

Economics Department

NBH WORKING PAPER

2001/5

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**BANKING SECTOR REFORM IN HUNGARY:
LESSONS LEARNED, CURRENT TRENDS AND PROSPECTS**

December, 2001.

Online ISSN: 1585 5600

ISSN 1419 5178

ISBN 963 9057 98 3

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This paper reviews the reform of and current trends in the Hungarian banking system and draws some lessons that can be useful for countries where the reforms are less advanced. The point is made in the paper that since the weak financial position of state enterprises has been one of the major sources of difficulties encountered by the banks in transition economies, it is crucial that the restructuring of the banks and enterprises go hand in hand. One lesson learned is that consolidation should be based on an accurate assessment of the difficulties of the banks to reduce the cost of consolidation and should be accompanied by a strengthening of regulation and supervision to prevent the reproduction of losses. The paper also discusses the reasons for the low depth of financial intermediation in Hungary and concludes that this situation will change only slowly.

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I. Introduction^{*}

Restructuring the banking systems in Central and Eastern European countries of transition (CEECs) to meet the requirements of a market economy has been a unique challenge of the past ten years. Market oriented reforms and bank restructuring are closely linked, since the success of transition from a centrally managed economy dominated by state ownership to a market economy based on private ownership greatly depends on the stability of the financial system. At the same time, reform of the banking system can not be implemented without: (1) macroeconomic stability; (2) a restructuring of the corporate sector; and (3) a reform of the regulatory framework. Market reforms are thus intertwined. Although the consolidations of the banking sectors have placed heavy burdens on the government budgets in the CEECs, the need for a comprehensive bank consolidation and restructuring can no longer be questioned in the light of experiences of the most advanced transition economies. There is general agreement among observers that Hungary has one of the strongest and most stable banking systems in the CEECs today. Hence, an examination of the Hungarian banking reform might provide some useful lessons for the countries less advanced on the road towards the market-orientated transformation of their banking sector.

Hungary was the first CEEC to embark upon a reform of its banking system. As was typically the case in the CEECs, Hungary had a monobank system prior to the reform, with the National Bank of Hungary (NBH) performing both central banking and commercial banking functions. As a first step, these two functions were separated and a two-tier banking system was created with the establishment of three state-owned banks which took over most of the commercial banking functions of the NBH in 1987. The latter became a central bank in the classical sense, although it retained for a while some para-fiscal functions, such as managing the government debt, and a limited range of commercial banking activity, such as channeling funds from official external sources to the domestic banking sector. Furthermore, the NBH retained initially the ownership of three commercial banks operating abroad and kept a minority ownership in two foreign invested private commercial banks operating in Hungary. The NBH divested itself of these activities over the years so that by now it performs only central banking functions.

As in most CEECs, there existed in Hungary, in addition to the monobank, two specialized state-owned banks prior to the establishment of the two-tier banking system. These were the National Savings Bank (NSB) set up to provide banking services for households and the Hungarian Foreign Trade Bank (HFTB) specialized in the financing of foreign trade. Foreign ownership was present with three joint venture commercial banks, one set up with off-shore status in 1979 and two set up with

^{*} This paper was presented at the Seventh Dubrovnik Economic Conference, Dubrovnik, Croatia, June 28-30, 2001. An earlier version of this paper was presented at a seminar on "Reforming and Opening Up China's Banking Sector" in Beijing on March 26-27, 2001. A shortened version of this paper, together with the other Seventh Dubrovnik Economic Conference Papers will be published at a later date. I am grateful for comments by Álmós Kovács and László Náray and for assistance by Csaba Mór . The views expressed are those of the author and do not necessarily reflect the official view of the National Bank of Hungary.

domestic status in 1985-86. However, the market share of these foreign banks was small, about 5 percent in 1990.

II. Causes of the Crisis in the Banking Sector

Banking crises can have many causes, but since the transition from a centrally managed to a market economy has some special aspects, the banking crises in the CEECs have had a number of common characteristics which have set them somewhat apart from the other banking crises in the world. The main causes of the banking crises in the transition countries can be traced back to the combination of the following factors: (1) the sharp drop in aggregate demand and output in the initial years of the reform; (2) the inheritance of bad loan portfolios from earlier times when credit was centrally directed; (3) segmentation of the credit market and lack of competition; (4) shortcomings in the regulatory and supervisory frameworks; and (5) weak management, inadequate internal control and large administrative costs of banks.

As known, the political and economic reforms led to the collapse of the markets in the countries of the former Council for Mutual Economic Assistance (CMEA), previously the principal export markets of the CEECs. The collapse of the CMEA trade triggered sharp falls in aggregate demand and output in all the CEECs. The liberalization of trade and the consequent increase in competition also contributed to the drop in output. In Hungary, GDP fell by about 20 percent in real terms during 1990-93 and similar or higher drops in GDP were registered in the other CEECs. Many corporate clients of the banks went bankrupt and were closed down, the ones that survived had difficulties to service their debt. The firms' ability to service their debt was also affected by the upsurge in real interest rates following the deregulation of interest rates and a rise in inflation that typically accompanied the liberalization of prices. During this period, inter enterprise credit rose substantially, which prolonged the survival of firms and delayed the surfacing of the true extent of the bad loan portfolio problem which later confronted the banks.

The creation of the two-tier banking system in Hungary left the ownership structure untouched, with the state retaining ownership over the banks which were greatly undercapitalized. The three newly established banks inherited a large amount of non-performing loan portfolio¹, since under the monobank system the extension of credit followed government directives and was not governed by profit considerations. The banking sector was characterized by strong sectoral segmentation because the portfolios taken over from the NBH by the three newly established commercial banks were distributed along sectoral lines: one received the heavy industry, manufacturing and part of the energy portfolio; another most of the agricultural portfolio; and the third the mining and services portfolio. This sectoral segmentation aggravated the banks' situation in Hungary, since it reduced the effectiveness of resource allocation and hindered the diversification of risks. The sectoral segmentation has proved to be difficult to do away with because of the natural inertia in bank-client relationships.

¹ Loans are generally classified as: "problem free", "to be watched", "sub-standard", "doubtful" and "bad". When we talk about bad or non-performing loans in this paper, we refer to the last three categories as a group.

One early lesson of the bank reform in Hungary is that the distribution of the corporate portfolios among the newly established commercial banks along sectoral lines was a mistake. Some sectoral specialization of banks exists in many well functioning banking systems, but a too heavy concentration exposes the banks to unduly high risks by tying them to the performance of one or two particular sectors. Moreover, it weakened competition, which was also hampered by the restrictions initially imposed on the free choice of banking. In addition, the inherited dominance of the household market by the NSB has hindered the other banks' ability to expand their deposit base.

Shortcomings in the regulatory framework also contributed importantly to the banking sector's problems. Prior to 1992, the existing rules for loan classification and provisions did not force the banks to practice prudent lending and to make adequate loan loss provisions. The rules for classifying problem loans did not correspond to international standards and were much less strict. It was left to the banks' own discretion how much they wished to provision. The provisioning for bad loans could be set aside only from after-tax profits, which provided little incentives for the banks to provision. The result was that the true problems of the banks were masked from the eye of the public and the government, and often even from the eye of the bank's management itself.

