Hungarian Enterprise Behavior in the Transition: 1991-92

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I. Overview

This study examines the behavior of Hungarian enterprises during 1991-1992. While it is based on interviews with six Hungarian firms:

- Budaprint, a state-owned textile enterprise;
- Gedeon Richter, a state-owned pharmaceutical firm in the process of being privatized;
- the Hungarian National Oil and Gas Trust, an integrated energy firm in the process of being reorganized for privatization;
- Műszertechnica, a privately-owned firm engaged in the manufacture of computers and electrical equipment;
- Szim, a state-owned firm in the machine tools sector;
- Taurus, a state-owned firm producing tires and rubber products;

these firms among them encompass a broad range of problems and characteristics typical of Hungarian industry. Thus, we believe that relatively broad interpretations and conclusions can be drawn from these case studies.

To further test the validity of the case study approach as a tool for investigating the effects of the transition from socialism to capitalism on East European firms, each of our respondents was interviewed twice, the first time in January 1991 and the second in the Spring and Summer of 1992. The earlier set of interviews was written up before the reinterviews were carried out, and they are presented below in unrevised form. This affords the reader an opportunity to compare our evaluations and prognostications based on the earlier set of interviews with what actually happened to the firms in the following year or more. Thus the reader should be able to form some impression of the utility of enterprise-level interviews as a tool for prognostication in a relatively turbulent environment.

Because the firms in this sample were strongly influenced by domestic and foreign shocks, we precede the case studies with a description of the economic and policy environment in 1991-92 and draw some general conclusions from the interviews. These conclusions are further refined after presentation of the interviews and their updates.
II. THE DOMESTIC ECONOMIC ENVIRONMENT AND ENTERPRISE BEHAVIOR

A. Overview

There were three principal impulses from the domestic economy that influenced enterprise behavior during the period under review. The first was the effect of the government's tight monetary policy, which acted to reduce aggregate demand; to force many enterprises to rely on inter-enterprise debt rather than on bank credit; and to hamper restructuring efforts of enterprises by making it difficult to obtain funds required for a restructuring of production. The second effect was a decline in aggregate demand, which made itself felt either in a reduced demand within Hungary for the output of the firms interviewed or in an increased degree of price competition and reduced profit margins on domestic sales. Finally, firms began to perceive a new regulatory regime emerging, one where they would face harder budget constraints and be required to make strategic decisions with less influence from government authorities.

B. Macroeconomic Conditions and Policies in Hungary

The macroeconomic policy stance has basically remained the same during the last ten years or so. The number one priority has been restrictive demand management in order to accelerate structural change in the economy and to maintain Hungary's ability to service foreign debt. From one year to another, though, quite significant shifts occurred among other important macroeconomic priorities like export performance, balance of payments, inflation and the budget deficit.

Improving or altogether good export performance during the last two years or three put the other priorities higher on the list. This does not necessarily mean that these "especially targeted" macroeconomic variables always showed the necessary improvement. For example, even if combatting inflation has been one of the arguments the government used in order to justify monetary restriction and the gradual withdrawal of the state from financial commitments linked to social and educational policies, the rate of inflation has been steadily increasing during the last few years. Whereas its rate did not reach 30% p.a. in 1990, consumer prices increased by 35.6% between January-September 1990 and January-September 1991 (KSH Tajékoztató, November 15, 1991).

Another example, now in a positive sense, of the relative inefficiency of monetary and fiscal policies in influencing macroeconomic developments was the unexpectedly low budget deficit in 1990 (HUF 1.4 billion instead of the HUF 9.9 billion planned for that year) which occurred due to surprisingly high corporate tax revenues collected at the end of the year.

If the efficiency of monetary policy is measured by monetary growth, then Hungarian monetary policy can be considered satisfactory. The growth of M2 has remained somewhat below that of the GDP deflator in 1990 and 1991 (by -0.8% in 1990, and by approx. -0.3%
in January-September 1991). The increase in interest rates came to a halt after the first quarter of 1991, and they seem to have stabilized, short term ones at 35% p.a., although several experts think this has occurred due to exceptionally favorable seasonal or conjunctural effects such as good crops, almost no increases in fuel prices, etc.. Nevertheless we have no reason to underestimate the favorable impacts of tight monetary policy. It is undoubtedly more than just an impression that Hungarian entrepreneurs, enterprises, state institutions and the households complain about the increasing scarcity of money. This is reflected by the fact that black market exchange rates of convertible currencies have never exceeded official rates by more than 5% since the Summer of 1990.

The situation of the budget has changed for the worse in 1991. Although the forecast of the 1991 budget deficit was HUF 78 billion it will probably exceed HUF 100 billion and 5% of the GDP, after reaching 3.5% in 1989, and practically 0% in 1990. This will be mostly due to the collapse of exports to Eastern Europe, a 5% decrease in household consumption and a 15% fall in the volume of gross industrial output.

The changes in the macroeconomic situation during 1991 point to the strong commitment of the government to keep monetary developments and external balances under strict control at the expense of the entrepreneurial sector and the households. The decrease in GDP, -7% as compared to -4% in 1990; in domestic absorption, -7% as compared to -5% in 1990; in gross fixed investment, -12% as compared to -6.3% in 1990; in household consumption, -5% as compared to -4% in 1990; and in gross industrial output at constant prices, -15% as compared to -8.5% in 1990 [forecasts from KOPINT Report 1991/3 (November), p. 72] with the annual CPI up by 35% from 29% in 1990 are all signs of a deepening recession. But the other side of the coin is that exports were down by only 5% from the 1990 level and the balance of payments deficit was USD 300-400 million only, less than half the forecast by the government in early 1991.

All the developments surveyed here show that the Hungarian economy has suffered a minor shock as compared to Poland, which is undergoing a really dramatic shock therapy. Hungary’s future development depends largely on how well the government can introduce incentives to productive investment and speed up privatization but it seems quite clear that not the whole productive sphere will need to be rebuilt from scratch.

C. Effects of Declining Domestic Demand

All firms reported that domestic demand for their product had either declined or, in the case of Müszertehnica and Gedeon Richter, that the profitability of domestic sales had fallen because of increased competition in the case of the former firm and rising costs and fixed domestic prices of output in the case of thee latter. Since the firms in the sample tended to export 60-80 percent of their production, the decline in domestic demand alone would not be a serious problem. However, when combined with import competition and the decline in sales to the ex-CMEA area, the total decline in demand has represented a significant shock for all the firms with the possible exception of Müszertehnica and Gedeon
Richter, who managed to retain much of their ex-CMEA markets, principally due to unique circumstances.

A second source of changes in demand for some firms was the liberalization of prices in Hungary and the elimination of subsidies for food and energy. These relative price changes had two effects. One was to alter the pattern of consumer demand away from food and basic consumer goods, such as textiles in the case of BudaPrint. The other effect was to raise the prices of energy and energy-intensive inputs.

Finally, some firms, such as Szim and Taurus, had domestic deliveries that were tied to the exports of other Hungarian firms, in the case of these two firms, the exports of buses by the Hungarian bus-maker Ikarus. In this way, what was a foreign trade shock for Ikarus from its loss of sales on the ex-CMEA markets in these two cases appears as a decline in the domestic sales of the Hungarian firms interviewed. Thus the operation of the so-called foreign trade multiplier is evident in this cascade of declining demand.

D. Effects of Monetary Policy

In 1990 and 1991, the government pursued a tight monetary policy for three reasons. One was to prevent the price increases caused by the elimination of food and energy subsidies from evolving into a self-sustaining inflationary spiral. The second objective was to restrain aggregate demand in a period when the import regime was being liberalized. The third objective was to promote a restructuring of industry by means of a tight-money policy that would force inefficient firms to improve their performance or to go bankrupt. The first two objectives, largely macroeconomic in nature, appear to have been achieved. The last objective, largely microeconomic, appears, based on our interviews, to have been only partially fulfilled at best.

The tight-money policy has had two additional consequences. One is a lack of long-term capital for the restructuring of enterprises. The other is an explosion of inter-enterprise debt. Under the old system of payments in Hungary, firms needed little in the way of working capital. Payments for their products were settled through the State Bank within a period of days or weeks in the case of sales to domestic and CMEA customers; only in the case of sales to the West were normal commercial payment terms with longer payment terms used. Even in the latter case, however, the National Bank of Hungary advanced forint payments against payments of hard currency due from foreign buyers.

The queuing (involuntary inter-enterprise debt) problem arose already in the two-tier banking system introduced in early 1987. Payments between enterprises have been settled through their respective merchant banks. The queuing problem originated as the result of a very severe and sudden, moreover, partly retroactive, credit crunch in early 1988. It is suspected by prominent experts that queuing is far from being only a result of liquidity problems of loss-making firms that would face bankruptcy in a market economy. Even some profitable enterprises do not pay their bills or pay them with considerable delays, using their
portfolio of different bank accounts in different banks. These companies simply use this sort of cheap debt as a substitute for expensive bank debt.

The banking reform left the financing of Hungarian enterprises to newly-created commercial banks and then, when monetary policy imposed tight lending limits on the banks, firms found themselves with insufficient capital to finance day-to-day purchases of inputs. This appears to be true for both the profitable and the unprofitable firms interviewed. A not a typical result of this situation was the respondent firm whose sales in 1990 fell by 20 percent but whose receivables and payables doubled despite a profitable year. Payment delays of 30 to 90 days and more beyond the due date were often reported and, given the high rates of inflation in Hungary until very recently, not only a lack of liquidity but also economic self-interest acted to induce even profitable firms to stretch payment terms wherever possible. Moreover, Gedeon Richter, which was continuing to export pharmaceuticals to the USSR, also reported payment delays from that country as well as from the Hungarian government. Indeed, only the private firm, among those firms interviewed, appears not to have suffered a serious degradation of its balance sheet due to overdue payments. Its managers did acknowledge delays in payments from Hungarian state-owned firms, but for this firm such delays were manageable. This was partly due to the fact that, because the firm, being private, did not have access to government credits in the past, and thus had to maintain an adequate level of working capital in the pre-tight-money period. Second, its dealings with the state sector in Hungary were a small part of its business. Finally, it may also be that because it was a private firm, state-owned firms tended to pay their obligations to it more promptly because it was not party to the tacit agreement among state-owned firms to accept payment delays.

