

SERBIAN CAPITAL MARKET: QUO VADIS**SIRBİSTAN SERMAYE PİYASASI: QUO VADIS****Assoc. Prof. Dr. Predrag DEDEIC*****ABSTRACT**

This article is dealing with present negative trends on Serbian capital market. Those trends are seen in a way that the current bad situation can be anticipated as an opportunity . The process of revitalization must encompass a lot of different subjects and make the balance of their interests. The need for changes is obvious but how to make it is a challenge that is discussed in the paper. The particular measures, that have to be incorporated to make the market deeper and wider, are analyzed thoroughly. How to change the situation where the public companies are rushing to become closed and IPOs of new ones do not exist?

What is our capital market policy and how the harmonization, of our legislation and practice, with EU rules is affecting market participants? How to build the capacity and independency of Serbian Securities Commission and its relationship with Ministry of finance make more efficient? How to open the door for new participants and new instruments such as municipal bonds, green and social bonds and other debt instruments? Do we need IPO of state enterprises? Dilemmas and answers linked to those questions and some other, make the substance of this article.

Keywords: *investments, capital market, strategy of capital market development, initial public offering, financial instruments.*

**“Fast means going slowly without interruption”
Japanese Proverb**

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I. INTRODUCTION

The Serbian capital market is shallow, illiquid and with inadequate investor base.¹ It suffers from structural issues. Its depth, once achieved in the privatization period, dramatically shrank in size.² Strong companies keep leaving the market, while the new ones are not taking their place. A significant number of investment companies is experiencing difficulties. There are no new financial instruments. The process of harmonization with the European Union (the EU) *acquis* is intensive, the regulations are changing. However, the state of the capital market remains run-down. The trend must be reversed, and the development chance seized. The market needs to prepare in time for admission to the *Capital Markets Union*.

The revival of the capital market should commence with the adoption of a strategy, involving all relevant stakeholders in its formulation, in the analysis of development preconditions and models from comparative practice. The government must understand the importance of the capital market development, it needs to initiate and monitor the process. In cooperation with the line ministry, Securities Commission, stock exchange, market participants, national and foreign experts and other stakeholders, the development of the market should be well thought, jump-started and sustained. It is not possible to directly apply other countries' successful models, but the successful practices should be used for creating a national model. Significant effort, time and adequate human and material resources are required in order to heal the structural disruptions and create the preconditions for growth. The technical assistance provided by international organizations in order to identify and quantify systemic problems and finding solutions proves to be useful.³

The prospects of economic development of Serbia are linked to foreign investments,⁴ privatization of public companies,⁵ the need for adequate development and investment of assets pooled by pension and investment funds, support to entrepreneurs and reliance on small and medium companies' growth, entailing alternative options for their financing on the capital market. These are all requisite components for the development of the capital market, which should be built in the strategy.

Continuous educational and promotional efforts will be required to resolve the consequences from the past and to restore the confidence in the capital market. The attempt at hurried capital market development via mass privatization was short lived in our country, as was the case in most of the transition countries.⁶ The new attempt must be essentially different and based on market regularities/principles.

The implementation of the strategy should result in the increase in the number of participants and their entire capacities (a number of market participants will not be able to survive the strain of the new conditions), in the introduction of new instruments directed at sustainable development and a widened investor base.⁷ The formula for the market attractiveness is simple: a protected and equal investor, and efficient, transparent, fair and stable operations. The main guardian of the principles is the Securities Commission. Therefore, the financial and human resources of the regulator must be adequate to maintain the required level of expertise and autonomy (from the state and the market participants).

capital markets. The example of Zambia, please see: IFC Invests in Bayport Zambia's First Bond, Supporting Access to Finance and Domestic Capital Markets, <<http://ifcext.ifc.org/IFCExt/Pressroom/IFCPressRoom.nsf/0/0161A4B20E84BA5A85257CD-D00678C88?opendocument>>9. 03. 2017.

1 The relevant international lists (FTSE list, Standard and Poor's, MSCI list, Dow Jones list etc.) place the Serbian capital market in the second to the last category (the so called frontier markets). These markets are perceived as unstable, high-risk, volatile in prices, illiquid and less accessible. On deficiencies in classification, please see **Guerrero**, Tomas (March 2013), 'Frontier Markets: A World of Opportunities', <<http://ssrn.com/abstract=2245075>> 02.03.2017, s. 3.

