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## FINANCIAL STABILITY AND GROWTH: DYNAMICS AND MEASURES

Finansijska stabilnost i rast:  
dinamika i mere

### Abstract

This paper addresses macroeconomic risks in the short and medium term. The problems related to budget deficit, public debt and external sustainability are piling up and will be increasingly challenging in the forthcoming three-year period. The year of 2017, in which public debt repayments will threaten to jeopardize country's external liquidity, is particularly critical. Objective assessment of medium-term prospects of the Serbian economy suggests that it will be difficult to maintain stability. Termination of negative trends assumes consolidation measures and avoidance of expansive measures that would result in deepening of the budget deficit. It is necessary to support economic growth through development of institutions and ambience. New funding forms have to be promoted – during the previous two terms of office, the Ministry of Economy announced it would legally regulate the field of venture capital and venture capital funds. This should be done through drafting and adoption of a special law. Thus, venture capital shall be clearly defined and recognized as a separate financial instrument, different and special compared to other similar financial instruments, while the venture capital funds are defined as special investment and financial institutions.

**Key words:** *stability, budget deficit, public debt, external sustainability, venture capital*

### Sažetak

U radu razmatramo makroekonomske rizike na kratak i srednji period. Povezani problemi budžetskog deficita, javnog duga i eksterne održivosti akumuliraju se i biće sve izazovnije u narednom trogodišnjem periodu. Naročito je kritična 2017. godina kada otplate javnog duga prete da ugroze eksternu likvidnost države. Objektivno sagledavanje srednjoročnih perspektiva privrede Srbije ukazuje na činjenicu da će biti teško održati stabilnost. Zaustavljanje negativnih trendova pretpostavlja mere konsolidacije i izbegavanje ekspanzivnih mera koje bi rezultirale produbljanjem budžetskog deficita. Neophodno je i da se izgradnjom institucija i ambijenta podrži privredni rast. Treba promovisati nove oblike finansiranja – prethodna dva ministarstva privrede najavila su zakonsko uređenje oblasti preduzetnog kapitala i fondova preduzetnog kapitala. Ovo treba učiniti kroz pripremu i donošenje posebnog zakona. Na taj način, preduzetni kapital se jasno definiše i prepoznaje kao zaseban finansijski instrument, različit i poseban u odnosu na druge slične finansijske instrumente, a fondovi preduzetnog kapitala kao posebne investicione i finansijske institucije.

**Cljučne reči:** *stabilnost, budžetski deficit, javni dug, eksterna održivost, preduzetni kapital*

## Short- and medium-term risks

In this section, we shall consider the dynamics of key indicators of macroeconomic stability: budget deficit, public debt, external debt and foreign exchange reserves. The aim is to objectively determine their trajectory, depending on the current situation, the latest official plans for economic policy, as well as projections and forecasts of the relevant variables in the next few years.

### Budget deficit and public debt

The general government deficit of 7.1% of GDP (EUR 2.4 bn), as envisaged for 2014, is too high. First, this is the highest budget deficit in the entire Eastern and Central Europe and, second, it shall increase by about 0.5% of GDP compared to 2013. Even though in October last year the Government announced adoption of the package of fiscal consolidation measures, of at least 2% of GDP, the actual scale of measures adopted in late 2013 is almost half the size and is not sufficient to halt growing deficit in 2014 [1, pp. 39-46]. Additional and pronounced deficit decrease in 2014, which has to be realized after the establishment of new Government, is the first necessary precondition for fiscal consolidation.

In the medium term, the frameworks of official economic policy are determined by the Fiscal strategy [4]. The latest Fiscal strategy, dating back to November 2013, envisaged that the general government deficit (including off-budget financial transactions) will decrease in 2015 and 2016 by almost 4 percentage points (p.p.) of GDP in total, i.e. from 7.1% of GDP in 2014 to 3.2% of GDP in 2016. However, the measures behind this decrease are not convincing. The largest savings (about two-thirds of total savings) are envisaged in allocations for the public sector employees and in refinancing of an expensive public debt by means of a cheaper one. However, the savings in wages are estimated too optimistically since they imply reduction of wages and employment, which is hardly feasible. Replacement of expensive debt with cheaper one would imply that almost all of the funds obtained from still uncertain privatization revenues and from more favorable bilateral borrowings should be used for early repayment of expensive loan and for cheaper financing

of deficit. Instead of such risky and unbalanced structure of medium-term savings, it would be more rational and credible to envisage commensurate savings in most of the budget items (pensions, subsidies, non-targeted social benefits, etc), instead of only in two.

Since the room for crisis avoidance is already narrowed, the public and politicians should be prepared for additional and painful austerity measures over the entire period 2014-2016. Only in this way could the trajectory of rising public debt reverse in 2017 – and even then only relatively (compared to GDP), while public debt will continue to grow in nominal terms after 2017. We shall note that it will be necessary over the entire period of consolidation to borrow about EUR 5 bn annually in order to finance deficit and repay the principal of the existing public debt. Mitigating circumstances in 2014 refer to slightly facilitated borrowing in the said year (EUR 3 bn loan from the United Arab Emirates) which, at the same time, can be dangerous if resulting in a delay in implementation of necessary measures. Gravity of the situation which Serbia faces is similar to that of Greece or Portugal – the countries implementing a long-standing program of deficit reduction. Adjustment will certainly take place in Serbia in the forthcoming period, but the question is whether to a lesser extent and controlled (over a three-year period of painful and politically unpopular measures) or uncontrolled (through production drop by over 5%, high unemployment growth, strong depreciation of the dinar and high inflation).