A dramatic change had occurred in this situation with the enactment of a number of new laws at the end of 1991, which has since been characterized as a "legislative shock therapy". The Financial Institutions Act imposed stricter rules for loan classification based on, although not yet fully conform to, international standards. It made loan-loss provisioning compulsory and the tax law was amended to allow the provisions to be made from pre-tax profits. The new Accounting Act did no longer permit unrealized interest rate receipts to be entered as income in the books of the banks, a measure aimed at encouraging debt collection. The Bankruptcy Law required the firms to initiate self-bankruptcy procedures when they defaulted on their debt for more than 90 days. This rule, which was more stringent than the prevailing regulations in many developed countries and was strictly enforced, deflated the inter enterprise credit balloon and triggered a wave of bankruptcies across the economy. Painful as it was, this process helped to weed out the unviable companies in the early stages of the reform, bringing to the surface the banks' already realized losses and narrowing at the same time the opportunity to accumulate further losses, which in the end reduced the cost of bank consolidation. In contrast, the lack of stringent bankruptcy rules in the Czech Republic, for instance, prolonged the market cleaning process and the time for the losses of the banking system to surface, adding to the eventual cost of restructuring (see below).

The banks also suffered from weak management practices. The newly established commercial banks had not enough experienced staff well versed in commercial banking and the modern methods of risk assessment. Although the banks gradually improved the competence of their staff, bad and irresponsible lending decisions were abundant in the early years of the reform. For instance "evergreening", whereby loans overdue are continuously renewed, was widely practiced. The decision-making mechanism often lacked a proper definition of responsibilities and the banks were slow in adopting adequate internal regulations. Decisions breaching the banks'

own internal regulations were frequent because of the lack of adequate internal controls. The inadequacy of the intra- and interbank information systems also weakened the quality of decisions. For instance, a client could borrow from different branches of the same bank, without the center knowing about it. Obviously such practice prevented the bank from making a proper assessment of risks. Similarly, taking advantage of the lack of adequate interbank debtor information systems, an unscrupulous client could mortgage his real estate several times over by going to different banks for a loan. The long delays in the registration of real estate transactions and other weaknesses in the registration system compounded the problems.

The corporate governance of the banks also suffered from deficiencies. Many of the people delegated by the state to the banks' boards of directors or supervisory boards were either people to whom the state wanted to make a favor or civil servants who were delegated there in order to supplement their meagre income. Many of these people were unprepared to fulfill the required managerial and supervisory responsibilities in the governing bodies of the banks. The fact that state-owned companies were major shareholders in some of the banks resulted in an intertwining of owner-creditor roles which hampered financial prudence.

Bank supervision was also inadequate initially. Since under the monobank system practically no outside supervisory control existed, it took considerable time for bank supervision to grow up to the task. At first, bank supervision was performed by a department in the Ministry of Finance. The supervisory tasks were transferred to an autonomous agency in 1992, but for reasons of inadequate powers and lack of well trained staff, the agency was unable to efficiently perform its duties for quite a number of years. Over time, the agency's powers were expanded, its autonomy was strengthened, and the capability of its staff was increased, leading to a considerable improvement in supervision.

It is difficult to rank by importance the factors discussed above in contributing to the banks' problems. It is widely agreed by people who have studied the history of bank restructuring in Hungary that the most important contributing factor was the drop in aggregate demand and output - - caused, as noted, by the collapse of the CMEA trade and the initial negative effects of such reform measures as the liberalization of trade and the elimination of subsidies - - which led to the insolvency of many firms. The contribution of bad lending decisions and outright fraud to the losses of the banks is estimated to have varied within a wide range of 10 to 40 percent depending on the banks. The inherited bad loan portfolio from the period preceding the reforms comes in as the second or third most important factor depending on the case.

III. Bank Consolidation

It became evident by 1992 that a consolidation and restructuring of the banking system could be no longer postponed, as some of the state-owned banks lost their entire capital. The consolidation started in late 1992 and proceeded in stages mainly because, as is the case usually with banking crises, the problems surfaced only gradually and the true magnitude of the problems did not become evident until 1993-94. At the beginning of the process, there was a debate on whether consolidation

should take the form of portfolio cleaning or recapitalization, and whether the banks' bad loan portfolios should be transferred to a specialized institution charged to "work out" the bad debt² or the work-out should be left with the banks which, after all, possessed the best information about the debtors. In the end, a combination of several approaches and techniques was used, representing a compromise between the different views.

The following is a brief summary of the different stages of the consolidation of the banking sector³.

a) Portfolio cleaning

As a first step in the bank consolidation process, those banks and savings cooperatives which had a capital adequacy ratio (CAR) of less than about 7 percent were given government bonds in exchange for their non-performing loans at the end of 1992. The bonds had a maturity of 20 years and carried market interest rates linked to the three-month treasury bill interest rate. A part of the bad loans was sold by the government at a discount to the Hungarian Development Bank (HDB) which was charged with the work-out. Another part of the bad loans was left with the banks to be worked out. To encourage the banks to work out the bad loans, the government gave them a fee of 2 percent. However, this fee was too low and did not really encourage the banks to do the work-out. Rather, they tried to sell the bad loans to different private work-out companies which appeared on the market. Those loans that could not be worked-out or sold that way were handed over to the HDB, which in many cases had to write off the debt. Continuing the consolidation process, three banks were given government bonds in exchange for bad loans on a case-by-case basis in March 1993. Altogether, the cost of these first portfolio cleaning exercises amounted to the equivalent of about 3.7 percent of GDP.

The above measure provided only a partial and temporary improvement in the situation of the banking sector for two main reasons. First, the exchange of government bonds for loans did not include doubtful and substandard loans and the consolidation did not address the issue of the banks' bad investments and contingent liabilities (e.g. guarantees, unused lines of credit), which continued to burden the credit institutions. Second, a major shortfall of this first attempt at consolidation was that it was not tied to changes in the management and operations of the banks. The government did order an audit of the banks participating in the portfolio cleaning, but this audit was done very quickly and superficially. Consequently, the situation of the banks continued to deteriorate because of continued bad banking practices, which was compounded by the further worsening of the debtors' financial position under the lagged impact of the collapse of output and the effects of the enforcement of the bankruptcy law.

² The term "work-out" covers the different techniques to deal with non-performing debt. It might include rescheduling of the debt, exchanging the debt for shares in the debtor company, forgiving part of the debt, or writing off the debt altogether.

³ A detailed description and critique of the Hungarian bank consolidation between 1992 and 1994 can be found in Ákos Balassa, "Restructuring and Recent Situation of the Hungarian Banking Sector", National Bank of Hungary, Workshop Studies, No. 4, 1996.