2 The turnover on the Belgrade Stock Exchange is dwindling (in 2016 it amounted to RSD 44.6 billion, in 2007 it was three times as much). The Stock Exchange has kept recording losses, while the number of companies comprising Belex 15 is decreasing.

3 For example, the EBRD technical cooperation project in the region (Local Currency & Capital Markets Development—Cross-regional dormant account resolution study). More about this, <<http://www.ebrd.com/what-we-do/sectors-and-topics/local-currency-and-capital-markets.html>>, 01.03.2017. Also, the International Finance Corporation (IFC) assists in development of domestic

4 There is the ever present danger of temporary investments the so called *hot money*. Please see ACCA (March 2012), 'The Rise of Capital Markets in Emerging and Frontier Economies', <<http://www.acca.ie/zm/en/technical-activities/technical-resources-search/2012/march/capital-markets-in-emerging-economies.html>>, 1.03.2017, s. 16.

5 The previous failures are the reason more for the companies to achieve the standards in line with the needs of prospective investors. ACCA (March 2012). 'The Rise of Capital Markets in Emerging and Frontier Economies', <<http://www.acca.ie/zm/en/technical-activities/technical-resources-search/2012/march/capital-markets-in-emerging-economies.html>>, 1.03.2017, s. 17.

6 **Black**, Bernard (2001), 'Legal and Institutional Preconditions for Strong Securities Markets', 48 UCLA Law Review, s.781-782.

7 It has been estimated that a significant proportion of capital is kept in a large number of inactive, low-value accounts. If a method for their activation was found, it would contribute to the liquidity of the market and potential increase in the investor base (instead of their current status of mere beneficiaries).

II. DEVELOPMENT PRECONDITIONS

Ratio of investment in revival of the Serbian capital market is based on the expected welfare; it is to bring: introduction of alternative forms of financing, alternative forms of investing, positive effect on the fiscal deficit and wider business environment (for example, providing the healthy competition to bank loans). The assorted publications state an array of positive effects: benefits on the fiscal, monetary and exchange rate policy.⁸ Anyhow, the capital market development strategy must be based on a technical analysis of met requirements⁹ after which it will be possible to set the direction and the dynamics of development. After its initialization, the process must be monitored and fine-tuned to respond to the changes (especially bearing in mind the new technologies and market internationalization).

There are many preconditions relevant to development. In accordance with the International Monetary Fund (the IMF) analyses, a stable macroeconomic policy is important, solid legal and institutional framework¹⁰ entailing good protection of creditors and investors, effective detection, prosecution and adequate sanctions for unlawful behavior.¹¹ Good financial reporting, professionalism and culture of compliance, incentives to companies and investors, absence of obstacles to movement of capital and innovation, incentives to introduction of new instruments, and continuous education and promotion etc., all comprise the integral part of such legal and business environment. There are authors calling special attention to adequacy of financial infrastructure, size of the market (appraisal of the critical mass of investors) and complementation (for example, the link between the presence and quality of state bonds and corporate bonds).¹² The additional critical capital market development factor is the existence of a

sufficient number of professional and experienced staff, both in government agencies and employed by market participants. Absence or deficiency in any of the listed preconditions demands adequate resolution of the problem in the strategy.

Such strategic approach must take into account the fact that the process of harmonization of the domestic legal systems with the EU *acquis* is underway.¹³ The time frame for implementation of new regulations and its effect on market participants should be carefully considered, as well as the arbitrariness of regulations in the region. In fact, the good investment conditions are foundations for development of the capital market (adequate removal of obstacles).¹⁴

The highly expressed bank-centric character of our system is essential to bear in mind in devising the strategy. Certainly, this is not the only hindrance to the development of the Serbian capital market. The classic division of the two sectors is a relic of an earlier period. Nowadays, their intertwining is a trend, as they become more closely connected. In addition to the fact that the banks are in a competitive position in relation to the capital market, at the same time they make the foundations of the capital market. Their shares are admitted to trading, they are issuers of bonds, authorized banks are knowledgeable and safe investment firms, cash deposits generate returns and contribute to the liquidity of the market, the securitization potential rests on them etc.¹⁵

The preconditions for the development of the Serbian capital market also exceed our state borders. The world in which the power centers shift and form new investment paradigms followed by technology innovations brings new challenges and new chances to be seized. Therefore, the development strategy must take into account the impact of a wider scope

8 **Laeven**, Luc (2014), 'IMF The Development of Local Capital Markets: Rationale and Challenges', Working Paper WP/14/234, s. 4.

