

# Financial Institutions Matter for Territorial Development

## Challenges to Achieve Growth and Positive Impact on Local Economies in Hungary (2007–2013)

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### Abstract

*Based on the facts that financial intermediary system has crucial impacts on national economic growth, territorial cohesion and local economic development as well, financial instruments and their intermediary institutions could play a greater role in territorial development. This paper aims to give a brief overview about the financial instruments' role in development policy in the EU and in Hungary, to highlight the special features of the Hungarian delivery system (2007–2013), and to identify the risks and challenges on local economic development in the current development period (2014–2020). The background research was based on the analyses of the Hungarian strategic development policy documents (Partnership Agreement, operational programmes) and the activity data of the institutional system, which managed the repayable funds between 2007–2013.*

**Keywords:** European Union, financial instruments, development policy

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### **I. The Financial Intermediary System Has Crucial and Geographically Different Impacts on National Economic Growth**

From national economic point of view, the direct support of start-

ups, strengthening their viability in their early stages, brings significant value on a nationwide level. The European Union and the member states play a key role in providing the support initiatives, giving explicit policy objectives and a financial framework to enterprise developments. In the context of market conditions, the financial intermediary system also has a serious impact on economic growth

and on business development. Furthermore, financial intermediation plays a decisive role in financial growth and in the social progress (MÉRŐ K. 2003; IMREH SZ. et al. 2007). It has also been documented in many previous research studies that in meeting economic needs the depth and the adequate *functioning of financial intermediation* have a considerable stimulating effect on the economic growth (SCHUMPETER, J. A. 1980; MERTON, R. 1995; LEVINE, R. 1997; MÉRŐ K. 2003; KAY, J. 2015).

Kay calls for the financial intermediary system to serve economic growth with four basic functions, including the banking sector, credit institutions and the capital market mediation. The most important aim of the financial intermediary system with these functions is to serve the financial needs of the real economy and for the entrepreneurs as accurately as possible. These four basic functions as follows: (1) presenting entrepreneurs with a *payment system* for exchanging goods and services; (2) providing mechanisms for pooling funds and their reallocation; (3) to offering a mode to transfer economic resources over time and across territories and industries; (4) *managing uncertainty and controlling risk*. *It should be noted that in addition*

*to the four basic functions the Hungarian literature* (MÉRŐ K. 2003; MERTON, R. – BODIE, Z. 1995, cited by ERDŐS M. – MÉRŐ K. 2010) adds the information processing function. It gives price information that helps (5) the decentralised decision making for the economic sectors; (6) and the overcoming of incentive problems to deal with the asymmetric information (for instance between borrowers and lenders).

In many territories, financial institutions are unable (4) to meet the needs of the real economy in terms of their risk management function (6) and to deal with the incentive problems. The inadequate operation of these functions cause imperfections in the information flow and leads to market failures in financing economic activities. In keeping with New-Keynesian economics, the asymmetrical information is the main source of market failure, which has particular importance in the financial sector. In financial transactions, one party must always have more information about the operation than its counterpart. By solving the incentive problems, the financial intermediary system can handle these inequalities, which can contribute to economic growth in the following ways: (1) partly by analysing and monitoring

continuously the financing needs of the economy and the economic actors; (2) partly increasing the management discipline of these actors and making sure the resources meet the originally intended purposes as promised by the debtor. The latter has a direct impact of boosting productivity and filtering projects that are planned to be implemented by the entrepreneurs. In the background of the inadequate operation of these functions, there is the ineffective decision-making order of the largest financial institutions. This has serious territorial implications. Among the financial intermediaries the most prestigious credit institutions' centralized corporate governance structure, the low-level autonomy of the branches, does not support the availability of local information in the headquarters and thus, their inclusion in funding decisions. Such types of locally available information, which can be acquired through personal and social connections, are for instance, the entrepreneurial preparedness, the financial awareness, and the motivations of the entrepreneurs, their personality traits or the payment discipline. However, in estimating the credit risk of micro and small enterprises, these factors play the most important role (BANAI Á. et al. 2016).