The responses of the firms did not suggest that the growth of inter-enterprise debt and the shortage of working capital hampered production by restricting their ability to purchase inputs. In this regard, it was only in the case of imported inputs, where payment could not be delayed, that managers expressed any concerns, but all firms in our sample that raised concerns about short-term liquidity were able to allocate funds for needed imports. Nevertheless, there is some possibility that the easier payments terms on the domestic market relative to imported inputs caused some otherwise uneconomic import substitution by Hungarian enterprises.

While managers were not excessively concerned about the effects of growing inter-enterprise debt on production, all of them were to various degrees concerned about its financial implications for their firms. Some firms, such as Gedeon Richter, viewed the accumulation of short-term assets of dubious quality as making the privatization of the firm more difficult since such assets would make the firm less attractive to foreign investors. Other firms also voiced concerns about the likelihood that some of the firms to which they had extended credit would not be able to pay their debts.

Despite these concerns, there seemed very little interest among managers of the state-owned firms toward refusing to sell to customers who could not pay promptly. Similarly,
the attitude of many managers was that the only way to rectify the problem would be to greatly expand the amount of credit available from the banking sector.

The lack of credit and the inability to raise additional funds in other ways appeared to be influencing the behavior of the state-owned firms in terms of restructuring. Many reported a lack of funds for capital investments that were viewed as vital for changing production in order to become more competitive on domestic or western markets. It should also be assumed that expenses associated with the maintenance of equipment and buildings are suffering as well. The inability to raise money domestically may also be playing an important role in influencing Hungarian firms to seek western firms as joint-venture partners or as possible investors, since these are the most obvious and perhaps the only ways to tap western capital.

The ability to create capital by not paying short-term obligations is also hampering the restructuring of the Hungarian economy, according to some respondents, because it enables loss-making firms to avoid bankruptcy, thus forestalling the movement of resources to more productive sectors. Managers of firms that were either losing money or unprofitable tended to take another view. First, they pointed to the fact that considerable restructuring and downsizing of their firms had taken place, see for example the Budaprint and Szim cases, and restructuring was continuing, at times in the face of political opposition. Second, they argued that much of their firm's long-term debt had been incurred as part of previous government-organized restructurings or injections of capital designed to make the firms viable. Indeed, this attitude that enterprise long-term debt had been arbitrarily and somewhat randomly imposed on firms and that it represented obligations that reflected past decisions of a now-discredited political system was widespread among our respondents. Thus, managers were resentful of this and at the same time somewhat fatalistic about the situation of heavily indebted firms. They were attempting to meet their long-term debt obligations, but it appeared that the servicing and repayment of long-term debt had the lowest claim on enterprise funds. In part this may reflect the above-mentioned belief that enterprises had little moral responsibility for these debts but other factors may be important as well. Among these are a belief that banks will not take action against enterprises unable to service their loans; uncertainty regarding the long-term creditability of the hard-budget tight-money policy; and the fact that the Hungarian capital market offers no useful means of refinancing firms in a way that would make debt-repayment easier. Thus servicing the debt out of operating profits, if these exist, is the only option for many firms.

The danger with this situation is that because these "old" debts are somewhat arbitrarily distributed among enterprises by past government investment policies, some firms that would prove profitable if unburdened by debt will fail even if they can operate profitably in terms of current revenues and expenses because they will lack the cash-flow needed to service debt. Moreover, the enterprise sector as a whole may prove to be "cash-starved" and unable to provide sufficient investment funds for restructuring and technical renovation.
III. INTERNATIONAL ECONOMIC ENVIRONMENT

A. Overview

All enterprises in our sample save the National Oil and Gas Trust depend on foreign markets for 60-80 percent of their sales. Exports tended to be equally divided between western markets and the ex-CMEA countries. With the economic collapse of the Soviet and East European economies and the reunification of Germany, sales to the CMEA countries declined in 1990 and the decline continued in 1991 with the breakdown of the CMEA and the reversion of its members to trade at world market prices and payments in convertible currencies.

B. Policy Measures and Recent Developments

The Impacts of Import Liberalization:

The list of import items subject to liberalization has reached 90% of all items of commodities imported. The impacts of liberalization have been clearly positive in creating a competitive domestic market environment. It had to be accompanied by a restrictive demand management in order to avoid the collapse of the import-competing producers and of the trade balance. Even so, a few sectors like consumer electronics have almost completely disappeared due to import competition that increased abruptly, leaving no opportunity to Hungarian producers for a "soft landing." Other domestic producers complain that they are unable to compete with foreign producers with very aggressive sales policies supported by large marketing budgets are producers of detergents, textiles, building materials and shoes. Another important fact is that the Hungarian customs duties system (average tariff rate: 13%) is not supported by few NTBs (non-tariff barriers) commonly used in all OECD countries.

Figures on Trade Performance:

The annual growth of convertible currency exports was 12.3% in 1988, 5.0% in 1989, and 9.5% in 1990. The comparable figure for all exports will be -5 to -6% in 1991.

Convertible currency imports declined by 2.8% in 1988, increased by 7.1% in 1989, 2.8% in 1990. The comparable figure for all imports for 1991 will be between 0 and 1%.

Terms of trade figures:

102.4 (1988), 102.8 (1989), 100.4 (1990). The KOPINT forecast for 1991 is 88.0. This deterioration will be due mostly to a sharp increase in import prices of oil, gas, etc., from the Soviet Union due to the conversion to payments in dollars.

Vis a vis the West, the most important measure was the liberalization of import restrictions so that by 1991 less than 10 percent of imports required licenses. This was achieved without creating a hard currency deficit and trade liberalization appears to have had positive effects on competition and on input supplies on the domestic market.

Trade with the ex-CMEA countries fell in 1991 in large part because Soviet enterprises lacked the hard currency to purchase Hungarian goods. In the case of Gedeon Richter, exports of pharmaceuticals to the USSR continued because these were purchased by a Soviet trading company with centrally allocated foreign exchange. In the case of Műszertechnica, sales are based on a scheme of bartering personal computers for Soviet steel; a process legal in the USSR only because the parties to the barter process are engaged in a joint venture. In addition to declining demand, the interests of some Hungarian exporters in the CMEA market has been reduced by administrative measures including a 30 percent tax on exports cleared in rubles.

C. Trade Relations with the West

Perhaps the most favorable development mentioned by firms was that Hungary’s import liberalization made it easy to import equipment and components from the West without undue delay. Of course, since firms could not delay payments on imports in the way that they could on domestic purchases, liquidity constraints limited respondents’ ability to import from the West. A number of firms, including Műszertechnica in computers and Budaprint in textiles, indicated greater market competition from imports including an increased market share for foreign producers and lower prices as the result of price competition.

All firms in the sample were attempting to increase sales to western markets. Some, such as Taurus, which had received support from the World Bank for a consulting study of its market position, were engaged in long-term measures to alter their technology and products to make them more competitive in western markets. However, the principal response to the need to expand sales to the West was to seek out joint venture partners. In part this is seen as a response to the relatively weak marketing network that most firms had in the West. Taurus perhaps had the strongest distribution network, but none of the firms interviewed had a strong structure of affiliates, subsidiaries, warehousing or production operations or even sales offices in western countries. Thus the extent to which exporting was used to penetrate foreign markets is much greater than would be the case in western firms of comparable size and dependence on foreign markets. Joint ventures are seen as a means for overcoming this structural weakness quickly and without the need to expend resources to develop foreign sales, service and production networks or to await the trained international business specialists that such a strategy would require.
D. Trade with the CMEA

Because the USSR played a pivotal role in Hungary's exports to the CMEA region, the developments of 1990 and 1991 had a particularly severe impact on Hungarian enterprises. With a few exceptions (Műszertechnica and Gedeon Richter), most respondents expected no exports to the USSR in the first half of 1991 and only several had some faint hopes that they could begin to export to the USSR in the second half of 1991 or by 1992 at the latest. On the Soviet market the difficulty is that Soviet importing firms must pay in hard currency for their imports from Hungary, and often they have no access to this means of payment. Managers of several firms said that there was a significant demand for their products in the USSR, and they hoped that barter arrangements or some non-dollar form of clearing could be arranged.

Possibilities for the improvement of the volume of exports to the USSR are mixed. On the one hand, the Hungarian government appears not to want to extend credits for the financing of exports to the USSR nor is it especially anxious to allow a reemergence of a large barter trade with the Soviet Union on the assumption that such trade would slow the restructuring of industry and help perpetuate the dual-sector (one for exports to the West, the other for exports to the USSR) nature of Hungarian industry. At the same time, knowledgeable respondents in Hungary reported that the devolution of central power in the USSR to individual republics has already given rise to a seemingly significant volume of barter trade between Hungary and those republics, like the Ukraine, that are sufficiently close to Hungary and have something to barter. What the true volume of this trade might be, and what its significant is for the firms in our sample could not be determined. Nevertheless, the payments difficulties of the USSR and the weakening of central authority in that country suggest that barter arrangements may have some useful role to play in restoring Hungarian trade with the USSR.

IV. CORPORATE RESTRUCTURING STRATEGIES

A. Overview

Both Hungary's foreign trade and macroeconomic policies as well as the shock from the collapse of ex-CMEA trade serve as an important impetus for the restructuring of Hungarian industry. Restructuring involves a wide range of activities and possibilities for Hungarian firms. First, it is to be understood that any restructuring activities entail a decreased dependence on ex-CMEA markets and a proportionally larger role for domestic and Western sales. This already raises the question of size, since some firms may not be able to shift products from the East to the West, and they must therefore reduce output and employment, even to the point of going out of existence. Other firms may wish to expand as their success on the domestic or western market dictates. A second element of restructuring involves changes in the product profile of individual enterprises as their market focus changes. Such changes in output profile may also be accompanied by changes in the firm's
technology. Finally, restructuring may involve changes in the organization of the firm’s business operations, for example by reorganizing management, the legal corporate structure or the nature of the firm’s ownership. Some element of all these restructuring strategies could be discerned among the firms interviewed.

B. Barriers to Restructuring

Changes in the size of firms is hampered by several factors. The first is that there are formal and informal political and social barriers to laying off workers and shutting down workplaces. Particularly in the case of firms that operated plants in small towns outside Budapest where the employment effects of shutdowns would be severe, managers noted that decreases in the workforce that were being implemented were often smaller than purely economic factors would dictate largely in response to government pressure or "expectations" that state-owned forms would do their part to help ease the problem of open unemployment. Firms also reported that tax laws made it less attractive than it might otherwise be to reduce employment as the financial benefits often accrued to the government rather than to the firm. Nevertheless, a downsizing of the labor force was a very common response, with Taurus, Szim, Budaprint, for example, all reducing their workforces by significant numbers.