9 It is important to consider all the elements which could affect successful outcome, and which pertain to the previous assumptions, costs involved, positive effects and potential adverse consequences. For example, the presence of a low or high interest rate and the fluctuation trend, monetary policy dealing with inflation, the relation between real economy and financial sector etc.

10 The legal framework beneficial to interests of investors (investor-friendly) entails high quality statutory reporting, good corporate governance and removal of obstacles to takeover mechanisms, for the purpose of building a deeper market. **Laeven**, Luc (2014), 'IMF The Development of Local Capital Markets: Rationale and Challenges', Working Paper WP/14/234, s. 9.

11 The effective actions by the regulator, prosecution and courts are crucial.

12 **Laeven**, Luc (2014), 'IMF The Development of Local Capital Markets: Rationale and Challenges', Working Paper WP/14/234, s. 7-17.

13 The latest amendments to the Law on the Capital Market (which were adopted in 2017) aligned its provisions to the Market Abuse Regulation or MAR (EU) No 596/2014. Further changes to the Law are expected by the end of the year. The work on amendments to the Law on Investment Funds is about to commence.

14 The removal of the regulatory obstacles is a complex strategic issue and requires an appraisal of the right timing. For example, in order to make membership of foreign clearing companies possible in the Central Securities Depository and Clearing House and allowing foreign currency investments in investment units of open-end investment funds, relaxation of tax requirements are called for.

15 **Warden**, Staci (2014), 'Framing the Issues: Strengthening Capital Markets in Developing Countries', <<http://www.milkeninstitute.org/publications/view/669>> 01.03.2017, s. 3-4.

of effects: geopolitics, economic dynamics, financial innovation etc.¹⁶ The link between Serbia and the EU is firm, proven by the example of the effect the surrounding had on Serbia in 2008, when the economic growth started drastically to fall.

The political risk (in Serbia and in the region) is one of the ever-present factors. A research has shown a positive trend of a declining political risk in Serbia as of 2009.¹⁷ The powerful political support to the development of the capital market at this point is of crucial importance to success. The Serbian capital market development strategy must have the mission and the concept: In 2030 Serbia commodities and financial market the leader in the region, and a sound component of the *Capital Markets Union*.

III. SOLUTION FINDING

Adoption of a strategy entails efforts and strong initial and relentless political support (involving wide political consensus) and professional (domestic and foreign) support, including adequate content and a plan with clear goals, based on knowledge and existing practice.¹⁸ As the best practice models are not directly applicable, and as there are not many states which have succeeded in establishing a deep and liquid capital market,¹⁹ a systemic approach is required in devising the strategy and in its application. The process of implementation should be managed by a special body comprised of experts and stakeholders.

The content of the strategy should offer solutions for numerous questions. Some of the issues are self-evident as essential parts of the strategy. Firstly, it is important to solve the problem of companies which were forced to be on the capital market in the privatization process. The companies would like to

exit the market, but do not have sufficient financial resources to pay out the dissenting shareholders and to transform into closed joint stock companies or change their status of a public company. Secondly, considering that the capital market rests on information, the problem of asymmetry of information ought to be adequately resolved.²⁰ Companies and their representatives should be efficiently sanctioned for false reporting. Transparency must be ensured and market manipulation prevented. The compliance behavior develops in markets where any form of manipulation in security prices is strictly sanctioned. Here, the role of a securities commission is of crucial importance. Thirdly, it is necessary to take into account the potential of privatization of public and other companies owned by the state through the stock exchange. This is one of the methods often mentioned as a way to strengthen the capital market and to make way for private entities.²¹ It is important to make the strategic decision as soon as possible, not to lose the position in the region and not to allow for destructive behavior.²² The example of experience of Cambodia is noteworthy.²³ One of the concerns present in public offerings of shares of public companies is that the offer would exceed demand, leading to a fall in prices. In this regard, the possibility of introducing a balancing mechanism between demand and supply should be considered (such as central bank which rectifies/adjusts disbalances in exchange rates, i.e. a market maker).²⁴

16 The workshop organized by the World Bank under the title The Financial System in Serbia - From 2025 Scenarios to Action Today, was held in Belgrade on 31 January 2017.

