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FOREWORD

The special issue of the journal is devoted to the papers presented at the International Scientific Conference “Sustainable business development under scenarios of possible economic slowdown” held at Riga International School of Economics and Business Administration (RISEBA), Latvia, on 10-12 April 2008 and was hosted by three leading in the field of Business Administration academic institutions of higher education in Latvia that are: Riga International School of Economics and Business Administration, Ventspils University College and BA School of Business and Finance (these institutions also run a joint PhD Business Administration program).

Participants from twelve countries – Latvia, Lithuania, Sweden, Germany, Switzerland, United Kingdom, Russia, Australia, Estonia, Poland, Denmark and USA – took part in the conference.

The conference topic was announced in February 2007 (during the previous conference), when Latvia and other countries experienced the rapid economic growth. At that time, it seemed that the conference issue on business development under scenarios of economic slowdown was too pessimistic. However, the forecast appeared to be right.

Nowadays discussions of economists and politicians are focused around the duration and seriousness of consequences of the slowdown in contrast to the last year’s focus – how long the rapid world economic growth would last. It is particularly applicable to the Baltic countries, where a number of indicators show that economic changes are occurring rapidly. The fast slowdown of the economic growth indicates on the fact that the Baltic countries have entered into a reverse stage of the development cycle, although the future positive growth is forecasted with respect to all three countries.

The conference agenda addressed three basic questions: 1) the severity of the situation in the Latvian economy and possible scenarios of further development; 2) the economic behavior of entrepreneurs under conditions of economic slowdown; 3) the Government’s role in the period of the rapid slowdown of the economic growth.

The considerable decline of the Latvian economy was forecasted the current economic situation. Simultaneously, the participants counted on the fact that the Government is able to avoid the economic recession and other shocks, e.g. depreciation of the lat. The overall forecast of entrepreneurs in the middle of 2008 is quite optimistic: 4-5% growth rate of GDP\(^1\). However, despite of this optimistic viewpoint it was admitted that the economic risks still remain very high, driven mainly by the current trade deficit and high inflation rate. Therefore, sound and rapid qualitative changes applied to the country’s economy are required in order to eliminate these risks.

The participants also admitted that the Latvian economy is strongly dependent on exports and, thus, on the global tendencies that are hard to influence. Hence, in order to solve Latvia’s economic problems the internal state changes are required in the first place. These changes have to be undertaken by both entrepreneurs and the Government.

It is of an utmost importance for the economy that the entrepreneurs were optimistic and proactive, although they have to understand that their growth opportunities will be limited due to two reasons. The first one has already been mentioned in connection with the economic slowdown. The second is tied to the fact that the Latvian in-house market is not very big and in order to continue to develop in line with their business ambitions the entrepreneurs often have to open up new markets outside Latvia.

\(^1\) According with prognoses (February 2008), at October 2008 estimated - 0%
Given the decline of the economic growth rate and the consequential growth of demand, the competition is expected to increase, the price competition in the first place. However, the price competition has its own limitations and, thus, could not be regarded as the entrepreneurial optimum. The involvement of business growth in the price competition could be a sound strategy in the markets where the competition level was low. Yet, in most of the economy sectors the growth and development potential is underpinned by innovations, by offering new and unique products, by improving relationships with customers, by modernizing the internal organization structure.

The great potential of the business development had hitherto been carried by the “copy-paste” strategy: when the demand grows rapidly, a number of other template businesses arise (whether local, or foreign). Nowadays, in contrast, the greatest potential lies within the creative and innovative thinking.

What do the entrepreneurs expect from the Government? The answer is: they do not possess the unified plan of actions. However, the entrepreneurs’ feasible expectations include: macroeconomic stability, rise of the economic competitiveness (that has fallen during the last years) and adequate support of the economy sectors, which do not feature free competition and which are dependent on public support.

The entrepreneurs are still in the lack of the vision of the country’s course of economic development, the vision that is clear and simple enough. Latvia is a small country and its resources are limited — it pertains to both nature and human resources. Therefore, consolidation of human resources in a number of priority directions could result in the larger contribution to the state economy as opposed to the case when there are no such priority directions or they are not clear enough for the entrepreneurs. However, in order for this consolidation to ensue, it is necessary to manage this process. And that is where the Government’s role as the leader lies corresponding with the entrepreneurs’ expectations.

Considering the complicated situation in the state economy, it is imperative to think innovatively and pragmatically as well as to increase productivity not only on the business, but also on the state level. The Government sector’s task is to serve the society. It is, therefore, essential that every lat spent carried a clear justification from the viewpoint of the goals set due to the reason that the state competitiveness is influenced by the consumers’ and entrepreneurs’ degree of reliance to the Government. In case the processes causing uncertainty towards the Government’s actions, e.g. it works in favor of one of the group’s interests or accomplishes such projects that are not supported by the society, then the entrepreneurs’ confidence towards the future weakens.

Under circumstances of the economic growth rate declining, the Government could initiate large-scale projects that encouraged the economic growth. At the same time for the sake of effective allocation of resources it is required to provide calculations on the project’s return justified scientifically. The current practice when decisions are taken on the subjective grounds is not viable from the state’s development viewpoint.

A number of the conference participants mentioned the importance of ensuring alterations in relation to the education system. One of the modifying criteria is that the education system has to be capable of preparing ambitious leaders thinking creatively and able to make decisions in the ever-changing environment.

Key words of conference: the Government’s role in the business environment stabilization, leadership, economic slowdown, sustainable development and competitiveness

On behalf of the Conference editorial board, 2008: V. Kozlinskis, A. Nipers
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Abstract: Any changes of aggregate expenditure in national economy involve the multiplier effect. Valuing possible effects of macroeconomic policy, one must take into account the coefficient of multiplier. Value of the coefficient depends first of all on the population’s marginal propensity to consume (MPC) and typically exceeds 1. But besides the MPC there are other factors that may substantially affect the value of multiplier. One of these factors is the marginal propensity to import (MPI). It is usually stated that the MPI cannot exceed 1.

The aim of the paper is to estimate the value of multiplier in Latvian economy in order to check whether this value might prove below 1 due to high MPI. Calculations of the coefficients of multiplier, MPC, and MPI for period of 1995 – 2006 are made by author on the basis of Latvian statistics. Conclusions and implications for macroeconomic policy are suggested.

Keywords: multiplier; gross domestic product (GDP); consumption function; marginal propensity to consume; imports; marginal propensity to import; Latvian economy.

1. Introduction: The Multiplier and the Marginal Propensity to Import in Theory

The concept of multiplier is an important element of macroeconomic theory. The coefficient of multiplier \( k \) shows that one money unit spent in a national economy causes an increase in GDP by more than one unit (1, p.93-119; 2; 3; 4; 5). By definition, \[ k = \Delta Y / \Delta A, \]

where \( Y \) is real GDP, and \( \Delta A \) is an increase in autonomous expenditure.

On the other hand, the coefficient of multiplier can be estimated on the basis of the marginal propensity to spend on domestic goods and services (\( \varepsilon \)):

\[ k = 1 / (1 - \varepsilon) \]

The multiplier effect is graphically illustrated by a typical chart as one presented on Fig. 1.

On the chart, size of the multiplier is determined by slope of the aggregate expenditure (AE) graph: the steeper is the graph, the greater proves the multiplier. In turn, the slope of the AE graph depends first of all on the consumption function, \( C = f(Y) \) and on the marginal propensity to consume (MPC) supposed by this function. In the first approximation, the size of the coefficient of multiplier (simple multiplier) depends on the marginal propensity to consume (MPC) which is the ratio of increase in consumer expenditures to increase in aggregate income (or GDP):

\[ MPC = \Delta C / \Delta Y \]

The idea of multiplier is of great importance for any decision making in economic policies, since the multiplier effect creates a kind of “leverage” that would “strengthen” any increase or decrease in the aggregate expenditure and lead to more substantial changes in national output, employment, and inflation. It is crucial therefore to realize how big an effect on national output may be caused, for example, changing government spending by 1 million or varying tax collections by a certain amount. Estimates of the multiplier must be taken into account at designing macroeconomic policies. How big an increase in government expenditures or cut in taxes is needed to avoid a recession? How big a cut in government spending, decrease in private investment or tax increase is needed to reduce inflation (what was especially relevant for Latvia in recent years)? Answers to questions of such kind will depend on the size of multiplier.
Some common considerations concerning the coefficient of multiplier are that:
value of the multiplier exceeds 1; possibility of the multiplier having size less than 1 is seldom discussed in economic literature.
value of the multiplier is comparatively lower during economic recessions and higher within periods of economic recovery (6, p.692).

However, besides the MPC, there is other major factor affecting the size of multiplier: it is the marginal propensity to import (MPI). The marginal propensity to import is defined as ratio of change in a nation’s imports to change in its GDP (7, p.512; 8, p.499 – 500):

\[ MPI = \frac{\Delta M}{\Delta Y} \]  

Since imports is subtracted from the sum of aggregate expenditure in national economy, the slope of the aggregate expenditure (AE) graph proves determined not just by the MPC but rather by the marginal propensity to spend on domestic goods and services (\( \varepsilon \)).

The marginal propensity to spend on domestic goods and services (or simply: marginal propensity to spend) equals the marginal propensity to consume less the marginal propensity to import:

\[ \varepsilon = MPC - MPI \]  

Taking into account the marginal propensity to import, the formula of multiplier should be modified in the following way:

\[ k = \frac{1}{1 - (MPC - MPI)} = \frac{1}{1 - \varepsilon}, \]  

or, which is actually the same,

\[ k = \frac{1}{1 - MPC + MPI} \]

MPI therefore reduces the size of multiplier (8, p. 480; 9, p.1122 – 1123). As North American authors point it out, it was increase in the US imports that proved to be the main factor reducing the multiplier in the American economy within the last decades of the 20th century (6, p.693).
On graph, MPI makes the AE line more flat and, in the extreme case, very high MPI could even turn the AE graph from climbing into a downward-sloping one (compare the graphs AE1, AE2, and AE3 in Fig. 2). In the last case, the coefficient of multiplier has to drop below 1.

![Graph showing different AE lines](image)

**Fig. 2.** Possible effects of imports on the slope of AE graph.

There are also some typical theoretical assumptions about the MPI:

- it is usually believed that MPI cannot reach or, all the more, exceed 1. Even values of MPI as 0.36 are referred to as “incredibly high” (6, p.693); one can also find stated in texts on macroeconomics that it does not make sense to suppose MPI exceeding 1.

- it is considered that MPI in a small country should be higher than in a big country (2, p.415–416).

- it is stated that MPI depends on the structure of a country’s imports: the marginal propensity to consume is higher if in the country’s imports dominate consumer goods rather than capital goods (7, p.512).

### 2. Multipliers in Real World: Is Latvia an Exception?

However, data concerning actual values of the coefficient of multiplier in real economies are sporadic and seldom available in literature. It is well known, for example, that J. M. Keynes in 1930s supposed the value of multiplier in the US economy to be close to 2.5 (1, p.106); it is possible to find some estimates of the multiplier in the US economy in selected years after 1960 (Table1).

The data of Table 1 prove, by the way, that within certain periods (namely, during the especially severe recessions of 1974 – 1975 and 1981 – 1982) the multiplier in the American economy fell below 1. It is mentioned in some economic texts that the size of multiplier in the UK by the end of 1990s could be just over 1.4 (8, p. 480). Sometimes values of the multiplier for particular countries are suggested as rather hypothetical (e.g., 1.11 for Belgium) (2, p.415–416).
Table 1. Historical Data: The Multiplier in the US Economy in Selected Years

<table>
<thead>
<tr>
<th>Years</th>
<th>(Billions of 1982 dollars)</th>
<th>Multiplier ($k = ΔY / ΔA$)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Change in Autonomous Expenditure ($ΔA$)</td>
<td>Change in Induced Expenditure ($ΔN$)</td>
</tr>
<tr>
<td>1960 – 87</td>
<td>+1121.9</td>
<td>+1032.4</td>
</tr>
<tr>
<td>1974 – 75</td>
<td>– 99.8</td>
<td>+ 65.5</td>
</tr>
<tr>
<td>1981 – 82</td>
<td>– 117.1</td>
<td>+ 34.3</td>
</tr>
<tr>
<td>1982 – 83</td>
<td>+ 50.3</td>
<td>+ 62.8</td>
</tr>
<tr>
<td>1983 – 87</td>
<td>+383.3</td>
<td>+157.2</td>
</tr>
</tbody>
</table>

Source: (6, p.692; with reference to the Economic Report of the president, 1988)

In this article, an attempt is made to estimate real value of the coefficient of multiplier for the Latvian economy in 2000 – 2006. It would be relevant, of course, to consider a longer historical period of time, but problems arise with comparability of statistical data. Because of often corrections in methodology of macroeconomic calculations in Latvian statistics, data for 2000 – 2006 are not directly comparable with data of previous periods.

Table 2. GDP of Latvia, 1999 – 2006: Expenditure of Gross Domestic Product (at constant prices of 2000, millions of Ls)

<table>
<thead>
<tr>
<th>GDP (Y)</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private final consumption Expenditure (C)</td>
<td>2 781</td>
<td>2 970</td>
<td>3 187</td>
<td>3 421</td>
<td>3 702</td>
<td>4 055</td>
<td>4 521</td>
<td>5 414</td>
</tr>
<tr>
<td>Gross capital formation (Ig)</td>
<td>1 098</td>
<td>1 126</td>
<td>1 448</td>
<td>1 532</td>
<td>1 870</td>
<td>2 300</td>
<td>2 494</td>
<td>2 965</td>
</tr>
<tr>
<td>Government final consumption Expenditure (G)</td>
<td>1 030</td>
<td>988</td>
<td>1 016</td>
<td>1 038</td>
<td>1 057</td>
<td>1 080</td>
<td>1 108</td>
<td>1 153</td>
</tr>
<tr>
<td>Exports of goods and services (X)</td>
<td>1 777</td>
<td>1 978</td>
<td>2 126</td>
<td>2 241</td>
<td>2 358</td>
<td>2 581</td>
<td>3 104</td>
<td>3 268</td>
</tr>
<tr>
<td>(–) Imports of goods and services (M)</td>
<td>2 242</td>
<td>2 312</td>
<td>2 643</td>
<td>2 767</td>
<td>3 129</td>
<td>3 648</td>
<td>4 187</td>
<td>4 919</td>
</tr>
</tbody>
</table>

Sources: 10, p. 50 – 53; 11, p.20

Latvian statistics, similarly to statistics of other countries, provides necessary data to compute the MPC (see Table 2). On the basis of these data, the consumption function graph for after-tax consumption, $C = f (Y)$, for the Latvian economy can be produced (Fig.3). Values of the marginal propensity to consume, as computed from the data presented in the Table 2, prove to be the following:

2000: $MPC = 189 / 307 = 0.62$;
2001: $MPC = 216 / 382 = 0.57$;
2002: $MPC = 234 / 332 = 0.70$;
2003: $MPC = 281 / 393 = 0.72$;
2004: $MPC = 353 / 507 = 0.70$;
2005: $MPC = 463 / 652 = 0.71$;
2006: $MPC = 893 / 840 = 1.06$ ($MPC$ exceeds 1, which is valued in economic texts as a hardly possible outcome);
2000 – 2006 on average: $MPC = 2629/3437 = 0.77$
The simple multiplier, $k = 1 / (1 - \text{MPC})$, as implied by the consumption function, should equal therefore:

- 2000: $k = 1 / (1 - 0.62) = 2.63$;
- 2001: $k = 1 / (1 - 0.57) = 2.33$;
- 2002: $k = 1 / (1 - 0.70) = 3.33$;
- 2003: $k = 1 / (1 - 0.72) = 3.57$;
- 2004: $k = 1 / (1 - 0.70) = 3.33$;
- 2005: $k = 1 / (1 - 0.71) = 3.45$;
- 2006: (a negative value of $k$, which does not make economic sense);
- 2000–2006 on average: $k = 1 / (1 - 0.77) = 4.35$.

Such estimates of the multiplier might indicate that any single lat of autonomous expenditure increased GDP of Latvia in particular years by 2.33 – 3.57 lats. In other words, one could conclude that a very strong multiplier effect took place, and it boosted the rapid growth of the Latvian economy in recent years.

On the other hand, taking into account the above-mentioned effect of MPI, we must modify our previous calculations related to the coefficient of multiplier in Latvia.

Our main objectives will be the following:
- To estimate the marginal propensity to import (MPI) in the Latvian economy;
- To find out whether the value of MPI cannot exceed 1;
- To value more accurately the size of multiplier, taking into account the effect of MPI;
- To check whether the value of multiplier in the economy of Latvia might drop below 1, due to the MPI;
- To check whether the value of multiplier is directly related to economic growth.

Latvia is a small open economy with a very significant share of imports in its GDP. Moreover, the foreign trade balance of Latvia since 1995 is characterized by enormously big and still growing deficit. The country’s imports in recent years 1.3 – 1.5 times exceeded...
exports, and the foreign trade deficit in 2006 – 2007 was above 25% of GDP (13, p. 62). In
the composition of imports, during 2002 – 2007, share of capital goods was 17 – 18%, while
share of consumer goods gradually decreased from 28 to 22% (13, p.23).

Figure 4, based on the data of Table 2, presents the total volume of the Latvian imports in
1999 – 2006 in its relation to increase in the country’s GDP.

![Figure 4](image)

Fig. 4. The relationship between GDP and imports in Latvia, 1999 – 2006.

These data demonstrate an extremely rapid growth of the Latvian imports along with the
impetuous increase in the country’s GDP. It implies an enormously high value of the marginal
propensity to import. Indeed, the marginal propensity to import in the Latvian economy,
estimated from the data of the Table 2, was as follows:

- 2000: MPI = 70 / 307 = 0.23;
- 2001: MPI = 331 / 382 = 0.87;
- 2002: MPI = 124 / 332 = 0.37;
- 2003: MPI = 362 / 393 = 0.92;
- 2004: MPI = 519 / 507 = 1.02;
- 2005: MPI = 539 / 652 = 0.83;
- 2006: MPI = 732 / 840 = 0.87;
- 2000 – 2006 on average: MPI = 2677 / 3437 = 0.79

It actually results in a negatively sloping graph of the aggregate expenditure on domestic
goods and services (Fig.5).

In this case, the coefficients of multiplier, as they follow from the formula (7), were:

- 2000: k = 1 / (1 – 0.62 + 0.23) = 1 / 0.61 = 1.64;
- 2001: k = 1 / (1 – 0.57 + 0.87) = 1 / 1.3 = 0.77;
- 2002: k = 1 / (1 – 0.70 + 0.37) = 1 / 0.67 = 1.49;
- 2003: k = 1 / (1 – 0.72 + 0.92) = 1 / 1.2 = 0.83;
- 2004: k = 1 / (1 – 0.70 + 1.02) = 1 / 1.32 = 0.76;
- 2005: k = 1 / (1 – 0.71 + 0.83) = 1 / 1.12 = 0.89;
- 2006: k = 1 / (1 – 1.06 + 0.87) = 1/ 0.81 = 1.23;
- 2000 – 2006 on average: k = 1 / (1 – 0.77 + 0.79) =
= 1 / 1.02 = 0.98.
Fig. 5. The consumption function (C), and the spending on domestic goods and services (C – M) in Latvia, 1999 – 2006

In order to support these findings by a more vast empirical material, one could try to use data for the preceding years, at least, those for 1995 – 1999. Unfortunately, data on total volume and structure of GDP for this period are not quite comparable to those for 2000 – 2006, and, in fact, sometimes seem somewhat doubtful. The data are presented in Table 3.

| Table3. GDP of Latvia, 1995 – 1999: Expenditure of Gross Domestic Product (at constant prices of 2000, millions of Ls) |
|---|---|---|---|---|---|
| GDP (Y) | 3 606.0 | 3 742.7 | 4 052.7 | 4 244.1 | 4 383.6 |
| Private final consumption expenditure (C) | 2 280.7 | 2 521.7 | 2 647.1 | 2 664.4 | 2 778.3 |
| Gross capital formation (Ig) | 500.7 | 611.9 | 685.9 | 1 031.4 | 1 058.7 |
| Government final consumption Expenditure (G) | 951.6 | 882.0 | 910.1 | 1 030.1 | 1 025.9 |
| Exports of goods and services (X) | 1 326.2 | 1 594.7 | 1 804.0 | 1 891.6 | 1 771.2 |
| Imports of goods and services (M) (–) | 1 453.3 | 1 867.6 | 1 994.4 | 2 373.4 | 2 250.5 |

Source: 12, p.52 - 55.

The marginal propensity to import in the Latvian economy, if calculated on the basis of these data, proves to be in some years even more impressive:

1996: 414.3 / 136.7 = 3.03;
1997: 126.8 / 310.0 = 0.41;
1998: 379.0 / 191.4 = 1.98;
1999: \[ -122.9 / 139.5 = - 0.88. \]
1996 – 1999 on average: \[ 797.2 / 777.6 = 1.03. \]
The values of multiplier, \( k = 1 / (1 – \text{MPC} + \text{MPI}) \), are then as follows:
1996: \( k = 1 / (1 – 1.76 + 3.03) = 0.44; \)
1997: \( k = 1 / (1 – 0.4 + 0.41) = 0.99; \)
1998: \( k = 1 / (1 – 0.1 + 1.98) = 0.35; \)
1999: \( k = 1 / (1 – 0.82 – 0.88), \text{negative value}; \)
1996 – 1999 on average: \( k = 1 / (1 – 0.64 + 1.03) = 0.72. \)

Though disputable, these results still can support the conclusion that the coefficient of multiplier in the Latvian economy typically was below 1.

As mentioned before, there is an alternative way to compute the coefficient of multiplier. The alternative method is based upon the concept of autonomous expenditure (A). Autonomous expenditure is the sum of those components of aggregate expenditure that are not influenced by changes in real GDP. These autonomous components of aggregate expenditure are:
- autonomous consumer expenditure (Co);
- gross investment (Ig);
- government purchases (G);
- exports (X).

For further considerations, the autonomous part of the consumer expenditure (Co) is ignored, as it is done in similar calculations made by North American authors (6, p.692). In this case,

\[ A = Ig + G + X \] (8)

The coefficient of multiplier, as it follows from the formulae (1) and (8), is

\[ k = \Delta Y / \Delta A = Y / (\Delta Ig + \Delta G + \Delta X) \] (9)

Using the data of Table 2 and substituting them in the formula (9), we obtain the following values of multiplier in the Latvian economy:

2000: \( k = 307 / (28 – 42 + 201) = 307 / 187 = 1.64 \)
2001: \( k = 382 / (322 + 28 + 148) = 382 / 498 = 0.77 \)
2002: \( k = 332 / (84 + 22 + 115) = 332 / 221 = 1.50 \)
2003: \( k = 393 / (338 + 19 + 117) = 393 / 474 = 0.83 \)
2004: \( k = 507 / (430 + 23 + 223) = 507 / 676 = 0.75 \)
2005: \( k = 652 / (194 + 28 + 523) = 652 / 745 = 0.88 \)
2006 \( k = 840 / (471 + 45 + 164) = 840 / 680 = 1.24; \)
2000 – 2006 on average: \( k = 3437 / (1867 + 123 + 1491) = 3437 / 3481 = 0.99 \)

Mathematically, indeed, these are the same figures as those obtained earlier on the basis of the formula (7). Minor differences appear just due to rounding off the numbers.

3. Conclusions:

Therefore, during all the period under discussion, values of the multiplier in the Latvian economy prove to be surprisingly low. In most part of the analyzed period the size of multiplier was below 1. Such a phenomenon cannot be regarded as unique, but still it is rather specific. Moreover, the low values of the multiplier occurred within the period of rapid economic growth. Indeed, GDP of the country increased in 2000 – 2005 at extremely high rates. The average annual growth rate of Latvia’s GDP in 2004 – 2006 exceeded 10% and was the highest among the EU member states; it reached 11.9% in 2006 (13, p.15; 14, p. p. 15). However, the analysis presented in the paper suggests that this growth was not caused or supported by the multiplier effect. The high rate of economic growth took place in Latvia
rather due to extensive increase in total volume of autonomous expenditure (first of all – gross investment and export, with minor role of government expenditure). Gross investment and exports contributed nearly equally to the increase of GDP. As concerns government spending, its impact on the economic growth proved comparatively modest. Our estimates of multiplier in the Latvian economy lead to general conclusion that fiscal policy of the government could not have sufficient impact on the country’s macroeconomic indices.

Low value of the multiplier implies that any changes in government spending have too weak “leverage” to substantially change the aggregate demand. It might be one of the reasons why attempts of the government fiscal policy to affect economic situation in recent years proved insufficient. A good example can be the government’s counter-inflationary program carried out since 2007 but having minor effect on inflation rates in the country. In general it seems that any attempts to affect economic situation (e.g., to raise rate of economic growth or reduce inflation) in Latvia would require enormously big change in government spending, taxation, private investment, or exports. To summarize,

- The size of multiplier in the economy of Latvia within the period of 1995 – 2006 was usually below 1.
- The values of multiplier in the Latvian economy proved so low mainly because of very high marginal propensity to import (MPI).
- The case of Latvia supports the statement that the MPI in a small country should be higher than in a big country.
- The MPI in the Latvian economy in most of the years since 1995 was extremely high; contrary to the typical assumptions, its value was close to 1 and in some years even exceeded 1.
- The case of Latvia can be used to support the view that the size of MPI is dependent of the composition of imports.
- In the case of Latvian economy, it seems hardly possible to prove the general statement
- That multiplier should be small when the economy goes into recession and are larger in recovery. In fact, value of multiplier was steadily low during all the period of rapid economic growth in Latvia.
- Weak multiplier effect implies that fiscal policy has minor effect on macroeconomic situation in Latvia

References
Abstract: Latvia has experienced an extremely high economic growth of late years. The same time the present macroeconomic situation in Latvia has been evaluated as the worst in the European Union. Economic growth, which is measured by the increase of GDP, shows the increase of economic activities, and is in correlation with the welfare. Latvia can be considered as an example where there is a rather high discrepancy between the level of economic activities and the welfare of people – high growth with low development. Development is a broader process than economic growth, as well as welfare can not be measured only in monetary terms. The analysis of economic processes in Latvia shows, that the rapid economic growth in Latvia has caused serious problems from the point of view of sustainable development.

Keywords: Economic growth, sustainable development, welfare, social inequality, regional inequality.

1. Introduction

The economic growth in Latvia in the first years of the 21st century is incredibly high. The annual GDP increase since year 2000 has been no less then 6%, last three years it has been more than 10%. It may seem that the state of mind of Latvian people and their satisfaction with the government is outstanding. But the reality is just the opposite – the political instability in Latvia is very high and one may say that Latvia tastes deep political crisis, and though the economic situation can not be evaluated as a crisis in classical meaning, the situation in economy of Latvia can not be evaluated as satisfactory. The usually mentioned problem is rather high inflation. But there are some more important problems form the point of view of sustainable development – the relevant increase in social and regional inequality, the dramatic loss of infrastructure and rural environment, the lack of national capital, and first of all the exodus of Latvians, mainly young persons, that will cause the aging of population in the nearest future. Some consider that the next generation will be the last generation of Latvians.

The object of research, the results of which are presented in the article, is the structure of economic growth in Latvia in time period 1991-2007, trying to analyze the social, regional, technological and other aspect of economic growth. The goal is to make conclusions about the causes, why the present economic situation in Latvia cannot be evaluated as satisfactory from the point of view of sustainable development.

The paper attempts to present the analysis of economic processes in nowadays Latvia through finding the reasons of the rapid economic growth and the implication of it on other macroeconomic processes. The main methods of research were the analysis of statistic data, quantitative and qualitative comparison of growth process in Latvia and other European countries, qualitative analysis of economic problems of economy of Latvia, based on public opinion, expressed in mass media, and on own observations.

2. Economic growth and sustainable development

The causes and development of the processes in Latvia economy can be analyzed taking into consideration the transition process in post-socialist countries, which is rather unique in the history of economics.

At the beginning of the XXI century the increase of GDP is no more considered a main macroeconomic indicator and economic growth is not the main goal of the economy. This
results from the basic concepts of the UN, as the main goal of economy from a modern point of view is considered to be its sustainable development. A rapid economic growth hardly ever is sustainable.

The concept of the sustainable development leads back to the 70-ies of the XX century. In 1972 the so-called “Club Of Rome Report” (1) was published, in which the authors draw a conclusion, that, if the present trends in economy continue unchanged, the limits to growth on the Earth will be reached sometime within the next 100 years. Five years later American sociologist Fred Hirsch published his “Social Limits To Growth” (2), where he postulated, that rapid economic growth does not increase the moral welfare, because a man compares his standard of living not with his own in the past, but with the present standard of living of other his contemporaries.

These essays, though some don’t consider them seriously, where among those, which caused changes in minds of the people about the goals of economy. In 1983 the World Commission on Environment and Development (WCED) was established by the United Nations. The report that WCED produced in 1987 – “Our Common Future” (3), advanced the concept of sustainable development - „...development that meets the needs of the present without compromising the ability of future generations to meet their needs”.

This definition does not explain the difference in the concepts “economic growth” and the “economic development”. As it is in the development of any system, growth is a necessary, but not a sufficient condition of the development.

Economic growth is an external notion, which indicates the increase of economic activities in some area. Development is a broader internal process. It includes raising living standards and poverty reduction. Economic growth may result in an improvement in the standard of living of a relatively small proportion of the population whilst the majority of the population remains poor. It is how the economic growth is distributed amongst the population that determines the level of development. The gap between the growth and development may appear also concerning production possibilities – if growth appears mainly from producing consumption goods it will lower production possibilities in the future. It is thus possible to have economic growth with no or little development. To investigate the economic development it is necessary to analyze the structure of the economic growth.

A big mistake in the present time Latvia is that these two concepts are considered to be equal.

Economic growth is measured by the increase of GDP. Economic development is more complicated process, which cannot be measured with one indicator. It is obvious; that each economy has its specific features and problems, and it is hardly possible to create a universal set of indicators, by which one can evaluate the eligibility of a certain economy to the criteria of the sustainable development. An economy should be evaluated not only by quantitative criteria, but also by qualitative expressions, which cannot be measured numerically. Another very important aspect is the “Three dimensions” of the sustainable development: environment – the basis, economy – the tool, social – the target. Still very often dimension of economy is considered as a goal, but other two dimensions only as the constraints, furthermore, environment frequently is considered only in the ecological aspect. But environment includes also political, cultural, religious, moral and other aspects.

3. Short chronological overview (revised from (4))
Latvia’s economy during the period of last eighteen years has gone through dynamic changes, which in a large degree are similar to that were noticed in all the countries of former socialist block during the transition process. This period can be divided into four steps:

Recession and substantial decrease of GDP during 1990-1993,
Stabilization of economy and slight increase of GDP during 1993-1999,
A rapid growth of economy and significant increase of GDP during 2000-2003 with low inflation, a rapid growth of economy and significant increase of GDP during 2004-2007 with high inflation and first symptoms of recession.

The significant decrease of economy after the collapse of Soviet Union and the socialist block is a common feature of economy in all the previous Soviet republics and socialist states in Europe. Economists still are searching for the most precise explanation of this phenomenon. There is a considerable correlation between the decrease of economy and the degree in which the economy of a particular state was integrated into the common economic system of Soviet Union and the socialist block. Latvia was a Soviet republic with one of the highest levels of economic development and perhaps of the most integrated one. That’s why the decrease of economy measured by the level of GDP was perhaps the largest among the Soviet republics of European part of the former Soviet Union and socialist countries in Europe. The GDP volume in 1993 was only 52.6 % of that one in 1990, so generally speaking the living standard decreased twice. Only in 2004 the living standard measured by GDP per capita exceeded the level of 1990. So the assertion that Latvia’s economy has been moving forwards faster than most of other former Soviet republics, for instance Belarus or Uzbekistan, if we take into consideration only the measure of GDP growth is not true.

### Table 1. Indicators of living standard and economic growth

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross domestic product at constant prices of 2000 (Millions of Lats)</th>
<th>Annual growth of gross domestic product (%)</th>
<th>Gross domestic product at average prices of 2000 per capita (Lats)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990*</td>
<td>6771.5</td>
<td>2.9</td>
<td>2542</td>
</tr>
<tr>
<td>1991*</td>
<td>5918.3</td>
<td>-12.6</td>
<td>2218</td>
</tr>
<tr>
<td>1992*</td>
<td>4018.5</td>
<td>-32.1</td>
<td>1512</td>
</tr>
<tr>
<td>1993*</td>
<td>3560.4</td>
<td>-11.4</td>
<td>1366</td>
</tr>
<tr>
<td>1994*</td>
<td>3638.7</td>
<td>2.2</td>
<td>1418</td>
</tr>
<tr>
<td>1995</td>
<td>3649.6</td>
<td>0.3</td>
<td>1469</td>
</tr>
<tr>
<td>1996</td>
<td>3790.7</td>
<td>3.9</td>
<td>1543</td>
</tr>
<tr>
<td>1997</td>
<td>4107.8</td>
<td>8.4</td>
<td>1688</td>
</tr>
<tr>
<td>1998</td>
<td>4302.3</td>
<td>4.7</td>
<td>1785</td>
</tr>
<tr>
<td>1999</td>
<td>4443.6</td>
<td>3.3</td>
<td>1859</td>
</tr>
<tr>
<td>2000</td>
<td>4750.8</td>
<td>6.9</td>
<td>2002</td>
</tr>
<tr>
<td>2001</td>
<td>5132.9</td>
<td>8.0</td>
<td>2180</td>
</tr>
<tr>
<td>2002</td>
<td>5465.1</td>
<td>6.5</td>
<td>2337</td>
</tr>
<tr>
<td>2003</td>
<td>5858.4</td>
<td>7.2</td>
<td>2519</td>
</tr>
<tr>
<td>2004</td>
<td>6366.8</td>
<td>8.7</td>
<td>2753</td>
</tr>
<tr>
<td>2005</td>
<td>7041.4</td>
<td>10.6</td>
<td>3061</td>
</tr>
<tr>
<td>2006</td>
<td>7902.9</td>
<td>12.2</td>
<td>3454</td>
</tr>
<tr>
<td>2007</td>
<td>8717.3</td>
<td>10.3</td>
<td>3831</td>
</tr>
</tbody>
</table>

*Source: Data of Central Statistical Bureau of Latvia (until 1995 - from earlier publications) (5).*

The explanation of changes in economy and living standard is more complex, and it cannot be measured only with GDP indicator. First we must say that the statistics of 1990 give only a conventional notion about the economy, because Latvia was a part of Soviet Union and it was hard to separate the activities that were mainly related to Latvia’s economy from that were more related to other Soviet republics. The export and import statistics of this period gives only a rough idea about the heart of the matter. Among the reasons of the substantial decrease of economy there are at least two that gives an explanation, that the decrease of the living standard was not so large as the decrease of GDP. One reason is that a substantial part of
Latvia’s economy during the Soviet period was the military industry. The wages of Soviet Army officers and military persons that were situated in Latvia also were included in the GDP of Latvia, as well as the industries that attended the Soviet Army. After the withdrawal of the Soviet Army this sector of economy disappeared. Another reason was that a notable part of economy moved to a shadow economy. During the period of institutional changes in Latvia’s economy and legislation the legal system was far from perfect and for entrepreneurs and employees it was possible and gainful not to show all their income or to set it as a transfer payment. So the real decrease of economy perhaps was not as large as it was shown in the statistics.

To give the correct interpretation of Latvia’s statistic data one must take into the consideration the fact that the decrease of economy was accompanied with a great inflation during the 1990-1993. That means that the inflation can be explained mostly by supply-side factors. Indeed - as Latvia doesn’t have its own energy resources they should be imported. After the collapse of the Soviet Union the former Soviet republics, mainly Russia that imported gas, oil products, coal etc. to Latvia, sold it for the market prices, that were much higher that the prices of these products in the Soviet Union. The desultory growth of the price of energy resources caused a notable growth of production and transportation costs in almost all enterprises.

### Table 2. Indicators of inflation and currency performance

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual inflation measured by CPI (%)</th>
<th>Annual inflation measured by GDP deflator (%)</th>
<th>Official exchange rate – period average (Lats per US dollar)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>172.2</td>
<td>162.6</td>
<td>...</td>
</tr>
<tr>
<td>1992</td>
<td>951.2</td>
<td>979.4</td>
<td>0.736*</td>
</tr>
<tr>
<td>1993</td>
<td>109.2</td>
<td>71.4</td>
<td>0.675</td>
</tr>
<tr>
<td>1994</td>
<td>35.9</td>
<td>38.3</td>
<td>0.560</td>
</tr>
<tr>
<td>1995</td>
<td>23.0</td>
<td>14.9</td>
<td>0.528</td>
</tr>
<tr>
<td>1996</td>
<td>17.6</td>
<td>15.2</td>
<td>0.551</td>
</tr>
<tr>
<td>1997</td>
<td>8.4</td>
<td>7.1</td>
<td>0.581</td>
</tr>
<tr>
<td>1998</td>
<td>4.7</td>
<td>4.4</td>
<td>0.590</td>
</tr>
<tr>
<td>1999</td>
<td>2.4</td>
<td>4.0</td>
<td>0.585</td>
</tr>
<tr>
<td>2000</td>
<td>2.6</td>
<td>4.2</td>
<td>0.607</td>
</tr>
<tr>
<td>2001</td>
<td>2.5</td>
<td>1.7</td>
<td>0.628</td>
</tr>
<tr>
<td>2002</td>
<td>1.9</td>
<td>3.6</td>
<td>0.618</td>
</tr>
<tr>
<td>2003</td>
<td>2.9</td>
<td>3.6</td>
<td>0.571</td>
</tr>
<tr>
<td>2004</td>
<td>6.2</td>
<td>7.0</td>
<td>0.540</td>
</tr>
<tr>
<td>2005</td>
<td>6.7</td>
<td>10.2</td>
<td>0.565</td>
</tr>
<tr>
<td>2006</td>
<td>6.5</td>
<td>11.1</td>
<td>0.560</td>
</tr>
<tr>
<td>2007</td>
<td>10.1</td>
<td>13.3</td>
<td>0.480</td>
</tr>
</tbody>
</table>

*Source: Calculations of author, based on data of Central Statistical Bureau of Latvia (5)*

*1 Lats = 200 Latvian rubles*

The same time the high level of inflation was accompanied by a relevant change of the price structure. The prices grew faster in the service sector and not so fast in the production sector. As a result of it was the change of the structure of the GDP. In 1990 the service sector gave only about one third of the GDP, just three years later the share of the service sector was about two thirds. This unbelievably rapid change of the GDP structure can be explained partially by the previously mentioned reason – the change of the price structure, partially by that the decrease of the output in the production sector was bigger than in the service sector (the decrease in the construction sector was more than five times, very large it was also in
fishing and agriculture sectors, but the decrease in service sector was only about 20%). This must be taken into consideration when one looks at the statistic data of Latvia published in the first half of the nineties. Even in the middle of the nineties the base year was not the year 1990, as in most of the countries, but the year 1993, when the change of price structure has been taken place.

After the period of recession in 1994 a slight increase of GDP took place, which was followed by a decrease in 1995. This was the year when banking crisis took place. Latvia was one of the first post socialist countries, which met this problem. Bank “Baltija” which was the largest bank in Latvia in the beginning of nineties went to bankruptcy. It caused serious direct problems to a large part of population as well as enterprises and local governmental institutions. Later it took some time to return the people the confidence towards banks, but at present time this problem along general lines is solved.

The end of the nineties was followed by a slight increase of GDP, and the beginning of the third millennium came with a significant growth of economy measured by increase of GDP. This was a period, which generally can be characterized as a recession in the European economy, so the rapid growth of Latvia’s economy may be considered as a surprise of some kind. The same time a rate of inflation was very low, so the real situation seems not concerning the economic theory.

Since the beginning of nineties the foreign trade balance in Latvia permanently has been negative with a tendency to enlarge. The self-regulating process of economy in this case reacts by changes in the monetary mechanism – the depreciation of national currency or the decrease of imports otherwise. In case of Latvia its national currency lats had a fixed exchange rate, but not connecting it to some other currency as in case of Estonia or Lithuania, for instance. Lats was connected to a currency board. In this case the monetary mechanism doesn’t react immediately, but cumulates the problems, which spring out after some period of time. Seems that the same has happened in Latvia’s economy and the joy about the rapid growth of economy accompanied by low inflation in 2000-2003 was groundless and premature, because the first half of 2004 came with a serious increase of inflation. From January 2005 lats is pegged to euro.

The situation that a significant part or capital resources in Latvia is owned by foreigners means that a notable part of profit is leaving Latvia and can be considered as a part of Latvian GDP but not Latvian GNP. The same time if we compare those two indicators we can see that until 2004 they did not differ significantly. The part of profit that was leaving Latvia was compensated by the income of Latvian employees, which got their salaries outside Latvia. Official statistics doesn’t give us the exact picture, but the fact is that a notable part of Latvia’s inhabitants are working as guest laborers in Ireland, Norway, Great Britain and other West European countries. After entering European Union the mobility of labor force has only increased and the inflow of foreign capital is accompanied by outflow of domestic labor force.

Generally speaking the economy of Latvia during the recent years has been developing in the most liberal way. It has caused such concomitants, as some kind of shock therapy effect on population, the increase of social inequality, but from the point of view of economic growth, taking into consideration the structural changes of economy, can be evaluated as successful. A controversial point is the survival of Latvian nation, but in the conditions of globalization this problem may be considered as one of little importance.

4. The role of economic culture and education in the entrepreneurial environment
Economic activities take place in a certain environment, and for an entrepreneur to succeed it is important to know this environment. But in case of Latvia it is necessary not only to know the environment, but also to create it, especially in the economic aspect. Some West-European economists in private discussions have mention as the main problem of economy of
Latvia not inflation or foreign trade deficit, but the awfully low level of economic culture in Latvia.

“Few cultural nations have so few written thoughts in the field of economics. Even translation from the work of other nations is limited. All this indicates that the broader society has little interest in theoretical concepts in economics or in economic policy. Economics is precisely what affects each and everyone’s personal interests, but people in Latvia consider economics something strange and interesting only to narrow specialists.” This is a quotation from the Latvian journal “Ekonomists” (The Economist) in 1935 (6). Since this time the situation in Latvia has not improved, but has become much worse, even compared to the Soviet time. An average Latvian almost doesn’t have a notion of elementary economic laws. Such an environment with a very low economic culture sets different requirements to entrepreneurs as in countries with higher level of economic culture. The polls of entrepreneurs show, that knowledge is considered to be one of the less important things for a successful business. Such a business environment is not sustainable, and causes the increase of crime and other social problems. In such a situation the entrepreneur should be also a teacher, who will increase the economic culture in his surroundings. But to be able to do this, he needs to have a high economic culture himself. This can be ensured by studies of economic theory. The same time the amount of these courses in the study programs commonly is being reduced. Economic theory often is considered to be unnecessary or even cumbersome for a future entrepreneur or financier.

For time period of fifty years, when Latvia was a part of the Soviet Union, economy was performing without the forth factor of production – enterprise. So after the collapse of the Soviet Union people didn’t have knowledge and practical skills in entrepreneurship. In the beginning of the 90-ies of the XX century most of newborn entrepreneurs of Latvia were orientated on profit maximization in a short-run. Since that time most of them have failed. Nevertheless until now profit maximization in short-run prevails. Obviously, such an approach is not sustainable.

Latvia has very good examples of Latvian entrepreneurs, who had a different approach – sustainability and social responsibility of an enterprise. As such an entrepreneur can be mentioned Augusts Dombrovskis – the owner of a lumber-mill in the suburban area of Riga in the beginning of the XX century. He built a nice recreation centre for his workers, where they could spend their free time; the only condition was not to use alcoholic drinks. He also established a creativity workshop for Latvian writers and poets and significantly increased the cultural environment in the area. Other good examples are the owner of the most famous confectionary in Latvia in the 30-ies of the XX century Vilhelms Kuze, who sponsored sports and culture and the owner of a textile factory Roberts Hiršs, who established a daycare centre in his factory, where the most of employees were female persons, and created a lot of other facilitations for his workers. The present generation of Latvians should be told about these examples of sustainable entrepreneurship.

In a contemporary world intellectual capital is becoming more and more important in the economy. Though, the role of the intellectual capital as a subject of business deal is underestimated in Latvia. Frequently the authors of ideas are unaware that they have the right to get the award for them or they consider such an award as desperate. Therefore often such ideas are sold cheap to foreigners, who make them their intellectual property, deriving a very high profit from it. To improve the situation much more attention, even in a governmental level should be paid to the science management.

5. Economic growth and inflation

As mentioned before, the economic growth in Latvia is incredibly high. Author considers four main reasons for this growth: 1) the rapid increase of capital stock mainly on the basis of
foreign investment and foreign credits, 2) the rapid increase of crediting, caused by the liberating of the real estate market, as follows the increase of the prices of the housing and building industry, and necessity for a large part of population to take credits to satisfy their basic needs for dwelling, 3) the increase of the quality of human capital due to the good basis of knowledge acquired still before the renewal of independence along with the entry of the market-orientated professional knowledge in the 90-ies of the XX century, 4) the gradual return of the “shadow economy” sector into the legal economy.

First two reasons can cause serious problems from the point of view of the sustainable development of economy of Latvia.

A rapid economic growth according economic theory links with high inflation. That exactly happened in Latvia the recent years. This was typical demand-side inflation. As the increase of nominal income for various groups of population differs, for a large part of population the real income is decreasing, causing the increase of social inequality. Developed countries are solving this problem, using „stop and go” policy, where rapid economic growth linked with increase of social inequality scales up the popularity of the social oriented parties, which are implementing restrictive economic policy, that hinders economic growth and lessens social inequality. Then the drying up of economic activities creates popularity for liberal orientated parties, which are using expansive economic policy. The political system serves well for this in developed Western democracies. The political system of Latvia is different; by historical reasons “socialism” is considered to be a very harmful thing, and the division in “left” and “right” parties is done by different principles, that may seem enigmatic for the Western democracies. Nevertheless at present there is a sharp necessity for social oriented parties in Latvia in the direct sense of the concept.

The charge for the rapid economic growth is the usage of natural resources and environmental pollution to an increasing degree. The large dependence of economy of Latvia from the foreign investor’s fears for, that from two criteria – profit maximization or environmental pollution minimization, the first one will be preferred. Besides that, the countries with lower level of technological infrastructure (which is Latvia, compared to West-European countries) need a larger increase of capital stock for the same increase of GDP ceteris paribus. This means, that the same economic growth causes a larger usage of natural resources in Latvia, compared, for instance with Denmark.

We may conclude that the negative factors, connected with rapid economic growth manifest themselves fully in Latvia. On the other hand the GDP per capita in Latvia is significantly lower than the EU average. People can compare their standard of living with West-European countries, and this comparison is not favorable for Latvia. In the Soviet times this problem was solved with the “iron curtain”, that cannot be considered as a solution nowadays.

The goal to “catch” the European Union the next 10, 20 or 40 years that is often mentioned in public presentations of Latvian politicians reminds the Soviet times, where there was a slogan “to catch and overtake America”. Some of Latvians remember the outcome of this chase. According the statistics, Latvia now is not the poorest one among the EU countries, not mentioning Romania and Bulgaria, Latvia has overtaken Poland. But most of population of Latvia asserts that they don’t sense it, and in a large degree they are true.