In the forthcoming period, public debt will continue to grow rapidly if stronger fiscal consolidation fails in the following three years. Stabilization of debt-to-GDP ratio by end 2016 – based on the 2014 budget and measures contained within the medium-term Fiscal strategy – is unlikely. Despite all efforts to reduce planned fiscal deficit in 2014, it is still higher than already high 2013 deficit. Bad practice to grant loans, primarily for borrowings to public enterprises, not only continued but the amount of anticipated guarantees is about 60% higher in nominal terms compared to the 2013 Budget Law plan. In addition, significant portion of savings in respect of measures planned for 2015 and 2016 is questionable, and there are also pronounced risks that fiscal adjustment in the

medium term will be lower than envisaged. It can be often heard in public that the Government can solve problem of increasing costs of public debt by using privatization revenues for early repayment of debts and by replacing expensive loans with cheap ones. However, even though gravity of the situation requires that these funds, if existing in the forthcoming years, are really used for repayment of current debts, this would only result in a one-time reduction of the public debt level, but not in a reversal of an upward trend. Revenue from sales of state assets and favorable loans granted on the basis of bilateral agreements can facilitate Government's funding of state liabilities in the next period and can reduce interest expenses. However, permanent and sustainable reduction of public debt requires sharp reduction of fiscal deficit and termination of guarantees issuing. Having in mind that slower economic growth of about 1% is expected next year, public debt could exceed 70% of GDP by the end of next year [4, pp. 58-63].

Serbia has recorded the highest public debt growth in the period after the crisis relative to comparable countries of Central and Eastern Europe. At the end of 2009, with public debt standing at about 38% of GDP, Serbia stood at an average level recorded in the observed countries. However, over the last four years, debt increased by almost 30% of GDP, far more than in other countries, so, today, Serbia is a country with the second largest share of public debt in GDP (right after Hungary). Extremely rapid growth of public debt, reported in the previous period, is an important cause of higher interest rates on Serbia's borrowings compared to other countries in the region. Hungary's debt stands at the level of about 80% of GDP, but it has remained practically the same in the last four years, which sends a clear signal to foreign investors that public debt has been brought under control. This is certainly most important, although not the only cause of lower interest rates compared to Serbia whose debt was explosively increasing in the same period. On the occasion of the latest issuing of Eurobonds, within a gap of only few days, these two countries reported similar interest rate of about 6% but with important difference in maturity – Hungary issued bonds with a 10-year maturity, Serbia with a 5-year maturity.

It is important to know that slow economic recovery cannot be a justification for strong public debt growth in recent year. Even though economic growth is an important determinant that greatly affects movement of public debt share in GDP, recession does not characterize Serbian economy only. In fact, except for Poland and Albania which achieved remarkable economic growth in this period, most of other countries have not yet achieved the level of real GDP they reported back in late 2008. Therefore, the reasons for a record high growth of Serbia's public debt should be sought in weak fiscal consolidation and in constant postponement of necessary structural reforms.

The main causes of a rapid increase in Serbia's public debt over the last four years are high fiscal deficit and increase in issued guarantees. Since 2009, deficit has constantly contributed to public debt increase, whereby the public deficits reported in previous two years are of particular concern. According to IMF methodology, fiscal deficit has been exceeding 7% of GDP for two consecutive years, while in other comparable countries, except for Albania, it has not been exceeding 5% of GDP. It is also indicative that Serbia belongs to a group of countries whose fiscal deficit has not reduced even though fiscal consolidation officially started back in the second half of 2012. On the other hand, contingent liabilities of the state (mainly in respect of guarantees issued for loans to public enterprises) increased from about EUR 900 million, as was the amount reported in late 2009, to about EUR 3 billion in late 2013, whereby issuance of new guarantees, planned for 2014, is projected at about EUR 800 million. Therefore, only in respect of issued guarantees, public debt has increased over the past four years by EUR 2 bn, i.e. more than 6% of this year's GDP.

#### External sustainability

In addition to the dynamics of budget deficit and public debt, we shall consider the potential development of Serbia's external position. We shall analyze the period by 2017, even though certain "lap times" are set depending on goals established by 2020 [8]. According to Fiscal strategy, time horizon, by definition, lasts for three years, and is thus somewhat shorter (by 2016). The first scenario to be considered is called baseline scenario, but it is essentially

optimistic (even though some of the results are certainly not such). Growth rates according to this scenario are rather high, and the model “jumps” through the external position. The second, alternative scenario relies more on the Fiscal strategy assumptions, economic growth rates are more modest, but the risks are accumulated in insufficient economic dynamics and high unemployment.

