1

Introduction

This book investigates the role of financial markets for corporate decisions and macroeconomic performance in the transition process, focusing on the experience of Hungary, one of the early reformers among formerly centrally planned economies. The book presents the results of an empirical analysis of company accounts for a large panel of Hungarian firms between 1989 and 1999, focusing on the role of financial market imperfections in determining corporate capital structure and investment decisions. This introductory chapter provides a brief discussion of the motivation and structure of the book.

The emphasis on the role of financial market imperfections for firms' decisions is due to three main reasons. First, in recent years this topic has received increasing attention in the theoretical and empirical economic literature. Second, there are specific aspects that make financial market imperfections particularly relevant for Eastern European countries. Third, the role of credit and financial markets during the transition process has been somewhat neglected by the literature on transitional economies, partly because initially other issues, such as labour market dynamics, appeared to be more relevant, and partly because of lack of adequate data.

In the past decades, financial market imperfections have been one of the central topics in microeconomics and macroeconomics, both theoretically and empirically. Recent developments in the theory of asymmetric information have produced an alternative approach to the standard neoclassical framework in the analysis of financial markets. Whereas in the standard neoclassical framework financial markets play a marginal role with respect to the real side of the economy, the new approach based on asymmetric information places financial markets at the core of macroeconomic dynamics. A number of contributions showed that financial market imperfections are a crucial factor for both short term and long term macroeconomic dynamics. In a long run perspective, growth is linked to the degree of development and efficiency of financial and credit markets (see, among others, King and Levine (1993a), Beck *et al.* (2000)). In a short term perspective, taking into account financial market imperfections allows to improve, both qualitatively and quantitatively,

the description of the propagation mechanism that explains aggregate fluctuations.

In the literature on the role of financial market imperfections, most contributions refer to developed economies. However, informational failures that are at the core of financial market imperfections are generally more pronounced in developing countries. Although transitional economies can be considered in many respects similar to developing economies, there are some factors specific to formerly centrally planned economies that made the initial conditions of Eastern European credit and financial markets quite unique. In particular, it is important to consider the organisation of economic relations during the planned system and, consequently, the challenge faced by financial institutions in the transition process.

In the planned system the financial sector was to a large extent fictitious, while generally firms had no binding budget constraint. If a firm was in shortage of liquidity or credit, a commercial bank could be ordered to provide an additional loan to the firm. The solvency of the whole system was secured by the central bank, that had always the possibility of printing money without generating inflation, since prices were controlled administratively. Moreover, as the problem of solvency was non-existent, there was no difference between borrowing from banks or from other firms. Therefore, at the beginning of the transition process, firms' debt was composed largely of *interenterprise credit.* Because in their lending decisions banks were merely executing what was stated in the plan, they hardly exercised any monitoring or risk assessment activity. As a result, at the beginning of transition, even if banks had an ongoing long term relationship with some firms, this relationship was largely uninformative.[1]

With the beginning of transition, the central bank no longer exercised a passive role, hard budget constraints were gradually imposed, and banks had to start providing, in a short period of time, a range of quite sophisticated services, often without the ability to do it. Moreover, the needs that they were facing were not comparable to those of a developing country, but rather to those of a developed economy. In this perspective, banks in Eastern European economies were in a worse condition than in other developing countries, because they did not have time to adjust to the needs of a growing economy. All the rules and regulations of financial intermediation had to be designed, starting from adequate bankruptcy procedures. Most importantly, banks had to develop monitoring skills: they had to collect information on their customers, learn how to assess risks and implement all those actions that reduce informational failures in the borrower-lender relationship.

Moreover, the early stages of transition were characterised by a high level of economic instability. In an unstable economic system, current performance is a poor indicator of future performance. Therefore, not only borrowers did

[1] A detailed description of how the credit system operated in planned economies is provided in IMF *et al.* (1992).