Information asymmetry, encoded in the corporate governance structure and in the decision support systems of financial intermediary institutions, result in a generally higher risk rating for entrepreneurs settling in less developed peripheral areas farther from the core area of the economy. For the branches settling in disadvantaged areas this phenomenon means greater transaction, information and monitoring costs. In order to compensate the territorial imbalances of the financial transfers, only the institutional and business model transformations of the intermediary institution system are the efficient steps in the long term (GÁL Z. – BURGER Cs. 2011), which should be highlighted by the institutions responsible for the delivery of the development policy.

Vito Tanzi, a professor of economic development at Cambridge University and former head of the International Monetary Fund and Italy's former economic minister, has also drawn the attention to the failure of self-correction in financial markets (TANZI, V. 2011, cited by FARKAS P. 2017b). The inadequate functioning of both above-mentioned functions of financial intermediation, related to information asymmetry, can cause distortions in macroeconomic growth and can easily amplify

the territorial inequalities as well; therefore, their exploration is essential for development policy. Following the lessons of the crisis in 2008, government interventions became critical to address market failures based on economic theories regarding the changing role of the state (FARKAS P. 2017a; 2017b).

In terms of financial instruments, lending typically has a higher impact on economic growth than capital support, but in terms of the growth promotion actions these two intermediation types are equally important (MÉRŐ K. 2003).

Regarding development policy, knowledge-intensive businesses with the most intensive growth opportunities, usually operating in the R&D and innovation sectors, have been receiving special attention in the current EU development period (2014–2020). They have special needs in terms of their financial support and in the financing of their development the role of venture capital and the related financial intermediary institutions (capital funds) have more significant impact on generating growth. Both the researchers of venture capital support and the opinion leaders of the venture capital industry have underlined the importance of the capital's origin (public or private) in these investments. It has proven

critical to ensure the development paths meet the expectations of the market players and the optimal involvement of private resources; thereby, the mobilization of their expertise and responsibility is critical (HVCA 2015; KARSAI J. 2015).

To achieve growth-promoting effects of financial intermediation processes and to handle the failure of some intermediation functions, due to their multiple effects and consequences, the intervention is not sufficient with isolated monetary and fiscal policy instruments. These policy instruments need to be applied in an integrated development strategy framework, considering territorial aspects (especially while correspondingly changing the 'spatially blind' nature of these two policies mentioned above) and to ensure the cohesion effects of the EU development funds.

## **II. Financial Intermediation and Financial Institutions' Impacts on Territorial Cohesion and on Local Economies**

The uneven territorial distribution of financial flows

can directly cause large territorial differences (GÁL Z. – BURGER Cs. 2011). For small and medium-sized enterprises (SMEs), these territorial differences become apparent when trying to access finance. For example, an enterprise in a disadvantaged area may face higher credit costs and their access to financial services can be more difficult and narrow. From the perspective of the financial service providers, these territorial differences appear in the size of information asymmetry.

In the geographical disparities caused by the financial flows, centre–periphery differences are the most dominant and the development of the urban network shows a positive correlation with the territorial structure of the banking system and the spatial spread of financial innovations (GÁL Z. 2014). This aspect of the territorial disparities draws attention to the point that the financial intermediary system has not only a pro-cyclical impact on the various economic development phases, but it also reinforces the territorial inequalities without central intervention as well.

### **III. Regarding the Financial Instruments' (FI) Role in Development Policy in the EU and in Hungary**

In recognizing these widespread effects of the financial intermediary system since 2010, the financial instruments have become increasingly important tools for delivering the European Union's cohesion policy. In the areas in which the supported activities generate income (enterprise development, business support, infrastructure development, research and development), financial instruments should be applied (EC 2010).

Their aim is to support enterprises and non-profit organizations which face obstacles accessing commercial banking products and are unable to obtain adequate financing from the financial market. When applying for a traditional loan or capital support their shortcomings include an insufficient collateral background, being too young, seed or start-up phased units, even when having predictable cash flows, conscious management attitude, and a well-prepared entrepreneurial approach.

