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## Challenges Of Regionalism: Development And Spatial Structure Of The Hungarian Banking System

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CHALLENGES OF REGIONALISM: DEVELOPMENT AND SPATIAL STRUCTURE  
OF THE HUNGARIAN BANKING SYSTEM

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**ABSTRACT:** This paper is concerned with the spatial characteristics of the Hungarian banking system. Financial services became the key sector in the processes of economic transformation and differentiated by uneven regional development. The spatial structure of the banking sector is characterised by a large-scale concentration in Budapest, but the foundation boom of branch offices is also typical in the regions, as the necessity of presence on the local markets, as well as the competition for the retail market stimulate banks to expand their branch networks. Commercial banks, which have their headquarters exclusively in Budapest, largely concentrate only on the collections of deposits in their national network, resulting in capital drainage and net capital loss in most of the regions. The presence of the centralised capital market and the lack of decentralised regional financial system can restrain and slow down regional development in the long run.

The paper is organised as follows. After the introductory section the spatial and structural characteristics and polarisation of the Hungarian banking system is discussed in the light of its progress made in the last ten years. This is followed by an analysis of a possible reorganisation and decentralisation of the spatial structure of banking at regional level without questioning the pre-eminent role of the national banking centre, but contributing to a more efficient operation of the network.

## INTRODUCTION

Financial Geography as a newly established sub-discipline of Economic Geography deals with the flows and transformation of the money, and the spatial, institutional and regulatory structure of financial capital (Leyshon 1995, 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 financial landscape of the World (Leyshon-Thrift 1988). These changes are usually associated with a single word, globalisation. Globalisation –giving a definition by Ron Martin – refer 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. 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 which 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 effect regional and local banks as well as different national banking systems. 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 accessing countries of Central and Eastern Europe, such as Poland, Czech Republic, Slovenia, Slovakia and Hungary which followed their reintegration into the world financial market in the early 1990s. They not only have to adopt new technologies and the financial

behaviour it accommodates, but also have to cope with a legacy of bad debts and a lack of experience in credit risk assessment. Central –Eastern European banking systems are accelerating through some features of the stages of development as a result of competition with more advanced systems and state encouragement of banking development. As European Union membership approaches in Central Europe's more advanced economies, Western European banks are aggressively moving to expand into what will soon be a home market for them. The result is the increasing pressure on margins, as more banks compete for relatively little business. This results in a reversal process of concentration than in EU, namely the growing number of institutions. Making matters worse for the locals, the foreign banks often boast deeper pockets, greater expertise and more solid reputation (Anderson-Kegels 1998). 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 and institutional structure of the national banking systems.

#### THE FIRST DECADE OF THE DEVELOPMENT IN 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. Following this Act, the National Bank of Hungary, performing primarily central bank functions and the institutionally separated commercial banks were set up in January 1987. Commercial banks who 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 type of banks by functions (34 commercial banks, 8 specialised banks, mortgage banks and building societies, 236 co-operative savings banks).

Since the reintroduction of two-tier banking (after 40 years discontinuance) 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, foreign capital inflow, a more intensive participation in the international division of labour and European integration all provided new opportunities and challenges for banking. The new actors of a rapidly developing economy, the mushrooming of associations and corporations and the greater demand for corporate and retail markets will transform the present banking system. Money markets will undergo radical rearrangements in the future and the balance of power will change as a consequence of market competition. Banks struggle for larger shares of the expanding market and for new customers which require both the expansion of the banking network and the perpetual innovation of banking.

If we take ten years of development in the banking system into consideration it can be divided into different periods. The short period between 1989-1992 was the peak time for

foundation of new banks. 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 the banking system was characterised between 1992-1995 by the first bankruptcies and failures. Over-gearred expansion of balance-sheets and increasing risk-taking stood in contrast with the low level of financial standing and the huge sum of inherited debt that was accumulated in the central bank before 1987. 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. The main purpose of bank consolidation and privatisation was to decrease the percentage of state ownership in the banking sector to at least below 25%.

In the third period, commencing in 1995, 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. In this latter period of development the branch network expansion was one of the major phenomena. This was due to business policies of banks shifting from the corporate to the retail market, intending to gain more of the market shares through easier access to retail customers, and on the other hand strengthening the competition which force mainly foreign banks without branches to build networks in order to hold their ground. Growing retail market from the mid-1990s has urged banks to establish their extensive nation-wide network of local branches. (This occurred partly through acquisition of offices of the liquidated banks and partly through the opening of new branches). Parallel to stabilisation processes, the growth of newly established banks halted and the founding of joint-ventures and subsidiaries of foreign banks were compensated with mergers and liquidations through the strengthening of concentration in banking. In the last years, new types of banks were formed, serving the special interest of the money market (mortgage banks, building societies, land and mortgage bank), but the concentration in banking will continue.

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 the Hungarian banking, the structure of ownership was entirely transformed; parallel with the process of the significant decrease in state ownership (20% recently), shares of foreign capital attained 65% of the banking system, gaining a majority of market shares within a short time. This very high proportion of foreign capital is among the highest in the European context. In the UK 53% of ownership is foreign, but in Finland it is only 1%, in Germany 2%). The main investors are, according to the portion of invested capital, still the leading German and Austrian entrepreneurs, following by the American, Dutch, French, Japanese and Korean investors. Activity of the Dutch banks is indicated by the fact that all the top-ranking Dutch banks opened

subsidiaries in Hungary (ABN Amro, ING, Rabobank) but British banks are conspicuous by their absence (Várhegyi 1997).

