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Conclusions

In the past two decades the Hungarian financial system has undergone a number of major changes in order to increase its efficiency. In particular, the banking sector reform was aimed at the separation of central banking and commercial banking functions, the restructuring of commercial banks and the definition of an appropriate regulatory framework. At the same time, the introduction of a new bankruptcy law was intended to enhance allocative efficiency and to provide agents with the appropriate incentives.

Institutional reforms *per se*, however, are not a sufficient condition for the achievement of an efficient credit allocation system. Once the new rules are created, agents have to learn to play by the rules. In particular, in transition economies, lenders have to develop project appraisal and monitoring skills, while borrowers must learn to respond appropriately to the new system of incentives. Whether the reform process in transition economies has succeeded in establishing an efficient incentive-based economic system is an open and much-debated issue.

In order to shed light on these issues, this book presented the results of an empirical investigation of the behaviour of Hungarian firms during the transition process, focusing in particular on the role of financial market imperfections for firms' capital structure and investment decisions. Following a survey of the theoretical and empirical literature, we started our analysis of the Hungarian experience by describing the evolution of the Hungarian economy since the beginning of transition, analysing in particular the role of financial markets and their transformation throughout this period.

We then moved to the microeconomic level, providing a descriptive analysis of corporate financial positions in Hungary between 1989 and 1999, focusing on indicators of leverage, liquidity, profitability and efficiency, and providing a characterisation of the static and dynamic features of the distribution of firms' financial positions. We found that Hungarian firms made relatively little use of external debt, and that a large fraction of firms did not use bank credit, while making extensive use of commercial credit. The debt structure ratio was remarkably high, both in absolute terms and when compared with other

countries, indicating that Hungarian firms made little use of long-term debt to finance their assets and, as a consequence, were highly vulnerable to shocks to their financial position. The current ratio indicates that this peculiar debt structure, based on a prominent role of short-term liabilities, is matched by a similar asset structure. Profitability indicators are quite low in international comparison, reflecting on the one hand the severe impact of the recession of the early nineties, and on the other hand the overall impact of firms' restructuring in the transition process.

These results for the overall sample were found to be largely robust to the disaggregation into sub-samples defined according to ownership (state-owned, private domestic, foreign), size (small, medium, large) and industry (Agriculture, Construction, Manufacturing, Utilities, Trade). State-owned firms have lower leverage than private firms and, within the latter group, foreign firms are significantly more leveraged than private domestic firms. State-owned firms display higher financial debt ratios than domestic private firms, and are the ones characterised by the highest pressure of interest expenses. As for liquidity, the debt structure is similar across ownership types. Profitability is lowest for state-owned firms, in terms of both return on assets and return on equity, reflecting low efficiency as measured by asset turnover and gross margin. Large firms have lower mean and median debt-asset ratios than small and medium firms, and are characterised by a higher bank debt and coverage ratio. Small firms tend to have a higher fraction of short term debt. Profitability is negatively related to size, largely reflecting a higher asset turnover ratio for small firms.

As for the evolution over time of the distribution of financial positions, the average debt-asset ratio rises between 1989 and 1992, to remain virtually stable thereafter. The average debt structure declines gradually throughout the sample period. The high percentage of short term debt appears to be mainly inherited from the past, rather than the outcome of the transition period. Profitability indicators display a procyclical behaviour, following closely the dynamics of the aggregate cycle. Intra-distribution mobility is quite low for all the financial ratios considered, with the only exception of profitability indicators.

Next, the analysis focused on the determinants of the capital structure of Hungarian firms in the 1990s. The aim was to investigate the presence of constraints for firms in achieving their optimal capital structure and, more generally, the efficiency of the banking sector in providing credit. The results indicate, on the one hand, a pecking order in firms' financing choices, suggesting the presence of forms of financial market imperfections that constrain firms in the achievement of their optimal capital structure. On the other hand, reforms seem to have hardened firms' budget constraints and rendered the credit allocation process more efficient and market oriented.

Finally, we examined the role of financial factors for corporate investment decisions, exploring differences before and after the introduction of major financial reforms, across sub-samples of firms defined according to size and