The only firm with appreciable current interest in expanding its operations was Müszertechnica, and the principal barrier appeared to be financial rather than the acquisition of necessary plant or equipment. The firm was planning to sell stock to the public to raise funds for expansion. It had purchased buildings from a state-owned firm, and an inspection of the facilities suggested that the firm had ample space to expand production at this facility. Gedeon Richter was constrained from expanding its product line, and therefore, conceivably, its overall size, by a lack of funds for bringing new pharmaceuticals to the market. This process is quite expensive, but the firm was unable to obtain R & D funds from the state or necessary loans from banks to finance these efforts. It is probable that, had the other firms wished to expand their operations in response to market developments, they too would have faced few difficulties in obtaining the needed labor, plant and equipment, but considerable, if not insurmountable, difficulties in obtaining the necessary long-term finance for new capital or the short-term credits needed to meet increased working capital requirements. Firms that have inherited large amounts of long-term debt would be particularly handicapped in efforts to increase their production.

Finally, the concept of bankruptcy was neither well understood nor did it seem a serious possibility to our respondents, although some admitted that some affiliates or plants would prove inviable in the long run and have to be closed. Nevertheless, in the immediate future, firms neither feared being forced into bankruptcy nor expected to undertake liquidation voluntarily.

Changes in product structure were being undertaken by virtually all firms interviewed, but here too, a variety of barriers was mentioned by respondents. Financing was a problem for many firms, but perhaps more important were a lack of familiarity with western market
needs and, even more, a conceptual framework for utilizing that knowledge. Firms varied considerably in this respect. For example, Taurus’ management appeared to have a good understanding of the global tire market and the firm’s role within that market. In part this surely reflects the firm’s long-standing involvement in the world market and such good knowledge of the global market and the firm’s position on this market was also evident among other respondent firms, such as Gedeon Richter, who had a strong and independent involvement in the western market. Taurus was also assisted by a study prepared by western consultants financed by World Bank funds. As a result, Taurus was able to articulate somewhat more clearly a restructuring of production that was based on a strategic vision of the firm’s position on world markets. It must be added that the firm’s managers admitted that their restructuring was not wholly up to this strategic vision due to financial and government constraints on Taurus’ efforts in this direction.

Other firms were to varying degrees less able to convert their knowledge and current export experience toward the west into a strategic vision of what their competitive advantage was and how it ought to be exploited and nurtured. Evidence of this failure to think about restructuring in such a strategic way, a way of charting the firm’s future that is common practice among western firms, was evident in two types of responses regarding restructuring of products and production. One was the notion, expressed by several respondents, that the firms was seeking better technology, usually in the form of western machinery, in order to become more competitive. While there is no doubt that better technology would make better products, little thought seems to have been given to which machinery and for which product lines it ought to be obtained. More problematic is the fact that injections of new capital to raise productivity reflect the old pattern of restructurings of unprofitable operations practiced by the former regime in Hungary. The Budaprint and Szim cases are telling examples of efforts to make firms more profitable by injecting more productive equipment into the firm. While profits may go up in the short run, in the long run they may not cover the true costs of the investment.

A second set of responses that reflected a lack of strategic thinking that would link market analysis and an understanding of the firm’s competitive advantages into an integrated vision for developing production had to do with explanations of actual or anticipated changes in products or technology. Many of these, while perfectly rational and proper under the circumstances, were also entirely ad hoc, with no strategic vision behind them. Thus, for example, Budaprint was forced to import cotton from the West; due to the higher quality of this cotton relative to previous supplies from the USSR, the firm moved toward the production of higher-quality fabric. Whether the market situation, or the firm’s long-term market strategy was consistent with such a decision was not clear. One of Szim’s affiliates was able to obtain a large number of western orders for computer-numerically-controlled machine tools, and thus Szim’s management chose of subsidize this affiliate in the hope that it would become profitable. While these are relatively small business decisions, they in the end determine the firm’s range of products and technologies, yet there appeared to be little in the way of a strategic vision of what the firm ought to be doing and more of a view that if
it's possible to do it and there is some argument to do so, then any available course of action ought to be undertaken.

On a larger scale this lack of strategic vision was evident in the choice of joint venture partners. In many cases Hungarian firms appeared to be hoping that a western firm would turn up as a joint venture partner in order to enable the Hungarian partner to change the product mix so that it would better penetrate western markets. Thus Hungarian firms sought as joint venture partners western firms that were financially strong and that had good reputations for their technology. Whether the western firm represented a good fit for the Hungarian firm in terms of the Hungarian partner's own capabilities and strategic objectives seemed of lesser concern. Moreover, the Hungarian partners in the joint venture appeared more interested in projects that would lead to quick exports and some infusion of capital and technology than in seeking out partnerships that were consistent with their own strategic objectives.

While such reactions may prove in the end to have been correct and profitable, there is a danger that the pattern of production of Hungarian firms will reflect more the short-term exigencies and opportunities thrown up by western markets and joint venture partners than by Hungarian firms' long-term competitive strengths and capabilities.

Finally, there is some evidence of reorganization of the internal structure of firms, much of it toward structures to be found in market economies. Examples include:

- Műszertechnica, which is evolving from a cooperative to a closely held corporation to a firm whose shares will be sold to the public.

- Hungarian National Oil and Gas Trust, which is being reorganized into separate production and distribution companies, much along the lines seen in the energy sector of developed market economies.

- Szim and Budaprint are organized in a holding company and affiliate framework to centralize long-term debt management.

- Gedeon Richter is being reorganized as a prelude to privatization. In these changes, the motivating factors of financial exigencies and impending ownership changes predominate. With the exception of Műszertechnica, there were no major organizational changes being undertaken to better reflect the reality of expanded dependence on western markets or to increase firms' responsiveness to or competitiveness on western markets.

C. Implications for Hungarian Industry

To the extent that the findings of these interviews can be generalized to Hungarian industry at large, a number of conclusions can be drawn:
1. The collapse of the CMEA market has had a significant impact on the demand for the products of most Hungarian firms. Distinguishing between the effect of the CMEA collapse and the consequences of a decline in domestic demand, competition from imports and from changes in relative prices is difficult, but the CMEA shock appears to be quantitatively the largest impulse acting on Hungarian firms.

2. Hungarian firms are being forced to make adjustments in output and employment, although government policies make it difficult to adjust labor, and product profiles, as rapidly as firms may wish to do.

3. Most Hungarian firms are being forced to turn toward western markets, but their adjustment in this direction is hampered by a lack of capital. However, simply increasing the amount of credit to the Hungarian enterprise sector is unlikely to solve the problem. Due to the existing volume of inter-enterprise debt, the ability of the Hungarian capital market to distinguish between viable and non-viable firms is limited. Therefore both potential winners and losers are now being starved of credits, but more credits would likely also go to both, thus delaying restructuring even more. This is especially true of firms in the state sector.

4. Enterprise adjustments in output volume and mix are generally in the right direction although constrained by the macroeconomic environment and by policy factors. However, the managers of Hungarian firms are not formulating long-term strategies for their enterprises to the extent that may be desirable. The great dependence on the resources of potential western partners and a faith that infusions of western technology and know-how are the keys to future profitability are leaving the future profile of Hungarian industrial production in considerable part to serendipitous contacts between western and Hungarian firms.

V. CASE STUDIES

A. Taurus

*Company Background*

Taurus is a large, state-owned enterprise that produces a variety of rubber goods, with tires for trucks and farm equipment accounting for over 50 percent of total turnover (sales) of approximately 2,000,000,000,000 Ft. It employs about 9,000 workers at six factories in Hungary.

*Markets.*

*Current Market Situation.* Of its tire production, over 60 percent is exported, largely to developed and developing market economies, where it is marketed by local sales representatives and offices and by dealers, or through state channels in developing countries.
where state trading is practiced. The technical rubber division is more dependent on the domestic market (slightly less than 60 percent of sales) and on the export side on the CMEA market. The company also imports tires and other rubber goods and the resale of these products accounts for 25 percent of the company's turnover.

**Recent Market Trends.** Although over 60 percent of tire production is exported, the actual demand for this product is even more subject to influence from international trade because a large component of domestic sales involves the provision of tires to Ikarus, Hungary's bus manufacturer. With Ikarus' markets in the former CMEA countries disappearing, the domestic demand for Taurus tires also declined. A further source of demand decline was the reduction of economic activity in Hungary, and to a lesser extent in the western countries to which Taurus exports. These declines in economic activity led to reduced transportation activity and therefore lower demand for replacement tires that are a mainstay of Taurus' business. At the same time, Taurus has expanded its ability to produce radial track tires, thus strengthening itself in a growing market segment.

**Market Strategies.** The firm's long term strategies are evolving in the framework of a number of long term trends. The first of these is that the tire industry and, indeed, the rubber industry, are mature industries. In international terms, this has meant that with a relatively slowly growing market, firms compete largely on the basis of costs of production, which are to a certain extent influenced by economies of scale. Thus there have been numerous mergers and takeovers in the industry, as witnessed by Taurus moving from the world's 32nd largest tire producer in 1989 to 21st in 1990 as firms with larger production merged. Taurus has been approached regarding takeover possibilities, but so far has shown no interest, perhaps in part due to the uncertainties of its future under privatization.

A second long term trend is the growing predominance of radial tires in the truck market and, although bias ply tires continue to dominate the market for agricultural vehicles, Taurus is producing radial tires for both markets.

The firm has developed plans to acquire new technology, some through joint ventures with western firms, in order to both strengthen its abilities in traditional areas and to facilitate some measure of diversification into more dynamic activities, especially in non-tire activities. A number of joint ventures is in place.

Although the firm saw a 20 percent decline in demand over the past two years as the result of the collapse of CMEA trade, it benefitted from strategic decisions made in the late 1970s to place greater reliance on exports to western markets. This, plus the depreciation of the forint vis a vis western currencies, has led to generally growing forint revenues, although the ongoing inflation in Hungary makes financial data of limited value.
**Corporate Operations.**

Taurus, while nominally government-owned, has been under the control of its corporate council. Thus state ownership has not been manifested in the imposition of microeconomic goals. The prices of the firm's output have been largely decontrolled, and it is free to set its business strategy and to make Western investments it considers desirable. After the respondents made these claims, it became evident that some qualification to this picture of sweeping autonomy was necessary along the following lines:

- there were rather specific price equalization taxes and taxes on exports to the CMEA;

- there were general complaints that the government charges firms with social and political objectives, yet expects them to be profitable. While respondents acknowledged that the government's mandates on fringe benefits were acceptable, they argued that they would wish to shut down some product lines and eliminate some 8-900 workers, but this was not economical due to wage regulations;

- there seem to be a number of formal and informal ratios of performance variables to which the firm is expected to adhere.