Projections referred to in the Government Fiscal strategy reflect hardly attainable scenario. It is assumed that economic growth will be accompanied by high growth of investments and exports on the one hand, and low growth of imports increase and consumption decline, on the other hand. We believe that these dependencies have not been set on credible grounds. In our baseline scenario, we assume that economic growth is accompanied by growth of investments and exports (despite consumption drop), but that they also have to be supported by more dynamic growth of imports than already envisaged. A possible consequence might be the entry into red zone of external sustainability indicator, while trends in foreign exchange reserves (which are reduced to the value of one-month import reported in 2017) are particularly critical. Alternatively, if assumed that export will grow faster than import (and that negative net export will really be reduced in accordance with Government plans), we estimate that investments will grow much slower than preferred and that economic growth, thus unemployment decrease, will be missing.

Objective assessment of medium-term prospects of the Serbian economy suggests that it will be difficult to maintain stability. In any case, external sustainability indicators will remain outside the sustainability zone and payment of external obligations will be jeopardized. In such conditions, arrangement with IMF becomes a short-term

imperative thus the time has come to consider the need for rescheduling payment of obligations in critical years (the year of 2017 being the first). Significant narrowing of foreign trade deficit partly relaxes country’s foreign position, but cannot avoid consequences on the other side – small-scale investment and lower economic growth. Unemployment will thus remain extremely high, so the question regarding social and economic sustainability of such economic system will arise again.

We shall further point to characteristics of the development scenario referred to in the Fiscal strategy, and then of the two other scenarios as well. First, we shall point to basic assumptions and results from the Government scenario (Table 1). We should primarily point to assumptions referring to drop in both personal consumption and government spending by 2016, with intact trajectory of GDP growth. Consumption drop provides low import growth rates with fairly rapid dynamics of export. As a result, negative balance of goods and services (net exports) almost halves compared to GDP for only three years, and as a consequence, foreign exchange reserves at the end of the period remain at the same level as at the beginning of the period, so there are no problems with external sustainability according to the Government scenario.

As for the described dynamics, the projected difference between export and import growth rates is overly optimistic. More specifically, according to our experience, one cannot expect that exports growth will be higher than imports growth in the period of three years. On the contrary, in only three years after 2000 exports grew more rapidly than imports, and the possible explanation is that structural breakthrough (and new trends in the observed series) occurred during 2013 is not, in our opinion, reason enough to make overly optimistic plans.

**Table 1: Fiscal strategy projections (real growth rates and %)**

	2013	2014	2015	2016
GDP	2.0	1.0	1.8	2.0
Personal consumption	-1.2	-1.8	-0.6	-0.3
Government spending	-3.0	-2.2	-4.4	-3.6
Investments	-3.4	4.7	9.6	8.9
Exports of goods and services	14.0	6.4	7.0	7.7
Imports of goods and services	2.3	1.6	3.5	4.6
Balance of goods and services,% of GDP	-11.9	-10.0	-8.6	-7.4

Source: [4, p. 13]

When it comes to our baseline scenario, it should be said that 2013 reported modest increase in gross domestic product, based on export growth, along with decline in overall domestic demand, consumption and investments within that framework, due to strict reduction of the goods and services deficit in balance of payments. Republic Statistical Office published annual projection of a 2.4% of GDP real growth in 2013. As in the previous cases, this estimate is based on some unrealistically assessed components – for example, growth of physical volume of manufacturing production is taken to assess GDP growth in manufacturing industry. However, in final (and correct) calculation based on financial indicators, such growth will prove to be overestimated, as was the case in past few years. Therefore, in this paper we adhere to previous estimate that 2013 GDP growth stood at 1.5%. For the years to come, we have chosen the scenario according to which the target GDP growth rate in 2020 will reach 4%, which is conditioned primarily by the fact that real growth of fixed investments will remain in 8%-10% rang in the period 2015-2017. At the same time, it is emphasized that GDP growth rate cannot exceed 3% in the last year of this three-year period (by 2016) – not even in case the investment cycle starts as early as 2014. Another condition is successful development of fiscal consolidation, i.e. calling a halt to public debt growth and stabilization thereof at the end of the period. Gradual increase in investment capital inflow is envisaged through foreign direct investment (FDI) and investment loans granted to national investors.

When it comes to foreign trade, it is assumed that export will maintain dynamic growth at double-digit annual rates, but not such high as was the 2013 rate achieved due to FIAT and to low base which this export was compared with. With about 40% of goods and services share in 2012 GDP, exports should stand closer to 60% of share in GDP in 2017. On the other hand, high investment growth will

induce significantly faster growth of imports than the one reported in 2013, but at the rates lower than export growth rates. Starting from 2014, household consumption could grow by 1%-2% a year in real terms, but it would have to be accompanied by permanent decrease in the government spending share in GDP.