As the economic growth in a large degree happened owing the large increase in the speculative sectors of economy, not in real economy, it had a small impact on the potential of economy. Not considering the small sectors economy, which share in GDP is less then 2%, the most rapid growth during the time period 2003-2007 has been in building – 93.3%, trading – 91.3%, financial intermediation – 76.3% and real estate sector – 67.8%, but the lowest increase in healthcare – 17.5%, agriculture – 21.9%, energetic industry – 21.8% and manufacturing – 26.7% (calculations of author, based on data of CSB of Latvia (7)). These
figures may seem rather optimistic, as building industry is considered to be the main in production of capital goods. But in case of Latvia even this industry in some degree can be considered as a speculative sector of economy, as there are examples, where buildings have been pulled down just some years after their completion and though obviously have been built not for direct use, but some speculative purpose. Anyway, there is a reason to assert, that the rapid economic growth has made a small impact on production possibility curve and consequently the aggregate supply in the nearest future.

The opening of the real estate market in Latvia caused a situation, when persons, mainly from abroad, who had savings, had an opportunity to place this money more profitable, than in banks. Real estate became the object of speculative transactions. The demand in this market was increasing very rapidly, the prices as well. Latvians, who needed real estate not for speculative transactions, but for living, had to compete in this market by taking credits with the further increase of demand and prices. Due to the multiplier effect there was an increase of the demand in other sectors – building, trading, financial services, insurance etc. This was the reason for the rapid economic growth, but in a large degree it was on credit and then not sustainable. This caused a situation, where not only the households didn’t recognize the risk of returning the credits, but the banks didn’t recognize the risk of regaining the credits as well.

If the real estate is considered as consumption good, then it is close to a perfectly non-tradable good, hence the price convergence does not happen. If the real estate is considered as capital good, then it is close to a perfectly tradable good, hence the price convergence happens rapidly. After the real estate market in Latvia was opened, it became just like the counterpart of the security market.

Herewith the rapid economic growth goes a rapid increase of social and regional inequality. A large number of mainly young Latvians have left the country not because only the reason, that they can earn more money abroad, but because the better other factors of welfare – dwelling and environment.

Sooner or later the rush had to be finished. Experts from West-European countries already have made forecasts, that Latvia will be no more source of easy profit – now Bulgaria, Romania, even Georgia and Kazakhstan are on the agenda. Perhaps these countries will repeat the Latvian scenario. Problems, that now are critical for Latvia, we have to solve ourselves.

Inflation in economy can be considered the same as the blood pressure in a human body. When a person runs very fast his blood pressure is higher than normally. The same happens in the economy. Inflation at present is the most discussed item in Latvia. Usually it turns out that the main problem that causes inflation is that Latvia will not join the Euro zone as soon as it was expected. This is a misleading way. Much more serious problems are:

the increase of social inequality,
the decrease of the international competitiveness of Latvian economy.

To discuss how to reduce the inflation, it is necessary to evaluate, what would be the impact on those measures on the problems mentioned before.

Until now the inflation in Latvia was a typical demand-side one. It was caused by the increase of the purchasing power as a result of:

1) Rapid increase of the monetary amount of the population,
2) Inflow of financial resources from abroad,
3) Rapid increase of crediting.

The first one mentioned in case of Latvia cannot be considered the same as income, because a large part of monetary means was formed by credits given from banks to households. According the data of the Financial and Capital Market Commission (8), on the end of February 2008 the total sum of household credits is 6 246.5 million lats, i.e. approximately 2800 lats on each inhabitant of Latvia, including nurslings and ancients.
Inflation from the demand side was pulled also by the increase of amount of consumers as the result of significant increase of number of tourists. For such a small economy like Latvia, one million tourists per year can be considered a large increase of the aggregate demand. Among other demand-side factors of inflation the expectations of inflation as a cause of it should be mentioned.

Starting from year 2008 most of economists consider that the economic growth will be slower in Latvia, especially taking into consideration the international situation. But the forecasts of inflation still remain rather pessimistic. The main reasons of it are the supply-side factors of inflation – prices of resources. Latvia in a large degree depends from the price of imported strategic resources – oil products, energy resources, grain, also sugar, etc. Even in 1918 after the proclamation of independence the famous Latvian economist Karl Ballod pointed out, that one of the first things that Latvia should do, is to eliminate its dependence from the imports of strategic resources. In 20-30-ies of the XX century, there were built three sugar-refineries and one large hydropower station. At present Latvia for 100% is dependant from the imported oil products, for 50% from imported energy resources, and all the three sugar-refineries currently are closed down. This is a striking example, that the sustainable development is only in the words of politicians, but the real processes in economy of Latvia are far from the concept of the sustainable development.

The significant growth of social inequality is one of the most important problems, which endanger the sustainable development of Latvia.

| Table 3. Inequality of income distribution - income quintile share ratio |
|-------------------------|---------|---------|
|                       | 2000    | 2006    |
| Latvia                 | 5.5     | 7.9     |
| Estonia                | 6.3     | 5.5     |
| Lithuania              | 5.0     | 6.3     |
| Germany                | 3.5     | 4.1     |
| Czech Rep.             | 3.4 (2001) | 3.5     |
| Finland                | 3.3     | 3.6     |
| EU 25                  | 4.5     | 4.8     |

Source: Data from Eurostat (9).

The most rapid increase of social inequality in Latvia started in 2004, when there was a sudden flash of inflation. That causes a treat for the social dimension of the sustainable development, the deformation of the social environment, the growth of hostility, which meaningly or accidentally are incited by the mass media, showing examples of senseless splendor among the toffs. History shows a lot of examples where such a deformation of the social environment has caused bloody events in form of revolutions and civil wars. Most of revolutions, for example the Great Revolution of France, year 1905 revolution in Russia, the “Song Revolution” in the Baltic states in the end of 80-ies of the XX century, happen not because people are living bad, but when they realize that they can live better.

6. Infrastructure and regional inequality

The history of Latvia obliges us to be thankful to our ancestries, especially in the XVII century, when in the territory of Latvia there took place a rapid development of infrastructure, taking as the example the most developed West-European countries. The Courland Duchy, ruled by the talented mercantilist Jacob Ketler became on of the most developed economies in the Baltic region. The Swedish Vidzeme developed a perfect infrastructure for agriculture. The developed infrastructure is one of the main reasons for efficiency of capital, which attracts investment and has a positive further impact on the infrastructure. This gives the explanation to the rapid development of economy in the XIX century, when Latvia was the
most developed part of the Russian Empire. The same time this was the root of one specific feature of Latvia: its capital – Riga is too large for the country. Approximately one half of the whole population lives in Riga and its surroundings. The difference in the standard of living in Riga and other parts of Latvia is larger then the difference between average level of Latvia and the one of the European Union.

Table 4. Dispersion of regional GDP per inhabitant - in % of the national GDP per inhabitant

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latvia</td>
<td>46.8</td>
<td>51.3</td>
</tr>
<tr>
<td>Estonia</td>
<td>38.7</td>
<td>41.2</td>
</tr>
<tr>
<td>Lithuania</td>
<td>19.0</td>
<td>23.5</td>
</tr>
<tr>
<td>Germany</td>
<td>28.1</td>
<td>28.3</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>21.3</td>
<td>23.3</td>
</tr>
<tr>
<td>Finland</td>
<td>21.8</td>
<td>19.8</td>
</tr>
<tr>
<td>Sweden</td>
<td>15.1</td>
<td>15.5</td>
</tr>
</tbody>
</table>

Source: Data from Eurostat (9).

At present, due to increasing regional inequality, Latvia rapidly is loosing its carefully created infrastructure. Single regional centers: Riga, Ventspils, have rather high level of the capital efficiency, so they attract investment and are developing rapidly. The same time in the most part of the territory economic activity is very low, so people are leaving this unfavorable environment either to Riga or to Ireland, England, Norway, etc. The sources of the European Union provided to reduce regional inequality in case of Latvia mainly arrive in Riga or other comparatively developed centers, and only are sharpening the problem.

For maintenance of infrastructure a significant role plays one of the sectors of economy – agriculture. This explains why almost all the countries support and try to maintain this very unprofitable sector. Joining the European Union Latvia agreed to the quotas of the agricultural production. These quotas even in such sub sector as milk industry, which perhaps is the one of the few sectors of agriculture, where Latvia has comparative advantage to other European countries, are lower than domestic demand for milk and milk products. This is a serious threat to existence of agriculture in Latvia. The latest events in the sector of sugar industry in Latvia are only the first stage in the prospective avalanche of events. The financial support of European Union to agriculture in case of Latvia can be considered like some kind of “coffin money” to this sector of Latvian economy. For most of peasants it is more profitable to sell their land and move to Riga, Ireland, England, etc.

The situation of Latvia, where half of population lives in the capital city and produces two thirds of the GDP is unique in the Europe, except ministates. According the data of the CSB of Latvia the GDP per capita in Riga was 7.36 times more than in Rezekne district, or taking bigger territorial units, in Riga statistic region 3.72 times more than in Latgale statistic region.

The rapid economic growth of Latvia would be causing no problems from the point of view of the sustainable development, if it would be even in all the regions and for all the social groups. Obviously, it is not so. Investors, doing their choice about the place of their business, are guided by one main criterion – profit. Obviously, profit will be higher in places with better infrastructure and higher qualified labor force. Therefore, if this process will be not controlled, the regional inequality will be only increasing, what exactly one can see in Latvia. This can be done, for instance, using different tax policy for different regions of Latvia, different credit policy, scattering the state administrative establishments throughout the whole territory, etc.
Only in the case if economic growth will be even in all the regions of Latvia, it will promote the sustainable development. At present it is not so, and people, who are visiting Riga and not other parts of Latvia, may have wrong impressions about the standard of living in this country.

7. Foreign trade deficit and lack of national capital

A large part of foreign investment in Latvia came into the real estate sector causing the problems mentioned before. Foreign investment in other sectors of economy had less impact on inflation but caused the increase of the foreign trade deficit. The balance of payment in Latvia has deficit since 1992. This is causing threats to the stability of national currency, and the forecasts about possible devaluation of lats, though are strictly denied by the Bank of Latvia, already have caused some fluctuations in the exchange market.

At present the gap between GDP and GNP is significantly increasing, even the compensation employees received from the rest of the world since 2003 has increased three times. The same time property income paid to the rest of the world in this time period has increased four times, in 2006 it was 930.4 million lats, and interest paid to the rest of the world was 413.0 million lats. Together these two figures make 11.9% of the GDP. In 2007 the gap between the GDP and GNP was 531.5 million lats, the GDP exceeded GNP for 3.9%, and in nearest future these figures will be only increasing.

Table 5. The gap between GDP and GNP

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP/GNP ratio (nominal)</th>
<th>Growth of real GDP (%)</th>
<th>Growth of real GNP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>0.996</td>
<td>0.3</td>
<td>...</td>
</tr>
<tr>
<td>2001</td>
<td>0.998</td>
<td>8.0</td>
<td>...</td>
</tr>
<tr>
<td>2002</td>
<td>0.997</td>
<td>6.5</td>
<td>8.4</td>
</tr>
<tr>
<td>2003</td>
<td>1.003</td>
<td>7.2</td>
<td>5.5</td>
</tr>
<tr>
<td>2004</td>
<td>1.023</td>
<td>8.7</td>
<td>6.5</td>
</tr>
<tr>
<td>2005</td>
<td>1.014</td>
<td>10.6</td>
<td>12.5</td>
</tr>
<tr>
<td>2006</td>
<td>1.028</td>
<td>11.9</td>
<td>10.3</td>
</tr>
<tr>
<td>2007</td>
<td>1.039</td>
<td>10.2</td>
<td>9.1</td>
</tr>
</tbody>
</table>

Source: Calculations of author, based on data of Central Statistical Bureau of Latvia (7).

Uncritical approach to foreign investments can be estimated as a serious threat for the sustainable development. According the expert data of IFO Institute for Economic Research in Munich, Germany, Latvia is among the few countries, that don’t have any control of the foreign investments. The distribution of the accumulate foreign investments by sectors of economy show that most of them flows to the most profitable sectors, including those, which have speculative nature – real estate activities, financial intermediation and trading. The profitability in the sectors of economy differs in a long run and in a short run, but the statistic shows, that short-run interests are determinative in the behavior of foreign investors in Latvia.

Sometimes it is presumed that foreign investments are the consequences of the foreign trade deficit, but the same time they may be considered the causes of it.

Of course foreign investment cannot be considered only as harmful for economy. But in the present situation of Latvia, they may cause serious problems to economy from the point of view of sustainable development. Usually it is regarded that foreign investment is the factor, that is increasing the competition, but in case of Latvia domestic investors frequently are crowded-out. Therefore the foreign investment should be regulated according their source, sector of economy and region of destination.
Table 6. Distribution of accrued foreign investment by sectors of economy year 2006 (%)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Share in GDP 2007</th>
<th>Foreign investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>3.4</td>
<td>1.0</td>
</tr>
<tr>
<td>Fishing</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Industry</td>
<td>13.8</td>
<td>14.3</td>
</tr>
<tr>
<td>Building</td>
<td>7.8</td>
<td>0.9</td>
</tr>
<tr>
<td>Trade</td>
<td>20.1</td>
<td>12.0</td>
</tr>
<tr>
<td>Hotels &amp; rest.</td>
<td>1.7</td>
<td>1.2</td>
</tr>
<tr>
<td>Transportation</td>
<td>12.3</td>
<td>11.5</td>
</tr>
<tr>
<td>Financial intern.</td>
<td>7.0</td>
<td>25.5</td>
</tr>
<tr>
<td>Real estate &amp; oth.</td>
<td>15.7</td>
<td>20.1</td>
</tr>
<tr>
<td>Public administer.</td>
<td>6.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Education</td>
<td>4.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Health</td>
<td>3.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Others</td>
<td>4.4</td>
<td>0.7</td>
</tr>
<tr>
<td>Not classified</td>
<td>X</td>
<td>12.6</td>
</tr>
</tbody>
</table>

Source: Data of Central Statistical Bureau of Latvia (7).

The economic growth in a very large degree was based on credits of Latvian households and enterprises. At present (quarter IV 2007) foreign debt, according the data of the Bank of Latvia (10) is 18.725 billion Ls. The total foreign debt has been increasing faster than GDP.

Table 7. Economic growth and foreign debt

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth of real GDP (%)</th>
<th>Ratio of foreign debt to GDP</th>
<th>Annual growth of foreign debt (%)</th>
<th>Annual growth of foreign debt (%) in comparable prices of 2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>7.2</td>
<td>0.795</td>
<td>…</td>
<td>…</td>
</tr>
<tr>
<td>2004</td>
<td>8.7</td>
<td>0.933</td>
<td>36.5</td>
<td>27.5</td>
</tr>
<tr>
<td>2005</td>
<td>10.6</td>
<td>0.994</td>
<td>29.7</td>
<td>17.7</td>
</tr>
<tr>
<td>2006</td>
<td>11.9</td>
<td>1.131</td>
<td>41.5</td>
<td>27.4</td>
</tr>
<tr>
<td>2007</td>
<td>10.2</td>
<td>1.333</td>
<td>47.0</td>
<td>29.9</td>
</tr>
</tbody>
</table>

Source: Calculations of author based on data of Central Statistical Bureau of Latvia (7) and the Bank of Latvia (10).

The table shows, that in the context of the global economic crisis Latvia can meet extremely serious problems in economy even in the short run. Indeed, if the total foreign debt exceeds GDP for 33%, if 43% of the total debts are short-time liabilities, then it is only a fractional consolation, that 68% of the total foreign debt and 85% of short-time liabilities constitutes the debt of domestic commercial banks to their parent companies in Scandinavia, etc.

Table 8. Imports and exports of Latvia

<table>
<thead>
<tr>
<th>Year</th>
<th>Imports (million lats, current prices)</th>
<th>Exports (million lats, current prices)</th>
<th>Import – export ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>3493.4</td>
<td>2689.5</td>
<td>1.299</td>
</tr>
<tr>
<td>2004</td>
<td>4428.9</td>
<td>3268.2</td>
<td>1.355</td>
</tr>
<tr>
<td>2005</td>
<td>5637.8</td>
<td>4334.7</td>
<td>1.301</td>
</tr>
<tr>
<td>2006</td>
<td>7412.3</td>
<td>5014.3</td>
<td>1.478</td>
</tr>
<tr>
<td>2007</td>
<td>9024.7</td>
<td>6197.1</td>
<td>1.456</td>
</tr>
</tbody>
</table>

Source: Data of Central Statistical Bureau of Latvia (7).

If the global financial and economic crisis will reach them, it is rather obvious, that Latvian banks will be in a grave situation and the economy of Latvia as well. The situation could be
considered as less dangerous, if the foreign trade balance will be positive. In case of Latvia it is not so. The latest data show some improvement in the balance of payments, but the situation still is far from satisfactory.

8. Demographic situation and morality

The renewal of independence was greeted with bright hopes about the future of the Latvian nation and the guarantee of maintenance of national identity. But the facts show, that in years of independence the number of population has decreased for more than 380 thousand or approximately 15%. Only in a very small degree it can be explained by emigration of non-Latvians. The official statistics does not include those approximately 100 thousand mainly young Latvians, who have left their native country for work in the Western Europe. That has caused a situation, where in different segments of the labor market there is insufficient supply, which likely will be increased by inflow of labor force from abroad. Usually it is explained only by the difference in the salaries, which arise from different marginal efficiencies of labor. Not disclaiming this reason, one cannot mention other important reasons, which shortly can be called “the state attitude and social environment”.

For some period of time we have the institution, which is responsible for the image of Latvia. This image is being made just like a ghost, which roams along the Europe. It is stressed that the main priority is to make this image attractive for anyone else except the citizens of Latvia. The main accent is put on that how we look, not how we feel. Such an attitude from the state is destroying the patriotic feelings of population and promoting the emigration processes. The distortion of the Latvian language leaves far behind the same processes in the Soviet time period. It will cause the loss of national identity in a large part of society, which may turn out to be a delayed action bomb.

A large part of Latvian society still remembers the Soviet time period, which cannot be considered as a good period in the history of Latvia. What was the worse thing in this time period? Perhaps the worse thing was the double standards in the morality. The state policy was based on lie. As it is hard to get on lie, the society met a strange phenomenon – duality of consciousness, where in daytime a person was thinking and speaking differently as in the evening and nighttime. This was done with full assurance and belief. During the 70-80-ies of the XX century this phenomenon had become already a norm. Therefore the changes in the beginning of 90-ies were met with great enthusiasm, because such a duality of consciousness is not normal for a human being. But with time it turned out, that nothing has really changed. The state policy is still based on lie; double standards in morality are even more popular than in the Soviet period. The blasphemy of religious sensibilities has such manifestations, which however were not allowed in the Soviet times. The morality has been so distorted, that a part of the society even not assumes possible the existence of such human qualities as virtue, and identify it with hypocrisy. This is perhaps the main threat to the sustainable development, because a human being comes to an end not when his body, but when his mind is being broken.

According the data of CSB of Latvia the demographic projections 2005-2050 forecast, that the number of population will continue to decrease, it will fall down the level of 2 million in 2033, and will be approximately 1.87 million in 2050 – a little more than after the World War I in 1920, when Latvia lost 40% of population (5).

9. Conclusions

Development is a broader process than economic growth, as well as welfare cannot be measured only in monetary terms. For the people welfare is more important than economic growth. Economic growth is a necessary, but not sufficient condition for the development.
The analysis of economic processes in Latvia shows, that the rapid economic growth in Latvia has caused serious problems from the point of view of sustainable development. Sustainable development is an instant increase of welfare for all inhabitants, not compromising the welfare in the nearest and further future.

At present the main threat to the sustainable development of Latvia consists of:

- social inequality
- regional inequality
- the loss of agriculture and infrastructure
- the lack of national capital
- emigration of young people
- the loss of national identity
- degradation of morals

The only strategic goal for an economy of any country, including Latvia, should be sustainable development of the economy, not of another kind.

References:
EVALUATION OF BUSINESS MACRO ENVIRONMENT: CASE OF ECONOMIC SLOWDOWN

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Abstract. Nowadays due to growing importance of competitiveness measurement (9) a lot of resources are invested in the issue-related researches. One of the major components of measuring competitiveness is evaluation of business macro environment (BME). Three approaches are mainly used to evaluate the BME: Analysis of key indicators (usually by segregating business environment in parts (4, 9), for instance, PESTEL analysis); Business surveys (for instance, IFO Business Climate Index in Germany, Economic Sentiment Index in Latvia, etc.). However, this approach does not give a clear explanation of how entrepreneurs carry out the BME evaluation and what information they use. More advanced (and rear) approach that combines results of the first two approaches and explains the gap between the evaluation results. In the economic slowdown conditions the analysis of key indicators is still appropriate to employ (with some exceptions though), but reasonable changes take place in the BME evaluation undertaken by the entrepreneurs for the reason that general economic indicators become less important. The most important information for the entrepreneurs to evaluate the BME in 2005-2006 was the average wages level in the country, but in the end of 2007 (in the beginning of the slowdown) - the overall employment situation.

Key words: business macro environment; methods of evaluating business macro environment; economic slowdown

Introduction

The evaluation of business macro environment has become crucial to making correct management decisions and forecasting the future situation in conditions of the current economic slowdown. The BME evaluation to be undertaken becomes more important at the scale of the Baltic because there is no previous experience of running businesses in the economic slowdown conditions within the region. After seven years of the rapid economic growth – in 2007, the GDP rose by 2 - 4% – in 2008², the GDP growth forecast accounts for 3-4% only. The Governments of the Baltic States need the BME to be more precise in order to support the economic activity in line with the current requirements. The BME assessment and forecasting development also strongly influence on the real-life management decision-making.

The research

This paper is a logical continuation of the previous study undertaken by the research team³. The research tasks were to find out, firstly, how the entrepreneurs undertake the BME evaluation; secondly, how the entrepreneurs make the BME evaluation in conditions of the economic slowdown; and thirdly, to identify directions for further research.

In order to find out how the entrepreneurs undertake the BME evaluation, a special survey (120-sample) was conducted⁴. To find out how the entrepreneurs make the BME evaluation in

² Prognoses (taking in to account 2 quarters of 2007), new prognoses at October 2008 estimated - 0%
³ In several periods, Jānis Vucāns, Aija Vucāne and Kristīne Guseva (in 2006) took part in the BME research (3, 4).
⁴ As just 120 businessmen from Kurzeme (Western part of Latvia) took part in polling, results can’t be related to all businessmen in Latvia, but results are useful for formulating establishing tendencies

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the economic slowdown conditions, representatives from different business areas were interviewed. The research was based on the primary information in part, whereas the secondary data (mainly statistical indicators) was used to describe the current economic situation.

**Research limitations**
The research limitations are primarily connected with the viability of widening the survey and interview samples taking into account the economy structure.

**Results and discussion**
The most widely used approaches to the BME evaluation are:
- Analysis of indicators (4)
- Business surveys
- More advanced (and rear) approach that combines and compares results of the first two approaches

All these methods are widely used for the BME’s short-term forecasting development (macro econometrics methods widely employed to forecast the BME changes previously faced reasonable dissatisfaction at present (2)).

The indicators analysis remains very popular approach to evaluate the BME. This approach employs M. Porter’s PESTEL model; the idea behind it is to analyse all parts of the BME separately and then to elaborate the aggregated indicator for each of them as well as for the whole business microenvironments (6, 7).

In 2005-2006, we tried to compare the indicators analysis results of the BME evaluation with the results obtained by conducting business surveys (3). The analytical comparison showed that there is a considerable difference between the results obtained by the indicators analysis and the business surveys approaches to the BME evaluation.

The most widely used approach to the BME evaluation (as well as to evaluation of the countries’ competitiveness (8, 9)) is business surveys.

The most popular indices elaborated in the frames of this approach are the IFO Business Climate Index in Germany, Economic Sentiment Index in the Baltic States and others. The business surveys results are widely used for short-term forecasting of the BME development (they also influence on managerial decisions made by the entrepreneurs), but it is still unclear how the entrepreneurs make this evaluation, on what information it is based. The black box model illustrates the evaluation process of the kind (fig.1).

![Results of Evaluation](image)

**Fig.1. How do entrepreneurs evaluate the BME?**

Therefore, it is necessary to conduct a further research on the process of the BME evaluation by the entrepreneurs.
After the entrepreneurs were asked whether the evaluation of the environmental business trends development was carried out in their enterprises, the results were somewhat unexpected.

![Figure 2](image)

**Fig. 2.** Has the evaluation of the business environment development trends been carried out at the enterprise?

A large part of the entrepreneurs (43%) does not make evaluation of the business environment at all. In the time period from 2006 to 2007, the main sources of information used for the BME evaluation were the Internet databases. Papers published in the newspapers and journals carried an equal importance. The enterprise internal information and the industry associations’ information were on the third and the fourth places, respectively. Therefore, it can be concluded – on the preliminary basis – that the information sources the entrepreneurs use to evaluate the BME are slightly untailored.

However, it is still unclear what kind of indicators the entrepreneurs employed to evaluate the BME. Taking into account the previous research results it is possible to make a preliminary conclusion that the indicators ranking used to evaluate the BME differ across countries.

![Figure 3](image)

**Fig. 3.** The most important external economic indicators taken into account while carrying out evaluation of the business environment

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1 These results are not applicable for the Western Europe, i.e. the countries with a relatively long history of the market economy.
In Latvia the entrepreneurs who undertake the BME evaluation and do further forecasting extensively use such indicators as the average salary, taxes and unemployment rates. The astonishing fact is a relative unimportance of the GDP growth indicator. Nonetheless, the indicators analysis still remains very useful.

Figure 4 shows that the turning point of the Economic Sentiment Index for all the Baltic countries (Latvia, Estonia, Lithuania) is in July 2007 – the ESI starts decreasing tremendously and its level has reached the record minimum since October 2005.

From a theoretical viewpoint, the impact of such leading indicators as the durable goods consumption, the construction industry and building permits growth, etc., became more salient. However in the current situation of the economic slowdown the entrepreneurs are employing a variety of indicators to compare different phases of the economic development for evaluating the BME.

The interviews results show that in the economic slowdown conditions a key factor in evaluating the BME is a situation in respective industries. The average salary level is also significant, but to a lesser extent. All in all, the entrepreneurs evaluate the situation more pessimistically in comparison to the researchers and specialists from governmental institutions.

The explanation is tied with the fact that a large part of the researchers drew main conclusions based on the economic performance in 2006-2007, which was quite successful overall, but with a subsequent slowdown in the end of the period. On the other hand, the psychological factor is very important for the entrepreneurs (it potentially carries equal importance with the external environment (5)), thus, we must take it into account. The economic slowdown with the GDP growth plummeting from 10% in 2007 to the anticipated 3-4% in 2008 makes the evaluation of the BME pessimistic at present.

Main conclusions

1. From the entrepreneurial point of view, the rapid decrease of the economic development rate (in Latvia the GDP growth drops from 11% in 2007 to 3-4%
(forecasted) in 2008). Therefore, the evaluation of the BME appears to be clearly pessimistic.

2. The largest part of the researchers uses the data of the previous years, when the economy was booming. Thus, the data analysis carried out in 2006-2007 cannot be applicable for forecasting the results of 2008-year of changing tendencies of economy.

3. In conditions of the economic slowdown the entrepreneurs used the up-to-date information mainly, e.g. results of the particular industry performance (average salary level is still playing an important role), in evaluating the BME.

References
Abstract: Concerned with employment, this paper deals with doubt regarding widely accepted corner stones of economic theory and measures based thereupon. The author has long doubted some prevailing economic theories as far as publicly discussed and applied. As a result of reflections and own practice as innovator, entrepreneur and consultant, the author draws conclusions, relating contradictory macro economic theories with developments outside of economy: With Human Nature and Culture. Moreover with Diversity of Values and the dealing with qualitative and quantitative information. The paper offers ways to explain, what leading researchers of economic science have admitted not to understand, and draws conclusions regarding cultural elements, which are decisive for the sustainable development of prosperity, social security, self-determination and independence. By offering different interpretations, the author seeks to induce new directions in scientific research. This paper is to be complemented by more detailed presentations of methodology of promotion and sustainable management.

Key Words: Values, sustainable, economy, promotion, qualitative, quantitative, Bilbao, science, Uexküll, Baltics.

Introduction: Roots of Economy - Outside of current Scopes

Much more than a „scientific“paper, this paper is a message to scientists. An impulse for new directions in scientific research, aimed at economists. Aimed at academics, who are aware and equally dissatisfied, that economic „science“ is currently basing its ability to predict developments much more upon extrapolations, than upon true understanding of the underlying rules shaping the course. Just like any human cognitive activity, science should aim at not only describing, but at understanding reality in all its forms, developments and sudden twists. By presenting his impressions and findings, the author aims at drawing the attention of the academic community to the fact, that what drives and decides about the course of economies may lie outside of the current focus of today’s economic science and its theories: In culture, namely in the ways, how people deal with qualitative values and quantitative criteria.

Method: Hermeneutic Semioses

The answer to the obligatory question, inherent in science, regarding the combination of methods applied in cognitive processes leading to new findings in all appropriate seriousness, requires a separate chapter, which is under work and would in any case expand this paper beyond the already exceeded quantitative limitations.

Such chapter shall probably also have to include narrative parts from autobiographical notes

In a short and etymologically fitting description, the method could be described as a series of “hermeneutic semioses” regarding economy and society. With such definition, reference to epistemology and Gettier (25) is not avoided, but temporarily circumvented. In further detailing such method at the denominational level, however postponing a more detailed description, it may well be added, that a hermeneutic semiosis, i.e. the interpretation of qualitative information behind developments, as signs, is not strictly related to the observation, interpretation and influencing of complexly intertwined realities as a system of objects, but rather as the observation and understanding of subjects, which means that one
must be aware, that the subjects do alter their characteristics by being observed and conclusions being communicated. Such interdependent influence can not only be shown in examples, such as the effects of publications like the report to the club of Rome upon the course of the world, but also be found in the theoretical writings by Jakob and Gore von Uexküll regarding science and its limited ability to serve more than a description: Understanding, which can hardly be derived from quantitative information alone, but rather requires qualitative information. Thus, the so called “soft” facts are the ones, which create the “hard” facts, if we understand that value is generated by observing values. How much such understanding may lead to and undergo shifts of paradigms, has also been described in great clarity by Thomas S. Kuhn, namely in his dissertation: “The Structure of Scientific Revolutions” (24).

Findings are Results of Semiosis and Reflection

Regarding Macro-Economy and Employment, the recognition of the obvious discrepancies between statements, predictions, measures and outcome has nourished doubt regarding the validity of the „laws“ and “rules“ of economic „science“. It also has led to reflections and independent own thought. Some conclusions are offered and outlined here, in order to invite better-prepared scientists of related fields, including the so-called „humanities“, to prove, correct or counter-prove the findings presented.

Under some aspects, this paper may be called a „semiotic“ paper. Not because of the specific language and deeper methodology related to that specific interdisciplinary science serving so many disciplines, but as result of a Semiosis, which derives from the fact, that the author, namely since the years 1974- 76, during studies in Italy, has synchronously been exposed to two different “worlds” and their dealing with the same socio-economic facts. Such detailed multifaceted insight then had drawn him to the quick prediction: „We are driving towards new ‘weaver upraises’! This time not due to the use of steam-power, but as a result of computerised automation“. What the world since has started to call „information technology“ has long proven this trend-prediction right.

In Command: Real Economy or Finance?

The immediate objective of this paper shall already be reached, if it leads to new and differently focused thought and research regarding the theses, doubts and alternative explanations outlined in it. This is the primary motivation of the undersigned, when he dares to express and share his observations, reflections and conclusions, by questioning and re-interpreting economic theory - and adding new theory, as a framework correlating existing contradicting theories with variable boundary conditions. Boundary conditions found not in "economy", less in “finance”, but in human nature, or: “Culture”. But it may be added at this point, that the purposefully fuzzy term “culture” here also includes the anomaly, that in recent days, and increasingly so, finance is no longer regarded as a side function serving economy, like bookkeeping, but rather tends at dominating and, thus strangling economy, because economy intrinsically must follow its own rules, not primarily driven by quantitative criteria. The abnormality, according to high ranking German bankers, meanwhile has gone further: While formerly at least three quarters of any bank’s transactions have been related to the creation and distribution of goods, this primary activity nowadays only accounts for a quarter of the transactions, while the majority is strictly related to financial products, no longer related to goods, such as doubtful “derivatives”.

Invitation to joint Efforts contributing to Success

More urgent, however, than the invitation extended to the academic world, regarding independent reflections and refocused research, is the immediate recognition and application
of the obvious, namely because the concepts presented are already proven. Having contributed to success stories of entrepreneurship and innovation as well as stable economic developments, both in industry and in the restructuring of depressed regions, the indication, how this has been achieved, and how methods, not solutions, can be adopted and adapted elsewhere, and even improved, the author presents this paper as an open invitation for a concerted action between private initiatives, public administrations and academia, to participating in the application of what works, and to study, why it works so well, how counterproductive hindrances can be overcome, and to share, what others could learn from it.

**Cognition, Mass Opinions and Independent Thought**

Science and scientists are not entirely free from prejudice. One such prejudice may be seen in the arbitrary definitions of science itself, its methodology and areas of application, resulting from lively discussions a century ago, in which the name v. Uexküll stands out as worth being remembered and reread. Possibly, not only as far as Jakob v. Uexküll, the outstanding Biologist from the Baltics, but his descendants and those, who continue to make reference to him, such as Kalevi Kull, semiologist from Tartu, Estonia, with his biography of v. Uexküll (1). Jakob’s son, Thure, half a century later, at the occasion of his own retirement from Munich’s university, in which he offered enlightening references to his father’s work, has hinted upon the areas, which science, until today, has remained unable to explain – and which science, with its current narrow focus, may never be able to address and understand. His bold statements in a foreword to a recollection of some of the most important of his fathers works, is worth reading for everyone concerned with cognition. (2)

Another comment, slightly more humorous, which returns to mind, when presenting this paper, is dating back nearly equally long: It has been attributed to Alexander v. Humboldt by a source, which the author no longer can ask for confirmation and details. In general lines, v. Humboldt supposedly has suggested: “If someone has found a new theory, better explaining reality, however contradicting currently prevailing theory and teaching, he (or she) better waits with the publication, until the author(s) of the currently prevailing theory have deceased, or at least have retired.” Obviously, this comment, by such outstanding and committed researcher and true pioneer of science, refers to the dealing with cognition by his fellow-scientists, and to their being all too human.

The extent, to which even intelligent personalities, otherwise regarded as examples of “independent thought”, like everyone, are inevitably subject of mass psychology and its inclination towards prejudice, is just one more “reason” to re-read and reflect about the writings by Hans Domizlaff, creator of “Brand Techniques” (3).

**Origins of all Economic Developments: “Culture”**

For the purpose of this paper, such “non-scientific” aspects as identity, values, attitudes, pride, which are the origin of all decisions, in their multitude shaping what we call “economy”, can be united under one intentionally fuzzy label: “Culture”. Culture is a Key to understanding those micro- and macro-economic developments, which some leading heads of economic science publicly have confessed not (yet) to understand, but to be working at: “...what happened in Japan - and what is now happening in Germany - and in Europe...” (6)

At the centre of economic interest in culture is the way, how people, as customers as well as entrepreneurs, and in any other role as part of any general public, deal with qualitative values and their diversity. Human values, thus, seem to be even far more important, namely for the course of economy, than assumed by authors, such as German industrial association leader, and former head of IBM Europe, Hans Olaf Henkel, (7) who are lately commenting about the lack of human and ethical values in current economic as well as political (and financial!) practice. Below, we shall find some hints upon the reason, why even the most outstanding researchers, fixed upon their areas of probably excessive specialisation, can not
find the origins of economic crisis, and can not fully understand, what decides over structural crisis, possibly crash, as argued to be inevitable by some authors, such as Hamer and Hamer (8), or, rather, the preferable alternative: Prosperity and functioning social security systems. This paper aims at indicating, how the approaching crash can be avoided, rather than be prepared for.

**Vote for a Concerted Action**

The fact alone, that some economic researchers call for an international “Marshall Plan for the World” (www.global-marshall-plan.de) indicates: The world has no time to wait. Or better: Humanity has no time to wait, while the world shall undoubtedly survive humanity, if not else. The global marsha l plan initiative itself, however, is misled and misleading by its own overwhelming focus only upon quantitative criteria and, consequently, upon distribution rather than local generation of wealth through own unique culture and offers, in order to overcome the origins of dependence.

Hands-on measures need to address and deal with the roots of the problems more, starting from trying to understand these better. As an entrepreneur, the author intends to indicate, how outstandingly effective and also most efficient measures of economic promotion have been applied (and proven), and how they can be optimised further, in order to be applied elsewhere. But also, how research could and should accompany study and help to fine-tune such hands-on approaches conceived, proven and optimised by practitioners for practise.

In addition, this paper is also intended as a reminder of what the author has pinpointed and questioned already before: Education (8) must widen the scope of people, rather than focusing and limiting it further. Education must lay the groundwork for thorough interdisciplinary cooperation, by providing an overlap of general knowledge of other fields, including the humanities. And education must proactively promote ethics and teach methodology of teamwork – and of understanding and communicating uniqueness and diversity by underlining the importance of understanding, expression and realisation of qualitative difference, in order to be able to cater to (and capitalise upon) human diversity.

**PART ONE: Basic facts.**

Old and ubiquitous knowledge could easily be overlooked as „common places“. But are those invalid?

What is the difference between “outdated” by fashions or trends and invalid or “wrong”? Revisions of old knowledge and principles under new circumstances, with new methods or additional information may provide additional insight or lead to new interpretations and understanding.

**Artefacts need an own Reason to Exist!**

The term “artefact”, in the strict sense of the word, is applicable to any and every result of human thought, action and inactivity. Thus, also to ideas, companies, institutions, brands and the like.

Without an own and unique reason to exist, companies and their offers can serve only shortsighted interests while creating harm to competitors and all societies. Comparable offers and their vendors, have a strong reason to seek their own place in the world by embarking upon uniqueness and qualitative distinction, rather than trying to compete through quantitative aspects. Excessive focus upon productivity alone only leads to the contrary of prosperity, pride and freedom: Unemployment.
Entrepreneurship, Employment and Societies

Fulfilling employment is at the heart of prosperity and social security, as well as of self-esteem, identity and pride, leading to “culture” - the unique Being of people - and to further unique offers and innovations. Fulfilling employment, thus, is a result of and leads to sustainable business activity. Fulfilling employment is also a prerequisite of both internal and external peace - and of any functioning democracy, its independence and self-determination. Also, additional prerequisites for the welfare of any community, and their peaceful harmony with other communities, originate from human nature. These may be characterised in terms of cultures, values, attitudes, specific competence, life styles, patterns of use, needs, scarcity, excess, and by many other aspects linked to these and driven by these. This cluster constitutes not only a rich source for innovations and offers catering to the uniqueness of people, groups and offers, but of sustainable politics for any specific region.

Job-Motors Entrepreneurship and Innovations

Entrepreneurship and its Innovations are the single most important sources of employment. Since the seventies, but more pointedly, since the eighties of the past century, responsible and insightful authors, such as Peter Glotz and Uwe Thomas (10), have exposed their detailed understanding and proposed adequate measures aimed at taking this fact into account more appropriately in national and international politics. Much longer, it has been a known and repeatedly proven commonplace, to state, that most employment, namely in any strong society and country, is provided by companies led by entrepreneurs. This statement, although to a lesser extent, also applies to a slightly different point of view (now a “mass opinion”), under which the same statistics are presented for the category “SMI”, thus by relating steady employment and new employment generated to size of companies alone.

The lack of fine, however significant difference in denomination, has a counterproductive effect upon the understanding of entrepreneurship and the origins of its potentials in comparison with anonymous, capital driven and employee managed entities, which are instead the object of most economic theories and thought, while they are hardly anywhere employing near to 20% of any population, and nowhere generating more new employment than they themselves destroy.

Entrepreneurship vs. Business Administration:

With regard to the qualitative distinction between values prevailing in entrepreneur-managed companies, and quantitative criteria prevailing in capital driven employee-managed corporations, also in view of theories (22) of managing (unnecessarily) “complex systems” (which prove to be close to superfluous, as long as companies are led by entrepreneurs) it may be the case, to underline the fact, that “cybernetics” regards the leadership as applied to ships, companies and states, based upon cognition and its communication. Such leadership requires responsibility, competence (e.g. the ability to personally instruct and show: how, how precisely), oversight and direct communication. With other words: Entrepreneurship as mentoring, sometimes demanding leadership.

Qualitative Distinction and Terminology matter!

The above may be seen as a hint upon the limited understanding of deeper origins of any complex problem. Whenever statistics are generated by relating facts to quantitative criteria and not to the more significant qualitative values-related categories, the outcome is a result of the limitations of quantitative criteria.

After all, what should matter in research is to understand, why which kind of mindsets, values and attitudes has which effect upon society. By mixing, for example, employee-managed and capital-driven companies with entrepreneur-led enterprises, in categories, like
SMI, relating employment only to size of companies, the effects of values upon employment may stay clear, although they clearly get diluted and less visible. Moreover, their relation to specific mindsets and values could become even more visible, if one went back in history and included also large entrepreneur-led companies into the research.

**Sustainability – Intrinsic Quality of Entrepreneurs**

Among others, the already mentioned Anton Zischka (11) offers deeper insight, leading to the observation, that from the moment, when entrepreneurs, such as Alfried Krupp, have been forced, in this case (among many even more destructive examples) by one specific bank, to change the structure of their companies into publicly traded, share based, and thus capital driven companies with employed managers, not only these companies, but their supportive effects for societies, have been undermined – until they disappeared in nameless conglomerates driven by quantitative criteria alone, and thus neglecting their role in society. On the other hand, the present return of Volkswagen group into a Family Company under a strong and competent entrepreneur as Dr. F. Piëch, promises extremely positive effects for Europe and the world and shows the social responsibility of the Porsche family for European society and its role in the world.

The recently propagated terms of “Corporate Citizenship” and “Corporate Governance” can in no way revive or emulate repressed values, visions and motivations of true entrepreneurs, the responsibility of which, in our days, is also reflected by personalities like George Soros (12). Rather, such terminology must appear as additional “noise” aimed at camouflaging the true origins of problems - and, thus, as sabotage of understanding and taking more fitting measures for a more sustainable course of economies and societies.

Sabotaging effects, which also are reflected in the resulting alterations of entrepreneurial activities, namely in countries, where a jump-started business practice follows century long communist desinformation about “Capitalism” rather than the tradition and example of West-European “Social Responsibility of Capital”, which has helped W-Germany and the EU to be so strong. Here, again, Anton Zischka may be named as a handy and very detailed source of insight. But also the first hand accounts by Helmut Schmidt (13) in his various autobiographical reflections.

**Origins of Multitudes of Egalitarian Effects?**

The question “Cuio Bono”, e.g. regarding the mentioned counterproductive developments, changes of paradigms, as well as of EU- and international standards, rules and regulations may be left to the appropriate investigation and answer by any interested party. Here, the question “Hony soy, qui mal y pense?” may leave further reflections to the reader and redirect this discourse back to the argument, that terminology (and its etymology) in fact is a Key to understanding complex problems better.

**Entrepreneurship – Ever understood by Science?**

The effectivity of entrepreneurial companies to generate sustainable employment is closely related to the effectiveness of entrepreneurial enterprises, to generate the unique offers, preferred by target groups for their incomparable properties. Their generation of employment can also be related to their efficiency of inventing and realising the most outstanding technical innovations. Increasingly wide spread mass opinions, however counter such facts by dispersing the ill belief, that innovation would require “size” instead of such different set of values and attitudes, not driven by numbers, but by unique ideas pursued as “causes” founding the indispensable specific Raison d’Etre of any artefact.
Entrepreneurs: Powerhouses, Mislead and Paralysed

The self-understanding of entrepreneurs, how they could be more successful under continuously deteriorating boundary conditions, has been subject of a continuous change of values and paradigms, partly induced, if not enforced, by the rules of accountants, bankers and politicians as well as scientists advising entrepreneurs from external, but also extraneous points of view: (Business-) “Administration” and Finance, not Entrepreneurship.

It might be worthwhile, to question, who is inducing the prejudice and rules of these groups in whose interests?

On the other hand, the author, so far, has not been able to note many successful efforts, to understand the deeper roots of what really makes (or: has made?) entrepreneurs so successful, both in realising their own individual visions and in being the core of any society, not only by continuously generating new fulfilling employment, but by adding pride and sustaining local values, and by contributing in manifold ways to their local and national communities and the local generation of wealth.

Science, Administration and Entrepreneurs

Hans Domizlaff, the mass psychologist, “father” of “Brand Techniques” and successful advisor of leading entrepreneurs and innovators, once stated: “Science and practical Entrepreneurship” (as well as Innovation) are “separated by principally different ways of looking at reality. As a result, the mutual relations nearly always are limited to the exchange of complete results. Only rarely a spirited co-operation in developments appears possible” (13). Such judgement must even be extended to include internal scientific laboratories in direct service of enterprises. But in specific clarity this applies to applied humanities, such as psychology, philosophy and their practical application by Design, as the professional means of translation of qualitative nature and identity into non-verbal language to be perceived as tangible experience.

Motivation of Entrepreneurs: Human Nature

Economy can probably best be described as the “Sum of Individual Transactions based upon and expressing Preferences and Identification”. While catering to human nature may be less the focus of interest of the sciences, it however is the natural focus of Entrepreneurs, and - supposedly - also of politics and public administrations, namely - one should suppose and might request - in free democracies. Not to speak of “Open Societies and its Enemies”", as Karl Popper titled his book, first published in 1945. A book, which, like many old books full of wisdom, however based upon an experience based not recently updated, might merit revision in view of current times. And this not only because the subtitle of Volume 2 bears a subtitle translating into: “Wrong Prophets - Hégel, Marx and the Consequences” (14). Consequences, one is tempted to add, which, because of their infiltration of “capitalist” economic theory, are motivating this paper, to induce overdue reflections.

Private Initiative at the Service of the Whole

Sustainability, which the world so badly needs for a sustainable future, can only become a reality - less: as soon, as needed - if the priorities between qualitative human and cultural values and quantitative criteria seize to be interchanged. Not only has Finance to serve Entrepreneurship, instead of controlling or paralysing economy. The catering to human values - and the generation of value based upon human values - has to be understood as the key to economy.

Uniqueness: Rise, Fall & Resurrection of Apple

In recent days, the ousting of Steven Jobbs - and the immediate, progressively destructive effects of employed, capital driven “business administration” upon Apple, as well as the last
minute rescue by the returned founder and his “interim” (i-) products, have shown the
difference between a strong cause reflected in a unique and unequivocal Corporate Culture
and offers - and the contrary: After Mr. Jobbs’s departure: Steady descent! Down to 2% (as
“much” as IBM in its best days) from over 60% market share in its own self created market:
“personal computers”. Some were interested in stopping this Innovation and the New
Industry. A former IBM Manager has been especially instrumental in destroying what once
had made Apple so overwhelmingly strong. The founder’s return to the helm, so far could
revive the spirit and uniqueness, but not make up for the lost ground. Consequences, of which
not so much the company or its shareholders suffer, but humanity: Lower levels of interfaces
between products and human users have become a “standard”, to which people got used to
bow. The results upon culture, mass opinions and attitudes are devastating, because the new
“standard” is. Is such destruction of human criteria an example to follow, e.g. in Europe,
regarding European innovations and industries based upon the riches of European cultural
diversities? And what about cultural resources elsewhere?