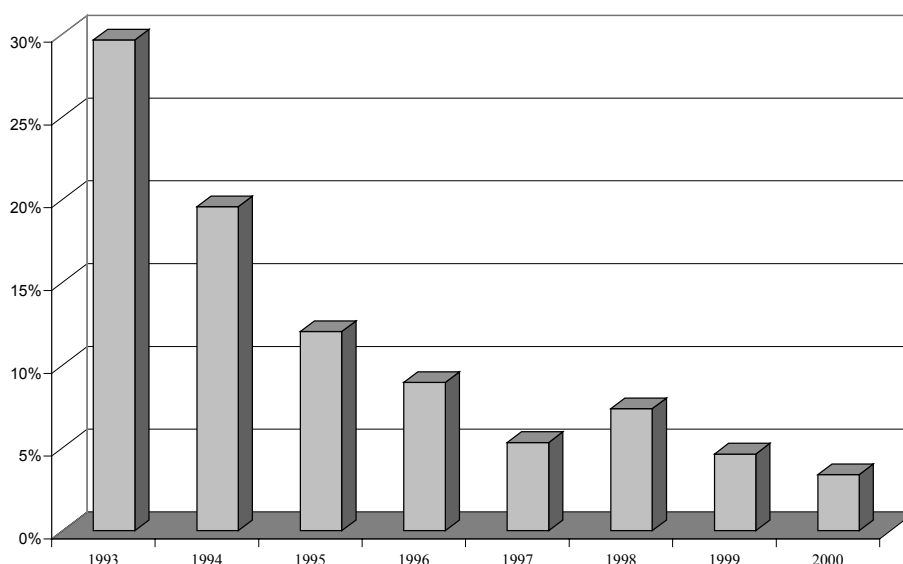
b) Enterprise-oriented portfolio cleaning

In the second half of 1993, another partial consolidation measure was implemented. This time the problem was approached from the side of the debtors. In order to avoid the closing down of certain state-owned enterprises which the authorities considered as important but which were unable to service their debt, the government cleaned out their debts from the banks' portfolio in exchange for government bonds. Most of the debt taken over by the government was then written off. At first, the debts of twelve large privileged industrial state-owned companies were cleaned out that way, but a number of other firms were added to the list later. The portfolio cleaning was successful in saving some of the large debtor firms, which were reorganized and successfully privatized later. Some firms have remained in state hands, while others had to be closed down eventually. The cost of this enterprise-oriented portfolio cleaning reached the equivalent of about 1.6 percent of GDP.

c) Recapitalization

Despite the above consolidation attempts, the amount of non-performing loans continued to increase to reach close to 30 percent of the total loan portfolio of the banks in 1993 (Chart 1). By that time, the Hungarian rules of loan classification were tightened to fully comply with international standards, which partly explains the increase. However, the continued deterioration of the debtors' financial position and the accumulation of new bad loans were also contributing factors.

Chart 1
Hungary -Nonperforming Loans as a Percentage of Total Loans

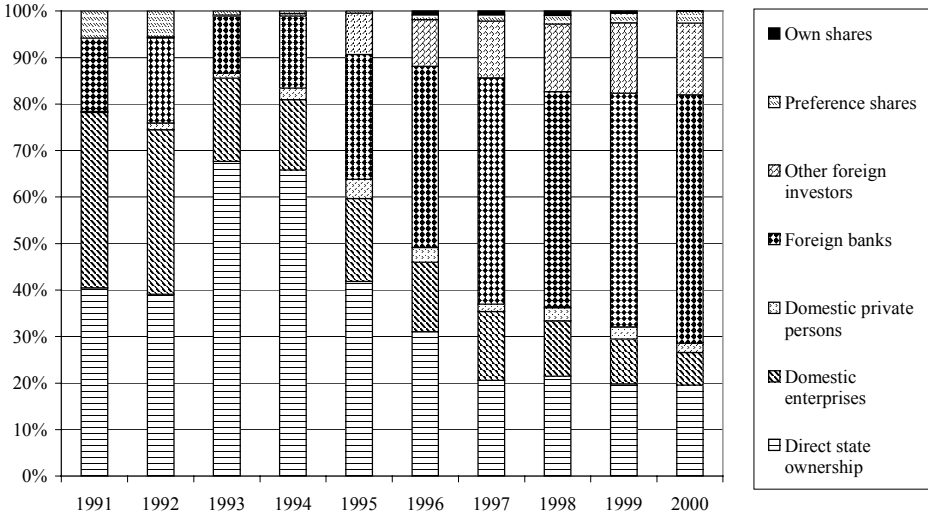


Source: National Bank of Hungary

It thus became clear by late 1993 that partial portfolio cleanings will not solve the problems of the banking system and that a full recapitalization of the banks by the

state, taking into account also the bad investments and contingent liabilities of the banks, was necessary. The recapitalization was implemented in three stages during 1993-94. In the first stage, the CARs of eight participating banks were raised to about zero percent. In the second stage, the CARs of these banks were increased to 4 percent. In the third stage, the CARs of four large state-owned banks were raised to 8 percent, i.e. the CAR required by the rules of the Bank for International Settlements (BIS). The recapitalization in the first and second stages took mainly the form of the government purchasing newly issued shares by the recapitalized banks. The government paid for these shares by bonds issued with the same conditions as the earlier consolidation bonds. As a result of this action, state ownership in the banking sector increased temporarily (Chart 2). In the third stage, the recapitalization took the form of the extension by the government of subordinated loans to the banks. This action did not involve an increase in government ownership in the banks. The total amount of recapitalization over the three stages amounted to the equivalent of 4.8 percent of GDP.

Chart 2
Hungary - Ownership Structure of the Banking Sector



Source: National Bank of Hungary

Recognizing at last that the banks possessed the best information about the debtors and were therefore the best placed to handle the problem loans, the latter were left with the banks to be worked out this time. Most of the banks established separate work-out units for that purpose, either within the bank or as an entity outside of the bank. One of the objectives of setting up separate work-out units was to avoid that the work-out activity interfere with the normal operations of the bank. An additional objective was to separate the “good” bank from the “bad” bank to set the stage for the privatization of the bank. There were also cases where the banks sold the bad debt to private work-out organizations. Generally, it took between 1 to 2 years for the problem loans to be worked out.

Learning from the previous mistakes when no detailed conditions were set for the banks whose portfolio was cleaned, the banks which were recapitalized were now

required to submit a consolidation program aimed at putting the bank on a sound footing. The programs included measures to streamline management, improve internal controls and modernize the operations of the bank. The undertakings were set out in an agreement which was signed by the bank and the Ministry of Finance.

In addition to the above described consolidation, two separate, but important bank consolidations took place later. The only large state-owned commercial bank which did not participate in the earlier consolidation schemes and was not privatized run up huge losses and had to be consolidated in 1998, the cost of which reached the equivalent of about 2 percent of GDP. Furthermore, a commercial bank operating abroad and owned by the NBH turned out to have a large bad loan portfolio when the NBH decided to sell it. After several attempts to sell the bank failed, the bank had to be closed down in 2000, with the NBH suffering a loss equivalent to about 0.7 percent of GDP. With this action, the consolidation of the Hungarian banking system had come to an end.

The total gross cost of the consolidation over the eight years from 1992 to 2000 amounted to approximately 13 percent of GDP. An international comparison suggests that this cost was not exceptionally high and was much smaller than in some emerging markets hit by financial crises in Latin America and Asia (Table 1).