Major difference between this scenario and the one presented in Fiscal strategy lies in dynamics, i.e. deficit share in foreign trade of goods and services (negative net export within GDP use). Fiscal strategy has projected permanent decrease in that share – from 11.9% in 2013 to 7.4% in 2016; at a similar investment pace, the consequence is a permanent drop in both government spending and personal consumption. One can easily observe that the target parameter in this case is maintenance of the level of foreign exchange reserves. What we rated as unrealistic is acceleration of economic growth with a steady decline in household consumption throughout the period, which would imply simultaneous production growth and drop in real wages. The core elements of this scenario are presented in Table 2.

The scenario is essentially optimistic because it is based on the assumption that investment cycle will start as early as 2014 and that fiscal consolidation will be successful. The essence of the problem is a negative credit balance with other countries. Due to Eurobonds (or loans for covering budget deficit), this negative balance is neutralized, so 2013 and 2014 will report no erosion of foreign exchange reserves; however, such an erosion will become more accelerated subsequently, and will be particularly pronounced in 2017 on the occasion of repayment jump due to maturity of Eurobonds package (the second and the third jump in repayment will mature in 2020 and 2021). Foreign exchange reserves in 2017 would be reduced to the value of one-month import of goods and services. The consequences would be external liquidity problems and enormous depreciation of the dinar.

**Table 2: Baseline scenario (real growth rates and %)**

	2013	2014	2015	2016	2017
GDP	1.5	1.0	2.0	2.5	3.0
Consumption	-3.3	0.4	0.9	0.8	1.0
Investments	-5.9	6.7	8.3	8.9	8.6
Exports of goods and services	20.8	10.4	10.4	10.3	12.1
Imports of goods and services	6.4	9.9	9.4	8.9	10.0
Balance of goods and services,% of GDP	-12.0	-12.5	-13.0	-13.0	-12.5

Alternatives to closing the overall balance of payments through said reduction in foreign exchange reserves would be, first, greater inflow of investment loans and/or increased net inflow of foreign direct investments, and second, refinancing or rescheduling of debt maturing in those years. Technically speaking, there is an alternative with a lower deficit of goods and services – in case investment cycle would be missing – but in such a case we should take into account prolonged economic growth closer to stagnation and further reduction of household consumption, which is certainly not an option to choose.

Net FDI inflow in the presented scenario would stand at around 5% of GDP from 2014 onwards (from EUR 1.7 bn to EUR 2 bn annually). Is there a possibility that net FDI might be higher (with possibly greater inflow of investment loans) and thereby, at least, to partly neutralize the erosion of foreign exchange reserves? In case there is, it would hardly be such to eliminate the need for rescheduling a portion of maturing obligations. If the assumption on FDI growth is questioned, adjustments necessary for maintaining external liquidity will be more difficult to implement. In such a case, additional risks would be activated, and we shall here mention only the most important ones.

The first is high foreign debt of the private sector, reaching around 80% of GDP. Cumulated public and private debt, combined with appreciation of the national currency, increases the probability of the external liquidity crisis. Recent studies have shown that external credit risk

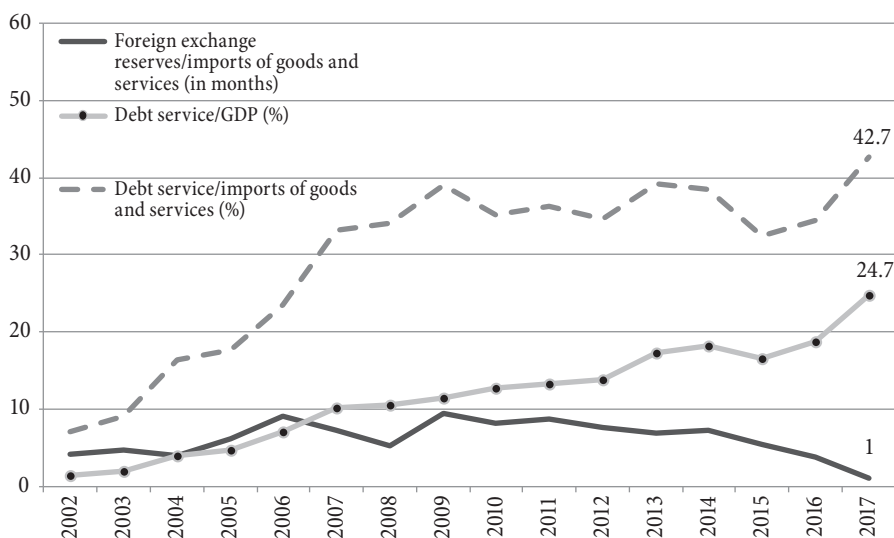
significantly increases if country’s foreign debt exceeds 50% of its GDP [2].

The second is a striking discrepancy of expenditures for servicing external public debt. These discrepancies, as pronounced in 2017, result from absence of any grounded strategy for public debt management over the previous years. Huge one-time outflows can, by their nature, jeopardize credit rating and country’s credibility through activation of the mechanism usually called liquidity shock. In order to reduce this risk, it is preferred to abandon the presumption that the country will no further borrow at the EU market since foreign trade deficit will most probably remain high by 2017. Decrease in high variability of outflows, on the basis of foreign public debt, reduces the probability of liquidity shock. It would certainly be preferred to develop and adopt consistent and realistic strategy for public debt management.