17 More on the effect of the political risk on the capital market in Serbia please see: **Minović, Jelena/ Erić, Dejan**, (2016), 'Impact of Political Risk on Frontier Capital Market, Inzinerine Ekonomika-Engineering Economics', 27(2), s. 156-162.

18 The World Bank, OECD, IMF and other international organizations have set the standards. The other experiences are valuable too, for example the experience of South Korea. Their capital market in 1995 resembled a casino. In the meanwhile it has developed into a sizable and respectable market. The highly active role of their government and incentive and requirement measures are exemplary. More about this: **Kim, Woo Chan** (2015), 'Korea's Capital Market Promotion Policies: IPOs and Other Supplementary Policy Experiences, KDI Journal of Economic Policy', 37(2), s. 64-96.

19 The good examples are those of Chile and Poland.

20 The problem can be solved by a combination of mechanisms of substantive and criminal liability and a mechanism of market participant reputation risk. The problem of financial-instrument-related frauds is expressed even in developed markets such as the USA. Please see **Black, Bernard** (2001), 'Legal and Institutional Preconditions for Strong Securities Markets', 48 UCLA Law Review, s.786-787.

21 This constitutes one of the recommendations for the development of the capital market contained in the White Book of the Foreign Investors Council. Please see: White Book of the Foreign Investors Council, 2016, s. 77.

22 There is no room on the market for hesitation. Take the example of shares of Telekom, which are being transferred via gift agreements (serving as sale agreements) as a consequence of the fact that the company is not a publicly traded company.

23 The turning point in the development of the capital market in Cambodia, was its decision to open the Water Utility Company (Phnom Penh Water Supply Authority - PPWSA) by issuing its shares to the public. The plan also encompassed the telecommunication company and the state-owned electricity supplier ACCA (June 2012). Making Capital Markets Work in Emerging and Frontier Economies: Case Studies, <<http://www.acca.ie/content/dam/acca/global/PDF-technical/global-economy/pol-afb-mcmw.pdf>> 01.03.2017, s. 17.

24 South Korea experiences are valuable. **Kim, Woo Chan** (2015), 'Korea's Capital Market Promotion Policies: IPOs and Other Supplementary Policy Experiences, KDI Journal of Economic Policy', 37(2), s. 86.

Fourthly, initial public offerings of small and medium companies should be encouraged. The potential primarily lies in medium-sized companies with the high growth perspective (mostly in the sector of information technologies and expert services)²⁵ and they need support in using this alternative approach to external financing. This would decrease their dependency on banks and could improve their *debt equity ratio*.²⁶ As opposed to the previous period in which the companies were forced by the privatization law to enter the capital market, this would mean a voluntary opening. Moreover, this is in fact the actual form of development of financing as proposed by the OECD.²⁷ Good selection, incentives, determination to pioneer the process, and education and promotion are of immense importance. Such opening of good companies must be supported by different inducements, for example as tax incentives. The research conducted by the World Federation of Exchanges proved that the desideratum of a company to go public exceeds the mere need for external financing. There are more benefits to reap such as positioning of the company for growth, investor diversification, cheaper financing and less exposure, exit option for founders etc.²⁸

The fifth important issue is to remove regulatory barriers hindering the development of the capital market, which are not present in the region (for example in Croatia) as this allows for better positioning of the market. As sixth, it is necessary to understand the relation between the commodity market and the capital market, to adequately regulate the stock exchange market of agricultural products in the first place²⁹ resulting in a positive effect on the capital market (derivatives). Seventhly, new government debt securities should be introduced stra-

tegitally (e.g. green bonds,³⁰ social bonds, different types of municipal bonds etc.) and to promote corporate bonds, mortgage bonds etc. Eighthly, a firm framework is required to strengthen the reputation of participants in the market – audit firms, investment firms, law firms, stock exchange, journalists specialized for the area and securities analysts. A special potential capacity lies with independent directors, in the work of compliance officers and director board committees such as audit etc. It is of special importance to have a range of instruments against *self-dealing* activities of directors, as this type of activity affects companies and the capital market much more than inside information misuses.³¹

Ninthly, an independent institution serving as both a regulatory authority and a watchdog on the market, such as the Securities Commission should be given a central position. It must be capable to preserve its independence and to adeptly respond to challenges. This entails retaining and attracting professional expert staff and having significant financial resources at disposal. The problem of inadequate human and financial resources of this type of autonomous authorities and the problem of prosecution of criminal actions, due to a lack of specialized knowledge in the judicial system, is found in developed countries as well. On the other hand, those who commit fraud and other illicit activities, as if by a rule are ready to employ significant financial resources to cover up their activities or for their own defense. One of the ways to tackle the expertise problem in Serbia could be the cooperation of judges, prosecution and the Securities Commission, participating in the Judicial Academy training programs. Also, excellent cooperation between the Securities Commission and the Ministry of Finance is imperative. The provision of funds required for the work and development of the Commission in conditions of a decrepit capital market and weakened market participants, remains an open, unresolved issue.