Social Responsibility of Capital
An outstanding and acribically documented, detailed account, regarding entrepreneurship
at its best and its working for the best of society, has been provided in various of his works by
Anton Zischka, e.g. in “War es ein Wunder?” (Has it been a Miracle?), an enlightening
account describing the German economic resurrection after being freed from Fascism and
War (10). What Zischka describes as Normality, to our days drives true entrepreneurs: The
drivenness to, both, co-operate and to do what is required by oneself, and focusing the efforts
of ones workforces to achieve, what is best for the whole and its parts; everyone focused upon
one’s own progress as well as for the best of the whole society.

The so called “Social Market Economy”, formulated before WW 2, can be seen as a
normal state of healthy economy, which, if entrepreneurship and human values prevail,
requires little admonishment, like Ludwig Erhard’s famous “Masst halten!”, to keep the
ubiquitous “black sheep” in line, and to let the example of elites work - also, through their
continued success. “Cowboy capitalism” and Rowdy behaviour of nouveau-riche “Super
capitalists” let loose after the fall of the socialist systems, behaving according to communist
text books distorting any notion of “capitalism” and true entrepreneurship, ruins the world.
The resulting shift from values to quantitative criteria leads capitalism and market economies
to the same collapse as communism, because the intrinsic error of thought, not objectives, is
the same: Egalitarianism and the prevailing of quantitative criteria.

Socially committed private initiative appears to be increasingly repressed and ridiculed by
counterproductive trends destining humanity, through a counterproductive interpretation of
freedom as “laissez-faire capitalism” (George Soros, 11), to collapse or, as it is called in the
financial world, “Crash”.

SECOND PART: Questioning Macro Economy
It may be appropriate to submit economic scientific theory and practice, as well as public
and national policies based thereupon, to questions like the following: “When have you last
heard implicit or explicit mention of the following theories? And when have you last doubted
this theory?” But also to add questions like: “If this Theory were true, what would really be
the Consequences? And, if the Contrary were true instead? Have any Measures been argued
based upon this Theory, as presumably viable Solutions to known Problems? Are these
Measures truly effective? And if not, Why not?” - All in all: Normal questions, as part of
independent thought. These questions now may be applied to numerous theses and antitheses
always following the same mentioned pattern:
What are the Relations between Finance and Economy?
What is the Formula of the Link?
The continuous presentation of the ups and downs of stock markets, and the ways these are commented, reflects and induces the assumption that stock rates, at least as an indicator, inform the public about the course of economy, that Finance and Economy are basically the same, or more linked, than in reality beneficial. An assumption which would also explain, how so many criteria from the finance-world make it into being applied by decision-makers in the world of economy, and even into changing and substituting the rules, values and attitudes, which make enterprises so powerful as sources of innovations and employment, thus to progressively suffocate economy and its sustainable course by diminishing and repressing its roots.

Availability of Money and Purchasing Power:
If Any, Which is the Relation to employment?
One way of looking at the links between financial markets and economy is to look at the relation of availability of money, via interest rates and the ability of industrial customers and private consumers. But Availability a true Key to employment? Under which kind of circumstances and in which culture? Here probably another assumption must be questioned, which often is tacitly combined into one logical building of doubtful stability. Where and in which way are economy and finance really and sustainably related, and where instead does unnecessary reciprocal conditioning, or the misinterpretation of Economy and Finance as “one” have counterproductive consequences upon the course of economy and the world? Of course, here the various types and aspects of finance and financing have to be distinguished too. Namely, when analysing entrepreneurial activity and its ability to turn its potentials, for the business and for the community, fully into sustainable reality.

Growth of Demand, Sales and GNP
and its Influence upon Employment?
In this context, the often-quoted relations lead to doubt. The initial stimulus for a close mental monitoring of developments over years has been seeded by the obvious contradictions between official statements and the facts observed in different locations and media: Whenever Politicians, Leaders of Administrations and Economists talk about employment, or rather, about fighting unemployment, they quote a supposed relationship between “economy” – or, better: demand, sales or GNP – and new employment.

We already know from other sources, such as Uwe Tomas (10), and repeated studies in many parts of the world: New lasting employment can not be expected from known and comparable main-stream offers, where the similarity automatically leads to price-wars, and, thus, cost competition as decisive Key success factor; this again leading to increased productivity and pressure upon labour cost and unemployment. New employment therefore can only be expected from new, currently unknown offers, so called “innovations”. Where is the link, though?

The relationship between any qualitative information, like the uniqueness of new offers and quantitative information, such as resulting sales or employment, are never cited in such quotes, and, thus, the substance of such “science-based” statements already poses various reasons for questions. The relation thus reiterated appears still interesting enough to question it in itself. The question not only is, whether economic Growth and/or increases of demand serve as a valid indicator for the course of employment, but: In which way, and why? Consequently, the above mentioned set of questions should be applied to the variants presented here below, of which the first rule is the most frequently heard, and often used to argue in favour of (or to justify) financial “gifts” by politicians towards their electorates. It may therefore be called the “thesis”.

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“Thesis”: “If Economy picks up, Employment shall pick up.”
When have you last heard this? When have you last doubted it? And so forth...
Equally old, however much less quoted, is the contra-diction of this thesis, which reads:

Anti-Thesis: “If Economy picks up, additional Demand shall be absorbed and served by growing Productivity. No significant new employment is to be expected!”

While this “rule” of economy has long appeared much more convincing to the author of this paper, namely because it seemed to reflect much better, what could be observed, since the sixties, but, moreover, since the seventies, in Europe, the author of this paper, lately, since the nineties, has topped this Antithesis by an adjourned variant of his own:

Anti-Thesis 2: “If economy picks up, additional Revenues from growing Demand and Sales shall be allocated and used in order to realise additional Gains in Productivity. Thus, growing Demand leads to more Unemployment.”

Supposedly, this Antithesis to mainstream mass opinions so far may not have been heard. And if so, the author would love to learn about it and enter into deeper discussion with those, who have formulated or quoted it.

If Antithesis 2 seems to be much more representing, what one can observe in the world today, this not only hints upon the intrinsic error of thought, which has brought down communist economies by proving socialism principally wrong (although, in many aspects, well motivated, i.e. based upon good intentions), but should be alarming any independently thinking individual, because it indicates, that “capitalism” and “market economy”, at least in their currently prevailing, and by some even much acclaimed variants of “cowboy capitalism” from the far west and “rowdy capitalism” from Europe’s East, now is in danger to fall over the same systematic error, which has shaken up the socialist states in the nineties of the past century.

Such danger may even be welcomed by thoughtless leftist ideologists as a late and unexpected verification of Karl Marx’ hope, that capitalism should be made stumble over its own feet, in order to prepare the ground for an otherwise little probable revolution and the definitive establishment of communist dictatorship. The much earlier fall of communism over the same errors not only leaves little to hope for the future of such leftist fascist rule - but also not for free market economies and open societies. Thus, the mentioned warnings by George Soros, e.g. in “The capitalist Threat” (12) do coincide with the observations presented here. Moreover, it is impressive, how George Soros has immediately expressed his clear view, when the author of this paper was still only expressing his impressions of the sudden unholy alliance of “Cowboy”- and “Rowdy”-capitalism from West and East overwhelming Social Market Economy. The committed engagement for a better, free world, by George Soros finds another expression in his speech, held in Brussels 2006: “Europe as a Prototype for a Global Open Society”, which, again coincides with the views exposed here. Beyond such visions, this paper aims at providing the practical tools for such leadership role: Tangible Success based upon High Esteem for Diversity. It shall need strong and convincing proof of the Alternative, in order to be followed more easily. Unless this proof is not produced, Soros’ quote of “legions of European Diplomats”, able to move the world through diplomatic offensives, shall lack the most important ingredient in the eyes of “Have-nots”: Tangible Results; Visible Prosperity.

PART THREE: The Roots of the Problems
Questions regarding Value, Cost and Price
What is economy other than the sum of transactions executed based upon human preferences? The roots of any problem of economy, thus, are in the satisfaction of such
preferences. Economy, if any, is a human science.

On micro economy, the pattern of questions, as applied earlier, may be useful to stimulate further cognitive processes: When have you last heard implicit or explicit mention of the supposed “rule”, that “price reflects cost”? Is the thesis, reduced to the formula?

“For price = f (cost)” right?

And when have you last had a doubt regarding the truth and the implicit and obvious effects of this assumption?

On the other hand, the antithesis to such thesis must equally be submitted to such scrutiny:

Is it not rather true, that “prices reflect the value of an offer for the customer or target group – and its purchasing power? Thus, should we not formulate the antithesis, in a different way, abbreviated as:

“For price = f (value, purchasing power) ≠ f (cost)”?

A synthesis is to be offered, in order to explain, under which circumstances which of the two theses prevail. And the combination of these Syntheses shall allow to gain some insight upon the factors really driving economy and deciding over Growth and Prosperity – or Downturn, into a rapidly accelerating Vortex - and Crash, as described by Hamer and Hamer.

(7) Destructive Focus on Quantitative Criteria:

The thesis, reflecting the overwhelming excessively one-sided focus upon price and cost alone, which apparently leads to the down turn – and to its acceleration, can be seen as a result of the prevailing of quantitative criteria over qualitative values and preferences. This misleading assumption is therefore in a vicious circle both origin and result of many counterproductive trends leading to totally comparable offers, often even hard to distinguish, none of which makes any target group really happy, but all of which somehow serve a general scope of specific objectives of mainstream markets.

Without Qualitative Diversity: Stagnation

Where none of the available offers awakes enthusiasm, the reason to substitute a still working product, more or less doing what it should, is minimal. Thus, replacement markets are limited, leading to the effects of market saturation. Who, instead, needs to purchase a product of such category, be it because of a new need or because of urgent replacement needs, shall among the not-exiting offers probably chose the less unfavourable, but for the rest the choice shall to a large extent be made based upon merely quantitative criteria, without considering other, more qualitative aspects. Thus, price, operating cost, vicinity of maintenance and the like are the dominating criteria, while values, attitudes and resulting preferences and unfulfilled desires and objectives remain unattended and dissatisfied.

Vendors, too, not understanding their existing and potential client base better, and probably disinterested in these, also due to trends and counterproductive influences suffocating their interest, awareness and ability, shall seek their competitive advantages also solely in quantitative aspects: End-user Price, Margins for retailers, and, to stay alive in such downward swirl: Cost, Productivity.

The consequences are known and ubiquitous: Unemployment, dislocation of manufacturing and sources, leading to fictitious new (however always both reduced and cheaper) employment elsewhere, while at the same time weakening the own local, regional and national economies.

Where comparable main-stream offers prevail, none of which is effectively aimed or reaching any specific target group, the understanding of - and interest in - qualitative
diversity, however reduced it may have been already before, disappears, and quantitative criteria prevail to an extent, that conscientious people may end up wanting to shake people and shout at them: “Wake up, Customers and Entrepreneurs, it is called Value Added Tax, not Cost Reduction Tax! There is a reason behind such Terminology. Just think what you could gain!”

**Promotion: No Subsidies for Transfers of Jobs!**

Misunderstood “competition” of public and national administrations, with costly gifts to speculators destroying jobs, is ubiquitous. It appears obvious, that “new employment” elsewhere, in combination with destruction of jobs at any original basis, should never be rewarded by any subsidies at all!

Competition by quantitative criteria being the error, this does not help any world region or nation. It is expensive! Not only for the “Losers” of the employment, but also for the supposed winners: With much less, as a much more effective, efficient and sustainable allocation of their notoriously limited resources, the respective regions and cities could proactively provide advice and support to their own local existing and future entrepreneurs in being very successful on international markets with own unique offers, creating much more fulfilling, increasingly better paid and more long-term employment. Proud awareness of own Identity and Independence would further stimulate lasting local economic development. It is just a matter of awareness; understanding and detailed teaching, to put this into practice and to turn so far unrecognised or disregarded potentials into steady sustainable prosperity and stable reality. And this is possible for every world region.

**Constructive Effects of Value Diversity**

Whenever people recognise offers, which cater to their so far not precisely realised dreams, desires and needs better, than all other offers known, “spontaneous purchases” are the result. Suddenly, machinery still working well, and other investment goods, are offered as surplus, leading to growing markets for used items (and constituting options for others, to realise what they could not afford before), in order to make room for the new acquisition. Where necessary, priorities of resource allocation undergo swift changes. This applies as much in investment goods and businesses and their tools etc. as it applies to private decision-making and “consumer” markets, both regarding long living items and short lived consumer goods.

In such situations and markets, prices, as long as they appear anywhere reasonable, hardly ever are a matter of discussion, at least not with the vendors. Rather, under these circumstances, price again is a function of the Value for the customer. Consequently, depreciation calculations and resource allocation are much more a topic, than the question, whether or not to purchase. Priorities shall be changed, to be able to pay the just price.

**Vast Potentials of Latent “New” Markets**

Diversity and uniqueness are, thus, creating new demand and markets, by transforming not precisely satisfied desires from what the undersigned long labels as “latent markets” into new markets, which can stringently be developed from market niches into solid segments. Consequently, so called “New Marketing” actually appears to be the only kind of marketing worth teaching and applying.

What we could call Mainstream- (or “Bookkeeper”-) Marketing, may serve, to create awareness about the ways, in which destructive quantitative thinking works, and to prepare own strategies to fend off plagiarism before it even can reach the market. One such measure, and here quantitative criteria do indeed find their place and role in economy, consists of being ahead not only in functionality and uniqueness of offers, but also in productivity, in order to make it prohibitively expensive for others to follow examples of a specific proprietary innovations.
Examples of long, proven Practise

Entrepreneurship, Innovation and Marketing are thus, in their very principle, concerned with a continuous effort of Bridging between new possibilities and latent, so far not sufficiently served Needs. An objective, which is worth pursuing and standing united for. Now, where are concrete examples? Many “small” ones, to which the author contributed, may sound too special, to convince the unrelated reader. Therefore it may be excused to describe a widely known innovation. Without disclosing secrets of other, actual cases, one such example may be given by hinting upon the large LCD-flat-screen technology, before its first realisation proactively proposed by the undersigned to his long-term client SHARP of Osaka. The client did follow this advice and proactively optimised function, production technology and market approaches. The parallel proactive optimisation at all “fronts” (market, technology and manufacturing technology / productivity) decisively left no void for “fast followers” - the Asian eulogy for plagiarism. As a result, the internal Key-modules of all large flat LCD-screens for computers and TV are made by Sharp or under license by Sharp, on Sharp equipment. The fact, that Sharp has withdrawn from offering finished products for Computers under its own brand must not mislead: Why should Sharp continue to compete with its customers, if these continue to sell the end products cheaper, than Sharp would, in order not to damage its brand? Consequently, Sharp, under its own name, and under Sharp’s own German brand “Loewe”, sells finished Large Screen LCDs only in the TV market. Having contributed to many success stories like these, the author of this paper aims at stimulating such competitiveness, based upon uniqueness and innovation as the result of “bridging between new (or so far unrealised) possibilities and latent markets”, namely in and from Europe.

Innovation: Realisation of better Fitting Offers

The term Innovation, in this and other contexts, is by no means linked or limited to any however defined “High Technology”, namely not to information technology as the currently only publicly noticed high technology.

While the author, for his own entrepreneurial activities, focuses his efforts upon the realisation of extremely energy saving technologies, he also insists upon the fact, that Innovation is not necessarily linked to Technologies at all! Innovation is any successful new and unprecedented offer effectively serving latent needs and preferences better than what has been known before.

Innovation focused upon Target Groups

The term Innovation, thus, to distinguish it from the more narrow, however not success-related term “invention”, relates to the fact, that something is new and fits so far unsatisfied demand or “latent markets” better than all other hitherto known solutions and offers. Such better fit can in many cases be reached by understanding and catering to qualitative preferences in the areas of “taste”, through different shapes and the like.

For creativity regarding better solutions, also, but not only regarding “taste”, own uniqueness and diversity of cultures, if sensibly taken as a source of creativity and innovation, can lead to unique solutions, but also to offers entirely based upon appearance, underlining the importance of “Design”, as a professional service for enterprises. Design, thus, lends itself as just another, however overly powerful “management tool” to be used soberly and competently by leaders to achieve and assure success. Being such a powerful tool of non-verbal communication, Design, in order to serve organisations at its best, requires leadership and direction through qualitative information. Therefore, in order to be put at the service of companies at its best, and to avoid the otherwise ubiquitous danger, of outsiders and their possibly artsy concepts, instead of management, shaping the identity of an enterprise, Design
requires qualitative information as briefing, and, thus, requires the respective preparation, competence and awareness from and by management. Design, thus, is a matter for the CEO. But it is also a measurement criterion for CEOs, how well they are able to focus upon the important, qualitative matters, and to delegate the urgent, quantitative matters far down, where they belong.

PART FOUR: Synthesis:
Boundary Conditions Decide! The aforementioned questions and theses have been raised, in order to call for new interpretation and to invoke a sober basic awareness, that Keynes’ thesis and the antitheses might altogether be right, just under different circumstances. Thus, it is a matter of the boundary conditions. Now: How can we describe the effects of such cultural boundary conditions upon economy? And how can they be influenced?

As we have seen, the prejudice, that “value”, and, moreover, “price”, has any prevailing relation to cost, can only dominate businesses and economies, where offers are generally comparable. It is a worthy subject of additional Consideration, to understand, which are the factors, which like an unholy alliance promote such prejudice, and, more importantly, the trend towards comparable offers rather than a trend towards offers more precisely aimed at specific diverse target groups. Who is interested in this matter is invited to require information and dialogue regarding this specific subject with the author. For the purposes of this paper, it must be sufficient, to show, that, as a vicious circle, such influences paralyse the economy at two fronts:

Demand - The public, and all target groups, as customers, who increasingly stop requiring (or expecting) offers more precisely meeting their individual preferences.

Offers - Managers and even Entrepreneurs increasingly disregard such diversity of requirements.

A world in order: Value originating from Values
Where offers are unique, prices reflect the value for the customer much more than cost. Moreover, we can observe that where uniquely fitting offers are insisted upon, both by clienteles and by entrepreneurs (and institutions, etc. for that sake) unique sales propositions are more in the focus and lead to an increased allocation of means towards innovation and increased uniqueness. Uniqueness, as well as Diversity, is strictly qualitative. Quantitative aspects, e.g. regarding cost and pricing, only start to become of relevance, both on the side of the target groups as well as on the side of who offers, once the uniqueness of an offer leads to its being preferable; Thus: When a true reason to exist for the offer is constituted. And, thus, also for those, who realise such offer. In markets, where unique offers prevail, competition is intended as competing to try to convince others of one’s own Being (Corporate Culture and – Identity, Brand) and the Being of one’s offers.

Thus, own Being relates to the Being of target groups and their resulting preferences.

Headed to the Waterfall - All happy aboard?
In markets, where offers are comparable, the only criterion of selection is reduced to quantitative difference, such as data, price, delivery times etc. Consequently, here competition is misunderstood as competing over price alone. And, in order to survive in the resulting cutthroat business-culture all focus of leadership and all resources are allocated upon productivity alone. The fact that this means lower wages, unemployment, dysfunctions of social security systems and the like, but also paralysis of political independence and self-determination, is often overlooked. Obviously, those who try to benefit as “Winners” from such trends, ridiculing those, who loose the price battles, hardly ever realise, that the course,
which they are so convinced of, that they impose their ways upon others, eventually not only shall lead to zero employment, but also to all “share holder values” resulting as zero.

**New Courses and their Landmarks**
A turn-around is, thus, overdue. And it is vital, to both understand the mechanics at the roots of economic developments, but also to recur to immediately feasible, proven hands-on measures and methods, like those successfully used and proven by the author, and mentioned in this paper, in order to initiate dialogues leading to their diffusion and ubiquitous availability. Parallel to such direct and proactive implementation of effective as well as most efficient measures, advice and communications must be directed at the importance of those factors, which really can change the boundary conditions in the cultures, in order to counter the destructive trend, which, with another misleading term, is often labelled as “Globalisation”, but rather, more precisely, could be addressed as the “Substitution of human and Cultural Values and their Diversity by Quantitative Criteria”.

**Value Diversity vs. Quantitative Criteria**
It is worthwhile to relate such reflection to the two Key-words, at the roots of this problem: “Qualitative” and “Quantitative”. While the latter relates to the “how much” question in all its many possible ways, the term “Qualitative” relates to the question “How”, and “how, precisely”? Qualitative information, therefore, is both at the core, and a prerequisite, of all cognition related to being. Of own Being as well as of the Being of all other Beings, both in nature, and of artefacts. Artefacts, in the strict sense of this word, are all results of human thought and actions (or non-actions): Ideas and Desires, Products and Services, Innovations and Cultures, but also Governments, Companies, Institutions, Clubs and Associations as well as Brands and Labels.

**Turnaround through Education, Media & Example**
The roots of the problem, and thus, of the boundary conditions, are to be found outside of economy, in human nature and culture, namely in attitudes towards uniqueness and diversity of human values and preferences.
This calls for a revision of criteria of business development and management as well as of its teaching in academia and extracurricular instruction. Above all, it calls for a proactive approach of instruction and support of entrepreneurs and management, but also of all official and unofficial “advisors” to enterprises, institutions, administrations and the like. Among these, the media, namely professional periodicals and general press also play an important role, as does education in general. The messages to be presented in ever new cases and stories, not only regard the matters of entrepreneurship as well as of innovations and their realisation in all different fields, to achieve truly unique sales propositions. And they also must not only address human uniqueness in all its diversity and riches, which is an inborn human element and right which requires to be understood, defended and lived, as well as the methods and techniques to understand and address target groups based upon their lifestyles, patterns of use and the like. Moreover the messages must implicitly exercise and explicitly inform about the nature and importance of qualitative information versus the presently prevailing focus of merely quantitative information and the paralysing effects, which this has upon perception, cognition, thinking, creation and living; in private and public life, in business and administration and in the sciences.

**Process Methodology: Systematic and Systemic**
Multidisciplinary and interdisciplinary co-operation is always the last resource, in cases of emergency. An example is the incredibly efficient methodology called “Value Engineering”, which was conceived in the US during WW 2 in order to overcome resource problems. It
however has seen its wider acceptance much later, since the sixties, namely in Europe, where the author started his initial freelance career by implementing the method and co-ordinating projects in high tech industries. The inclusion of qualitative aspects later has widened the scope and applicability of this Value Engineering-approach. As “Value Design” - Methodology it has lead to a “tool-box” of team techniques for different specific matters, but also has been subject of continued discussions, leading to a better understanding of team work as the centre of inclusive holistic processes of innovation.

**Power of Teams: Focused Holistic Optimisation**

“Universal geniuses” have existed and shaped the world for its better before, but are possible also in our days, if not repressed. It may therefore be another aspect to be addressed appropriately, how education can foster, rather than paralyse and expulse people with a naturally wider scope of understanding different topics into their very depth. After all: Does Creativity not consist of the linking of formerly unrelated concepts into a new Whole, which has a reason to exist, by, for instance, solving problems better, or for the first time at all? Because of its significance for invention and innovation, this, again, is a complex, which is mentioned as an invitation for further dedicated dialogues while not elaborated upon here.

The function of “Universal Geniuses”, however, can perfectly be realised by Teams of properly combined persons and applying a methodology, appropriately adapted to the problems at hand. Apart from the mentioned Value Design Methodology, a number of widely known techniques are applied, not only to resolve specific pressing problems, but also in order to include people into processes and, thus, share knowledge. This is beneficial both for the coherence and stringency of Corporate Cultures and Identities, but also for the understanding of long-term objectives, opportunities and threats, thus, of scenarios and strategies based upon these.

It is therefore a requirement, as another hands-on measure, that academic and extracurricular education fosters holism by enabling increased interdisciplinary co-operation in research and application, and by preparing future researchers and business leaders and their personnel better, by a wider scope of teaching, beyond the very boundaries of any specific area of specialisation, and by teaching and exercising the application of the methodical tools of systematic as much as systemic team processes.

Here, also because of its “eye opening” effects upon all senses, and, thus, upon awareness and “vigilance” in its very physiological and psychological sense, it appears indicated to at least mention the only sound method for the formulation of “strategies”, which, thus, sticks out as a supposed “must” for all professions of applied sciences: “Scenario Techniques”. For the text books (17) and teaching, the author gladly indicates Ute von Reibnitz, as the outstanding professional in this field in Europe.

**Promotion of Economy starts from Entrepreneurs**

All economic development starts from entrepreneurial initiatives and activities, which, at their best, are circled around uniqueness of offers, innovation, concern for target groups and responsibility for the public in general.

It falls into the categories of disentangling and unravelling the manifold inter-relations between finance and economy, which appears to be recommendable, if one underlines the fact, that the currently prevailing “fashion” of “steering” economy through purely quantitative measures, namely through influencing financial boundary conditions, is not only not the only way to achieve objectives of sustainable steady economic development, but rather proves to be an origin of counterproductive effects not taken into account so far. Moreover, steering economy through quantitative criteria and boundary conditions appears to be by far not the most effective and much less the most efficient manner to achieve and maintain sustainable
situations for economy and society and all, what depends upon this: Prosperity, Social Security, Identity, Pride, Self Determination, Independence, Internal and External Peace.

**Promotion of Economy – Support of Value Diversity**

Effective Promotion of economic development, as proven in practice, starts and ends with what leads each individual business activity to being sustainable. And all business activity, in order to be sustainable, in addition to other prerequisites, needs to be characterised by its very own and very specific reason to exist. Without such own “Raison d’Etre” any business can only be aimed at destroying another one (or more), rather than by creating a proprietary clientele and target group by competing via uniqueness of offers, pleasing customers better, instead of offering the same as others, just cheaper. Competing with me-too-offers can not be called sustainable, because it leads to unemployment and many more counterproductive developments and effects of an increased focus upon price and productivity alone, instead of uniqueness and its world-wide presentation and appreciation by specific target groups.

Efficient Promotion of economic development, beyond the argument raised to explain the basic rule for effective promotion, should channel all notoriously limited, if not scarce public resources to those businesses, which prove to be the most effective columns of any economy: Entrepreneurial companies, i.e. companies managed by owners and their families. Experience from micro-credit lending policies in Asia, based upon their cultural context would even be more pronounced to this extent: With focus upon businesses managed by female owners. While that may have good reasons in some world-regions, and may induce sober critical thought and observation elsewhere, here the more industry-focused argument limits its referral to the following facts: Entrepreneurial companies are the ones, which provide the overwhelming part of any currently existing employment, but also of unique offers and innovations, and, consequently, of new employment!

**Key to Prosperity: Human Attitudes and Values**

The difference, which decides over crisis or prosperity, lies in the attitudes of individuals, decision makers and society as a whole. This regards attitudes regarding the diversity of people, their dreams, desires, values, attitudes, needs and preferences. This Diversity makes it worthwhile to cater individually, with unique offers, to diverse target groups. Diversity is a natural fact, and respecting and supporting the understanding and importance of diversity leads to Sustainability; just as much in business, economy and politics, as it does, regarding bio-diversity, in environmental matters. Where unique offers are proactively enforced, both by seeking and insisting upon them, and by realising them, the same uniqueness, the better it reaches its target groups, the more leads to full employment, prosperity and the rest.

**Synthesis: A simple Logical Chain!**

The Synthesis, offering a new understanding for the formerly contradicting theses and antitheses regarding macro economy and business administration is quickly expressed:

“Where uniqueness, and diversity of such uniqueness, prevails (without allowing anyone to superimpose own uniqueness and views over others in a quantitative sense of superiority and use of power) the diversity of ways of Being of human beings shall lead to a Diversity of Demand and to a Diversity of Offers. The Diversity of offers, in turn, in order to be conceived, realised and marketed, requires Human Beings and shall lead to sustainable new employment. Full employment strengthens social security systems and self esteem of societies, along with independence and self determination. All these, if available and implemented everywhere, are a necessary prerequisite, although no sufficient precondition for inner and outer peace.”

In order to achieve this, little is needed: Awareness and Proactive Support - not just Tolerance, but rather: Joyful Encouragement and mutual Support in realising individual and
group-uniqueness as true “Being”. No one should any longer accept totally comparable offers as “choice”, how ever cheap their pricing, but insist upon the precise fulfilment of own individual desires and preferences. Where the fitting offers are not available, communication of each unfulfilled desire as well as own entrepreneurial realisation of such innovations shall both lead to more offers supporting Human Diversity; And to more entrepreneurial companies providing fulfilling employment.

In addition, one may include side-effects of identity, pride etc. into the “equation” and come to a better understanding of what really determines not only economic and financial, but political and national independence and self determination.

Europe, its people and enterprises, and any of its cities, regions, states and nations, by following this route, have all to win and nothing to lose. Moreover, by establishing a widely visible example, Europe can serve to peoples in Africa, the Americas, Asia and elsewhere, in order to follow suit, by taking such examples as landmarks for establishing their very own and diverse peaceful courses towards sustainable prosperity.

**SIXTH PART: Concrete Measures to be applied**

“Bilbao Effect”: Result of Holistic Promotion of Entrepreneurship, Uniqueness and InnovationThe effects of a stringent course of promoting economic and social development, strictly based upon local identity and values, and focused upon entrepreneurial companies, uniqueness, and innovation, to which the undersigned had the honour to significantly contribute such views and practice, by personally implementing his proposed measures, can be observed in the Spanish Basque Country.

Here, based upon the initial far sighted ideas by regional politicians, not only to provide financial help, which would evaporate, if alone, but also to provide access to new technologies, and because this also would not be enough, to provide Knowledge and Methodology of Design, the undersigned has implemented his proposals of both methodology and of integrating all these measures into one single concept and package of closely concerted actions. Such efforts, in their practical realisation, at the time have still found numerous obstacles of understanding, integration of competencies and the like. Today, however, the current structure and name of the institution “bai”, then initiated in the rubbles of a long empty building as “DZ”, now, after 25 years, precisely represent all the guidelines then proposed and fought for. And the results of such success can be seen everywhere in and around Bilbao and throughout and beyond the entire Basque Country.

On the other hand, this exemplary concept, never completely implemented in Bilbao to the last detail, still offers additional opportunity for further improvement, not only regarding effectivity and efficiency, but regarding speed of such effectivity. A speed, which appears desirable in view of the course of some societies and the world. Moreover, as new free states, having focused upon quantitative criteria only, are reaching the predictable saturation levels soon, the consequences are predictable. To avoid turmoil and repercussions, counterproductive for self determination and peace, one must proactively seek to implement feasible measures immediately. Thanks to the Basque example, the measures are both: Readily Available and Proven. And these measures can not only be adapted, but even be improved and become speedier, as the following example indicates.

**Open Invitation to a EU-Region: baltic.spin**

As a first case, aimed at the Baltic Sea Region, as yet another European region often divided by fluctuating borders, however, coherent in the culture and rich variety of its identities, the Private Initiative project baltics and the Private Public Partnership project baltic.spin are ready to be implemented. The latter being proposed as a flanking measure to boost the swift realisation of the potentials of this uniquely sustainable and promising approach initiated by baltics.
More detailed presentations regarding the new project proposals, *baltics* and *baltic.spin*, are subject of separate detailed publications (19) and copies and are available from the author. The same applies to the “re-invention” of Design Promotion and its completion and implementation as the holistic Promotion of Sustainable Entrepreneurial Enterprise and Innovation in the Basque Country (20). Likewise, the methodology, which allows to put qualitative distinction at the disposal and into the practise of entrepreneurs, managers and administrations, and to turn Uniqueness and Design as well as the addressing of Target Groups with means, such as the “Life Style Matrix” and distinct “Patterns of Use” into “Management Tools”, shall be made available upon request.

**CONCLUSION: Qualitative Diversity matters!**

**Human Diversity - Key to Employment!**

Employment, and Unemployment, is probably the most important aspects of any Economy, in order to serve their society. Economy is the sum of individual transactions based upon diverse preferences. Thus: Economy is driven by human beings, groups, and their needs and preferences. As long as humanity exists, not two people have been entirely identical in their needs, likings and preferences. Common denominators of qualitative details, however, serve, to identify and distinguish Target Groups, in order to aim and cater to these more and more precisely. However, it must be recognised and proactively observed and applied, that the definition of such common denominators must address the qualitative aspects of human diversity, far beyond superficial or merely quantitative aspects of needs and desires: Values, Attitudes, Preferences, translated into different Life Styles and Patterns of Use.

**Egalitarianism is the Root of Structural Crisis!**

Sustainability is not only a matter of bio-diversity in the environmental field, but of proactively defending, encouraging and supporting qualitative Human Diversity in all its aspects. Egalitarian approaches, independently of their ideological origins, are counterproductive to self-realisation, employment, prosperity, functioning social systems and peace. Moreover, in not considering individual diversity as well as the diversity of communities, egalitarian approaches do undermine the equal right of Identity and Culture. A right, for which efforts currently are under way, to establish an international “charter” to explicit assure it in front of - and by - the world community. A charter, for which, one should think, no need should exist. Existing fierce Opposition against it, makes it all the more important to support its implementation.

**Reinvention of Looking at Economic Matters**

Employment undoubtedly is the single most important key indicator of health of societies and their economies.

As unemployment statistics have often been altered, the only valid indicator of Prosperity and a Functioning Economy assuring a healthy society, can be seen in the Number of Persons actively Paying into Social Security from their own ongoing professional activity, for which their employers also pay their full, unsubsidised dues. The misunderstanding of Economy, imposed upon people and practised by exclusively paying attention to quantitative aspects, as if Economy were nothing more than a proper application of arithmetic, or, worse, as if economies, together with their societies, were at the service of Finance, instead of serving customers and societies, leads to structural crisis and, predictably, to local and global Crashes, including - and starting from - the financial world.

Habitual interpretations of ups and downs of demand as cycles, and the presumed Logic of a link between demand and employment, mislead and hinder the recognition and understanding of the origins of a progressive structural crisis, which in Europe is measurable since decades in terms of decreasing employment. Excessive specialisation of the sciences,
moreover, of research regarding economy, and its ill linkage to the world of Finance, hinders
the recognition of roots of the course of prosperity or crisis outside of economy.

The same applies to the interpretation of dysfunctions of social security systems only as
consequences of demographic developments, while social systems could still function well,
with full employment.

Current demographic developments have their origins in the publications of studies, such
as the first and second report to the Club of Rome (21). A hint which links the changes of a
researched continuum through the results of such research, as mentioned, to the writings by
Jakob von Uexküll et al. (1, 2)

Holistic Knowledge and its Relation to Peace

The prejudice, that knowledge ages (or might unnecessarily overfill any brains?) and the
consequent limitations of curricula to information of actual usefulness for immediate
application, paralyses people, groups and societies, and their ability to create and use
Uniqueness and constant Innovation, as a means to maintain functioning sustainable
economies and societies. Moreover, it hinders their understanding of the world, their ability to
maintain and develop Democracy as a valid method of self determined peaceful rule, and of
establishing Peace as the Normality, which it, regrettably, currently is not yet, despite a recent
good record in Central Europe. An unprecedented record, which may mislead some to
believe, that Peace would already be the desired “Normality” and would not require utmost
further Vigilance and Defence Readiness for its continuity and expansion to other world
regions.

Example: Turnaround of the Basque Economy

Europe, in all its cultural and ethnical diversity and riches, can serve the world as example,
How lived diversity of Values leads to tangible Prosperity and self determined Independence
of others (possibly even despite economic downturns or even a potentially imminent financial
crash, intentionally or not endangering countries and world regions) administrations and
private initiative need to proactively apply and nurture the use of identity and culture. The
example developed in the Basque Biscay province provides both, proof and hints upon
possible improvement, as reflected in the PI and PPP projects baltics and baltic.spin proposed
for the Baltic Sea Region.

Proven Hands-On Measures for Immediate Results:

In order for Entrepreneurship (not just administration of businesses) to play its unique role
in employment and innovation, and, thus, as Creators of additional fulfilling employment,
which only entrepreneur-managed companies can play, Entrepreneurs need to be supported in
their ways and ethical values, among which social responsibility of capital stands as much
out, as does their drive to find and realise, new ways to satisfy needs.

Currently, such entrepreneurship appears more paralysed then ever, by imposing upon
companies the merely quantitative thinking and the ways, which are typical of anonymous,
capital driven companies - and an economic science not understanding, why and how
entrepreneurship is so different from merely materialistic theories, why this difference makes
it so successful. And why this difference is of utter importance for the health, prosperity,
pride, independence and self determination of societies everywhere around the world.

While it therefore is important, to teach, develop and practise true entrepreneurial spirit,
the proposed close co-operation between private sector, experienced mentors and select
academic institutions aims at assuring sustainable Growth, employment and development for
companies, and for any world region, by turning their potentials, based upon truly unique
offers and innovations, into lasting exemplary realities. And right away.
Such mentoring also shall provide the tools and methodology for turning qualitative diversity into success. And the proposed involvement of academic institutions shall lead to new focuses of research and improved of teaching, providing for employees and, eventually, entrepreneurs fully conscious and able to address qualitative diversity and to realise uniqueness in Corporate Cultures, Brand Identities and – most importantly - Offers.

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8. HAMER, EBERHARD & HAMER, EIKE: Was passiert, wenn der Crash kommt?
Abstract: This paper analyses some of the key issues faced by family businesses (FBs) in the UK. Perhaps because most family businesses are Small and Medium sized Enterprises (SMEs), in the UK it is rare to draw any distinction between the problems faced by FBs and SMEs, yet FB have some unique characteristics and problems. The paper examines certain key issues for the development (and perhaps the very existence), of the FBs. These areas are motivation (to found the business), development/diversification, sustainability (it is this family succession that most distinguishes an FOB from other businesses), and the role and importance of technology in all aspects of the business. These issues are discussed, with reference to the available literature and are highlighted by evidence from three case studies, each of which is taken from a different business sector in the UK.

Keywords: Family Business, SMEs, Business survival and development, business succession.

1. Introduction

What is a family business? A family business can be defined according to a number of different criteria. Miller and Le Breton – Miller, define a family business as “… business, whether public or private, in which a family controls the largest block of shares or votes and has one or more of its members in key management positions” (2005:518). We prefer to define a family business as comprising one of three distinct types, which can overlap.

1. Businesses that are owned by members of the same family, typically with the family owning over half of the shares.
2. Businesses controlled by members of the same family, even if the family is not the majority owner. In this case the family can lose control if the owners become unhappy with the performance of the business.
3. Businesses in which the ownership and/or management pass from one generation to the next. This may be thought of as a ‘higher order’ of family business.

As the majority family businesses (FBs) are SMEs, there is a not unnatural tendency to assume that FBs face exactly the same challenges as non-family businesses of a similar size. Whilst such assumptions are generally true, there are additional considerations that apply exclusively to FBs, which present such companies with unique threats and opportunities. One obvious difference which gives the FB its unique character is the fact that a business relationship is ‘embedded’ within the wider context of family relationships (Birley et al., 1999; Chua et al., 2003; Sharma, 2004; Cater and Schwab, 2008). There are also different issues between family owned businesses (FOBs) and family controlled businesses (FCBs), which are often overlooked, such as succession and inheritance. In practice, data deficiencies mean that it is difficult to distinguish between these different types of FBs.

2. Family Businesses in the UK

The British Family Business appears to be alive and well, although its existence receives less attention in the UK than in many other Countries. A London Business School survey (undertaken in the late 1980s) found that of 8,000 of the largest UK companies, some 75%
were FBs (Bridge et al, 1998:131). When the family business becomes large and are floated on the stock market, issues of control can assume paramount importance. For example, Rocco Forte lost of control of the Trust House Forte group, which his father had built up when, in 1996, the institutional shareholders lost confidence and accepted a hostile takeover offer from the Granada Group. Although some family businesses have grown into very large organisations, for example Sainsbury’s food chain, these are not typical and the majority is small. Indeed they comprise the majority of all small businesses (Bridge et al. 1998:129). Notwithstanding the impressive numbers of FBs, discussion in Britain does not generally differentiate them from SMEs in general.

SMEs, and therefore FBs, are highly important to the UK economy. Using the standard definition of small businesses (less than 50 employees) and medium sized businesses (50-249 employees) and large (250 or more employees), the Government estimates that of the 4.5 million businesses in the UK in 2006, 99% were small, 0.6% was medium and 0.1% was large (UK, 2007). These SME’s account for 59% of employment and 52% of turnover. Small business alone accounted for 47% of employment and 37% of turnover.

However, despite these impressive statistics, it is important to note that the failure rate amongst such businesses is also high: approximately 400,000 (10%) of SME’s cease trading every year, with a similar number of new businesses being created. Many of these are likely to have been forced into closure through accumulated debts. The typical life of an SME is three and a half years. With their high bankruptcy rate and even higher rate of ceasing trading as an independent business, questions of business strategy and succession are key issues for SMEs and of vital important to their long – term economic success.

It is interesting to speculate on why the British should find it so difficult to differentiate the FB from an SME. One possible explanation lies in the social make-up of UK society, with the demise of the large extended family as a social unit. However, the onslaughts on the traditional composition of the family are being felt throughout most of the world and include divorce and the geographical dispersion of the extended family due to the search for employment. While these factors could have implications for the future of the FB in many countries, they are taking place within the context of cultural differences, for example between the Americans, British, Swiss, Germans, Scandinavians and other northern Europeans on the one hand and the Arab nations, Japanese, Chinese, Latin Americans and Southern Europeans on the other. The former compartmentalise and differentiate between work and family relationships, while the latter emphasise the important of the extended family, friends and personal relationships as a basis for business.

Family businesses predominate in diverse sectors: the retail sector characterised by the ‘corner shop’ in which all-family members, including children are expected to serve. Catering, including wholesale suppliers, restaurants and ‘take away’ hot food shops. Family businesses in the skilled trades (plumber, electrician, joiner and builder) have long been common, as have unskilled trades in the construction industry. Often these service sector businesses are dominated by ethnic minority groups – Pakistani families run retail, textile wholesale and restaurant businesses. Chinese families run wholesale, restaurant and ‘take away’ food businesses. Irish families have long run businesses in construction and building. More recently, East Europeans migrant workers are establishing businesses in the construction industry, often as transferred or ‘posted’ workers (these are workers working for a company not based in the UK). Since the 2004 EU enlargement, Polish shops and bakers are opening in most UK towns to serve the needs of the growing numbers of Polish workers. Interestingly, some of these ethnic minority family businesses are facing a labour crisis as their (British born) children go to University and have an expectation of a better career. In some instances, the family business is used to finance sending their children to University to study to become a doctor or solicitor and this is a key expectation of the founder. In such
cases, whilst completing their full time education, the children are expected to help out as and when necessary in the business; however the long – term expectation is that they will not go into the business full – time. Thus, there may well be times during which the FB experiences both a crisis of succession, and/or one of staffing. Indian restaurants have recently called for a relaxation of immigration rules to ease their labour crisis.

3. Advantages and Disadvantages of the Family Business

We have argued that FBs possess many aspects which are different to other businesses and so it is worth considering the advantages and disadvantages of the family business. As with most SWOT (Strengths, Weaknesses, Opportunities, and Threats) analyses, many of the identified variables might be considered as both a strength (‘advantage’) or a weakness (‘disadvantage’), depending on the specific circumstances and interpretation. There are, however, certain key considerations:

3.1 Common Values. Members of the same family are likely to share the same values, ethos and beliefs on how things should be done. This gives the FOB an extra sense of purpose and pride - and this might well translate into a competitive advantage for the business.

3.2 Flexible Employment. Family businesses can offer flexible employment - in particular in terms of job content (with tasks and responsibilities being widely shared between family members) - and in terms of hours to enable job sharing, part –time commitment, and working from home. The family business may not need to take out employers' liability insurance, if it only employs close family members.

3.3 Commitment. The level of commitment to the business must be high, or it is unlikely to succeed. Whilst wage – earning employees, working for someone, else can afford to adopt a more relaxed attitude towards their employment commitments, the FOB is providing for the family and can only do so with a high level of commitment from all involved. Family members may be more willing to make financial sacrifices for the sake of the business, or what, they might regard as their future inheritance. This may (and generally does) involve working long and sometimes antisocial hours, foregoing holidays, and accepting lower pay than they would get elsewhere to help the business especially in difficult times. Some members of the family may even work without pay. Employment legislation may be ignored. It is this bond of loyalty - both to the business and, by extension, to the family - that makes the FOB different to most other businesses. Family members are expected to show a level of loyalty and commitment, that far exceeds that expected of an employee. Family members support the business in return for future business stability, and accumulated wealth, sometimes with an expectation of inheritance.

3.4 Family Relationships - However, close personal relationships between family members can be both a strength and weakness, depending on the situation: if family members fall out, the closeness of such relationships may become a major weakness, and source of problems within the business. Most FOBs fail to distinguish between family and business life, personal disagreements can translate into commercial disagreements, with negative effects on the smooth running of the business. One key issue in this respect is the question of how one deal with poorly performing family members, especially as those concerned may not view the business in the same light as the founder. Major disadvantages, therefore, can be summarised as potentially including a lack of career progression, low skill jobs, a lack of training, and low pay - often below the official minimum wage.

3.5 Business Skills - The knowledge that one is building for future generations encourages long-term thinking – itself necessary for growth and success. The downside of this, however, is the potential for a family controlled business to become “fossilised” in its development, or to lack new skills. Just because the new MD is a member of the family, it does not mean that they have been blessed with infinite commercial wisdom, and an ability to understand and
react to, changes in the market. Thus, the lack of business skills may be a problem, especially when coupled with intergenerational disputes over strategy and succession.

4. The Stages of Business Development

Research into family businesses has produced several models of growth and development, which are broadly similar (Steinmetz, 1969; Boardman et al, 1981; Churchill and Lewis, 1983; Scott and Bruce, 1987; McNally, 2001; Brockmann et al, 2006; Cater and Schwab, 2008). For example Chisnall (1987) and Dewhurst and Burns (1993) propose a four stage model; survival, consolidation, development, and expansion. Scott and Bruce (1987) analysed these models and propose 5 stages of business development; Inception, Survival, Growth, Expansion, and Maturity. They also link each stage of growth to a major catalyst of motivation - “each stage of a business is preceded by a crisis…” (p46), and suggest that such crises are precipitated by “Changes in both external and purely internal factors…”

In order to analyse our case studies, we have adapted and reduced these models to three stages; ‘start up’ which includes inception and survival, ‘strategic development’ to include growth, expansion and maturity, and ‘sustainability’ which includes prospects for future business survival in terms of the markets, management and ownership succession.

4.1 Start Up

What were the driving factors that led the owners to found the company in the first place? How was finance obtained? If a relative founded the business, why has the current owner/manager agreed to become involved? There are many reasons for starting a business (Scott and Bruce, 1987). Dewhurst and Burns (1993:12) divide the initial motivation into ‘push’ or ‘pull’ factors. ‘Push’ factors include unemployment, job dissatisfaction, seeking life style changes or lack of current income. ‘Pull’ factors include a perception of an opportunity or a desire to be rich. Some pull factors can be related to general aspirations and desires, rather than money - the desire to ‘better oneself’ or ‘prove something’: “I wanted to be the best at…” “I wanted to show people that I had the ability to …” Although monetary success may be an indicator that they had achieved the success they sought.