The third risk to be activated, should the country’s foreign liquidity become jeopardized, is the risk of accelerated depreciation of the national currency, whose effect would be quickly spilled over to inflation. Probability of activating the said risk depends not only on the possible liquidity shock but also on the level of current appreciation of the national currency and the level of current balance of payments deficit. The conditions for activation of this risk in Serbia definitely exist and they should be taken into account.

The Figure 1 shows the dynamics of three important indicators of external liquidity according to the baseline

**Figure 1: External sustainability indicators according to the baseline scenario**



scenario. It confirms strong exposure to the aforementioned risks. All three indicators reach and exceed critical values. Debt servicing against exports of goods and services stands constantly above the upper recommended limit of 25%, debt servicing through GDP reaches 25% and the ratio of foreign exchange reserves to imports of goods and services drops to 1 month (foreign exchange reserves, worth 6-month imports, is considered a preferred minimum limit).

In our second scenario we assume strong reduction of negative net exports (as in the Fiscal strategy), but it has its price – lower investments. In fact, it is impossible to maintain high level of investments, as preferred, with low rates of import growth. Therefore, according to alternative scenario (see Table 3), we have envisaged lower deficit of goods and services – in case investment cycle is missing – and, accordingly, defense of foreign exchange reserves. However, in that case we should take into account prolonged economic growth close to stagnation and further reduction of household consumption, as well as fewer possibilities for unemployment decrease. This certainly is not the option to choose, but we shall present here a scenario based on that option. A scenario illustrating this option actually starts from decrease in share of goods and services deficit as presented in Fiscal strategy by 2016, except that we added the year of 2017 in which such process slows down.

It is assumed here that FDI share in GDP will stand at 3% (about EUR 1 bn), while foreign exchange reserves in the critical year of 2017 will retain the 3.7-month value. As the main consequence, growth rate will be reduced to 1.5% by 2020 due to insufficient investment inflow by 2017. There will be no employment growth!

As for indicators of external liquidity, we mentioned that the level of foreign reserves remains at a higher level

according to alternative scenario, but it is interesting that the other two indicators have worse values compared to baseline scenario. This is due to lower export growth rates (hence the values) in the second scenario.

## Economic policy, reforms and growth

Part of the professional and general public raises a dilemma again: savings or growth. The view is presented that the savings (embodied in fiscal consolidation measures) reduce economic growth, and that sustainability of economic and financial system of the country requires just the opposite – measures to stimulate growth. Simply put, it is said that current measures, aimed at increase in public revenues (most pronounced – VAT increase) and decrease in public expenditures (control over expenditures related to the public sector wages and pensions, control over goods, services and subsidies expenditures) are not good and that they are counterproductive. In this respect, few facts have to be mentioned. First, unexpectedly poor collection of public revenues is not a consequence of the so-called Laffer curve (higher tax rates - lower income), but of growing tax evasion [4, pp. 11-15]. Second, consolidation is not a matter of choice, but of necessity. To finance deficit and service old debts we will need more than EUR 5 bn a year in the following couple of years and creditors have already expressed the requirement for measures to heal public finance; otherwise, we might run out of the necessary financial resources and would be forced to undergo more painful and severe adjustment. We cannot neglect the fact that the IMF and the World Bank have based their support (financial and conceptual) mainly on consolidation measures. Country's rating and borrowing costs are closely connected to the support of these institutions. Third, the proposed measures, i.e. reducing labor levy or abundant

**Table 3: Alternative scenario (real growth rates and %)**

	2013	2014	2015	2016	2017
GDP	1.5	1.0	1.5	2.0	2.0
Consumption	-3.3	-1.8	-0.8	0.2	1.8
Investments	-5.9	4.1	3.7	3.1	0.8
Exports of goods and services	20.8	5.7	4.7	4.6	5.8
Imports of goods and services	6.4	1.5	1.5	2.1	4.8
Balance of goods and services,% of GDP	-12.0	-10.0	-8.6	-7.4	-7.0

investments from borrowing, would certainly result in an increase in already high deficit (as well as in greater risk, instability and costs of public and private sector's borrowing), while the effects on growth of economy and revenues would remain completely uncertain. Unfortunately, there is no room for expansionary fiscal policy, whereby public debt stock and annual liabilities speak in favor of the said.

The message of the above discussion is that the new Government should not consider adventurous measures. Moves that may appear tempting to wider segments of population can result in rapid collapse of public finance, having thus extensive consequences. Quantitative analysis in the previous section of this paper shows that, as early as 2017, we shall face severe blow of public debt servicing. To reduce the force of such a blow it is necessary to think of consolidation as of priority.

This should not lead to a conclusion that economic growth is not important and that intensifying thereof is impossible. Economic growth would bring higher public revenues and would allow consumption and employment growth. Answers to the question of how to achieve such growth are available, but the problem is that not much is done to implement the said. We shall further remind of the list of tasks waiting for another Government.

