentration of financial services scattered throughout the region (*Szabadföldi*

2001). However, it is also notable that conditions in rival capitals are similar, except for Vienna where the labour market cannot compete with Hungarian wage levels.

The limited potential of the Hungarian economy weakens the attractiveness of the Hungarian capital as an international financial centre. For Budapest, proximity of Balkan markets and the prospects of dynamic economic development in Southeastern Europe may create real competitive advantages, namely by generating high demand for financial and other business services. All these developments may emphasise the strategic geographical position of Budapest thanks to geographical proximity and better “local economic expertise”. There is no assurance, however, that regional development will lead to the creation of a new Eastern European financial centre. Modern informational technology, growing international openness of large financial centres, their already manifest and foreseeable concentration as well as the deepening embeddedness of key economic players in the Eastern European region are all factors that can override the advantages of geographical and cultural proximity. A structure is much more likely to strike root in which simpler, less resource-intensive services are locally available to customers while others are provided by traditional Western European or overseas financial centres. Even so, there is a genuine niche for creating a regional sub-centre and for providing certain special back office services (*Bellon 1998, Pelly 2001*). According to an alternative scenario, the capital would remain primarily a national financial centre – providing higher quality services than today – while extending its network of international relations (and strengthening its ties to Southeast Europe).

The state of the Budapest-centred financial system, including the domestic banking system, in the late 1990s rendered it unsuitable for playing a more significant regional role according to international standards. In the early 2000s, Budapest chances of occupying that role have somewhat improved due to the good performance of the private sector and its regional expansion. However, in my view, Budapest is not in a position to become an exclusive financial centre of the region. Nevertheless, similarly to its erstwhile role in the early twentieth century, it could serve as a financial sub-centre for certain distributive and intermediary international functions. This could enable actors of the international financial market to exploit certain services-related and geographical conditions of Budapest’s favourable strategic location.

Territorial levels of bank network building

Paralleling the territorial concentration of banking and capital markets, there is an increase in the number of players in the financial sector creating intensifying competition in the ever-widening banking markets. *With the enlargement of branch networks, deconcentration processes became more pronounced already during the period of transition.* Against the general tendency observable in the EU, consolidation of the Hungarian market was not accompanied by a decrease in the number of branches. On the contrary, the branch network is still growing, although at a slower pace than before. Despite this broadening of the branch network, the concentration of retail banking is still higher than that of corporate banking and is further increased by the market share of the largest bank (*Móré-Nagy 2004*). The imperative of being present on local markets (resource accumulation, credit placement) and competition for retail markets motivate financial institutions to *build up networks outside the capital as well*. In the course of doing so, they seek to involve local resources. The primary means of market penetration is the broadening of the branch network. The role of foreign ownership capital is dominant in developing the organisational and territorial framework of branch networks. This holds true not only of the level of capital involvement and technology, but also of the spatial scope of market building strategies (optimal size of the network in the case of larger retail banks would be around hundred units).

In the countryside, positive effects of foreign financial capital investments became visible with the widening of branch networks and the improving quality of services. Foreign-owned banks were responsible for the rapid widening of branch networks in the latter half of the 1990s. They played a decisive role in widening branch networks, improving branch accessibility and, as a result, in reducing territorial disparities. However, the building of bank networks proceeds strictly according to business motives and profit-oriented priorities. These are the considerations that determine network development at regional and local levels in the strategies of network-building banks. *The current state of financial services accessibility is most importantly characterised by the concentration of such services in the capital and the almost total absence of banks in rural areas (i.e. villages).* At present, 223 settlements (99% of which are towns) locate branches of commercial banks. To put it differently, bank networks are not present in villages accounting for 93% of all settlements. While nationwide, the ratio of population per bank branch improved by 18% between 1998 and 2004, this figure worsened by 5.3% in small regions which display the worst branch accessibility figures. The

number of small regions with access figures below the national average increased from 97 to 102. Domestic banks continue to resort to the so-called “redlining strategy” not only in network development but also with regard to certain services segments. *The majority of banks are still uninterested, for instance, in agricultural investments or in financing SMEs or regional development.* At the same time, it is also true that some banks have lately sought to improve their positions in these markets as well. Meanwhile, in view of the spatial location of these sectors, access enjoyed by countryside regions to banking services has worsened overall. As noted above, in the transitional period, development of banking networks significantly alleviated territorial differences. Today, however, the slowing down of network deconcentration and the closing down of certain branches (financial exclusion) as well as poor access to banking services at some territorial and settlement levels have increased territorial inequalities once again.