Table 1

The Cost of Bank Consolidation in Selected Countries

Country	Percent of GDP
<i>Latin-America</i>	
Argentina (1980-82)	55 %
Chile (1981-85)	41%
Uruguay (1981-84)	31%
Venezuela (1994-95)	17%
Mexico (1994-95)	12-15 %
Brazil (1994-96)	5-10 %
<i>Asia</i>	
Thailand (1997-)	35 %
Indonesia (1997-)	33 %
South-Korea (1997-)	20 %
Malaysia (1997-)	19 %
<i>Transition countries</i>	
Bulgaria (1990s)	14%
Czech Republic (1990s)	18%*
Hungary (1991-2000)	13%
Poland (1990s)	6 %
<i>Industrial countries</i>	
Spain (1977-85)	15-17%
Japan (1990s)	14 %
Finland (1991-94)	8 %
Sweden (1991-93)	4,5%
Norway (1987-89)	4%

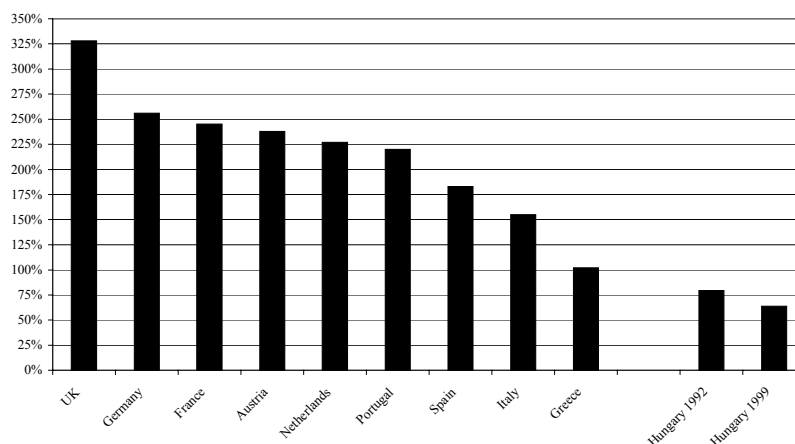
Sources:

(1) Bank for International Settlements, 66th Annual Report, 1996. (2) Gerard Caprio - Daniela Klingebiel, “Bank Insolvencies: Cross-country Experience”, World Bank, Policy Research Working Paper 1620; 1996. (3) IMF: World Economic Outlook, 1998. (4) IMF, “International Capital Markets: Developments, Prospects, and Key Policy Issues”, September 2000. (5) Carl-Johan Lindgren - Gillian Garcia - Matthew I. Saal, “Bank Soundness and Macroeconomic Policy”. IMF, 1996. (6) Czech National Bank.

* The consolidation of the banking system in the Czech Republic is still going on. Some estimates put the total cost as high as 30 percent of GDP.

To a large extent, this was due to the relatively low level of financial depth in Hungary. Chart 3 shows the total assets of the banking system as a percentage of GDP. In 1992, i.e. prior to the bank consolidation, this ratio was about 75 percent in Hungary, much lower than the ratios observed in the developed countries, ranging between 150 percent and 325 percent. The ratio in Hungary declined even further to reach less than 70 percent in 1999. This can be explained by the low level of credit to the corporate and household sectors. As shown in Chart 4, such credit accounted for only about 25 percent of GDP in Hungary, compared with more than 100 percent in the United Kingdom, Germany and Japan and 70 percent in the United States. Several factors explain this low level of credit. First, as a result of the privatization and the inflow of foreign direct investment (FDI), many companies operating in Hungary are owned by multinational firms which borrow from their mother companies or from banks abroad, bypassing the domestic banking system. At the same time, these companies produce a major part of the Hungarian GDP, with foreign invested companies accounting for about 70 percent of Hungary’s total exports. Second, many Hungarian firms lack a sufficiently long track record to make them acceptable credit risk for banks. Third, credit to households has been constrained by the low level of incomes and the high risks involved in lending to this sector. Thus, one can say that Hungary was “fortunate” that bank consolidation came at a time when the lack of financial depth helped to limit the cost of consolidation.

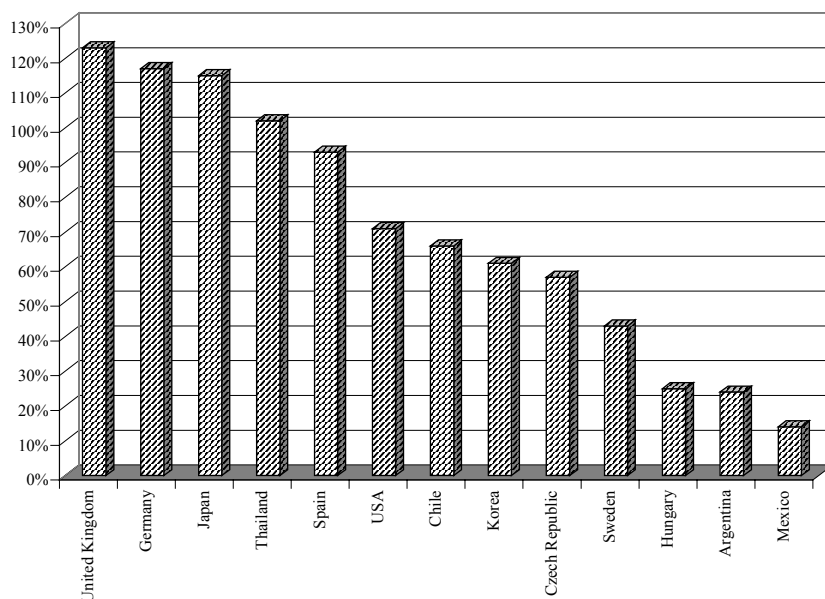
Chart 3
Total Assets of the Banking System as a Percentage of GDP in Selected European Countries*



*1997 data for all countries other than Hungary

Sources: European Central Bank, “EU Banks Income Structure”, April 2000; and National Bank of Hungary

Chart 4
Loans Extended to the Private Sector as a Percentage of GDP in Selected Countries*



*Pre-crisis (1996) data for Korea and Thailand, 1999 data for other countries
 Source: IMF, International Financial Statistics

IV. Privatization of the Banks

The government regarded the privatization of the state-owned banks as the final step in strengthening and stabilizing the banking system. In formulating the privatization strategy, it was concluded that the banks should preferably be sold to strategic owners who can provide needed capital, technology and know-how. In practice, this meant selling most of the Hungarian state-owned banks to foreign banks. Six state-owned banks, representing a market share of 31 percent at the end of 1995, were sold to foreign banks. In the first phase of the privatization, the government maintained a minority shareholding in these banks. The European Bank for Reconstruction and Development (EBRD) also participated as a minority shareholder in the privatization of three of the banks. The initial presence of the government and the EBRD was regarded by the strategic buyers as some sort of guarantee should the banks run into unanticipated difficulties. The minority shares were eventually purchased by the strategic owners.

The government ruled that the NSB, the largest Hungarian bank with a market share of 29 percent prior to the privatization, should be privatized through the stock exchange. Besides the intention of keeping the management of the largest bank entirely in Hungarian hands, another objective was to promote the development of the domestic capital market. This bank has since performed well and is a strong competitor in the market.

The increased presence of foreign investors in the Hungarian banking sector was not only a result of privatization. Hungary has practiced a liberal licensing policy

leading to many foreign banks setting up subsidiaries in Hungary. As a result of the privatization and the “greenfield” establishment of foreign banks, the second half of 1990s witnessed a dramatic change in the ownership structure of the banking sector (Chart 2). State ownership fell to 20 percent of the banking system’s share capital by 1997 and currently only one larger and one small commercial banks and a few credit institutions fulfilling special functions remain in state ownership⁴. Foreign ownership amounts to almost 70 percent⁵ of the share capital of the banking system and is dominated by banks from the European Union (EU), a reflection of the close integration of the country into the EU, which Hungary is expected to formally join within the next few years.

