

## FINANCING SMEs IN SERBIA\*

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### Abstract

*The sector of small and medium-sized enterprises (SME) has an extremely important role for the Serbian economic development. This sector accounts for 99.0% of business entities, and it accounts for 20% of over all employed population, generates over 20% of aggregate profits, and over 10% of exports and 60% of imports of the Serbian economy. Further development of this sector greatly depends on the support which entrepreneurs and small and medium-sized enterprises get from the financial sector. Although Serbian financial sector has been noticeable improved in several last years, where the most significant development has been within banking sector, the necessary support for the SMEs is still on the low level. The commercial bank loans are very expensive and unaffordable for the majority of interested entities. The financial support for the SMEs provided by the state agencies and organizations has increased in the past period, but still do not meet all the needs of the SME sector. How an entrepreneur or small and medium-sized enterprise could get financial source and what is its price, is the issue examined within this paper.*

**Key words:** SME sector, financing sector, state financial support, Serbia

### Introduction

Small and medium-sized enterprises are extremely important for European economies where they have a dominant position. From a total number of about twenty millions enterprises in European Union in 2007, 99% were small and medium-sized. Furthermore, SME participated in about 60% of GDP and employed approximately two third of the total number of employees in the EU private sector<sup>4</sup>. In order to create a favorable business environment and to improve the competitiveness in SME sector, the EU countries adopted a number of regulation and stimulation measures, which are based on principles defined in Small Business Act for Europe<sup>5</sup>.

The majority of transitional economies, understanding the importance of SME's and streaming to join the EU, have formulated their national SME development policies and created the programs and strategies for this sector. The transition countries pay significant attention to SMEs, since the development of this sector is highly important for the success of the overall economic reforms directed to market economy creation. In fact, the comparative advantage of SME is its flexibility, its fast adaptation to changes and they are also appropriate for satisfying the fluctuate market demands. Additionally, the low fixed costs present important baseline and comparative advantage of these enterprises. Simultaneously, the great number of these firms is characterized by innovativeness, entrepreneurship initiative and creativity, which is of remarkable significance for the accelerating technological development. And last, but not the least, the SME sector is indispensable for the new job vacancies creation (which is of considerable importance for Serbia that has approximately 18% unemployment rate).

The importance of SME development is highly respected in Serbia, as well as. In comparison to international standards, as well as in comparison to the institutional framework in some neighborhood countries, the overall economic environment and institutional framework for SME support in Serbia is not developed enough. Namely, the SME sector in Serbia is facing the massive challenges in their

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<sup>4</sup> "Statistics in focus", EUROSTAT 31/2008, 2008

<sup>5</sup> "A Small Business Act" for Europe June 2008

activities, including<sup>6</sup>: the lack of financial recourses, legislation (low regulations), and market information, then harmonized standards, information on technologies, human capital, etc.

One of the key issues and limitations for faster SME development in Serbia are the lack of financial resources and the adequate support from the financial institutions. Concerning the mentioned facts and based on empirical data and comparative analyses, our research is focused on the relation between SME and financial sector in Serbia, that is, the analyses of fundamental obstacles and guidelines for enhancing the interaction between the SME and financial sector.

### **1. SME sector development in Serbia**

SME sector is becoming more and more important for Serbian economy. The reinforcement of SME sector role in the period 2001-2008 is, at the first place, the result of general business environment improvement and enhancement measures undertaken by the all administration levels. Accordingly, the development of the SME sector in Serbia has favorable trends, regarding the growing number of this enterprises, the number of employees, the overall turnover, and, finally, the profitability level.

The SME sector in Serbia is participating with 99.8% in the total number of enterprises, 65% in employment, over 2/3 of total turnover, over 36% in GDP creation, about 60% of BDV, and over 50% of export, while the small and medium enterprises are the most profitable segment of Serbian economy in the recent years. The importance of this sector in moderating the unemployment rate (the result of great industrial systems' restructuring and privatization process), as well as the implementation of structural reforms through increase of private sector contribution in GDP creation, regarding the fact that practically all the Sims's are private ownership should be underlined.