Changes occurring in the organisational and administrative system of branch networks are also space sensitive. New bank strategies in the early 2000s began to emphasise *organisational centralisation*, particularly that of certain business divisions. This has clearly strengthened Budapest’s role yet again. In addition, an increasing number of financial institutions sought to rationalise what had formerly been a scattered organisational and administrative structure. They *created regional head offices*, which were to replace county centres, in accordance with the general trend of regionalisation. They also began to decentralise certain monitoring functions. In 2002, 6 of the 13 banks with nationwide branch networks had at least a three-level organisational structure. The majority of foreign-owned banks adopted this structure in setting up their branch networks. In other words, they imported successful practices from abroad in reshaping domestic banks.

Banks with larger branch networks are more likely to build a more decentralised organisation, whereas banks operating smaller networks and employing a smaller workforce are more prone to centralise. However, the establishment of regionally deconcentrated organisational units does not entail the weakening of decisional competencies of the capital head office. Strategic decisions and those concerning future development are still taken at *bank headquarters* seated in the capital or in the headquarters of foreign ‘mother banks’ (McKillop, Hutchinson 1991). No doubt, bank decentralisation has rational limits posed by economies of scale. Nevertheless, Western examples show that even within centralised banking structures it is possible to decentralise certain financial services at the regional level without undermining the role of the

national bank centre. This can contribute to the more effective operation of the entire network. Currently, however, organisational decentralisation frequently remains formal in Hungary. Decision competencies outside the centre are limited. Banking products are centrally developed. The banking sector fails to offer services and products specifically tailored to local needs. Identical conditions apply all throughout the country. Diverse circumstances and levels of development in different regions could, however, justify the offer of certain customised services.

Regional centres and sub-centres constitute the next level of banking networks. As the first step towards decentralisation, banks establish regional control offices and endow local branches with varying control functions. Regional centres occupy a middle ground between the national centre and local branches. They supervise the units of the branch network in their territory. Whether a certain location serves as a financial centre can be defined by a combination of several qualitative and quantitative features. These include number of bank centres and branches, the position occupied in the bank's organisational hierarchy, presence of other financial institutions, the number and ratio of employees in the financial sector and the direction of their change (Wágner 2004). It can be observed that the financial role of five major towns (Pécs, Győr, Szeged, Debrecen, Miskolc) has strengthened. These towns started to take over certain regional (sub-)central functions.

It is also worth noting the agglomeration of providers of financial services and the opening of several regional agencies (*Table 3*). These cannot be regarded, however, as genuine regional centres. Full-fledged regional centres are defined in the pertaining literature as locally established financial institutions in a position to generate independent information or, alternatively, as centres representing foreign institutions (Tickell 1996). In light of the heavily centralised organisational and operational structure of banks in Hungary, it would be premature to refer to existing regional representations as genuine financial centres. Their output of original information is restricted, information flows mainly towards the centre and only to a limited extent towards local units. Despite their having been entrusted with certain decision-making rights, competencies of such regional units remain narrow. Amounts at their disposal are maximised.

In regions (or to use international terminology, in regional sub-centres) themselves, enlarging the institutional basis of financial mediation and services may be prompted, first, by access to

(and in many cases monopoly of) labour and informational resources in so-called quasi-regional centres, and second, by intensifying competition among banks for shares of local markets. The emergence of such competition is in many cases not dependent on a given region's economic performance. Overall, chances of establishing locally-based banks in Hungary, the presence of which is generally regarded as necessary for qualifying as a regional financial centre, are low. The concentration of capital – a prerequisite for creating and efficiently operating independent banks – is not favoured by current conditions, especially not in less developed regions.