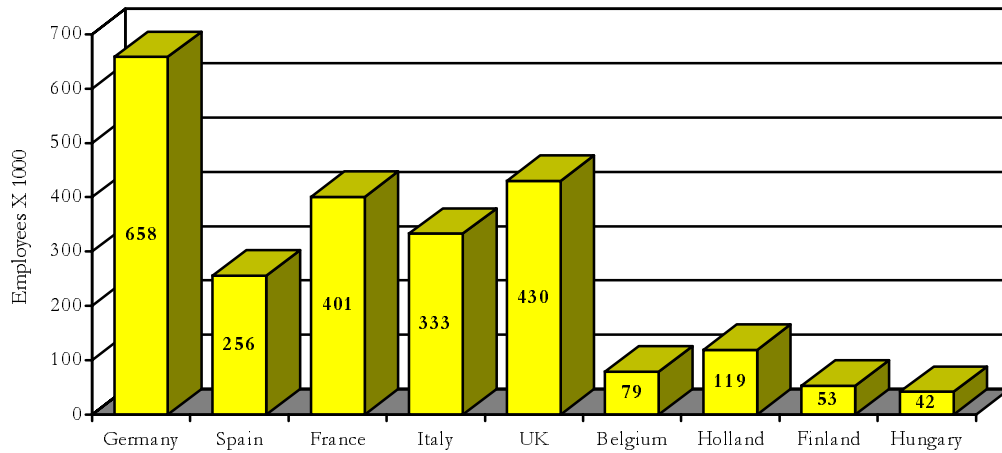
To summarise the role of foreign capital in the Hungarian banking system it can be said that such a rapid process of privatisation of banking without foreign capital inflow would have been impossible. Foreign capital inflow into the banking system together with the ownership shares from privatisation, comprising a total of 220 billion HUF, that was directly invested into banks based in Budapest but ran through the channels of a branch network.<sup>10</sup> 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. (Per capita investment of foreign capital accounted for 1,950 USD in Hungary, compared to 1,040 USD in the Czech Republic and 832 USD in Poland till 1999.)(Wachtel 1997).

In the consequence of successful privatisation competitiveness of the banking system is strengthened: increased its balance sheet account, improved the quality of portfolios, but the proportion of the bad debts is still higher than the EU average, which have increased significantly by certain banks (Postabank, Realbank). By the end of the 1990s the Hungarian banking system affected by radical legislative, administrative and institutional changes, such as the privatisation of many banks, foreign capital inflow, the introduction of a more universal banking model, the liberalisation of the credit market and the consequent intensification of competition.

The dimension of the Hungarian banking system is small according to the size of banks and the ratio of balance sheet status to GDP (72% for Hungary and 110-240 % for EU countries). The total assets in the Hungarian banking system is still only a fraction of a big European banks, and the largest Hungarian bank (OTP Bank) is only the sixth among Central Europe's largest banks ranked by assets. Concerning the number of employees in banking reached 45 000 in 1990, but after that is started to diminish and by 1998 fell back to 38 260 employees. However, the ratio of employment in banking expanded within the share of employees from 1% in 1990 to 2.5% in 1997. (This ratio in EU countries ranges from 2–4%.) In the banking and insurance sector of Budapest accounted for 47% employees worked in 1996 that was 3.65% of the total employment in Budapest. (In contrast, Vienna had 42,000 (5.6% of total employment), and in Munich 59,000 (9.8%) worked in banking and insurance.) (Figure 1).

Figure 1

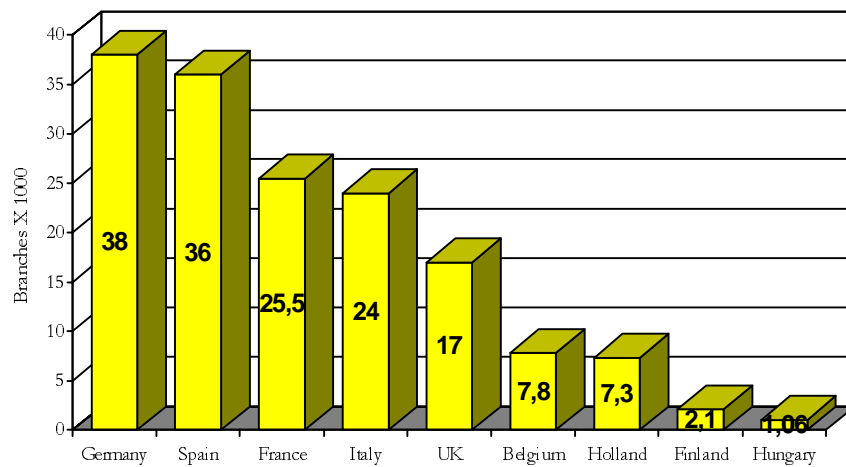
*Employment in banking in some European countries (1994)*



The smaller size and extension of the banking network is highlighted by European comparisons. Countries with smaller territories, such as Belgium and Holland there are seven times more branch offices and in the less densely populated Finland has twice as much offices than in Hungary. The number of branches in 1995 accounted for 1000, but the consequences of rapid expansion in the last few years it grew up to 1400. (Gál 1998).(Figure 2)

Figure 2

*Number of branches of banking in some European countries (1995)*



## STRUCTURAL AND SPATIAL POLARITY OF THE BANKING SYSTEM IN THE 1990S

Concerning the merger and acquisition activity in the different European national banking systems, there is a recognition among member states of the possibility of increasing concentration in banking in Europe, leading to domination by large banks situated in few financial centres of the single market. Recent global financial crises highlighted the vulnerability and constrain of the state supervision of the international financial markets, questioning for the traditional control functions of the nation-state. In the consequence of the

diminishing financial role of the state the growing importance of the *EMU at supranational level* goes parallel with the strenuous effort being made to build up strong *regional financial markets* that will be able to serve the interests of the regional economy better and represent a link between local economies and financial centres. The Hungarian banking system is characterised by the lack of strong local and regional banks that one can argue, explainable partly with the adjustment to the more concentrated international banking structures, but on the other hand it is the result of structural polarisation.