The SME development in Serbia (and in the other Western Balkans countries)<sup>7</sup> show that there has been a significant improvement in business environment and SME development in the county since 2000. Serbia has adopted the SME development policy which is in accordance with the EU policies and it is actively engaged on improvement of the macroeconomic measures in order to foster the further SME development.

Macroeconomic stability, the reforms in judicial system, tax system, customs system, as well as in the procedures regarding starting a business are evaluated to have a positive impact on business environment. It is reported that the most significant changes are made in the procedures related to starting a business, getting credits (through guarantee fund establishment, start-up support, exports and innovations), also by organizing different agencies on national and regional level the small and midium-sized business is being facilitated. Furthermore, the improvement has been made concerning investors' protections by adoption of new law on bankruptcy proceedings. On the other hand, there are still missing the improvements in the field of entrepreneurship education, e-business, cluster establishment, access to foreign markets, as well as in the administrative regulation and institutional infrastructure.

Serbian SME policy index for 10 policy dimensions has the value of 2 and 3 (according to the data for 2007), which indicates that Serbia is on the half of its way towards a well structured system of SME incentives necessary for EU accession in comparison to the other Western Balkans countries<sup>8</sup>.

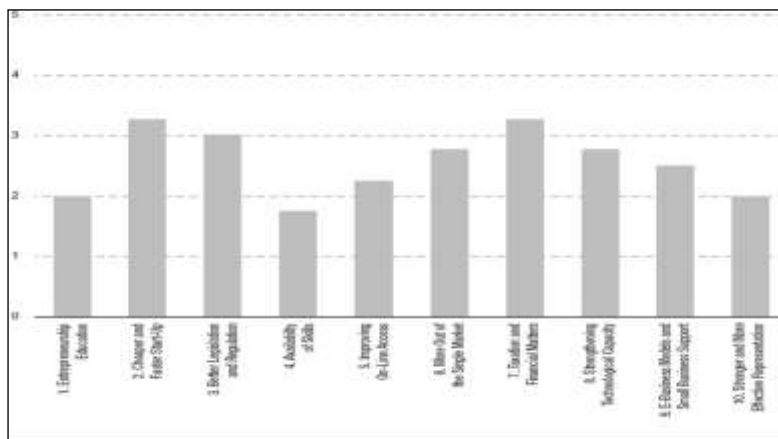
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<sup>6</sup> "Strategy for development of competitive and innovative SMEs in the period 2008-2013", 2008

<sup>7</sup> Igor Brkanovic, Milan Lalovic, Aleksandar Lakic, Srdjan Tilger, "Study on Micro-finance Support to Start-up in Serbia", International Labour Organization, Belgrade, 2007

<sup>8</sup> "Report on the Implementation of the European Charter for Small Enterprises in the Western Balkans" – OECD, EU, 2007

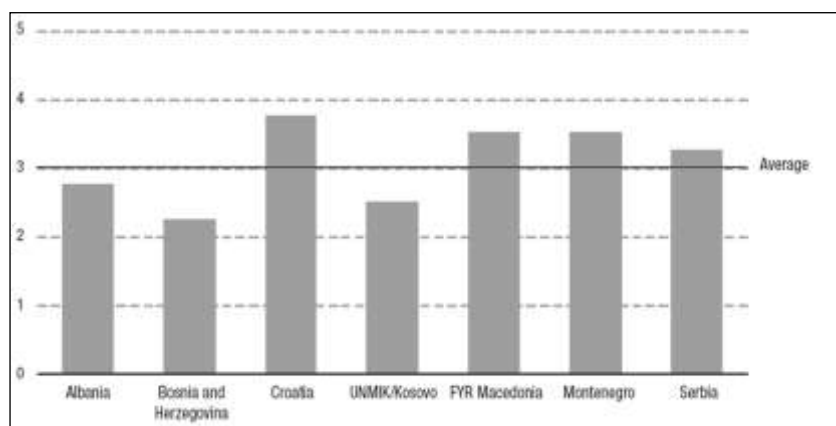
Graph.1. SME policy index for Serbia based on EU and OECD data



