

# THE START-UP FINANCING OF SMALL AND MEDIUM-SIZED REGIONAL BUSINESSES IN LITHUANIA

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The development of small and medium-sized enterprises (SME) is a vital resource to contemporary rural businesses and to the regional economy. Moreover the significance of available start-up financing of small and medium-sized business is a fundamental issue for the evolution of rural companies and infrastructure development in transitional countries. On the other hand, an adequate economic infrastructure policy can improve these conditions even more. This paper presents a research on the dynamics of the start-up financing of small and medium-sized regional firms in Lithuania.

*Start-up financing, small and medium-sized enterprise, regional development.*

## **Introduction**

The small and medium-sized enterprises are essential to the development of the rural businesses in contemporary economy. They turned out to be a most active segment of the economy. Their comprehensive challenge is distinct by great flexibility in the adjustment to the changing market conditions. The discussed small and medium size enterprises are of particular significance to such issues as the economic development, the competitiveness, and changes in the structure of economy or unemployment size.

Meanwhile a development of the macroeconomic environment for small and medium businesses can be partially related to the monetary policy under the currency board. Restriction on money supply under the currency board system eliminates some tools from the central bank. There are very few possibilities for the central bank to influence money supply. Money balances are regulated by economic agents demand and balance of payments adjustments (Fleming, 1996). In the simplest way it can be consider that economic agents decide what the monetary base should be (Zettermeyer, 1996). If they want to increase monetary base they just sell foreign exchange to the central bank. Central bank increases reserves and issues new emission of litas.

## **Methodology of Investigation**

The significance of bank credits and private savings for start-up financing of small and medium-sized business is very important for transitional country's economic growth. However, the information about the forms and level of financing in transitional period is still not enough. The paper presents a research on some chosen forms of the start-up financing to a sector of small and medium-sized firms in Lithuania. It has been worked out on the basis of author's interview study; Lithuania's Department of Statistics data and literature.

## Results of Research

Lithuania's inflation was restrained and boosted again after the introduction of currency board fourteen years ago. We already assumed earlier that the consumer price index (CPI) better indicates non-traded goods while the producer price index (PPI) – traded goods. So, the main source of local inflation is observed in non-traded goods and services. It is obvious that centrally planned economies inherited really undervalued level of non-traded goods. During the first half of the first decade in 21<sup>st</sup> century CPI and PPI were negative in Lithuania. That deflationary pressure on Lithuania's economy was widely discussed in 2004. From the macroeconomic theory a long deflation has negative impact on output and it increases unemployment. On the other hand in the case of currency board arrangement the deflation process is a response to the current account deficit and an automatic reply of economic agents in decreasing monetary base (Dubauskas, 2004).

Time deposit interest rates are reliable indicators of the credibility of Currency Board arrangements and the position of Lithuanian litas. Changes of interest rates after the introduction of the currency board are obvious. There is a general decrease in interest rates after the April 1994, i.e., after the introduction of the currency board. Despite that a very permanent risk premium exists for litas deposits. These interest rates' difference continuously fluctuates around 3-4 percents. Consequently the credibility of Litas has some room to an enlargement. The particularly significant argument is that about 50 percent of savings are held in terms of foreign currencies in Lithuania (data from the Bank of Lithuania, 1996-2002). These accounts mainly can be named as Eurodollar time deposits. We can see that difference of interest rates increased after the financial crisis in Russia, in 1998. Besides the crisis has impact on Lithuania's GDP real growth also. It was only five percent growth instead of expected seven percent. So, the interest rate difference is a trusty indicator for credibility of domestic currency in the comparison with backing currency under the currency board system.

Other important issue in the country's monetary policy is the National Reserves. It is a really substantial question in the case of 100 percent litas backing by foreign exchange reserves. There is continuous growth in Lithuania's official reserves last years. According to the Bank of Lithuania information, sometimes reserves are around 50 percent larger than requested for the full backing of litas during the last years. These premium reserves are not considered as backed monetary base and we will see later why. Fluctuations of reserves occur because of earned profits and interest withdrawing together with other seasonal business cycles. Revenues from privatization are reflected in official reserves as well. Lithuanian Telecom was privatized in July 1998. We can notice a large expansion in official reserves in July 1998. It happened when the Ministry of Finance asked Bank of Lithuania to deposit money, which was received from privatization deals. However, the Bank of Lithuania did not increased monetary base by that amount. Lithuanian Telecom, probably the largest telecommunications network in the Baltic's, was sold for USD600 million to Scandinavian companies. So-called "cash-

