Journal of Applied Economics and Business

OPEN ACCESS ARTICLE

Access to Finance: Case of the Baltic States

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Abstract

The purpose of this research is by analysing financial resources availability in the three Baltic States to develop recommendations for improving access to financial services. The research methodology used in this paper starts with a literature review in order to highlight the importance of financial services availability from companies and financial market perspectives. The analysis conducted in this paper is based on data and statistics provided mainly by the Baltic States Central banks, by certain empirical studies and by the World economic forum data base. During development of the paper the generally accepted qualitative and quantitative methods of economic research were used including comparative analysis and synthesis, graphical illustration methods. To analyse access to finance is a multifaceted task, the author of the paper in this research has mostly concentrated on the main sources of finance: loans, stock markets and venture capital. The study results highlight the need to recognize that countries require sound and at the same time well-functioning financial markets. Only in this case financial markets can provide resources for investments as sound banking loans, properly regulated securities exchanges, venture capital, and other sources.

Keywords: *Access to finance; Financial market efficiency; Loans; Stock markets; Venture capital.*

Introduction

Financial markets all over the world face a number of significant and interrelated challenges that could prevent a real growth after an economic crisis as in the most advanced economies as in the developing markets as well. The remaining financial difficulties in the euro zone have led to a long-lasting sovereign debt crisis that has now reached the highest point. Scientists together with governments are looking for cooperation and management of the current economic challenges while preparing their economies to perform well in an increasingly difficult and changing environment. Financial markets activities mostly focused on the short-term crisis management, remain critical for countries to establish the fundamentals that contribute to economic growth and development in the long run.

In the Baltic States SMEs form the largest part of companies, providing the majority of jobs. Small firms find it difficult to obtain commercial bank financing, especially long-term loans, for a number of reasons, including lack of collateral, difficulties in proving creditworthiness, small cash flows, inadequate credit history, high risk premiums, underdeveloped bank-borrower relationships and high transaction costs. This is evidenced in [1], [2], [3], [4], [5] and [6].

In particular, [7] conclude that smaller firms and firms in countries with underdeveloped financial and legal systems use less external finance, based on data from a firm-level survey in 48 countries. Additionally there exists a positive correlation between the financial market development on one hand, and the companies' access to finance, on the other hand [8].

Access to finance plays a significant role in the development of the company, while the company's development level is dependent on the availability of financial services; at the same time access to finance is dependent on the financial market development and vice versa, available financial services improve financial market efficiency. Access to finance can be analysed from different aspects:

- How available are financial services for companies and individuals in general;
- Who can afford financial services in general;
- What are the main resources of financing: loans, securities and venture capital?

Backed by solid empirical evidence, development practitioners are becoming increasingly convinced that efficient, well-functioning financial systems are crucial in channelling funds to the most productive uses and in allocating risks to those who can best bear them, thus boosting economic growth, improving opportunities and income distribution, and reducing poverty [9], [10], [11], [12], [13], [14] and [15] .

ANALYSES AND RESULTS

The author of the paper relied on "The Global Competitiveness Report" of the World Economic Forum, by assessing development of the financial markets of the Baltic States from international competiveness perspective.

This forum has, for more than thirty years, provided detailed assessments of the productive potential of nations worldwide. The Report contributes to an understanding of the key factors that determine economic growth, helps to explain why some countries are more successful than others in raising income levels and opportunities for their respective populations, and offers policymakers and business leaders an important tool in the formulation of improved economic policies and institutional reforms.

In accordance with World Economic forum's report financial market efficiency can be characterised by following factors:

- Availability of financial services;
- Affordability of financial services;
- Financing through local equity market;
- Ease of access to loans;
- Venture capital availability.

Factors characterising trustworthiness and confidence are:

- Soundness of banks;
- Regulation of securities exchanges;
- Legal rights index

In Fig. 1 are reflected the main determinants of financial market development in the Baltic States in accordance with World Economic forum's report. As we can see all efficiency determinants correlate with access to finance. Analysing availability of financial services in the Baltic States in general, the author concluded that in Estonia companies and individuals have better access than in Latvia and Lithuania, ranking Estonia in 43rd place (2012), within 45 best countries, at the same level as Slovak Republic and Czech Republic, and not far from Japan's and Israel's levels. Whereas Latvia's and Lithuania's positions are 65 and 74 respectively, placing Latvia at the same level as Jamaica and Colombia, and for Lithuania - Uganda and Zambia.