It is widely agreed that the restructuring of ownership has strengthened and stabilized the Hungarian banking system, as reflected in the current high level of CAR (14 percent on average for the banking sector) and the improvement in the quality of loan portfolio: the amount of non-performing loans as a proportion of the total loan portfolio fell from 30 percent in 1993 to about 3 percent in 2000 (Chart 1). The presence of foreign banks has been a major factor behind the increase in the quality and variety of banking products and services. It also increased competition, helping to compress the margins between deposit and loan interest rates from an average of over 9 percent in 1994 to about 3 percent currently. The presence of foreign banks has also helped to boost Hungary’s attractiveness for FDI, as many interested foreign investors can find in Hungary subsidiaries of banks operating in their home countries.

V. Bank Regulation and Supervision

The experience worldwide shows that the quality and effectiveness of bank regulation and supervision plays an important role in preventing bank crises. Prudential regulation and supervision have greatly improved over the years in Hungary. The government has been aided in this effort by the EU accession process which requires the harmonization of the Hungarian regulatory frameworks with those in effect in the EU. Bank supervision was strengthened by granting greater autonomy to the bank supervisory agency and by improving the skills of its staff through training and the hiring of better qualified personnel. The move from an institution-based to a group-based supervision was also intended to improve supervision. This move involved merging under the aegis of a single agency the supervision of banks, brokerage firms, insurance companies and pension funds. The resulting consolidation of the supervisory activities permits a more effective supervision of financial groups when banks own brokerage firms, insurance companies and pension funds. There is a trend internationally and also in Hungary for banks to expand their activities into these financial services. During the Russian financial crisis of 1998, many Hungarian banks suffered losses as a result of the substantial open foreign exchange position of their brokerage firms, underlying the importance of a consolidated approach to supervision.

⁴ These are the Eximbank, the Hungarian Development Bank, four housing savings institutions and two mortgage banks.

⁵ This number includes the minority holdings by foreigners of NSB’s shares.

VI. The Experience of Some Other Transition Countries⁶

The bank reforms in Poland and the Czech Republic were broadly similar to that in Hungary but were implemented at a somewhat later date. The difficulties faced by the banking systems of these countries stemmed by and large from the same sources as in Hungary, namely the drop in GDP; inherited bad loan portfolios; lack of prudent risk management and lending owing to weak management practices; and shortcomings in the regulatory framework and bank supervision. While the Polish banking sector attained stability thanks to a consolidation-cum-privatization program, the Czech banking reform has taken longer. In Poland, the problem loans were left with the banks to be worked out. Recapitalization was tied to the banks improving their operations and risk management practices. Simultaneously with the consolidation program, Poland was also strengthening supervision. The cost of consolidation is estimated at 6 percent of GDP, less than in the Czech Republic or Hungary (Table 1). One reason for the lower cost is that the bank credit to GDP ratio prior to the consolidation was only 11 percent on Poland, much lower than either in Hungary (33 percent) or the Czech Republic (51 percent)⁷. The Polish banking sector, like that of Hungary, is dominated by foreign banks.

Restructuring of the Czech banking sector took place in three stages. First came the consolidation of large banks in the early 1990s, followed by the consolidation of medium-sized and small banks in the mid-1990s, and finally by the implementation of a stabilization plan targeting small banks. Success of the restructuring of the banking sector depended largely on the success of transferring the leading Czech banks into the hands of strategic private owners capable of effective corporate governance, since the earlier coupon-based privatization of these banks had resulted in a scattered ownership structure which, together with the restriction on foreign ownership, meant that in practice the state retained control over the banks. In order to improve the management and operation of the banks, the government adopted a new privatization program in 1997 with the aim of selling the large banks to foreign banks. The privatization process is all but completed by now, but the operations of the privatized banks is being hampered by the large-scale reorganizations that had to be carried out by the new owners, and by the lingering problems associated with the large size of non-performing loans.

VII. Current Trends in the Hungarian Banking Sector and Prospects

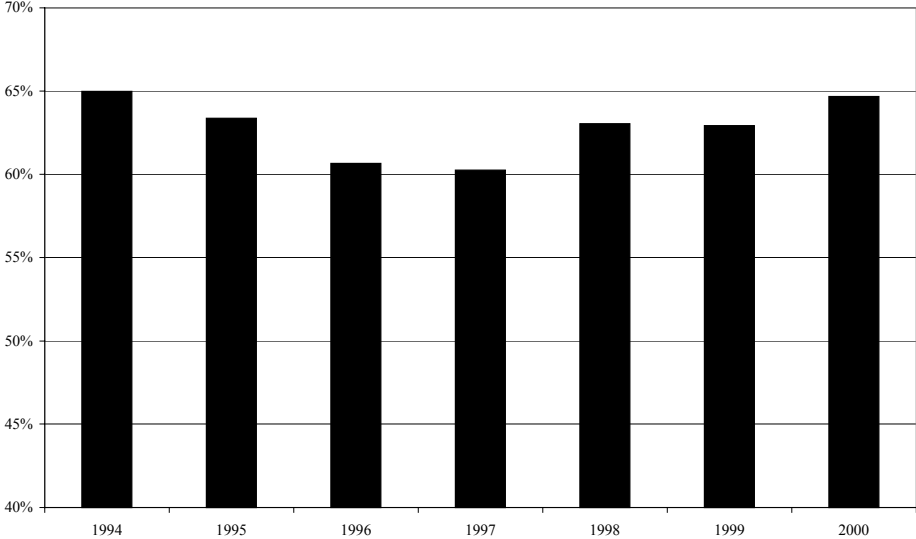
As discussed above, the depth of financial intermediation is low in Hungary. However, after declining through 1997, the total assets of the banking system as a ratio of GDP has started to rise (Chart 5). This trend is expected to continue with the

⁶ This section draws on information from the following sources: (1) Fernando Montes-Negret – Luca Papi, "The Polish Experience in Bank and Enterprise Restructuring", World Bank, January 1997. (2) Moody's, "Czech Republic – Banking System Outlook", October 2000. (3) IMF, "Poland - Selected Issues", IMF Staff Country Reports No. 99/32, 1999. (4) IMF, "Czech Republic - Selected Issues", IMF Staff Country Reports No. 98/36, 1998.

⁷ Source: IMF, *International Financial Statistics*

development of the economy in general and of the small- and medium-sized domestic enterprise sector in particular. Lending to the household sector is also expected to rise as a result of the growth in household incomes and the efforts by banks, driven by competition, to expand their areas of activities. The widening of the exchange rate band to ± 15 percent in May 2001 and the consequent increase in the exchange rate risk is also likely to encourage the corporate sector to rely somewhat less on borrowing from abroad and to increase their borrowing in domestic currency from banks in Hungary as a means of hedging their risk⁸. Nevertheless, it is unlikely that the depth of financial intermediation in Hungary will reach the level attained in the EU any time soon, since the multinational firms will continue to dominate the corporate sector for some time to come and these firms will tend to rely to an extent on borrowing from their mother companies abroad.

