# THE HUNGARIAN FINANCIAL SECTOR AND THE EUROPEAN INTEGRATION

**Csaba Lentner, Lilla Huszár, and Pál Kolozsi**
**University Of West Hungary**
**Institute of Finance, Accountancy and Statistics, Hungary**

## THE BANKING AND FINANCIAL MARKET

Since the establishment of the two-tier bank system fifty years ago, the Hungarian commercial banking sector has not only formed in its institutions but it has even strengthened. The consolidation period followed by the stabilization period has meant both the improvement of the credit society and supervisory control, and even the formation of the more cautious credit processes, which was followed by the western investors in the banking sector. The fusions of the financial institutions in the privatised Hungarian banking sector were followed by the concentration of capital and centralization launching good bases for the further stabilization in the Hungarian financial sector.

On the one hand the advanced state level has become one of the key factors of the economic growth in Hungary, on the other hand the control of the participants in the financial and capital market meaning the suppression of the grey and black market. The significant participants of this process are the adequately working credit societies, which can promote the economic growth by their basic activities and the most effective outlay of the sources they had gained and their role in the financing of the national debt is getting more and more important.

In the scope of the harmonization the control system of the national bank control follows the system formed by the EU. In terms of the financial types of the institutions and the financial service activities the European model has a significant role in the Hungarian experience.

The Hungarian capital market had an important development during the last decade. Due to the market problems caused by the Russian economic crisis in 1998 a huge recession came followed by stagnation from the beginning of 2000. Deficiencies in the control and supervision were brought to the surface by the market problems. The bankruptcy of dozens of broker companies caused the investors huge losses. The concentration process being applied is to avoid these kinds of losses.

In the Hungarian control of the capital market it has to be taken into consideration that the capital market has a rapid development all over the world. A huge scale of innovation and the globalisation of the markets are characteristic.

Basic changes have been caused in the operation of the capital market by the deregulation of the foreign exchange. A part of the effective rules has become redundant, though the safe operation of the national investors has to be proved at the same time. The launch of the liquid market is the condition of the hedgings coming to the front.

The Hungarian economic policy has directly applied the growth model since the end of the 1980s (indirectly from the 1970s), which affects the inner economy from outside the external capital markets. There has never been such a level of capital accumulation that could make the stable operation of the Hungarian national economy possible. The institutions of the banking sector and the capital market have become the technical appliances and organizers of the capital movements from outside to inside, which changed a lot last decade. The bases of the safe management of the capital import are the commercial banking sector and stock exchange possessing adequate capital intensiveness and liquidity. This financial sector in Hungary follows the changes experienced in the world economy and in the EU concerning its financial situation and control elements. The Hungarian financial elements have become external systems and also the integrated participants of the developed world of finance.

# THE MAIN CHARACTERS OF THE BANK ADVISORY BOARD TODAY

Due to the evaluation of the commercial, financial elements and the decrease in the differences between the activities it has been realized in many countries all over the world that the only way to supervise the institutions of the capital and financial market effectively is launching an advisory board.
The Hungarian banking system acclimatised by the end of the millennium needed the State Bank Supervision, the Stock Exchange Supervision and the Insurance Authority to operate merged in order to form the overall supervision of the loan banks, which provide investment services. This way it will be possible:

- To the supervisors to share the information gained whilst supervising in order to see the whole group's risk
- To supervise the same kind of activities in the same point of views
- To prove the same requirement system for each activity
- To get such an effective information flow among the supervisors, which help them to prepare for the innovation expected in their own sector
- To take over the knowledge for other sectors

During the last years crisis symptoms were experienced in the national and international capital markets. To avoid repetitions the advisory boards need to be watchfulness and the supervision theories need to be improved. In the decontrolled capital markets of the EU, South-East Asia and North America the strengthening of the regulation process has been experienced for several years.

# THE EU-MATURITY OF THE NATIONAL BANK

During the harmonisation of the joining process it has been established that the rules of the national bank absolutely meet the community requirements. By the 1990s the national bank had given up refinancing the sectors of the production and by the end of the millennium it had given up issuing a letter of credit for the state finance deficiency. The central bank does not even go on with its commercial-bank activities.