An important question is the extent to which the reasons that led a person to found the business in the first place are a direct determinant of its likely success. Do they produce motivation or a determination to succeed? Also, they are an indicator of what the founder feels to be important in their lives - to a certain extent might even be likened to the “mission statement” of a larger organisation – and therefore can be used to define business success. If the founder was seeking life-style changes then this may be a more important determinant of success than traditional financial criteria. Caroline Cosgrove, founder of “Baby Concierge”, the ‘one-stop-shop’ consultancy service for expectant parents, saw a gap in the market after being both shocked and disappointed after her first shopping trip for her new baby:

“I had expected it to be exciting but the whole experience was dreadful. The shop assistant did not seem to know much more than I did about their products and the range of options was confusing. I came back from my first trip exhausted, with 20 pram brochures but no pram. It seemed crazy that there was no one-stop shop staffed with people who could genuinely help.” (Atkins, 2008)

Alternatively, the founder might have been motivated by the desire to escape from something. Such motives are usually associated with ones’ current employment, which has become boring, uninteresting, annoying, or frustrating: “I wanted to escape from the rut I was in”, “I thought that there must be more to life than a ‘nine-to-five routine’, or “Anything was preferable to what I was doing.” Whilst it might be argued such attitudes are not the most psychologically stable base on which to found a business, they can lead to success. For example, Nick Wheeler founded Charles Tyrwhitt Shirts in 1986, because he ‘didn’t like
being told what to do by other people’ (Morrison, 2008). Michael Thompson, founder of the children’s nursery chain “Child Base”, resigned his lucrative position working in his father’s company, as he was “fed up of being in his father’s shadow” (Thompson, 2008). Having been ousted from the business his father build up, Rocco Forte has gone on to found his own chain of luxury hotels.

Statistics relating to the motivation to found one’s own business vary greatly, as a consequence of diverse business sectors, economic conditions, competition, and the psychology and personal circumstances of the founder. All have made for a rather haphazard coverage of the reasons for business start-ups. Despite this, there are common key themes that emerge from various case studies: the desire to escape from the ‘rat race’ or the desire to be one’s own boss and the desire to make a living out of what was an interest, hobby or pastime. It is important to note that, in general terms, a positive motivation (to found the business) is perhaps more likely to lead to success than a negative motivation. In addition to being central to the foundation of the business, this motivation generally keeps the business going through the most difficult phase: the first 1 – 3 years of trading.

Having decided to start a business, raising finance, both for the initial start-up and to sustain the business during a loss-making early period, is the next hurdle to be overcome. Potential sources of finance include savings, mortgaging the house, start-up loans from a bank, borrowing from family members. Accurate market research and cash-flow projections are key to accurate estimates of how much money would be required. Simply running out of money is one of the main reasons for business failure during the start-up phase.

4.2 Strategic Development

Family businesses also face the same sort of business pressures as other SME’s - how to survive in highly competitive markets, often with low profit margins; problems in raising finance for expansion, which in turn can make them highly vulnerable to interest rate changes. To be successful, the business must come to terms with important external factors: market demand, achieving a competitive edge or unique selling proposition (USPs), and coping with the impact of technological change. Accurate market research is critical, knowledge of the competition and financing new investment are important issues. Changes in information technology has affected many businesses in recent years, at the very least, it has provided a way in which businesses can communicate with customers.

Formulating a business strategy is problematic at the best of times, but more so for those who may be without any formal business training and limited business experience. Will diversification into new markets or extending the supply chain, may take the business away from its raison d’être and into new markets in which they no longer have any expertise or competitive advantage?

Knowing there is a market is no guarantee that your business will succeed. For example, although the market for ‘eating out’ is growing, it is also highly competitive. The Tampopo chain of restaurants adopted a unique approach to ‘eating out’ by offered a fusion of East Asian foods, served to customers who sit at benches that they have to share with strangers. Even the somewhat conservatively – minded British appear to have accepted this radical concept. We could also cite examples of some of the Japanese restaurants in which the customer’s order is cooked at their table. Or the pizza houses that let customers design their own toppings. The list is endless, but they all give (or at least gave until the competition moved in) a USP that distinguished them from their direct competitors. Low barriers to entry are a key limitation on successful business strategies.

Whilst such considerations are faced by all businesses, the FOBs faces difficulties and advantages not experienced by other firms. For example, expansion in any direction generally requires finance, and whilst an SME might go public to raise the finance for expansion, such
an option may not be open to the FOB, in which, by definition, control is held in the hands of a single family. Traditional sources of finance available to FOBs may have been exhausted during the start-up phase. Also, the managerial challenges of strategic development facing family businesses should not be underestimated. How does the family get agreement on the new strategy? How can the existing business be managed and at the same time extra labour resource become available for new ventures. This is how long hours can become a feature of FBs, which in turn causes tension in family relationships.

4.3 Sustainability

Whilst all companies wish to sustain their operations as far into the future as possible (generally through expansion and growth), for the FOB the question of sustainability is more than one of mere commercial development. Sustainability is a big problem for most SMEs. If the business survives, who will take over either the ownership and or the control?

Table 1: ‘Mediators of Success’ and the Stages of Business Development

<table>
<thead>
<tr>
<th>Key Criteria</th>
<th>Business Development Stage</th>
<th>Start Up</th>
<th>Strategic Development</th>
<th>Sustainability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Motivation</td>
<td></td>
<td>Reasons for founding the business</td>
<td>Reasons for business development/expansion</td>
<td>Reasons for passing the business on to successor</td>
</tr>
<tr>
<td>Market Research</td>
<td></td>
<td>Level of demand for the product/service? Level of competition?</td>
<td>What changes in demand patterns since the business was founded? Role of technology?</td>
<td>Likely future demand patterns? How will technological developments affect the business?</td>
</tr>
<tr>
<td>Money</td>
<td></td>
<td>Money needed to found the business initially. Generally savings, a business loan, or re-mortgaging house (if owner).</td>
<td>Money needed to fund business expansion plans. Possible choice: financed from business profits, or take out another loan?</td>
<td></td>
</tr>
<tr>
<td>Markets &amp; Competition</td>
<td></td>
<td>What product/service are we going to sell? To whom? Pricing level? Our Experience of this sector? Are there any local competitors?</td>
<td>What other (different and/or additional) products/services are we going to sell, in view of changing demand and level of competition?</td>
<td></td>
</tr>
<tr>
<td>Managing (Growth)</td>
<td></td>
<td>Key issue is survival; likely that little thought given to development much beyond foreseeable future.</td>
<td>How will the development phase be managed? Main focus is on the sustainability of the business.</td>
<td>Main focus still on the sustainability of the business, but now in addition, there is issue of succession.</td>
</tr>
<tr>
<td>Managing (People)</td>
<td></td>
<td>Key issue is survival; all family members expected to become involved. Growth is dependent on people</td>
<td>Focus is on staffing issues: in particular the suitability of personnel for key business developmental roles.</td>
<td>Major focus now on the succession of ownership and control.</td>
</tr>
</tbody>
</table>

The consensus of research on family businesses would appear to suggest that succession (passing control to the next generation) is the second stage at which most business fatalities occur - the first most likely failure stage being the ‘start-up’, or lasting beyond the first three years (Longenecker and Schoen, 1978; Beckhard and Dyer, 1983a and 1983b; Handler and
Kram, 1988; Handler, 1994; Fox et al., 1996; Morris et al., 1997; Birley et al., 1999; Sharma et al., 2003; Sharma and Irving, 2005). Indeed only 30% of western family businesses survive into the second generation, and 15% to the third generation (Birley et al., 1999:599).

Who will inherit control of the business after the current owner has either retired or died is a major issue? Unlike the majority of companies, in which people are employed for monetary reward, a family business is a business that is run by the family for the family, and carries with it the unwritten expectation that the founder is building an empire that will be not just a source of family income for generations, but a testimonial to their entrepreneurship, initiative and vision. In other words, many FOBs may be likened to the family legacy - much like the ‘family silver’, the business is intended to remain in the family long after the founder has departed. This question of succession is the major difference between the FOB and other SMEs. But there is no guarantee that the founders dream will be inherited by their offspring. Nor is there any guarantee that the children have inherited the founder’s business acumen. If the family does not want to take over the business, it must be sold or closed. If sold, it may remain a family business, albeit a different family, or may become absorbed into a much larger organisation.

5. Three Case Studies
This paper explores some of these issues by examining three families owned and managed businesses. Given that all three businesses have been in existence for some time, they are not typical of SMEs. These businesses are the winners, although that may not be how the proprietors view them. The case studies are taken from different business sectors (1) business to business; (2) consumer: niche market (personalised, relatively high - value assembly and retail) and (3) consumer: mass - market (mail –order). Each case study is examined through the three stages outlined previously: start up, strategic development, and sustainability. ‘Mediators of Success’ for the Family Business include: (1) Motivation, (2) Market Research, (3) Money, (4) Markets (& Competition), and (5) Management. The last, Management, can be sub-divided into the management of growth (of the business), and the management of people (the family and any paid non-family members. Whilst these variables are influential at all of the three stages of development, their precise focus may change.

6. Case Study 1: ‘Fast Signs’
Outline. This FOB was founded in 1984 by a husband and wife team, who continue to run the business. Initially the business was established to design, produce and erect ‘for sale’ signs for Estate Agents in South Wales. In the UK most property is sold though an estate agents who advertise the property in the local press, in estate agents windows, and increasingly on the Internet. These Estate Agents place their ‘for sale’ signs outside the property, to advertise, to help prospective purchasers locate the property, and also to identify which Estate Agent is selling the property.

Motivation. Paradoxically the initial motivation was not to start their own business but to relocate from a London commuting town to somewhere they wanted to live, and for the wife to get out of school teaching, which she said was ‘overwhelming’ her life. Both had trained as primary school teachers and had no previous business experience or business education. However the wife came from a family with a history of small business ventures – her mother bought and ran a small shop, her two sisters jointly ran a hairdressing business, and her brother runs a business in the USA. They decided where they wanted to live and the decision to start the business was very much a secondary consideration. The husband had worked on and off since 1973 for a business, which provided a similar service, where he was employed
to drive the van, put up and take down the estate agents signs. He was aware that he had no knowledge of the production side of the business.

Market Research. Prior to starting the business they had conducted a number of preparation activities. Both enrolled on a basic silk screening course run by the local technical college. The wife conducted a market research exercise by administering a telephone survey to establish that local estate agents were interested in this service. They established that nobody was currently providing this business in this area and that the estate agents were interested. Estate agents currently requested sales staff put up and take down signs, for which they had little interest or skill, with the result that signs fell down and were often not collected following the sale of the house. These estate agents were subsequently visited to discuss ‘face to face’ their interest in purchasing this service and all were very enthusiastic. One estate agent with three offices claimed that he put up 60 boards a month. The figures provided by the estate agents were used to develop a business plan. Unfortunately, the Estate Agents massively exaggerated the number of properties they sold, and so in their first year of trading the business recorded a staggering loss, which brought them very close to bankruptcy.

Start-up finance. They sold their house in the Home Counties and with the proceeds bought a derelict farmhouse, and converted the farm buildings for use as workshops. A business start-up loan was obtained from a bank, at what they described as ‘extortionate’ interest rates. With hindsight, they felt that this was a mistake – they should have taken a mortgage on the house instead of buying it for cash, because the interest rate on a mortgage would have been much lower than for the bank loan.

Business strategy and operation. In order to establish the business, they offered a ‘no-loss’ gamble to the estate agents in that they would produce the signs without charge and the estate agent would only pay each time they requested a sign to be erected. So there were three distinct elements to the business activity; the production of signs, using silk screen technology, leasing – they own estate agents signs which are of no use except to a particular customer and (iii) erection service putting up and taking down signs as requested by estate agent. The business was officially launched in 1984, and the first year was very difficult; although they has a very good take up from estate agents, they also experienced what can only be described as a major problem of income generation, which came about because the estate agents had massively over-estimated their demand. The good take-up from estate agents meant they bore a heavy cost in producing the signs, which they owned. While they had budgeted for an expenditure of £19K and an income of £26K, in the first year, in the event they spent £39K and had an income of substantially much less than they thought. In the 1st month of trading they had an income of just £148. One estate agent, who had told them that he would order 60 signs per month, ordered just 3 boards. It was a disaster; the bank became very nervous and they came very close to bankruptcy. However they survived and by 1989 they had paid off all their loans and had £10K in the bank.

6.2. Strategic Development

Technological change and diversification. Since the initial start up, this business has embraced the challenges and opportunity of new technology, by moving from silkscreen production to computer aided design, laser cutters and digital printing. This has facilitated diversification into the production of signs more generally, with an erection service for anybody who needs a sign and most recently into the printing of large-scale images for domestic customers. Design has become a major part of the business. But the new technology has both increased the capital demands of the business and at the same time as lessening the ‘barriers to entry’ with the result that competition is intense and profit margins low. A number of ‘sign makers’ franchise businesses have started and have tried to compete, so far without
success. However one consequence of this competition is strong customer resistance to price increases.

They started diversifying immediately, not because they planned it, but because people approached them and asked them to make signs for vans. Very early on they bought a lettering machine for £5,000, which produced coloured vinyl letters sheets. This was an alternative to the traditional ‘sign writing’ with paint and a brush, with the attraction that it was much cheaper. Although this machine utilised 1950s technology, their account number was 309, indicating that only 308 similar machines existed in the country, and they became the first computerised sign writing business in the area.

In 1989, they invested £38K in new computerised technology and bought a plotter, which could produce 1-metre wide signs. This computer technology made both silkscreen production and the traditional sign writer’s craft obsolete, and paved the way for diversification into sign production in general. The new technology also signalled their diversification into design – signs no longer consisted of just letters – they had the capacity to produce shapes and utilise photographic images. They now design and produce graphics for vehicles, especially ‘transfers’ prior to a re-spray, business signs for vans, board, pavement and post mounted signs, site and safety signs, advertising signs and banners. And they also provide an instillation service for these signs. However the adoption of this new technology was not without problems – for a considerable time it did not work and they came close to asking for it to be taken away. As a result it took them many years to recoup their investment. In 1992 they further upgraded their equipment. By 2004, they were being left behind compared with newly emerging competitors and invested a further £60K in new equipment.

Although they have diversified into signs, the estate agents side of the business is still important and accounts for about 40% of their business. Also, it is an area of business which has until recently been relatively shielded from competition. Currently a franchised sign making business has established and is trying to undercut their service to estate agents offering to under-cut them by 50%. Some estate agents have complained about their relatively high price, but have been locked into contracts with them. Others realise that at these prices the new business must be uneconomic, and fear being let down. The franchise fixes prices nationally, and they believe that these may be viable in large towns, but are unviable in a largely rural area, where there can be a 40-mile drive between jobs.

Finance. Finance for the investing in new technology is another area of controversy. Since the business is located in an area of high unemployment, grants are available from various public bodies to support investment, which will create or protect jobs (Thomas, 2001). Although they have been able to use this source of finance to adopt modern computerised technology, it has not been without problems. They complain that grants are awarded to allow competitors to establish. How can new jobs be created if they are simply transferred from one business to another? They complain that some competitors only survive until the grants run out. In 2006 one competitor was established with £300K worth of Government Grants and rent-free accommodation from the local Council worth £45K – it has just gone bust. Grants were awarded on the basis of only the most casual of business plans, although they noted from their current application that the process had been considerably tightened up. One competitor was singled out for particular criticism. This business managed to obtain £586K worth of grants, and went bust. One machine alone cost £100K, which the proprietor managed to purchase from the liquidator for just £3K and start up again with almost free technology and therefore no debt.

Business development. More recently the advent of domestic digital photographic revolution has enabled further diversification – the production of digital images for domestic customers. They opened a rented shop in a nearby town in 2007, specifically to act as a showroom for the production large colour images from digital files on canvas, acrylic or
board, which can be mounted and used for a variety of purposes. Similar shops are currently springing up in many large towns. This business is trading under a different name ‘corrugated iron’, because they did not feel that anybody would go to ‘Fast Sign’s for the production of digital images, and because they had recently hired a business coach, who had advised them to separate their businesses into distinct, stand alone activities. Their motivation for this expansion from B2B to B2C was that the latest investment in equipment left them with surplus capacity, which needed to be used. They had established a web site, but notwithstanding the fact that their web site had already received 330,000 hits, compared with just 12,000 hits in a single year for the Fast Signs web site, they had only received one on-line order. They admitted that they could not compete with other larger on-line order businesses, not withstanding that they used superior quality materials (exhibition quality frames and canvas). As a result, they saw their market as producing personal prints for local customers and pictures for local holidaymakers. This new business was picking up only slowly. Christmas would provide a test for the long-term viability of this business.

In 1993 they introduced the quality assurance standard ISO 9001 and became the only sign firm in the region to have it. They felt that the process of gaining accreditation had been very beneficial. They had looked at all their processes and involved all their staff in doing so. As a result, they experienced less ‘cock-ups’, cut waste, and the improved process had saved them both time and materials. But since then, they felt that things had been allowed to drift. The Business currently employs 8 staff and has a £250K per annum turnover. In common with many small businesses, they are making only normal profits. Their own earnings take no account of the hours worked, or the fact that there are two of them working. Paradoxically, since they started this business because teaching dominated their life, their business dominated their life far more than teaching would ever have done, and for lower financial reward.

### 6.3 Sustainability

Markets and Competition It is clear that sign production using the new computer technology has become a very competitive area in recent years, aided by low entry costs. Some competitors have managed to find their own niche markets. One ex-customer specialises in signs for exhibitions, another in signs for vehicles. However, competition is becoming an increasing problem. They felt that they still had a competitive edge. Silk screen technology is still suitable for low quality, high volume signs—anything with a run of about 100, and they still use this technology for part of their business—indeed since most of their more recent competitors have no silk screening capacity, they have a monopoly for this type of work. Also quality of their production and design and reliability in delivery, were part of their strategy. They describe picking up quite a bit of work from one competitor who was disorganised and missed deadlines. Many of their competitors had no or poor design capacity. But this approach to meeting the competition by reliability had inflicted a serious cost on medium term development. Typically, customers would turn up demanding signs, which they urgently need in a couple of days. As a result, everything would be dropped to meet this production. The consequence of this was they were always trying to meet very tight deadlines, and business development did not take place. They became locked into trying to meet deadlines for small orders and low margin business. While they were clear that what they should be doing is diversifying into the higher margin business 2 business activity. A number of large firms that were previously customers have been taken over, but they could not find the time to promote themselves with the new owners. Although they had followed some customers as they had expanded outside the geographical region, with more effort, many other possibilities could have been developed. Managerial capacity is clearly limiting business development.
The business was dominated by production. They admitted that they really did not know much about marketing and finance and this was a continuing problem. At the time of the interview, they had a severe cash flow problem caused by the discovery that they had £50K of outstanding debts, and admitted that they never had any idea of their cash flow position. This was a major problem because they were at the limit of their borrowing capacity. One cause of this problem was that long-standing member of staff had omitted to chase up unpaid bills for the last six months and they had failed to notice. Previously she had been very efficient, but now really wanted to retire and only had not done so because of problems with her husband’s pension.

Succession. The long-term future of the business is very uncertain. There is conflict between the wife who would clearly like to retire and the husband who wants to know what they would live on! Since they have no children, and no other member of the family is either involved or interested, this business will not continue within the same family. Although most of their workers have been with them for a very long time, a worker take-over is not likely – they have neither the interest, nor the ability. If the business is to survive, it will eventually have to be sold. They had previously been advised that the business was not saleable, although they thought that this would have to be looked at again.

6. Case Study 2: ‘Lancashire Cycles’

Outline. This is a retail business, which sells cycles, and cycling equipment, although it is very different from the usual high street cycle shop. The business was established to build and sell custom made bicycles to enthusiasts, and custom build wheels for racing teams. Cycles typically cost in excess of £1,000 and some racing cycles considerably more than this. Frames are purchased from a wholesaler and sold as complete cycles under the frame manufacturers own brand name. Other frames are purchased from well known specialist frame builders and sold as complete cycles under the Lancashire Cycles own name. The business was started by the current proprietor in 1994, initially as a one-man private business, but has since become a partnership then a limited company.

7.1 Start Up

Motivation and business strategy the proprietor confessed to having absolutely no business experience or knowledge. Initial finance came from a £6,000 addition to the mortgage on his house. At first sight the business appears as if it was a classic case of a person turning their hobby into a business, however this is not the case. The proprietor was not a cycle-racing enthusiast but had previously worked for two other specialist cycle shops. His motivation for starting the business was he ‘thought that he could do it better’. Given this motivation, it is perhaps not surprising that he has very strong ideas about business strategy and compares his own approach to that of his competitors. He refuses to sell children’s cycles, because that would distract the business from its niche market – ‘once you start selling children’s cycles, it dominates your business and your specialist products become marginalised’. He also refuses to view price as the way to achieve a competitive edge, comparing the price of his own cycles with those of a nearby competitor (his own brand cycles were more than twice the price of his competitors own brand cycles). Brand loyalty is important and he argued that if you set out to compete of price ‘you attract the wrong sort of customer’. Other competitors have found this – once interest rates rose, your customer base disappeared. He was clear, that the majority of his customers were 40+ professionals – lawyers and doctors etc. The cycles are built to individual customers specifications, including measuring the customer on a ‘cycle jig’, thereby building a cycle, tailor made to fit the customer. This is better than a mass production cycle, and not as expensive as a bespoke built cycle. As he put it ‘other shops sell cycles and do not care whether the cycle fits the customer or not’. This USP gives this specialist firm its
competitive edge, but restricts sales because the customer has to come to the shop to be measured.

7.2 Strategic Development

**Product development and marketing.** The business started by specialising in racing cycles. During his first year he had a turnover of £1/2m. When a velodrome opened in a nearby town, he responded by producing track cycles, however this was always going to be a small market. He only produces bikes to order, which takes about 4 weeks for a simple order, 6-8 weeks to supply a more specialised order. There is no attempt to keep any frames in stock – there are a lot of frame sizes and colours – he only orders a frame when he gets an order. However he does keep a very limited stock of cycles, but only as examples of what he can supply. This business strategy means he has limited stocking costs.

Once clear indication of his business strategy comes from the fact that he refuses to supply the biggest segment of the cycle market - mountain bikes - because he says that he does not have the specialist knowledge. His next product development was to produce specialist touring bikes but as he puts it ‘These are not easy. They are a lot more difficult than racing bikes - you have to give them a lot of thought. However one problem with entering this very specialist market is that there is not enough demand in the local market – he needed to supply a national market. His strategy for achieving this was interesting and very successful – he sought reviews of his cycles in the national cycling press. Asked how difficult it was to get the national press to review his cycles he said he found it very easy – he just rang them up, however he did admit that one magazine was ‘snobby’ and did not want to know. When a review came out he could not believe it - he could not have written a more positive review himself and his touring cycle went on to win the magazines ‘cycle of the year’ award. After this review, he said that everything want mad - demand took off and he struggled to meet it. He stopped all advertising. Following his success in the national cycling press, he hired a specialist to develop a web site and a major part of this web site is copies of the reviews of his cycles in the national press.

**Premises and strategic development.** The business occupied very small premises, which gave it one of the highest turnovers per square metre in the Country. His turnover increased every year until 2005 when if fell – this was because of the size of the premises – ‘there was not enough storage or space to work - all my time was spent looking for things - you could not move’. A move to larger premises became overdue and this took place in 2006. These larger premises have enabled diversification by expanding parts and clothing retailing, including developing a mail order capacity. The business currently employs six staff.

7.3 Sustainability

Markets and competition. Since the move to the new premises, the business is developing rapidly - parts and clothing retailing, and mail order. The extra space has also given scope for future business development by developing the supply chain. One plan is to increase the cycle repair capacity. Another possibility under consideration is to produce and spray steel frames on site. When aluminium started to replace steel, his frame supply started to source all frames from Taiwan because aluminium welding is much more difficult. However, aluminium has not been the threat expected – steel has a longer life, is easier to repair, and does not have much weight disadvantage because aluminium frames have to be made bigger to get the strength. He currently sells more steel bikes than aluminium. A longer-term plan is to move into physiotherapy and fitness testing. Whether this business can retain its distinctive niche market and USP while diversifying into highly competitive markets remains to be seen.

**Succession.** Given his age and his younger business partner, handing on the business will not become an issue for some time. When it does, the plan is to eventually take more of a back seat. However, given his personal enthusiasm for the business, it is doubtful whether he
could ever be persuaded to ‘let go’. But this business also illustrates the problem of family succession. The owner has three children and his wife wants him to involve them in the business. However, as yet they have shown no interest. If they are not interested, involvement would be good for the long – term viability of the business. However, unlike Fast Signs, there are other options, which would give the business sustainability - it could be sold to worker buy out, or to another enthusiast, or to a competitor. Indeed approaches have already been made to buy the business.

8. Case study 3: ‘Lagoland’

Outline This is a large, multi-million pound, multi site retailing business which was established in 1964 in an area of national beauty in the north of England, and is now a second generation family retail business, run by the founder’s three sons. The father was, by all accounts, a classic serial entrepreneur, who established several businesses. It seems likely that he felt challenged and motivated by the idea of starting up a business, but perhaps just as equally bored by the thought of becoming involved in the daily operations and control of the business he founded. One of his businesses sold animal feed to farmers and he discovered that the farmers he visited wanted to freeze unsold poultry and meat for direct sale to the public, but couldn’t because they did not have access to plastic bags. So he established this particular business as a low tech plastics supply business selling polythene bags and sheets to farmers. As well as polythene bags for chest freezers, he sold polythene sheets as haystack covers and for silage. From this he extended his range to selling freezers (with a delivery and installation service), frozen food and egg boxes.

8.1 Start Up

Motivation. The father abruptly left the business in 1974 for personal reasons and gave the business to his three sons, two of whom were only in their early 20s (21yrs and 23yrs), and one was still at School. Only one of the sons had any business experience and this was limited to having just completed a business studies degree, and having run an island community in Africa. At the time they took over the business, it has a turnover of only a few hundred thousand pounds. Not taking over the family business was not an option. However, the business they inherited was limited in terms of future development. The potential for premium pricing, pricing differential, or price increases was somewhat limited.

8.2 Strategic Development

Diversification The business the sons inherited in 1974 was low tech - administrative systems were manual and paper-based, sales were high volume and low margin. So the three sons set about developing the business. They quickly concluded that they needed to diversify.

An obvious diversification for the plastic sheeting presented itself in the form of the yachting and boating fraternity, moored (quite literally) on the nearby Lake. In addition to the locals, the lake attracted millions of visitors each year, and hundreds of these paid not inconsiderable sums in mooring charges. The plastic sheeting served as an ideal covering to keep the boats from the worst effects of the weather – especially during the autumn and winter months, when many vessels remained unused for six months or more. This first expansion proved lucrative, and, although impossible to prove, may well have been the key development that stopped the business going the way of many others in this region that did not have at least a minor interest in the tourism market.

The next step was to move in supplying domestic customers - a move that coincided with the freezer revolution and their business took off. However, demand for freezer products was highly seasonal – concentrated in the spring and autumn, and the obvious direction for diversification was to extend their range into kitchenware more generally. When interviewed,
they felt that one consequence of youth was that they had tremendous energy and confidence in their own ability - ‘it never occurred for one second that we could fail’.

As they expanded, they moved into new premises. The business was being run from a two-bedroom house, with four administrative staff working in one bedroom, orders taken in the front room and customer records kept in the bathroom. The business was being spread across a number of sites in the locality. In 1979, they moved all the business to one site.

In 1980 they bought a wholesale company. This brought the first ever computer into the company, and a computer based mailing list. This wholesale business was highly successful at first, especially since it coincided with the growth in microwaves but as the microwave boom peaked, it went into decline and they eventually decided to close it. By the late 1980s the business was static. So their next step was to establish a mail order business using their computerised systems. This did well and turnover increased from £3 million to £7m in one year. They moved into different product categories, and issued paper catalogues. In the 1990s they established a web based catalogue and electronic ordering facility. In the 1990s, they simplified their name to reflect the current business.

The mail order business had become so successful that they quickly realised that they had capacity problems – they couldn’t get the orders out - they were turning over one thousand orders a day, but if they issued more catalogues this could be increased to two thousand orders a day. This led to the establishment of a new 80,000 sq ft distribution centre in a nearby town dedicated to the mail order business. This became the heart of the business, supplying products to replenish the shelves of our mail order despatch department and the growing number of retail stores nationwide. They have the capacity to pick, pack and despatch up to 10,000 orders a day; all automatically loaded into several 40 ft. long trailers. All a far cry from the early days when the brothers used to trundle customers’ parcels down to the local Post Office on a trolley!

In the 1990s they also started opening stores, which have done well. Incidentally they think that they made a mistake. It took them three years to open their first store, whereas they should have opened in several cities at the same time. They now have 35 shops, and are currently opening 2 or 3 a year. Ownership is important – they believe that they only have the capacity to open 2 or 3 stores a year and to do it properly, whereas they believe that a PLC would not want to open less than 20 per year. As a result of their success they have been given exclusive rights for some new products from major brand suppliers.

Their business philosophy is that (1) it has got to be right and (2) they are risk averse. For this reason they are reluctant to borrow to finance expansion, preferring to finance expansion out of income. Turnover in 2007 will be between £130 and £153 million. They only owe the banks £5 million. They have over 1409 staff, many of which are part time. Innovation is a key part of their business aims - they are always searching for something new. People turn up with an idea and get seen. Some have led to new products – for example, a charity line for charity production events with a donation being given to the charity. They believe this would not happen at a big PLC – they would not get past the front door.

Management style Management style is a particularly important characteristic of FBs and is an explanatory factor for the success of this business. When they took over the business, the sons agreed that the middle son should become Managing Director, as the person with the most appropriate skills and temperament – ‘he was an organiser and a doer’. The three brothers get on extremely well and partitioned the business according to areas of strength, which are complementary, and all the brothers accept this. One became the purchasing director, because he was very detailed and meticulous and the third the marketing director, who said that he was not allowed near any people management issues because this is not his strength.
The decision making process is also interesting. Any big decision will not be taken unless it is unanimous. Small decisions (such as branching out in to a new product line), which do not have a major impact on the business, do not have to be unanimous – but they will all agree to let another have his way and see if it works. This consensual method of decision taking has always been a characteristic of their management style.

8.3 Sustainability
Although this is a 2nd generation family business, sustainability as a family business is a big problem and it is unlikely to become a 3rd generation a family business, mainly because none of the 7 grandchildren are either interested in the business, or possess the competence. Interestingly, a third generation would not be able to replicate the business model adopted by the 2nd generation. The three brothers get on extremely well and are very close. This sort of working relationship could never be reproduced by the grand children.

However, sustainability can be achieved via various options including sale to venture capitalists. Approaches have already been made. However the current owners are concerned to maintaining the business’s social responsibility ethos and support for the local community, and are concerned that venture capitalists would assess strip the business. Sale to a competitor is another option, but would probably lead to closure and relocation in order to achieve economies of scale. Paradoxically, the current owners favour sale to an overseas parent as the best option to provide for sustainability of the business in its current form.

Summary and Conclusions
The table below illustrates some common features of our three businesses as well as some differences. Interestingly, despite their differences, sustainability is a major issue for all three businesses. None will continue as family businesses and none will continue in their current form.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Fast Signs</th>
<th>Lancashire Cycles</th>
<th>Lagoland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Motivation to Start</td>
<td>To 'escape' teaching</td>
<td>Be his own boss</td>
<td>Father – entrepreneur</td>
</tr>
<tr>
<td>Initial Finance</td>
<td>Bank loan</td>
<td>Increased mortgage</td>
<td>Bank loan</td>
</tr>
<tr>
<td>Development</td>
<td>From B2B to consumer markets</td>
<td>Horizontal &amp; vertical integration</td>
<td>From B2B, through niche consumer, to mass consumer</td>
</tr>
<tr>
<td>Competition</td>
<td>Intense</td>
<td>Niche market</td>
<td>Market leader</td>
</tr>
<tr>
<td>Technology</td>
<td>Constant change - opportunity &amp; threat</td>
<td>Traditional technology combined with personalised service</td>
<td>Mass – market, web site and telephone. Key to business</td>
</tr>
<tr>
<td>Sustainability</td>
<td>No children</td>
<td>No interest</td>
<td>No interest/competence</td>
</tr>
</tbody>
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References:
RESTRINGURING OF BUSINESS AS A WAY OF INCREASING A COMPANY’S VALUE

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Abstract: Business managers in Latvia divide restructuring into two main kinds. The strategic restructuring is intended to increase the value of equity for shareholders, keep the corporative property and deal with other issues for an enterprise to maintain its functional condition. The restructuring of companies in a situation of crisis is focused on the restructuring solutions for insolvent or bankrupt enterprises to lead them back in the condition of functional enterprise.

In generally, restructuring is the corporate management term for the act of partially dismantling and reorganizing a company for the purpose of making it more efficient and therefore more profitable. It generally involves selling off portions of the company and making severe staff reductions.

Key words: value of business, corporate restructuring, merging of companies, synergy effect

1. Introduction

The object of this article is restructuring of business that can be used to improve company’s financial statement, prevent it s bankruptcy and increase company s value.

The main goal is to prove that restructuring of business is one of the most important decisions of company’s value increasing.

The author of the article suggests that the increasing of company’s value can be measured using traditional financial analysis methods (coefficients, patterns) as well as calculating the effect of restructuring as a variation of investment with initial expenses and forthcoming profit in the future.

For the time being the international practice and experience of restructuring suggests that it is one of the most difficult managerial tasks.

The author of this article reviews existing methods of enterprise financial statement analysis as well as methods of cash flow discounting. The author analyses which existing method of restructuring that can be proposal used in transitional economics, for example, in Latvia.

2. The main restructuring content

Methods of business restructuring to prevent bankruptcy of enterprise and improve its financial position are frequently applied in developed countries. A characteristic feature of rather new Latvian market is that financing methods and organization, as well as cash flow management, used by most of small and average businesses, are not rational. The financial instability causes high rate of bankruptcies among new enterprises.

The low level of financial management, and inability of financial managers to apply anti-crisis mechanisms in time, rather often is bound up with lack of knowledge specializing in methods and practices of contemporary anti-crisis management.

Restructuring is not a single transformation in the structure of capital or production. It is a process demanding an account of many restrictions and peculiarity of the company where it is carried out.

Consequently, it is necessary to implement it when already having clear aims, conception of restructuring, understanding of all its phases and methods for necessary actions.

It is possible to divide restructuring into two main kinds. The strategic restructuring is intended to increase the value of equity, keep the corporative property and deal with other
issues for the firm to maintain its functional condition. The restructuring of companies is focused on the restructuring solutions for insolvent or bankrupt enterprises to lead them back in the suitable condition of enterprise. In the circumstances of Latvia the most interesting aims, principles and techniques are those relating to the restructuring of business experiencing a situation of crisis.

Generally, there are three stages in the development of crisis situation.

The early stage is characterized by the occasional signs of insufficiency in production and sales, appearing as increase in stocks of goods and materials, when the rate of rise in the volume of sales is stable or decreasing, acceleration of credit turnover and problems regarding to delivery or quality of production.

Shortage of materials (as a result of steps taken to economize the financial resources by reducing the stocks of goods and materials), more frequent problems regarding to the quality of production, suspension of sales using credit and demands for cash payments by suppliers, overdue payment of wages – this all is what marks for the intermediate stage.

At the last stages of the crisis whole company is operating chaotically. Schedules of production are not being carried out; production is being often sent back because of poor quality or obstructed by chronic shortage of materials; period for repayment of debtor’s debts is increasing. Besides, suppliers are demanding cash payments, while creditors are demanding changed terms of credit. Finally, it is becoming apparent that company is seriously short of own current assets.

The situation of crisis can be described as not enough effective management of assets and debts to creditors, determining drain of financial means away from owners and leading at the end to what are not completely fulfilled demands of creditors.

One of the main ends of restructuring is to lead company out of a crisis. In addition it is necessary of all its phases and methods for necessary actions. To achieve subordinate aims, such as to increase production effectiveness, change character of assets management and apply opportunities of borrowed funds (1).

The selling of portions of the company, such as a division that is no longer profitable or which has distracted management from its core business, can greatly improve the company's balance sheet. Staff reductions are often accomplished partly through the selling or closing of unprofitable portions of the company and partly by consolidating or outsourcing parts of the company that perform redundant functions (such as payroll, human resources, and training) left over from old acquisitions that were never fully integrated into the parent organization.

Other characteristics of restructuring can include:

- Changes in corporate management (usually with golden parachutes)
- Sale of underutilized assets, such as patents or brands
- Outsourcing of operations such as payroll and technical support to a more efficient third party
- Moving of operations such as manufacturing to lower-cost locations
- Reorganization of functions such as sales, marketing, and distribution
- Renegotiation of labor contracts to reduce overhead
- Refinancing of corporate debt to reduce interest payments
- A major public relations campaign to reposition the company with consumers

2. Levels of a company restructuring

How to restructure a company? This question is still opened. There is more than one way of company’s restructuring. Moreover, even the sequence of the levels of restructuring may substantially vary depending on the situation of the company, its potential, position in the market, behavior of the competitors, descriptions of the producible goods and services and many other factors.
Following basic principles of the method of projects management can mark out few levels of projects marketing restructuring.

**First level** – determination the aims of restructuring. Owners and management have to define what exactly does not satisfy them in a current activity of the company and what do they want to obtain in a result of the structural changes. Further development of company and restructuring programs fate depends on how correctly they will define the aims and the range of the tasks.

**Second level** – diagnostics of the company. It is necessary to find company’s problems, to define its weak and strong sides, to understand the prospects of development and profitability of the further investing in this business. During the diagnostics of company, a legal, tax analysis, analysis of operating activity, market and investment attractiveness of the company is carried out. Its financial state, strategy and activity of administration also have to be studied.

**Third level** - restructuring programme. There are made a few alternative variants of company development at this level as a result of data diagnostics. For every variant the methods of restructuring are determined, the indexes of prognoses are calculated, possible risks and amount of the used resources are appraised. On the basis of different criteria, the owners and management of company conduct the estimation of efficiency to one or another alternative and carry out choice, according to which the restructuring program is taking into consideration the limitations of the resources, are specified.

**Fourth level** – realization of restructuring according to the developed program. A team of specialists, which are involved in the work, is being formed. This is followed by the sequential implementation of all the levels of the program. During conducting the fourth level of restructuring, purpose indexes are specified and, if there is a deviation from their planned values, a company carries out an adjustment of the program.

Finally the **fifth level** – maintenance of the restructuring program and estimation of its results. At the last level the team, which is responsible for realization of the program, controls the accomplishment of purpose indexes, analyses received results and prepares total report of the work that has been done.

**3. Company’s strategy and restructuring aims**

To carry out above-mentioned levels successfully, it is necessary to formulate restructuring aims correctly. They are determined, coming from the general strategy of the company. In a management terminology: the strategy is a general direction of the company’s actions, following which in a prospect have to take to planned aims.

The process of choosing strategy takes place after ascertainment of company’s current strategy and accomplishment of a careful analysis of products briefcase. The last action is one of the major instruments of strategic management. In fact the analysis of a briefcase allows balancing the business risks, its money receipts, which as a result increase shared financial return.

In the conditions of the economy of Latvia the competent analysis of business-case with a subsequent elaboration of restructuring program can substantially improve position of a company and in many times promote its value. Such effect can be explained that Latvian companies business-cases is not well organized now and surplus diversified, cause too much questions for investors, and, as a result, underestimated.

A company that has been restructured effectively will generally be leaner, more efficient, better organized, and better focused on its core business. If the restructured company was a leverage acquisition, the parent company will likely resell it at a profit when the restructuring has proven successful.
The most important indicator relating to the productivity of business activity is increase in the value of equity; therefore the restructuring usually is realized towards this direction. The choice to take the indicator of company’s value as a criterion for restructuring is not unintentional. After all, a kind and technology of production, parameters of products and sale markets are not of great importance for owners. The criterion for productivity of their financial contributions in a particular company is a steady increase in the value of investments, determining a rise in personal prosperity of owners, as well as stable development of the enterprise.

The value of company is defined by evaluation of business (operating enterprise). Out of three traditional approaches to the evaluation, merely the method of discounted cash flow, as we suggest, completely reflects internal economical value of company. It is determined by a high correlation of cash flow to indicators of the company’s market value, as well as by economical meaning of the cash flow indicator taking into account all decisions linked with company’s operational and financial activity, as well as that of investments (2).

Indicator of enterprise’s value, determined by the method of discounted cash flow, consists of cash flow, added to a current value, from a period of enterprise’s stabilization (period of calculation) and developed. Thus, strategic aims of the enterprise are formulated and specified, high quality and quantitative purpose parameters, which the system has to reach, discounted value of cash flow beyond the period of calculation.

Business value obtained by the method of discounted cash flow often turns out to be a negative number, which in fact means that funds are draining away from shareholders. It is caused by consequences of crisis situation, such as chronic shortage of own current assets, necessity to repay significant liabilities, increased or decreased need for investments as a result of multiple unregulated reappraisals of basic funds for depreciation deductions. Traditional task of business restructuring is to maximize the value of business.

Restructuring of company is to change company’s structure (or, in other words, organization, arrangement of its elements), as well as elements forming its business under influence of factors of external or internal environment. Restructuring includes: improvement in management system, financial economical policy of company, its operational activity, system of marketing and sale, personnel management.

The main reason for companies to carry out restructuring is a low productiveness of their activity, appearing through unsatisfactory financial indicators, shortage of current assets, and high amount of liabilities of debtors or debts to creditors (3).

However, as any modification influencing scale of business or market conditions demands adequately changed management system and program of restructuring to be carried out, even successful companies are often running structural transformations.

Defined aims and strategy of company will determine one certain type of restructuring: operational or strategic.

The operational restructuring includes transformation of company’s structure, aimed to financial recovery (if the company experiences situation of crisis) or improvement in solvency. It is carried out by applying internal resources of company through the instruments of decreasing and “aligning” (a transition from indirect costs to direct ones) expenses, separating and selling unprofiled and auxiliary businesses. The result of the operational restructuring is a transparent and more manageable company, with managers and owners being clearly aware of the businesses to be developed and those to get free from. The operational restructuring encourages improvements in results of business activity in the short term and creates conditions for further, strategic restructuring to be carried out.

The strategic restructuring is a process of structural transformations intended to improve the appeal of company in the eyes of investors and expand its opportunities in attracting external financing and increase in value. Implementation of this sort of restructuring is
directed towards achievement of long-term aims. The result of successful completion of the restructuring is increased flow of the current value of forthcoming incomes, increase in competitiveness of company and market value of its equity. Carrying out both operational and strategic restructuring may encompass either all elements of business-system or its separate components.

Methods of business restructuring to prevent bankruptcy of enterprise and improve its financial position are frequently applied in developed countries. A characteristic feature of rather new Latvian market is that financing methods and organization, as well as cash flow management, used by most of small and average businesses, are not rational. The financial instability causes high rate of bankruptcies among new enterprises. The low level of financial management, and inability of financial managers to apply anti-crisis mechanisms in time, rather often is bound up with lack of knowledge specializing in methods and practices of contemporary anti-crisis management.

Important element of anti-crisis management is evaluation of enterprise’s financial standing, liquidity, solvency and productiveness of activity, yet it is necessary also to evaluate external and internal factors influencing the financial standing of enterprise.

Research of the financial standing of business activity in order to detect, as soon as possible, signs of business crisis, causing threat of bankruptcy, is a part of the common financial analysis. In the same time this part of the financial analysis has distinctions in relation to both objects and methods to carry it out.

Those objects of observation within the possible crisis area that may suggest threat of bankruptcy are at first the indicators of enterprise’s production, investments and flow of recurrent and prospective payments and the indicators of development of net cash flow.

The existing level of threatening bankruptcy is evaluated by the absolute liquidity ratio. It gives option to determine extent, to which all the pressing liabilities of enterprise can be implemented by the existing assets of high liquidity within the terms defined by legislature of a particular country. It is unsatisfactory condition for the payments to be ensured if the coefficient is less then 0, 2(4).

The level of threatening bankruptcy in future can be determined by two indicators:

- absolute liquidity ratio;
- autonomy ratio.

Evaluation of these indicators is linked with dynamics for several periods. A stable tendency to decreasing level of the ratios suggests suspended threat of bankruptcy at least until the next period. By the absolute value of the ratios it is possible to determine time for the suspended threat to become real (the lower is the absolute value of the ratios, the more inevitable is the threat of enterprise bankruptcy). There are frequent observations in the related literature that optimal value for the absolute liquidity ratio is 0, 7, but for the autonomy ratio it is comparable to 0, 5, nevertheless distinctions of branch and size of company may significantly affect these average norms.

The following indicators determine capacity to neutralize threat of bankruptcy on the base of company’s internal potential:

- Return on assets (ROA);
- Circulation of assets ratio.

The first indicator provides a notion of way the capital invested in funds of company is capable to generate a profit, i.e. to produce additional cash flow to implement a growing amount of payments. Meanwhile the other reflects the rate of additional cash flow to build up, i.e. it works as a multiplicator for build-up of company’s profit. The foundation of this universal evaluation is the Dupont Pattern.

Methods for integral evaluation of threatening bankruptcy are grounded on a complex analysis of the indicators (which can be supplemented with others, if necessary) given above.
It is the Altman Pattern that is one of the most widespread methods of integral evaluation in the practice of foreign financial management (5).

4. The methods of restructuring.

When choosing the most appropriate methods to lead company out of a crisis, it is necessary to take into consideration all range of the existing methods for business restructuring.

Business restructuring is structural changes in the area of company’s properties, changes in liabilities to creditors, organizational structure of management, increase in labor productivity, reduce in production costs, and thus it is a rising of effectiveness in activity of company and improvement of financial position.

The corporative restructuring embraces broad body of actions, methods and techniques intended to improve financial standing, overcome crisis of company and then to increase the value of company.

Restructuring can be divided in four large directions:
1) Merging of companies;
2) Division of companies;
3) Restructuring of properties;
4) Actions, intended to remove financial problems.

Applying outsourcing, i.e. consigning certain works to a subcontractor provides an option to form virtual corporations. Usually virtual corporations are formed on a base of large, well-known brand holders when they found a sort of alliance with subcontractors and commit to them as much functions as possible (up to production), meanwhile themselves dealing only with an advancement of production in market, advertisement, marketing, technical scientific and design development, strategic planning and like. A transition to a virtual corporation provides additional flexibility in the risk management and rising of the financial stability, as all new trends of development are not linked with large investments in those business areas that are committed to subcontractors, thus decreasing risk of bankruptcy.

One of the methods for business restructuring relates to property of company. A characteristic example for this method can be a privatization. In this case privatization is not a transfer of state-owned property to private hands but rather a transition of public company with shares belonging to a large number of shareholders in private ownership, with a small group of investors (often managers of company) buying the shares. Such actions may be intended to decrease costs necessary in servicing a large number of shareholders, to prevent contradictions between shareholders and managers about issues relating to long-term business planning, and to lead company out of crisis situation. Mechanism of privatization resembles that of joining and it is carried out, buying shares not only by means of group of individuals but also by leveraged buyout, as it is frequently practiced. It gives option for investors to suspend huge costs and Purchase Company even when not having a considerable capital.