As a matter of principle, we will have to address another topical issue. It is a dilemma whether Serbia is hit by a wave of (neo)liberalism or, on the contrary, the state overly interferes with the economy. This topic deserves a separate essay, and we will adhere to our view that the great number of economic problems stem actually from insufficient application of market mechanisms to Serbian economy<sup>1</sup>. The consequences are reflected in accumulated problems in public finance. Losses and consequent guarantees in public enterprises, companies in pre-restructuring, excessive employment in public sector, delay in pension reform, excessive subsidization, control over some prices, losses in the banking sector and other problems are, more or less directly, the consequences of the Government's excessive interference in social developments and persistent neglecting of the market

logic (thus every other logic). The common denominator for these phenomena is the country's adulation to narrow and wide interest groups (from privileged businessmen to various strata of the population—for example, those employed in certain cities, trade unions or retirees) and avoidance of measures more painful in the short term, but inevitable and necessary. It is amazing that almost all the instruments of state interventionism have been tested in Serbia, but that the market and neo(liberalism) are blamed for bad situation!

On the other hand, it should be noted that the state failed to intervene where it should have – in the development of institutions, infrastructure and environment, for providing more dynamic investment and economic activities. There is little progress in areas such as starting a business, granting construction permits, facilitating tax payment, inspection supervision, bankruptcy proceedings, protection of competition, public-private partnerships [6], [7], [10]. Inefficient judiciary and protection of contracts are also persistent problems. One gets the impression that, instead of solving operational problems, it's easier to readdress the (philosophical) issue of savings vs. growth, state vs. market. The European Bank for Reconstruction and Development noted in its latest report that said issues were very important, thus crucial for economic growth. EBRD indicated the importance of the broader concept of country's organization, such as the importance of democracy, rule of law and mature political institutions, as well as specific issues that are often forgotten, such as human capital, education and inclusion [1], [3].

When it comes to financing growth, we face several problems. First, public resources are not abundant. Capital investments are low and declining – they decreased in 2013 by more than RSD 40 bn compared to 2012. Second, the government support to growth has been inefficient thus far (through Development Fund and other institutions), and shift in this field is not on the horizon. Third, banking resources have traditionally been geared towards mature loan seekers. However, they can hardly be relied upon in the process of developing new economic structure. We shall further address the very innovative funding resources in detail, and shall make the most concrete contribution to the issue of financing development.

1 See the meticulous analysis drafted by Prof. Lj. Madžar [5].



## Looking for new funding resources for innovative business

Many businesses, especially micro, small and medium-sized, especially at the early and initial stage of business operations, fail to meet the requirements for obtaining bank loans, especially regarding debt collateral (particularly in terms of mortgage). Also, these businesses often lack credit history required in order to obtain the loan. Although they have marketable innovative ideas, the difficulty arises out of the fact that these businesses often lack know-how and skills in the fields of economy, finance, marketing, management and business law, necessary for placing their ideas on the market in the form of goods and services, thus making a profit. On the other hand, due especially to increased risk, banks do not generally show particular interest in granting loans for business projects and ventures of these businesses, but for projects and ventures of large companies. At the same time, financial resources for the implementation of a significant number of business ventures and projects, coming from public and international institutional financial resources, are rarely available to small and medium-sized businesses in the necessary critical mass. The existing investment funds are most interested in investing in large corporate entities and joint stock companies whose shares are traded on the capital market, while neither venture capital nor microfinance market are available and developed in our country to the extent necessary [12].

Venture capital is an alternative source of financing for the target company which is assessed by the venture capital fund as having good prospects, innovative and entrepreneurial potential and business perspectives to develop, grow and become competitive as an important economic entity able to generate high return on invested capital. After some time, measured in years, when the target company develops and achieves business success, improves its corporate management and entrepreneurial culture, i.e. when it emerges from business crisis or undergoes reorganization thus improving its business performance and increasing its value and the value of its capital with the help of professional, mentoring support, know-how and advice provided by the venture capital fund,

this fund shall determine the most appropriate method to terminate the investment activity and shall leave the ownership structure of the target company (disinvestment) by selling its stake, i.e. the target company's shares. Venture capital implies an active approach to the target company management contrary to classical (traditional) financial instruments such as, for example, bank loan in which case the commercial bank is interested in repayment of debt principal and interest. Venture capital investments represent a form of non-public investment (private placements) in company's private equity.

Apart from venture capital, the venture capital fund invests and places mezzanine capital in the target companies, as a form of financial resources ranked by their characteristics between financial liability (debt) of the target company as debtor, i.e. financial claim of the venture capital fund as creditor and private equity of the target company, i.e. between debt (borrowed) capital and equity of the target company (examples: subordinated loan, a loan with profit share, i.e. loan with interest based on the target company's profit, convertible shares and warrants, etc.). Higher private equity reflects business and financial steadfastness of the company and provides greater guarantees (but certainly not a complete safety) for creditors, enabling them to enforce their claims against the company. Higher private equity positively affects company's creditworthiness and business reputation as essential requirements for successful operations, and in the capacity of guarantee capital substance acts to protect company's creditors as well as those investing in the company and members of that company, thus creating prospects for new business arrangements, new revenue generation and company's access to new financial resources. Combination of private equity increase and provision of business support to the company increasing its private equity, then further expansion of business network as well as mastering new know-how and technology, increases the company's business performance and additionally facilitates conclusion of new business arrangements and access to new funding sources. By providing mezzanine and debt capital the target company gets chance to obtain working capital, necessary for sustainable operations and development.