The spatial structure of banking system is polarised compared to the network which existed at the turn of the century (when the number of independent banks scattered throughout the countryside were overshadowed within the banking network, and there were proportionally few branches in banking before World War I, consequently only 5.7% of the network was concentrated in Budapest), the recent banking system is characterised by strong spatial concentration (Gál 1999/a).

The fact that all the 41 banks except one are based and headquartered in Budapest results in a deformed structure in the banking system. Banking in Hungary is still the most centralised branch of the 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. Consequently local and regional banks are missing from the Hungarian banking system. (However, this strongly monopolistic structure is more in line with international tendencies, which are characterised by overconcentration at the global level; in contrast to other transitional economies, such as Poland, where the role of regional banking is significant.).

From the deformed spatial structure of the banking network of the early 1990s arose more difficulties:

- Lower density of the network meant both the low level of availability of branch offices and the higher structural polarisation of the branch network. On the one hand this meant that the rapid expansion of banking, initially concentrated almost exclusively in Budapest, was not followed by the extension of the branch network at a rapid pace in the countryside. On the other hand the new banks established in 1987 inherited a particular branch network from the National Bank of Hungary, since branches were missing from certain county seats, accompanied with a spatial-regional asymmetry. The structure was even more distorted by the fact that the traditional retail bank (OTP-National Savings Bank) had had offices usually in all settlements where population exceeded 5000, but the dynamically developing foreign banks just started to expand their branch network in the last few years (Gál 1998/b).

- The other marginal pole of the national banking system is the dense network of the co-operative savings banks scattered throughout the countryside. The most important disadvantages of these are their weak financial standing (accounting for only 5% of the total balance sheet of banking) and lack of strong centres or headquarters. Despite the number of co-operative savings



banks being 1,700, thereby accounting for 62% of the total national network, most of these small savings banks situated in the smaller towns and villages have a very low capital circulation and can supply only a narrow range of services.

– The third reason of the polarity is, that branches of banks based in Budapest have much less room for making independent decisions than the branches of county seats during the communist period. Since the Hungarian banking system is characterised by overcentralised management, controlling and structural system, branches are not in a real decision-making position, partly because they have got only limited information. Most of the banks offer the same services all over the country and do not have local advertising strategy. Banks usually do not lay stress on the uniform appearance of their branch offices; therefore appearances very much depend only on the hierarchical position of a certain bank.

The start of the 1980s and 1990s was the first period of boom in the establishment of banks: 17 commercial banks founded about 350 branches, concentrating 85% of the new offices into the provincial cities. During the next period of the two-tier banking system between 1992-1996 the network was considerably restructured. Expansion of the banking system was restricted very much by the huge inherited debt imposed a large burden on the institutions. The smaller banks went bankrupt (Ybl Bank), others were liquidated (Dunabank, Iparbankház) or some of them were merged. The big banks rescheduled their policy of network building and a few closed some of their branch offices, but the other banks such as Budapest Bank and Postabank started a spectacular growth in network expansion. Accordingly, between 1992-1996 the number of banking institutions decreased due to the bankruptcies, mergers and the purchasing processes of privatisation. In only two years (1995-1996), six banks were liquidated or merged into other commercial banks.

The foreign-owned banks started to expand their branch network (by purchase through privatisation and opening new branches) later and more cautiously than only after 1995. There are different reasons for this more cautious policy. There are different reasons for this policy. On the one hand, these banks were strong enough in terms of capital intensiveness, therefore they could adjust the pace of network building to their own pace of development. On the other hand, foreign-owned banks were first of all interested in corporate banking supplying services for the joint-stock companies. The boom period of the establishment of joint-stock companies was in 1990–1991 and afterwards the corporate market started to become saturated. However, the foreign owned banks switched to rapid expansion through building their extensive branch network, gaining both larger market shares and leading positions in terms of profitability, and grew more rapidly than the bigger banks<sup>1</sup>.

Recently, the tendency of concentration has decreased due to the successful expansion of the foreign-owned and medium-sized banks<sup>1</sup>. The balance of power in the banking system which held sway at the end of the first decade of two-tier banking will be expected to readjust

according to growing competition for larger market shares. According to surveys, a shift from the moderate deconcentration will emerge and the few large banks (from the group of the medium-sized and the foreign-owned ones) with considerable financial standing will dominate in the retail market. Besides these, 10-15 banks will play an important role in the banking system.

#### SPATIAL DEVELOPMENT OF THE HUNGARIAN BANKING NETWORK

Regarding to the diffusion of the banking network, it is very important to survey the geographical location and the different hierarchical types of settlement where banks are located.

At the birth of the two-tier banking system the network was characterised by a certain spatial balance due to the evenly allocated branches of the OTP Bank (National Savings Bank), located in more than 270 settlements. After the foundation of the new commercial banks significant spatial asymmetry occurred within the country since certain banks were missing from particular regions and county seats: KHB (Commercial Credit Bank) dominates in the Great Plain region, MHB (National Credit Bank) in Northern Transdanubia and BB (Budapest Bank) around Budapest.