The requirements applying to the national banks of the EU members can be found in the chapter dealing with the community financial policy of the Treaty signed in Maastricht. From the minutes enclosed to the Treaty, there are only two of them, which deal with requirements for the national banks. The important criteria are:

- To prove the central bank's institutional, personal, functional and financial independence
- There have to be dispositions for integration

Three areas can be separated according to the compatibility of the bank regulation in the EU:

- The independence of the central bank
- The goals of the central bank according to the principles in the Treaty
- The regulation of the relations between the central bank and state finance

Although the institutional independence of the Hungarian National Bank (MNB) had been declared it could be queried before 2002. The rules of the Hungarian National Bank did not meet the EU-requirements concerning the financial independence because they did not preclude it unanimously that the Parliament or the government cannot force the national bank to determine such a budget, which endangers the primary goal of the national bank. According to the Treaty the maintenance of the price stability should be indicated as the national banks' main goal. The former Hungarian regulation was different concerning the main aim.

The new regulation accepted by the Parliament in 2001 was created in the spirit of the agreement in Brussels in 1991. It might remain a further problem that the Minister of Finance still possesses the property rights at the general meetings, which can make the institutional independence of the national bank doubtful from the budget policy.

## THE LATEST CHANGES IN THE FINANCIAL AND MONETARY POLICY OF THE NATIONAL BANK

Due to the huge scale of decline of the capital markets the inflation rate of the year 2001 could be showed only with uncertainty. So the national bank decided to retest the opportunities of its monetary policy.

The point of the new inflation targeting system is that the national bank forms its policy as a function of the inflation's target and its predictions. The monetary policy's aim is to bring down the infation rate, so for 2003 is to reach an annual inflation rate below 4,5% and for the end of 2004 an annual inflation level of 3.5+/-1%. The inflation rate in Mars was 4,7 %, and because of the recession of the world economy and the low level of the price of the petrol, the inflation target of this year can be met despite the fact that the Hungarian National Bank doesn't focus on it.

The new monetary policy of the Hungarian National Bank – which exists since May 2001 – was successful in 2002, because the inflation rate in December was 4,8%, and the target was 4,5+/-1%. Despite that fact, there was a serious debate about this policy in Hungary. Some experts said that the monetary policy of the national bank – which is based on the appreciation of the national currency and so the desinflation of the imported tradable goods – was the responsible of the loss of competitiveness of the Hungarian economy, and the increase of the unemployment rate. Some critics were formulated when in January speculators have attacked the flotation band of the Hungarian national currency, but the good and surprising decisions of the national bank have neutralised these speculators, and the bank of issue didn't have to change the monetary system, so to move the exchange rate band. The international experiences show that the monetary policy can modify the competitiveness only in short term, because in long term other factors – like the level of the educational system, the level of the infrastructure etc. – are much more important.

The regulation of exchange rates is to evaluate a stable real rate. It is not only the interest of the national economy, but one of the requirements of the EU. The aim is to get a monetary parity in accordance with the real and market relations after we have turned to the fixed exchange rates. In order to reach all these mentioned above, the monetary policy of the national bank has to be adequate.

## FURTHER CHANGES, CHALLENGES

- During the EU-joining the Ministers of Finance of the EU countries have made a three-part schedule for the Central and Eastern European countries. The first period means the harmonization of the exchange rate policy. The candidates join the European rate system and stop the crawling depreciation or the floating. The second period begins with joining and the third one means the introduction of Euro.

- If Euro is introduced in Hungary, its advantageous effect will have to be animalised and the terms of the Hungarian competition will have to be optimised. Hungary will have to strive for it together with the European Commission.
- The coordination of the national monetary policies will follow the introduction of Euro. By the time Hungary is a member of the EU, the Hungarian National Bank should be suitable to show adequate positions and interests in the integrated policy of the EU.
- By the time of the joining the foreign-owned banks will have become branch institutions. It will be expedient to increase the credit standing and solvency of the national companies so that they could stand their ground in the credit competition.
- According to the community rules the direct control competence of the Hungarian supervision will decrease but it will have to be prepared for the control invitations coming from the member states of the EU.
- It is very important to Hungary to meet the requirements of the price stability, which means the condensing of the inflation certainly by the national bank.
- In order to reach the inflation goal formed by both the government and the Hungarian National Bank (MNB) it is still important how much the forint is to the Euro.
- The Copenhagen-criteria stipulate that the condition of the membership in the EU is to undertake the obligation of taking part in the monetary union. Since Hungary is striving to meet the conditions in its economy policy, it has already pledged itself.
- The consequences of the overall liberalization of the foreign currency may cause the Hungarian national economy serious afflictions. The financial sector can take an important role to maintain the stability of Forint and moderate the decrease of the export and competitiveness.
- By the end of the millennium the Hungarian banking sector had left an extensive development stage for a qualitative development stage.
- In the next decade the financial sector will have to deal with the reorganization of the undercapitalled companies.