Source: "Report on the Implementation of the European Charter for Small Enterprises in the Western Balkans" – OECD, EU, 2008

Serbia is evaluated favourable concerning faster and not so expensive business establishment, legislative improvements, SME taxation and financing and also technological capacity building. However, Serbia is lacking behind the other Western Balkans countries concerning entrepreneurship education and training, e-business, skills and knowledge necessary for SME development, SME support within the public sector.

Graph 2. SME policy index for Western Balkan for taxation and provision of finance based on EU and OECD data



SOURCE: "REPORT ON THE IMPLEMENTATION OF THE EUROPEAN CHARTER FOR SMALL ENTERPRISES IN THE WESTERN BALKANS" – OECD, EU, 2008

In spite that Serbia is well ranked in comparison with other Western Balkans countries in the pillar of taxation and provision of finance, the numerous changes in relation between banking sector and SMEs should be made.

## 2. Basic indicators of the banking sector development in Serbia

Financial sector of the Republic of Serbia comprises of a number of different financial institutions, dominant are, understandably, banks (with 90% of the total balance amount of the financial sector in 2008.), while non-banking institutions, like insurance, leasing companies, and voluntary pension and investment funds take significantly lower share.

The size and structure of Serbian financial sector since the beginning of intensive transitional changes (generally spoken, since the beginning of 2001.) has been constantly changing, in a first place by influence of restructuring and privatisation process in banking and insurance sector, together with insti-

tutional infrastructure reshaping which allowed the business activities not presented in the former Serbian financial system (including investment funds, voluntary pension funds and leasing companies) [7]. The changes in the number of business entities comprising Serbian financial sector is presented in the following table 1.

**Table 1. Structure of the financial sector in Serbia in 2000-2008 period (number of business entities)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Banks	86	49	50	47	43	40	37	35	34
Insurance companies	35	n/a	n/a	40	40	19	17	20	22
Leasing companies	-	-	-	10	12	13	15	17	17
Voluntary pension funds	-	-	-	-	-	-	1	7	9
Investment funds	-	-	-	-	-	-	-	10	12

The biggest, and for SME's activities the most important, part of Serbian financial sector in general, is banking sector. The massive restructuring were successfully implemented within this sector during the passed period. Changes in the number of banks, their ownership structure and the participation of determined categories in total balance sum of Serbian banking sector could be represented by the following table<sup>9</sup>.

**Table 2. Ownership structure of Serbian banking sector in 2002-30.09.2008.**

End of period	No. of banks	State owned banks		Privately owned banks			
				Private dom. banks		Foreign banks	
		No.	Share ( % )	No.	Share ( % )	No.	Share ( % )
2002	50	23	49.4	15	23.6	12	27.0
2003	47	17	46.7	19	30.4	11	22.9
2004	43	14	36.1	18	26.2	11	37.7
2005	41	11	26.1	12	10.6	18	63.3
2006	37	8	14.9	7	6.5	22	78.6
2007	35	8	15.7	6	8.8	21	75.5
2008	34	8	15.5	6	9.4	21	75.5

EBRD has declared that Serbia made the obvious progress in banks' reforming (Table 2), creating the prerequisites for establishment of stable and efficient financial system. However, although it has made a significant improvement since 2001, and also has the key performances on the region average, Serbian banking sector is still in delay in comparison to the Croatian, which is the region leader.