**Financial Performance.**

The principal problem the firm faces is due to shortage of credit and the resulting expansion of inter-enterprise debt. Under the pre-reform system, the firm needed much less working capital as domestic deliveries were paid in 8 days and CMEA exports were credited when they crossed the border. The move toward convertible currency markets, where terms are 90 ± 30 days is only partly responsible for the payment delays the firm is experiencing. About three-fourths of the firm's domestic receivables are 30-60 days overdue. The firm is charging interest on these, but this is seen as neither preventing the erosion of these assets by inflation nor expediting payment. Indeed, in many cases the interest appears not to be paid. The obvious response for the firm is to delay its own payments to suppliers to the extent possible. It has generally exhausted its possibilities for raising short term capital. Thus the company's short term assets and liabilities have grown much more rapidly than the other items on its balance sheet.

The firm foresees the greatest dangers facing it as coming from the financial sphere. If the outstanding debts of enterprises to each other cannot be regularized and turned into bank debt or discounted, then the firm may become saddled with bad debts of its customers or experience difficulties from a shortage of working capital. A second incipient source of difficulty was government pressure, both at the national and at the local level, to preserve employment at the expense of profits.
Summary

Because the firm is oriented toward the west, it has suffered less than many other firms from the collapse of CMEA, although the effects of the CMEA-shock have not been negligible. Moreover, the strong hard-currency earnings of the firm give it a measure of independence. Nevertheless, it is not able to escape the effects of the Hungarian liquidity crunch. Also evident is the fact that the firm's strategic planning is somewhat behind that of western tire makers, in part because of the firm's uncertainties regarding future privatization. This firm has undertaken some restructuring, aided in part by the advice of western consultants obtained under a World Bank program, but it appears that the execution of this restructuring program is hedged by both the credit crunch that faces the firm and, perhaps more importantly, the perception of explicit and implicit limits on the amount of restructuring that would be tolerated by the government and by society. The possibility of the abandonment of certain product lines thus raises the issue of increased imports and their implication for the balance of payments as well as of increased unemployment and its macroeconomic and regional implications. While some of these concerns would also impinge on the strategic decisions of a firm in a West European country, they would not play as important a role as they do in Hungary.

B. Műszertechnika

Company Background

Műszertechnika is a privately-owned firm with over 400 employees and a 1990 turnover of about 25 billion forint. It has subsidiaries abroad, in Switzerland, the United States, Taiwan, the FRG and Czechoslovakia, as well as in Hungary. The firm began as a cooperative in 1981 and quickly branched out from the manufacture of electrical instruments to the assembly of IBM-compatible computers and later to other areas of electronics. It also has offices for computer service and maintenance, training computer users and operators, and software development.

Markets.

A. Current Market Situation. IBM-compatible personal computers account for the largest share of the firm's business, and Műszertechnika is a major factor on the Hungarian market. Company executives believe that imports (primarily from the West) account for about 50 percent of domestic sales, while Műszertechnika accounts for 20-30 percent of domestic sales, or 40-60 percent of domestically-produced sales. There are over 100 computer manufacturers in Hungary, although only 4 or 5 are large by industry standards. Currently PCs account for about 70 percent of turnover, and 30 percent of turnover is exported.

The company is also engaged in the production of: large-scale display boards for stadium, air- and rail-terminal, etc. use; asynchronous motor controllers; power distribution
systems (with the cooperation of Brown-Boveri); and telecommunications equipment. The firm's venture into telecommunications equipment is also a partnership, with Ericson, and was established to help that firm bid (successfully) to supply a switching center for the Hungarian telecommunications system. Some of these products are exported to the West.

The firm does not export its PCs to the West, but it does export components and subsystems, such as disc-drive controllers and software, to German-speaking countries. The Soviet Union is the main market for the firm's computers. While the traditional form of trade with the USSR has virtually disappeared, Műszertechnica has, however, continued to propose in the Soviet market for two reasons. One is a willingness and ability to find customers and to develop a special relationship with each customer. Second is the fact that Műszertechnica has a joint venture with a steel mill in Kazakhstan. Thus, even though Soviet firms now lack foreign exchange and are prohibited from engaging in barter trade (although a number of Hungarian respondents indicated that "informal" barter trade with the USSR was in fact taking place, generally with the active or tacit cooperation of Republical or municipal authorities in the USSR), the joint venture arrangement permits the two partners to engage in a profitable form of barter trade.

Műszertechnica ships personal computers to its partner in the USSR; given the high price of PCs there, the sale of these computers to Soviet buyers is very profitable for the Soviet partner. This partner pays for the computers by trading steel for them. Then Műszertechnica undertakes to sell the steel in Western Europe (eg. Italy, Germany, etc.) and in the Far East. The Hungarian firm incurs considerable expenses in the disposal of the steel, using its personnel to oversee the shipment of the steel in the USSR, storing it in Hungary and employing its agents to sell it in hard currency markets. These costs come to about 50 percent of the value of the steel received from the Soviet partner. Nevertheless, this business is enormously profitable and company officials appear to have little inclination to move out of this market prematurely.

B. Recent Market Trends and Market Strategies. Despite the current profitability of computers sales to the USSR, the firm recognizes that this market, or at least its present level of profitability, will not continue in the future. They cited both the possibility of political and economic instability in the USSR bringing a halt to their sales there and the likelihood that Soviet producers would eventually begin to assemble PCs from imported components such as Műszertechnica did. In addition to the eventual erosion of the Soviet market, competition, both foreign and domestic, have been driving down the price of computers in Hungary. Thus, the company is beginning to diversify away from computers; they currently account for 70 percent of sales but within two years, their share will be only 50 percent.

Emphasis will be placed instead on large display boards, the telecommunications venture with Ericson, power transmission (with Brown-Boveri), some consumer electronics, computers for banks (with a Brazilian partner) and other possibilities. To some extent, these are based on the firm's general expertise in electronics and to some extent they are driven by
market opportunities (for example, the partnership with Ericson). Nevertheless, they are all dependent on finding an appropriate western partner who, it would appear, will provide the technology and components as well as the marketing of the product in the West. Thus, Műszertechnica provides its strength on the Hungarian market, its skill and competitive costs in assembly operations and its know-how in electronics. As such, the firm is dependent on its western partners for the success of its diversification efforts.

**Corporate Operations.**

Műszertechnica is 100 percent privately owned, with 125 shareholders, all of whom are natural persons, and all of whom are affiliated with the company. Because it is not a public company, the shares are not yet traded. The firm wishes to make a private placement of shares for $10-15 million and then, within 12 months or so to go public either through a domestic offering followed by a foreign one, or directly on the Vienna Stock Exchange. There is also a possibility that the firm's foreign partners will choose to acquire some of its shares.

Given the ownership structure of the firm, management is entirely autonomous; there is no workers' council and the firm's workers are not unionized. More than 150 of Műszertechnica's workers have university degrees, and the average wage is 23,000 ft/month (versus the average industrial wage of 10-15,000 ft/mo). Labor costs are augmented by about 43 percent to cover insurance, wage taxes and other fringes. R & D expenses are about 5-10 percent of revenues.

**Financial Performance.**

Műszertechnica is profitable and will pay its first dividend in the Spring of 1991; on the advice of its bankers, it is continuing to reinvest the bulk of its profits. Because of the relatively liquid position of the company, it was possible to pay those accounts payable that it wished to pay (presumably in cases where it was seen as possible and advantageous to delay payment, this may have been done). The firm has experienced delays in payments from state-owned Hungarian firms. Its usual payment terms are 15 days, but actual payments are running about 30 days beyond that, and to protect its financial position, the firm has borrowed to cover accounts receivable (at a nominal rate of 32 percent, which is most likely a negative real rate).

**Conclusions.**

Because the firm is a private one, its finances were stronger than those of many state-owned firms interviewed, and this has helped the firm in the current circumstances. The firm has not suffered from the collapse of trade with the USSR, although its situation is unique. In general, the profitability of its computer operations depends on existing barriers and market imperfections in the former CMEA countries and the availability of computer components. The firm's leadership recognizes that long run viability will depend on the
ability to develop products whose profitability depends more on genuine competitiveness on world markets and less on exploiting trade barriers and market imperfections. In general, the way toward this end is being sought through joint ventures with Western firms. Műszertechnica has considerable room for manoeuvre in developing its business strategies, but such high dependence on foreign partners may impose new types of constraints on future decisions.

C. Szim

Company Background

Szim is a state-owned enterprise in the machine tool industry. The firm was established in 1963, when the government combined a number of machine-tool enterprises into one large multi-plant concern. This arrangement proved satisfactory for the 1960s. In the mid-1970s, the firm borrowed money (at the behest of the state, say company officials) to update its technology. Repaying these loans proved difficult in the latter part of the decade both due to the downturn of the Hungarian economy and due to greater fiscal stringency.

The firm’s difficulties led to a change in the management, the infusion of 1.2 billion forint in the form of a loan to increase working capital and improve the firm’s technology. The resulting restructuring reduced the labor force from 6,300 to 4,500, resulted in the sale of four factories, and changed the firm’s output profile from simple to computer-numerically-controlled machine tools that are higher unit value but less material intensive (the consumption of steel castings fell from 13,000 tons per year to 2,300). Such a restructuring was painful and politically controversial, especially over the issues of redundant workers and factory closings. Nevertheless, the restructuring had the desired results in the sense that profits increased from 56 million forint in 1980 to 700 million forint in 1987. These profits appear to have been posted before the repayment of the loans since the company’s officials cited loan repayments as the reason why Szim failed to upgrade its production facilities in the 1980s.

Changes in the tax system and the fiscal and monetary policies of the late 1980s led to a further reorganization of the firm. Individual establishments were set up as independent firms, wholly owned by the central administration, which was recast in the form of a holding company. The latter assumed all the liabilities of the former Szim, which it hoped to finance from profits of the eleven subsidiaries. The subsidiaries, being thus cleaned up from a financial standpoint, were able to appear as better joint-venture partners for western firms. The number of employees in the subsidiary firms is 3,500-3,700, and turnover in 1990 was expected to be 4-4.5 billion forint, reflecting the ongoing downsizing of the firm.