At the very beginning of the millennium the integration of the Hungarian financial sector with the EU can be said almost absolutely complete but it is the next decade's job to socialize the operation of the banking sector.

# ROLES OF BANKING IN HUNGARY AT THE MILLENNIUM

At the end of the consolidation process of the '90s, relieving bank crisis, the Hungarian commercial monetary institutions have stabilized. An improvement in their profitability and capital comparison figures was clear. Their operational security has been established, but their mediator role is less significant as it is common in Western Europe. The gap between deposit and credit interests has become smaller in the past years, which was to a certain extent balanced out by the decrease in compulsory deposit. After the monetary crisis in Russia and the Far East, the compulsory deposit of banks grew once again, which lead to decline in profitability. This meant increase in differentiation. The group of banks offering low quality investments and operating at a low level of cost efficiency was clearly visible. Members of this were mostly consolidated formerly state-run banks and legers-behind, without significant capital.

The monetary challenges of the Millennium affected the capital markets and the banking sector in different ways and to different extents. Prompt stock-exchange trade fell by 47%, the share trade stood still and the scene of trading of government bonds changed to the bank-to-bank market. The BUX index fell 11% in HUF and 20,6% in USD in a year starting December 1999. The negative yield, backed by numerous unclear situations around stock exchange companies, made the investment activity fall back. Nevertheless credit-institutions accelerated, based on the economic stability drawn by Maastricht-figures and the permanently high economic growth rate. Prospectively the credit demand of the entrepreneur-sector will stay high in the near future, expanded by the additional capital need indicated by the acceleration effect of the Széchenyi National Program for Development. The - despite its dynamic increase in the past - still small banking oriented gross municipal liability will increase steadily, if the growth in earnings matches the economic growth. Mostly if among the factors of GDP instead of the slowing down of export growth, domestic production and consumption gains importance on a substitution basis. In the field of gathering funds for municipal and entrepreneur activity, a lower dynamism level is to expect, mainly because of the fading competitiveness of the domestic enterprises, loss in profitability and the growing level of inflation, imported from the EU. The additional lending outs of the banking sector will probably narrow down, caused by the lack of profitability guarantees.

It is very likely that concentration will have an important role in the banking sector, in the next few years, mainly with the monetary institutions with foreign ownership background. Up to this date and further at the foreign owners, the most significant element has been concentration in the Hungarian banking sector, 60% of which belongs to them, proving the integration of Hungarian banking procedures into the concentration actions in the EU.

Increase of credit grants and the restructuring of assets have been the two main factors in the bank-balances in the year 2000 as well. The amount of customer credits rose nominally by 33%, out of which entrepreneurial credits increased by 28,45% in 2000. The share of the customer credits in the total of assets was 44,4% by the end of 1999; it developed to 51,2% by the end of 2000. The municipal credits grew faster than the entrepreneurial ones, by 43,7%, but the stock of these only accounts for 5% of the total banking assets. The amount of municipal deposits at banks increased only by 15,7%, which if distant from the growth in credits, in 2000; this lead to further decrease of credits being covered by deposits. The coverage ratio, 142,9% at the end of 1999 fell to 124,7% by the end of 2000. According to international lectures, the situation turns risky if the coverage ratio goes below 140%. In Hungary, for the dynamism of gathering funds was far below the speed of credit grants, the financing of these credits was only possible through rearranging assets. In comparison to the end of the last year the stockpiles of deposits at the central bank and foreign credit-institutions went down by 30%.

The bank-portfolios underlying classification obligation have produced a total growth of 16,2%, out of which 21,6% was due to in-balance factors, 8,5% to out of-balance factors. The share of the increased classified portfolio has improved radically throughout the year 2000. The share of portfolio-elements classified "problematic" (below average, doubtful and faulty) decreased from 3,7% in 1999, to 2,8%. Among the entrepreneurial credits this rata fell from 4,9% to 3,4%.