25 In the period 1977-1980, the company Apple Computer sold 121,000 computers, followed by millions in demand. By means of capital market financing, shares were sold in the amount of USD 65 million. **Kim, Kenneth/ Nofsinger, John**, (2007), Corporate Governance, New Jersey, Pearson Education.

26 Best practice example - the case of Jamaica. ACCA (June 2012). Making Capital Markets Work in Emerging and Frontier Economies: Case Studies, <<http://www.acca.ie/content/dam/acca/global/PDF-technical/global-economy/pol-afb-mcmw.pdf>> 01.03.2017, s. 14.

27 The OECD report for G-20 talks about the widely spread need to use the capital market for such purposes, World Federation of Exchanges (WFE) SME Financing and Equity Markets, <<https://www.world-exchanges.org/home/index.php/news/world-exchange-news/world-federation-of-exchanges-publishes-report-into-sme-financing-equity-markets>> 09.03.2017, s. 5

28 World Federation of Exchanges (WFE), SME Financing and Equity Markets <<https://www.world-exchanges.org/home/index.php/news/world-exchange-news/world-federation-of-exchanges-publishes-report-into-sme-financing-equity-markets>> 09.03.2017, s. 22

29 It is necessary to put in place a legal framework for the functioning of a commodity exchange. Our commodity exchange operates in destructive conditions created by the gray market, the existence of which, inter alia, damages the state budget.

30 Please see ICMA (International Capital Market Association), The green Bond Principles <https://www.google.rs/webhp?sourceid=chrome-instant&rlz=1C1EODB_enRS721RS721&ion=1&espv=2&ie=UTF-8#q=icma+green+bond+principles&*>> 01.03.2017.

31 The capital market can be strong even without the norms preventing insider trading, but of course, they will make it stronger. It has been estimated that firm supervision of this type increases share prices by 5%. More of this in **Bhattacharya, Utpal/ Hazem, Daouk** 'The World Price of Insider Trading', <<http://onlinelibrary.wiley.com/doi/10.1111/1540-6261.00416/full>> 14.03.2017. Efficient detection and combat against insider trading, in addition to expertise demands significant financial resources. In 2001, the New York Stock Exchange spent USD 95 million for curbs on insider trading.

Tenthly, it is required to analyze the possibility of establishing a state-owned investment fund (*Sovereign Wealth Fund SWF*). A state investment fund where assets are foreign exchange reserves, gold, natural resources, pensions, industry, oil reserves aim to generate long-term profit. They bring about many positive effects such as generating long-term profit, restructuring national economy by investing in cutting-edge technology and highly technical services etc.³²

IV. CONCLUSION

The Serbian capital market is classified in the category of *frontier markets*. It has been decreasing constantly as a consequence of withdrawal from the market by strong companies, while the new fast-growing companies which could utilize this alternative form of financing, are not entering the market. The trend must be reversed urgently, and the development chance seized.

The renewal of the market is a complex task entailing the existence of a strategy. The Government, in cooperation with the line ministry, Securities Commission, stock exchange, market participants and other stakeholders must formulate, jump-start and support its development. It is not possible to directly copy or apply a development model proven as successful in other countries. It can only serve as a road map for development of one's own. The process will last and will require continuous monitoring and fine-tuning. The formulation of a strategy must take into account a number of preconditions and to produce and offer solutions. Some of the relevant facts certainly include: macroeconomic policy stability, legal and institutional framework securing and stimulating investments, sound financial reporting, advanced culture of compliance, support to initial public offerings of private and state-owned companies, widening of the investor base, removal of obstacles to movement of capital and to innovation, incentives for introduction of new instruments and market participants, development of commodity exchanges, education and promotion etc.

32 **Guerrero**, Tomas, (March 2013), 'Frontier Markets: A World of Opportunities', <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245075>, 10.03.2017, s. 4.