

Quarterly Enterprise Survey

No4 (10)
November 2004

- The Industrial Confidence Indicator decreased from -0.05 in July to -0.07 in October.
- The managers' expectations about future changes in the business climate sharply decreased.
- As expected by the managers, decreases in production have been recorded during the 3rd quarter.
- Managers expect continued production increases during the 4th quarter, but less so than during the 3rd quarter.
- In the 4th quarter managers expect demand growth to slow down.
- The accessibility and affordability of short and long term loans have deteriorated.
- Lack of raw materials became important impediment to production growth.
- During the 4th quarter managers expect continuing purchase and sale prices increases.

A group of 300 manufacturing firms is used to monitor their managers' perceptions of changes in the business climate and company performance.

In this issue: Results of a survey conducted in October 2004

Firms' performance: Q3 04 vs. Q2 04

Firms' expectations: Q4 04 vs. Q3 04

Business climate: Assessment for October '04, expectations for the next 6 months.

GENERAL INDICATORS

Industrial confidence indicator

The *Industrial Confidence Indicator* has decreased by 2 points, falling from -0.05 for the 3rd quarter to -0.07 for the 4th quarter of 2004. This is due to decreases in all three components of the indicator, namely production plans for the next 3-4 months, assessment of the volume of new orders, and assessment of finished goods stocks. The most significant decline was observed with respect to the production plans of enterprises (see PRODUCTION INDICATORS).

Business climate

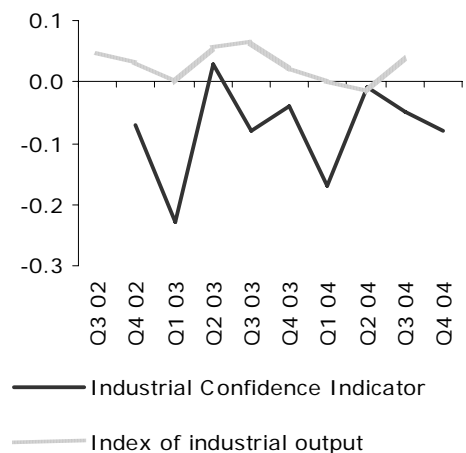
Results of this survey are comparable with results of a similar survey conducted in October 1999, shortly before presidential elections as well. Then, the forecast of firms concerning the quality of business environment was pessimistic: the "pessimists" outweighed the "optimists" by about 18%. In October 2004, predictions for the business environment for next six months were pessimistic too. After improvement in July 2004, expectations of managers for positive changes in the business environment in October 2004 deteriorated significantly again. The *index of business climate* decreased by 20 points: from 0.10 to -0.10. This resulted from increase in the number of "pessimistic" managers (from 16.9% to 21.2%) perceiving the general economic conditions for activity as deteriorating, and the decrease in the number of optimistic managers (from 26.4% to 12.4%) expecting improvement of the situation. The main explanation here can be uncertainty of business as to the economic policy of the government after elections. This was typical for business both in 1999 and 2004.

However, there is one interesting detail: after Viktor Yushchenko was appointed prime-minister end of 1999, business optimism started rising and reached its peak in the 2nd quarter 2001. It remains to be seen, what will be the business spirit after elections 2004.

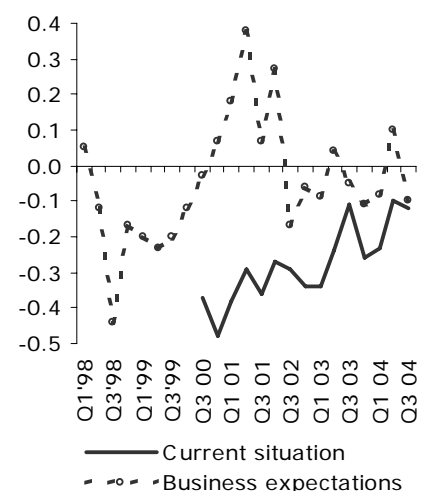
Regulatory climate

The percentage of firms considering the regulatory climate to be a significant impediment to business development has reduced from 39.9% in August to 31.8% in October. This was due to decreased importance of one of the three components in this indicator, namely the *high regulatory burden*. Significance of *frequent changes in economic in regulations* and *corruption* components remained practically without any change (see IMPEDIMENTS TO PRODUCTION).