Chart 5
Hungary - Total Assets of Credit Institutions as a Percentage of GDP



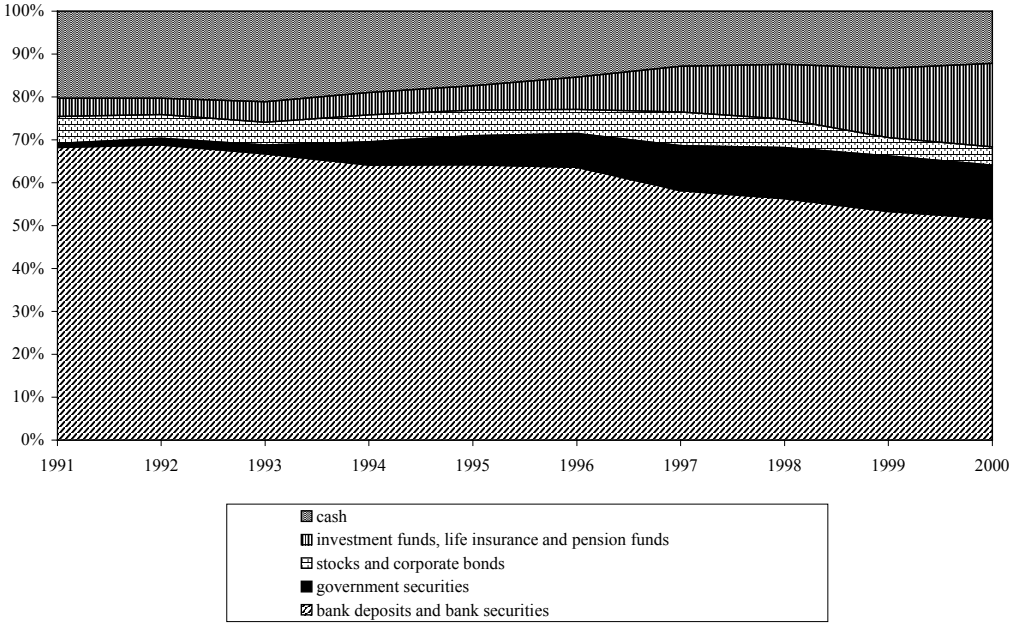
Source: National Bank of Hungary

A trend that might also put a constraint on the development of financial intermediation through the Hungarian banking system is the declining share of the households’ financial savings held in the form of bank deposits in favor of other forms of savings, such as government securities, life insurance and pension funds (Chart 6). Since this trend is likely to continue and might not be offset by a sufficiently rapid growth in total household savings, large corporate clients might find it difficult to satisfy their borrowing needs in domestic currency, as the prudential limits on the banks’ open positions will limit the banks ability to borrow from abroad to meet the

⁸ Between March 1995 and May 2001, a preannounced crawling peg with a narrow band of ± 2.25 percent was in effect in Hungary. The relatively low level of exchange rate risk encouraged borrowing from abroad to take advantage of the lower foreign interest rates.

demand for credit. Thus, banks in Hungary might not be able to exploit to its full potential the competitive edge that they have in the domestic currency market.

Chart 6
Hungary - Breakdown of Financial Assets of Households by Form of Holdings



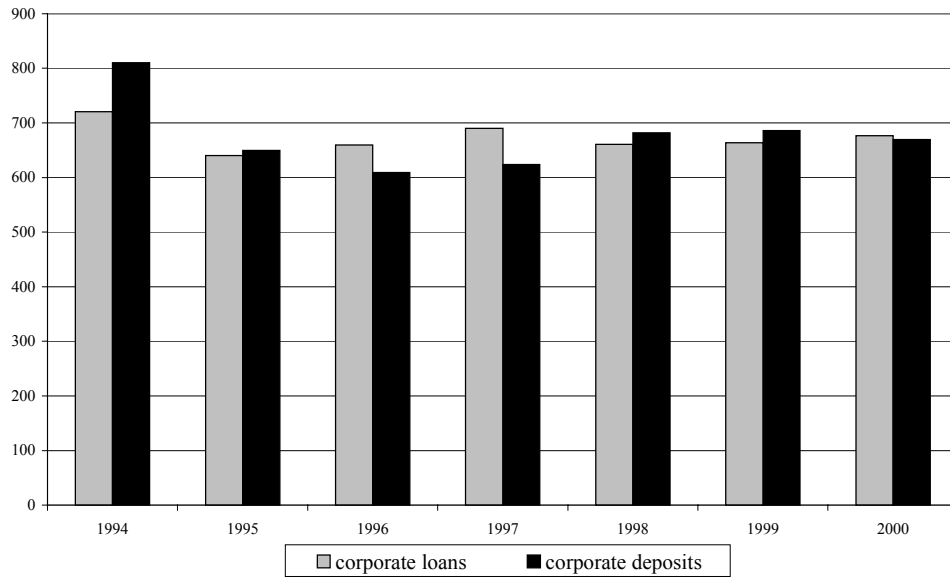
Source: National Bank of Hungary

Reflecting the history of the development of the banking sector in Hungary, there is a wide difference in the degree of concentration between the corporate and the household credit markets. In the corporate sector, the concentration is relatively low, with the Herfindahl index being just above 600 both for corporate loans and deposits (Chart 7)⁹. This reflects the presence of the many foreign bank subsidiaries which started operations in Hungary as a greenfield project initially concentrating on the less risky corporate market¹⁰. In the household sector, the concentration is much higher because of the dominance of the NSB which initially had enjoyed a quasi monopoly in this market. However, the degree of concentration has fallen sharply in the household market, with the Herfindahl index dropping from almost 7000 in 1994 to about 2000 in the year 2000 (Chart 8). This development reflects the efforts of foreign-owned banks to extend their activities to the household sector in order both to increase their deposit base and to capture a greater share of the household credit market. The resulting increase in competition has led to a substantial improvement in the banking services provided to households. One measure of this improvement is the rapid growth of bank cards from 75 per 1000 inhabitants in 1995 to 450 in 2000.

⁹ The Herfindahl index is calculated as the sum of the squares of each bank's market share in percent. If there were only one bank, the Herfindahl index would be 10.000 (100% x 100%). A value in excess of 1.500 is considered as representing significant concentration.

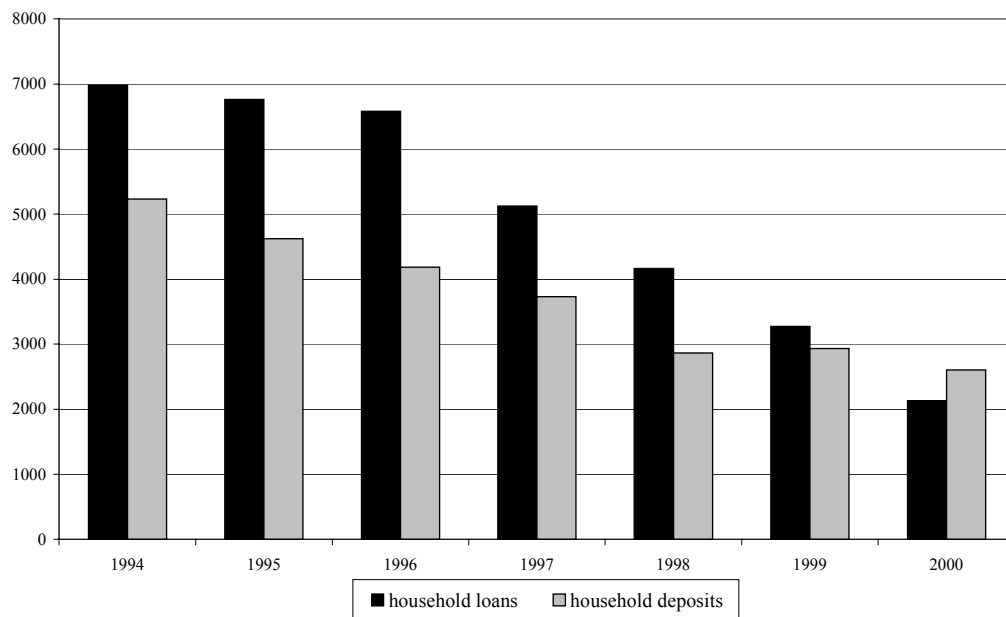
¹⁰ Of the 29 foreign-owned commercial banks, 21 are greenfield projects and 8 are privatized banks.