Markets

Current Market Situation. In the 1980s between two-thirds and three-quarters of the firm’s output was exported, with 30-40 percent of exports to hard-currency areas and the
remainder to the CMEA market. Of CMEA sales, in 1990 the Soviet Union accounted for 40 percent. Moreover, Szim’s sales of pneumatic brake systems for trucks and busses, some 30 percent of turnover, were very dependent on the requirements of the Ikarus bus factory, whose sales to the USSR have also collapsed this year.

Recent Market Trends. In 1991 Szim anticipates no shipments to the USSR because, although there is demand for Szim’s products, Soviet firms have no hard currency and no inter-governmental trade agreement exists between Hungary and the USSR to provide financing. This collapse of Soviet demand, coupled with declines in sales to the rest of CMEA and reduced investment within Hungary leads Szim’s management to anticipate a decline in production of 40 percent in 1991.

Market Strategies. Szim is following a dual-track strategy. One track consists of efforts to strengthen marketing efforts in the former CMEA market. Szim’s trading company is building up its sales organization in Romania, Czechoslovakia and the USSR in the hope that the second half of 1991 and 1992 will see a recovery of trade with these countries. The hope is that such a revival of trade, possibly on the basis of ad hoc barter arrangements would put Szim in a good competitive position if it can also produce products that embody modern technology and can be competitive with western products. Szim has also altered its product mix, moving from machine tools to equipment, such as a sausage-filling machine, that is likely to be in greater demand in the USSR.

The second track is to seek new markets in the West. This is being done in part through joint ventures and cooperation with western firms that previously supplied technology to Szim. For example, the Szim subsidiary that previously produced pneumatic brake systems for Ikarus obtained technical and marketing assistance through a joint venture with the western firm that supplied the brake technology (Knorr Bremse) so as to switch production to brake systems for trains. Similar efforts are being made in the machine tools segment of Szim’s business, sometimes on the basis of prior relations with western firms, in other cases on the basis of new relationships. Given its excess capacity, Szim can offer western firms the possibility to create new capacities, staffed by qualified and relatively inexpensive workers, much more rapidly than could be achieved by building new facilities in West Europe. An example of this type of strategy was a joint venture with the West German firm Maho. A complete production line for Maho machine tools was being installed in Szim’s Budapest factory (where the previous production equipment had all been removed) and in a new building that Szim had constructed. The output will carry the Maho trademark and will represent an important source of hard-currency sales for Szim. Hungarian workers will be trained both in Germany and in Hungary. Szim’s other operating companies are all being actively encouraged to develop similar partnerships, and several were reported to be in advantageous stages of negotiation with western partners. One success story was the subsidiary Budapest Machine Tool Company, which produces about 300-350 CNC machines per year. In 1991 it has orders for over 200 machines from the West, including 104 from the United States and 70 from Germany.
Corporate Operations

Szim is a holding company, with production taking place in eleven subsidiaries and joint stock companies, and two limited liability companies. Some of the production companies have foreign ownership, but the holding company has no outside owners. This lack of outside ownership in the holding company is likely to continue for several reasons. First, given the diversity of Szim’s activities, a foreigner having ownership interest in the holding company could be in a compromising position vis-à-vis a western rival who had a joint venture with one of Szim’s operating subsidiaries. In any case, since the financial position of the holding company is worse than that of the operating affiliates, there is little foreign interest in the holding company.

Each of the operating firms has a workers’ council and workers are also represented in the supervisory committee along with representatives of the owners, banks and foreign trade organizations. On the other hand, the holding company has only 23 employees, and thus it is not required to elect a workers’ council. Instead, all the holding company employees, presumably mainly managers of various sorts, take part in the General Assembly.

Management believes that there will be little direct privatization of Szim, principally because the machine tools sector is likely to experience more difficult times, and thus profit opportunities will be greater for investors in other sectors. The operating companies will hopefully attract foreign investors through joint venture arrangements, although management does not expect all the operating subsidiaries to survive the next few years.

Financial Performance

Szim is clearly struggling through a difficult period. The Holding Company holds the debt of the operating subsidiaries, and thus carries the burden of trying to manage this debt while allocating resources among the operating subsidiaries. In part this reflects the old Hungarian pattern of cross-subsidization, with profitable units taxed to subsidize loss-making ones. Thus management admits that some affiliates have not been able to fulfill their financial obligations to the Holding Company, yet they have not been shut down. In some cases, this subsidization is justified on the basis of a subsidiary’s prospects. For example, the Budapest Machine Tool Co. mentioned above suffered a fall in sales from 1.6 billion ft. in 1989 to 1.2 million ft. in 1990, and suffered a very large loss in the latter year because it incurred a series of cancellations of orders after it had purchased the materials needed to fulfill these orders. The Holding Company kept the subsidiary afloat because of their good prospects in western markets (see above, p.15).

Nevertheless, it is difficult to tell how much cross-subsidization reflects good future prospects and how much represents the difficulty of down-sizing the firm in the face of a 40 percent decline in demand. Management admitted that further cuts in the labor force, and perhaps in the subsidiaries, would have to be made. However, labor costs account for only 12-15 percent of production costs and shedding workers is expensive. The firm must provide
1-3 months severance pay and often forgives employee debts to the firm (these may be associated with employee purchase of company housing and thus possibly involve large amounts of money).

Production has not been disrupted by difficulties in obtaining inputs, either of domestic origin or the foreign components that are critical for exports destined for the West. Indeed, company officials reported that Hungary's import liberalization had greatly reduced problems in obtaining foreign inputs.

Like other Hungarian firms, Szim has experienced increasing delays in payments from customers. In the past, CMEA exports based on inter-governmental agreements were paid in 10 days; on hard currency exports, terms of payment were 6-12 months net. Now some subsidiaries have invoices outstanding that are 4-5 years old. As the subsidiaries are experiencing delays in payments, they are also delaying their payments to the Holding Company. Thus, in a sense, the Holding Company, by being the last in line to get paid, is a source of credit to the subsidiaries.

Conclusions

The difficulties of the machine tool sector appear to be long term ones. The various administrative reorganizations and refinancings of the past reflect both the lack of competitiveness of the sector and the difficulty in down-sizing the industry and concentrating its efforts in a narrower range of products. Past restructurings and infusions of capital never fully addressed these problems, and thus Szim now finds itself with accumulated debts from the past and a collapsed CMEA market. The strategy of cleaning up the finances of the operating companies in order to make them attractive joint venture partners for western firms is a reasonable one, so long as their debts to the Holding Company remain relatively "soft." However, this strategy does mean that the ultimate size and product mix of Szim will depend on which western firms negotiate joint ventures with the operating companies. This lack of strategic control over Szim's future direction makes the Holding Company rather immaterial except as a repository of bad debt. However, without access to meaningful resources combined with the equally important right to close affiliates and shed labor as required, it is unclear precisely what more the Holding Company can do in a strategic sense. A key problem facing management is that there is a need for a physical restructuring and reorganization of the firm at the same time that management must deal with the repayment of old debts. The attitude of management appears, correctly, to be to turn Szim into a profitable firm first, and to worry about debt later. The financial environment in Hungary may be conducive to such a strategy, but there is a danger that, by the time Szim becomes profitable on a day-to-day basis, it will be so awash in debt that the company may never achieve viability and the Holding Company and its debts will have to be written off while some of the subsidiaries survive.
D. Gedeon Richter Chemical Works (RG)

Company Background

RG is the nationalized successor of one of Hungary’s premier pharmaceutical firms, which was established in 1923. It is currently organized as a shareholding company with Hungarian Commercial Credit Bank holding 10 percent of the shares, a German partner 0.5 percent, and the state the remainder. The firm is in the midst of being privatized, and it was selected for early privatization because of its strong condition, the importance placed by Hungarian authorities on the future of the Hungarian pharmaceutical industry, which has a long and successful tradition, and the importance of international trade and technology transfer in the pharmaceutical industry.

Market

Current Market Situation. RG had sales of 17 billion ft. in 1990. Products included ethical drugs such as steroids, peptides, antibacterial agents and contraceptives as well as cosmetics, veterinary products and agro-chemicals, the latter three categories accounting for 5 percent of sales. About 20 percent of RG’s output is consumed within Hungary and the remainder exported. About one-half of exports (40 percent of sales) go to the West and the remainder to the former CMEA countries, with the USSR accounting for about two-thirds of CMEA deliveries. Unlike other Hungarian firms, whose sales to the USSR have collapsed, there has not been such a great decline in RG’s exports to the other CMEA countries, although there have been payment delays on the Soviet side.

Recent Market Trends. A major change has occurred on the domestic market for RG’s ethical drugs (ethical drugs are those that are prescribed by physicians as opposed to so-called proprietary drugs, which are sold to the public without a doctor’s prescription). All pharmaceuticals consumed in Hungary are subsidized by the government. The government’s objective was to keep prices low, so it failed to include in the prices any markup for R & D expenditures. (This is a problem faced by pharmaceutical companies world-wide; R & D expenditures are very high in part because much R & D activity never comes up with a marketable drug, but governments only wish to allow at most a markup on successful drugs that covers only that particular drug’s development costs.) In Hungary, the government was then supposed to cover R & D costs through transfers of funds to the drug companies.

This system has a number of implications:

- the prices of pharmaceuticals in Hungary are very low - about one-half the cost of imports of comparable generic drugs;

- the government has considerable control over domestic producers’ marketing strategies as it licenses all drug imports and allocates production of various drugs among Hungarian pharmaceutical firms.
Two years ago the system was changed by placing health expenditures under the social security budget and separating that budget from general government expenditures. The social security budget lacks funds for financing the R & D expenditures of the pharmaceutical firms, yet the firms are not permitted to raise domestic sales to cover their R & D costs. Moreover, RG has had to improve the packaging of drugs and has faced rising input costs, so that, with fixed output prices, the profitability of domestic sales has fallen.