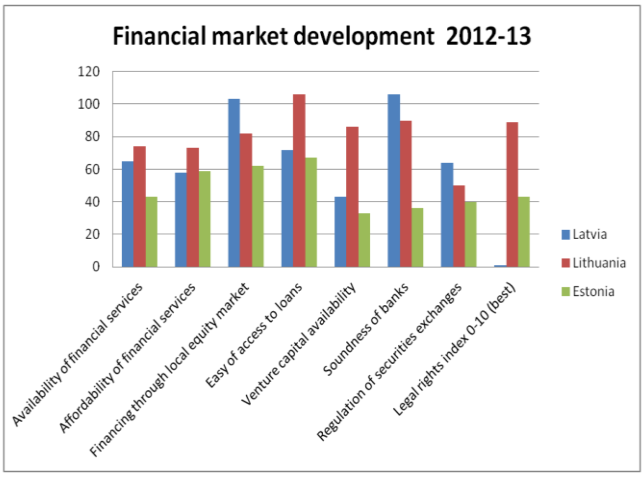

FIG.1. GLOBAL COMPETIVENESS INDEX 2012-13 OF FINANCIAL MARKET DEVELOPMENT FOR THE BALTIC STATES (RANK/144 COUNTRIES) [16]

Whereas access to finance is significantly better in Estonia, the affordability of financial services is rather similar in the all Baltic countries, placing Latvia and Estonia in 58 and 59 places out of 144 countries, and Lithuania in 73rd place. By evaluating the positions of the Baltic States in the world countries ranks, Latvia shows an improved affordability of financial services when compared with access to services, whereas in Estonia the situation is opposite, as for Lithuania in both determinants situation is the same.

In Fig. 2. are presented the responses of companies to inquiry of the most problematic factors of doing business in the Baltic States. Access to financing was the third ranked most pressing problem faced by Latvian entrepreneurs after too high tax rates and inefficient government. For Lithuanian entrepreneurs' access to finance was ranked as the six ranked obstacle, as they consider tax rates and tax regulations alongside with corruption and inefficient government more problematic. Access to financing was the second ranked obstacle to doing business in Estonia.

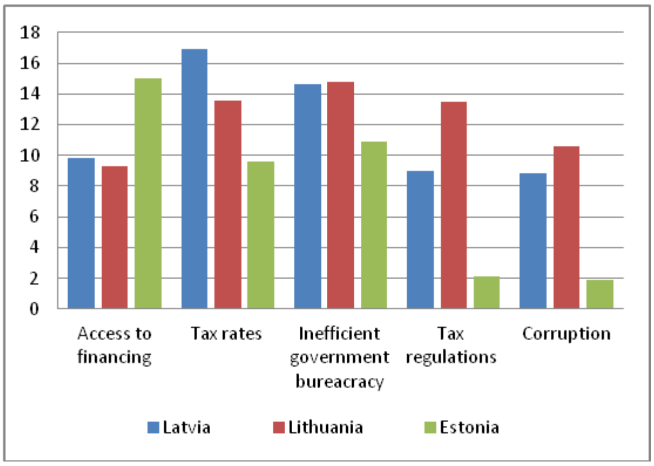

FIG. 2. THE MAIN OBSTACLES TO DOING BUSINESS IN THE BALTIC STATES 2012-2013, % [17]

Loans

The period from 2004 to 2007 was marked by buoyant growth of the Baltic States economies and banking sector, characterised by investment inflows, lending boom and a very low exposure to non-performing loans in the loan portfolios. In 2006-2007 all three Baltic States were actively working on the introduction of the euro and were trying to reduce too high inflation, for example Latvian government was forced into action to set up a working group on inflation which published an anti-inflation plan in early March 2007. As a result if in the beginning of 2006 access to loans in Lithuania and Estonia was at the same level and significantly better than in Latvia, after government reforms Latvia and Lithuania worsened their positions equally. Whereas Estonia continued to strengthen financing possibilities for companies and individuals till 2008.

Starting from the third quarter of 2008, the first signs of growing stress became apparent mainly as a result of the shrinking economic activity, drying-up lending and an ever accelerating fall in real estate prices. In the second half of the year, access to loans worsened against the background of the collapse of Lehman Brothers and the subsequent liquidity squeeze and deterioration of the external economic environment. In Latvia situation was complicated with the take-over of JSC Parex banka in 2008 and the government turning to international donors for assistance. Despite the fact that Lithuania didn't use international aid, the problems in the country were very similar to Latvia's, as a result Lithuania's access to credits was only slightly better than the Latvia's. Only starting from 2010, the situation can be assumed to normalise, yet the high provisions ratio, significant losses of the banking sector and shrinking loans still suggest that the availability of loans remains problematic.