The EBTs' of banks – according to previous estimates – grew from 37 milliard HUF in 1999, above the 100-milliard HUF level. The improvement of the following factors had significant roles in the in the increase of returns: net interest return, increase of net target deposit, and the increase of return of so called other monetary and investment services; which all grew more rapidly than in 1999. As follows from the improvement of the returns, the profitability of the banking sector was much higher in 2000 (ROA: 1,2; ROE: 14,5), than in 1999 (ROA: 0,6; ROE: 6,4). The raise in profitability was due to the fall in number of deficit making banks and to the fact that the deficit made by these banks in 2000 was less than a year earlier. In 1999, there were 18 institutions producing a negative yield, a year later only 9. Investigating the complete banking sector, it can be shown that the net interest return has nominally grown, but the growth ratio was lower than the increase in total assets. This caused that the share of net interest return, compared to the total of assets, has decreased. At the same time, the specific target deposit stock and operational cost-effectiveness has increased radically.

The improvement of the profitability of monetary institutions was not followed by the capability of the banking sector to overtake further public duty. In 1999 the corporate tax of commercial monetary institutions amounted to 13.691,5 million HUF, in 2000, 19.535.8 million HUF were paid into the central budget. The raise in return on assets by 170% was only followed by the increase in payments into the central budget of 42,7%, this shows that the amount of corporate tax paid was 60% lower than the increase in return on assets in banking. When comparing the data of the low public duty bearing capacity of monetary institutions with the direct payments to the state budget of other organizations; we can discover the signs of additional public duty related tensions. The ratio of the payments by economic organizations into the state budget was 13,7% in 1999, 12,7% in 2000. The corporate tax payments of the commercial monetary sector, which exceeds the economic organizations involved in the bearing of public duty, in profitability and productivity, provided only 0,42% in 1999 and 0,53% of the total budget returns in 2000. The corporate tax payments of economic organizations were 32,4 times in 1999, in 2000 24 times the sum of the same tax paid by commercial banks.

# THE INTEGRATION PHASE OF THE HUNGARIAN BANKING SECTOR INTO THE EUROPEAN UNION AT THE MILLENNIUM

The Western European and Northern American banks have acquired a significant 60% ownership in the Hungarian commercial banks. In the Hungarian banking praxis of the Millennium the credit regulations applied in the developed market economies, prudential theories, the Basel banking directives and EU accounting standards are in full effect. The Hungarian banking system became an integrated part of the banking system of the EU member states, of the developed market economies, so the Hungarian monetary sector was imbedded in to the European Union in the last decade. Even though the legislative and operational harmonization of the Hungarian monetary sector requires further actions in several issues.

In the 4th Chapter, dealing with the free flow of services, the Hungarian government asked the EU for temporary derogation, taking Hungarian characteristics into account, in the following areas:

- The prohibition of acquiring agricultural land for mortgage credit institutions shall remain in tact for 10 years.
- The insurance value limit of the Investor-Security Fund would not reach the minimum requirement of 20000 Euro (5,2 million HUF) in the first 5 years of Hungary's EU membership. According to this, no requests of higher Investor-Security insurances, valid in other countries, can be taken into consideration.
- The prohibition of foreign investments of insurance organizations should remain for the first 5 years of the Hungarian EU membership.

The first point of derogation request is strongly linked to the 10 year Hungarian derogation request concerning rules of acquirement of agricultural land, outlined in the Chapter on Free capital flow. These two will most probably negotiated at the same time.

The Committee shows a positive attitude towards granting Hungary's derogation request on the insurance limit of the Investor-security Fund. The common statement, issued in November 2000, repeatedly calls Hungary up to prepare a schedule of the way of reaching the standards the EU set up for its future members.
Hungary wished to negotiate the issue of the foreign investment prohibition of insurance companies in the round of the 4th Chapter, for it is part of our derogation requests in connection with the prohibition of foreign investments by institutional investors, Hungary has handed in within the 4th Chapter. Not only that the common statement does not give an offer on the above, further more it directs Hungary to supervise its request for the derogation. The members of the European Committee have considered prudential efforts quite as effective as temporary derogations. One of these tools is currency matching, which means transforming the currency of obligations (technical reserves of insurance) and receivables (investments) into the same one.