RG has made the decision to remain in the Soviet market. This partly reflects the sunk costs of having conducted clinical trials of its drugs in that country to get them approved, and the fact that the Soviet Union continues to purchase drugs from RG. In 1990 sales to the USSR amounted to $250 million and in 1991 the company expects sales of $200 million. Officials estimate that the firm has about 15 percent of the Soviet market for pharmaceuticals. Richter faces some difficulty in negotiating appropriate prices with the Soviet FTC that imports pharmaceuticals, as the FTC’s budget is fixed and it thus wishes to pay low prices. Since 1990, payments for pharmaceutical exports to CMEA were settled in hard currencies, partly under the impetus of a Hungarian tax of 30 percent on ruble exports. RG reported that in 1990 hard currency settlements worked well, but in 1991 there have been payment delays, particularly in the case of the USSR. RG participates in MEDIPEX, a trading company that handles exports to the Soviet Union for the Hungarian pharmaceutical industry and has already established sales offices in several of the Soviet republics.

**Market Strategies.** The company hopes to maintain its strong position in the markets of the former CMEA market while expanding sales to the West. Because the pharmaceutical industry is highly internationalized, with all firms seeking the widest distribution of their drugs in order to better amortize R & D expenditures, it is important for RG to find a western partner as part of the privatization process one who will enable RG to reach western markets effectively. RG also wishes to strengthen its product line, and it has some promising drugs under development, although lack of adequate financing is hampering its efforts.

**Corporate Operations**

A large part of the firm’s efforts are directed toward its privatization in the so-called first wave of privatization of Hungary’s “blue chip” companies. The firm will be reconstituted as a joint stock company and a western partner will be sought who will purchase about one-half of the shares. This will allow RG to expand its facilities and increase its working capital. Subsequently there will be an offering of shares in Hungary.

Richter has good contacts with western pharmaceutical firms, both through purchases and sales of pharmaceutical intermediates on the world market and through purchases and sales of technology and licenses. It is also seeking advice from western banks in its choice of a partner. As yet neither the change in corporate structure nor the search for a partner have had a significant impact on day-to-day operations.
An important part of maintaining competitiveness in the pharmaceutical field is the discovery of new drugs and bringing them to market. The latter is both time consuming, sometimes taking as long as 10-12 years, and expensive, up to $200 million. When a drug is identified as having potentially useful medical properties, a lengthy series of tests of efficacy, toxicity and side effects must be conducted, first on animals and then on human subjects. Before a drug can be marketed, it must be approved by national authorities, which can only be done on the basis of clinical trials that often must be replicated in each country where approval is sought. Richter has six new products under development and finding sufficient funds to bring these drugs to market is a serious problem for management.

Financial Performance.

The firm is profitable, although profits have been squeezed by developments on the domestic market and by difficulties on the CMEA market as well. The firm has experienced delays in payment by the USSR as well as delays by Hungarian banks in clearing the payments. Hungarian government payments for drugs have been subject to greater delays than in the past. Consequently GR is borrowing to maintain its liquidity and is able to pay its suppliers on a current basis. Nevertheless, the accumulation of receivables and the need to acquire short term debt is of considerable concern to management and to the firm's western advisors. A large accumulation of questionable assets and short term debt will make the firm less attractive to potential western partners.

Conclusions

The fact that GR is a source of pharmaceuticals that would otherwise have to be obtained in the West at higher prices has kept its traded with the Soviet Union from declining as much as that of other Hungarian firms. Also important is the fact that the import of pharmaceuticals in the USSR continues to be centralized in one trading company and purchases are financed from central funds. How this will evolve in the future will be a key issue for GR.

A second important question is one of choosing a western partner. A major pharmaceutical firm from the US or Western Europe is likely to see GR primarily as an entry-way to the Soviet and East European markets. Such a firm would also offer a strong retail network in Western Europe and North America, although it is not evident to what extent the partner would wish to use GR as a major source for those markets. On the other hand, a Japanese partner would be more likely to view GR as a potential entry-way not only to the ex-CMEA market, but also and more important, an entry-way into the EC market. In the long run, this might yield greater exports for the Hungarian firm, but in the short run it may be less attractive since such a strategy would require the creation of a new marketing network in Western Europe. In the short run, the firm faces liquidity problems, although these are not as life-threatening as those faced by other Hungarian firms.
E. Budaprint

Company Background

Budaprint is a state-owned holding company whose subsidiaries produce 12 billion ft. of textile products and employ 8,500 people. Its principal products are cotton textiles, which account for 20-30 percent of turnover, but whose share in output is declining, and printed fabrics. The firm had its beginning in 1963 when 8 textile firms employing some 25,000 workers were merged into one unit. The company's organization was changed again in 1989, when a holding company and seven subsidiaries organized as shareholding or limited-liability companies were formed.

Markets

Current Market Situation. Budaprint used to export about 60 percent of its production, with exports split about evenly between the CMEA market and the West. Export transactions were handled by Budaprint's own Foreign Trade Corporation (FTC). The remaining 40 percent of production was destined for the domestic market, where it was distributed by an affiliate through shops and catalogs. Budaprint's share of the domestic market has declined from 35 percent in 1988 to 20 percent in 1990, largely due to competition from imports.

Recent Market Trends. Budaprint has suffered a sharp decline in demand on all its markets in 1990. Domestic demand (sales?) declined by 15 percent in nominal terms in 1991. CMEA and Western sales also contracted and the Hungarian textile industry saw its production fall by 20 percent in the course of the year. Moreover, textile prices on the domestic market have fallen. Under the old pricing system, which existed through 1988, Budaprint's domestic prices were de jure to reflect world market prices, but with textile imports severely restricted by the government, the company was able to set prices to provide a 3-5 percent profit margin. The import liberalization of 1990 made the need to price to the world market effective, and Budaprint had to adjust prices to meet foreign competition on the domestic market.

Market Strategies. The company is responding to worsening market situation largely by reducing output in an effort to avert bankruptcy.

Corporate Operations

As the company is now unprofitable, and its losses are being covered by the government, management must decide what to do. One possibility is privatization, where the firm would be sold to investors and the proceeds used to pay off (some) of the government's contributions used to cover operating losses. This possibility is, however, outside the scope of competence of Buda-print; such a decision to privatize would have to be made by the government. The other possibility would be for Budaprint to declare bankruptcy under the
terms set out in Hungary's bankruptcy law. This law, however, is almost never invoked, either by loss-making firms or by their creditors, and its use is not contemplated by Budaprint's managers.

Thus the company continues to respond to market developments by reducing production and employment. In 1989-1990, employment fell by 17 percent and further cuts are anticipated. Moreover, average real wages have fallen because nominal wage growth has not kept up with inflation. Thus, in 1989 the average wage was 100,000 ft/year, in 1990 it was 120,000 ft/year while the official estimate of inflation was 28 percent. Finally, the shedding of labor has been matched by a failure to renew the capital stock. In particular, the yarn-making and weaving operations are quite outdated in all subsidiaries although there are some other operations that are quite modern. The average age of machinery in the subsidiaries is about 10 years.

In addition to a decline in demand, the firm has faced difficulties in the import of its primary raw material, cotton. This was imported mainly from the USSR, but these supplies have been disrupted. In 1989, the firm had to supplement Soviet supplies with purchases in Greece, and for 1991 company officials were uncertain how much, if any, cotton they could expect from the USSR. This has had a financial and strategic impact on Budaprint, since Soviet cotton was cheaper (by some 35 percent) but also of lower quality. Thus the need to substitute western cotton imposes an additional financial strain on the firm. Moreover, because foreign cotton is of higher quality, Budaprint is attempting to produce fabrics of higher quality for more fashionable uses.

**Financial Performance**

The profitability of the firm has been declining for some time, and in 1990 it lost 120 million ft. The firm owes debts to banks, to suppliers of gas and electricity and is unable to pay some of its tax liabilities. Net debt is estimated to be 40-45 percent of group assets. The share of inter-enterprise debt is rising and the share of bank credit declining because banks are reducing their loans. The firm thus faces severe liquidity problems and management must husband resources to maintain sufficient liquidity to purchase imported inputs, since payments to foreign suppliers, unlike those to domestic ones, cannot be delayed.

**Conclusions**

Budaprint's slow and gradual slide into insolvency has left it with a weak financial structure, few competitive advantages and no strategic plan for revising its fortunes. It is likely that the Hungarian government tolerated Budaprint's existence on the basis of the fact that it was a net earner of both dollars and rubles, with normal year exports of $26 million and rubles 32 million. With firms now expected to earn a profit, and both Western and ex-CMEA sales falling, there is little to justify the subsidy costs of these shrinking trade surpluses. Thus management views 1991 as the crisis year. Demand for its output is down in both domestic and foreign markets, debts are mounting and none of the affiliates are financially viable and management is unable to cope with the situation. Respondents also
Hungarian Enterprise Behavior

complained that the government had no policy toward the industry, although one might argue, albeit somewhat unkindly, that a policy is likely to mean, at least to people in the industry, an injection of resources and that the government’s policy of neglect was, in fact, a policy designed to eliminate loss-making firms in the textile sector.

F. Hungarian National Oil and Gas Trust (OKGT)

Company Background

The firm is involved in exploration, transportation, refining and distribution of oil and gas in Hungary. The firm is being reorganized on the basis of a World Bank loan that was made in 1989 to help the company restructure so as to:

- update and strengthen management information systems;
- allow energy prices to more accurately reflect world market prices by removing subsidies;
- separate the production of oil and gas from the distribution network and to convert the oil operation into a national oil company;
- allow foreigners to participate in exploration activities;
- raise needed new capital, including foreign capital, through privatization.

This reorganization is going on at this time and is the main management issue facing the firm.

Markets

Corporate Operations

Prior to 1991, the company operated its activities in the production, distribution and wholesaling of oil and natural gas on an integrated basis. There were 23 separate companies, but each was vertically integrated. Moreover, OKGT had a monopoly over the retailing of petrol, and the distribution of natural gas to households was organized in 5 firms, each with a mandate for a particular region of Hungary. (Distribution of natural gas in Budapest was not part of OKGT’s activities.) The firm is now in the midst of implementing major organizational changes. It has a variety of affiliates in the following fields:

- exploration and transportation;
- gas supply - which will be decentralized;
- machine manufacture and construction - which will become an independent privatized firm;

- technical development - which will become an independent private firm;

- gas supply - the five regional distribution firms will become independent. On July 1, 1991 they became subject to the Ministry of Industry rather than to (OKGT). They will become joint stock companies through a process to be supervised by the Ministry of Industry and the State Property Agency. At first, the state will own 80 percent of the shares and local bodies 20 percent. In 1992, the firms will undertake a public offering equal to 50 percent of the state's share. They will further expand private shareholding by means of an ESOP (Employee Stock Ownership program). Foreign investors will be able to purchase up to 45 percent of the equity of these firms, and talks are under way with western gas firms to develop such purchases.