The spatial appearance and the regional diffusion of the new branches of banks reflected the Hungarian economic processes in the 1990s:

- The prevailing majority of economic associations, within it the joint-venture companies and the accumulated capital outside Budapest flowed into the Transdanubian region, firstly into the north-western part. All these are underpinned by indices of corporations, associations, household savings and figures of indebtedness for the population.

- The structure of diffusion of the banking network had followed this spatial pattern for the first time by the beginning of the 1990s. At that time banks were interested mainly in building up branches in the Transdanubian region. This was evident because the largest unexploited territories of financial services were situated in Western Hungary.

- 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 the 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 1998).

There were significant differences behind the well-balanced greater regions concerning network density within the regions and counties. In some counties the number of new branches exceeded ten between 1978-1990 (Győr-Moson-Sopron, Baranya, Hajdú-Bihar), while in other places only a few branches were opened (Fejér, Komárom-Esztergom, Tolna) and in some counties exclusively planted only in the county seats (Borsod, Fejér, Szabolcs-Szatmár-Bereg). An extreme exception was Esztergom-Komárom County where no branch was opened between 1987-

1990 in Tatabánya, the county seat, where economic depression affected its heavy industrial background. For instance, during the short period between 1995-1997 there was no increase of the branches in North-Western Transdanubia, as it was viewed as a saturated region.

A general characteristic of the period between 1992-1996 was the growing importance of Budapest in the expansion of the branch network (319 bank offices made up 26% of the national network in 1997). All banks starting to open new branches have opened 2-3 new offices in the capital city in the past five years, and last year 20 banks had branches there.

Within Budapest most of the principal 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 townscape. In 1990 about two thirds of the financial organisations were based in the 5th District, namely in the core area of the city centre itself which is still the most popular domicile for new banks. By the end of the 1990s business (financial) functions of the 5th District had become saturated and a few years ago the financial organisations started to diffuse towards the surrounding inner city districts. Despite the expansion of banks the low density of network in Budapest is surprising, namely one office per 7,758 inhabitants (15,000 without the OTP). This fact unambiguously demonstrates the low level of the extension of the banking network in the capital city. The lack of banking services is more striking in the outer area of Budapest, resulting in overcrowded city centre branches.

In Hungary the number of banking institutions is 1,319, together with 1,700 co-operative savings banks, stands at about 3,100. Taking the figures of the network density into account, there is one office per 3,200 inhabitants, which is still a much lower density than in the Western European counterparts, where there is one bank per 1,400-1,500 inhabitants. In spite of the boom in the foundation of new branches (last year a branch office opening ceremony took place every week on average) mainly by the foreign and joint ventures banks. These banks still do not have enough branches in Hungary, although spectacular progress has been made, especially since 1996.

Surveying the banking network according to the network density figures we can find a few counties with lower density of banks. Szabolcs-Szatmár-Bereg and Pest counties are the most unsupplied areas, accounting for half of the national average in 1995. In the case of the former, its economic and geographical situation, the activity of entrepreneurs, the low level of foreign capital inflow etc. would be the explanation for the smaller interest of the banks. In the case of Pest County, the capital city causes backwash effects, which influence the development of the banking network. Relative to population, Hajdú-Bihar, Borsod-Abaúj-Zemplén, Komárom-

Esztergom, Nógrád and Fejér counties were also badly supplied by banking services. These counties could be the main target areas of expansion in the near future (Figure 8).

Surveying the distribution of the banking network according to the settlement types is more expedient than investigating at county 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. Since by the beginning of the 1990s the number of branches had exceeded the number of larger cities, which had been the main targets of the earlier expanding banks, consequently these banks turned their interest towards the smaller settlements. The first branches in villages were also opened .

Those banks just recently started to develop their network - most of them are foreign owned - situating themselves solely in regional centres. As a consequence of this, certain larger cities (Pécs, Győr, Szeged, Székesfehérvár), despite not being seats of a regional bank, have been started to play significant roles in the operation of financial services in which different organisations of the financial sector (banks, insurance companies, consulting) attract each other mutually. This also induces increased competition in the local-regional market.

At the beginning of the 1990s the banking network was rather more polarised, both hierarchically and regionally, than nowadays. A more developed network existed in the county seats and in the cities of Western Hungary (which were targets of foreign companies and banks); while in Northern Hungary and in the northern part of the Great Plain the banking network is less developed than in Pest county, where the central role of Budapest counterbalances its disadvantage. In recent years a shift has taken place, levelling out the expansion of the banking network in favour of the eastern parts of the country. During these years the number of branches in the cities of Eastern and Southern Hungary increased more rapidly than in the western counterparts which were previously the most saturated parts of the country, considering the number of branches. It can be said that the network building expansion of branches initially followed the pattern of the spatial-economic division of the country, as banks mainly were opening branches in Western Hungary. Since the mid-1990s, after the relative saturation of West-Hungary and owing to the process of nivellation, banks have started their expansion towards the eastern and southern parts of the country along the urban hierarchy. Two years ago, Győr, Pécs, and Székesfehérvár were considered the largest financial centres outside Budapest, while recently Miskolc gained the leading position in the number of branches (37), followed by Győr and Kecskemét (each with 32 branch offices), then Pécs and Szeged (31-31), and

**finally by Debrecen (28)<sup>2</sup>.** The main targets are the large cities in East and South Hungary, such as Miskolc, Szeged, Debrecen, Nyíregyháza gained a temporary leading position in size of the local network (Figure 9).

The Hungarian banks, because of the centralised structure of banking, aim at completely covering the relatively small banking market. This tendency promotes equalisation among the different parts of Hungary. 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 embeddedness, which can induce mutual attractiveness toward the other types of financial, and business services. The agglomeration of financial services not only generates the competition in the local market but might result in the performance of certain regional financial centre functions in larger cities despite the lack of locally based institutions.