After 2010 Latvia showed significant improvements in crediting and almost reached the level of Estonia, at the same time in Lithuania the improvement of credit availability was moderately stable. The crisis affected Latvia's market more severely than others, as during 2 crisis years the drop of availabilities of loans was 41% compared with 38% and 35% in Lithuania and Estonia respectively.

It is interesting to compare the performance of the Baltic States as a group with other EU groups. The crisis had similar effect on all economic groups, but the effect was stronger in the Baltic region, when during 2 years the availability of loans decreased by 38%, whereas in EU-12 (Accession) and EU-15 only by 25%. The author positively values that after the crisis recovery was more dynamic in the Baltic region, when access to loans improved by 10%; at the same time in EU-12 and EU-15 it decreased by 3% and 6% respectively.

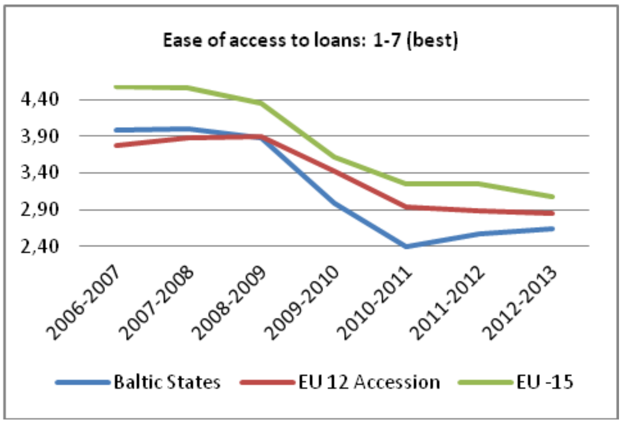

FIG. 3. EASE OF ACESS TO LOANS FROM 2006-2013 [18], [19], [20] and [21]

Comparing the Baltic financial markets with EU-12 and EU-15 the author concluded that our markets were not as stable, as fluctuations in the access to financing are significantly higher than average for the EU (see Fig. 3).

The Doing Business getting credit indicator measures the legal rights of borrowers and lenders with respect to secured transactions through one set of indicators and the sharing of credit information through another.

The ranking on the ease of getting credit is based on the percentile rankings on its component indicators: the depth of credit information index (weighted at

37.5%) and the strength of legal rights index (weighted at 62.5%) (see Table 1).

The strength of legal rights index measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending. Strong creditor rights expand the availability of loans. In Latvia, in accordance with Doing Business report, lenders have better legal protection during bankruptcy and reorganization of the debtor; they are more confident about the return of their investment in cases of default and therefore more willing to issue credits, whereas the situation in Estonia corresponds to the average level in Eastern Europe & Central Asia region. Estonia and especially Lithuania have to amend current laws, improving protection for lenders and for borrowers.

TABLE 1 RANKING ON THE EASE OF GETTING CREDIT IN THE BALTIC STATES, RANK/185 COUNTRIES [17]

	Estonia	Latvia	Lithuania	Eastern Europe & Central Asia
Getting credit (rank)	40	4	53	-
Strength of legal rights index (0-10)	7	10	5	7
Depth of credit information index (0-6)	5	5	6	5
Public registry coverage (% of adults)	0	63,8	24,4	17,3
Number of individuals		908374		
Number of firms		56993		
Private bureau coverage (% of adults)	33,4	0	81,2	29,8
Number of individuals	200 000		1 577 143	514 715
Number of firms	100 000		220 789	24 811

The depth of credit information index measures rules and practices affecting the coverage, scope and accessibility of credit information available through either a public credit registry or a private credit bureau. For regulators, credit information systems provide a powerful tool for supervising banks and monitoring credit risk and credit trends in the economy. Regulators often use information from credit bureaus to assess whether current provisioning is adequate and to analyze developments in credit markets and interest rates. The results may guide changes in the legislation governing financial institutions. Research in Argentina, Brazil and Mexico found that credit registries played a valuable role in credit risk evaluation and in supervision, including in calculations of credit risk for capital or as a check on a bank's internal ratings [22]. In 2008 the Bank of Latvia's registry of debtors was transformed into a full-fledged credit registry. It now collects both positive and negative information on borrowers, borrower guarantors and their obligations. The registry is also able to record more precise information, such as the type of settlement of the borrower's obligations and the date on which settlement of a delayed payment is registered. And the registry expanded its coverage from 3,5% of adults in 2008 to 63,8% in 2013. In Lithuania both private bureau and public registry record the number of individuals and firms listed in registry with information on their borrowing history from the past 5 years. As a result Latvia needs to continue the started process of improving the registry of debtors, whereas Estonia has to be more active in this direction.