However the main aims of business restructuring, rather important aspect of restructuring process is to gain additional effect of synergy. For example, in the case of merger the direct effect of synergy is that a value of merged company is higher then a sum of its separate parts; in the case of division works the inverse effect of synergy – value of remained parts of firm after selling or separating is higher then difference between initial value of firm and sold subdivision.

One of frequently practiced variations of business restructuring to overcome crisis of company and obtain effect of synergy is to divide assets of company, applying various ways: for example, selling, spinning-off assets and a subdivision, spinning-off a part of equity and others, up to liquidating a separate enterprise of company. The crucial condition for a partial sale of shares or sale of whole company (voluntary liquidation) is whether the reduced net
value of sold assets will be higher than that of anticipated cash flow in the case of further application of the assets. This condition is becoming stronger especially after announcement about voluntary liquidation of company.

Spin-off, i.e. giving away part of assets when a branch or subsidiary is separated from main company, gaining self-dependence, somehow resembles sale of assets, but obtained synergy is not so clearly distinctive in terms of value because process of spin-off is bound up with huge costs. However, it is often the way companies overcome crisis, as well as avoid taxes due to sale of stocks, while subdivisions, when becoming self-dependant, gain additional flexibility in their financial management, option to choose organizational structure for their management, option to conclude new contracts, etc. When it is about division of properties, usually it is never carried out in practice as shares of the new company are divided between shareholders of subsidiary adequately to the existing proportion.

Spinning-off a part of equity somehow differs from the method given above, besides a part of common shares of subsidiary is sold in public sale while a parent company holds the majority interest. This procedure makes it possible to attract additional means to finance separate business trends and overcome financial problems, moreover subsidiary, when gaining independency in share quotation, becomes more appealing to investors.

Complicatedness of actions to prevent the financial problems depends on the level of difficulty inherent in the problems, from insolvency to financial crash. A string of actions to prevent the problems is included in arrangements, voluntary concluded with creditors to delay repayments, on compromises between debtors and creditors, by which creditors agree that a part of debts is discharged by money, receiving a remaining part by a common bill of exchange. Besides it is possible to reach an agreement with creditors on the voluntary liquidation, even before the company is acknowledged to be bankrupt.

It is the actions aimed to reorganization of company that will be most effective to overcome a crisis of company. The reorganization envisages changes in the capital structure of company experiencing financial difficulties. It is intended to decrease fixed costs, i.e. to decrease the part of securities with fixed expenses and increase the part of securities with limited income. It is always useful to carry out reorganization when it may increase the value of company in comparison with the value of liquidity. The reorganization must take place in line with a well-founded, objective and suitable reorganization plan.

In general any reorganization is a process bounded with analyzing the means and financial sources of company, evaluating the existing standing of company, detecting the factors that cause worsening financial standing, drafting a plan of actions to overcome a crisis of company. It is the effectiveness of management methods that is analyzed by evaluating increase in financial stability and profitability of activity of separate subdivisions and whole company, and that at the end must increase the market value of company.

The main task for managers and investors is to find those solutions for management of company and overcoming crisis that are most effective and encourage increase in the market value of company. When analyzing and evaluating the effectiveness of a particular method for business restructuring, the main aim is to ground the financial or managerial decision making. Any financial or managerial decision is linked with a degree of uncertainty and risk; therefore it is necessary to take into consideration the influence of internal and external factors on the financial standing and working efficiency of a particular firm, when selecting a method for restructuring.

It is necessary to pay attention to the analysis, evaluation and prognostication of the cash flow, when overcoming a crisis in company. The analysis of the cash flow requires taking into account the income and drain of funds, evaluating not only the net profit, but also other indicators, such as solvency, liquidity, depreciation deductions, and flow of labor capital. The cash flow management determines its influence on the volume of sale, production costs,
relation between constant capital and variable capital, prime cost of realizable production and gross profit.

The adopted method for restructuring can be considered as a variation of investment with the initial expenses and forthcoming profit in future; therefore it is necessary to discount the cash flow, when calculating the possible value of company after the completed restructuring. Evaluation of the adopted restructuring method is to make prognostication of the net cash flow characterizing the current standing of company, ignoring the expenses of restructuring.

5. Conclusions
In the light of all stated above it is necessary to pay attention to:
1. When prognosticating and planning the activity of firm, its management must take into account the opportunities of restructuring to prevent crisis in company;
2. In the situation of crisis the financial economists of company must evaluate all the possible variations to overcome crisis, including methods of restructuring;
3. As the restructuring process is regulated in many respects by the normative acts frequently being altered, it is of necessity to carry out constantly the monitoring of juridical collateral.
4. For the time being the international practice and experience of restructuring suggests that it is one of the most difficult managerial tasks. Restructuring is not a single transformation in the structure of capital or production. It is a process demanding an account of many restrictions and peculiarity of the company where it is carried out. Consequently, it is necessary to implement it when already having clear aims, conception of restructuring,
5. Restructuring of company is to change company’s structure (or, in other words, organization, arrangement of its elements), as well as elements forming its business under influence of factors of external or internal environment.
6. Restructuring includes: improvement in management system, financial economical policy of company, its operational activity, system of marketing and sale, personnel management.
7. The effect of the restructuring process can be measured using business evaluation methods according firm existing financial statement.
8. It is necessary to take into account statistical data from the developed countries, when evaluating possible methods to overcome crisis of company.

References
THE ROLE OF FINANCIAL REPORTING FOR THE DEVELOPMENT OF BUSINESS: EVIDENCE FROM LATVIA

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Abstract. It is well known that the financial statement is the basic source of the financial information on the companies’ activities in the business world. Not casually, Accounting is often said to be the ‘language’ of business. The purpose of the financial reporting is presentation of objective and useful information on activity of the company to the broad audience of users. To what extent the information contained in the financial statements is objective and useful is determined by two factors: regulation and presentation of statements. The given paper reveals the problems of preparation of financial statements by Latvian companies, which occur because of regulatory legislation’s imperfection and its differences with international standards, and also because of its accounting practices. The aim of this paper is to provide recommendations on financial statement quality improvements, which would ensure adequacy of financial information disclosure on Latvian companies’ activities and comparability of indicators of the financial reporting for international users. The qualitatively prepared financial statement, including the Intellectual Capital Report, the author considers as a factor, which ensures the strengthening of investment attractiveness of Latvian companies and development of Latvian business in the European market.


1. Introduction

The introduction of the international accounting and financial reporting rules to practice of the Latvian companies took place on 1 January 1993 and was connected to the adoption of two Latvian laws, i.e. the Law ‘On Accounting’ and the ‘Annual Accounts Law’. Since then the development of the Latvian accounting system has been influenced by the legislation of the European countries.

From 2005 all listed EU companies (including banks and insurance companies) must prepare their consolidated financial statements in strict accordance with international accounting standards (IFRS). Application of IFRS lets the companies to work with partners and investors without regard to their geographical location. IFRS are necessary not only for large companies but can also help medium and small businesses to present their financial reports in a standardized way that is accessible to international markets. Currently, in Latvia there are nine standards of accounting, which are based on the IFRS.

The interest in studying international accounting systems and IFRS in Latvia intensifies with each year, not only among the accountants and financial executives of large companies, but also from the representatives of small and medium businesses. As information technology, products and services are spread around the world the accountant becomes involved into the process, because the company that employs him is also a participant in it.

The process of introducing international standards of financial reporting in practices of Latvian companies is not simple and remains controversial, because the rules on financial reporting in Latvia differ from IFRS. In addition, many accountants and financial executives do not understand the role and the meaning of the accounting standards, believing that there is no great necessity to apply them in practice.

Therefore, there are real problems with the practical implementation of IFRS, which are related both to the accounting and tax legislation as well as the level of professional training for accountants and financial professionals.
The circumstances outlined above have motivated the author to undertake the research with the aim to receive the answers to the following questions:

What does the transparency of financial information ensure for users?
What hampers the financial statement to be transparent?
How to make the financial statement more useful for the users and how to make the company more attractive for the investors?

2. Latvian Accounting and Reporting System and IFRS

Latvian accounting and reporting system is characterized by the following features:

The laws on accounting
Governmental rules and directives
- Tax legislation
- National plan of accounts
- Latvian accounting standards.
- Company's accounting policy
- Methodology of determining of financial results.

The Latvian accounting system is based on the macroeconomic’s approach; it is greatly influenced by the tax legislation and state directives, which results in the strict regulation of the accounting procedures.

The system of regulating accounting practices in Latvia was shaped under the influence of the legislation of European countries. The minimum level of correspondence across the financial reports in European Union is provided via directives, which lay the foundation for Latvian accounting laws: Latvian Law ‘Annual Accounts Law’ is based on the fourth EU directive on businesses’ annual reports; Latvian Law ‘On Consolidated Accounts’ corresponds to the seventh EU directive on consolidated reports; Latvian Law ‘On Sworn Auditors’ is issued based on the eighth directive on persons responsible for the legally mandated verification of accounting documentation.

The consequences of tax legislation influence on the development of Latvian accounting sphere in general and accountant's profession in particular, will be analyzed further in the text.

Current Latvian legislation determines only the most important aspects of preparing of financial statements. In international practice financial reporting standards are guidelines for applying accounting legislation and directives. Standards contain several alternative solutions and their application is voluntary. If the legislation that regulates accounting practices in Latvia cannot provide comprehensive guidelines for a particular accounting question, it is suggested that one use International Financial Reporting Standards (IFRS), on condition that they do not contradict Latvian laws.

Analysis of current accounting legislation and IFRS allows determining the main differences between Latvian legislation and IFRS:

1) Latvian accounting laws are approximately 50-60 pages in volume, the volume of IFRS is more than a 2000 pages; Latvian and International Accounting Standards differ in the amount of information they contain.

2) The most significant difference is in the fact that financial reports that are prepared according to IFRS are based on ‘fair’ value; whereas Latvian legislation primarily concentrates on the fact that transactions should be reflected at their ‘historical’ value, that is at the acquisition value;

3) Accepted Latvian accounting standards have more of a legislative power; the application of IFRS is voluntary and the IFRS by themselves are recommendations.

4) There are also differences in accounting for company acquisitions or sales; transactions among related partners, and contracts with derivatives.
After analyzing legislation that regulates accounting practices in Latvia, one can point out the following characteristic features:

1) Tax legislation dominates accounting practices. Significant influence of tax legislation on accounting is proved by the fact, that calculation of financial result (profit or loss) is tied to calculating income tax from businesses. In formats of income statements that are recommended by the law one of the most important analytical indicators – ‘operating profit’ is absent.

2) The ‘Annual Accounts Low’ does not sufficiently develop the meaning of conceptual foundation of accounting practices for preparing financial reports. In Chapter 5 ‘Rules of Valuation (article 25) the law only briefly mentions the necessity to observe basic accounting concepts and principles while valuing final accounts positions. The annual report shall be prepared in accordance with the following principles (2):

- Going concern assumption
- Consistent use of the same valuation methods from year to year
- Items shall be valued in accordance with the principles of prudence
- All income gained and expenses incurred during the reporting year have to be taken into consideration irrespective of the date the invoice was issued or received; expenses shall match the revenues for the reporting period
- Assets and liabilities must be valued separately
- The annual report must be prepared in Latvian; the monetary unit of the Republic of Latvia shall be used as a measure of value.

3) Accounting legislation does not take into account the particularities of preparing annual reports for individual entrepreneurs, partnerships and publicly owned companies.

4) Accounting legislation uses the term inspection to designate verification of financial reports as opposed to the word "audit", which is commonly accepted internationally. Latvian legislature does not pay enough attention to the questions of terminology. However, it is precisely the word inspection that has a powerful psychological impact on the accountant, who perceives inspection as a method for finding mistakes and punish those responsible for it. Afraid of mistakes, the accountant believes that one's main job is to calculate taxes correctly. There are thus no resources for analytical, creative work.

Summarizing the abovementioned, author can make the following conclusions:

- There is currently no precise understanding of the purpose of preparing financial reports in Latvian accounting practice.
- Accounting procedures and financial reports in most cases reflect primarily the interests of one group of users – government tax agencies.
- Latvia's accession into the EU as well as the expansion of international economic and financial links, necessitate preparing financial reports in the interests of investors and creditors.
- Preparing financial reports in the interests of investors and creditors demands standardizing financial reporting, which, to a significant extent, is ensured by the international standards of financial reporting and Latvian accounting standards that are based on those.

The role of International Accounting Standards is to minimize the differences between financial reports in different countries and provide, on that basis, comparability and reliability of information, for users, who rely on financial reports as the main source of information about the company.

Applying IFRS ensures:

- The methodological basis for accounting and financial reports.
- Clearness of financial information for a wide variety of users, which makes reports ‘transparent’.
- Unification of national accounting systems, creating conditions for the successful integration of Latvian accounting system into the European one.

The major concepts of IFRS are:
- The Fair value concept
- Priority of economic content over legal form
- Transparency of financial information.

*Fair value* is an exchange price for the assets or liability in a transaction between a knowledgeable, willing parties and financially independent persons. The arguments for and against Fair value are shown in the Table 1.

The introduction of the International Financial Reporting Standards into practice of the Latvian companies increases prominence of Fair value as a basis for a true and fair view of companies’ financial performance and position.

### Table 1. The arguments for and against Fair value

<table>
<thead>
<tr>
<th>The argument for:</th>
<th>The argument against:</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Fair value provides a more solid and accurate base for future cash flows comparing to historical costs, because it reflects current market value of these cash flows.</td>
<td>- There is a need for an active market with relevant valuation objects and a necessity in qualified professional valuators.</td>
</tr>
<tr>
<td>- It ensures transparency of financial information; reduces accounting risk.</td>
<td>- For many assets and liabilities that are measured at fair value, no market value is available</td>
</tr>
<tr>
<td>- The analytical role of financial information for users enhances</td>
<td>- There are problem by regarding a mathematical calculation of a hypothetical market price as a “fair value”</td>
</tr>
</tbody>
</table>

3. What hampers the financial statement to be transparent?

In order to study the opinions of the accountants and financial executives of Latvian companies about the necessity and possibility of practically applying IFRS, the author had disseminated a questionnaire among the graduates of the course ‘International Financial Reporting Standards’. 112 accountants in Riga were questioned in March 2007.

The basic part of the questionnaire had eight questions included related to IFRS and Fair value, as well as five questions characterizing the size of the enterprise, where respondent is employed, main industry of the enterprise and the type of enterprise.

*The survey of the respondents’ characteristics revealed the following features of the accountants:*

- 71.0 per cent of accountants are employed by the companies with less than 50 total people employed (small business); 18.0 per cent are employed in companies, whose staff does not exceed 250 people (medium business) and 11.0 per cent - are employed in companies whose staff exceeds 250 people (large business).
- A significant part of respondents (42.9 per cent) are employed by companies where annual turnover exceeds 1 million LVL.
- More than 80 per cent of accountants are employed by limited liability companies. This type of enterprise has historically been very popular in Latvia. The necessary initial capital upon the registration of company is merely 2000 LVL. Business partnership is the least popular enterprise form.
- 75.0 per cent of accountants represent companies that do not have subsidiaries. 17.9 per cent - represent subsidiary companies of various conglomerates and 7.1 per cent are representatives of conglomerates or holding companies.
The distribution of respondents by the types of business is as follows: 43.9 per cent represent retail business; 16.8 per cent - the service sector; 21.4 per cent - the manufacturing sector; 7 per cent - construction; and financial business – 10.8 per cent.

The distribution of the participants of the questionnaire confirms overall tendencies in the development of Latvian companies (4):

- Enterprises employing up to 50 people comprised 93 per cent of the total number of enterprises in Latvia;
- The most popular sphere of enterprises is trade (43.0 per cent);
- Limited liability companies (Ltd.) take the largest ratio in the companies’ structure (64.9 per cent).

4. An overview of survey results

More than 80 per cent of accountants have given a positive answer to the first question on the questionnaire – ‘Do you find the application of IFRS useful in a company where you work?’ Accountants, who worked in holding companies and financial and banking industries, have indicated complete confidence in applying IFRS in practice.

The Table 2 presented below shows the distribution of respondent’s answer to the question: ‘Do you apply some of IFRS in practice?’ and find out the relationship between the main field of company's operations and practical application of IFRS. More than a half of the respondents apply some of IFRS in practice. IFRS is very important in the banking and financial sectors, as well as in the service sector of industry. Trading companies use IFRS the least. For instance, about 24 per cent of retail companies do not use IFRS at all and about 40 per cent are not certain if they do. IFRS is not used by one third of the companies involved in production and construction.

Generally a large number of companies in each industry sector use particular IFRS in practice.

Table 2. The distribution of respondent’s answers to the question ‘Do you apply some of IFRS in practice?’

<table>
<thead>
<tr>
<th>Industry / Answers</th>
<th>Yes %</th>
<th>No %</th>
<th>Don’t know %</th>
<th>Total %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail trade</td>
<td>38.1</td>
<td>23.8</td>
<td>38.1</td>
<td>100</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>42.9</td>
<td>35.7</td>
<td>21.4</td>
<td>100</td>
</tr>
<tr>
<td>Services</td>
<td>78.9</td>
<td>15.8</td>
<td>5.3</td>
<td>100</td>
</tr>
<tr>
<td>Construction</td>
<td>50.0</td>
<td>25.0</td>
<td>25.0</td>
<td>100</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>41.7</td>
<td>33.3</td>
<td>25.0</td>
<td>100</td>
</tr>
<tr>
<td>Financial services</td>
<td>100.0</td>
<td>-</td>
<td>-</td>
<td>100</td>
</tr>
<tr>
<td>Real estate</td>
<td>66.7</td>
<td>33.3</td>
<td>-</td>
<td>100</td>
</tr>
<tr>
<td>Others</td>
<td>60.0</td>
<td>20.0</td>
<td>20.0</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>55.4</td>
<td>25.0</td>
<td>19.6</td>
<td>100</td>
</tr>
</tbody>
</table>

The third question was asked in order to clarify, whether the respondents are familiar with the notion of *fair value* and whether they use it while evaluating company assets.

In spite of the fact that all accountants in Latvia perform revaluation of company's assets and liabilities in foreign currency at the date of preparing financial reports, many of them (more than 55 per cent) do not understand the essence of valuation based on *fair value*.

The answers of the respondents to the fourth question highlight those areas of accounting where the application of IFRS is the most prevalent. The following objects of accounting are named among those: capital assets, financial investments, traded securities and inventories.
Factors that have influenced the responses the most are the size of business and industry membership. For example, for companies, whose annual turnover exceeds 1 million LVL, the most important objects of accounting are financial investments, fixed assets and short-term liabilities.

One of the most widely discussed themes among academics and practitioners of accounting in Latvia is the definition of the company’s accounting policy. Latvian legislature and theory are not yet clear in explaining the term accounting policy. Practitioners, however, believe that accounting policy is the ‘system of implementing accounting at a particular business’.

The author of this paper believes that under the accounting policy of the company, one should understand the methodology of preparing financial reports, which is based on the fundamental concepts and principles of accounting.

The system of accounting encompasses all the aspects of organization and maintenance of bookkeeping, which is managed by a separate department (functional unit) within a company. The author treats accounting policy in this context as one of the elements of the accounting system within an enterprise.

The responses to the fifth discussion question (do you apply IFRS in developing company's accounting policy?) were ambiguous. 69.6 per cent of responses were positive. Obviously, those accountants who use IFRS in practice have included in their company's accounting policy, the corresponding methodology of recognizing and valuing the objects of accounting according to the IFRS. 30.1 per cent of respondents do not use IFRS when developing accounting policy it is most likely that in companies that they represent the accounting policy is absent.

75 per cent of respondents have expressed doubts about the readiness of Latvian companies to transition to IFRS. That was the response of accountants to the sixth question ‘Are Latvian companies ready to make a transition to IFRS?’ Only one eighth of the respondents (12.5 per cent) have expressed readiness to prepare financial reports on the basis of IFRS in 2006 already, and, several of them, as has been mentioned above, have used particular standards when preparing financial reports for the year 2005.

‘What is the benefit of applying IFRS in practice?’ - this was the seventh question that was addressed to respondents, who use IFRS in their work. The possible answer choices were distributed as follows (per cent):

- The basis for developing company's accounting policy - 73.2;
- "Transparency" of financial reports for users - 58.9;
- Harmonization of financial reports - 55.4;
- Access to capital markets - 17.9;
- Wider access to cheaper loans and investment - 8.9;
- Others - 3.6;
- Don't see any benefits - 1.8.

The responses to the eighth question ‘What hampers the progress of application of IFRS in practice?’ are summarized below (per cent):

- Incomplete legal framework (uncertainty of state policy towards IFRS) - 67.9;
- **Lack of professional knowledge about IFRS - 66.1**;
- Psychologically not ready - 19.6;
- There are no obstacles - 10.7;
- There is no practical necessity - 7.1.

The Table 3 shows the distribution of respondent's answers to this question, depending on the industry of the business:
Table 3. The distribution of respondent’s answers to the question ‘What hampers the progress of application of IFRS in practice?’

<table>
<thead>
<tr>
<th>Industry</th>
<th>Lack of knowledge %</th>
<th>Psychologically not ready %</th>
<th>Incomplete legal framework %</th>
<th>Nothing prevents %</th>
<th>No practical necessity %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail trade</td>
<td>71.4</td>
<td>28.6</td>
<td>66.7</td>
<td>9.5</td>
<td>9.5</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>64.3</td>
<td>21.4</td>
<td>71.4</td>
<td>0.0</td>
<td>14.3</td>
</tr>
<tr>
<td>Services</td>
<td>73.7</td>
<td>10.5</td>
<td>68.4</td>
<td>0.0</td>
<td>5.3</td>
</tr>
<tr>
<td>Construction</td>
<td>75.0</td>
<td>25.0</td>
<td>75.0</td>
<td>25.0</td>
<td>25.0</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>66.7</td>
<td>16.7</td>
<td>75.0</td>
<td>8.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Financial services</td>
<td>66.7</td>
<td>0.0</td>
<td>66.7</td>
<td>33.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Real estate</td>
<td>33.3</td>
<td>0.0</td>
<td>33.3</td>
<td>33.3</td>
<td>33.3</td>
</tr>
<tr>
<td>Others</td>
<td>40.0</td>
<td>20.0</td>
<td>60.0</td>
<td>20.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>66.1</td>
<td>19.6</td>
<td>67.9</td>
<td>10.7</td>
<td>7.1</td>
</tr>
</tbody>
</table>

These tables indicate that accountants, who work in different branches of the economy, are unified in their opinion about the factors that constrain active application of IFRS in practical work. On the basis of the survey results, a number of general conclusions can be drawn.

Responses to the questionnaire reflect the reality, that has formed on the level of the state, private enterprise and professionals and which is typical for the current stage of the development of Latvian accounting system.

A large part of the respondents, who have participated in the questionnaire, work in companies, among which the companies with the following characteristics are prevalent:
- The amount of staff employed – up to 50 people.
- Net annual turnover – up to 500,000 LVL.
- Type of business – Limited Liability Company.
- Independent company.

The results of the research confirm that most of the respondents understand the purpose and objectives of IFRS, and, overall, consider this question pertinent to Latvian accounting practice. At the same time, one should note that there are ambiguous and contradicting answers that indicate a certain lack of confidence from the respondents in this opinion.

5. How to make the financial statement more useful?

With occurrence in scientific area of concepts ‘New Economy’, ‘Knowledge Economy’, the role of such accounting category as an ‘Intangible Assets’ raises. In economical literature intangible assets is defined as an ‘Intellectual Capital’ or ‘Intellectual Assets’, which becomes the most important type of assets for many companies, because it influences their value-added potential in the market economy. Intellectual capital, involved in process of creation customer and stockholder value, it is considered through a prism of strategy of the company.

The term Intellectual Capital illustrates the new usage of accounting term Intangible Assets as the object of Management of the company. The main focus of the management role in this context is the increase of the share value of the company by involvement of underused resources: knowledge, competences, organizational structure, information technologies, customer satisfaction, etc. Supplementing the annual report with this information, we have increased transparency. The company's strong and weak areas are exposed and this provides stakeholders with a better understanding of the company's potential and consequently increasing stakeholders' trust.

Reports on Intellectual Capital prepared and published by some companies are supplementary to traditional financial reports. Report on intellectual capital is considered as a
tool for its measurement, its management and enhancement of company attractiveness for investors.

The system of indicators describes the company’s value creation process. Indicators can be both financial and non financial. All indicators must be verifiable even when not purposely audited. IC is highly specific to each company, therefore the contents of such a report of a separate company is individual. Many companies when preparing IC report are guided by the scheme, suggested by MERITUM Guidelines.

List of possible measuring indicators for all Intangibles, which are typical for Knowledge-based companies, are shown in the Table 4. Knowledge-based company, such as educational or consultancies institutions, have knowledge as the only outcome of their transformation processes.

Table 4. Intellectual Assets Report (6)

<table>
<thead>
<tr>
<th>Components of Intellectual Capital</th>
<th>Indicators</th>
<th>Type of indicator</th>
</tr>
</thead>
<tbody>
<tr>
<td>HUMAN CAPITAL</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Human resources (Staff structure)</td>
<td>Number of staff</td>
<td>NFI</td>
</tr>
<tr>
<td></td>
<td>Percentage of full-time employees</td>
<td>NFI</td>
</tr>
<tr>
<td>Training and Education</td>
<td>Total days training per employee (annual average)</td>
<td>NFI</td>
</tr>
<tr>
<td></td>
<td>Expenses for training and education per employee (LVL)</td>
<td>FI</td>
</tr>
<tr>
<td>Employee Survey</td>
<td>Average satisfaction of the employees with training activities Cost of survey</td>
<td>NFI</td>
</tr>
<tr>
<td></td>
<td></td>
<td>FI</td>
</tr>
<tr>
<td>STRUCTURAL CAPITAL</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Processes and equipment</td>
<td>IT expenditure per employee (LVL)</td>
<td>FI</td>
</tr>
<tr>
<td></td>
<td>Reliability of hardware and software</td>
<td>NFI</td>
</tr>
<tr>
<td>Quality management of study process</td>
<td>Cost of quality management system (LVL)</td>
<td>FI</td>
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<tr>
<td></td>
<td>Number of employees involved in quality management system</td>
<td>NFI</td>
</tr>
<tr>
<td>R &amp; D and Innovation</td>
<td>Internal R&amp;D expenditure</td>
<td>FI</td>
</tr>
<tr>
<td>RELATIONAL CAPITAL</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project cooperation and Network</td>
<td>Number of new program categories</td>
<td>NFI</td>
</tr>
<tr>
<td></td>
<td>Project revenues from customer projects (LVL)</td>
<td>FI</td>
</tr>
<tr>
<td>Conferences and publications</td>
<td>Number of international meetings hosted by organization</td>
<td>NFI</td>
</tr>
<tr>
<td>Customers</td>
<td>Number of international studentsNumber of students of ERASMUS exchange programs</td>
<td>NFI</td>
</tr>
<tr>
<td></td>
<td>Customer satisfaction (feedback results)</td>
<td>NFI</td>
</tr>
</tbody>
</table>

6. Conclusions

IFRS are becoming an integral element of the Latvian accounting system. The study and application of IFRS in practice will let Latvian companies create financial reports that are reliable and useful to their users. ‘Transparency’ of financial reports will ensure the attractiveness of Latvian companies for foreign investors.

The process of transferring to the IFRS will require new knowledge from accountants and financial professionals as well as the creation of a system of preparing accountants that responds to the demands of the changing current situation. The results of the accountant survey, which has been mentioned above, have also clarified the reasons preventing active application of IFRS in practice. About 70% of accountants mentioned the lack of professional knowledge in the field of international accounting and IFRS as one of the main problems.

The concept of Fair value ensures the valuation of the financial situation of the company and its operating results based on current market conditions. Such evaluation allows answer
the question: “How much my business is worth today?” The concept of Fair value allows to reduce the accounting risk and to improve a quality of the financial statement from the point of view of financial management.

Intangibles are the major ‘driver’ of company growth. In an economy where innovation, information and communication technologies, networks and alliances, as well as the quality of human resources and the way in which they are organized, intangibles will continue to be vital to companies. Current financial statement provides very little information about Intangible Assets. Intellectual capital report is supplementary to traditional financial reports. Intellectual capital (IC) report seems to have a fundamental function of self-analysis for the company. These reports are vitally important for the proprietors and investors as they allow measure the activity of the company and its prospects.

References

SEARCHING FOR OPPORTUNITIES OUTSIDE HOME ECONOMY: RUSSIAN CARGO TRANSPORTATION MARKET, ITS PERSPECTIVES AND OPPORTUNITIES FOR GROWTH.

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Abstract. The research was written with the purpose to investigate situation on the Russian cargo transportation market and to identify external and internal factors influencing on feasibility of establishing Latvian cargo transportation subsidiary in Russian market.

The main aim of research is to explore whether and to what extent it is feasible to establish subsidiary company on Russian cargo transportation market. The dissertation is based on the basis of scientific sources, educational literature, statistical data and observation of Russian transport branch development peculiarities, using strategic and financial management tools, analyses.

The research performed is of analytical and predictive types; the information collection method was in the form of deskwork and documentation survey.

The outcome of research provides the answer to the main research question, which is based on the results of thorough analyses performed.

Keywords: cargo transportation market, Russian market, Latvian subsidiaries, macro economic analyses, micro economic analyses, suitability and feasibility of strategy.

Introduction
Cargo transportation business in Latvia has always played significant role in the economical, political and social life of Latvian people and considered to be a kind of perspective activity both for the state and private business. Few years ago, it was one of the most profitable and attractive branches not only for Latvian entrepreneurs, but also for foreign investments.

However, the situation has changed after Latvian accession in European Union. Globalization, fast changing business political and economical environment, adoption of EU regulations, policies and tough competition from East-European transporters’ side are main factors that have lead to the decrease in profitability not only in separate company, but in the whole cargo transportation branch. Latvian business owners are confronted with issues such as how to survive and to keep company profitable. That in turn raises the question what strategies and possibilities to undertake for further development. Whereas there are few or limited development opportunities on Latvian market, because of negative tendency caused mainly by EU enlargement, Russian market, being one of the most stable and fast developing markets in the world opens broad possibilities for transportation business development. Thereby, one of the main strategic aspects and possibilities for future development is entering Russian cargo transportation market by establishing subsidiary company.

The main area of this research is strategic management, where one of the steps involves “scanning and evaluating the external environment and the organizational environment” (Coulter, 2005).
The topic is attractive and actual for the authors because Latvian auto carriers are faced with new difficulties, problems, many companies go bankruptcy and there are no prerequisites for transportation branch development in the nearest future, at the same time, Russian cargo transportation market seems very attractive for the investments. As Drucker (1985) argues, “before getting excited about a new business idea, it is crucial to understand whether the idea fills a need and meets the criteria for an opportunity”. Thou, from the investor’s point of view, it is necessary to analyse and evaluate the feasibility of establishing subsidiary company in Russian market.

This research is of analytical and predictive types. The analytical method has been used because the researcher goes beyond merely describing the characteristics of situation to analyzing and explaining why or how it is happening. The predictive type has been used because research not only analyses the particular situation, but also gives a forecast of particular phenomena occurring in given circumstances.

The investigation is of co-relational type, because the researcher is keen on identification of many important factors influencing on the main problem. Hence, the study is conducted in the natural environment of the organization with minimum interference by the researcher and the study settings are noncontrived.

In this dissertation two types of analysis units are used: industry and organization units, because research questions analyses both Russian cargo transportation industry attractiveness and financial ratios forecast of future subsidiary.

The time horizon is longitudinal study, because the researcher has undertaken a study at several points in time in order to answer each research question.

**Literature review**

The purpose of literature review is identify what is feasibility; why it is importation in this research; what are the main aspects, external and internal factors the feasibility depends on and methods of its measurement.

**Observation of situation on Russian cargo transportation market**

Constant deficit of Russian permissions, and especially universal permissions CEMT and bilateral transit transportations to the third countries, sharp increase of transportation expenses, tough competition from European giants and all other facts mentioned above, compels Latvian cargo transportation companies, especially those who actively working on East direction, to search for a new ways of survival and developments. Some of them have already started to adopt effective and favorable to a branch model: to establish the company in a territory of Russian Federation and to register fleet in the same place.

For the last 2-3 years on the Russian cargo transportation market exhilaration of economic activity was indicated. It is promoted by a number of the created bills, amendments, regulations and resolutions being a part of new Russian transport policy, which is targeted at Russian carriers’ protection.

According to Irina Polyakova, “Russian Transport” magazine observer (2006), in year 2006 - 2007 the Russian economy has entered the new phase of the development linked with underestimated ruble exchange rate exhaustion effect, caused by the crisis in year 1998. The further strengthening of ruble in this period is predicted, but with more lower rates 3 - 4, 5 % per year, against 6, 9 % in year 2004. If such dynamics continues, the real effective exchange rate course will overcome pre-crisis level of year 1997 by the end of year 2008.

Gross national product per capita (GDP) at purchasing power parity (PPP) in Russia has steady positive dynamics since year 1999. Russian GDP on PPP is considered to be average among countries of Eastern Europe from USA level (Federal State Statistics Service, 2007). Growth of Russian production competitiveness is promoted by the new tendency – outrunning
growth of labor productivity in comparison with ruble exchange rate strengthening. Productivity growth gives on average 6% per year that almost in 1.5 times advances ruble exchange rate strengthening ratio. Owing to fast development of telecommunications sector and new projects of a transport infrastructure realization, the transport and communication market share has raised from 23% to 27% of all investments into economy (RosBusiness Consulting Group data, 2007).

According to Gennady Blagodatny, “Russian Transport” magazine observer (2007), truck cargo transportations have made 264 million tons (103.4%), and the cargo turnover has made 21 billion t/km (109.7%). The volume of cargo transportations, executed by foreign traffic on the Russian market has grown and made 36 million tons in year 2006. The growth tendency has proceeded in the first half of the year 2007, including market shares of the Russian carriers in total amount of the international truck cargo transportations (40.7%).

According to Anatoly Nasonov (2006), the first deputy of transport minister in Russia, year 2005 was considered as the year of new Russian Federation transport strategy. At the end of year 2005 the set of important documents concerning new transport strategy, focused on the period till year 2020, was examined by the State Council, by the Russian Federation Government and finally was accepted on December 16th, year 2005 in Moscow.

The strategy is focused on change of a cargo transportation branch role in formation of gross domestic product (GDP). The main questions are: realization of transit potential, export of goods, increase of Russian carriers’ competitiveness on the world market.

The major aims of the strategy are: realization of the complex infrastructural projects directed on increase of Russian transport corridors appeal by delivery expediting, development of logistical and information technologies, complex modernization of Russian Federation border check points. Increase of competitiveness of the Russian carriers on the cargo transportation market. Realization of strategy’s main aims and objectives will allow Russia to strengthen positions on the world cargo transportation market.

Joining WTO and full membership of Russia in multilateral trade system and guaranteed by WTO legislations transparency, should lead to increase of country participation in international trade, increase of its investment appeal, and also growth of possibilities for its transit potential realization, and consequently, will positively affect to a whole logistics system.

To conclude, the situation on the Russian cargo transportation market is getting more stable, financially attractive. Recovery of Russian economy, strategically important decision to enter WTO, support and protection of Russian carriers by government, development and implementation of “Russian Transport Policy” program – all these facts bring along the growth and prosperity of the branch. That is why, now it is beneficial situation and positive circumstances for establishing cargo Transportation Company in the Russian market.

**Feasibility**

Feasibility analysis is the process of determines if a business idea is viable (Barringer & Ireland, 2004).

According to Hofstrand and Holz-Clause (2007), a feasibility analysis is an important tool that helps to assess the viability of starting a new value-added business, or re-organizing or expanding an existing business. It provides important information needed to make the critical decision of whether to go forward with a business venture. A feasible business venture is one where the business will generate adequate cash flow and profits, withstand the risks it will encounter, remain viable in the long-term and meet the goals of the founders.

As the main aim of research is directly related to identification of external and internal factors influencing on feasibility of company establishment, there is a need to define what external and internal business environment is and how it should be analysed.
External Environment

Duncan (1972) defined business external environment as all the factors outside of the direct control of the business that are taken into consideration by the organization in its decision making.

Dess and Beard (1984) emphasized that these factors depend on the complexity and dynamism of the environment. Macro-factors such as the economy, government policy and social change can have a significant effect on a company's success but the relationship is fairly one way. However, whilst these macro factors can fundamentally change the environment of an organization one individual business can rarely do much on its own to shape them.

Fig. 1: External and Internal Environment

According to Johnson and Scholes (2002), as it is shown in the Figure 1, external environment can be divided into two parts: macro environment that affects all the companies and microenvironment that affects companies only in particular industry. External environment can be audited in detail using such approaches as PESTEL Analysis, Michael Porter's Five Forces Analysis and SWOT Analysis.

The macro environment consists of many factors such as new laws, tax changes, trade barriers, demographic changes, government policy and etc. These factors can be categorized and analyzed using PESTEL model analysis.

The microenvironment is the set of factors that directly influence on organization, and its actions and responses. It is crucial to analyze competitive forces in an industry's environment.
in order to identify the opportunities and threats confronting an organization. The most popular and effective model for this kind of analysis is Michael Porter’s five forces model.

Five forces model was developed in year 1980 in his book “Competitive Strategy: Techniques for Analyzing Industries and Competitors”. Porter (1980) defined the forces which drive competition, contending that the competitive environment is created by the interaction of five different forces acting on a business: rivalry among existing companies, the threat of new entrants into the market, the bargaining power of supplier, the bargaining power of the buyers, and the threat of substitute products or services.

Main idea of Porter’s five forces theory is that every business still operates within a framework of buyers, suppliers, competitors, substitutes and new entrants. There always will be necessity to produce goods or services, to find buyers and to offer attractive terms and conditions. There always will be those who produce and sell similar product or substitutes. That is why Porter’s theory is still ‘up-to-date’ and considered to be one of external environment main analysis.

**Internal Environment**

According to Lusthaus et al (2002), the internal environment refers to factors inside the organization that make up what might be called the organization’s ‘personality’, and influence the organization’s cohesiveness and the energy it displays in pursuing its goals. Factors that make up the internal environment include the organization’s culture, performance-related incentive and rewards, the institutional ‘climate’ in general, the history and traditions of the organization, leadership and management style, the existence of a generally recognized and accepted mission statement, organizational structure and shared norms and values that promote teamwork in the pursuit of the organization’s goals.

To develop powerful strategy on the market successfully, company should pay attention not only to external environment analysis, but on internal environment as well. The most popular analysis for evaluation, overall strategic position of the company is SWOT analysis. According to Mintzberg (1990), the SWOT originates from the so called “Design-School”, which seeks to establish a fit between an organizations strengths and weaknesses with the opportunities and threats in its external environment. Key distinction of SWOT analysis from other is that it focuses on both: external and internal issues. SWOT analysis classifies the internal aspects of the company as strength or weaknesses and external factors as opportunities or threats. By analyzing the external environment (threats and opportunities), and internal environment (weaknesses and strengths) factors and development of the simple matrix, it is possible to formulate right strategy of organization.

**Financial feasibility constraints**

According to Kovaljov (2002), the criteria used in the investment analysis can be divided in two groups. First group based on discounted factors criteria (taking into consideration time factor) and the second group is based on accounting estimated criteria. The first group includes: NPV (Net Present Value), PI (Profitability Index), IRR (Internal Rate of Return), MIRR (Modified Internal Rate of Return). The second group includes criteria: PP (Payback Period) and ARR (Accounting Rate of Return). From a position of the theory, the criteria constructed in view of the factor of time, better founded, it gives a priority at a substantiation of investment character decisions.

According to Arnold (2005), there are two approaches to evaluating investments within the company. Net Present Value and Internal Rate of Return are in common usage in most large organizations, but they are regarded not complete without techniques of Payback Period and Return on Investment.
Literature review has revealed the overall positive economic situation on the Russian cargo transportation market, which should be investigated more thoroughly in next dissertation chapters. It has identified and explained the meaning of three main factors that influence on feasibility of establishing subsidiary company in Russian cargo transportation market. These are external environment factors, internal environment factors and company establishment financial feasibility constraints.

**Theoretical Framework**

The purpose of this chapter is to determine and investigate independent, dependent variables, to show the relationships between them with a necessity of deeper problem understanding. Theoretical framework is developed on the basis of information about the current situation on Russian cargo transportation market, as well as on the basis of theory, opinions and literature materials.

According to Sekaran (2003), a theoretical framework is a conceptual model of how one theorizes or makes logical sense of the relationships among several factors that have been identified as important to the problem.

The dependent variable in this research is formulated as following: *Factors influencing on feasibility of establishing Latvian cargo transportation subsidiary in Russian market.*

All the independent variables could be structured into two big groups: internal environment factors and external environment factors.

**Fig. 2: Relationships and associations between variables**

Any organization functions within the limits of external and internal environments. They predetermine feasibility of project and functioning success of the company; impose the certain restrictions on operational actions. Every action of the company is possible only if the environment allows its realisation. External and Internal environments are independent variables of this research and are interconnected. Moreover, all the components of external (macro and micro) environment as well as internal environment have direct or indirect influence one on another.

For example stable economic situation redounds to the growth of GDP level, and there appears a new opportunity for the company to invest in new capacities, product developments, to create new workplaces. Changes in political situation or the legislation can be the
significant factor influencing on how the company will perform further, whether it will be still profitable to work in this niche or it is time to look for a new possibilities.

Investigating external (macro, micro) and internal environment are the crucial first steps related to developing of new business ideas, assessing feasibility, implementing innovations and launching new ventures. It will develop business-planning capabilities, skills and understanding, including market and competitor research and the use of important financial concepts such as cash flow and investment attractiveness analyses. Without scanning internal and external business environment, there is no opportunity to explore whether the project will be feasible or not.

**Research Question 1**

_What key drivers for change of macro environment are likely to have a high impact on the success of failure of Latvian subsidiary company Transportation Company establishing in Russia?_

**International Drivers**

Location of activity is a crucial source of potential advantage and one of the distinguishing features of international strategy relative to other diversification strategies. Moreover, the success of new economic powerhouses such as the so-called BRICs – Brazil, Russia, India and China (Friedman, 2006) is generating new opportunities and challenges for business internationally. Given internationalization’s complexity, international strategy should be underpinned by a careful diagnosis of the strengths and direction of trend in particular markets. George Yip’s (2003) drivers of globalization’ framework provides a basis for such diagnosis. The key insight from Yip’s drivers’ framework is that the internationalization potential of industry is variable. There are many different factors that can support or inhibit it, and next an important step in determine an internationalization strategy is a realistic assessment of the true scope for internalization in the particular industry, in our case - Russian transportation market.

**PESTEL Analysis**

- **Taxation**

  Russian taxes are listed and regulated by the Russian Tax Code. The profits tax is levied on an enterprise's gross profits. Effective January 2002, the profit tax rate was reduced from 35% to 24%, a list of deductible expenses was drawn up, and the provisions on depreciation were changed. VAT is designed as a tax to be borne ultimately by consumers, but is collected on a basis similar to the EU model. VAT is calculated on the sales value and is applied at a general uniform rate of 18%. Imports are also subject to VAT and are calculated based on the customs value of the item plus customs duties and customs fees. Import duties are assessed at specified rates, ranging from 5 to 30%. They are also assessed according to classification and are applied to the customs value of the imported goods (including shipping charges and insurance). (Kommersant Magazine, 2003).

- **Market Access**

  Most of the goods can be freely imported into Russia. The importers have to fill in a "customs freight declaration statement" of which 54 paragraphs are written in Russian. Certificates of origin and conformity certificates have to be presented to the customs. Russia applies the Harmonised Customs System. The customs duty is calculated Ad valorem on the CIF value of the goods. The duties and taxes are imposed by the State Customs Committee. There is one single external tariff called "general tariff", from 5% to 30% with a current 14% average. Customs duties are an essential element of the Russian commercial policy, that's
which the rates often change. Furthermore, Russia is not yet a member of the WTO (negotiation in process) and that explains these frequent variations (http://www.vch.ru).

- Corruption
  Corruption remains a serious problem in Russia, with the country ranking 126th on Transparency International's (TI's) 2005 Index (with a score of 2.4). TI's report noted that Russia's drop from 2004 (from 90th place and a score of 2.8) was so severe that it likely reflects a statistically significant drop in the perceptions of corruption here (http://www.transparency.org). Corruption in commercial and bureaucratic transactions and problems with the implementation of customs regulations also inhibit investment. Customs officials are extremely inconsistent in how they apply the law.

- External Threat
  No conventional external threat exists. However, the stepwise expansion of NATO into Eastern Europe and the three Baltic states of the former Soviet Union has caused irritation in Russia, some of which has been alleviated by participation in the NATO–Russia Council and by a NATO promise not to deploy nuclear weapons in the new member countries.

- Transportation Policy
  The Government takes necessary measures for providing state support and policy regarding assistance to business in a question of logistics sphere development. “Complex development of large transport corridors is carried out according to the key directions emphasized by the President of Russia, and the aims put by the Government of Russia with a purpose of competitiveness increase and realization of transit potential of the country, increase of complex safety of transport system and improvement of an investment climate of transport sphere”, pointed out the Minister of Transport (Burilin, 2007). Within the framework of the Federal Related Program “Modernization of Transportation System in Russia 2002-2010” it was spent 160 billion Euros by the federal budget to improve the situation on the transportation market since the year 2002. The logical continuation of this program will be the Federal Related Program “Modernization of Transportation System in Russia 2010-2015”, announces The Ministry of Transport.

  The Government put different economic barriers (such as limitation of permissions) to European transportation companies with a purpose to increase an economic appeal of the transportation sector for investors and thus to increase economy of the country. Nevertheless, significant achievements were reached in mutual relations between Russia and the European Union in the coordinated development of an infrastructure and logistics within the limits of Transport dialogue which became the main step of realization of project “Transport of a motoring map on the general economic space of Russia – EU”.

- General Economic Trends
  Russia’s economic reforms have made considerable progress since Mr. Putin became a President in year 2000; although large and corrupt bureaucracy still remains an obstacle to the reform implementation. Russian GDP growth and the surplus/deficit in the state budget are closely linked to world oil prices. The GDP growth rate was 7.2% in 2004, slackened to 6.4% in 2005, and reached 6.5% in 2006. IMF forecasts GDP growth to remain stagnant at 6.5% in year 2007. The current-account surplus will narrow gradually, but is still projected reach nearly US$ 75bn (5.7% of GDP) in year 2008. Global prices continue to have a major effect on export performance of Russia because commodities (particularly oil, natural gas, metals, and timber) comprise 80% of Russian exports (Ernst & Young, 2007).

- External Debt
  At the end of year 2004, the external debt totaled US$197.4 billion, but in 2005 and 2006 Russia used its oil-fed Stabilization Fund to repay substantial amounts to the International Monetary Fund and the Paris Club of international lenders (FINAM, 2007).