In conclusion it can be seen that different banks are situated on different levels of network construction in the recent period of development. The share of the larger cities from the banking network intensively increased from 35-40% to about 50% (with Budapest 66%) between 1987 and the early 1990s owing to the fact that at least a dozen new banks entered the market and started their network development. Bankruptcies and the rationalisation policy of network development in the following period mainly affected these larger cities as the major beneficiaries of the boom in banking expansion. Despite several new branches opening, the proportion of larger cities within the banking network fell to 43% (or 63% including Budapest), parallel with the network diffusion towards the smaller settlements.

Taking the expansion of the banking network into account, some experts believe that the spread of electronic home banking will counterbalance the traditional way of branch office building. According to others, whose opinion I share, there is a brighter future for the traditional expansion of the branch network since customers are much more devoted to a personal style of administration and rely more on branch offices. Despite the probability that virtual banking will be widespread in the future, building a more cost-intensive branch network is still very important. In addition, about 40% of the population has as yet no contact with banking. The figures for the year 1998 justify both these theories of the future prospects of banking (Bonin et al. 1998).

## THE CHALLENGES OF REGIONAL BANKING

Study of banking history reveals a wide variety of the development of different national banking systems. These systems currently experience 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. The Hungarian banking system is characterised by the lack of regional banks and by the strong agglomeration of the services in the financial centre of Budapest, that can be partly explained by the accommodation to the

conditions of the more concentrated international financial markets, which currently undermining and diminishing the role of the local markets. However, recent moves, both toward 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 establishment 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):

1. Money is sensitive to local differences in economic return (crises still have a distinctly local origin) and local, regional banking systems tend to be more rooted in and committed to the local economy and community than local branches of centralised national or international banks.

2. The effects of the financial crises increase the instability of global markets and seriously questioning the regulative and controlling role of the nation-state over capital flows.

3. Decentralised banking systems have been important in certain European countries, such as Germany, Italy, France, and Poland.

4. The boom of private enterprise, privatisation, the necessity of their presence in the local markets and competition for the retail markets also requires the expansion of the banking network in the regions. Regional banks may well be serving the interests of local economies and SMEs better than financial-centre banks whose priorities relate more to national and international markets.

5. Besides the corporate and the retail market project financing will be one of the another businesses for banks which have to support the regional development programmes through financing infrastructural, power and telecommunicational investment and co-operating with regional and local administrations.

To survey how the money moves between locations and regions raising the problems of integration between the global and local level, or between centre and periphery that concerns an irregular financial division of labour between central and peripheral areas. Emergence of uneven economic development among regions large extent is caused by the uneven interregional capital flows. Capital is mobile across regional boundaries and usually flows from the regions with lower profitability into the regions offering higher rate of return. 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).

The extremely concentrated national and international financial markets and the lack of strong regional markets might slow down regional economic development in the long run because of different factors stated below:

– Certain national and international banking centres discriminate against particular regions. This refers to usually credit discrimination which means that nationwide banks are less prepared to make credit available to agents in the periphery because they allocate loanable funds based on an implicit regional reserve ratio. Core regions and financial centres through the centralised branch banks may invest the savings drained out of the peripheral regions in favour of lending in core regions, slowing down the development in the peripheries and resulting in spatial polarisation of the regions (Chick & Dow 1988).

– National banks can only slowly acquire local embeddedness. The distance between decisional and operative centres within a national branch bank structure reduces the availability of information about local firms and local growth prospects. The uniform lending standards by nationwide banks disproportionately affect certain regions. Credit is made available on the same terms in different locations through the branch system regardless the specific regional requirements and conditions.

– In a national branching system, local branches may adopt more cautious and restrictive lending policy as they are likely to be constrained by head office in the degree of freedom as most of the strategic decisions are made at headquarters of banks. Because of the centralised structure the decision-making autonomy is limited therefore large loans require head office approval. Local branch management of national banks is often in the hands of directors only temporarily committed to that branch who tend to be very risk averse, opting for safe large investment, rather than riskier smaller investment, even to the detriment of important innovative projects for the growth of the local economy. On the other hand, if a national bank is seeking to rationalise its operation, it is likely that the branches in peripheral and economically declining areas are the first to be closed down (Porteous 1996).

– Within the centralised banking network information asymmetries are often occurred: the headquarters very often assess higher risk due to poor information on small borrowers in remote or peripheral regions, and because of market segmentation. Larger distance between peripheral regions and the core centres cause larger cost of transactions and monitoring and may result in a more expensive credit. (McKillop & Hutchinson 1990). Information and transaction costs of the supply side are higher in relatively isolated regions for lenders based in the core. Although the cost of credit may be equalised across regions in an integrated banking system, the availability of credit may differ, which continues to limit the access to the credit supply.

The solutions in a longer term should be *the reorganisation of the institutional and managerial structure of the banks* and to find what kind of banks (local, regional or national) are the best suited to foster development of peripheral regions. On the other hand there is a

strong need to create decentralised financial sources and establish regional financial centres in order to serve interests of local economies better. The regional banking systems represent a link between local economies and national, international financial centres. This highlights the problems of *integration between the global, national and regional level*. The integration model is a kind of reaction on theories exclusively focusing on “*localism*” and “*globalisation*”. In the first, it is considered to be detrimental to set up of banks from outside of the region, through opening of branches, mergers, or the purchase of local banks. The localism theory based both on the notion of local segmentation of financial markets and on the idea of keeping the savings of a region within the boundaries of the region. This latter can be counterproductive as savings must be free to move in search of the best investment opportunities and returns in a wider unified monetary system. Local banks have smaller ability to invest savings in the same area where they were collected, as local banks very often tend to have grater willingness to export and invest capital – under better conditions of returns – out of the region than do local branches of external banks. Therefore, the main challenge for a region is to offer the best opportunities for investment, attracting capital. On the other hand, the theory on *globalisation*, leads to the argument that global integration of the financial markets removes regional disparities in financial structures and capital availability. In fact, advantages of globalisation are not distributed evenly among regions, as they tend to be located in the stronger and better organised ones. So, in the absence of corrective policies, regional disparities could become wider rather than narrower (Alessandrini-Zazzaro 1999).