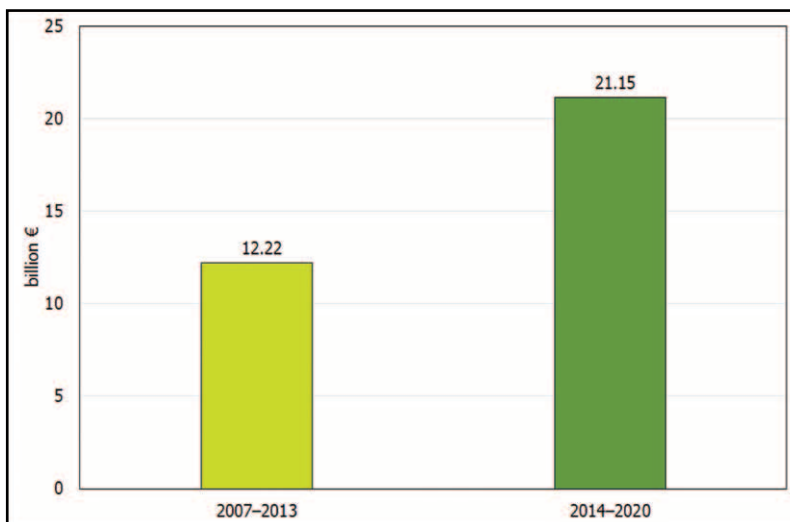


Figure 1: Growing allocations to financial instruments in Hungary, 2007–2013., 2014–2020.

Source: EC 2015b

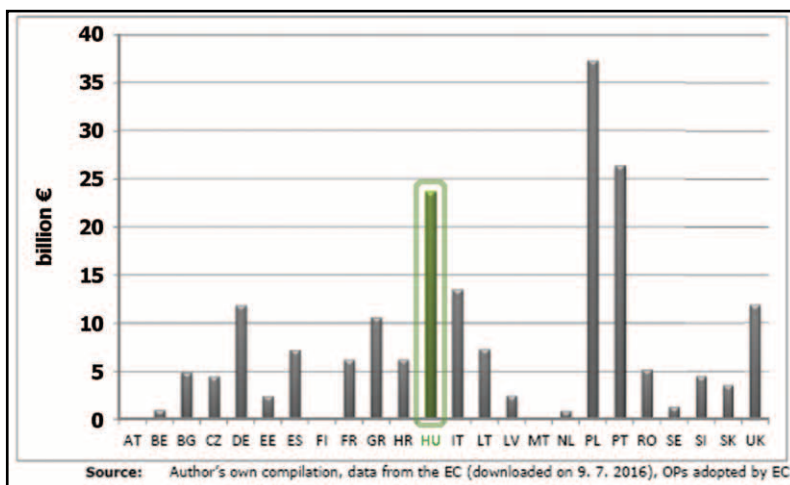


Figure 2: Hungary allocated the third largest amount to financial instruments for the 2014–2020 period

Source: EP 2016

Hungary implemented these instruments initially in the 2007–2013 development cycle (€820 million in the framework of the Economic Development Operational Program's Financial

Instruments Priority and €48 million in the 7 Regional Operational Programs) and their allocation to the 2014–2020 period has almost tripled (€25 billion under the dedicated priority of the Economic Development and Innovation Operational Program) (*Figure 1*). With the latter amount among the member states, Hungary has the third largest resource allocation for financial instruments (*Figure 2*).

From 2007–2013, the Hungarian financial instruments have served the enhancement of the territorial competitiveness and the development of small and medium-sized companies. In the 2014–2020 period, the excessive resource allocation has reached more policy objectives and diversified fields. As set out in the Partnership Agreement (in line with the guidelines of the European Commission) Hungary's strategic objective in using financial instruments are to support businesses that have limited or no access to traditional commercial banking products and services. Moreover, Hungary has hoped to promote the catching up processes of the economically less developed areas. The key products of these supported financial instruments are the credit products, especially combined microcredit products that consist of grant type support and a portion of repayable fund.