Chart 7
**Hungary - Market Concentration of Corporate Loans and Deposits
 (Herfindahl-index)**



Source: National Bank of Hungary

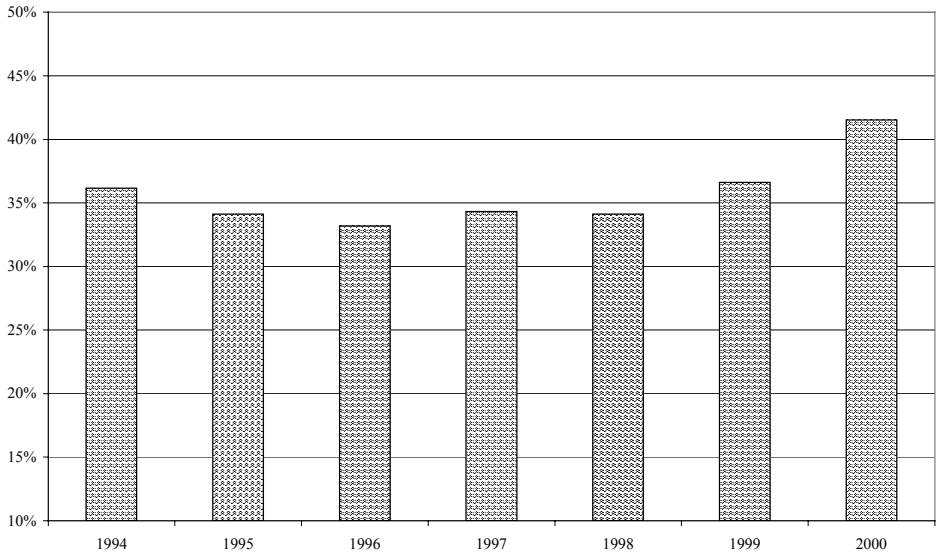
Chart 8
**Hungary - Market Concentration of Household Loans and Deposits
 (Herfindahl-index)**



Source: National Bank of Hungary

The robust economic growth, together with the decline in inflation and the consequent fall in the return on government securities, have led to an increase of the share of loans to the corporate and household sectors in the total assets of banks. This share, which stagnated at 33-34 percent during 1995-98, rose to almost 42 percent in 2000 (Chart 9). Despite this shift toward more risky assets, the share of non-performing loans in the total loan portfolio of banks continued to decline as mentioned earlier (Chart 1).

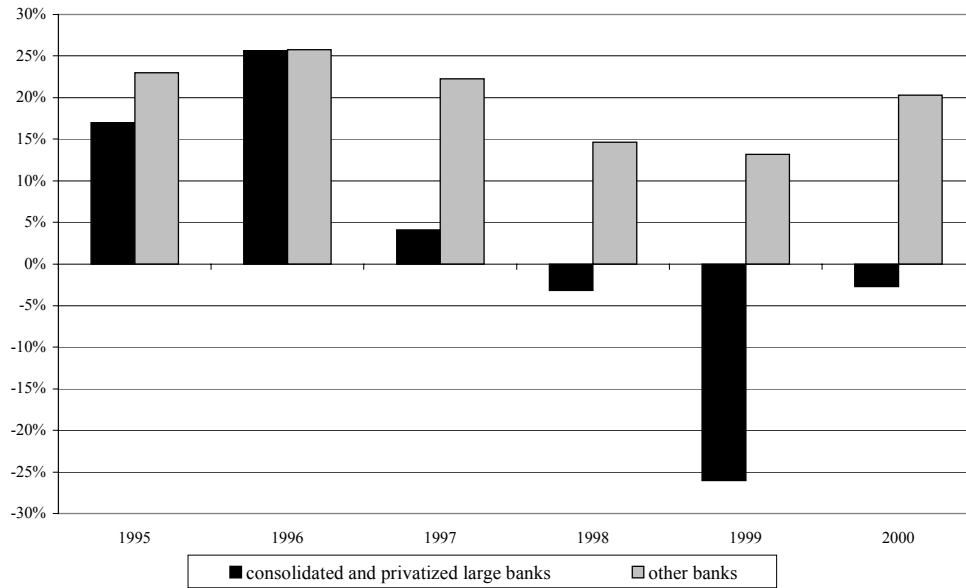
Chart 9
Hungary - Corporate and Household Loans as a Percentage of Total Assets



Source: National Bank of Hungary

The profitability of banks, as measured by the pre-tax return on equity (ROE), evolved very differently for the banks established as greenfield projects and for the large privatized banks (Chart 10). For the former, the ROE declined in 1997-99, but remained positive and recovered in 2000. The decline reflected the fall in the rate of inflation, the narrowing of the interest rate margins due to the intensified competition, and the cost of investments aimed at developing banking business in the retail sector. For the large privatized banks, the ROE fell sharply and turned negative during 1998-2000, showing that the restructuring of the formerly state-owned banks is a difficult and time consuming process. Despite progress in reducing operating costs, the ratio of such costs to the total assets of the banking system as a whole remains high by international standards (Chart 11), but the ratio is much higher in the formerly state-owned privatized banks than in the greenfield banks.

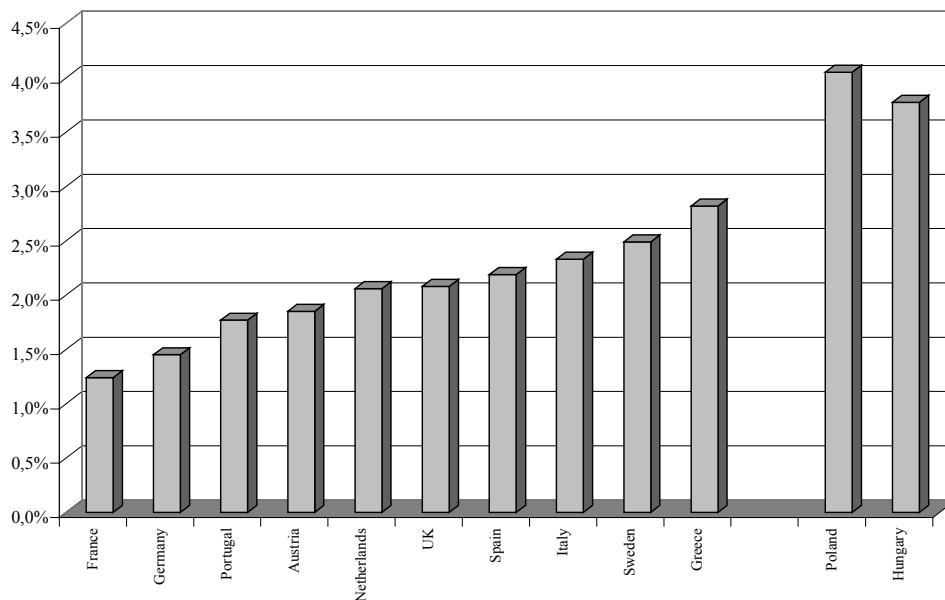
Chart 10
Hungary - Return on Equity*



*Calculated with pre-tax profit; the Postabank, the Hungarian Development Bank and the Realbank are not included.