The best way to solve the integration problems is the co-existence, complementarity and interaction between different regions and between the centre and the periphery. This reorganisation can be take place through passive integration that arises from outside of the region and means not only capital inflow, but also the entry of non-resident banks opening new branches or incorporating local banks. On the other hand, regional, local banks, in an active way, can participate in inter-regional expansion, which allows local banks to open up to the outside without abandoning their own regional hinterlands. It is important for regional banking system to compete with other areas in order to gain benefit of both regional and sectoral diversification. The inter-regional integration of banking system is the most suitable model for the future development in Europe and this model can be partly adopted by the Hungarian banking. It offers perspective of the development of regional finance partly through branches of national banks channelling the innovation and providing wider range of services and strong equity background in order to protect less prosperous local branches. On the other hand, the modernisation of the existing local banks and the creation of new institutions in the regions meet the challenges posed by technological, institutional and regulatory changes that transform the world of finance serving the needs of local economy and communities. The most important



step towards this system is the establishment of a strong regional financial centre that can serve the interests of a particular region:

- Regional centres have an ability to capitalise on localised information spillovers which reduce the costs of local lending, and are closer to the actors of the local economy. The more centralised firms loose their competitive edge if their headquarters are located far from the region where they intend to operate.

- Prosperous regional centre can prevent capital drainage from the region by the national financial centre.

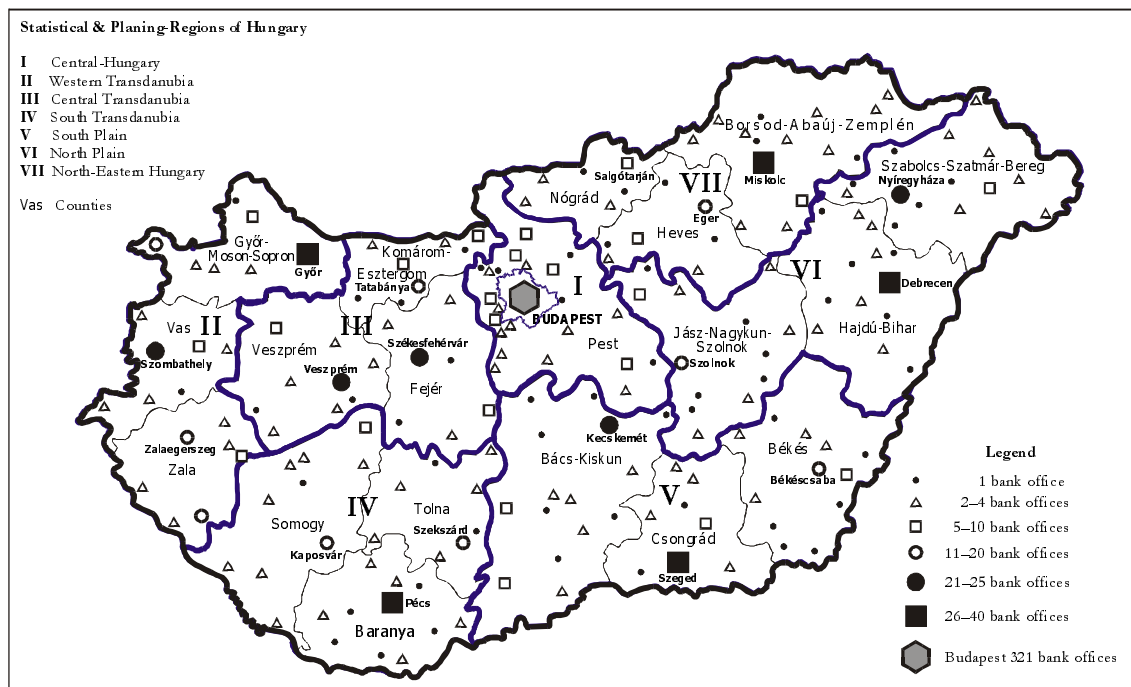
- Regional financial centre, which is closer to its hinterland, may have lower fixed costs and therefore it is able to serve better SMEs.

- The traditional national financial centres face to decentralisation forces as their costs of operation are increasing (expensive labour cost, high real estate and renting prices), and the rapid development of communication technology appears to strengthen the forces favouring decentralisation since large volumes of information may increasingly be accessed from remote locations at low cost.

The Hungarian banking system is characterised by a strong spatial concentration. The leading role of Budapest is unique even in European context. The fact *that every bank is headquartered in Budapest* results in a deformed structure in the banking system. Banking in Hungary is still the most centralised branch of economy. The conditions of capital concentration are unfavourable outside Budapest and the most developed regions of the country. There is a threat of new kind of dependence between the capital city and the regions: filtering-down persists, the central region, making use of advantages of its location, filters the most profitable lines of banking (corporate, portfolio management, risk management, private banking) and diverts to the peripheries the traditional, uniformed and less profitable services. Taking into account capital transfers (regarding to banking capital and the central budget flows) among Budapest and the regions it can be said that capital transfers at the expense of the regions is negative (Figure 9).