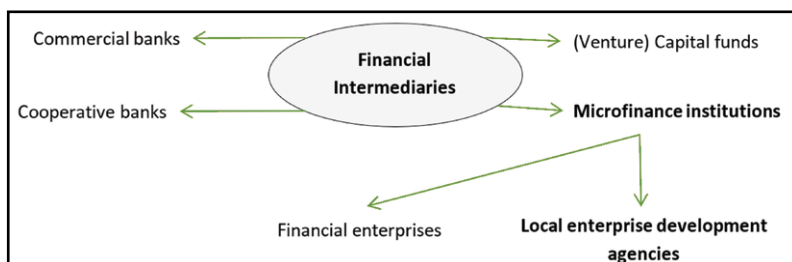
The target sectors of the aid are (1) the research and development, innovation, (2) competitiveness of small and medium-sized enterprises, (3) employment promotion, (4) information–communication technologies (5) and energy. Furthermore, there is also a technical objective to provide these subsidized products without administrative burdens and easy access to the institutional system and development funds. Additionally, the scope of beneficiaries has expanded, and these financial instruments have become available to not only SMEs, but to non-profit organizations and households.

#### **IV. Special Features of the FIs Intermediary System in Hungary (2007–2013): High Institutional Diversity and Extensive Mediation Network**

In the period 2007–2013, the diversity of institution types which deployed the repayable supports of the EU's cohesion policy played an especially important role in the development of the most appropriate financial products for the SMEs. For the member states to prepare for the 2014–2020 period, this conclusion has been disseminated by the

European Commission (EC 2016) as a recommendation, emphasizing that institutional diversity plays the most important role in adapting successfully to the SMEs' financing needs. The various institutional types which intermediated the repayable funds to the final beneficiaries showed a high degree

of diversity in Hungary (*Figure 3*), these financial instruments were deployed by commercial banks, local cooperative banks, local enterprise development agencies, and financial enterprises, providing microloans and (venture) capital funds.



*Figure 3:* High diversity of financial intermediary institutions in Hungary, 2007–2013.  
*Source:* edition of the author

In terms of the financial intermediaries' number a total of 415 mediation contracts were concluded by the end of 2014, and the number of intermediators was 165 at this time (NYIKOS GY. 2016b). Since banks and local cooperative banks had an extensive branch network in this period, territorially there was a very widespread network of intermediary points. The number of financial intermediaries was also outstanding on a European scale. This extensive network also operated with low costs and management fees (*Figure 4*). At the

same time the setup of the adequate legal framework for the financial products and the instalment of the intermediary network were quite time-consuming, therefore, at the end of the period, there was a serious pressure on the intermediary system to pay out the allocated amounts to the final beneficiaries in time, especially in the case of venture capital products. By the end of 2014, only 75 billion Ft were disbursed out of the 130 billion Ft framework of the available venture capital subsidies.



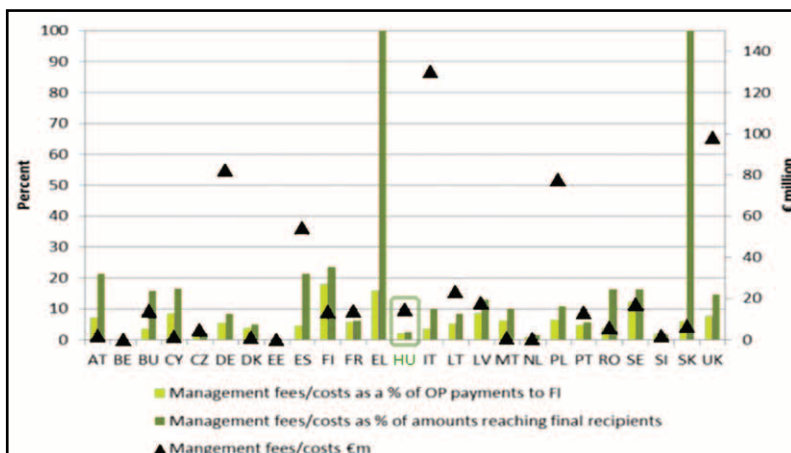


Figure 4: Management fees and costs of the financial intermediary system disbursing the repayable EU funds  
 Source: ΝΥΙΚΟΣ GY. 2016b

Looking at the breakdown of the financial intermediaries by type, at the end of the period (2014) the local cooperative banks and the financial enterprises have reached the largest number (Figure 5). Among the institution types the local enterprise development

agencies were the most successful; these intermediators concluded the most contracts. This was also determined by the regulations; the maximum available loan amount offered by these agencies was 10 million Ft.