privatization" takes place in Lithuania, since 1996. Among companies registered on the privatization list was Lithuania's Mažeikiai oil refinery, one of the biggest refineries in Eastern Europe. Thirty-three percent of company's shares were sold to the USA company "Williams International" for USD150 million in 1999. The additional twenty percent of shares was sold to Williams later. Russia's company Yukos obtained Mažeikiai refinery from Williams International in 2002. The last capital movement in Mažeikiai oil refinery was when Polish company PKN Orlen has bought the refinery from Yukos. The agreement between Orlen and Yukos International to buy out the latter's 53.7 percent stake in the company, was made in June 2006. Several weeks later, PKN Orlen signed a deal with the Lithuanian government to buy a further 30.66 percent. The European Union's regulatory authority approved the deal on November 7, after ruling that it would not significantly harm competition in the European economic area or any substantial part of it. The buy-out was finalized on 15 December 2006, with USD1492 million being paid by PKN Orlen to Yukos International, and USD852 million to the Lithuanian Government. Another companies sold from the privatization list during the last ten years are - Lithuania Shipping Company "Lisco", Lithuanian Airlines "Lietuvos oro linijos", Lithuanian Power Company, Lithuanian Gas Company, and the State owned commercial banks the Savings Bank "Lietuvos taupomasis bankas", Agricultural Bank of Lithuania "Žemės ūkio bankas".

An aspect of the transition that has proven difficult to implement is the clarification of property rights to the land (Aidis, 2005). An individual claim to land that has been nationalized after invaders took control of the country from 1940 to 1990 is not fulfilled. Local bureaucrats and market reforms antagonists create all possible obstacles and inspections before land can be returned to owners or compensations can be paid. Therefore many owners cannot receive official deeds on their property and land. This problem that rural business cannot be efficiently developed is revealed in the interview study. A question about property rights to the land was not answered in 66 percent of cases. That problem (concerning rural infrastructure improvement and regional public management paradigm) was created because of so called partial law of the restitution. It means that each owner or successor must again apply for his or her land, and rural bureaucrats can decide what to do. Turning to the regional financial management system the inheritance from the former centrally controlled economy is not so evident.

## **Interview Study**

Throughout the research two separate interview studies with the time lag for a few years were done. During the interview study the questionnaire on was developed and implemented (in cooperation with the Organization of Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) research teams). Moreover the assistance from the Department of Statistics to the Government of the Republic of Lithuania was really helpful for increasing a credibility of this survey. A survey on more than 100 small and medium size regional firms was conducted in 1999 and 2003. Eventually we found that costs in terms of

time and money would have become too large. Instead of that we make an effort to have all important industries, and different proprietorship structures represented. An attempt was also made to obtain a reasonably representative size distribution. Nevertheless this sample depends on companies' good will to answer the comprehensive questionnaire. This circumstance is particularly important in the post-authoritarian country where sincerity with information is not a tradition.

Another reason why the sample of rural firms may be biased is that some businesses in transition economies are involved in quasi-legal or illegal activities. Such firms and those evading unenforceable tax rules are not likely to participate in the study. Moreover there can be mentioned two sides of shadow economy. One part is rural and other businesses that are official registered in governmental institutions, but they submit wrong data about their profits and activities. The other group consists from firms that are not registered at all. Thus, the sample is likely to be biased in such a way that many informal arrangements are not captured. We hope to detect the existence of informal financial arrangements, however, even if their importance could be underestimated. A basic part of the analysis is a comparison done on 1999th and 2003rd year survey. The main fields of this study are:

- Start-up financing and traces of informal borrowing;
- Gross sales, total and net profit;
- Obstacles created by local and central governments;
- Businesses responses to economic uncertainty and adjustments to high interest rates for credit;
- Additional investment and indicators of business condition;
- Structure of ownership and distribution of shareholders;
- General evaluation of business environment.

## **Start-Up Financing**

For the period of the research was revealed that own savings dominate as a source of start-up financing in Lithuania. About 60 percent of all firms started up with an owner finance as full or partial financing in the 90's. Relatives and friends balanced own resources in a few cases. Other resources were in the second place, i.e. around 25 percent. The vouchers privatization of a company was one of the possibilities to get onto the business ladder. Very few firms took loans from a local or a foreign bank. Definitions as "other sources," or "friends and relatives" and "private savings" have specific meanings in the post-communist societies. The most interesting part of this year interview was involvement into the survey some financial institutions, such as regional commercial banks. Our projects carefully tried to find out roots of informal activities in the emerging Central Eastern European countries during years of these studies. It seems that some institutions really can be the case. New and much smaller industrial companies were less involved in the informal financial structures. These rural companies usually dominated in our interview studies. As an example one commercial bank from Lithuania discloses that near to 90 percent of start-up financing came from the "other sources." The originating equity capital of this bank was millions of US dollars. That was already

discussed about a definition as "the other sources" in different scientific workshops on management theory. It is not clear how things work in other CEE countries, but in Lithuania we really can find tracks of informal borrowing (as well as lending) in the settlement and the following activities of some private institutions. A few financial institutions were involved into the last survey. In 2003, small and medium sized companies are increasing their net profits in comparison with previous years result. An observed decrease from 17 to 8 percent in unprofitable firm's shows that rural business conditions improving. Therefore ineffective companies are vanishing. Companies that have gross sales and services above one million litas composed around 45 percent in 2003 compare with 27 percent in 1999. There are a few companies with gross sales and services amounting up to LTL10 million.