Securities

When a company wants to raise money, one of its first decisions is whether to do so by bank lending or by issuing bonds and shares. In the 20th century, most company finance, apart from share issues was raised by bank loans. But since about 1980 there has been an ongoing trend for disintermediation, where large and credit worthy companies have found they effectively have to pay out less in interest if they borrow from the capital markets rather than banks. The tendency for companies to borrow from capital markets instead of banks has been especially strong in the US. According to the Lena Komileva writing for *The Financial Times*, Capital Markets overtook bank lending as the leading source of long term finance in 2009 - this reflects the additional risk aversion and regulation of banks following the 2008 financial crisis [23].

However in the Baltic States financial market loans are more accessible for small and medium companies and in general bank-loans remain the main resource of financing. Capital market consists of fixed income debt securities and share market. In the Baltic States, the fixed income securities market is small by international standards, yet it has developed a versatile legislative framework and adequate institutions. Baltic fixed income securities market offers government debt securities, debt securities of joint stock companies, mortgage bonds and other securities. Share market, the second component of capital market, plays a less significant role in the Baltic States at present than debt securities market. Baltic countries, like other EU accession countries, started with a small number of shares, all of which were offered through initial public offering. Many shares had fairly liquid trading. Gradually the number of listed companies grew. Besides those that appeared in the list through privatisation programs, there were also newly established joint-stock companies. By analysing availability of equity market (see Fig.3) one may conclude that most developed is Estonian market, than Lithuanian and in the third place Latvian. The crisis effected all countries very negatively, but recovery is more dynamic in Latvia, as a result availability of equity market worsen in Estonia by 40%, in Lithuania by 36% and in Latvia by 33%. Still Estonia and Lithuania enjoy better positions than Latvia.

To forecast future prognosis of equity market development the author compared Baltic countries with other EU-12 accession countries and old EU-15 countries (see Fig.4).

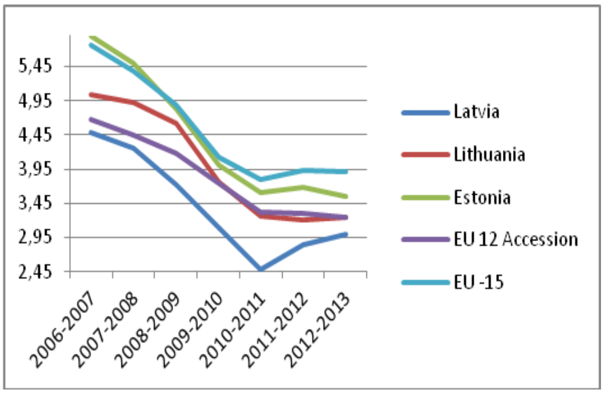

FIG.4. FINANCING THROUGH LOCAL EQUITY MARKET IN THE BALTIC STATES: 1-7(BEST) [18], [19], [20] and [21]

The situation in Estonian market had been the best, and before the crisis was even better than in EU-15, but unfortunately after the crisis the tendency remains negative, when EU-15 started to show an improvement. As for Lithuania, the Lithuanian position worsened more significantly than in other average EU-12 accession countries, but moderate improvements in recent years could be observed as a positive tendency. Availability of Latvian equity market so far was the most unstable, as a result more unattractive for potential issuers, but positive changes can be observed.

Venture capital

Venture capital (VC) is financial capital provided to early-stage, high-potential, high risk, growth start-up companies. The venture capital fund makes money by owning equity in the companies it invests in, which usually have a novel technology or business model in high technology industries, such as biotechnology, IT, software, etc. The typical venture capital investment occurs after the seed funding round as growth funding round in the interest of generating a return through an eventual realization event, such as an IPO or trade sale of the company. Venture capital is a subset of private equity. Therefore, all venture capital is private equity, but not all private equity is venture capital [24]. In addition to angel investing and other seed funding options, venture capital is attractive for new companies with limited operating history that are too small to raise capital in the public markets and have not reached the point where they are able to secure a bank loan or complete a debt offering. In exchange for the high risk that venture capitalists assume by investing in smaller and less mature companies, venture capitalists usually get significant control over company decisions, in addition to a significant portion of the company's ownership (and consequently value).