Source: National Bank of Hungary

Chart 11
Operating Costs as a Percentage of Total Assets in Selected EU
and Central European Countries*



Sources: European Central Bank; National Bank of Hungary

The setting up of subsidiaries by many foreign banks has led to the Hungarian market being over-banked: the average size of banks is 700 million dollars, compared with an average of 2.6 billion dollars in the euro zone¹¹. This situation is likely to change as competition will push toward greater concentration in the banking sector in the years to come. The concentration has already started with mergers and acquisitions initiated in Hungary, or as a result of mergers of the mother banks abroad. Some foreign bank subsidiaries already closed their operations and withdrew from the Hungarian market. When this process is over, there will be a fewer number, but larger sized banks, providing a full range of corporate and retail banking services. Some foreign bank subsidiaries, rather than withdrawing altogether from the Hungarian market, might downgrade their presence to a representative office, providing a limited range of services to their preferred corporate customers.

VIII. Lessons from the Hungarian Bank Reform

There are lessons to be drawn from the Hungarian experience with bank reform, a few of which are worthwhile to highlight.

1. Consolidation of the banking system should be based on an accurate assessment of the sources of difficulties of the banks. It is true that the multi-phased consolidation applied by the Hungarian government was partly imposed by the events, as the deterioration of the debtors' financial position was prompted by a fall in aggregate demand and output of which both the long duration and the magnitude were unanticipated. Nevertheless, it can be said that a more thorough examination of the banks' financial situation would have revealed earlier the extent of the problems faced by the banks and would have allowed a more careful planning of the consolidation process. In this respect, it is important to emphasize that the *enforcement of strict loan classification and provisioning rules according to international standards will help the problems to surface early*.

2. There was a debate in Hungary whether the responsibility to work out the bad loans should be given to a separate central institution or should be left with the banks. Initially both methods were tried, but it soon became apparent that *banks were much more successful in working out the loans if they were given the right incentives*. The incentive was that the banks could retain the difference between the actual loan recovery rate and the assumed recovery rate on which the consolidation was based. The biggest drawback of a central work-out institution is the loss of information about the debtors when the portfolio is transferred out of the creditor bank. When the work-out responsibility is left with the bank, it is important to *separate the normal activities of the bank ("good" bank) from the work-out activity ("bad" bank)* so that the former can concentrate on client relationship and is not burdened with the task of debt collection. The staff of the work-out unit should be given incentives to finish the job speedily, *otherwise self preservation will draw out the process for too long*.

¹¹ These numbers include the savings cooperatives in the euro zone which are excluded in Hungary where they are very small. Excluding the savings cooperatives in the euro zone as well, the difference in the average size of banks is even larger.

3. If consolidation takes place in several stages as in Hungary, the issue of “moral hazard” is raised: there is a danger that the banks, counting on another rescue operation, will not improve their operations and engage in sufficiently prudent lending. In this regard, the greatest weakness of the Hungarian consolidation process was that in the first phases of the consolidation, the banks were not compelled by the government to implement internal reforms to improve the efficiency of their operations by restructuring management, reducing costs, and strengthening risk assessment and internal controls. When banks were eventually required to submit a restructuring program under the recapitalization phase, the implementations of the programs were not adequately monitored and enforced by the government. This can be partly explained by the fact that the government did not wish to keep the banks in public ownership and regarded the consolidation as a step toward the privatization of the banks. However, privatization itself took longer than expected so that the lack of adequate restructuring of the banks prior to privatization resulted in the end in a lower sales price, i.e. smaller privatization receipts for the government. In other words, bank reform should *address adequately both the “stock” problem through recapitalization or portfolio cleaning and the “flow” problem through measures designed to prevent the reproduction of losses.*

4. Privatization is no panacea, but experience worldwide has shown that state-owned banks are more likely to get into trouble than private banks. It is the view of this author that the consolidation of banks in a country moving from a centrally managed to a market economy should be followed by the privatization of the banks. The choice of an appropriate privatization strategy is crucial. The coupon-based privatization in the Czech Republic turned out to be a failure, while the privatization of banks into the hands of strategic owners in Hungary and Poland proved to be beneficial. There is also an example of successful privatization through the stock exchange, that of the NSB in Hungary. *The important thing is to have an ownership structure that ensures effective corporate governance.* Experience worldwide shows that ownership through the stock exchange is a powerful disciplinary force for the management of any bank and the Hungarian experience with NSB confirms that this can work in a transition country as well. At the same time, the presence of foreign banks can infuse useful competition into the banking system.

5. Consolidation of the banking system should be accompanied by the improvement of prudential regulation and the strengthening of supervision. *It is very important that the supervisory authority be granted enough autonomy from the government and be empowered to use adequate supervisory measures and sanctions.*

6. It should be strongly emphasized that the success of bank consolidation depends in the end on the health of the corporate sector. Banks are as good as the economy in which they operate. Bank reform must be accompanied by the restructuring of the corporate sector if one of the major sources of the difficulties encountered by the banks was the weak financial position of the debtors. In Hungary, this restructuring was brought about by the strict enforcement of a *stringent bankruptcy law* and by the privatization to strategic owners of state-owned enterprises. *In a transition economy, it is crucial that the restructuring of the banking and corporate sectors go in tandem. Banks must divest themselves not only of their bad loans but also of their bad clients.*

7. The Hungarian authorities' liberal policy of bank licensing and the privatization to strategic owners have resulted in the Hungarian market being dominated by foreign banks. This has helped to achieve a relatively high level of capital adequacy ratio for the banking system as a whole and has also led to a substantial improvement in banking services, accompanied by a marked narrowing of the interest rate spreads. The foreign bank subsidiaries established as greenfield projects have been slow to move into the retail banking business, but this has changed in recent years with some of the foreign-owned banks moving aggressively into this area. Hungary was the first country in Central and Eastern Europe to start reforming its banking system and foreign banks were eager to establish themselves in the country in the initial years of the reforms in order to secure a presence in Central Europe. However, a process of concentration has started now, as foreign banks are reassessing their role in Hungary in the light of their relative competitive position in the country and their global strategy in the region. One lesson of the Hungarian experience is that the *restructuring of the large formerly state-owned privatized banks proves to be a difficult task* as reflected by the negative ROEs of these banks for the last three years. Owing to the large presence of multinational firms and the low leverage of the Hungarian corporate and household sectors, *the depth of financial intermediation is low*, constraining the efficiency of monetary policy.

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