Venture capital is highly developed in the world (the United States, the United Kingdom, the Netherlands, Germany and many other European countries) where numerous venture capital funds are operational and where economic-financial and legal practice and theory are already developed, extensive professional literature is available as well as curricula and court cases, and where other fields, important in this respect, are developed. International development institutions play important role in the field of venture capital investments – European Bank for Reconstruction and Development (EBRD), European Investment Fund (EIF) and International Finance Corporation (IFC), as part of the World Bank Group. The most important European association of venture capital is the European Association of Private Equity and Venture Capital (EVCA), which has rich practice.

The Republic of Serbia lacks venture capital. There are just few examples of venture capital investments in Serbia. A good illustration of the lack of venture capital in Serbia is the latest research of the World Economic Forum – The Global Competitiveness Report 2013-2014, according to which the Republic of Serbia is ranked 129th of 148 countries in the category of Venture Capital Availability. According to the Global Venture Capital and Private Equity Country Attractiveness Index 2013, the Republic of Serbia is ranked 82nd out of 118 countries (economies). An additional concern is that these rankings have a tendency to fall, if observed over many years – for example, according to the Global Competitiveness Report 2011-2012, the Republic of Serbia is ranked 121st in the category of Venture Capital Availability while it was ranked 70th in the Global Venture Capital and Private Equity Country Attractiveness Index 2012, meaning it fell by 12 places in a year.

Venture capital in Serbia is not recognized in regulatory terms as a special financial instrument and legal business, neither are the companies that provide such capital. In addition, there is no legal ground set by other laws for recognizing holders of venture capital and business operations they perform. Thus, there is no legal ground to regulate tax and other fiscal and public incentives for venture capital. These incentives are the instruments necessary for the completion of venture capital

framework and for greater recognition of this financial instrument. Experiences of other countries show that such incentives stimulate attraction of the new venture capital investments. The lack of legal regulation significantly limits participation of venture capital funds in various types of programs, projects, competitions, incentives for attracting investments and business development. Lack of legal regulation prevents greater participation of the public finance funds in encouraging the development of venture capital, such as financing in the form of the so-called fund-of-funds in the case when public fund invests resources in private fund, or in form of joint investment of public and private funds in other private funds or in target companies. Lack of legal recognition negatively affects the promotion of venture capital in Serbia. Entrepreneurs (particularly those managing micro, small and medium-sized companies as well as family businesses), lawyers and economists are neither sufficiently informed about nor familiar with characteristics and importance of risky venture capital. The above-said diminishes the importance of business associations of entities dealing with venture capital, and significantly lowers the possibility to attract venture capital investments.

During the previous two terms of office, the Ministry of Economy announced it would legally regulate the field of venture capital, venture capital funds and business activities thereof. This should be done through drafting and adoption of a special law [9]. In this way, venture capital is clearly defined and recognized as a separate financial instrument, different and special compared to other similar financial instruments, while venture capital funds are recognized as special investment and financial institutions. Separate regulation in this field brings legal clarity and practical usability of norms, thus positively affecting attraction of large-scale investments.

The Law should regulate the establishment and operations of venture capital funds and management companies, then administering of the venture capital funds and management companies, supervision over the work of these funds and companies, as well as other important issues in the field of venture capital funds. This Law would stipulate that the venture capital fund shall invest and dispose of venture capital under the term

prescribed by said Law, and shall be allowed to invest in target companies and place mezzanine capital, loans and collaterals, i.e. loans in the form of guarantees and legal entity sureties. This Law should regulate legal form of the venture capital fund as a limited partnership, limited liability company or joint stock company, along with appropriate application of the Law governing companies. The amount of the fund's private equity should be regulated in a way to create sufficient substance of guarantee to creditors, while not being an obstacle to establishment of funds.

When it comes to founders, members and investors in the venture capital fund, the Law should set the terms and limitations prohibiting engagement of persons convicted of business-financial criminal offences and commercial offences, persons subject to imposed security measure or protective measure of prohibition to carry out the occupation, activity or duty, as well as persons whose contract on sales of capital or assets of the privatization subject was terminated due to failure to perform contractual obligations. The law should provide that an investor in the venture capital fund can only be a professional client within the meaning of the Law regulating capital markets. The Law defines a professional client as a client with sufficient experience, know-how and competences to independently make decisions on investment activities and proper assessment of risk related to investment activities, as well as a client who meets the requirements stipulated by the Law. Professional clients, in terms of all investment services, activities and financial instruments, are: persons subject to obligation of getting approvals, i.e. supervision by the competent authority for conducting business operations in the financial market, such as: credit institutions, investment companies, other financial institutions whose business operation is approved or supervised by an appropriate supervisory authority, insurance companies, collective investment institutions and their management companies, pension funds and their management companies, commodity exchange dealers as well as other persons supervised by the competent authority; legal entities that meet at least two of the following requirements: 1) total assets of at least EUR 20,000,000, 2) annual operating income of at least 40,000,000 and 3) equity in the amount of at least