- Country Risks
This information (www.ondd.be) is based upon a systematic analysis of the political and financial situation of the country, and is collected from the most reliable information sources: the International Monetary Funds, the World Bank, the Institute of International Finance, the Economist Intelligence Unit, the Wiener Institut für Internationale Wirtschaftsvergleiche etc. These analyses reflect macro analysis from a credit insurer's point of view:

**Fig. 3: Risk assessment**

ONDD insures investments in Russia against 1) war risk, 2) the risk of expropriation and government action and 3) the transfer risk regarding payment of dividends or repatriation of capital. The maximum reimbursement period for medium- and long-term transactions with Russia has been set at 10 years. Concessional financing is excluded.

**Transportation Trends**

“Russia is measured to increase investments into development of a transport infrastructure”, informed the deputy minister of economic development and trade of the Russian Federation Cyril Androsov during the conference "Investment prospects of the Russian economy: development of a transport infrastructure ". By estimation of officials, the need for investments into a transport infrastructure of the country up to the end of 2020 makes 1 trillion Euros, but to allocate such means from the state budget is impossible. The problem solution is the help of private investors which, however, is obvious in deficiency. The volume of investments into an infrastructure of transport hardly holds out up to 2 % of gross national product while in the majority of other countries of the world this parameter makes minimum 4 %. Transfer of the Russian transport infrastructure system into a new qualitative level will demand significant investments of the federal budget – 4.8 % of Gross National Product. (www.finam.ru; 26.11.07)

- Well trained workforce

Russia’s labor force generally is considered well-educated and skilled, although its strengths increasingly are mismatched to the needs of the national economy. In year 2005 Russia’s active labor force was estimated at 74.2 million individuals.

- Level of education

Russia traditionally has had a highly educated population. According to the 2002 census, 99.5 percent of the population above age 10 was literate.

- Trade regulations and standards

Russia’s standards regime remains extremely complex due to its lack of clarity and overall redundancy. There is a selection of tariffs for every good entering Russia. Importers are required to complete a Russian customs freight declaration for every item imported. A declaration must be supported by the following documents: contracts, commercial documents such as commercial invoices and packing lists, transport documents, import licenses if applicable, certificates of conformity and/or safety, certificates of origin if applicable, and
documents confirming legitimacy of importers. In addition, currency control regulations require issuance of a “passport” for both exports and imports to ensure that hard currency earnings are repatriated to Russia. The regulations also ensure that transfers of hard currency payments for imports are for goods actually received and properly valued.

**Answer to Research Question 1**
The following key drivers for change of macro and micro environment have been identified which are likely to have a high impact on the success or failure of Latvian transportation subsidiary company establishing in Russia:
- Drivers for internationalization of Russian markets (similar customer needs and tastes; scale economies, WTO continues to push for greater openness, interdependence)
- Recovery of Russian economy
- Strategically important decision to enter WTO
- Support and protection of Russian carriers by government
- Development and implementation of “Russian Transport Policy” program

All these facts bring along the growth and prosperity of the branch.

**Research Question 2**
_How competitive forces of transportation industry influence on feasibility of Latvian subsidiary company subsidiary establishing in Russia and what influence can be exerted?_

The most appropriate economic model to analyze the competitive structure of cargo transportation market in Russia is Porter's Five Forces analysis. This model will help to analyze the attractiveness of the cargo transportation industry by considering five different forces within a market: the likelihood of new entry, the power of buyers, the power of suppliers, the degree of rivalry, and the substitute threat.

**Table 1**: Level of threat in Porter’s 5 forces analysis

<table>
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<tr>
<th>Factors</th>
<th>Level of threat</th>
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<tbody>
<tr>
<td>The likelihood of new entry</td>
<td>Middle</td>
</tr>
<tr>
<td>The power of buyers</td>
<td>High</td>
</tr>
<tr>
<td>The power of suppliers</td>
<td>Middle</td>
</tr>
<tr>
<td>The degree of rivalry</td>
<td>High</td>
</tr>
<tr>
<td>The substitute threat</td>
<td>Low</td>
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</tbody>
</table>

**Answer to Research Question 2**
Analysis of the microenvironment led to the conclusion that the main drivers of competition are cost, quality, technologies and employees. The low costs strategy is not a competitive advantage. At present, Russian cargo transportation companies compete on differentiation: they are able to provide the full range of logistics services, including transportation itself, warehouse logistics, and management of client’s stocks, intermediation in customs, consultations, etc. The average level of threats according to analyzed factors using Porter’s model is middle. Thus, microenvironment has negative as well as positive effects on the transportation company establishing in Russia. Nevertheless, it is obvious that establishing company is likely to generate returns in the foreseeable perspective. However, the five forces
can change over time as market conditions alter, that is why the transportation market should be constantly analyzed.

**Research Question 3**

*Whether and to what extent it is feasible to establish Latvian subsidiary company on Russian cargo transportation market?*

The main aim is to measure profitability using different economic methods described in the literature review chapter: Net Present Value (NPV), Internal Rate of Return (IRR), Payback Period (PP), Return on investments (ROI) and Profitability Index (PI). On the basis of these results the final decision (whether to establish the company or not) could be made.

**Answer to Research Question 3**

- **ROI (or ROCE)** 88, 7% for 5 years
- The payback period is 3.2 years
- NPV of the project equals 247052 Euro
- Profitability Index is 1.31
- IRR is 20.0%
- MIRR is 17.0%
- Required rate of return (WACC) is 10.5%

All ratios show that the strategic project should be accepted and the main conclusion is that the project is profitable.

**Conclusions**

Under scenarios of possible economic slowdown new way of sustainable business development should be identified. Due to difficult situation on the Latvian cargo transportation market, many companies are forced to search for a new ways of survival and new ways for making profit. And one of the opportunities is to open cargo Transportation Companies in Russia.

The research has identified the feasibility of Latvian cargo transportation subsidiary establishing on the Russian market.

**Future Work**

The analyses of this dissertation show that there are opportunities and growth possibilities for establishing cargo Transportation Company on the Russian market.

However, establishing a new company on the foreign market is very difficult, risky and critical process, which presupposes thoroughgoing research and investigation. Thus, it is not enough just to analyze market and several variables from internal and external environment, what is done in this research project.

Future work could be started with completion of mentioned above analyses: profitability analysis from customer’s point of view, Johnson and Scholes strategy evaluation method, blue ocean strategy analysis.

A future research could be amended by transportation industry consolidation curve analysis, Competitive Profile Matrix analyses and Strategic Map analysis. One of the future research questions could be built on the findings of this research, for example creation of TOWS matrix strategic choice.

Finally, as this project is directed for 5 years, in future it would be valuable to test the proposed profitability evaluation methods developed in this research on real figures of the company, comparing financial results. It would provide company with an opportunity to evaluate themselves, asses the strategy chosen.
Bibliography

Abstract: At present many commercial banks in Latvia face the problem of imbalanced liquidity caused by the mismatch between the terms of borrowing and lending. Thus, during the last 5 years, a rapid growth of long-term lending was not sufficiently covered by long-term resources. Many banks were forced to transform significant amounts of short-term resources into long-term assets running the risk of imbalanced liquidity. In spite of the fact that the implementation of the government’s anti-crisis programme will undoubtedly affect the banking sector and will lead to a gradual slowing down of lending growth rates, the problem of finding long-term resources will remain high on the banks’ agenda. In the authors’ opinion, an important role in attracting long-term bank resources should be played by the issue of securities: bonds, mortgage bonds, etc. as well as by the creation of subordinated liabilities. The present article is devoted to the analysis of the level of equilibrium of bank assets and liabilities by terms and amounts, to the identification of the existing problems in imbalanced liquidity risk management, and to the search for the optimal solution to these problems. The authors also reveal an interconnection between the imbalanced liquidity risk and other risks of a commercial bank (credit, interest rate, market, reputation risks, etc.). They identify the sources of the imbalanced liquidity risk, characterize the impact of each risk source and propose methods for controlling the risk.

Key words: gap analysis, imbalanced liquidity, bank risks, resource base, liquidity ratios, liquidity limits.

1. Introduction

The current tendencies of Latvian banking sector prove that the majority of Latvian commercial banks work in the conditions of imbalanced liquidity.

The nature of the liquidity risk lies in specific peculiarities of banking institutions activities. Thanks to a big amount of short-term resources banks can afford to offer long-term loans drawing their profit from higher interest rates on loans. It causes a situation with a discrepancy in the terms and the sums of assets and liabilities. As a result, the bank is exposed to the risk of being short of current liquidity in case a large number of depositors would like
to withdraw their money. The bank is able to collect its resource base either by attracting additional deposits at higher interest rates or by means of a compelled unprofitable realization (selling) of its other assets. Apart from that, another source of potential liquidity problems is bank sensitivity to the fluctuations in interest rates: in case they grow, some of the depositors could withdraw their money in search of higher income in other deposits (investments); obtaining liquid assets by means of loan borrowing could prove to be more expensive while some kinds of loans could turn out to be unavailable.

To resolve these problems bank policy should be sensible and prudent when balancing the terms and the sums of its assets and liabilities. It should also keep (a certain amount of) current liquidity and negotiable securities. Commercial banks could also strike contracts with other banks on reserve crediting in accordance with which the latter would be bound to allow credits in emergency cases.

Alongside with the problem of imbalanced liquidity having become quite acute, a lot of Latvian commercial banks find themselves in a position when their liquidity ratio many times exceeds the required standard. That means they work with surplus liquidity and, therefore, do not use all existing resources so that they could obtain a maximally efficient financial and commercial result (N. Konovalova, 2007).

So, for instance, at the end of 2007 liquidity ratio of several banks made up more than 70% (FCMC, 2008) instead of standard 30%. In the 6-year period from 2002 to 2007 the average liquidity ratio within the system of Latvian commercial banks fluctuated between 48,1% and 62,1% (N. Konovalova, 2007).

The above-stated fact, indicative both of the assets and liabilities term imbalance and comparatively high liquidity ratios, means that bank liquidity must not be considered one-sidedly. The assessment of commercial bank liquidity should be carried out comprehensively on the basis of such techniques as gap-analysis, ratio methods, limiting, flow of funds, etc.

Taking into account the above-mentioned, the authors make a research of the problems of imbalanced liquidity in commercial banks considering the influence of both external and internal factors; reveal the reasons, which have caused them, as well as expose the drawbacks in the imbalanced liquidity risk management.

The aim of the research is to assess the level of imbalanced liquidity within different commercial bank groups in Latvia on the basis of gap-analysis, to reveal the most significant factors of risk influencing the imbalance of bank assets and liabilities, as well as to work out some recommendations on how to improve the imbalanced liquidity risk management for commercial banks.

The research tasks:
- to assess the level of assets and liabilities balance within different commercial bank groups in Latvia;
- to reveal the reasons for imbalanced liquidity in Latvian commercial banks;
- to estimate the influence of factors on the level of imbalanced liquidity;
- to expose the existing problems in banking liquidity management;
- to work out some suggestions on how to decrease the level of imbalanced liquidity for Latvian commercial banks.

The problems of imbalanced liquidity have been dealt with in the works of such foreign authors as Josepf F. Sinkey Jr., Peter S.Rose, Greuning H.Van, Brajovics Bratanovic S., Chris J. Barltrop, Diana McNoughton, O. Lavrushin, R. Olhova, A.Lobanov, A. Chugunov and others. However, inadequate attention is being paid to the problems of imbalanced liquidity risk in Latvia.

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7 The liquidity ratio is established as the ratio of high liquid assets (cash, correspondent accounts “nistro” with the terms up to 30 days and high liquid securities) to the current liabilities with residual maturity up to 30 days.
On the other hand, the activity of Latvian commercial banks confirms a necessity to estimate the level of imbalanced liquidity as well as to improve the methods of approach to the imbalanced liquidity risk management.

2. Importance of Liquidity Management

Liquidity risk is a risk of a bank not able to pay its legally required liabilities without substantial losses, as well as not able to overcome unforeseen changes in bank resources and/or market conditions, since it will not have adequate liquid assets (FCMC, 2007).

Liquidity risk is a greater concern and management challenge for banks in today’s environment. Increased competition for consumer deposits, a wider array of wholesale and capital market products, and technological advancements have resulted in significant changes in funding structures and liquidity management techniques.

Traditionally, banks rely on retail deposits and savings accounts as a primary funding source. Generally, these deposits represent a stable and low-cost source of funds. For the past several years, core deposits as a percentage of liabilities have steadily reduced and may significantly go down in the future since retail consumers continue to evaluate the variety of competing savings vehicles and their relative yields. The growth in, and consumers’ acceptance of e-technologies may boost this trend by making it easier for consumers to compare rates and to transfer funds between banking institutions easily and rapidly.

Increased reliance on market funding, however, has made banks more exposed to the price and credit sensitivities of major investors. As a rule, institutional investors are more credit sensitive and will be less willing than retail customers to provide funds to a bank facing real or perceived financial difficulties. A bank’s ability to access the capital markets may also be adversely affected by events not directly related to them.

Along with the shift from relatively credit-neutral to credit-sensitive funds providers, banks have turned increasingly to asset securitization and other off balance-sheet operations. As these off balance-sheet activities have grown, they have become increasingly important in the management and analysis of liquidity. These activities can either supply liquidity or increase liquidity risk, depending on the specific transaction and then-current level of interest rates.

Banks are successfully adjusting to this secular shift by using market sources to meet their funding requirements. While employing market sources, banks are able to diversify their funding bases among funds providers and across maturities. Unlike core deposits, whose maturities are generally determined by the preferences of depositors, funds in the institutional markets can be accessed at a variety of tenors. Due to the many choices among market funding alternatives, banks can enjoy greater flexibility in managing their cash flows and liquidity needs.

The imbalanced liquidity risk is closely connected with other main risks in banking activity.

Realization of any risk at a bank entails a reduction of incoming payments, growth in expenses for attraction of resources, which, in its turn, leads to deterioration of the liquid position. Regardless of these factors, meeting the demand for liquid assets must be of a high priority for the bank. Refusal of funds for the customer may seriously undermine the trust in the bank (M.Kudinska, 2007).

The primary risks that may affect liquidity are: reputation risk, strategic risk, credit risk, interest rate risk, market price risk and operational risk. If these risks are not properly managed and controlled, they will eventually undermine a bank’s liquidity position.

Reputation risk

Reputation risk is the current and prospective impact on earnings and capital arising from negative publicity. A bank’s reputation for discharge its obligations and operating in a safe
and sound manner is essential to borrowing funds at a reasonable cost and retaining funds during troubled times. Negative public opinion, whatever the cause, may cause depositors, other funds providers, and investors to seek greater compensation, such as higher rates or additional credit support, for maintaining deposit balances with a bank or conducting any other business with it.

A bank that is exposed to significant reputation risk should seek to mitigate liquidity risk by diversifying the sources and maturities of market funding and increasing asset liquidity, as appropriate.

**Strategic risk**

Strategic risk is the current and prospective impact on earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes. No strategic goal or objective should be planned without prior considering its expected impact on a bank’s funding abilities. The bank must be able to raise money required to meet its obligations at a tolerable cost. The ability to attract and maintain sufficient liquidity is often an issue at banks experiencing rapid asset growth. If management misjudges the impact on liquidity of entering a new business activity, the bank’s strategic risk increases. Management should carefully consider whether the funding planned to support a strategic risk initiative will increase liquidity risk to an unacceptable level.

**Credit risk**

Credit risk is the current and prospective risk to earnings or capital arising from the counterparty’s failure to discharge a contractual obligation with the bank or otherwise to perform as agreed. A bank that assumes more credit risk, through asset concentrations or adoption of new underwriting standards in conjunction with untested business lines, may be increasing its liquidity risk. Credit-sensitive wholesale funds providers may be concerned about that the banks increased credit exposure could lead to credit problems and insufficient earnings. The bank’s ability to meet its obligations may eventually be compromised. Institutional investors and rating agencies consider the level of overdue loans, nonperforming loans, allowances for loans and leases, and loan charge-offs as indications of trends in credit quality and potential liquidity problems. If credit risk is elevated, the bank may have to pay a premium to access funds or lure depositors. If credit risk has undermined the bank’s financial viability, funding may not be available at any price. Most large bank failures have involved the combined effects of severe credit and liquidity aggravation.

**Interest rate risk**

Interest rate risk is the current and prospective risk to earnings or capital arising from fluctuations in interest rates. Changing interest rates affect income earned on assets and the cost of funding those assets. If a bank experiences a decline in earnings from a change in market interest rates, funds providers may question the financial stability of the bank and demand a premium. They may even refuse to provide funding.

A change in interest rates also affects the economic value of the balance sheet. For example, the present value of most investment securities decreases in a rising rate environment. To maintain the total value of assets serving as collateral in repurchase agreements or pledged against deposits, the bank may have to pledge or encumber additional securities, thus increasing its cost of funds. The cost of alternative funding sources also may increase as depositors and other lenders demand market interest rates in a rising rate environment.

Off-balance-sheet instruments that a bank uses to manage its interest rate risk may also cause liquidity risk. The cash flows of those instruments often are very sensitive to changes in rates, and, if not properly managed, can result in unexpected funding requirements or other cash outflows during periods of fluctuating interest rates.
**Market price risk**

Market price risk is the risk to earnings or capital arising from changes in the value of trading books comprising of financial instruments. Market price risk may result in volatile earnings. This risk is most prevalent in large banks that actively trade financial instruments. Market price risk is closely monitored by funds providers when assessing a bank's financial position and creditworthiness. If market price risk and its perceived impact on earnings or capital is too great, funds providers may require the bank to pay increased rates for funds, may not be willing to invest in longer-term maturities, or may refuse to provide funding whatsoever.

**Operational risk**

Operational risk is the current and prospective risk to earnings and capital arising from inadequate or failed internal processes, people and systems or from external events – various types of human or technical errors, contingencies, fire and other factors of this sort. Systems that directly affect liquidity include computer-based funds transfer systems, e-banking, and operations governing payment card usage (credit, debit, etc). If product lines change, management must adjust the systems to ensure that all transactions can be handled. Significant problems can develop very quickly if transaction processing systems fail or delay execution. If customers have difficulty accessing their online accounts, they may close them, which will diminish liquidity. Operational risk should be considered in the bank's contingency planning process.

Senior management should monitor various internal as well as market indicators of potential liquidity problems at the bank. These indicators, while not necessarily requiring drastic corrective action, may prompt senior management of the bank to do additional monitoring or analysis.

A liquidity problem may first show up in the bank's financial monitoring system as a downward trend with potential long-term consequences for earnings or capital. Examples of such internal indicators are:

- negative trend or significantly increased risk in any area or product line;
- concentrations in either assets or liabilities.
- deterioration of asset quality indicators;
- decline in earnings performance or projections;

Financial and Capital Market Commission (FCMC) has developed a rating system that serves for identifying, analyzing and assessing risks incurred by banking institutions (i.e., for assessing risk profile) and evaluating the quality and sufficiency of risk management methods used by institutions, as well as their adequacy to the volume and complexity of operations. FCMC suggests two aspects for the evaluation of liquidity risk management quality:

- Assets and liabilities cash flow maturity mismatch, which also includes the risk that a bank will be unable to meet its liabilities without suffering considerable losses due to its inability to overcome unexpected decrease in resources;
- Market liquidity risk, i.e. the risk that in case of necessity a bank will not have access to resources in the market, and/or that it will be unable to liquidate positions (e.g. sell its assets) in short time and without considerable losses. This also includes bank’s inability to timely diagnose changes in market conditions (decrease in market liquidity).

Depending on certain criteria, a bank is included into one of four quality groups (Table 1)
**Table 1. Characteristics of liquidity risk**

<table>
<thead>
<tr>
<th>Risk groups</th>
<th>Assets and liabilities cash flow maturity mismatch</th>
<th>Market liquidity risk level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low risk group</td>
<td>Commercial banks with balanced claims and liabilities; total position is positive starting with the group with residual maturity from 31 days; liquidity ratio for the past year exceeds 50% and is stable; cash and liquid money market instruments comprise a large proportion of liquid assets (more than 80%); scenario analysis reveals the absence of potential liquidity problems.</td>
<td>Commercial banks which funding sources are sufficiently diversified, that is, there are no concentrated positions (deposits of each individual customer/group of interrelated customers do not exceed 2% of bank’s liabilities; loans of each individual loan providers (excluding shareholders and companies of the group) do not exceed 5% of bank’s liabilities; amount of deposits/loans with the same maturity does not exceed 5% of bank’s liabilities), volume of deposits is constantly growing, in case of necessity a bank can promptly attract resources from other sources without additional expenses or losses, and/or there are no problems for maintaining long-term and short-term liquidity, because in case of necessity it is possible to receive support from the parent bank or other companies of the group.</td>
</tr>
<tr>
<td>Moderate risk group</td>
<td>Commercial banks where the amounts of total negative liquidity positions are not substantial; total position is positive starting with the group with residual maturity from 91 days, and/or liquidity ratio for the past year is 30-50% and stable, and/or cash and liquid money market instruments comprise a substantial proportion of liquid assets, and/or scenario analysis reveals potential liquidity problems, but such problems are not substantial.</td>
<td>Commercial banks which funding sources are sufficiently diversified but do not meet some quantitative criteria defined for “low risk” rating; concentration does not exceed quantitative criteria defined for “low risk” rating more than three-fold, and/or volume of deposits is stable but it does not show a tendency to increase, and/or in case of necessity a bank can attract resources from other sources promptly enough and without substantial expenses or losses, and/or there are no expected problems for maintaining short-term liquidity, but there might be problems for maintaining long-term liquidity, because, for example, a substantial proportion of total assets is comprised of the assets, fast disposal of which is complicated (e.g. loans).</td>
</tr>
<tr>
<td>Substantial risk group</td>
<td>Commercial banks where the amounts of total negative liquidity positions are substantial; total position is positive starting with the group with residual maturity from 181 days, and/or liquidity ratio for the past year is average and shows a tendency to decrease and/or substantially fluctuates, and/or cash and liquid money market instruments comprise a small proportion of liquid assets (less than 50%), and/or scenario analysis reveals substantial potential</td>
<td>Commercial banks that have several funding concentrations; concentration does not exceed quantitative criteria defined for “low risk” rating more than ten-fold, and/or volume of deposits is unstable and shows a tendency to decrease, and/or a bank might be unable to promptly attract resources from other sources and/or this might be connected to substantial expenses or losses, and/or there are no problems for maintaining short-term liquidity, but substantial problems for maintaining long-term liquidity.</td>
</tr>
</tbody>
</table>

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Commercial banks where the amounts of total negative liquidity positions are large; total position is positive starting with the group with residual maturity from 361 days, and/or liquidity ratio for the past year is close to 30% or lower, it is possible that a bank fails to comply with certain liquidity ratio requirements, and/or cash and liquid money market instruments comprise an unsubstantial proportion of liquid assets, and/or scenario analysis reveals substantial potential liquidity problems.

Commercial banks that have substantial funding concentration due to the following reasons: deposits of each individual customer/group of interrelated customers exceed 20% of bank’s liabilities, and/or credits of each individual creditor exceed 50% of bank’s liabilities, and/or amount of deposits/loans with the same maturity exceeds 50% of bank’s liabilities, and/or deposit base is unstable, and/or deposit volume substantially decreases, and/or in case of necessity a bank will be unable to attract resources from other sources, and/or there are substantial problems for maintaining liquidity.

3. The measurement of liquidity imbalance.

To assess a bank liquidity level it is necessary to analyse the state of assets and liabilities structure of commercial banks in the context of terms and sums and to estimate their liquidity position. Net liquidity position is estimated using gap-analysis - each term deposit group (up to 1 month, from 1 to 3 months, from 3 to 6 months, from 6 to 12 months, from 1 to 5 years and over 5 years) being studied separately.

A positive net liquidity position in each assets and liabilities term group indicates a surplus of placed resources over those attracted within a considered term group. The higher positive net liquidity position in the group up to 1 month is, the higher is the current bank liquidity. Positive net liquidity position in longer term groups indicates a shortage of long-term bank resources. The deficit of long-term bank resources could be reimbursed at the expense of the bank equity. However, in case bank equity proves not to be enough to cover its long-term assets, it could develop liquidity problems when the maturity of its long-term liabilities approaches.

The case of negative net liquidity position in each assets and liabilities term group indicates a surplus of attracted resources over those placed within this term group. The higher negative net liquidity position in the current group compared to the short- and long-term groups is, the higher is liquidity risk, since „short” resources are redirected into longer term investments, and there could be a term mismatch between the maturity of a bank short-term liabilities and its long-term assets maturity.

Negative net liquidity position in „longer” terms will show that long-term resources are used not only for long-term investments but are also placed in shorter term assets. Such resource placement will positively characterize a bank liquidity.

Alongside with the net liquidity position a total liquidity position – the gap between assets and liabilities in the cumulative total position and in the order of increasing terms is estimated.

In order to estimate the level of imbalanced liquidity it is reasonable to divide all Latvian commercial banks into 4 groups:

1st group – banks fully owned by foreign investors;
2nd group – banks with mixed capital (Latvian and foreign capital);
3rd group – banks fully owned by private Latvian investors;
4th group – bank fully owned by the state.
Table 2. Characteristics of the groups of Latvian commercial banks

<table>
<thead>
<tr>
<th>Group of banks</th>
<th>Number of banks in the group</th>
<th>Total assets at the end of 2006, million lats</th>
<th>Percentage of total assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group 1</td>
<td>9</td>
<td>8645452</td>
<td>57,85</td>
</tr>
<tr>
<td>Group 1</td>
<td>5</td>
<td>1917940</td>
<td>12,83</td>
</tr>
<tr>
<td>Group 1</td>
<td>6</td>
<td>685130</td>
<td>4,59</td>
</tr>
<tr>
<td>Group 1</td>
<td>1</td>
<td>3696141</td>
<td>24,73</td>
</tr>
<tr>
<td>Total</td>
<td>21</td>
<td>14954549</td>
<td>100,0</td>
</tr>
</tbody>
</table>

To carry out a comparative analysis of imbalanced liquidity in different bank groups the authors make use of relative gap indicators: the *net relative gap* and the *cumulative relative gap*.

The **net relative gap** is specified as the ratio of the absolute net gap value to total assets. The changes in the net relative gap indicator over time and in different bank groups are illustrated in Fig 1, which shows that the highest gap in 2006 was observed at 1 month term. It testifies to some surplus of current resources, a part of which is redistributed by banks to cover their short- and long-term active operations. The authors have established that the biggest current gap in 2006 was observed within the 3rd group of banks (33.53%); the equity of those banks has been built up on the basis of Latvian private business. This group was followed by the 1st group or foreign capital banks and then - the 2nd group banks, these with mixed capital; their current net gap being 21,24% and 20,22%, accordingly. The lowest current gap (10,7%) was observed in the 4th bank group or the state-owned bank, which makes it possible to conclude that only insufficient amount of current resources of this bank was redirected into longer term assets.

With terms becoming longer (within the range of 1 month to 1 year) the range of gap shrinks to testify to higher balanced assets and liabilities at the considered term period.

The analysis of long-term (over 1 year) assets and liabilities mismatch shows that the highest term mismatch, which is characterized by the shortage of long-term resources, was observed in the 2nd and the 3rd bank groups. In the 3rd bank group the relative net gap indicator in term deposits from 1 up to 5 years constituted 21%, and in term deposits over 5 years – 23,2 %. As concerns the 2nd group – they were 14,6% and 6,4%, accordingly.

**Figure 1.** Latvian Commercial Bank’s Asset Structure at the end of 2006 (in percentage)

It should be noted that the bank with the lowest assets and liabilities mismatch in the period from 1 to 5 years was the state owned bank (*Mortgage Bank*), the net relative gap of
which made up a little more than 1%. As concerns the period over 5 years the gap increase up to 9% was observed in Mortgage Bank. However, due to the bank’s well-diversified long-term resource base (term deposits, mortgage bonds, subordinated liabilities and others) constantly increasing, any signs of liquidity risk do not threaten the bank.

The results obtained and worked out with the use of the cumulative relative gap made it possible for the authors to come to the same conclusions. Moreover, the cumulative relative gap vividly reveals high assets and liabilities term mismatch within the 3rd group of banks.

The characteristics of the change of the cumulative gap indicator at different terms are shown in Fig. 2.

A further analysis presupposes the assessment of percentage level of resource surplus or shortage within each term group in the context of bank groups. The total summary is given in Fig. 3.

The results of the analysis have shown that the 3rd group of banks suffered the most acute shortage of long-term resources. The resource shortage in terms from 1 to 5 years constituted 74.55%. The resource shortage in terms over 5 years constituted 71.7%. Second biggest deficit of long-term resources is the 2nd bank group (with the resource shortage within the range from 1 to 5 years being 69%, and the resource shortage in the terms over 5 years - 42%). The 1st bank group, on the whole, was characterized by some resource surplus in the terms from 1 to 5 years (9%). At the same time a considerable shortage of resources has been estimated within this bank group in the terms over 5 years (51%). The above-mentioned fact can be explained because it was exactly these banks (particularly such branch leaders as AS Hansabanka and AS SEB Unibanka) that in line with their aggressive credit policy had placed the main part of their assets in long-term credits with the terms over 5 years, not always having a reliable long-term resource supply. Mortgage Bank has a quite sufficient coverage of its long-term placements within the terms of 1 to 5 years with a 5% surplus of its long-term resources coverage within this term group. At the same time, a 30% shortage of its long-term resources in the terms over 5 years is observed in this bank. However, as it was stated above, the well-diversified long-term resource base of the bank does not give reason to the authors to consider this circumstance to be negative.

![Figure 2. Latvian Commercial Bank’s Liquidity Cumulative Gaps at the end of 2006, (in percentage to total assets)](image-url)
The summary of the structure of assets and liabilities in the context of terms makes it possible to implement redistribution of surplus money resources between different term groups. Such redistribution is carried out on the basis of either transformation of long-term resources into short-term investments or short-term resources into long-term investments.

The following circumstance should be taken into account: the procedure of transformation of short-term resources into long-term investments could aggravate the situation in the context of bank liquidity. Therefore, a constant supervision over the state of the term structure of assets and liabilities, the observance of the established net liquidity position limits and the dynamics of the change of liquid funds must be provided. A bank can make a decision on the transformation of short-term resources into medium-term or long-term investments provided there is no danger to liquidity.

The short-term resources transformation coefficient is worked out as the ratio of gap between short-term resources and short-term assets to short-term resources.

In case there is surplus amount of short-term resources, a certain part of them could be redirected into long-term assets; however, in the authors’ opinion, the transformation share of short resources being turned into long-term investments must not exceed 20%.

Figure 4 illustrates the transformation level within groups of Latvian commercial banks at the end of 2006.
The estimated transformation indicators prove the above-stated conclusions made by the authors. Thus, the highest indicator of short-term (within the terms up to 1 year) resources transformation into long-term assets (within the terms over 1 year) was observed in the 3rd bank group (51.74%), which testifies the highest degree of imbalanced liquidity risk in this bank group. The state owned bank had the lowest transformation indicator (18.4%), which confirms the authors’ conclusions on a sufficiently good assets and liabilities term balance in this bank. The 1st bank group has the transformation indicator at the level of 22%, and the 2nd – at the level of 26, 75%, which stipulates the existence of the imbalanced liquidity risk, although less dangerous than in the 3rd bank group.

To assess the transformation risk in the case of short-term resources financing long-term assets, it is possible to make use of assets and liabilities superposition technique in the context of terms. It helps to estimate the level of the imbalanced liquidity risk taken by a bank. The superposition technique could be presented in the form of a matrix. The matrices were made using the 2006 financial statements of Latvian commercial banks as the source of information. Off-balance sheet items were not taken into account by the authors due to two reasons: firstly, because not all commercial banks state their off-balance deals in their annual financial statements, secondly, because off-balance operations only insufficiently effect the imbalanced liquidity risk. See balance matrices in Tables 3-6.

Table 3. Matrix for maturity-matched assets and liabilities of the first group of commercial banks as of December 31, 2006 (ths.LVL)

<table>
<thead>
<tr>
<th>Assets/ Liabilities</th>
<th>Up to 1 month</th>
<th>1 to 3 months</th>
<th>3 to 6 months</th>
<th>6 to 12 months</th>
<th>1 to 5 years</th>
<th>Over 5 years</th>
<th>Others</th>
<th>Total assets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Up to 1 month</strong></td>
<td>1795559</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1795559</td>
</tr>
<tr>
<td><strong>1 to 3 months</strong></td>
<td></td>
<td>333861</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>333861</td>
</tr>
<tr>
<td><strong>3 to 6 months</strong></td>
<td>522534</td>
<td>460255</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>982789</td>
</tr>
<tr>
<td><strong>6-12 months</strong></td>
<td>369194</td>
<td></td>
<td>99202</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>468396</td>
</tr>
<tr>
<td><strong>1 to 5 years</strong></td>
<td>105545</td>
<td></td>
<td></td>
<td>3185631</td>
<td></td>
<td></td>
<td></td>
<td>3291176</td>
</tr>
<tr>
<td><strong>Over 5 years</strong></td>
<td>839426</td>
<td>67336</td>
<td></td>
<td>564136</td>
<td>275892</td>
<td></td>
<td></td>
<td>1746780</td>
</tr>
<tr>
<td><strong>Others</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>26891</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>3632248</td>
<td>401197</td>
<td>460255</td>
<td>99202</td>
<td>3185631</td>
<td>564136</td>
<td>302783</td>
<td>8645452</td>
</tr>
</tbody>
</table>

*Source: Latvian commercial banks’ annual reports 2006*
Table 4. Matrix for maturity-matched assets and liabilities of the second group of commercial banks as of December 31, 2006 (ths. LVL)

<table>
<thead>
<tr>
<th>Assets/Liabilities</th>
<th>Up to 1 month</th>
<th>1 to 3 months</th>
<th>3 to 6 months</th>
<th>6 to 12 months</th>
<th>1 to 5 years</th>
<th>Over 5 years</th>
<th>Others</th>
<th>Total assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1 month</td>
<td>834782</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>834782</td>
</tr>
<tr>
<td>1 to 3 months</td>
<td>23001</td>
<td>70767</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>93768</td>
</tr>
<tr>
<td>3 to 6 months</td>
<td></td>
<td>156909</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>156909</td>
</tr>
<tr>
<td>6-12 months</td>
<td></td>
<td>79590</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>79590</td>
</tr>
<tr>
<td>1 to 5 years</td>
<td>280771</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>406486</td>
</tr>
<tr>
<td>Over 5 years</td>
<td>84111</td>
<td>676</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>286440</td>
</tr>
<tr>
<td>Others</td>
<td>48920</td>
<td>10938</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>59965</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>1222665</td>
<td>70767</td>
<td>206505</td>
<td>90528</td>
<td>125715</td>
<td>201653</td>
<td>107</td>
<td>1917940</td>
</tr>
</tbody>
</table>

Table 5. Matrix for maturity-matched assets and liabilities of the third group of commercial banks as of December 31, 2006 (ths. LVL)

<table>
<thead>
<tr>
<th>Assets/Liabilities</th>
<th>Up to 1 month</th>
<th>1 to 3 months</th>
<th>3 to 6 months</th>
<th>6 to 12 months</th>
<th>1 to 5 years</th>
<th>Over 5 years</th>
<th>Others</th>
<th>Total assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1 month</td>
<td>1063529</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1063529</td>
</tr>
<tr>
<td>1 to 3 months</td>
<td>177513</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>177513</td>
</tr>
<tr>
<td>3 to 6 months</td>
<td></td>
<td>41129</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>41129</td>
</tr>
<tr>
<td>6-12 months</td>
<td></td>
<td>215640</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>215640</td>
</tr>
<tr>
<td>1 to 5 years</td>
<td>779040</td>
<td></td>
<td>264250</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1043290</td>
</tr>
<tr>
<td>Over 5 years</td>
<td>457975</td>
<td>181348</td>
<td>33190</td>
<td>159059</td>
<td>212798</td>
<td>68849</td>
<td>1113219</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>41821</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>2300544</td>
<td>358861</td>
<td>74319</td>
<td>374699</td>
<td>264250</td>
<td>212798</td>
<td>110670</td>
<td>3696141</td>
</tr>
</tbody>
</table>
As stated above, in the authors’ opinion, the maturity mismatcing between assets and liabilities is exposed as liquidity shortage or excess. Liquidity shortage is revealed in the case when long-term assets are financed by short-term liabilities, while liquidity excess is revealed in the case when a bank uses its long-term resources to fund its short-term assets. The results of calculations have exposed a predisposition of Latvian commercial banks to liquidity shortage. Long-term assets, financed by short-term liabilities in Tables 3-6 are displayed in bold. The authors called the ratio of these assets to the value of total assets as the imbalanced liquidity coefficient. The imbalanced liquidity coefficients are displayed in Fig. 5.

**Table 6. Matrix for maturity-matched assets and liabilities of the fourth group of commercial banks as of December 31, 2006 (ths.LVL)**

<table>
<thead>
<tr>
<th>Assets/Liabilities</th>
<th>Up to 1 month</th>
<th>1 to 3 months</th>
<th>3 to 6 months</th>
<th>6 to 12 months</th>
<th>1 to 5 years</th>
<th>Over 5 years</th>
<th>Others</th>
<th>Total assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1 month</td>
<td>131553</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>131553</td>
</tr>
<tr>
<td>1 to 3 months</td>
<td>3526</td>
<td>20250</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>23776</td>
</tr>
<tr>
<td>3 to 6 months</td>
<td>7956</td>
<td>16764</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>24720</td>
</tr>
<tr>
<td>6-12 months</td>
<td>8323</td>
<td>37383</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>45706</td>
</tr>
<tr>
<td>1 to 5 years</td>
<td></td>
<td>249055</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>249055</td>
</tr>
<tr>
<td>Over 5 years</td>
<td><strong>50918</strong></td>
<td></td>
<td>12334</td>
<td>139679</td>
<td>7389</td>
<td></td>
<td></td>
<td>210320</td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total liabilities</td>
<td>202276</td>
<td>20250</td>
<td>16764</td>
<td>37383</td>
<td>261389</td>
<td>139679</td>
<td>7389</td>
<td>685130</td>
</tr>
</tbody>
</table>

**Figure 5.** Latvian Commercial Bank’s Liquidity Imbalance Ratio at the end of 2006 (%)
The imbalanced liquidity coefficients have confirmed the above-made conclusions with regard to the degree of the assets and liabilities mismatch of Latvian commercial banks in the context of different bank groups. The techniques used by the authors in the assessment of Latvian commercial banks liquidity risk made it possible to draw the following conclusions: the state owned bank Mortgage bank has the best balanced structure of its assets and liabilities (see Fig. 4 and 5). Being conservative in the context of risk, Mortgage bank pays great attention to the control of risks, including the liquidity risk.

It is necessary to note that the bank had a big portfolio of credits. In the assets structure, the portfolio of loans at the end of 2006 made up 72%, which is the highest ratio in the context of bank groups (see Fig. 6).

A big proportion of loans demands a creation of adequate terms resource base. At the end of 2006, 58% of the resource base of the Mortgage bank was made up by its medium- and long-term resources, which had the following structure: 69% - commitments to credit institutions, 3% - deposits of private and juridical entities, 10% - the emission of mortgage bonds, 15% - the bank owned equity, 3% - subordinated resources. Thus, we can see that this bank has a well-diversified long-term resource base.

The 1st bank group – banks with foreign capital - is characterized by a sufficiently balanced liquidity level (11.7 % - the imbalanced liquidity coefficient and 18.4 % – the transformation coefficient). It is the biggest bank group – their share of assets in the system structure constitutes 58% (see Fig. 7). The majority of this group of banks is subsidiary companies of large European bank groups with a well-established risk management system.
The 2nd bank group – banks with mixed capital – are on the borderline of balanced liquidity (22.2% - the imbalanced liquidity coefficient and 26.75% - the transformation coefficient). This situation can be explained by the fact that several banks in this group have not yet fully introduced an imbalanced liquidity risk control system.

The 3rd bank group - banks with Latvian private capital - experience the most acute problems with imbalanced liquidity. This bank group share in the bank system assets constituted 25% in 2006 (see Fig. 7). The imbalanced liquidity coefficient of this group was 43.58% and the transformation coefficient was 51.7%, which testifies to the inadequate attention paid by the banks’ administration to the liquidity management. This group of banks was characterized by a large amount of demand accounts and term deposits - up to 1 month - resources (62% of total liabilities) (see Fig. 8). The greatest part of short-term deposits make an unstable bank resource base, so called „hot money”. Banks which invest their „hot money” into long-term or medium-term investments are highly exposed to the risk of imbalanced liquidity. Since this group of banks are quite active in crediting (the credit market share of this bank group being 20% (see Fig. 8) and their credit portfolio being 38.7% in the assets structure (see graph 6)), a considerable part of demand accounts and up to 1 month resources is used in credit operations.

The authors of the article strongly recommend that risk managers of this bank group should pay serious attention to the formation of long-term and medium-term liabilities, and, in particular, need to consider a possibility of issuing long-term debt securities, as well as possibility of attracting subordinated capital.

4. Conclusions
Based on the results of the research the authors have come to the following conclusions:

1. On the basis of the gap analysis results it has been established that the state-owned Mortgage Bank is characterized by the lowest risk of maturity mismatch. At the end of 2006, its liquidity gap for the time period from 1 to 5 years was slightly above 1% of Bank’s total assets. At the same time, this bank had the lowest up to 1 month gap ratio (10.7%) which is indicative of an insignificant redistribution of the bank’s current liabilities into short- and long-term assets.

2. It has been discovered by the authors that the 3rd group banks, whose capital belong to Latvian private business, had the highest up to 1 month gap ratio (33.5%) at the end of 2006. This indicated a surplus of current liabilities (with residual maturities up 30 days), a certain share of which was redistributed by the banks to cover their short-term and long-term active operations.

![Figure 8. Latvian Commercial Bank's Credit Portfolio Structure at the end of 2006, %](image-url)
3. The 1st group banks – established on the basis of foreign capital, and the 2nd group – mixed-capital banks, had a current gap ratio of 21.2% and 20.2% respectively.

4. The analysis of the long-term (over 1 year) assets and liabilities mismatching shows that it was the 3rd and the 2nd group banks that had the highest mismatch between asset-liability maturities characterized by the shortage of long-term resources. At the end of 2006 in the 3rd group of banks the liquidity gap ratio for the time period from 1 to 5 years was 21%, and for the time period over 5 years – 23.2%. In the 2nd group it was 14.6% and 6.4% respectively.

5. The computed results of the cumulative gap have revealed that the 3rd group banks are characterized by the highest maturity mismatches between liabilities and assets, which means that this particular bank group is exposed to a high liquidity risk.

6. The analysis of assets-liabilities structure also has revealed that it is the 3rd group banks that experience the most acute shortage of long-term resources: there was a 74.5% shortage of resources with residual maturities from 1 to 5 years and a 71.7% shortage of resources with maturities over 5 years at the end of 2006.

7. The second place with regard to long-term resources shortage was occupied by the 2nd group banks: at the end of 2006 the shortage of resources with residual maturities from 1 to 5 years was 69%, and for those over 5 years – 42%.

8. The 1st group of banks was characterized by the availability of certain amount of excess resources with residual maturities from 1 to 5 years (9%). On the other hand, the group had a sufficiently high deficit of resources with residual maturity over 5 years (51%).

9. The results of the analysis of variables showing the transformation of short-term resources into long-term assets have revealed that the 3rd group of banks had the highest transformation ratio (at the end of 2006 - 51.7%), which is indicative of the highest level of liquidity risk in this particular group. Mortgage Bank had the lowest transformation ratio (18.4%), which confirms the authors’ conclusion of comparatively good balance between the bank's assets and liabilities with regard to the residual maturities.

10. Based on the built up matrices of maturity-matched assets and liabilities, the authors have come to the conclusion that the state-owned Mortgage bank had the best matched structure of assets and liabilities (its liquidity imbalance ratio was 7.43% at the end of 2006). The 1st group banks were characterized by a relatively low liquidity risk (their liquidity imbalance ratio was 11.7 %). Mixed-capital banks with liquidity imbalance ratio of 22.2 % are included by the authors in substantial risk group. Banks with Latvian private capital had the biggest risk of maturity mismatch. In this group average liquidity imbalance ratio made up 43.6% at the end of 2006.

11. On the whole, the level of assets and liabilities balance in Latvia could be considered sufficient, although commercial banks should pay more attention to their liquidity management.

On the basis of the obtained results and conclusions the authors of the study have worked out the following recommendations for commercial banks on how to reduce the level of maturity and amount mismatches between assets and liabilities, as well as on how to improve the liquidity management.

1. For the purpose of comparing the levels of liquidity risk assumed by different banks, the authors propose to use the liquidity imbalance ratio as well as the liquidity gap ratios.

2. To constantly assess the level of liquidity positions on the basis of gap analysis.

3. To establish and regularly review the limits for the gap positions.
4. To determine the standard values of long- and short-term liquidity ratios in internal normative documents and to monitor the compliance with these ratios.
5. To carry out a complex assessment of the liquidity positions.
6. To work out and introduce into liquidity management practice a system of various internal as well as market indicators of potential liquidity problems at the bank.
7. To conduct the analysis of factors influencing the liquidity imbalance and to identify the most significant factors that can threaten liquidity.
8. To constantly conduct the analysis of active operations of banks with a view of establishing the level of high-liquid assets with a subsequent control over their dynamics.
9. To practice a short-term liquidity planning based on cash flows.
10. To carry out the assessment of the bank’s cash flows using a scenario analysis method (technique).
11. Under the threat of liquidity crisis, either to practice the regrouping assets, thus increasing the share of high-liquid resources, or to raise find additional capital through the following tools:
    - share capital increase;
    - acquiring subordinated liabilities;
    - term deposits placed by customers;
    - issuing debt securities;
    - raising interbank loans.

References

Abstract: Network analysis is one of the most popular methods of scientific research at present. The aim of the topic is to examine the specific features of entrepreneurship in network markets. Network goods are those goods which meet the following characteristics: complementarities; high economy of scale; network externalities; lock-in effects. These characteristics of network goods and network markets give some advantages and form some new problems for enterprises: prices, legislation problems, etc. Advantages: information and information exchange; flexibility; development of non-commercial organisations; social contacts. Problems: contradictions in the information; complexity of economic life; protection of information; price-decisions; legislation. It is important to construct the most effective business model, which is capable to be competitive and cooperative in the network markets.

Keywords: network analysis, network markets, network externalities, lock-in effects, path dependency, spillover effects.

1. Introduction
Network goods have become a very often-researched subject of scientific works recently. We would like to pay attention to the specific features of network goods and to their principle difference from traditional goods as well as to those advantages and disadvantages they give to SMEs.

The object of the research: a firm in the network economy.

The goal of the research: to show some new advantages and disadvantages of the network space for SMEs.

The methods applied: institutional analysis.

In our article we apply to sociological works on network analysis by D.Knoke, P. Marsden, S.Wasserman, B.Wellman, etc. We also apply to the works on network economic analysis by M.Castells, O.Shy. In the analysis of information and information rationality we pay attention to some works by H.Simon and K.Arrow. While examining lock-ins and switching costs as well as some special characteristics of network markets works by J.Farrell, P. Klemperer, Shapiro C.and Varian H. are of particular interest. We use Information Economy Report 2007-2008, United Nations as a data basis for the research.