Figure 9

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



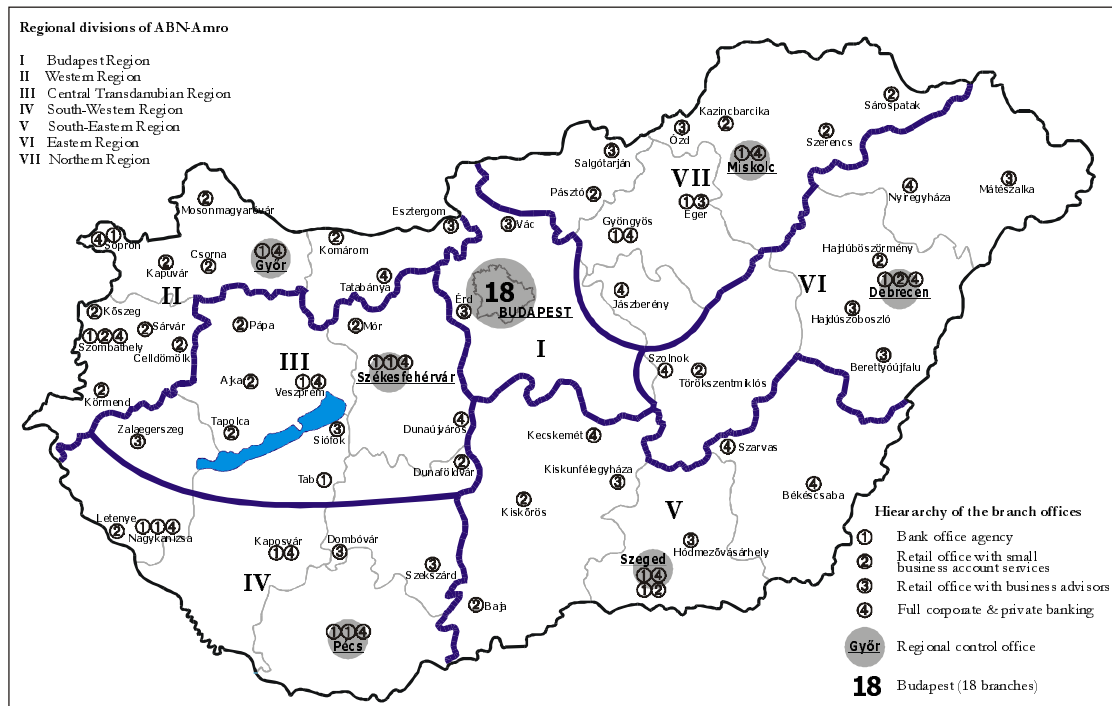
There are four principal tasks on the agenda of the development of a more decentralised banking network in Hungary. First, it is necessary to *expand further the density of the branch network and to extend the range of branch services of the commercial banks in the regions. Second, the formation of regional and municipal banks. The third one is the establishment of regional branches of the Hungarian Regional Development Bank. Fourthly, one must ensure the institutional connection of Budapest to international money markets (Gál 1999/a).*

1. In Hungary the local-regional credit supply operate through the centralised national branch-banking system, and local savings banks operate in restricted rural and urban areas. National banks with branches usually do not provide adequate credit supply for the local SMEs and do not finance municipal projects and infrastructural investments in the regions. National banks are not interested in these less profitable and prudent businesses as they have different orientation of profile and tasks. Therefore they often seem to discriminate against particular regions. Recently, commercial banks with larger network reorganise their institutional and managerial structure forming a hierarchically-built domestic network of branch offices, decentralising certain control functions (Figure 10). Banks are starting to pay much closer attention to the geography of their distribution networks. Besides national head office they form regional control offices and local branch offices with various functions in order to rationalise their dispersed structures and to take the first steps towards decentralisation and inter-regional integration of banking, in order to use their resources in a more productive way. Regional control offices play the role of intermediate tiers between head office and local branches, having 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 been overlapped the territories of the statistical regions, but their regional headquarters, in the most cases, have been concentrated in regional centres. Recently banks are in the expansion phase of their branch building process. In a few years time they have to concern about network restructuring which is sensitive to geographical variation in profitability, risk, debt and social conditions in a particular area (Geenhuizen 1999).

Figure 10

*ABN-Amro Bank The Hungarian branch network and its regional divisions*



2. Within the banking system the formation of locally based regional and municipal banks independent from the national branch network would be very important in order to serve regional interests of that region where they operate and assisting in the regional economic development. This requires the amendment of the Banking Act, which would allow municipalities, chambers of commerce, economic organisations and private enterprises to establish banks with a strong state support in order to make provision of public duties derives from the state commission. This can be financing public investment, credit supply for local governments, and the intermediation of EU structural funds. These banks can be followed the pattern of the German *volksbanke or sparkasse* and might be based on the stronger Hungarian co-operative savings banks. These institutions will be the major financial agents of municipalities, and will be able to serve smaller businesses better and to promote the direct integration of regions, located in longer distance from the cores, into the global economy. Only a strong regional bank can ensure an adequate credit circulation and can prevent mass capital outflow from a particular region (Illés 1993).

3. Because of the different interests of commercial banks were stated above, only a decentralised regional developing bank network can promote effectively regional development. Therefore, the establishment of regional branches of the Hungarian Development Bank Ltd ("MFB") is necessary. MFB, formed on 1 January 1997, has been the leading institution as the legal predecessor of the wholly state-owned credit institution formed in 1991. MFB's original task is to facilitate the modernisation and invigoration of the Hungarian economy, to participate in regional development, to manage and mediate state funds and allocated for development purposes, and to raise funds in international markets and financing of regional development programmes of municipalities. Furthermore, MFB pays special attention in supporting small and medium-sized enterprises, a sector that plays an important role in the development of the Hungarian economy carrying out large-scale capital expenditure projects in the fields of infrastructure, telecommunication, and the energy sector.