The starting capital requirement in case of cooperative credit institutions is lower than the EU beneficial limit, at the moment. Hungarian negotiators have expressed the wish at the talks taking place in the fall of 2000, that the cooperative credit institutions, operating at the time of Hungary's EU entry, should fulfill the integration criteria only 5 years after the date of entry. The member states have indicated in their common statement that they accept the Hungarian request, as far as there will be an appropriate schedule set up on the phases of capital extension.

As a part of the continuous harmonization process towards the EU standards, in the first half of 2001. the legislation of credit institutions and monetary enterprises (1996. CXII.) has been modified in the way that it is the Minister of finances, who is in charge of the regulation of those chapters, which falls in the competence of the EU Authority.

Also included into the law-harmonization towards the EU, credit grants covered with individual pawn-rights based on real estate constitute mortgage-credit institutional activity, as a consequence of changing the law on mortgage credit institutions and mortgage-certificates in the first half of 2001. This modification has changed the range of ways of credit grants as well. Individual pawn-right, in the legislative meaning of the word, became equal coverage for mortgage, so its documentation on the property page is ensured. It became possible for mortgage credit institutions to determine the value of real estate as security of credits. This action is necessary when purchasing mortgage credits from insurance organizations and other credit institutions. The change in law puts down the prudential expectations considering regulation of the time-span of mortgage credits, the rules of flexible issue of pre-installments, and conditions of purchase of receivables.

The change of the law on savings banks for housing projects (1996 CXIII) in the first half of 2001 served the enforcement of EU monetary regulations in the Hungarian legislation. The 2000/12/EK guideline of the European Parliament and Council prescribes that the foundation of a bank requires at least 5 Million EURO starting capital, which equals ca. 1,3 milliard HUF. The change in the law enabled the savings banks running housing oriented projects to open affiliates in Hungary, after its entry, provided they act in accordance to the law. The EU Authority notifies the Authority in charge in the member state on these regulations in no longer than two months. In case of a credit institute residing in a non-member country, an affiliated office can only be set up if it suits all the requirements valid in Hungary.

The foundation certificate of the European Community prohibits special rights to be granted to state sectors. Therefore the restriction that the liquid assets of savings banks with housing projects can to the most part be used for purchase of bonds and treasury valuables issued by the Hungarian state, is reasonable. From a prudential point of view, the investment regulation still remains that the savings bank has to spend its free assets on adequate valuables and bonds of states meeting specific requirements, such as OECD or EU countries. With special attention to the liquidity requirements of savings banks with housing projects in their credit grant phase, the fulfillment of prescribed investments ratios have to be verified monthly, not just every 3 months and have to be corrected with the amount available on the last day of the previous month.

The change in the legislation of the central bank came along in the first half of 2001 as well. According to the acceptance level of Chapter 11, called Economic and Monetary Union, in November 2000, the following requirements still had to be met concerning the Hungarian central bank-law:

According to the Maastricht agreement it is prohibited for the central bank to grant short-term credits to the central budget, in case of liquidity problems. In real life, this step has not been taken since 1995.
The main goals of the central bank and the monetary policy have to match the words of the Maastricht agreement; stability of prices has to be specially emphasized. This involves the proper change of the Constitution.
Numerous phases concerning institutional, operational and personnel liberty of the central bank have to be modified, according to the regulation set up in November 2000.

The criteria, besides the modification of the Constitution, have been fulfilled on the level of laws, though the Hungarian central bank has to prepare to join the institutions and mechanisms operating the economic and Monetary Union, after Hungary becomes a member. The Hungarian commercial and central banking system, owing to the legislative changes in 2001, basically suits the requirement levels and systems of the European Union. The future stability of present banking statuses and the emerging claims for changes and their opportunities have to be analyzed taking all the above into consideration.

# THE POSSIBLE DIRECTIONS OF THE DEVELOPMENT OF THE HUNGARIAN BANKING SYSTEM AFTER THE MILLENNIUM

The integration of the Hungarian banking system became remarkable after the gain of ownership of Western European investors in the Hungarian monetary institution sector and after acquiring the banking directives of Basel. This resulted in the operation of monetary institutions in Hungary, banking control and business actions being very similar to the EU practice. The representative research conducted by the National bank wished to find the answer to the question, what factors will influence the future development of the commercial banking sector, in the opinion of the office holders of the sector. The EU integration placed fifth from the 14 possible influencing factors. Examining their importance, the evolution of macroeconomic environment, the hardening of market competition, bank-fusion and the monetary policy were considered more influential as joining of the EU. What is more, the EU integration only ranks ninth among the big, Western European-owned banks. We can conclude that the EU law-harmonization is not among the most important factors influencing the further development of the monetary institutes, except with the small and medium-sized banks, which have a hard time fulfilling the capital and prudential criteria set in EU directives.