2. Network researches and network economy
Network analysis origins from sociology works written in the end of XXth century (1). Methodological potential of network analysis is very high since it gives the possibility to describe the relationship between households and firms in the most rational way, to operate data as on the micro, as on the macro level. That’s the reason why network analysis in sociology has created the basis for developing socio-economic and economic network researches. Network methodology gives the opportunity to conduct interdisciplinary analysis.

Mr. M.Castells calls our modern global society “the society of network structures”, emphasising on the one hand their universal character, and on the other hand their determining character, when the power of a structure proves to be stronger, than the structure of a power, and the fact of one’s belonging to a certain structure becomes the most important origin of power and changes in a society (2). Networks are considered as structures, contributing to the development of a number of spheres, and leading to the globalisation of the world economy in the end.
A network as a decentralized controlling system becomes more and more important. While discussing the globalization of the world economy, one may very often come across the statement that the globalisation itself is not a new phenomenon, since the world has been global all the time. Sometimes there are references even to the Ancient Rome, under the aegis of which there was the most part of the antique world; to the medieval Hanseatic League, and to different global ideas, occupying the human society from time to time.

But the main specific feature of the modern globalisation is its global, in fact universal, nature; involvement of the world society into the open system of political, social, financial, economic and cultural connections based on the up-to-date communication and information technologies. The world has been always global in the physical sense, since it has represented a single whole - a physical foundation of the world civilisation. But in information and communication terms at the present stage of its development the world is just approaching the genuine globalization. During the century’s connections between different parts of the world used to be occasional and chaotic. Regular relations between Europe and non-European civilisations began to form only after the greatest geographical discoveries. But nevertheless the world was still a totality of nation-states till the XXth century, when the Westfalen System with its principal of national sovereignty climaxed in its development. Today the Westfalen System is at last being overcome with a truly globalised world being formed. Communication possibilities emerging thanks to the development of the communication facilities and Internet technology became the precondition of this process and diminished the costs of the information transmission at personal, production and international levels.

Networks are playing an important role in this process.

Firms built their internal and external connections on a network principle, and these processes take place in different cultural and national contexts. Network economy is of great importance at present.

Network goods should be determined through their characteristics:

- Complementarity
- High economy of scale
- Network externalities
- Lock-in effects

Complementarity means that consumers in network markets buy the goods which may be used with other goods of the network. In this way consumers buy not separate goods, but parts of a system, of a network. It is of great importance that the goods work on the same standard.

The cost structure of network goods differs from the one of traditional goods: the biggest part of the costs applies to the initial stage of the production process, but the further copy process costs very little in comparison with the initial costs. That means that a firm may have a very high economy of scale in network markets.

Network externalities cause the rising utility for consumers: every additional user enlarges the utility of a network for other consumers. The demand curve looks differently. The readiness to pay rises with the rise of the number of consumers. But after a certain moment the readiness to pay goes down, since all those who were ready to pay more for joining the network have already done it. That fact means that the network has reached its optimal size.

The main problem is – what size of a network may be looked upon as an optimal one? What size of a network should be considered a critical mass – a size of a network when joining it gives advantages to consumers? And if there is no critical mass yet, can we create or imitate it ourselves thus producing network externalities?

If we speak about network goods we should take into consideration lock-in effects. These effects mean forming of some behavioral stereotypes making it difficult for consumers to change producers. There is a possibility of forming institutional lock-ins, path dependency effects, etc (3).
Network markets are everywhere. Internet services, banking services, transport services, etc. Network effects are used in Christmas effects, network marketing, network advertising.

The number of Internet users is growing, and we notice the most rapid dynamics of this growth in transition economies.

**Table 1. Internet users by level of development and region**

<table>
<thead>
<tr>
<th>Region</th>
<th>2005</th>
<th>% Change 2005-2006</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>1,006,429,544</td>
<td>12.4</td>
<td>1,131,078,697</td>
</tr>
<tr>
<td>Developed economies</td>
<td>529,869,769</td>
<td>6.8</td>
<td>566,077,247</td>
</tr>
<tr>
<td>Asia</td>
<td>86,975,900</td>
<td>2.8</td>
<td>89,439,100</td>
</tr>
<tr>
<td>Europe</td>
<td>205,089,269</td>
<td>10.7</td>
<td>227,077,547</td>
</tr>
<tr>
<td>North America</td>
<td>220,860,600</td>
<td>4.6</td>
<td>231,060,600</td>
</tr>
<tr>
<td>Oceania</td>
<td>16,944,000</td>
<td>9.2</td>
<td>18,500,000</td>
</tr>
<tr>
<td>Developing countries</td>
<td>433,560,239</td>
<td>17.9</td>
<td>511,035,250</td>
</tr>
<tr>
<td>Africa</td>
<td>33,032,605</td>
<td>31.4</td>
<td>43,397,500</td>
</tr>
<tr>
<td>Asia</td>
<td>311,164,987</td>
<td>16.1</td>
<td>361,391,800</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>89,022,947</td>
<td>18.9</td>
<td>105,864,150</td>
</tr>
<tr>
<td>Oceania</td>
<td>339,700</td>
<td>12.4</td>
<td>381,800</td>
</tr>
<tr>
<td>Transition economies</td>
<td>42,999,536</td>
<td>25.5</td>
<td>53,966,200</td>
</tr>
</tbody>
</table>


The resembling situation is with mobile subscribers.

**Table 2. Mobile subscribers per 100 populations worldwide in 2002 and 2006**

<table>
<thead>
<tr>
<th>Region</th>
<th>Subscribers per 100 pop.</th>
<th>% change 2002-2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
<td>2006</td>
</tr>
<tr>
<td>Developed economies</td>
<td>11</td>
<td>29</td>
</tr>
<tr>
<td>Africa</td>
<td>4</td>
<td>21</td>
</tr>
<tr>
<td>Asia</td>
<td>11</td>
<td>28</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>19</td>
<td>53</td>
</tr>
<tr>
<td>Transition economies</td>
<td>12</td>
<td>69</td>
</tr>
<tr>
<td>Developed economies</td>
<td>64</td>
<td>91</td>
</tr>
<tr>
<td>World</td>
<td>19</td>
<td>41</td>
</tr>
</tbody>
</table>

Table 3. Growth in the number of mobile telephone subscribers worldwide, 2001-2005

<table>
<thead>
<tr>
<th></th>
<th>Subscriptions 2001</th>
<th>Subscriptions 2005</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developing countries</td>
<td>388 674 941</td>
<td>1 167 050 600</td>
<td>200.26</td>
</tr>
<tr>
<td>Africa</td>
<td>26 091 686</td>
<td>134 296 038</td>
<td>414.71</td>
</tr>
<tr>
<td>Asia and Oceania</td>
<td>278 511 819</td>
<td>793 375 236</td>
<td>184.86</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>84 071 436</td>
<td>239 379 326</td>
<td>184.73</td>
</tr>
<tr>
<td>Transition economies</td>
<td>22 325 131</td>
<td>185 068 576</td>
<td>728.97</td>
</tr>
<tr>
<td>Developed countries</td>
<td>553 610 317</td>
<td>804 830 507</td>
<td>45.38</td>
</tr>
<tr>
<td>World total</td>
<td>964 612 390</td>
<td>2 156 951 688</td>
<td>123.61</td>
</tr>
</tbody>
</table>


Modern SMEs work under the conditions of great flows of different sorts of information and they should operate this information in a proper way.

In the modern economy sometimes it is necessary to create a network or to become a member of a network for getting profits.

Specific features of network markets produce some special advantages and problems for the firms working in such markets.

3. Advantages and Disadvantages of network markets

First of all, we should say a few words about the transformation of the political system under the influence of the information processes. At a certain time the appearance of effective mass media played an important role in the formation of democratic states; we mean periodicals, books, and radio and TV a little bit later. Mass media diminish transaction costs of collecting the information and provide the deliberate participation of wider circles of the population in the political life of a society. During the past period a democratic nation state was created.

But a habitual model of democracy has been being gradually changed. The appearance and the development of Internet give the possibility to an unlimited number of persons to have an efficient access to a grate volume of information. Every citizen receives a possibility to turn to an unlimited auditorium, bearing almost zero costs. Some supporters of “teledemocracy” and “cyberdemocracy” appear. These conceptions mean, that more and more problems are solved on the basis of referendums, minimising the populist effects of the “plebiscite democracy”. So the ideas of creation of an effective civil society meet a necessary material basis thanks to the modern technologies. And the process of “electronic democratisation” overcomes national borders and becomes universal.

Political shifts determine further economic development, and we should pay attention to those main features connected with the spreading of economic and financial information as the next important sphere of the influence of information processes on the globalisation of the world economy.

Internet network and co-systems and technologies make information on markets and prices worldwide increasingly more available for potential market players. The world market -
being to some extent an abstract category - turns into a reality. A vivid example is mail-order trade via television or Internet, successfully operating in many countries.

New economic forms have been being built around global network structures, and access through such networks to knowledge and technological skills becomes considerably easier. The world economic system is becoming still more “transparent”. Capital is either global from the very beginning, or becomes global in the economy, forming around electronic networks.

The share of financial data is increasing. The development of Internet-technologies facilitates this process and creates a basis for the more efficient transmission of financial information. The information potential may be realised with maximum efficiency under the condition that the communication structures, mostly corresponding with new communication systems, have been worked out. These communication structures could lead to the possibility of distributing information flows at the optimum level.

In this case it is very important that the information exchange systems are formed beyond national and regional borders. Other more traditional forms of international cooperation (joint ventures, strategic alliances) carry limited possibilities for information exchange, while virtual networks allow it to be overcome. At present we witness international networks, which rapidly and successfully develop under the conditions of globalisation and the new information space. A total information space is being created. This space gives a number of positive externalities to those with access to it, and there are a lot of potential possibilities for its replenishment and quality improvement. Thus there is a possibility that the renovation of the information bank of a network may lead to the multiplication of positive externalities. MPS in this case is probably a percentage of closed information.

Besides financial and economic tasks, modern conditions of the economic space promote the development of international non-commercial organisations. The development of new means of communications has led to the possibility of creating and increasing the influence of different transnational non-commercial institutions. In future such organisations may undertake to solve a number of global problems and will be a serious, workable alternative to government mechanisms for solving similar problems.

One of the most significant effects of the influence of information over the process of globalisation is the enlargement of cultural connections between people from different regions and of different national traditions. Modern communication means (Internet, satellite television) provide every person with potential links to every other person, regardless of location or the distance separating them. Such possibilities create the basis for the formation of common cultural values and destroy widespread stereotypes. A modern person has an access to a large pool of information concerning behaviour models, culture and life styles, different from those, which are peculiar to his native environment. A modern person has better opportunities to evaluate these questions on his own, obtaining information more directly. So there is an interaction and an interconditionality of different cultures and this process is becoming still easier and more available as more means of communication emerge.

Thus, we can establish a general positive tendency of the influence of the information process over the globalisation of the world economy, permeated by all the aforementioned factors. This tendency means the overcoming or the softening of the asymmetry of information, the increasing of the volume of information available to a large number of people. Against this background, tariffs for communication services are being reduced worldwide. This tendency is supposed to continue in the near future and, according to some predictions, this reduction may even take the form of a dramatic drop in prices.

Now we shall turn our attention to some problems, arising in the process of globalisation of the world economy in connection with the broadening of the information space.
It is well known that very often a positive phenomenon gives rise to its reverse, resulting in some negative consequences. This is totally applicable to the informatisation of the society. We have already considered the fact that the information has become wider and more available for many people. But this great volume of information creates certain difficulties as well. Information volume continues to grow, and the inevitable contradiction arising at its origins creates contradictions in the information itself. Sometimes it is difficult even for specialists to deal with such information, not to mention ordinary people. Mr. Herbert Simon, in his article “Rationality as Process and as Product of Thought”, points out that information is of clear benefit only in a world, where there is a lack of information. However, he argues, where there is an information surplus it begins to play a negative role, drawing us away from something significant; in such circumstances, the real good is not the information, but attention (4).

All this is accompanied by the considerable complexity of economic life, and again on a global scale. Multinational corporations and banks evolve, the financial sphere broadens, exchange mechanisms become more complicated, etc. Today, the difficulty is not in receiving information, in treating it in a qualified way.

There are some difficulties in creation and further development of a network structure. It’s forming demands a formation of information flows between participants of that economic process for which it is being created. In this connection it is necessary to provide a rapid access of new participants to the existing information resources, a rapid setup of all participants to new information materials, a rapid construction of direct multilateral, mainly horizontal connections between participants. All this may be achieved with many difficulties.

There is a problem of protection in network markets. On the one hand it is necessary to provide an effective protection of the goods, but on the other hand if we exclude non-legal users we may lose a part of the network’s utility, since the number of users enlarge the utility of the network (5).

Another important problem is price-decisions. Modern technologies drastically modify market relationship. Some economists say that the situation looks like a perfect competition: minimal transaction costs, free access to information, low prices. But the rising utility of a network makes us think over a possibility to raise prices for network goods. High economy of scale diminishes the role of costs in price decisions. That means that the importance of supply in price decisions will fall, but the importance of demand in the process will rise.

![Fig.1. Structure of costs of network goods](image-url)
The above-mentioned lock-in effects may also influence price decisions. For example, great switching costs may make consumers stay in the system in spite of the fact that prices in the system are at high level. In his turn a producer may diversify goods and services inside the system creating a chain of short-term contracts, supporting high prices for certain goods. J.Farrel and P.Klemperer examine a special kind of equilibrium with switching costs, which differs from a classical equilibrium (6).

So standard demand-supply models may turn out not effective in network markets.

Another difficult problem is legislation. It often does not meet the demands of network markets.

A question concerning the influence of network markets is of great interest. This influence is very provocative.

On the one hand some spillover effects may promote the development of other industries. To some extent spillover effects may be looked upon as characteristics of network goods.

On the other hand network markets produce many problems for other industries. Network structures may cause negative selection, competing with qualified but weak non-network goods. Lock-in effects may promote old and not effective decisions. On a social level there is a possibility that we begin to choose not information but an origin of information.

The development of information and communication technologies influence social aspects, and this influence is not always positive. Mass media bring down an avalanche of information over people, and this information is very difficult for processing. It is appropriate to remind of Mr. A.Toffler’s ideas. Within a constant movement from one working place to another, from one domicile to another people lose the capability to think on their own, they have no time to “settle down”. At present, in the conditions of the enforcement of the globalization process, these tendencies become stronger.

Emphasising positive aspects of informatization, we have already mentioned that it expands the connections between people of different cultures. But there is an opposite side of the process, when traditional group connections are excluded by functional information connections, which will entail mutual alienation between people. Strange as it may seem, in the epoch of global changes and intercommunication of cultures centrifugal forces may be stronger than centripetal forces.

Factors of formation of a human personality change, as well as motivation and vision of world. Potential cognitive abilities together with mental outlook make people socially withdrawn. All these processes are not inoffensive while their influence on the human psychology.
It is necessary to pay particular attention to the asymmetry in the access to the information for different countries. The differences in material and educational level don’t give equal opportunities to all members of the international economic space. But the process of the information development goes on with increased speed, that’s why the gap in the provision with information is getting wider.

The instability in the intercommunication world becomes stronger; the tendency to the growth of social contradictions in connection with the difficulties of adaptation to new technologies is actual even for most developed countries. All these problems have arisen inevitably and are the consequence of the strong process of globalisation of the world economy. We should use some global mechanisms (international organisations, international talks), corresponding with the scale of the problems, to solve the problems.

It is time to take serious decisions on restructuring enterprises, public institutions, and administrative organisations. Applied researches are getting more urgent in the process of controlling network structures, the investigation in the motivation and psychological peculiarities of their participants, the foundation of a new corporate culture.

**4. Modified Firm’s Behavior**

IT has drastically changed the process of decision taking by economic subjects. Consumers’ behavior is changing, so is the one of firms. Maximized utility evidently remains its basis (from the point of view of orthodox-edge neoclassic principles), but the aim is realized otherwise: microsubject turns into active IT-user. We suppose to consider the ongoing changes at the firm’s level highlighting specific features of its activity against IT background.

Many years ago Ronald Coase, a prominent American economist, put the following question, ‘Why do firms exist?’ (7) The answer is that the firm allows decreasing transactional costs of the market coordination. If ‘spontaneous order’ saves transactional costs in volume of big groups, than hierarchy achieves the same outcome in volume of small groups that is within the firm’s structure. Modern IT allows decreasing transactional costs in many fields of the economy nearly to zero. It implies transactional costs connected with search for suppliers and buyers, selection of specific and interspecific resources and settlement of many other problems, which earlier required much more time and money.

Internet wields today so great influence on the firm’s activities that network possibilities are considered not as a competitive advantage, but as an essential prerequisite for doing business at the modern level, which is compliance with the world concept of the firm’s qualified activities. K. Kelly illustrates this idea as follows: ‘In the network economy the main objective of the firm is not maximized value of the firm, but maximized value of the firm’s network’ (8).

In the firm’s activities the Internet is still playing more important role as a network of networks. First, a company uses it only as one more marketing channel, than the Internet is beginning to be used to bring together all economic subjects, eventually transformation of the company is taking place, when many business processes are totally automated.

The new term ‘information proficiency’ of the company has been coined. It implies the ability of the company and the one of other institutions efficiently and systematically uses information to attain strategic objectives, a method to combine skills of the company with those advantages provided by electronic ways of exchange [9]. To become electronically profitable the company has to pursue a well-thought-out information policy, clear-cut information priorities, corporate culture covering information aspects, and finally highly qualified personnel able to perform tasks connected with information.

Modern studies show that the most competitive firms are those that are able to constantly improve themselves on the basis of technological innovations and introduce them. The idea of
learning-by-doing aimed at getting a competitive edge is widely being spread. K.J.Arrow, an American economist, was the first who set out the concept of learning in the course of production (10). It is a well-known microeconomic phenomenon at the level of a single firm. Its gist is that with production or investment process being performed in some particular field, a kind of skills that Arrow calls ‘lessons’ based on the aggregated experience are formed. They form competitive advantages for firms. So far such skills are substantially confined to accumulating organizational experience enabling to make use of more flexible management forms and thus to rapidly solve production problems at less transactional cost.

I. Nonaka, a Japanese economist, calls attention to the necessity to form the so-called ‘knowledge-creating company’, i.e. a company which can fast produce new and up-to-date methods of control and management by introducing cutting-edge technologies that provide tight communication links between different company units and ‘common cognitive base’ for interaction of the company’s employees (11).

In his other work co-authored with H. Takeuchi, I. Nonaka maintains this argument and underlines that vertical hierarchy, considered to be the most efficient management system in the industrialized society, is losing its importance in today’s circumstances. The problems are getting diversified and many-dimensional with communication with inferior layers getting less flexible. The bureaucratic structure operates well in a stable environment as being highly formalized, centralized, intended to standardize the working process, it perfectly conforms to tasks of a wide-scale production and, thus, it successfully operates in stable and mature sectors characterized by mainly rational and repeating types of activities. But bureaucratic control may suppress initiative and burden the company in periods of rapid change (12).

The organizational culture changes, in particular ethics of the firm. With horizontal relations and links narrow operational tasks, which employees face, are difficult to carry out. Occasionally administrative control is impossible to exercise. The remuneration system is modified to meet to a greater extent inner motivation of employees. The instructional forms are replaced with ethics of obligation to strengthen the positions the qualified and skilled workers take. With distinctions between managers and employees being eliminated, eradication of the system of formal control develops a kind of quasi-independent employment. An employee, being ‘an owner’ of some part of intangible means of production – particularized knowledge – and greatly controlling their own production is very much like self-employed.

Changes in communication between the company and its clients take place. The latter are also getting more flexible, selective and able to efficiently and successfully get adapted to the changeable conditions.

Thus, the company using the Internet for organizing its own operation faces a number of specific features not peculiar to companies in their traditional form.

First, the limits of the firm and its activities are changing. Intercompany interaction and cooperation with other firms become faster and less expensive. This statement is true for both structural and geographical aspects, as the company’s regional units can be involved in the communication mentioned. The company as a whole can make contracts and deals with far-away or remote contractors.

Second, firms succeed in greater transparency of their operations. The work of their employees gets more evident. There are fewer possibilities to conceal their own blunders and mistakes than before. Opportunistic behavior is getting less spread.

Pricing gets more transparent as information on prices are easily available in information space with possibilities to be compared. Clients can follow the process of execution of their orders. Suppliers can get in touch with their clients in case of disputes or uncertainty in decision taking. Production is being adapted to the requirements of the particular client – the process called ‘mass customization’.
Third, the time for inter-company transactions decreases. New flexible forms of organization and management, rapid capital flows, inter-institutional connections and increasing intensification of labor, all together lead to speeding up production process. The firm’s reaction time is also its competitive criterion, the extent of its adaptability to the ongoing economic processes influenced by new technologies and information shifts.

And, at last, fourth, the Internet promotes standardization in both software and Net behavior. It helps decrease costs connected with consumer behavior appraisal and operating costs.

A new organization form – a network company emerged in the globalized economy. The first company applied the module-structure was Nike, that enabled the firm to perform efficiently. Among the major advantages of module-structure we can name flexibility, ability to adjust and to meet changing demands of the market. It also has a number of drawbacks such as: lax control, great distance between employees, decreasing purely psychologically incentives and may result in lower productivity. That’s why new companies employed in virtual business tend to realize the set tasks.

5. Conclusions
We have to take into consideration these provocative advantages and disadvantages. All countries face many similar problems. The complexity of the situation in the globalisation of the world economy is also caused by a number of specific factors. But the integration to the modern global economy is not only desirable, but necessary for every country, and one of the first steps in this direction is the involving in the world information space, which creates preconditions for a successful participation in the world globalisation process.

In spite of all these contradictions the process of spreading of network structures is global, and modern SMEs should understand and use the possibilities of network markets.

References
NEW OUTSIDE BLOCKHOLDERS, PERFORMANCE AND GOVERNANCE IN GERMANY

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Abstract: In this paper we examine stock price reactions to announcements of large block purchases with German targets. We can show that the formation of new outside blocks leads to significant value creation for target shareholders, regardless the acquirer’s intention. Splitting the sample by acquirer intention indicates that activist and strategic blocks entail significantly higher abnormal returns than purely financial blocks. The positive effect of activist block purchases still persists when we control for other block- and target-specific factors in cross-section. We do not find a significant relation between incumbent ownership structure and announcement effects, sustaining the recent evidence that existing large blockholders do not necessarily play a significant role in disciplining management.

Keywords: Large blockholders, block purchases, corporate governance, event study

1. Introduction

Many theoretical analyses argue that the involvement of large shareholders in monitoring or control activities has the potential to limit agency problems (Shleifer and Vishny (1986), Maug (1998), and Noe (2002)). Empirical support for this argument has been provided by a number of studies. (e.g. Agrawal and Mandelker (1990), Hartzell and Starks (2003), Holderness (2003)). Results are, however, still ambiguous.

Most of the studies are static in nature, examining the impact of already existing large blockholders on firm performance or monitoring related variables like management turnover. In contrast, the body of empirical research on the dynamic effects of changes in ownership structure is considerably smaller. These studies investigate large block purchases and the corresponding market reactions to measure the wealth effect induced by large outside blockholders. Substantial empirical evidence shows that capital markets react positively to the formation of outside blockholders in anticipation of an increased takeover probability and enhanced monitoring (e.g. Choi (1991), Barclay and Holderness (1991)). Recent studies further document a strong influence of block- and target-specific characteristics on the realized wealth effects (e.g. Bethel, Liebeskind and Opler (1998), Park, Selvili and Song (2008)).

So far, the role of large blockholders appears fairly well explored, both statically and dynamically. However, the studies presented above focus entirely on the USA. In contrast, evidence on the role and effect of large blockholders in Europe is scare. Although a number of papers investigates the role of existing shareholders in this context (e.g. Franks and Mayer (2001), Dherment-Ferere, Köke and Renneboog (2004), Heiss and Köke (2004)), empirical evidence on the market reaction to new block formations is surprisingly sparse and inconsistent, especially with regard to Germany. We aim to fill this gap.

There are three specific characteristics of the German financial system that make us expect significantly lower abnormal returns to target shareholders than those observed in empirical studies that focus on the US market.

Firstly, the near absence of hostile takeovers and the low levels of merger activity in Germany relatively to the UK and the US suggest that there has been little or no market for corporate control in Germany. Although acquisitions of large block stakes may act as a substitute for the traditional market for corporate control (Franks and Mayer (2001), Köke
(2004)), this implies that one of the key explanations for the positive wealth effects of block purchases presented in US studies, namely the takeover anticipation hypothesis, is likely to play a substantially lower role in explaining market reactions to the formation of new blockholders. Hence, we would expect significantly lower abnormal returns than in the studies that focus on countries with active markets for corporate control.

Secondly, Germany in particular is characterized by a substantially higher ownership concentration than the US (La Porta, Lopez-de-Silanes and Shleifer (1999), Facchio and Lang (2002)). Becht and Boehmer (2003) document that over 80% of officially exchange listed German corporations have a minority blockholder controlling over 25% of the votes and that 65% are majority controlled. Hence, chances are high that block purchases in Germany take place in companies that already have at least one incumbent large shareholder. Conversely, this raises the question if the capital market also values incremental monitoring by an additional large blockholder, and whether this incremental benefit relates to block- and firm-specific characteristics. Thus, we expect lower abnormal returns than in countries that are characterized by a more diffused ownership structure such as the US or the UK.

Thirdly, private benefits of control are higher in Germany than in the US (Dyck and Zingales (2004)). Consequently, minority shareholders face a higher risk of expropriation by incumbent controlling shareholders. In turn, this may affect the distribution of wealth between the block acquirer and incumbent target blockholders. Theoretically, this should lead to lower abnormal returns to target shareholders than in countries with a low level of private benefits.

Given the above considerations, we will shed light on the economic implications of block purchases in Germany by studying a new set of data with 85 block purchases with German targets between 1997 and 2007. We focus on de-facto minority block purchases between 5% and 49.9% of target voting stock, since we want to detangle the wealth effects of implicit majority control transfers from block- and target-specific effects such as acquirers’ intention (e.g. activist investor) or target firms’ incumbent ownership structure.

We make four key findings: First, block purchases in German companies lead to positive abnormal returns on average, regardless of the identity of the buyer. Second, block purchases by activist investors are accompanied with significantly higher abnormal returns than purely financial block purchases. This finding leads to the conclusion that activist acquirers either have superior monitoring or target selection abilities. Third, target characteristics that are frequently related to effective monitoring such as the presence of incumbent large shareholders have at most a marginal effect on the market reaction. Fourth, the share price reaction is negatively correlated to target firms’ market capitalizations and valuation levels.

The remainder of the paper is structured as follows: Section 2 describes the empirical evidence on block purchases. In section 3 we discuss the sample selection procedure, relevant block- and firm-specific data and the econometric strategy. In section 4 we present univariate and multivariate analyses of share price announcement effects to minority block acquisition. Section 5 summarizes the findings and concludes.

2. Literature Review

Considering the US evidence, the majority of the early studies on the impact of block purchase on corporate performance find positive abnormal returns for the target upon the announcement of an accumulation of 5% or more of the common stock by an outside investor. In general, there are three main hypotheses that explain the source of value creation to target shareholders.

The “anticipated takeover bid hypothesis” is based on the notion that block purchases (or “toehold acquisitions”) can start an inter-firm investment process, implying that the positive valuation effect is due to investors’ perception of an increased probability of a subsequent takeover. Using a sample of 337 new large block formations during the period 1978-1980,
Mikkelson and Ruback (1985) examine the valuation effects of toehold acquisitions. They document that block purchases that are not followed by investment outcomes (e.g. takeovers, targeted repurchases) lead to significant negative abnormal returns for target shareholders in the post-toehold period. These results imply that the value increase at toehold acquisitions is an adjustment for the expected takeover premiums, and that the absence of takeovers makes investors revise downward the expected benefits of future takeover bids. Choi (1991) and Sudarsanam (1996) confirm these findings and further identify the increased probability of an external or internal control transfer as a potential source of value gains to target shareholders. Accordingly, the “monitoring hypothesis” (or “control transfer hypothesis”) states that block purchases increase the probability of control transfers, which is expected to increase the target firm’s management efficiency and thus future performance. Supporting the monitoring hypothesis, Holderness and Sheehan (1985) and Barclay and Holderness (1991) find that block purchases are typically followed by abnormal stock price appreciations and also increased management turnover for both purchases by “corporate raiders” and negotiated block trades, respectively.

Finally, the “undervaluation hypothesis” states that block purchases are generally attempted by investors, who either possess private information or superior security analysis skills, enabling them to ascertain that the target’s shares are temporarily undervalued. There is, however, no robust empirical validation of this hypothesis, given the methodological problems to identify exactly a state of temporary undervaluation (Holderness and Sheehan (1985), Shome and Singh (1995)). Since the mid 1990s, empirical evidence on the wealth effects of block purchases has focused increasingly on cross-sectional relationships between the observed share price reactions and block- or firm-specific characteristics. With regard to block-specific characteristics, especially the identity and intention of the acquirer has drawn attention. Shome and Singh (1995) document significantly higher abnormal returns to target shareholders if the acquirer of the block is either a corporation or an institutional investor. They attribute this finding to increased market power and future synergies and to efficient-monitoring, respectively. Distinguishing between activist, strategic and financial blocks, Bethel, Liebeskind and Opler (1998) document significant abnormal returns for target shareholders upon the announcement of block purchases by activist investors. In contrast, they only find marginally positive and slightly negative abnormal returns for financial and strategic blocks, respectively.

Recent studies also take into account the interaction between block- and target-specific characteristics. For example, Akhigbe, Madura and Spencer (2004) and Park, Selvili and Song (2008) document a significant impact of control related firm-specific characteristics. Basing their argumentation on the monitoring hypothesis, they state that the incremental benefit from an additional outside shareholder significantly depends on the target firms’ existing internal and external monitoring mechanisms such as managerial ownership or leverage.

Whilst there has been considerable empirical support for positive wealth effects in the US, evidence on the impact of block purchases in European economies is sparse. Only few studies explicitly examine the capital market reaction to the announcement of block purchases in this context. Banerjee, Leleux and Vermaelen (1997) analyze the effects of non-controlling stake purchases for a sample of 122 French listed companies by holding and non-holding firms. Stake purchases by non-holding companies generate significant abnormal returns whereas similar operations by holding companies do not affect target value significantly. This result suggests that large blockholders per se do not guarantee effective monitoring, supporting the above US evidence on the influence of blockholder identity. Croci (2007) analyses 136 block purchases by 15 well-known corporate raiders (e.g. Guy Wyser-Pratte) in Europe between 1990 and 2001. He documents a positive market reaction to the first public announcement for
the entire European sample, supporting the US evidence on positive wealth effects from activist block formations. Although these findings do not contradict the US evidence, they do not explicitly account for cross-sectional block- and target-specific characteristics.

However, several studies provide German evidence on the link between *existing* large blockholders and firm performance. Analyzing 715 German takeovers during 1980 and 1995, Boehmer (2000) shows that neither the bidder’s ownership structure nor the bidder’s ownership identity have an impact on the economic value of the transactions. Given his initial hypothesis that effective monitoring by large blockholders should lead to value enhancing transactions, he concludes that high concentrated ownership per se only has a modest cross-sectional effect on German firms. Accordingly, Franks and Mayer (2001) show that *existing* large shareholdings are not important in explaining differences in management disciplining for a sample of poorly performing German firms. Dherment-Ferere, Köke and Renneboog (2004), who use large panels for Belgian, French, German and UK firms, confirm this result. Neither existing blockholders nor creditors play an active role in disciplining management in poorly performing German firms. However, block purchases, i.e. the formations of *new* large blockholders, may have a monitoring role in Germany.

To sum up, there is no consistent empirical evidence on capital market reaction on the announcement of block purchases in Germany or other comparable European governance systems. A clarification of the value consequences of block purchases in this context is needed.

### 3. Data and Methodology

#### 3.1 Minority block purchases

Relevant block purchases were identified using the SDC/Thomson One Banker Deals database. The initial sample comprises all 12,328 completed M&A transactions with German targets from 1997-2007. We then use 9 criteria to further specify the sample: (1) The acquired block size is 5% to 49.9%; (2) The initial ownership of the block acquirer is 0%; (3) The target is no financial services firm; (4) The target is a public company and daily stock prices for the period $t_{-20}$ to $t_{+20}$ are available; (5) de-facto minority acquisition (no indirect formation of majority control blocks); (6) Acquisition by outside investor; (7) Identity of acquirer and specific size of acquired stake known (in % of voting stock); (8) Accounting data and consistent ownership information available; (9) No material confounding news announcements within the 10 days around the announcement day $t_0$.

Following Choi (1991), we define outside minority blocks as investors who own more than 5% but less than 50% of the target’s firm voting stock after the purchase (criterion (1)). As we are only interested in the formation of *new* outside blocks, we require the initial ownership to be 0% (criterion 2). We further exclude financial services firms (criterion (3)) to guarantee the comparability of accounting data across the sample companies. Using criterion (4), we only include companies with sufficient return data for the estimation of the market model parameters. Applying criteria (1) to (4), we derive 218 transactions. As we are only interested in de-facto
Table 1: Sample Selection

This table shows the total number of completed M&A transactions with German target over the 10 year period from 1997 to 2007 initially obtained from the SDC/Thomson One Banker Deals database and the number of transactions included after the application of defined selection criteria (1) to (9).

<table>
<thead>
<tr>
<th>M&amp;A transactions with German target (1997-2007)</th>
<th>Number</th>
<th>% of all reported transactions</th>
<th>% of initial minority block purchases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Screened after criteria (1) and (2)</td>
<td>1,252</td>
<td>10.2%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Screened after criterion (3)</td>
<td>1,134</td>
<td>9.2%</td>
<td>90.6%</td>
</tr>
<tr>
<td>Screened after criterion (4)</td>
<td>218</td>
<td>1.8%</td>
<td>17.4%</td>
</tr>
<tr>
<td>Screened after criterion (5), (6) and (7)</td>
<td>144</td>
<td>1.2%</td>
<td>11.5%</td>
</tr>
<tr>
<td>Screened after criterion (8)</td>
<td>100</td>
<td>0.8%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Screened after criterion (9)</td>
<td>85</td>
<td>0.7%</td>
<td>6.8%</td>
</tr>
</tbody>
</table>

Minority block purchases by outside investors, we apply criteria (5) and (6) to control for minority purchases that lead to de-facto control blocks (e.g. if the acquirer was holding additional stock options prior to the reported minority block purchase) and for minority block purchases of insiders or affiliated companies. The control for the formation of de-facto control blocks is particularly important, since private benefits of control and thus the potential of minority shareholder expropriation are relatively high in Germany (Nenova (2003), Dyck and Zingales (2004)). The inclusion of acquisitions of de-facto majority control would probably lead to biased results. Hence, we use the Factiva news database and ownership information from Hoppenstedt Börsenführer and the BaFin database on holdings of voting rights (“Stimmrechtsdatenbank”) to identify de-facto acquisitions of majority control as well as block purchases by insiders. Applying criterion (7), we only include those deals where the identity of the acquirer and the exact size of the acquired block is known.

The exact identity of the investor is important for the further cross-sectional analysis of abnormal returns. For the same reason, we are also interested in the exact size of the acquired stake by investor. Thus, we have to exclude most consortial block acquisitions, as the acquired stake size is generally reported as a total and not by acquiring party. Criterion (8) ensures that we can test hypotheses with regard to the firm-specific financial performance and ownership structure. We obtain accounting data from Thomson’s Worldscope database and ownership information for the quarter before and after the block purchase from Hoppenstedt Börsenführer, BaFin Stimmrechtsdatenbank and the ownership module of Thomson One Banker. Combined, these sources offer a fairly precise picture of the target’s ownership structure in the quarter prior to the transaction. Finally we control for material events such as M&A transactions or earnings surprises (criterion (9)) within the 10 days around the announcement of the block purchase at to in order to isolate the economic effect of the transaction. Our final sample contains 85 transactions that fulfill all of the above criteria.

**Block characteristics**

When examining the wealth effect of new block formations for target shareholders, one has to take into account that the explanation of the effect could be a distribution of both, block characteristics and target specific factors. With regard to block characteristics, several studies show that there are significant differences between the various types outside blockholders, especially among institutional investors (e.g. Gaspara, Massa and Matos (2005), Cronqvist and Fahlenbrach (2007)). Hence, the use of a formal classification scheme for the type of outside investor does not seem appropriate to capture the effect of the underlying economic intention of the individual block purchase. For example, a non-financial company may on the one hand build up a minority position in another non-financial company with the intention to found or to further strengthen a strategic collaboration. On the other hand, the company may also regard the investment as purely financial and not even intend any business affiliation.
with the target. Taking into account this differentiation, we follow Bethel, Liebeskind and Opler (1998) who distinguish between three types of outside block purchases according to their inherent intention: (1) activist blocks, (2) strategic blocks and (3) financial blocks. They define activist block purchases as those made by investors that are known for activist policies in the past and those with announced intention to influence corporate policy. Block acquisitions that are made by other companies and that are unopposed by management are considered strategic. Financial block purchases are those made by banks, pension funds, money managers, and individuals who do not act as an activist investor.

Following this definition, we require for a block to be considered as an activist that the acquirer explicitly states that he will attempt to actively influence the management of the firm in order to increase firm value or to be known for activist policies in the past. We expect the wealth effect of activist blocks to be higher than that of financial blocks.

With regard to strategic block purchases, Chan et al. (1997) show a positive market reaction to announcements of both horizontal and non-horizontal strategic alliances, even when there is no equity participation. Allen and Phillips (2000) show that block purchases that are accompanied by strategic agreements and alliances result in significantly larger excess stock returns to target shareholders when compared to block purchases by companies that are not associated with strategic intentions. Hence, we further narrow our definition and consider only those blocks as strategic where either the acquirer or the target management explicitly states that the deal rational is strategic. In turn, the block purchases by corporations that do not have a strategic intent are classified as financial block purchases in our sample. In order to systematically classify the block purchases, we screen all news announcements around the block purchase in the Factiva database for relevant information and classify the transactions accordingly. Apart from the type of intention, the size of the acquired block is likely to affect potential monitoring activities by the partial acquirer. Blockholders owning large stakes are more likely to monitor management actions since they face a liquidity problem (Maug (1998)). Furthermore, the likelihood that the benefit of monitoring exceeds the cost increases with the size of the blockholding (Park, Selvili and Song (2008)). Consequently, we include into our sample the proportion of target voting stock acquired as a measure for block size. We further identify those block purchases made with stated takeover intention, since the observed wealth effect from these transactions might partially reflect an anticipated change in majority control. Finally, we also identify those block acquisitions that are made via private placements instead of an open market transaction or a block transfer. Several studies (e.g. Hertzel and Smith (1993), Hertzel et al. (2002), Barclay, Holderness and Sheehan (2007)) report a positive market reaction to most types of private placement announcements. Hence, we control for this effect in order to correctly assess the economic impact of the corporate governance related block- and target-specific characteristics. Panel A of table 2 presents descriptive statistics on block characteristics. Financial blocks represent nearly half (48.2%) of the total transactions in our sample. Activist and strategic block purchases account for 21.2% and 30.6% of all transactions, respectively. The average size (% of voting stock) of the block purchase is 16.5%. Comparing the block parameters by block type, we find that strategic blocks are on average larger than activist and financial blocks. They also in here a takeover intention more frequently. Naturally, none of the purely financial blocks in our sample has a takeover intention.

3.3 Target characteristics

Apart from block-specific characteristics, we are interested in the ownership structure of the target company. The presence of large shareholders is generally regarded as beneficial, since their monitoring or control activities have the potential to limit agency problems. Conversely, this implies that if the target company already has one or more large blockholders
prior to the block purchase, the incremental monitoring-related benefit from an additional large blockholder is likely to diminish. Thus, we include three proxy variables into our sample to control for target ownership structure. We first count the number of ownership blocks holding at least 5% of voting stock in the quarter prior to the block purchase. We then measure ownership concentration as the total proportion of voting stock held by these large blocks. We also identify those targets that have at least one controlling shareholder holding over 25% of voting rights. In this case, at least one incumbent shareholder holds a blocking minority (25-50%) or even majority control (>50%). We expect lower incremental benefits from a new large blockholder in the presence of incumbent large blockholders and thus a weaker capital market reaction. Second, we include additional financial information about the target companies that have a potential effect on the market reaction. We distinguish between factors affecting potential benefits through incremental monitoring and other factors. Considering factors that relate to the monitoring hypothesis, Helwege, Pirinsky and Stulz (2005) assume that the level of information asymmetries decreases with firm size. They argue that larger firms are more frequently monitored by analysts, institutional investors and regulators. We therefore measure the target’s market capitalization prior to the block purchase \((t_{-21})\) as a proxy for firm size. Debt can be regarded as an external corporate governance device, since it can reduce the agency cost between management and owners (Jensen (1986)). The higher the target’s level of debt prior to the block purchase, the lower we expect the incremental monitoring benefit from a new blockholder. Therefore, we include the debt ratio into our sample to proxy the extent of the monitoring effect of debt.

Unrelated to the monitoring hypothesis, stake purchases might also be perceived as a signal that the target company is undervalued (Banerjee, Leleux and Vermaelen (1997)). We therefore include the market-to-book ratio to proxy target firms’ valuation levels. Panel B of Table 2 summarizes target firm characteristics of the sample.

3.4 Method of measuring abnormal returns
To assess the value implication of the block purchase on the remaining shareholders, we use standard event study methodology. Expected returns are generated from the market model parameters, estimated with daily returns from 220 days before the block purchase announcement \((t_{-220})\) to 21 day before the announcement \((t_{-21})\). Adjusted prices (taking into account dividend payments and relevant changes to the capital structure) are used to calculate stock returns.

The CDAX9 is used as a proxy for the market returns. Abnormal returns (ARs) are calculated as the difference between actual returns and estimated returns from the market model in the event window. Following the suggestion by Harrington and Shrider (2007), we use the test statistic of Boehmer, Musumeci and Poulsen (1991) to test the significance of cumulated abnormal returns.
Table 2: Sample description of block characteristics

This table describes the data collected for the description of new block characteristics. The acquired block size is measured as the proportion of targets’ common stock acquired. Takeover intention is a binary variable that takes on the value of 1 if the block purchase is made with an expressly stated takeover intention. Private placement is binary variable that takes on the value of 1 if the transaction is a private placement. The percentages for acquired block size, takeover intention and private placement represent the fraction of the total number transactions by block type (i.e. by column). Block concentration is measured as the sum of voting stock held by all blocks >5%. The number of ownership blocks represents the number of all ownership blocks >5%. Presence of controlling shareholder is a binary variable that takes on the value of 1 if the target firm has an incumbent large shareholder holding at least 25% of voting stock in the quarter prior to the transaction. Market-to-book ratio is defined as the market value of common equity to the book value of common equity at the end of the estimation period ($t_{21}$). Debt ratio is defined as the as the book value of debt (Worldscope item 03255) divided by the firm value (Worldscope item 03255 + market value of equity at $t_{21}$). Market value represents the market value of targets’ common equity at $t_{21}$.

Panel A: Sample description of block characteristics

<table>
<thead>
<tr>
<th>Acquiring block type</th>
<th>All blocks</th>
<th>Activist blocks</th>
<th>Strategic blocks</th>
<th>Financial blocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of observations</td>
<td>85</td>
<td>18</td>
<td>26</td>
<td>41</td>
</tr>
<tr>
<td>Percentage of total sample</td>
<td>100.0%</td>
<td>21.2%</td>
<td>30.6%</td>
<td>48.2%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Acquired block size by class</th>
<th>5% - 15%</th>
<th>15% - 25%</th>
<th>25% - 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>51.8%</td>
<td>18.8%</td>
<td>29.4%</td>
</tr>
<tr>
<td>Median</td>
<td>61.1%</td>
<td>11.1%</td>
<td>27.8%</td>
</tr>
<tr>
<td>Stdev.</td>
<td>23.1%</td>
<td>19.2%</td>
<td>57.7%</td>
</tr>
<tr>
<td>Takeover intention</td>
<td>6</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Number of blocks by block type</td>
<td>7.1%</td>
<td>11.1%</td>
<td>15.4%</td>
</tr>
<tr>
<td>Private placement</td>
<td>11</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Number of blocks by block type</td>
<td>12.9%</td>
<td>16.7%</td>
<td>11.5%</td>
</tr>
</tbody>
</table>

Panel B: Sample description of target characteristics by acquiring block type

<table>
<thead>
<tr>
<th>Ownership characteristics</th>
<th>All blocks</th>
<th>Activist blocks</th>
<th>Strategic blocks</th>
<th>Financial blocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Block concentration (&gt;5% blocks)</td>
<td>44.4%</td>
<td>42.3%</td>
<td>42.6%</td>
<td>46.5%</td>
</tr>
<tr>
<td>Mean</td>
<td>44.3%</td>
<td>42.1%</td>
<td>38.6%</td>
<td>50.5%</td>
</tr>
<tr>
<td>Median</td>
<td>2.3</td>
<td>2.7</td>
<td>2.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Number of large blocks</td>
<td>2.0</td>
<td>2.5</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Presence of controlling shareholder</td>
<td>50</td>
<td>9</td>
<td>15</td>
<td>26</td>
</tr>
<tr>
<td>Number of blocks by type</td>
<td>58.8%</td>
<td>50.0%</td>
<td>57.7%</td>
<td>63.4%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial characteristics</th>
<th>All blocks</th>
<th>Activist blocks</th>
<th>Strategic blocks</th>
<th>Financial blocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market-to-book ratio</td>
<td>5.3</td>
<td>1.5</td>
<td>2.5</td>
<td>8.8</td>
</tr>
<tr>
<td>Mean</td>
<td>1.5</td>
<td>1.3</td>
<td>1.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Debt ratio</td>
<td>36.1%</td>
<td>31.5%</td>
<td>40.5%</td>
<td>35.4%</td>
</tr>
<tr>
<td>Mean</td>
<td>33.3%</td>
<td>23.8%</td>
<td>44.6%</td>
<td>33.3%</td>
</tr>
<tr>
<td>Market value [€ Mio.]</td>
<td>797.8</td>
<td>332.8</td>
<td>118.8</td>
<td>1432.6</td>
</tr>
<tr>
<td>Mean</td>
<td>86.7</td>
<td>212.2</td>
<td>52.5</td>
<td>112.7</td>
</tr>
</tbody>
</table>
4. Results

4.1 Announcement Effects

Table 3: Cumulative average abnormal target returns

This table shows the average cumulative abnormal returns for the total sample 85 minority block acquisitions and for the 3 sub-samples by acquirer category. Statistical significance at the 1%, 5%, and 10% level is denoted with ***, **, *. The statistical significance is tested using the test-statistic of Boehmer, Musumeci and Poulsen (1991) (z-statistics) and the standard t-test (t-statistics).