Investigation on obstacles created by local and central governments was exercised only in the last year survey. According to respondent answers – the fifty three percent of them had problems with municipal or local governments. Twenty-six percent of barriers were imposed by central government institutions. In the third place are obstacles created by competitors – 11 percent. None of the firms mentioned problems related to informal institutions in their business foundations. Comparing answers about uncertainty in expected profits we can find an obvious improvement. Less than 42 percent of firms replied that it is very difficult, but possible to manage, against 67 percent in 1999. Eleven percent of companies do not have problems compare with three percent in previous survey. The same percentage of companies cannot manage all these problems – three percent in both studies. More companies had limited problems in 1999 – 24 percent against 5 percent in 2003.

A permanently sustaining problem is high interest rates for credit. There is a positive change – 69 percent of companies "do not take loans at all" comparing with 45 percent in 2003. If only twenty three percent of firms took loans "only in the exceptional case" in 2003, thirty four percent of companies did so in 1999. That is an obvious indication that the local financial system does not supply accessible financial resources to rural businesses in Lithuania. As a result only about five percent of firms continue to take loans in a response to high interest rates, in 2003. In comparison, none of the firms continued to take loans in a response to high interest rates in 1999. Certainly real interest rates for loans were a little higher in 1999 than in 2003. Corrections in attitude to competitors demonstrate changes in transitional markets. In addition supplier investments were not important during 1999 versus increased supplier credits in Lithuania in 2003. Better trade relations raised a competition from imports from 14 percent to 37 percent. Development of new firms and infrastructure also increased number of local competitors in the domestic economy from 58 to 66 percent.

## **Conclusion**

A start-up finance measures company's willingness to achieve the substantial economic goals in small and medium sizes businesses especially in rural companies. During the interview study the enhanced questionnaire was implemented.

The start-up credit dynamics involves all settlements from the private sources which are very useful for the discussed economic entities. A final observation can be that Lithuania does not seem to differ from most Central and Eastern European countries with respect to financing of entrepreneurship in the transitional period from centrally planned to market economy. Own savings are the primary source of rural businesses start-up financing with help from family and friends. In Lithuania we found that supplier investments were not important during 90's versus increased supplier credits in the beginning of 21<sup>st</sup> century.

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## MAŽŲ IR VIDUTINIŲ ĮMONIŲ PRADINIS FINANSAVIMAS LIETUVOJE

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### Santrauka

Straipsnyje aptariamos pradinės verslo finansavimo galimybės, skirtos mažų ir vidutinių įmonių kaimo verslo plėtrai Lietuvoje. Taip pat nagrinėjama regioninio verslo finansų infrastruktūros pokyčiai veikiant valiutų valdybai pereinamos ekonomikos šalyje. Atliktos daugiau nei penkių dešimčių įmonių apklausos 1999 ir 2003 metais. Lietuva infrastruktūros verslo požiūriu nedaug skiriasi nuo kitų Vidurio ir Rytų Europos regiono šalių. Pagrindinis tokio pradinio kaimo verslų finansavimo šaltinis dažnai yra nuosavos santaupos, kartais padedant draugams ar giminaičiams. Požiūrio į konkurentus skirtingas suvokimas taip pat parodo vykstančius pokyčius kaimo versle, kylančios ekonomikos šalyse. Formuojantis geresniems tarptautinės prekybos ryšiams importo sukeliama konkurenciją padidėjo nuo keturiolikos iki trisdešimt septynių procentų. Naujų įmonių ir infrastruktūros plėtra padidino konkurenciją tarp vietos verslininkų nuo penkiasdešimt aštuonių iki šešiasdešimt šešių procentų. Tuo pačiu apklausos Lietuvoje metu pastebėta, kad gamintojų ir tiekėjų investicijos nebuvo svarbios 1999 metais lyginant su padidėjusių gamintojų paskolų suteikimų 2003 metais. Deja, mažai įmonių tuo metu naudojami komercinių bankų paskolomis. Apibendrinant galima teigti, kad Lietuvoje gauti rezultatai yra panašūs į gretimų Lietuvai šalių verslo makroekonominės aplinkos ir pradinio finansavimo tyrimų duomenis.

*Pradinis finansavimas, smulkus ir vidutinis verslas, regionų verslo plėtra.*

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