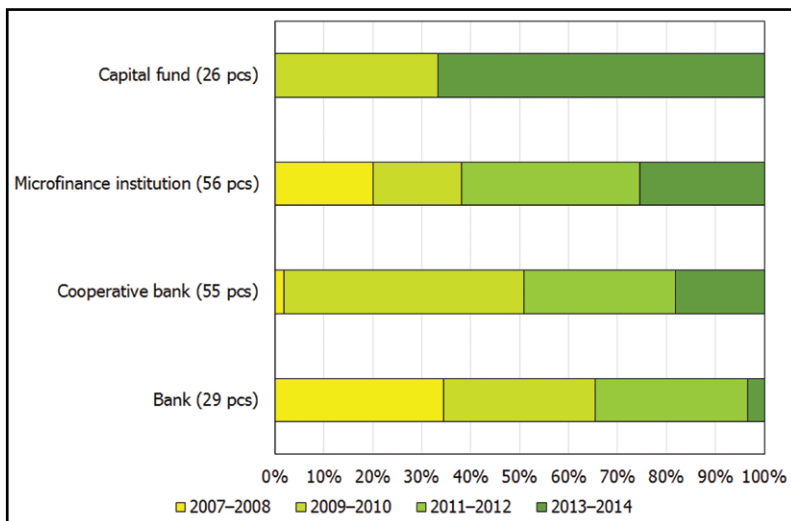


Figure 5: Date of accession and institution type (as a percentage of those institution which joined until 2014)  
 Source of data: HDB 2016

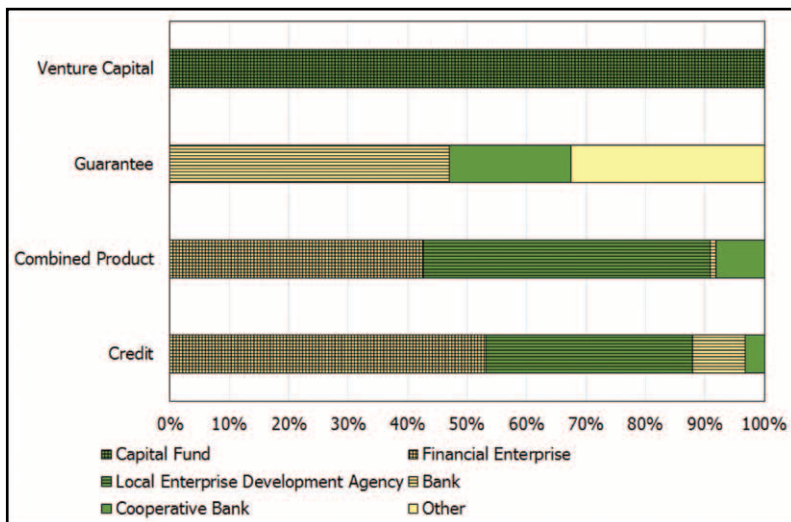


Figure 6: Intermediaries by financial products (transaction number %, July 2016)  
 Source of data: HDB 2016

A further specific feature of the Hungarian institutional system is that financial intermediaries were specialized in one single financial product. Loan and combined microcredit products

were offered by co-operative banks and local enterprise development agencies; the guarantee products by commercial banks, while capital products were disbursed through equity funds (*Figure 6; Table 1*).

financial intermediator	number of contracts with financial intermediaries					product types			
	12 2011	12 2012	12 2013	12 2014	12 2015	Loan	Comb. Micro.	Gua- rantee	Vent. Capit.
Venture Capital Fund Management Company	8	18	27	28	29				X
Commercial Bank	99	116	119	120	120	X		X	
financial enterprise (mainly loan intermediators)	53	76	94	97	97	X	X		
Cooperative Banks	76	111	134	134	134	X	X		
Local Enterprise Development companies	35	35	35	35	35	X	X		
total	271	356	409	414	415				