OKGT officials indicated that this phase of the restructuring of the firm is being held up by the following problems:

- failure to set up the Joint Stock Companies

- lack of laws for:

- permitting local bodies to become part-owners of distribution companies;

- regulating licensing and concessions for public utilities.

- creating a system of regulatory agencies for private and profit-oriented public utility companies.

In the refining, marketing and exploration activities of OKGT, there are 11 companies involved. These will be regrouped along one of the 3 following alternatives:

1. Totally independent joint stock companies with no integrating framework (this option is not favored by OKGT).

2. 9 companies merged into 2 separate joint stock companies, one for research, exploration production and transportation of gas, the other for refining and marketing. (OKGT officials believe this arrangement would be attractive to foreign investors.)

3. 9 companies will be merged into one joint stock company with upstream and downstream activities separated into two divisions. (This alternative appears to favored by the World Bank.)
The OKGT believes that investment and foreign participation are most needed in refining and in reducing Hungary's dependence on Soviet deliveries of oil and gas. These have, officials reported, fallen, forcing the company to seek substitutes on the spot market.

**Financial Performance**

**Conclusions**

The reorganization of OKGT reflects the problems of dis-mantling an organizational structure that was consistent with a planned economy - i.e., vertical integration to minimize the need for planning of input and output flows - and creating one that will be consistent with a market economy. This should permit a more rational evaluation of the value of various services and thus a better allocation of investment in the gas and oil sector. At the same time, it is hard to project how profitable the new units will be and whether they can mesh together smoothly in what is likely to be a chaotic period for the Hungarian energy sector.

**IV. "Typical" Industrial Firms in the Transition**

The firms described in the previous chapter were re-interviewed in the Spring and Summer of 1992. Because the background of each firm was described fully in the preceding chapter, the updates are relatively brief and focus on those areas that were viewed as key or strategic for each firm. It is worth noting that not all firms survived the year or more between interviews with unchanged legal form and enterprise structure. This close-up view of the disappearance or metamorphosis of Hungarian firms is both poignant and instructive for an understanding the transformation process at a micro-level.

**A. Taurus**

The 1991 financial year ended with heavy losses for the firm. It made some profit before tax, but interest payments on short-term credits were much greater than this profit. The stock of short-term credit increased by 35% between 1990 and 1991, and most of this increment was used for interest payments. Sales receipts reached HUF 16 billion in 1991, which was HUF 2.2 billion less than in 1990. This decline was due to the shrinking of the firm's domestic market shares, since its convertible currency exports actually increased from HUF 8.5 billion to HUF 8.6 billion, approximately USD 105 million, between 1990 and 1991.

Taurus has two main profiles. One is tyre production, and this division has been a source of losses; for several years; tyre production was also a loss-maker for most major multinational firms in 1990. Import liberalization was a nearly fatal blow to the firm, because its profits originated from its quasi-monopolistic sales of imported tyres on the domestic market during most of the 1980s.
The second main division is rubber products used in oil production. This division has suffered from payment problems on its traditional Soviet, and later CIS market, although its products are in high demand there.

The number one strategic task now faced by management is privatization. The enterprise ought to have been transformed into a corporation in March or April, but the State Property Agency did not give its approval. The reason was the firm's huge debt, altogether around HUF 2.5 billion. The company avoided bankruptcy only through a deal with the Hungarian Credit Bank, which agreed to provide short-term financing to the firm. If it had not done so, Taurus would have been forced by the new Bankruptcy Law to declare bankruptcy after 90 days of non-payment of its arrears. The bank's strategy toward Taurus now seems to be that of an active interest in its privatization. A possible solution that the bank would be apparently ready to negotiate is a debt-equity swap. This would mean a swap of the firm's long-term debts for its shares during transformation.

Although the only positive step definitely taken by the bank was its commitment to maintain current financing, this was enough for the SPA to give a green light to the transformation process. As the differences between the financial situations of the different plants of Taurus became more and more evident, the former holding-based transformation approach has lost most of its support. The firm will transform itself into 6 independent joint stock companies using the same brand name, and foreign investors are expected to participate separately in them.

The value of the net assets of the firm is evaluated at around HUF 5 billion, which gives most of its successors relatively good perspectives of privatization. The privatization process seems to be hampered by the fact that the tyre division, or its successor firm, is considered by foreign investors just an uninteresting low-technology part of the worldwide overcapacity in tyre production. Therefore it might well happen that the tyre division, or the Budapest plant within it, can not be privatized at all. The failure of negotiations with Michelin and Goodyear also points to this direction. Thus, the firm's inability to resolve all its strategic handicaps has left with no alternative but partition, dismemberment and bankruptcy for some plants.

B. Műszertechnika

The company is still considered one of the most successful national private firms in Hungary, although the Kontrax group also has had very favourable press coverage. Műszertechnika is by and large on the same development track as in early 1991. The major developments have been in the realm of mergers and acquisitions although the firm itself has been less active than its owner (28%) and President-CEO, Mr. Gábor Széles.

The firm itself teamed up with two major multinational firms. One of them is IBM, with which Műszertechnika created a hardware- and software-making joint venture also interested in trade. This joint venture is expected to be the number one player on the
Hungarian and eventually also on the East Central European market for computer technology and equipment, but exact figures on its financial strength and technical size are not yet available.

The other strategic alliance was concluded with Ericsson in early 1990. This initially very small joint venture was created in order to help Műszertechnika enter the rapidly-expanding Hungarian telecom equipment market. The joint venture was one of the winners of the 1990 switchboard tender, which guarantees a 35 to 65% annual share on the domestic market between 1991 and 1996 for the JV. This made it possible that its number of employees increase from 2 in January 1990 to 180 in May 1992. Its annual sales are planned to reach HUF 1 billion in 1992.

The President-CEO of Műszertechnika, a firm with approx. HUF 9 billion in annual sales, made a very courageous step in 1991 when he acquired a qualified 10% equity stake in the Videoton group, annual sales, HUF 12-15 billion. Although Videoton has been a holding-based group with a negative book value of assets due to its HUF 25 billion debt, most of its capacities represent a reasonably high technological standard. The acquisition of these capacities is probably the first step toward the creation of a Műszertechnika group of electronics firms.

Thus by retaining its financial viability, Műszertechnika has been able to follow its strategic and technological objectives relatively successfully.

C. Szim

The Hungarian machine tools industry is near extinction due to its financial problems linked to the collapse of domestic demand and traditional export markets in CMEA countries. SZIM as a group does not have serious chances of survival either.

SZIM transformed itself into a holding-based industrial conglomerate back in 1988. Therefore it provided one of the examples of spontaneous privatization with the setting up of an empty shell type holding. Ten subsidiaries were created around the holding. Out of these subsidiaries, two joint ventures, MAHO-SZIM and Knorr-Bremse - SZIM, proved successful and their business perspectives are really reassuring. Four other subsidiaries, however, are already under liquidation, and two or three more could join them shortly due to the new bankruptcy legislation.

The privatization of the group has been a very complicated process. The strategy of the management of the holding was focussed on the creation of strong JVs. In case all the assets of the group, and the holding could be transferred to these, the holding would have liquidated itself. The success of this strategy strongly depended on a deal struck with the SPA. This deal was part of the group’s privatization programme, and it stipulated that half the state revenue from the sale of the group’s assets could be used to prepare the different subsidiaries for privatization. This deal worked for one subsidiary or two, but it could not be
taken for granted that the SPA would stick to the old deal after some candidates for
privatization began to face the danger of liquidation. After liquidation, the complicated
privatization problem of the subsidiaries would become a much simpler one of selling their
assets. In any event, the 30 year old SZIM story is coming to an end soon, and this end will
not be a happy one.

D. Gedeon Richter

Gedeon Richter had a successful year in 1991, with profits before tax up by 43% from their 1990 level, and reaching HUF 1.14 billion. As the biggest Hungarian
pharmaceuticals firm, it is in an advantageous position for further privatization. Details are
not known, but management is probably negotiating with a major Japanese investor.
Management has been reluctant to talk about the current situation of the company. This
confirms expectations that privatization would take place soon.

Gedeon Richter, a limited share company, will increase its stock capital prior to
privatization. Shareholders took a quite conservative approach at the general assembly with
86% of the 1991 profit used for an increase of the reserve capital of the firm, and only 14%
paid out as dividends.

Some performance data are available for the company, but they cannot be really
compared with the 1990 ones due to the fact that Gedeon Richter underwent transformation
and reorganisation, with some privatization at the same time. For example: employment
decided from 6119 to 5941 between 1990 and 1991, while net sales increased from HUF 4.2 billion to HUF 16.1 billion, and exports from HUF 3.0 billion to HUF 10.7 billion. The
book value of assets also remained almost the same: HUF 17.2 billion in 1991 as compared
to HUF 16.7 billion in 1990.

E. Budaprint

The firm has been operating since 1989 as a holding-based group. The holding is a
typical empty shell employing only 23 persons. Its major source of revenue is leasing to its
subsidiaries. The combined output of the subsidiaries is only 30 million square meters, one
fourth of production in the mid-eighties. This substantial shrinking of output has been mainly
due to the collapse of exports to the Soviet market. The group now has less than 10 thousand
employees, while employment surpassed 23 thousand in 1985, and jobs are lost continuously.
The reason for the ongoing crisis is undercapitalisation, which leads to decreasing
competitiveness on Western markets. Sales on the domestic market are no way out because
the decline in living standards in Hungary which hit the household consumption of textile and
clothing the most. Undercapitalisation is further exacerbated by indebtedness of most of the
subsidiaries. An injection of capital was expected from privatization, but privatization did
not take place in any of the 5 productive subsidiaries.
This has been no surprise since these companies have neither high-value assets nor significant market shares to offer. Therefore some subsidiaries looked for new privatization techniques like debt-equity swaps with major creditor banks. Another option would be the transformation of real estate leasing agreements between the holding and the subsidiaries into an increase of the equity stake of the holding in them. Although this option is also being negotiated, its implementation would not help resuscitate productive activities of the subsidiaries. Some of them do not rule out, in fact, the possibility of partly becoming real estate trading or leasing firms. Along with SZIM, the case of Budaprint is another symptom of Hungarian desindustrialisation within the sample.