**Table 3. Transitional indicators of banking sector restructuring and interest rate liberalization**

	2001	2002	2003	2004	2005	2006	2007	2008
Albania	2.33	2.33	2.33	2.33	2.67	2.67	2.67	2.67
Bosnia and Herzegovina	2.33	2.33	2.33	2.33	2.67	2.67	2.67	2.67
Croatia	3.33	3.33	3.67	3.67	4.00	4.00	4.00	4.00
Montenegro	1.67	1.67	2.00	2.00	2.33	2.33	2.67	2.67
Serbia	1.00	2.33	2.33	2.33	2.67	2.67	2.67	3.00

<sup>9</sup> "Doing business 2009", World Bank

### 3. System of financial support to SME sector in Serbia

The finance resources' provision under favorable conditions is of a key importance for SMEs. Due to that fact, the relations between SMEs and financial sector improvement is crucial for current business operations and SME further development. Thus, it requires special attention.

A relatively wide system for financial support to SMEs has been formed in Serbia, which, first of all, entails commercial banks services (from their own sources or through credit lines from abroad) and support provided by public (state) sector, as well as leasing companies. Besides, there is a considerable number of organizations doing business in Serbia (from international organizations, non-profit and humanitarian organizations of the civil sector to private entities) which are a part of the support to SMEs offering various forms of assistance in financing or providing direct access to particular sources of financing. At the same time, unlike other countries in transition, offer by micro credit organizations as well as the role of private investment funds in SMEs funding is limited.

In the banking sector of Serbia, during the last few years, there has been an increase in loans granted to SME sector. Majority of banks formed divisions for small and micro enterprises and created bank products to suit the needs of these economic entities. Some banks offer technical support to SMEs in the process of filling in loan applications and bank risk assessment. Apart from that, good territorial coverage has been provided by the banks which provide easier access to loans by SMEs from almost all parts of the country.

Unfortunately, regardless of the increase in the offer of banking sector, the conditions for loan making are still not favorable, especially from the point of view of the capital price, collaterals (which amount up to 200% from the loan requirement) and complicated and expensive procedures (whose realization is difficult due to the lack of a unique system of cadastre in the whole country) and different methodologies in submitting loan applications.

Possibilities of SMEs to access bank sources have still been unfavorable if compared to big enterprises. That, however, refers to effective interest rates as well as loan approving procedures. Access to sources of financing is still limited to this sector.

**Table 4. Weighted average 12 months interest rates and interest rate spread 2000-2008, (as %)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Active interest rate	77.90	32.52	19.16	14.81	14.59	14.41	15.88	11.13	18.11
Passive interest rate	6.31	4.08	2.62	2.74	3.60	3.71	5.06	4.08	7.32
Interest rate spread	71.59	28.44	16.54	12.07	10.99	10.70	10.82	7.05	10.79

The biggest problem lies in high interest rates on loans granted by commercial banks, which are relatively high in Serbia. High interest rates on loans granted by commercial banks are caused by the Central bank's policy, level of credit risk of the country (BB-), but also by overall situation on bank's products market in Serbia.

These circumstances have led to the strengthening of the financial leasing. During the last few years Serbia has made a big step forward in the field of financial leasing, and became the leader in the West Balkans region. According to the research made by OECD and EU on SMEs development in Serbia and other countries of the Western Balkans region [8], the sector of leasing operations got the best score in Serbia. Financing through leasing brings about several advantages to SMEs, starting from a simpler procedure, possibility of financing up to 100% of the value of the object of leasing, tax treatment of the leasing (which are considered to be operational costs) as well as payments made according to the inflow of finances and servicing of the equipment.

Understanding, on the one hand, the importance and the role of SMEs in economic development and the need for more favorable conditions in financing on the other, the state support to SMEs sector be-

comes more versatile. The Republic of Serbia has developed an ever increasing system of financial support to this sector under much favorable conditions in relation to market conditions provided by the banks.

The Fund for development of the Republic of Serbia, National service for employment and the Guarantee Fund have a special role in facilitating the access of SMEs to the sources of financing. These institutions enable SMEs to get subsidies. Such loans are often below the level of inflation, which makes them extremely favorable (e.g. Fund for development of the Republic of Serbia provides long-term loans (5 years) with one year grace period and interest rate of 3% per annum). During the last few years special attention has been paid to «start-up» loans (through the National service for employment) which commercial banks are not interested in because of borrowing power and collateral.