*Table 1:* Breakdown of financial intermediaries by institutional and product type in the 2007–2013 EU development period in Hungary

Comb. Micro. = Combined Microcred.; Vent. Capit. = Venture Capital

*Source:* NYIKOS Gy. 2016a

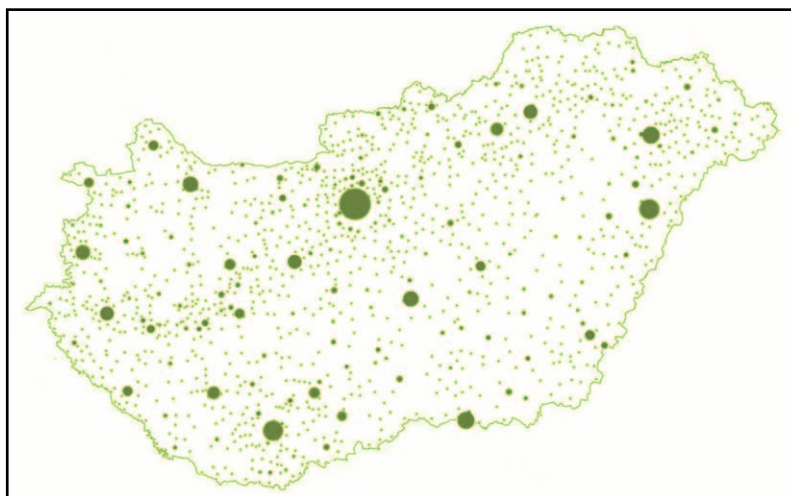
Among the credit products the combined microcredit was the most popular; 40 percent of the final beneficiaries applied for the JEREMIE Program contracted for these combined products. This meant nearly 5800 transactions and approximately 58 billion Ft to the Hungarian SMEs.

## **V. FIs and Their Intermediary Institutions Could Have Contributed More to Territorial Development**

Firms using financial instruments are characterized by

a strong territorial concentration. Most of the beneficiaries can be connected to Budapest and to the county seat towns (*Figure 7*). Regarding the sectoral classification of the beneficiaries, the highest geographical concentration is visible among the companies operating in the information–communication (ICT) sector. 60 percent of the financial

instruments were used in this sector, where most of the beneficiaries were settled in Budapest and Pest County. (SZÁZADVÉG 2016) The use of financial instruments was consistent with the general territorial features of capital flows and financial innovations (GÁL Z. 2014), outlining urban–rural inequalities.



*Figure 7: Geographical distribution of the reached enterprises with credit and guarantee products*

*Source of data: SZÁZADVÉG 2016*

In addition to the fact that in the use of these cohesion policy funds the most developed territories have dominated, in the breakdown of the beneficiary enterprises, instead of the micro ones, the medium-sized ones were in the highest number. In the background, due to the low willingness of

the small and medium-sized enterprises to borrow, to pay out these subsidies in time by the financial intermediaries, the scope of the target groups was extended by the medium-sized enterprises. At the same time the maximum available credit amount reached the 200 million Ft (even though,

microloans are generally below 10 million Ft in Hungary).

The unsuccessful reaching of the originally intended target groups is highlighted by the fact that in 2016 the size of the loan gap measured in the Hungarian corporate sector reached 570 million Ft (HDB 2016). This loan gap was estimated by the Hungarian Development Bank based on a representative survey, (1) partly due to the size of the refused loan applications, (2) partly due to the lack of credit supply (3) and the partly by the size of the loan applications that have not been submitted due to fears of refusal.

In terms of the use of capital products, urban–rural inequalities are even more prevalent, and regarding the details of this phenomenon, the effects of Budapest stand out.