<table>
<thead>
<tr>
<th>Event time period</th>
<th>Panel A: Total sample (N=85)</th>
<th>Panel B: Activist blocks (N=18)</th>
<th>Panel C: Strategic blocks (N=26)</th>
<th>Panel D: Financial blocks (N=41)</th>
</tr>
</thead>
<tbody>
<tr>
<td>[-20;20]</td>
<td>10.7% 3.54*** 4.42***</td>
<td>12.1% 2.73** 3.59***</td>
<td>13.1% 2.39*** 3.01***</td>
<td>5.3% 3.33*** 3.06***</td>
</tr>
<tr>
<td>[-10;10]</td>
<td>9.4%  5.59*** 5.74***</td>
<td>11.5% 5.22*** 5.81***</td>
<td>11.3% 4.45*** 5.21***</td>
<td>3.6% 2.86*** 3.33***</td>
</tr>
<tr>
<td>[-5;5]</td>
<td>8.7%  6.47*** 6.49***</td>
<td>11.9% 5.94*** 6.69***</td>
<td>11.9% 6.61*** 7.56***</td>
<td>2.8% 2.63*** 3.01***</td>
</tr>
<tr>
<td>[-2;2]</td>
<td>8.1%  6.61*** 6.80***</td>
<td>11.2% 7.33*** 6.23***</td>
<td>11.8% 6.52*** 7.56***</td>
<td>6.2% 3.39*** 3.18***</td>
</tr>
<tr>
<td>[-1;1]</td>
<td>8.0%  6.52*** 7.56***</td>
<td>11.2% 6.16*** 6.55***</td>
<td>11.8% 5.97*** 6.2%</td>
<td>6.2% 3.39*** 3.18***</td>
</tr>
<tr>
<td>[-1;0]</td>
<td>5.3%  5.54*** 5.97***</td>
<td>11.8% 6.16*** 6.55***</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Figure 1: Cumulative average abnormal returns

Table 3 documents the average cumulative abnormal returns and test statistics for the total sample (panel A) and for the three sub samples by block type (panel B, C and D). The results from panel A suggests that purchases of minority blocks lead to a statistically significant positive market reactions. The average abnormal return amounts to 8.0% ($z = 7.56$) in the event window [-1, 1].

Panel B and C show that both activist and strategic block purchases lead to statistically positive announcement effects. Average cumulative abnormal returns in the event window [-1;1] amount to 11.8% ($z = 6.55$) for activist blocks. We also find strategic block purchases to create significant value to target shareholders. The average cumulative abnormal return of transactions with strategic intend is 11.3% ($z = 5.43$) in the event window [-1;1]. Panel D shows that the market also reacts positively to financial block purchases. However, the wealth
effect is significantly lower than for activist and strategic blocks. Figure I illustrates a dynamic view on the development of the cumulative abnormal returns in the [-10; 10] event window.\textsuperscript{10} The results show that there is a run-up in stock prices before the event. Here are two possible explanations for this observation. First, a large amount of the block purchases is carried out through open market purchases, and it can take months to accumulate a stake for which an official notification is required. As a consequence, the market may already react to increased buy-side pressure before an official announcement of a new block formation.

Second, there is a potential lag of 9 days between the actual block purchase and the mandatory public announcement.\textsuperscript{11}

Hence, it cannot be ruled out that information on the transaction is already known to individual market participants prior to the official announcement date. Summing up, our approach to examine minority block purchase in Germany reveals a value creation to targets’ shareholders for all minority block types. At the first glance, the univariate analysis also seems to confirm our initial hypothesis that activist and strategic blocks hold more potential for value creation than financial blocks. However, the sample statistics presented in Table 2 suggest systematic differences in block and target company characteristics. In order to control for these factors, we conduct multivariate analyses in the following section.

### 4.2 Determinants of abnormal returns

We design four regression models to determine the drivers of the observed wealth effects to target shareholders. The abnormal return in the period [-1; 1] serves as dependent
Table 4 summarizes design and results for the four regression models. All test statistics are computed using White’s heteroskedasticity-consistent covariance matrix (White (1980)).

The variables included into our model are structured following our initial hypotheses on the factors that potentially explain the observed wealth effect.

We include five variables to control for block-specific “takeover intention” and “private placement” is each dummy variables taking on the value 1 if the attribute is true. “Block size” is a metric variable that measures the size of the new block as the proportion of voting stock acquired. We also proxy target company characteristics via a predefined set of variables and distinguish between target ownership characteristics and target financial characteristics. A total of three variables is used to describe the ownership structure of the target prior to the acquisition. “Concentration of existing blocks” equals the combined share of voting rights of all blocks bigger than or equal to 5%. “Number of blocks” represents the number of all blocks larger than 5%. The dummy variable “presence of controlling shareholder” takes on the value of 1 if the target company has a controlling blockholder (>25% voting rights) in the quarter prior to the block purchase. With regard to the target’s financial characteristics, we include three variables (“logarithm of market value”, “debt ratio”, and “market-to-book ratio”).

In order to shed light on the drivers of the wealth effect to target shareholders, we first design a model that does not control for the intentions of the block acquirer. Hence, we omit the dummy variables “activist block”, “strategic block” and “takeover intention” from the estimation model 1. We then include these variables again in models 2 to 4, where we explicitly control for the type of blockholder and takeover intention. Models 2 to 4 only differ in the variables used to control for the targets’ ownership structure prior to the acquisition, since the underlying economic hypotheses for each variable differ from each other.

We refrain from jointly using the variables “concentration of existing blocks”, “number of existing blocks” and “presence of controlling shareholder” in one model to avoid a multicollinearity problem. Comparing model 1 to the other models, we see that the inclusion of block intention significantly influences the regression results. The coefficients of the variables “block size” and “concentration of existing blocks” still have the expected sign, but are not statistically significant anymore. In contrast, the coefficient of the activist dummy is positive and highly significant for models 2, 3 and 4, suggesting that activist blocks have a greater monitoring potential than purely financial blocks.

This result supports the findings of Bethel, Liebeskind and Opler (1998) and Park, Selvili and Song (2008). However, it may also be the outcome of systematic differences in target selection, Cronqvist and Fahlenbrach (2007) provide evidence that block purchases by activists can be rather associated with influence on corporate policy and firm performance than with a selection explanation. In line with the US evidence we interpret our findings in a way that the positive abnormal returns around activist block purchases in our sample stem from positive capital market expectations with regard to beneficial monitoring activities.

Inconsistent with the univariate results, the regression models show that strategic blocks do not have a significant positive effect when abnormal returns are controlled for block and target characteristics. Block size and takeover intention both have a positive coefficient as expected, but are not statistically significant. Consistent with model 1, the dummy variable for private placement has a negative and insignificant coefficient.

Considering the ownership structure of the target prior to the block purchase, we find negative coefficients for all proxy variables as initially hypothesized. However, only the number of blocks in model 2 shows a statistical significance. If the capital market valued either ownership concentration or the presence of large blockholders, we would expect an immediate market reaction to an announcement of any substantial change affecting these factors. This result indirectly supports recent evidence by Beiner et al. (2006) who show that
neither the presence of a controlling shareholder nor large blockholders have a significant valuation impact. The finding is also consistent with Dherment-Ferere, Köke, and Renneboog (2004) who report that large shareholders do not play a significant role in disciplining underperforming management.

Regarding targets’ financial characteristics, the debt ratio has no significant impact on the market reaction. Although we would have expected a negative correlation between leverage according our initial hypothesis, this result supports Dherment-Ferere, Köke, and Renneboog (2004) who cannot find robust evidence of creditor monitoring in German companies with high leverage. The coefficients for firm size and market-to-book ratio are negative and significant also when we control for block intention. With regard to firm size, this result suggests that the incremental benefit from new outside blockholders in large firms is likely to diminish, given the increased extend of external monitoring by analysts, regulatory authorities and other parties.

Our finding that abnormal returns to target firms’ shareholders tend to be higher for companies with low valuation levels (reflected by a low market-to-book ratio) may be subject to two different effects. On the one hand, the capital market might perceive a block purchase in a target with a low market-to-book ratio as an undervaluation signal. On the other hand, one can interpret this result as an indication for decreasing incremental monitoring benefits from new large blockholders in the presence of high growth opportunities. As the discretion on the part of management may be higher in high growth companies (Helwege, Pirinsky and Stulz (2005)), external monitoring by large outside blockholders might become inefficient.

5. Conclusions and Outlook

In this study we investigate share price reactions to the formation of new minority outside blocks for a sample of 85 German block purchases between 1997 and 2007.

In the first part, we document a significant wealth creation for target companies, regardless of the economic intention of the acquirer. Most importantly, this finding is consistent with the US evidence, despite the structural differences initially discussed. Given the low takeover activity in Germany, we attribute the observed wealth creation to either the monitoring or the undervaluation hypothesis. We then analyze whether the market reacts differently to block purchases based on block and target characteristics. We can only confirm a significant positive relationship between activist block purchases and abnormal returns when we jointly control for other block- and target-specific characteristics. However, we cannot clearly distinguish if the driver of this effect is the market’s perception of a superior monitoring ability by activist investors or rather superior stock picking skills. Considering target characteristics, our results also suggest that existing target ownership structure has at most a marginal impact on the amplitude of the market reaction. We interpret this finding as a dynamic (i.e. based on the observed capital market reaction) confirmation of the recent, mostly static (i.e. based on regression analysis of accounting measures) evidence that there is no significant relation between ownership concentration and large blockholders on the one hand and firm value (Beiner et al. (2006)) or effective monitoring (Dherment-Ferere, Köke and Renneboog (2004)) on the other hand.

Validations of this interpretation in further detail should be a fruitful topic for future research.

Footnotes

1. A large shareholder (blockholder) is generally defined as an entity that owns at least 5% of a firm’s outstanding shares.
2. Faccio and Stolin (2006) show that bidding firms may use partial acquisitions (acquisitions of majority control but not of 100% control) to expropriate the target firms’ minority shareholders.
Accordingly, Martynova and Renneboog (2006) document that the abnormal returns to the announcements of partial acquisitions to target shareholders are substantially lower than for full acquisitions.

3. The Hoppenstedt Börsenführer is a quarterly stock guide that contains profiles and financial data for all listed German companies.

4. The German Federal Financial Supervisory Authority (BaFin) has drawn up a consolidated overview of the holdings of voting rights in German companies listed on the first segment of the German stock exchanges, given the publication requirements set out in the Securities Trading Act (WpHG). This database on holdings of voting rights is based exclusively on data gathered from the statutory publications made in supra-regional official stock exchange gazettes (e.g. Börsen-Zeitung). For the purpose of our study, the BaFin has kindly provided us with historical ownership information from this database.

5. We would regard as a formal classification scheme the economic sector based classification of the German Central Bank (based on the European System of Accounts (ESA 95)).

6. In our sample, this category includes individual activist investors (e.g. Guy Wyser-Pratte) as well as institutional activist investors.

7. There are three general hypotheses that explain the value effect of private placements: monitoring, value certification and management entrenchment. For a detailed theoretical description and empirical analysis see Barclay, Holderness and Sheehan (2007).

8. Although German law basically allows an investor owning more than 50% of all shares to appoint management, owning more than 25% of the voting stock grants the right to veto decisions.

9. The CDAX (or composite DAX) is a German all-share index introduced in 1993 that covers all German shares that are admitted to the Prime Standard and General Standard segments. Therefore, the index reflects the performance of the overall German equity market and is thus well suited for the purpose of this study.

10. We refrain from analyzing the development of cumulative abnormal returns for the [-20;20] event window, since we only controlled for interfering material events in the 10 days before and after the announcement. Hence, the development of cumulative average abnormal returns over the longer period is likely to be affected by unrelated corporate events.

11. §21 AktG (corporate law) requires that target management must be notified immediately if another corporation’s engagement exceeds 25% or 50% of the target’s voting rights. Since we do not want to address the complex process of voting rights disclosure in this context, we refer to Becht and Böhmer (2003) who discuss several transparency issues that arise from the current legal provisions covering the disclosure of control rights.

12. Using the abnormal return over the [-10; 10] event window as the dependent variable leads to the same qualitative results

References


MODELING OF WORK-COMMITMENT DETERMINANTS: A CROSS-CULTURAL COMPARISON

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Abstract: The object of the current analysis is the work commitment phenomenon and the possibilities of modeling it by analysing its components and the system of influencing factors searching for most significant determinants. The objective is to discuss the possible components of work-commitment phenomenon, propose the system of commitment-influencing factors and test their significance using an appropriate mathematical methodology. An addition task is to implement cross-cultural analysis, modeling general sample and separate samples for different cultures. In this paper the quantitative research methodology was chosen. However, the special attention should be driven to the choice of the adequate data modeling method, taking into account the limitations emanating from semi-qualitative data characteristics. In the current analysis Bayesian classification technique is used. Cross-cultural comparison was made for five countries from rather different cultural clusters: Great Britain, USA, Russian Federation, Japan and Germany. The cross-cultural comparison analysis yielded the relative non-homogeneity of the best predictors across the countries, with the best predictors being the factors of work climate, perception of the place of work in life, job security, interesting job, income, sex and pride related to the type of work.

Keywords: Commitment, organisational culture, personnel management, cross-cultural analysis, international business administration, Bayesian analysis, Russian Federation, non-parametric methods, panel data modeling.

1. Work Commitment Problematics

Work commitment as a phenomenon is one of the central factors, influencing organisational culture, organisational behaviour and organisational effectiveness as an outcome. The current phenomenon can have a multi-layer complex structure, being a result of a set of influencing factors of different type and nature. The object of the current research is work commitment as a resulting factor or, more precisely, the whole system of work commitment determinants, significance of separate components and its variations in different cultures. In this study these components are analysed in general context and in cross-cultural context, with the aim to access the possible differences in work commitment influencing factors. The current topic is of special importance in connection to two different practical questions:

- commitment as a factor influencing organizational development, and
- cross-cultural differences and the ways of commitment effective management.

The first question is related to employees' motivation to be the member of the current organisation, the factor influencing the time of working within the organisation. This issue is directly connected with organisational learning, when drawbacks in organisational development are caused by continuous changes in personnel structure. In addition, open market possibilities and liberalization of human capital movement in Europe has been
influencing in the first turn the countries of Eastern Europe and Baltic States, where employees short-time orientation and increased personnel mobility has become an actual topic, imposing a certain set of limitations for sustainable development of local businesses, especially in small and dynamic economies, such as the Baltic States.

The second question is related to international human resources management and cross-cultural conflicts management, when the cross-cultural differences and subsequent differences in organisational culture should be taken into account when elaborating effective managerial strategies with the aim of avoiding cross-cultural conflicts and obtaining superior performance.

In this context, the analysis of the current topic can be related, but not limited, to three research tasks:

- elaborating the system of commitment determinants by defining a set of hypothetically significant indicators and classifying separate variables in corresponding groups;
- estimating system with the aim to determine significant dependencies and the nature of their relationships with work commitment factor behaviour;
- testing for cross-cultural differences in the structure of significant determinants.

2. Work Commitment Determinants: Model Structure

Work commitment, being a complex phenomenon, can be represented by several components (variables), such as:

- degree of overall satisfaction from work;
- degree of being proud to work in the organization;
- intentions to change the job;
- willing to work hard for organization to succeed;
- other.

Current variables can form a unique factor (using factor analysis techniques) or can be analysed separately, as different components can be related to determinants in a different way (example: I can be satisfied by my job, but still want to change it just because I want some new challenges in my life).

The phenomenon of work commitment or any of its components can be directly or indirectly influenced by multiple factors, so the structure of system of determinants can be quite complicated. In general context, the current phenomenon can emanate from two types of sources and the model of work commitment determinants was structured as follows:

- a) direct factors;
- b) synthetic or “realisation” factors (realisation of desired level of certain work-place characteristics or its correspondence with the actual level).

Here, two types of influencing factors should be considered: "hard" (or external) and "soft" (or internal) factors. The first group of factors consists of:

- real characteristics of the workplace and work climate (working time, advancement possibilities, stress, income, whether the job is interesting, whether the climate is good, etc.).

All these factors can directly or indirectly influence the degree of work satisfaction and commitment. At the same time the factors of the second group cannot be omitted. The second, “soft” group of factors consists of:

- personal attitude towards work as a part of life (personal importance of work) and different motivation factors.

The factors of the current group are forming “the base” of the relationships and their significance, influencing the personal perception of the workplace characteristics and workplace and commitment as a whole. For example, if the work is perceived as just a mean
of earning money, the factor of negative work climate can be of less or no influence for the person. The system of hypothesized work commitment determinants can be represented by the following scheme:

![Diagram of work commitment determinants](image)

**Fig 1.** The system of work commitment determinants (by author).

Here, the degree of work commitment of a person is indirectly influenced by a set of the different characteristics of the workplace through their realisation factor, as well by general attitude of the person to work. Here, the motivation factors are represented by personal estimations about the importance of different work characteristics. These factors are important for measuring importance/presence balance, as considering only the "presence" factor of a certain work characteristics (for example "flexible working time") can lead to inconsistent findings, if the current factor is of no personal importance).

Consequently, the set of independent variables, tested in the models, included three types of variables, with the first subset ("hard" indicators) of consisting of:

1. **Job characteristics group:**
   - Income, advancement, independence, interesting job, possibility to help people, useful to society, job security, flexibility of working time;

2. **Work climate group:**
   - Relations between colleagues, relations between management and employees.

3. **Workplace characteristics group:**
   - Working hours, working place.

4. **Stress group:**
   - Stress, hard physical work, dangerous conditions, possibility to loose the job.

5. **Socio-demographic group:**
   - Age, sex, hierarchical level.

The subset of “soft” indicators included:

2. **Personal attitudes to work, estimations:**
   - Job as a way of earning money, job as a most important activity.
   - Estimations concerning the importance of certain work characteristics.
   - Synthetic index (realisation).

To measure the balance of importance/presence of certain job characteristics, or the “realisation factor”, mentioned earlier, synthetic index for each characteristic was calculated.

---

9 The choice of the current set of characteristics was limited by survey data (1) and can be accomplished by other factors.
and included in the analysis, representing the difference between the importance of certain job characteristics and its presence in real job:

\[ \text{IndexRealis}_n = X_{n,imp} - X_{n,real} \]

Here, the positive value of realisation index (or the “non-realisation” in this case) can influence the degree of work satisfaction negatively. (In the data set the negative cases were recoded as zero differences, as it’s not logical to suppose that the negative difference can enlarge the satisfaction and commitment. In total, about 43 independent variables were tested in the models.

3. Data Characteristics and Modeling Methodology

The methodologies used in research of organizational culture and cross-cultural studies can significantly vary, ranging from pure qualitative approach (interview or case studies based) to quantitative modeling approach. At the same time the character of data, which is qualitative in nature (survey-based ordinal indicators (Likert scale) and categorical variables), poses a certain set of limitations for reliable statistical analysis, as:

- most of the variables are non-normally distributed
- no predetermined exact theoretical model specification
- non-linear dependencies can hold
- variables are nominal and ordered categorical variables.

Taking into account the data set characteristics and the absence of mathematically predetermined model type Bayesian classification modelling was chosen for the analysis (estimated in B-Course (see Myllumäki et al, 2002, pp 369-387)).

Bayesian approach is designed to analyse discrete categorical variables and helps to overcome a set of limitations, set by the semi-qualitative character of data. In general, Bayesian dependence network is a representation of probability distribution over a set of random variables, consisting of the directed acyclic graph, with the nodes corresponding to domain variables and the arcs define a set of independence assumptions that allow the joint probability distribution for a data vector to be factorised as a product of simple conditional probabilities (Nokelainen et al, 2004, p 872). Bayesian classification modeling means searching for the best predictors for group memberships and testing for class similarity, or estimating the probability that variable belongs to the certain class. Here, the models are compared by calculating the ratio of the following probabilities (B-Course, 2008):

\[ P(c = c, v/Dm) = \frac{\sum_{l=1}^{|Vc|} N_{c,i,l} + 1}{\sum_{l=1}^{|Vc|} N_{c,1+l} + \sum_{l=2}^{|Vc|} N_{c,2+l} + \cdots + \sum_{l=|Vc|}^{Nc,n,v,n+1}} \]

where

- \( D \) - data set with \( N \) data vectors and \( n \) predictor variables
- \( D_m \) - transformed data set according to the model (variable discretization)
- \( V_i \) - the \( i^{th} \) column of \( D \) and it has \(|V_i|\) different values.
- \( V_c \) - the class column of data and \(|V_c|\) is the number of classes
- \( D_{C=c} \) - data matrix containing rows of the data matrix that have \( c \) in their class column,
- \( D_{C=c} \) has \( N_c \) rows
- \( N_{c,i,l} \) - the number of rows in data matrix \( D_{C=c} \), that have value 1 in the \( i^{th} \) predictor variable.

The sum \( N_{c,i,1} + N_{c,i,2} + \cdots + N_{c,i,|V_i|} \) is denoted by \( N_{c,i} \)
The predictive accuracy of each model is estimated on the base of leave-one-out cross validation. The number of estimated models for classification modeling equals \(2^n\), with \(n\) – number of variables (B-Course, 2008).

The data used in the analysis is the partial data of the open archive of the ISSP international survey on work orientations (ZA Online Study Catalogue, 1997), the data for five countries are analysed, presented as Likert type scale answers (ordered variables) and a set of respondent profile related data (categorical variables). The countries chosen for analysis are Russian Federation, Germany, Japan, USA and Great Britain, representing different cultural clusters and, consequently, having the potentially different systems of work satisfaction and commitment. In the current analysis one general model for every commitment-reflecting variable was estimated by classification modeling with the aim to determine significant relationships. In addition, country effects were tested by re-estimation of separate models for each country.

4. Work Commitment Determinants: Modeling Results

The general model was estimated for two dependent variables: 1) overall satisfaction from work and 2) pride related to being within the organization. According to the results the best classification model included 16 factors: 14 different job and personal characteristics-related factors and two socio-demographic components: sex and age. (The general model included data from 25 countries and, thus, wasn’t limited to five countries mentioned above.) The structure of the best predictors for the both models is presented in the following table.

**Table 1. Structure of the best predictors of the Bayesian classification models for overall satisfaction and pride related to organization**

<table>
<thead>
<tr>
<th>Satisfaction</th>
<th>Pride</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Work is most important activity</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Job is a way for earning money</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Working hard</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Opportunities for advancement are high</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Job is interesting</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Flexibility working hours</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Relations management/employees</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Relations colleagues</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Fatigue</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Stress</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Pride related to the type of work</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Worry about losing the job</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Realisation advancement</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Realisation help people</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Sex</strong></td>
<td>*</td>
</tr>
<tr>
<td><strong>Age</strong></td>
<td>*</td>
</tr>
</tbody>
</table>

Three factors were common for the both models: one factor from the group of work climate (relations between management/employees), one factor from the group of personal attitudes (work as a most important activity) and the factor of the pride related to the type of work. From the job characteristics group the important factors are possibilities for advancement and the realisation of the current factor, interesting job and flexibility of working hours. Three factors of stress group were significant as well: stress, fatigue and the worrying about loosing the job. The factor of relations between colleagues was important in satisfaction model. The factor of perception of the job as a way of earning money (or
more), working hard (or not) and realisation of the possibility to help other people are significant in pride model. Models for the countries were estimated for three dependent variables: 1) overall satisfaction from work, 2) pride related to being working within the organization, 3) intentions to change the job. The structure of the best predictors for the fifteen models (3 x 5) is presented in the following Table 2. Structure of the best predictors of the Bayesian classification models of overall satisfaction, pride related to organization and intentions to change the work for Germany, Great Britain, USA, Russia and Japan (G – Germany, GB – Great Britain, J – Japan).

<table>
<thead>
<tr>
<th>Predictor</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Job as a way of earning money</td>
<td>USA</td>
</tr>
<tr>
<td>Work as a most important activity</td>
<td>USA, G, GB, RUS</td>
</tr>
<tr>
<td>Working hard</td>
<td>USA</td>
</tr>
<tr>
<td>Importance of job security</td>
<td>USA, G, J</td>
</tr>
<tr>
<td>Importance of high income</td>
<td>J</td>
</tr>
<tr>
<td>Importance: help other people</td>
<td>USA, G, RUS</td>
</tr>
<tr>
<td>Importance of good advancement</td>
<td>USA, G, J, GB, RUS</td>
</tr>
<tr>
<td>Importance: useful to society</td>
<td>J</td>
</tr>
<tr>
<td>Importance of independent work</td>
<td>J</td>
</tr>
<tr>
<td>Importance: flexible working time</td>
<td>USA, G</td>
</tr>
<tr>
<td>High income</td>
<td>G, J, GB, RUS</td>
</tr>
<tr>
<td>Possibility using skills</td>
<td>RUS</td>
</tr>
<tr>
<td>Job useful for society</td>
<td>GB</td>
</tr>
<tr>
<td>Job is secure</td>
<td>USA, G, GB, RUS</td>
</tr>
<tr>
<td>Opportunities for advancement are high</td>
<td>USA, J</td>
</tr>
<tr>
<td>Job is interesting</td>
<td>USA, G, J, GB</td>
</tr>
<tr>
<td>Can work independently</td>
<td>USA, J, RUS</td>
</tr>
<tr>
<td>Pride related to the type of work</td>
<td>USA, G, J, GB, RUS</td>
</tr>
<tr>
<td>Pride related to organization</td>
<td>J, RUS</td>
</tr>
<tr>
<td>Training at work</td>
<td>GB</td>
</tr>
<tr>
<td>Stress</td>
<td>GB, RUS</td>
</tr>
<tr>
<td>Hard physical work</td>
<td>USA, G, J</td>
</tr>
<tr>
<td>Fatigue</td>
<td>USA, G, GB</td>
</tr>
<tr>
<td>Dangerous conditions</td>
<td>USA, G, GB</td>
</tr>
<tr>
<td>Flexibility of working hours</td>
<td>G, J, GB</td>
</tr>
<tr>
<td>Work place (home/office)</td>
<td>RUS</td>
</tr>
<tr>
<td>Relations management/employees</td>
<td>USA, G, J, GB, RUS</td>
</tr>
<tr>
<td>Relations colleagues</td>
<td>G, J, GB, RUS</td>
</tr>
<tr>
<td>Worry about losing the job</td>
<td>J, USA</td>
</tr>
<tr>
<td>Realisation high income</td>
<td>USA, G</td>
</tr>
<tr>
<td>Realisation secure job</td>
<td>USA, RUS</td>
</tr>
<tr>
<td>Realisation advancement possibilities</td>
<td>USA, G, GB</td>
</tr>
<tr>
<td>Realisation interesting job</td>
<td>J, RUS</td>
</tr>
<tr>
<td>Realisation independent work</td>
<td>USA, G, RUS</td>
</tr>
<tr>
<td>Realisation help people</td>
<td>G, GB, RUS</td>
</tr>
<tr>
<td>Realisation useful for society</td>
<td>USA, G, RUS</td>
</tr>
<tr>
<td>Age</td>
<td>USA, J, GB</td>
</tr>
<tr>
<td>Sex</td>
<td>USA, G, J, GB</td>
</tr>
<tr>
<td>Position</td>
<td>J, GB</td>
</tr>
</tbody>
</table>
The cross-cultural comparison analysis yielded the relative non-homogeneity of the best predictors across the countries, as about 18 factors were significant for 1 or 2 countries and only 9 factors were common for 4 or 5 countries. The factors which were significant in the most (4 or 5) cases were: both factors from the group of work climate (relations between management/employees and relations between colleagues), one factor from the group of personal attitudes (work as a most important activity), three factors from the group of job characteristics (job security, interesting job, income), one factor from motivation group (motivation factor of advancement possibilities), pride related to the type of work, and one factor from socio-demographic group (sex). The countries with the unique factors were mainly Japan, Russia and USA.

For the USA the most common predictors (predictors significant in 3 or 2 models from 3) are: possibilities of advancement at work (motivation, presence, realisation), independence (presence and realisation), job security (presence, realisation), interesting job, perception of the work as a mean of earning money and pride related to the type of work.

For Germany the most common predictors are: high income (presence, realisation), relations between management and employees, interesting job, possibility to help other people (motivation, realisation), flexibility of working hours, sex, perception of work as a most important activity and pride related to the type of the work.

For Japan the most common predictors are: age, income (presence and motivation factor), relations between colleagues, presence or realisation of the factors of interesting job, independence and advancement.

For Great Britain the most common predictors are: job security, interesting job, degree of fatigue, flexibility of working hours, relations between colleagues and pride related to the type of the job.

For Russia the most common predictors are: job security (presence and realisation), independence (presence and realisation), and realisation of the possibility to help other people, pride related to the type of work, both factors of relations group: relations between management and employees and between colleagues, work stress and realisation of interesting job factor.

Presented results are the part of the study. Additional details can be available from the author by request.

References
FUTURE PERSPECTIVES OF COMPETITIVENESS OF LATVIA’S MASHINERY AND METALWORKING INDUSTRY

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Abstract: Machinery and metalworking is a strategic sector (further MMS) with high value added. Its operations require wide knowledge and deep skills. MMS supplies all sectors of national economy with machines, equipment, spare parts and manufacturing systems and related services, as well as needed technologies and human capital and knowledge.

The EU research outlines the following criteria for future competitiveness of MMS:

- Problem solving competence;
- Customized knowledge;
- Technological excellence;
- Quality and confidence;
- Personnel quality and costs;
- Education and training;
- Investment in capital goods.

The dominance of low cost approach so far compensated weakness in other competitiveness factors. The recent rapid increase of wage levels, raw material and service costs ask for more and more efforts local companies should introduce to keep their competitiveness. As a result the industry strategy will be shifted to innovation, investment in new technologies and qualified labour.

Keywords: Machinery and metalworking sector; competitiveness, productivity, added value, high technology, medium-high technology life-long learning system.

Introduction

Recent years have introduced rapid changes in Latvia’s economy. Globalisation more and more is linked to higher competition. Rapid development of Asian markets reflects growth of internal demand and increase of production costs, thus influencing local processing industry, including machinery and metal processing sector (MMS). However, all recent studies were made before essential restructuring started, in a period of the most optimistic forecasts and high GDP growth, and could not be used to forecast sector development. Strategic development plan of MMS was designed also in wealthy age, in 2005. Latest analysis ordered by Ministry of Economics in 2007 to Baltic Consulting Ltd. “Section perspectives of processing industry, forecasted restructuring till 2020” is based on updated information. As a consequence, new research in today’s economic situation with aim to update MMS strategic development plan obtain increasing importance.

1. Mechanical engineering sector till 1990ies

In 1930s, before World War II, the manufacturing sector had relatively little impact to Latvia’s economy: only 13.5 percent of the labour force was employed in industry. Major industrial sectors at that time included agro business, food processing, light industries, woodworking, and building materials. Since 1950s Latvia began to industrialize and became the most industrialized Baltic state. By 1990 processing industries accounted for nearly half of the GDP and a little less than one-third of employment.

The most rapid industrial development took place in the following areas: machine building and the electronics, chemicals, and electric power industries. Changes in the structure of the Latvian industrial sector are shown in Table 1.
Table 1. Share of Industrial Output and Employment by Sub-sector, Selected Years (percent).

<table>
<thead>
<tr>
<th>Sub-sector</th>
<th>Share of Industrial Output</th>
<th>Share of Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electric Power</td>
<td>1.4</td>
<td>1.2</td>
</tr>
<tr>
<td>Engineering (including machine building and electronics)</td>
<td>21.3</td>
<td>21.8</td>
</tr>
<tr>
<td>Chemicals</td>
<td>5.9</td>
<td>6.2</td>
</tr>
<tr>
<td>Wood and Paper</td>
<td>7.7</td>
<td>5.8</td>
</tr>
<tr>
<td>Building Materials</td>
<td>3.5</td>
<td>3.8</td>
</tr>
<tr>
<td>Light Industries</td>
<td>25.2</td>
<td>25.1</td>
</tr>
<tr>
<td>Food Industries</td>
<td>27.6</td>
<td>27.7</td>
</tr>
<tr>
<td>Other (including research and technical colleges)</td>
<td>7.4</td>
<td>8.4</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: The figures shown are probably underestimated due to underreported production for military use. Source: State Statistical Bureau, World Bank.

According to World Bank report the share of the engineering sector, which was insignificant in the early 1950s, had increased to 21.3 percent of industrial output by 1970. By 1985, engineering had become the largest industrial sector, and by 1990 it contributed 26.3 percent to industrial output and almost 39 percent of industrial employment. The share of communication equipment and electronics increased from less than 6 percent of industrial output in the 1970s to more than 9 percent by the end of the 1980s.

Altogether in 1990, the non-traditional industries of engineering and chemicals contributed more than 33 percent to industrial output and more than 44 percent to industrial employment. During the 1970s, the industrial sector grew by an annual average rate of 5 to 6 percent (in constant prices). In the 1980s, the growth rate slowed down to about 3 to 4 percent per year. Taking account of the increase in the industrial labour force, which was moderate, as well as the rapid increase in capital stock per worker, the net increase in productivity in the 1980s appears to have been low, indicating low efficiency in the use of capital and human resources. At the end of 1990ies situation in engineering sector turned to gigantic enterprises with extensive way of operation and overall stagnation.

After regaining independence, in 1991 manufacturing industry was heavily influenced by reforms of transition to market economy and rapid privatisation. Almost all former gigantic state owned enterprises were unable to meet competition and adapt to market economy. As a result they became insolvent and in many cases unique machinery was sold off by liquidation administrators for a metal price. Management buy-outs didn’t help to rise up additional investment; local firms were not involved in country’s telecom infrastructure modernisation, but foreign investors were reluctant to acquire firms because of their large debts aroused in a period of hyper inflation and barter deals with Russia. It took several years that newly established fresh SMEs started to replace stagnating base of former state owned industry.

Today Latvian manufacturing industry has ~16% share in GDP (2006) which is a low figure compared to ~25% in EU. MMS’s share in Latvia’s GDP is significant - ~4%. One job in MMS generates 3-5 new jobs in supplying and benefiting sectors thus giving total indirect share in GDP 15%.
Figure 1. Latvian manufacturing industry in 2007; source: Association of Mechanical Engineering and Metalworking Industries of Latvia.

MMS companies are classified according to business activities:

- NACE 27 - Manufacture of basic metals
- NACE 28 – Manufacture of metal products
- NACE 29 – Manufacture of machinery and equipment
- NACE 31 – Manufacture of electrical machinery and apparatus
- NACE 33 – Manufacture of medical; precision and optical instruments, watches and clocks
- NACE 34 – Manufacture of motor vehicles, trailers and semi – trailers
- NACE 35 – Manufacture of other transport equipment
- NACE 37.1 – Scrap recycling

Figure 2. Structure of mechanical engineering sector in 2007; source: Association of Mechanical Engineering and Metalworking Industries of Latvia

MMS is one of the fastest growing sub-sectors in Latvia. It forms 82% of manufacturing value added. About 70% of the industry's manufacturing aggregate amount is exported. The “backbone” of the industry in Latvia consists of small and medium-sized enterprises. The products they offer are specialised and individualized. The industry is mainly export focused; even small firms are participants of the global market.
Sectors of production of metals and metal articles constitute approximately one-tenth of the total value added of manufacturing. Exports account for almost three-fourths of the total sold products of these sectors. The domestic market share has been showing a tendency of expansion recently. Development of construction has resulted in increased demand for finished metal articles.

Figure 3. Sector output and export (million EUR); source: Association of Mechanical Engineering and Metalworking Industries of Latvia.

Figure 4. MMS Export countries in 2005; source: Association of Mechanical Engineering and Metalworking Industries of Latvia.

Figure 5. Quarterly Growth Dynamics of Production of Metals and Metal Articles (level of 2000 =100); source: http://www.em.gov.lv/em/2nd/?cat=137
Metals and metal articles produced in Latvia are highly competitive around the world and most of them are traded in the EU member states (almost 80% of exports) and almost a half of the products are exported to the EU-15 markets.

Production of machinery and equipment was a rapidly growing sector until 2005, and its production volumes had almost doubled over the period of 2000-2005. However, its growth rates have not been increasing since 2005, and the production volumes decreased in 2006 and 2007.

![Figure 6. Quarterly Growth Dynamics of Production of Machinery and Equipment](http://www.em.gov.lv/em/2nd/?cat=137)

It is a typically export-oriented sector, as almost three-fourths of its products are being exported. The main sales markets of the sector are the EU member states, and almost a half of the products for exports to the EU are directed to Lithuania and Estonia. A relatively big share of the sector’s exports is related to the markets of CIS countries.

Production of electrical and optical equipment has been developing rapidly over the recent years. Production volumes of the sector have almost doubled in the last five years. Fast growth in this sector is also observed in 2007.

![Figure 7. Quarterly Growth Dynamics of Production of Electrical and Optical Equipment](http://www.em.gov.lv/em/2nd/?cat=137)

After joining the EU, growth of the sector slightly slowed down but remained on a steady level (6-8%). The sector has stable trading partners in the CIS countries, Estonia and Lithuania.
2. Future perspectives of Latvian mechanical engineering sector

Competitiveness of Nations is determined by particular sector’s competitiveness. Therefore it is important to analyse critical success factors of each sector’s competitiveness. European mechanical engineering is a world leader with 41% of global output; Europe is the world's largest producer and exporter of machinery, including complete plant exports.

This broad sector is responsible for about 8 per cent of EU employment. 2 per cent of its turnover is spent on R&D. Over 80 per cent of the firms in the sector in the EU are SMEs of less than 20 employees. SMEs in machinery and equipment sector account for the same share of employment as large firms. There has been substantial innovation in this sector in recent years and the innovation potential remains high. This is essentially due to the use and application of micro-electronics. At the same time the production process in average remains labour intensive and, in particular, skilled labour and engineers are required. Since the mid-1970s a new generation of computer aided machines have been developed and overtime diffused in the sector. Different machines can be combined together - for example production machines together with conveyor systems, robots and testing machines - to form computer controlled systems. These systems offer much greater flexibility than was available before. The application of micro-electronics and the integration of computers into production has resulted in substantial changes in the nature and range of products offered. CAD (Computer Aided Design) and PPS (Production Planning Systems) have been adopted in most firms.

Responsiveness to customers is becoming increasingly important and customers are increasingly demanding services together with the products, such as training, specialized software, and maintenance. This opens up the possibility of a high degree of specialization in production which offers good opportunities to SMEs. Diffusion of the main computer technologies available is underway and should underpin the demand for mechanical engineering products in the next period. Another source of current and future demand is the increasing demand for environmental technology and firms in the mechanical engineering sector are the main suppliers of this.

The EU research outlines the following criteria for future competitiveness of machinery and metalworking sector. Internal competitive factors under company control:

- **The company – creator of wealth.** The following analysis suggests that the majority of key factors determining the competitiveness of mechanical engineering firms depend on the firms themselves. Others are generated in the interplay between the company and its business environment. A few are imposed by that environment and innovation culture on the company. The key factors to increase competitiveness would be management knowledge, leadership and innovation culture in company.

- **Ability to solve customers’ problems.** Today manufacturing a good machine and selling it is not enough, the manufacturer must also do everything necessary to ensure that production on the line where his machine is installed fulfils his customer’s business objectives throughout the machine’s life. What counts for the buyer of a machine are not the technical characteristics of the machine as such but its capacity to carry out the tasks assigned to it by the buyer. Customers buy performance, not equipment.

- **Key know-how supply.** Within the mechanical engineering product range the EU has a competitive edge in customized equipment, special models and turn-key plant supply. The secret of a company’s competitiveness in these types of supply lies with possession of unique engineering know-how and a capacity to exploit and develop it beyond the reach of competitors.

- **Technological edge.** It is appropriate to distinguish between key, IPR-protected know-how and overall technological level. In the second case a manufacturer
achieves a technological edge over another by carrying a technology available to both to a higher level of excellence, thus enabling him to offer a better performing product. Whilst key know-how is embodied into customized, specialized pieces of equipment, maintaining a technological edge is necessary for competitiveness in all kinds of engineering equipment, in speciality as well as in mass-produced standard equipment, in high- as well as in medium- and low-tech equipment. The optimal application of a simple technology gives a competitive advantage as well. If Europe remains competitive on many medium-tech products it is thanks to technological perfection. Staying ahead requires not only a very high degree of product innovation but also innovative thinking applied to the manufacturing process and, indeed, in all company functions. Organizational innovation, with flexible, task-oriented decision structures, is a growing part of overall innovation.

- **Quality, reliability.** The customer buys engineering equipment for reasons of quality and reliability above all. Quality and reliability of supply refers in the first place to the performance and durability of the product but also to delivery and service.

- **Production breadth.** Mechanical Engineering is the second sector by number of products after the Chemical Industry. But the range of mechanical products is not only a question of number but even more of breadth. Production breadth has a competitive value at both company and country/bloc levels. The typical end-user of mechanical equipment needs several types of equipment, models or sizes. It is practical for him to purchase all he needs from a single supplier. Streamlining contacts with suppliers is a real cost saver that outweighs to some degree higher sale price. Using different products from the same supplier has technical advantages too, like interoperability. Breadth of supply is also a powerful means of making customers loyal to a brand.

- **Production depth.** Further processing a product adds to its value. The added value is measured by the sales value (output) less the purchase cost of the intermediate consumption (inputs). It is equivalent to the value of the factors (labour, materials) used in the processing plus eventual profit. Production depth is measured as the share of value added on output value.

- **Company size.** SMEs are well suited for the production of speciality equipment. Manufacturing of such products does not require long production lines or big factory halls. It is carried out most efficiently by small, well-coordinated teams of highly skilled and specialized staff in flexible production cells. Also the diversity of products and applied technologies in mechanical engineering is so great that it fosters the development of small, specialized production collectives. In general, smaller production units have competitive advantages and disadvantages. SMEs are generally superior to large generalists in their own field of specialization, they are innovative, have shorter lead times in product development, are close to their customers and know them better, are flexible in adapting to individual customers’ demands and quicker in responding to changing market conditions. On the other hand they admittedly have handicaps, e.g. in financing, basic research, product breadth or servicing distant markets. This competitive analysis covers companies with 20 employees or more.

Competitive factors in the interaction between the company and its environment.

- **Price.** It has been often said that sale price is a less important competitive factor in the engineering business than the sort of factors discussed in the previous sections – problem solving and marketing ability, production breadth and depth, quality and reliability. On balance this is a fair statement, but it requires certain clarifications.
Due to their uniqueness it is very difficult or impossible to compare price bids on customized and special equipment and draw conclusions on the relative importance of price for an order. Even in the sale of standard pieces of equipment from a catalogue, other factors like quality and date and conditions of delivery play major roles. Price is most important for the sale of standard, long-batch equipment, less important for special, short-batch equipment and least for equipment with exclusive technology.

- **Investment in the Engineering Sector.** Here we refer to investment in mechanical engineering companies, not to investment in mechanical engineering equipment and plant. The majority of EU mechanical engineering companies are family-owned SMEs. These companies generally finance their activities with the owner family’s capital, other private investors, bank loans and re-investment of part of the net profit. All these four sources of capital are insufficient. Private investors have limited financial resources and do not always want the firm to become very large for fear of losing control. Bank loans are expensive and, before granting them, banks demand collateral security that SMEs cannot always provide. In 2003 €10,479 million were invested in the EU Mechanical Engineering Industry. This gives an investment intensity of 4.7 thousand euros per employee. Such a level of investment is too low compared to USA or Far East countries.

- **Labour costs.** Labour cost in EU mechanical engineering companies account for ¾ of value added. In other words labour is by far the biggest cost factor. Although this may surprise some, mechanical engineering is more labour intensive than capital intensive.

- **Labour productivity.** The real burden placed on companies depends not so much on the absolute value of labour costs but on the wage adjusted labour productivity. Research shows that high labour cost is positively correlated with high labour productivity.

- **Optimization of value chain.** The value chain or supply chain is the sum of value-adding processing of a product from raw material to finished product. It is represented by all the economic agents who take part in the processing from farmer or miner to vendor of the finished product. This concept also includes the relations among processors and among processing stages: the value-adding chain links supply sources, manufacturers, distributors and markets. “Chain” is a simplification: what we usually see in practice is a value network with loops and parallel paths. The optimization of the value-adding chain gives to all the involved economic agents a competitive advantage.

- **Outsourcing; delocalisation.** Outsourcing means that a processor purchases intermediate goods or services from an outside supplier that adds to the value of his processing. Contracting work out or sub-contracting is a similar concept. Since the length of the stretch in the value chain that a processor or sector processes in-house continuously changes in function of the relative prices of intermediate goods, there are is no stable definition of their own processing range or core business. This means that outsourcing essentially applies to purchases within their own processing range, not at its edges. This aspect is often overlooked by literature on outsourcing. Manufacturers have always contracted work out. In recent years the Manufacturing Industry has outsourced more and more manufacture of parts and sub-assemblies. Business services are also outsourced.

- **Industrial clusters; regional concentration.** Historically mechanical engineering was born in areas with a developed Steel Industry, which is understandable from the points of view of materials supply and work force skills. Steel mills are mostly
found near rivers or lakes that can supply water and power, with iron mines in the surrounding hills. Nevertheless, recent German studies in Cologne show destructive role of large steel processing cartels, too.

Geographical proximity of MMS firms in Latvia is relatively high in Daugavpils and Liepaja cities and Jelgava district.

Competitiveness of local firms in Latvia so far was driven by low cost factor, thus compensating lack of competitiveness factors described in above.

Last years showed rapid growth of average gross wage. According to CSB it increased from LVL 297 (EUR 422) in December 2005 to LVL 480 (EUR 683) in December 2007. Average wage growth trend in Latvia was by 14% higher compared to Lithuania and Estonia.

Rapid increase of inflation has stimulated jump up of other needed resource costs. In the period of 2000-2003 producer prices grew up slowly, but in 2004-2006 average growth was already 11%. In February 2008 producer prices has grown up by 29, 3% compared to February, 2006. It could be forecasted that producer price will keep growing, as oil prices and electricity tariffs (37% average by JSC “Latvenergo”) will significantly increase. From 01.05.2008, gas price has grown up by 30%.

More problems to MMS causes crisis of real estate sector and following decrease of scale of building as construction has been the main promoter of internal demand for last years.

The main focus in new situation should be paid to:

- Increase of productivity;
- Shift to more technologically complex products with higher added value (from component to subsystem and system delivery).

Unfortunately, share of high-tech products in manufacturing industry was only 5,2% (in 2005). Manufacturing industry among others has demonstrated the most rapid investment growth in both high-tech (22,3%) and medium high-tech (18,8%) sub-sectors since 2004 during last three years.

Conclusions

Aggregation and synthesis of research analysis and available public statistical data allow us to make the following conclusions:

- The recent research works in MMS have been carried out before the dramatic changes in Latvia’s economy took place.
- The strategic documents of MMS are based on outdated data and materials.
- MMS has lost its low price competitiveness; therefore higher attention must be paid to increase in productivity and production of technologically more complex products with high added value creating demand for highly skilled workforce.
- The education system of engineering sciences is not yet production oriented.

Recommendations to keep MMS competitiveness:

Analysis of MMS situation and corrections to the strategy of the sector should be carried out:

EU structural aid finance for period 2007-2013 should be invested in high- and medium-high technology sub-sectors using added value as one of key selection criteria in focused and efficient way;

Investments in human resources;
The highest educational institutions of Latvia should concentrate on specialists with existing higher degree education and prepare two and one-year study programmes of 2nd level higher professional education in engineering sciences.

Using modern technologies expand the distance learning possibilities within natural sciences in order to allow the employed engineers acquire part of the study courses besides working in production.

To develop life-long learning system in Latvia to provide opportunities for personnel training within whole employment period;

To arrange the education system in engineering sciences to harmonize it with needs of the industry.

References