The pole position of macroeconomic environment is considerable. Hungarian economic growth is constantly high, about 5%, since 1997. Government forecasts predict a constant growth of 5-6% in the future. Nevertheless, it may seem contradictory that the Hungarian banking system sees the most important external force in macroeconomic environmental changes and economic growth, despite it being uniquely high in Europe. This can point in the direction that the banking sector is suspicious when receiving the macroeconomic prospects from the central bank or the government, though this behavior is simply justified by the constantly worsening macroeconomic conditions, mainly the monetary balance.

It is only probable from the point of view of the banking sector, but seems sure from my own prospective that the fast, 5 %, growth of the Hungarian economy was and will be accompanied by monetary unbalance in the first years of the new decade. The main causes of the decline in exports, providing the basis of economic growth, are the fading of the demand for goods on western markets and the insignificant increase of domestic purchase-power. The real growth in exports, standing at 29,9% in 1997, fell back by 50% and will decline to one third of the original in the period between 2000 and 2002. Adding up to this, comes the 250% increase in the deficit of the foreign trade and payment balances. The due price of the constant, but foreign operated economic growth is, increasing financial unbalance and worsening of budget positions, which means an annual 500 milliard increase in internal public debt. All these negative factors will affect the development and business policy of the Hungarian banking sector, focussing more and more on the financing of public deficit.

Concerning traditionally financed branches, the Hungarian banking system turned from entrepreneurial credit expansion, to municipal credit grants, for these grantees have appropriate incomes and state guarantees. Unlike housing-, car- and student-loans the grants of agricultural and emergency-entrepreneurial credits have not been organized yet. The main measure of capital input and pre-financing of big companies operating in customs-free areas, stays the internal credit grant of the home base companies, or the ensuring of advance payments. Entrepreneurs in the middle ranges have chosen the ways of financing through capital market channels. Owing to the restructuring of Hungarian money-market channels and the increase in nominal public deficit, the primal target of liquid source lend outs of domestic monetary institutions became the state valuable market, instead of the entrepreneurial sector. According to the accumulated balances of the commercial banks, the share of state valuables counted up to 50% already in the mid90's.

A solid market for free assets of commercial banks is ensured by the spiraling net and gross financing demand of the central budget. The gross finance demand of the central budget has increased by 73,3% between 1997 and 2001, this change was brought about by the spiraling deficit of the central household, expired state valuables, loss of privatization incomes, which provide less and less compensatory value anyway (See: Table 5). The 3.496

milliard HUF gross finance demand of the public household in 2001 limits the movement range of the Hungarian monetary policy. The central issue of the preservation of the Hungarian economy, capable of 15.000-milliard GDP production, was the settlement of 797-milliard HUF debt-service and its interests in 2000. In addition to the coverage – mostly form foreign markets – of the 3.487,8 milliard HUF 2000 gross finance demand and the 3.496 milliard HUF of 2001. One of the main figures of domestic purchase of issued state valuables is the commercial banking sector. The monetary institutions can realize a solid profit by investing into fully guaranteed state valuables. It is highly probable that, as long as the public household is making deficit, the main investment target of the commercial banking sector will be the state valuable market. Regarding profit and security of investment it is unlikely that satisfaction of credit demand of enterprises, in need of additional capital supply; or of the agricultural farmers would overcome commercial banking interests, involved in state valuable investments.

In the post-millennium operation of the Hungarian banking sector the desirable goal is to develop a banking business policy, which concentrates on the public needs, and on the finance demands of loss-making branches, independent from the ownership background. The most important step to be taken is the socialization of the banking business policies, developing their capability of bearing further public duty and social responsibility. All these topics have to emerge sooner or later, not only in public household and social regards, but also for the prolonged operation of monetary institutions in Hungary. To the realization of all these, with the words of Széchenyi István, we need to "negotiate, labor and act (…)"

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