The banks, operating and mediating regional development funds (PHARE, ISPA, SAPARD etc), have to form a network of the regional development banks on regional level in order to mediate European development funds into the level of use. Here it is not enough to create different frameworks of support; there is a strong need to establish institutions mediating funds between the EU/ state level as the provider and the regional levels as the destination. In addition, one of the main tasks of the regional development banks is the promotion of the regional projects and investments from the financial side. This includes the provisions of medium and long-term loans for SMEs, portfolio management and investment advisory services, promotion of the creation of technology centres, incubators and innovation oriented enterprises.

4. Concerning the question whether Budapest will become a real financial centre by international standard. 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. As a consequence of rapid restructuring and modernisation of Budapest's economy, the capital city has become one of the most important innovation-centres of the region, which might play an important bridge-head in foreign capital inflow and investment within Central and East European countries. Budapest has a traditional metropolitan townscape, adequate infrastructural background and stable economic environment, which are quite important attractive forces for the investment of multinational companies. Lots of multinational companies (Pepsi Co., Kodak, Nestle, Xerox, Shell) built regional bridgeheads facing Eastern Europe from Budapest. On the other hand, there are certain 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 most likely to utilise only the simpler financial services in the Central European region, and the

services requiring more resources, will utilise in traditional Western European and overseas financial centres in the future, too. In addition, the smaller size of the national financial market, the weakness of domestic capital (the activity of the black economy), the low level of economic interactions within the regions, the small activity of banking system abroad and the consequently smaller size of banks (smaller provisions for expected liabilities), Budapest is not suitable for the role of regional financial centre. Foreign banks that opened their subsidiary banks in Hungary established branches and subsidiaries in other Central European countries, too. Consequently, foreign banks concentrate more on covering each national market rather than on establishing a single regional banking centre, for instance, in Budapest.<sup>28</sup>

According to some banking experts, Budapest could successfully apply only for the position of a subordinate *offshore like regional financial centre* specialised in certain services. Subject to these conditions, services which 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, but the exact date of integration into the EU and EMU may influence the development of the Hungarian banking system and the international role of Budapest (Bellon 1998).

## CONCLUSION

In evaluating the competitiveness of the Hungarian banking system, it can be said that the banking sector has been strengthened since 1994 and it has become a more profitable sector. However, progress in banking is significant only comparing to the previous state of the banking system: by international standards the quality of the sector is still very low. The proportion of outstanding claims, despite the significant decrease, is still higher than in any country of the European Union. The role of the Hungarian banking system in the economy lags far behind more developed countries. The ratio of balanced-sheet footings to GDP is 72%, which is a very low percentage, but it indicates an enormous opportunity for progress in the banking market. Despite the general recovery of banking, the sector has remained polarised. In 1995, banks with foreign ownership that accounted for one quarter of the market produced 70% of profit after taxes. Their profitability and efficiency was twice higher than at banks of Hungarian ownership (Várhegyi-Gáspár 1997).

Surveying the spatial characteristics of the Hungarian banking system, it can be stated that economic changes are very much dependent on financial services, which reflect the processes of economic transformation. Financial services became the key sector of business services differentiated by spatial and regional development characteristics as well. The spatial structure of the banking sector in Hungary is characterised by a large-scale concentration in Budapest, but the foundation boom of branch offices is also typical in the countryside, as the necessity of

presence on the local markets (collections of resources and credit allocation etc.), as well as the competition for the retail market stimulate banks to build out their national networks.

At the same time, the commercial banks, which have their headquarters in Budapest, largely concentrate only on the collections of deposits in their national network, resulting in capital drainage and net capital loss in most of the regions. The presence of the centralised capital market and the lack of decentralised regional financial (banking) system can restrain and slow down regional development in the long run. Local and regional credits can only be received in Hungary through the centralised network of bank offices and through, in limited extent, the weak local co-operative saving banks. Within the centralised banking structure, the regional decentralisation of certain commercial banking services is possible, without questioning the pre-eminent role of the national banking centre, but contributing to a more efficient operation of the network. The example of the British banking system demonstrates the development of a series of provincial financial centres, through the decentralisation of certain back-office functions into particular cities serving operation of a more efficient and more autonomous banking network which contributes to the success of regional economies (Tickell 1996).

The Hungarian banking exemplifies a pre-eminent position of the national financial centre partly due to Hungary's much smaller market size 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, but to find the right way of certain decentralisation in the banking sector is inevitable.

Summarising the experiences of Hungarian banking, it can be said that the openness of this sector compared to others contributed more to the modernisation and competitiveness of the overall banking system. Until now, the activity of foreign banks depends on their subsidiary companies, which have to be established before starting their operation. In the last instance, the question becomes whether the national banking system is ready to be fully liberalised and able to withstand increasing competition within the European Union.

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1 While the share of the five largest banks in 1990 was 83% of the total banking sector assets, by 1997 the five largest and oldest banks' share had decreased to 54%, and the ten largest banks, including newly established and more dynamic institutions, accounted for 72% of banking assets.

2 In other banking institutions such as the State Treasury, representative branches of NBH, regional headquarters, single branches, representative or cash office, correct spatial differences derive from the number of banks or branches. Regional centres (Győr, Pécs) and greater county seats (Kecskemét, Székesfehérvár) usually have the complete range of these institutions.