EUR 2,000,000; the Republic, autonomous provinces and local self-government units as well as other states or national and regional bodies, the National Bank of Serbia and the central banks of other countries, international and supranational institutions such as the International Monetary Fund, European Central Bank, European Investment Bank and similar international organizations. It should be prescribed that, apart from a professional client, investor may be another entity committed to invest a certain amount (e.g. at least EUR 50,000) and to provide written statement confirming its awareness of the risky nature of such investment. Investor may be complex venture capital fund (fund-of-funds), as a corporation investing financial resources in venture capital funds. The Law should provide that financial resources owned by the Republic of Serbia, autonomous province and local self-government unit (public financial resources) may be invested in the venture capital fund, as well as that the committee of investors may be established in the venture capital fund, whereby the establishment of the committee of investors shall be obligatory when public financial resources and public-private financial resources are invested in the venture capital fund.

It is very important to define the goal of investment activity and venture capital placement in terms of the development of business concept in the initial stage of target company (seed capital), development of products and/or services and initial business operations of the target company (initial capital) and development of such target company after initial and starting phase, through improvement of company's business capacities, widening of its market, further development of products and services and/or through investment activity aimed at providing additional working capital (development capital).

When it comes to structure of investments and placements of venture capital fund, this Law should establish the obligation of venture capital fund to invest, in the form of venture capital, at least 70% of total financial resources invested in the target companies, as well as to invest mezzanine capital with economic substance of private equity capital. The remaining 30% of financial resources should be invested, i.e. placed to target companies as mezzanine capital with economic substance of debt

capital (borrowed capital), loans and collaterals, i.e. loans in the form of guarantees and legal entity sureties. The law should provide that at least 50% of the financial resources invested, i.e. placed by the venture capital fund in target companies, shall originate from private investors, i.e. from privately-owned financial resources. Furthermore, the Law should stipulate a maximum period during which the venture capital fund may hold venture capital within the target company. Stipulation of such limitations and terms is aimed at ensuring compliance with the European regulation governing venture capital, control and allocation of state aid, as well as with the European funds' terms of financing. At the same time, national regulations have to be amended and harmonized in accordance with the rules on granting state aid. Venture capital funds are non-deposit financial institutions, so there is no systemic risk like the one related to depository financial institutions, thus the reason for prescribing such limitations and terms is not of such nature. The real reason lies in the fact that venture capital funds will use state aid, including tax incentives and public resources, so it is necessary to establish the structure of investments enabling to achieve investment goal and the purpose of the very Law. In this respect, the law and other regulations should impose tax and other public incentives for venture and mezzanine capital, i.e. for venture capital funds, investors, venture and mezzanine capital investments and for target companies. Tax incentive of particular importance would be the one reducing tax liabilities of the venture capital fund, in respect of taxation of capital gain generated by transfer of share in company's private equity through disinvestment, because it enables reinvestment of the financial resources acquired in such way.

Venture capital fund management should be prescribed as an alternative, as follows: by the management company or by own (internal) management administration of the venture capital fund. At the same time, the Law should regulate the contract on venture capital fund management, concluded between the venture capital fund and the management company, as well as activity and management tasks, management duties, private equity of the management company and relations in respect of joint capital and voting rights of the venture capital fund

and the management company, terms and limitations for founders, members, general manager, governing and supervisory bodies of the management company, modeled on the terms and limitations prescribed for founders, members and investors in the venture capital fund.

Further, pursuant to the EU regulation, this Law should stipulate competences of the Securities Commission important for supervising the implementation of this law and operations of the venture capital funds and the managing companies, as well as forms of supervisions, preventive measures and elimination of irregularities. Securities Commission has already gained extensive experience in supervising operations of investment funds, of the companies managing these funds, as well as of existing financial institutions most similar to venture capital institutions. At the same time, the Law should regulate reporting of the venture capital funds and the management companies to Securities Commission as well as compulsory audit of these entities, which enables to obtain evidence for expression of an opinion on regularity and legality of business operations conducted by the venture capital fund, i.e. by the management company.

Through regulation of the venture capital funds it has been envisaged to create conditions for implementation of new activities performed by the present Agency for Export Insurance and Financing (future Agency for financing and rehabilitation of the economy). It has also been envisaged that this Agency will invest in venture capital funds. In this way, the Agency would be a complex venture capital fund (fund-of-funds). In this respect, under the Ministry of Economy budget section the 2014 Budget Law envisaged financial resources in the amount of about RSD 33 bn for the purchase of national financial assets. The resources within this appropriation are intended for the purchase of accounts receivable in the amount of RSD 17.4 bn in respect of employment relationship with companies under privatization process, as well as for the share in equity of the financial institutions dealing with loan operations and issuing of guarantees, and share in equity of economic entities, in the amount of RSD 16 bn. It remains to be seen which of these initiatives will survive after establishment of new Government but, in any case,

a good idea for the promotion of venture capital in Serbia should not be rejected.

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