Moreover, the government of the Republic of Serbia tries to provide access to international credit lines through mediation or initiation of direct contracts between domestic banks and foreign financial institutions (European Agency for Reconstruction, European Investment Bank, German development bank KfW, Italian Mondimpresa, etc) in order to enable SMEs to take more favorable loans, as well as get incentives by foreign governments.

Apart from that, through the network of regional agencies for development of SMEs, the state assists in providing information to entrepreneurs on credit conditions and helps in evaluating entrepreneurs' ideas. It also provides training for business plan development (financial management) and offers assistance in filling in loan applications.

However, there are numerous problems in offering help to the SMEs financing by the public sector. Survey showed<sup>10</sup> that loans which are offered by the public institutions are not available through the whole year, but temporarily in accordance to annual plans of these institutions. Administrative procedures in terms of applying for a loan are complicated for SMEs and greatly centralized (with low or no influence of local institutions in decision making process). Apart from the National service for employment which has a wide network of branches and affiliations all over the country, other institutions are mainly located in the borrower's place of residence. Consultancy services are not of a high quality, and they often refer to application procedure only. Due to centralized procedure, costs are disproportionately high.

Funds available to SMEs through non-profit organizations are fairly limited and far below demanded. What makes loans granted by such organizations attractive is the habit of these organizations to visit clients in the place of their residence and create loans which directly suit the client's needs. Also, consultancy services are of a better quality. Although the prices of the loans are relatively high, they are much lower than those provided by commercial banks.

### **Concluding remarks**

For further SMEs sector improvement, it is necessary to create more favorable business environment in which the improvement of relations between banking and SMEs sector would be of a key importance. Still, finances have been one of the main issues and needs regarding the SMEs sector. In order to solve financial problems of the SMEs, it is necessary to strengthen and improve partnership between SMEs and financial institutions including financial institutions through which the state stimulates development of this sector.

Establishing partnership between SMEs and banking sector entails improvement of business and investment climate, development of appropriate financial products (especially increasing offer of banking products in terms of providing access to mid-term and long-term sources of financing) as well as introduction of new mechanisms of financial support to SMEs by the state (particularly in access to "start-up" loans, female entrepreneurship funding, etc), incentives to the system of micro financing and improvement of tax incentives and simplification of tax policy. This entails implementation of

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<sup>10</sup> Igor Brkanovic, Milan Lalovic, Aleksandar Lakic, Srdjan Tilger, "Study on Micro-finance Support to Start-up in Serbia", International Labour Organization, Belgrade, 2007

legal and other normative activities in order to create appropriate institutional environment harmonized with the EU, as well as to strengthen institutional capacities for support to SMEs.

At the same time, it is necessary to strengthen internal capacities of SMEs through knowledge improvement on finances and financial management. It is necessary to raise awareness on the importance of financing from the equity capital, as well as development of business incubators and clusters.

During the last few years Serbia has made a significant step forward in developing functional frameworks for support to SMEs. Despite the existence of such framework, support has not been coherent and integrated and it is not adequately financed. Significant efforts should be made towards improvement of partnership between SMEs and financial sector. Along with that, it is necessary to develop better coordination between financial and non-financial support to SMEs, especially for the newly established enterprises.

Limited financial potentials of the public sector and unfavorable loan conditions remain key problems of SME financing in Serbia. Due to that, many SMEs are directed to internal (often very limited) sources of financing, and many entrepreneur ideas remain undeveloped. Strengthening of competition on the financial market should enable development of credit activities towards SMEs sector, both from the banking sector and other financial institutions, with reduction of prices and improvement of capital maturity. Unfortunately, negative effects of the world economic crisis do not contribute to resolution of these issues, because state funds intended for financing of SMEs (due to reductions in budget) are becoming scarce, and banks are becoming more cautious in terms of SMEs financing, which creates unfavorable conditions for creation of new SMEs and their existence on the market.

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