Relevant surveys on economic activity and opportunities for capital accumulation in regions outside the capital are based on the analysis of entrepreneurial activity, profitability figures of firms and the territorial distribution of personal income tax. Budapest claimed a higher share of all factors crucial to economic growth – such as local capital accumulation, FDI and the development of financial services – than the relative size of its population (*Figure 2*). In addition to Budapest, capital accumulation benefits primarily thriving towns of central and western regions followed by regional centres and dynamically developing county seats. At the same time, almost 80% of villages and underdeveloped small regions continue to lack mobile capital. The low level of capital concentration in the countryside – a good indicator of economic performance in these regions – is tied up with the lack of locally founded financial institutions (*Nemes Nagy 1995*). The majority of cooperatives cannot meet the EUR 1 million capital stock limit necessary for the establishment of mutual savings banks. The capital stock limit of EUR 8 million required for the establishment of banks poses an even more serious obstacle to launching financial institutions in the countryside. Therefore, changes in recent years highlight the danger of a new kind of dependence between the capital and the regions in terms of financial transfers. The *filtering role* of Budapest is due *primarily* to its key position in controlling information flow. The capital-centred banking system filters the most valuable financial services (corporate banking, portfolio and risk management, private banking) and relegates more traditional and less profitable services to the periphery.

Table 3: Potential regional bank and financial centres in 2001 and 2002

Towns	Number of banks	Number of seats of mutual savings banks	Number of non-bank financial intermediaries	Number of bank branches	Number of financial employees	Frequency of regional bank centre role
	2002	2002	2002	2001	2002	
Debrecen	13	0	22	25	1 632	4
Győr	13	1	36	27	2 073	5
Miskolc	13	0	40	24	2 108	5
Pécs	13	0	35	23	1 610	5
Szeged	13	3	37	25	1 573	4
Hungary	28	189	n.a	1168	52748	-

Source: Wágner I. (2004), on the basis of yearbooks of the Hungarian Financial Sector and Stock Exchange and the Regional Statistics Yearbook. Note: number of financial employees given by county. Regional bank centre role: territorial centres of banks with regional organisational structures in the given settlement.

Surveys carried out in the first half of the 1990s, outlined several possible directions how to develop the Hungarian banking system, ease its excessive centralisation and promote decentralisation to some extent at least. Suggestions included the enlargement of branch networks of commercial banks in the countryside, integration of mutual savings ‘cooperatives’, establishment of municipal financial institutions and the creation of a network of regional development banks (Illés 1993). In addition to the already mentioned lack of resources necessary to meet capital stock requirements, however, keen competition on an already saturated domestic market also hinders the entry of new actors with independent branch networks in the group of the currently operating 13 banks. On the contrary, what we are likely to see in the future is a growing concentration of the banking sector, a *slow decrease in the number of independent financial institutions, and an increased emphasis on exploiting the potential inherent in the integration of the savings cooperative sector.*

Since the bulk of the banking network is located in large and medium-sized towns, the impact of the commercial banking network at the level of small towns and villages is weak (while 33% of money circulation took place in small villages without bank branches in 2000). Strengthening the market positions of mutual savings banks with extensive networks in the countryside could lay the groundwork for spreading financial services to lower settlement levels (no financial services are available at almost half of all settlements, i.e. in the

residential environment of nearly 15% of the population). Approximately 2.5-3 million people live in villages where the only financial institution available is a mutual savings 'cooperative'. The current decentralisation of such mutual savings banks can be regarded as a significant competitive advantage at local banking markets. At the same time, conditions for the efficient and professional functioning of these excessively scattered savings bank networks can only be *ensured by integrating savings 'cooperatives'* under the auspices of an 'umbrella' bank. The optimal operative size would enable the efficient functioning of 70-100 mutual savings 'cooperatives' (Kiss 2000).