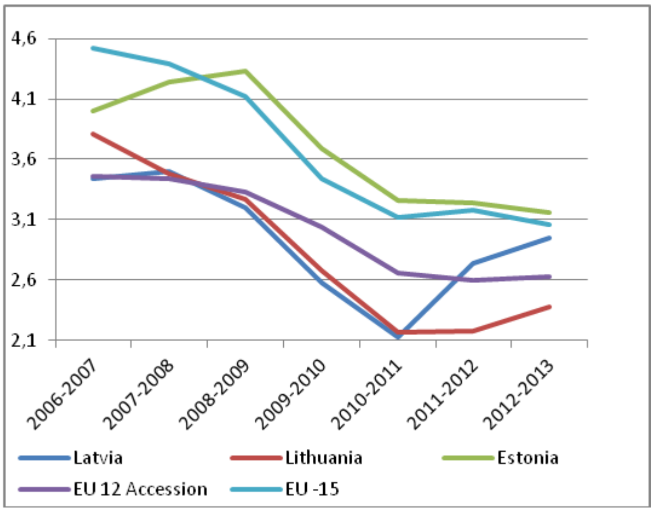

FIG 5. VENTURE CAPITAL AVAILABILITY: 1-7(BEST)

[18], [19], [20] and [21]

Venture capital availability also characterises how innovative the country is. From the analysis of access to venture capital in the Baltic States the author concluded that Estonian financial market is more innovative when compared with Latvia's and Lithuania's and, what is very positive, more creative than average EU-15 markets. The crisis in general affected negatively also this market, but it catalysed Lithuanian and Latvian markets to look for new non-traditional finance possibilities.

Conclusion

Based on the results of empirical analyses the author offers recommendations for improving the availability of financial services in the Baltic markets.

SME access to finance in the Baltic financial markets is a fundamental component of financial market efficiency and at the same time has a significant importance for the creation of new businesses, the growth and development of already existing ones, which, in their turn, foster the economic and social development of a country. Backed by solid empirical evidence, development practitioners are becoming increasingly convinced that efficient, well-functioning financial systems are crucial in channelling funds to the most productive uses and in allocating risks to those who can best bear them, thus boosting economic growth, improving opportunities and income distribution, and reducing poverty. However, most surveys emphasize that SMEs report, consistently, the access to finance as one of the most important obstacles to their functioning and development. The main caveats and directions for improvement are as follows.

First, improvement of financial market efficiency needs the revaluation of: (a) macroeconomic policy and data transparency; (b) supervision and regulation of financial intermediaries and (c) institutional and market infrastructure.

Second, macroeconomic policy and data transparency by strengthening responsibility and increasing the political risk can therefore enhance credibility. As a result companies will receive access to finance with lower borrowing costs and in general stronger support for sound macroeconomic policies by a well-informed public.

Third, in recent years the problems in financial intermediaries' sector activities have highlighted the necessity of structural reforms in this sector regulation and supervision all over the world:

- The need for greater supervisory intensity and adequate resources to deal effectively with systemically important system participants;
- The importance of applying a system-wide, macro perspective to the micro-prudential supervision of financial intermediaries to assist in identifying, analysing and taking pre-emptive action to address systemic risk;
- The increasing focus on effective crisis management, recovery and resolution measures in reducing both the probability and impact of the intermediary failures.

For Latvia the most vital improvements have to be done in equity market (from financing through local equity market perspective, and from regulation of securities exchange perspective), as well as greater intensity of supervision of banking activities in order to avoid possible bankruptcy of banks (the case of the bank "Krajbanka" bankruptcy in 2011).

For Lithuania it is essential to ease access to loans. To do that, Lithuanian government needs to amend collateral and bankruptcy laws, protecting more the rights of borrowers and lenders and thus facilitating lending. Nevertheless, rather well established registry of debtors compared to other Baltic States, was not sufficient to avoid problems in the banking sector (bank "Snoras" bankruptcy in 2011), as a result a more intensive supervision of financial intermediaries is still recommended.

As for Estonia, improvements have to be made in credit information systems, and in legal protection for lenders and borrowers.

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