Although Budapest and Pest County, the only competitive territories in Hungary have been excluded from many support scheme or have received a much lower allocation of funds, it can be seen in the nearest convergence regions that the beneficiaries are in many cases businesses with headquarters in the capital and only with branch offices in rural areas. Looking at the distribution of the investments by the location of project delivery, Northern Hungary and Central

Transdanubia are highlighted, because these two areas jointly receives more capital support than the other four convergence regions together (SZÁZADVÉG 2016). Their development level is strikingly different and the development gap between them is increasing. While the gross domestic product at market prices was at €6955 million in Northern Hungary and €8637 million in Central Transdanubia, by 2016 this has increased to €8832 million in Northern Hungary and to €11631 million in Central Transdanubia (EUROSTAT 2018).

Based on the final evaluation of the FIs in the period of 2007–2013 in terms of the geographical distribution of capital subsidies, it was revealed that there was a strong correlation between the number of capital investments and the number of innovative enterprises. Compared to the number of research sites, Central Transdanubia and Northern Hungary are highly over-represented in terms of their acquired resources. This is likely to be due the easy access of Budapest from the marked region's urban areas, especially in Székesfehérvár, Veszprém and Eger. In accordance with the general territorial characteristics of the banking system and the financial processes, in the spatial

pattern of the deployed FIs also the urban–rural inequalities were the most dominant.

## **VI. Mixed and Development Dependent FIs for More Cohesion Effects**

Based on the evaluation of the period 2007–2013, both the institutional system and the development of financial products need to be fine-tuned for the successful reach of the originally intended target groups. From the aspect of the territorial features of the institutional system it can be noted that in the bigger cities of rural areas the local cooperative banks were the most active actors, meanwhile in smaller settlements the enterprise development agencies. Beside this, the same two types of institutions were the most successful in deploying microcredit and combined microcredits, and thus in addressing smaller businesses.

Among the financial products, the strong Budapest effect, especially in capital products is partly due to the fact that the majority of the capital funds' headquarter is in Budapest and partly to the particularly strong territorial concentration of research, development and

innovation activities in the capital city. Budapest concentrated the 56 percent of researchers and developers in Hungary and 44 percent of research and development units in 2011 (HCSO 2016), meanwhile the capital city consisted the 37 percent of total GDP in Hungary and the 17 percent of population (homepage of HCSO).

To create financial products, which fit for the intended target groups' needs in a sufficiently standardized form, it would be a positive shift to mix the supports from the European Regional Development Fund (ERDF) and the European Social Fund (ESF) in financial product level. In the case of credit and guarantee products, it would mean the emergence of stronger educational functions, serving financial awareness and enhancing management competences integrating them in one single financial service package. In the case of capital supports, these financial services could be more integrated with mentoring and incubation activities, which could increase the efficiency of other enterprise development funds as well.

In order to reduce the strong Budapest effect in capital subsidies, in the transfer of capital products a more decentralized

intermediary system would be needed. For the creation of the above mentioned, mixed financial products with the ‘ESF-type’ activities, a higher level cooperation would be required between venture capital fund managers and the most important institutions of knowledge and technology transfer (for instance higher education institutions, colleges, start-up incubators, research institutes or think tank groups). By doing so, they could increase their own efficiency and the effectiveness of cohesion policy at the same time. In order to establish these connections, venture funds have to change their institutional behaviour, modifying their decision-making system (on business model level) and their location selection methods as well. This step would create a more diversified institution system in the financial intermediation, expanding the institution types of the Hungarian intermediaries with the organisations responsible for the knowledge and technology transfer and with the appropriate social organisations that aim to increase financial literacy and awareness. To reach the above-mentioned goals local cooperative banks and commercial banks may

also need transformations in their operational and management model, which points have been already highlighted by Gál and Burger (GÁL Z. – BURGER Cs. 2011).

In align with the territorially based eligibility system for cohesion policy funds and for other EU subsidies, in the planning of the financial instruments a further breakthrough could be the creation of development-dependent tools on level of the final beneficiaries. In the development of these financial products, in line with standardization requirements, the development level of the applicants’ place of business and the applicants’ own development level could be the basic determinants, so that the lower the development level of a territory, the greater the proportion of the financial education purposed ‘ESF-type’ activities in the microcredit and guarantee products. In order to increase financial competencies, this ESF-type support would ensure the developing abilities of enterprises to make them capable to receive the repayable EU funds and on long term to prepare them to get finance on financial markets.

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