Given the total assets of mutual savings banks, their actual integration would produce the fifth largest bank in Hungary. At present, the regional performance of such mutual savings 'cooperatives' is best in the regions of Southern Transdanubia and Southern Great Plain. Here they can rely on a strong agricultural basis, although they have also acquired solid positions on urban markets as well. In the capital and the region of Central Hungary, the performance of mutual savings 'cooperatives' is weak since this market is dominated by commercial banks. In the long run, it would be advisable to alleviate the still existing polarisation of the Hungarian banking system by encouraging cooperation between commercial banks with smaller – spatially more concentrated – networks, on the one hand, and mutual savings 'cooperatives' with more extensive networks in villages and small towns, on the other. Currently, the whole of the Hungarian banking market could not be covered without the sector of mutual savings banks. This is because it is unrealistic to expect commercial banks to set up branches even in smaller towns. At the same time, expansion of mutual savings 'cooperatives' in towns may continue (Gál 2003b).

Conclusion

Having examined almost two decades of the development of the Hungarian two-tier banking system, we can observe that the financial services sector accurately reflected territorial developments induced by processes of economic transition. Having been the first to introduce a two-tier bank system, Hungary gained considerable competitive advantages in the region. Due to a massive demand for capital in the course of the rapid modernisation ushered in by the general economic crisis, the development of the banking sector was entirely determined by market processes – and primarily by decisions of foreign owners – already in the early phase of the political-economic transition.

The banking sector is characterised primarily by strong organisational centralisation and territorial polarisation, the latter being crucially reflected in the strong Budapest-centredness of the entire sector. Following a decade of extensive development (territorial extension) of the banking network, organisational centralisation appears to become more dominant in the early 2000s. This is, of course, no Hungarian peculiarity. It is clearly normal for national financial centres to be set up in cities with the largest population and the strongest economic activity. The extent to which this sector is centred on Budapest, however, cannot be fully explained either by reference to the small size of the country, nor by the imperative of having to adjust to international financial structures (i.e. having to optimise the size of financial centres). Historical circumstances rooted in the crisis of the 1980s are at least as much dominant. The heavily centralised (Budapest-centred) structure was created by decisions of a 'reformist' elite that was itself based in Budapest. These decisions gave priority to an optimal concentration of resources. Nor did the ever-deepening economic crisis – more severely affecting the undercapitalised countryside economy – favour the creation of decentralised structures.

For the most part, structures of the banking sector – which were also to inform the institutional and legal framework – had already been set up at the point when they were taken over by foreign investors. The mid-1990s saw the extensive enlargement of the branch network in the countryside. Banks opting for this strategy were aiming at involving resources outside the capital and were seeking to improve their positions on the domestic market. This extension of networks restored territorial balance to some extent. Parallel to this, however, structural challenges (competition by non-bank financial intermediaries, spread of universal banking, strengthening competition, concentration of banks, introduction of IT technologies, increasing operational cost efficiency) facing the Hungarian banking system now integrated into developed financial markets resulted in a growing organisational centralisation of banks and a shrinking workforce from the early 2000s. The effects of the latter processes amplified territorial inequalities once again. Organisational centralisation, rationalisation of banking branch networks (financial exclusion, i.e. withdrawal from some less profitable regions, closing down of branches) and the organisational and territorial concentration of certain banking activities further widened the gap between Budapest and the countryside. These processes have not only significantly contributed to territorial disparities, but have also increased the traditional centralisation of *crediting practices in the banking sector*. While the closing down of bank branches and concomitant layoffs mostly affected units at the lowest

levels of the settlement hierarchy and socially segregated residential areas, organisational centralisation has had the same effects on financial institutions (territorial head offices) of major towns outside the capital. The peculiarity of these negative developments – in contrast to those in Western Europe – is that they had begun before branch networks of a reasonable size could be completed. Strategic investment decisions in the sector significantly exacerbated territorial disparities after the end of the 1990s. In view of the Hungarian regions' limited potential to accumulate capital through the activities of local enterprises, the launching of new financial institutions in the countryside or the creation of genuine regional financial centres outside the capital are not viable options. Given a sufficient level of capitalisation, the locally embedded mutual savings cooperative sector combining local and market perspectives can assume a modernising role – similarly to the German model. This is partly because without this sector it would be impossible to cover the entire Hungarian market today. Competition for banking markets, however, also leads commercial banks to exploit market opportunities outside the capital. The development of branch networks – the pace of which has slowed down in comparison to former times – continues both in the retail market and local markets. On these markets, the significance of local expertise is increased in new strategic areas (e.g. SMEs, regional project financing).

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