F. OKGT

OKGT has been known under a new name in Hungary: MOL Rt (corporation limited by shares) since October 1, 1991, the day of its legal transformation. MOL Rt is the legal successor of OKGT, but it is a much smaller firm. It does not include some service firms and equipment manufacturers that formerly belonged to OKGT, although it has an equity stake in some of them while it leases land and/or equipment to others. The privatization of these independent successors of OKGT is possible, but MOL Rt itself belongs to the group of strategic firms in which the state will keep majority ownership.

The transformed structure of MOL Rt consists of two major divisions: 1. prospecting and production (extraction), 2. oil and gas processing and sales. These divisions are profit centers, the management of the RT retained only strategic decisionmaking functions for itself. The second profit center is at least by one order of magnitude bigger than the first one. It includes the four big Hungarian refinery plants as well as ÁFOR, the retail arm of MOL Rt which operates gas stations across the country.

The economic perspectives of MOL Rt are somewhat uncertain due to the half-hearted deregulation of the oil and gas sector. The firm will have to enter an almost completely open competition in domestic prospecting and extraction due to the new concession legislation, but it operates in a regulated domestic market environment as a seller of oil and gas products. Its profits reached HUF 35 billion in 1991, HUF 6 billion less than in 1990. This profit is just at the minimally acceptable level for this very capital-intensive company that is also hit by the severe taxation on the use of mineral resources and by the anti-trust regulation. The latter does not allow for automatic consumer price increases of oil and gas products in case the firm's increasing costs would make them necessary.

The taxation of the use of mineral resources has an especially drastic form in the Hungarian oil and gas industry. MOL Rt has to transfer 37.5% of the current world market price based equivalent of the oil and gas extracted immediately to the state budget, long before these products are manufactured and sold. This leads to significant interest losses for the firm due to the high nominal interest rates in Hungary, which have not been reflected in oil and gas price increases. MOL Rt transferred in 1991 HUF 146 billion (USD 1.8 billion) to the budget, 39% of the sales revenues of the company.
VI. CONCLUSIONS FROM THE CASE STUDY UPDATES

The updates give a quite reliable impression of the 1992 situation of Hungarian industry as a whole. Basically three groups of firms can be observed in the sample, and the same three groups are distinguishable in Hungarian industry altogether. Group 1 is that of firms in a promising situation and good perspectives for expansion. These are, in general, new private companies or, in a few cases, big state firms in monopolistic positions. In spite of its problems, MOL Rt belongs to the latter type of firms, whereas Műszertechnika is a strongly expansive private company with good chances of becoming an industrial giant - in Hungarian circumstances, of course. Richter is a rather special case, since it belongs to the small number of state, or quasi-state firms performing well even according to international standards. This is true, by the way, for most of Hungarian pharmaceuticals firms.

Group 2 is that of drifting firms. This is the behavioural pattern among Hungarian firms that deserves the most attention in research for at least two reasons.

First, this type of behavior is quite new in the literature which has known only two fundamental types of enterprise behavior: produce or perish.

This distinction supposes that any firm unable to increase its assets or to respond to the expectations of its owners in any other way has to face bankruptcy or liquidation in a market economy. There are, of course, well known cases in market economies, e.g. Austrian, German or French state firms like VOEST, the Deutsche Bundesbahn or Bull that have been permanent loss-makers during recent years without any real danger of liquidation. But these firms satisfy some special, maybe only political, needs of their owners, i.e. their governments, while many drifting firms in Hungary are not kept alive by the government. They survive only due to their managers' insistence on grasping even the slightest chance of keep the company alive.

Many Hungarian firms, mostly state or recently privatised ones, are living off their assets but do not face immediate liquidation. The interest of their owner might be this, but no one expresses this interest clearly enough. The managers of these firms play for time, aware of the fact that many Hungarian firms like theirs are in a comparable situation and a wave of liquidations would cause an earthquake-like shock for the whole economy.

The bankruptcy legislation in force from January 1, 1992 and applied from April 8 has increased the monthly average number of bankruptcies from approximately 240 to approximately 1000, and it is predicted half of these will end with liquidation. But there are many cases where agreements on debt settlement are reached between creditors and debtors because a really consequent application of this law would result in a loss of most clients for banks and firms providing suppliers' credits on the domestic market. So far only about 7% of Hungarian firms have been liquidated even on the basis of this drastic bankruptcy law. This law is mostly criticised for its one-sided legal structure, namely, that it is providing protection only to the creditor, but does not really help resolve the debtor's problems. For
example, it makes bankruptcy unavoidable even for a firm that is a net creditor, but it is unable to repay just one of its debts due to liquidity problems originating from the irredeemability of its assets.

Second, "drifting" firms have been able to survive and, due to the dwindling of the assets of most of them, they can be considered as increasingly interesting targets for investors. There is normally a point of inflexion in the process of the shrinking of their assets. This point of inflexion means the minimum of the book value of the assets of the company until a short time before liquidation is started. It often happens that the book value, or the sales price of the firm, increases somewhat immediately before liquidation when owners and managers realize that privatization is no longer possible. In this case they are interested in demonstrating relatively high values of the assets of the firm in order to reach better debt settlements or debt/equity swaps.

Examples for the drifting type of firms unable to grow but successfully avoiding liquidation can be found in our sample, too. Taurus and Budaprint are such cases, albeit they are different with respect to the distance they have drifted away from a healthy financial and market situation. Neither of the two firms, more accurately: holding-based industrial conglomerates, will be able to survive as a whole, but Taurus seems to have a string of viable subsidiaries while the drifting of Budaprint might well end in its becoming part of the third group of Hungarian industrial firms.

The third group is that of companies bound to disappear from the Hungarian economic scene unless they are rescued by the government. The Ministry of Industry and Trade has proposed a government rescue action for a dozen big state firms that are in a difficult financial situation but considered competitive in case of an appropriate injection of working capital. Their privatization is out of the question, in most cases because the combined value of their assets and liabilities is already negative.

Holding-based conglomerates are a special "subset" of the third group. In their case most fixed capital usually belongs to the holding, frequently an empty-shell, but the holding is responsible for the repayment of most of the debt of the former monolithic state firm. Managers of such holdings might find a way to rescue at least part of the productive subsidiaries of the holding. The solution normally consists either in the transfer of the legally transferable fixed assets from the holding to the subsidiaries while the holding remains the main debtor, or in debt-equity swaps in which creditors might obtain the holding’s shares in part of the subsidiaries in exchange for credits.

Therefore the third group is far from being homogenous, and it cannot be concluded that it will disappear as a whole. Parts of it might survive, but only as small or medium sized enterprises with no significant debt load and a much narrower market niche than the original big state firm. This is the case of SZIM, which, as the legal successor of the former monolithic state firm, i.e. the holding, is under liquidation, but at least two of its subsidiaries face a promising future. They belong to the first group of Hungarian industrial firms, and it
might be interesting to mention that there are very few drifting firms in the environment of disappearing holdings. Options are clear for most subsidiaries of these after the disappearance of the holding: either long-term survival or liquidation together with or not much time after that of the holding.

VII. ENTERPRISE BEHAVIOUR AND INDUSTRIAL POLICY

Drifting can normally not be a long-term attitude, but its large-scale presence as a behavioral pattern among Hungarian industrial firms is a telling proof of the current transitional situation of the Hungarian economy. We estimate that around 60% of Hungarian industrial firms are now drifting to some extent, 15 to 20% are in a serious danger of liquidation, whereas the rest, at least 20%, can make long-term plans.

The future, even the short-term one, of Hungarian industry largely depends on where the drifters will moving. If most of them disappear in one year or two this would mean a considerable deindustrialization process for Hungary. If most of them survive, there would be no significant structural change in the Hungarian industry. A compromise scenario seems the most likely, in which 30 to 50% of the drifting enterprises cannot be long-term survivors. This would already mean a sizeable structural cleanup process in Hungarian industry.

No precise forecast can be given on the direction of this far-reaching structural change, but its dimensions can be assessed to some extent. First of all, it will not simply mean macrostructural change with structural shifts only among industries. It will also have a regional and an enterprise dimension. The interaction of the three dimensions means that the reaction of each enterprise to this transformation of industry will largely depend not only on the change of the macrostructural role of the industry it belongs to. It will be also be strongly influenced by the development of the region where the firm is located and the adjustment perspectives of other firms with comparable types of ownership, size, market pattern etc. Macrostructural change will have more and more an average character with fewer direct implications for the transformation of an industry on the firms that are part of it. Enterprise behaviour and reaction to the crisis will therefore be conditional upon the development of the given industry, of the region and the type of enterprise.

It is likely, for example, that the clothing industry as such will not stop shrinking during the years 1992-1993 or beyond, but there seem to be good perspectives for small, newly created, i.e. not arising from privatization, and debt-free private firms in this industry. These would prosper by either subcontracting or selling on nearby, demand-pull type foreign markets like the Ukraine or Romania. Eventually good export chances on these markets or widespread subcontracting for German, Italian or Austrian firms means that clothing firms located in the western or the southeastern regions of the country will be much more promising than the average of the industry.
Such patterns of Hungarian industrial development will be recognized by industrial policy quite soon, and it will lose its unilateral macrostructure-oriented character. In recent months the Ministry of Industry and Trade has expressed its interest in stopping the disindustrialisation process more and more frequently. Now it is ready to take its part in enterprise crisis management for 12 big state firms facing bankruptcy and eventual liquidation due to external market factors beyond their control. It can also be expected that the ministry will play a more active role in regional crisis management because it has turned out, for example, in the case of the DIMAG Steel Works in Miskolc, that the government's pseudo-liberal hands-off approach is unable to resolve major regional crisis situations without a substantial additional burden on the state budget. Therefore preventive regional crisis management together with the conditioning of potentially privatizable state firms will have to be incorporated into industrial policy. Its financial background can be created from part of current privatization revenues. The use of these revenues is now limited by law to the repayment of the state debt, but it is clear that an eventual slowdown of the privatization process will threaten with a deepening of the budget crisis, and this could be prevented only with state expenditure on preparing firms for privatization.

Finally a serious methodological problem hampering the correct assessment of enterprise behavioural patterns has to be mentioned. Enterprises with clear non-state ownership patterns are increasingly reluctant to be interviewed by researchers because they are afraid of data leakages eventually serving:

- pressure groups wishing to attack the management for political reasons,
- creditors eager to get a correct picture of the financial situation of the firm, or
- competitors interested in hostile takeovers.

Their fears are partly justified by the fact that the legal framework for the protection of confidential business information is still missing. If the so-called Data Protection Act is adopted by Parliament, managers will probably be easier to approach for information, but this law does not even figure on the agenda of the Parliament as yet.