Survey based Industrial Confidence Indicator vs. Index of Industrial Output



Indices of Overall Business Climate



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Lending climate

The lending climate in general remains favourable. The *high interest rates* indicator moved from the 5th to the 6th position in the list of impediments to production, whereas its absolute value decreased from 31.3% to 23.7%. And the *access to loans indicator* has reached its lowest value – only 5.8% of respondents consider the insufficient access to loans to an impediment to production. According to managers, the willingness of firms to take loans and the willingness of banks to provide them remained rather high compared to the same period in the past years. However, the lending climate indicators for short-term and long-term loans have declined compared to the 2nd quarter of 2004.

Managers reported that the banks became less willing to provide short-term loans during the 3rd quarter of 2004 compared to the 2nd quarter of 2004 (58.9% vs. 80.1%). The affordability of short-term loans for firms has also decreased: the share of firms considering short-term loans to be affordable has dropped to 44.4% in the 3rd quarter of 2004 from 54.5% in the 2nd quarter.

The situation with long-term loans looks approximately the same. According to managers, the willingness of banks to provide long-term loans has decreased: the share of managers reporting banks to be willing to provide long-term loans has decreased from 64.2% in the 2nd quarter of 2004 to 39.2% in the 3rd quarter of 2004. The affordability of long-term loans for firms has also deteriorated from 35.0% in the 2nd quarter to 27.5% in the 3rd quarter.

PRODUCTION INDICATORS

As expected by managers, the output growth slightly decelerated in the 3rd quarter compared to the 2nd quarter due to deceleration of domestic demand growth. The *index of production* decreased from 0.53 to 0.28. It should be noted that the deceleration was more intensive than expected by managers: the *index of production expectations* in the 3rd quarter made up 0.35.

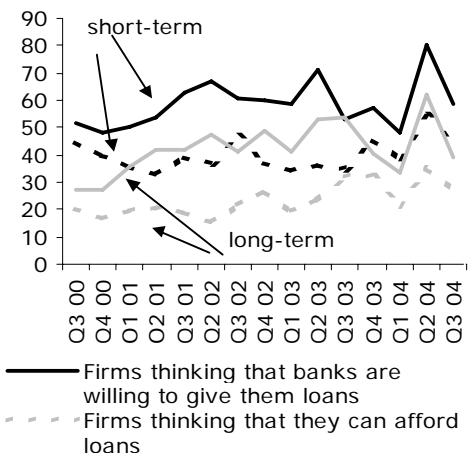
The highest *index of production* was recorded for light industry (0.53). The lowest value is recorded for printing (0.17) and machine building (0.18). As usual, the smallest companies (up to 50 employees) experienced the lowest production growth (0.05). Unlike in previous quarters, the highest *index of production* was recorded for medium-sized companies (0.51) rather than large ones (0.36). This is in compliance with expectations of large firms for this quarter: in July the large companies among the other groups had the worst production plans for the next 3 months. The *index of production* for state-owned firms was lower than for privatised and de novo private firms (0.15 vs. 0.27 and 0.21 respectively).

In the 4th quarter 43.8% of firms plan no changes in production volumes, 22.5% plan reduction, and 33.7% expect an increase of production. This is reflected in the *index of production expectations* equal to 0.12, what is less compared to the *index of production expectations* for the 3rd quarter (0.44). The difference between index values is explained by the cut in the share of "growing" firms (from 48.9% to 33.7%). The index has followed the downward path for three quarters in a row.

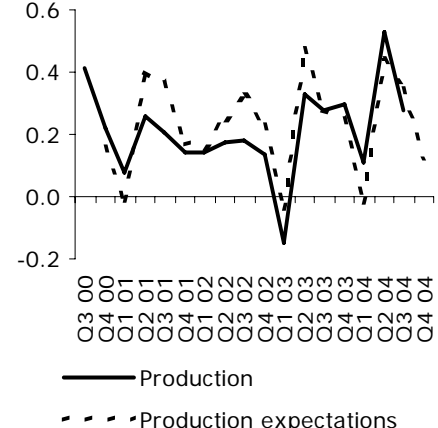
Decrease in the *index of production expectations* was reported in all the industries. There is practically no difference between plans of firms with different size: *indices of production expectations* for small, medium-sized and large firms are equal to 0.12, 0.17, and 0.16 respectively. Among the firms of different types of ownership, the state-owned firms unlike in previous quarters have the most optimistic production plans: the *index of production expectations* is equal to 0.26, whereas the respective index values for privatised and de novo private firms make up 0.10 and 0.48.

Demand, sales, new orders

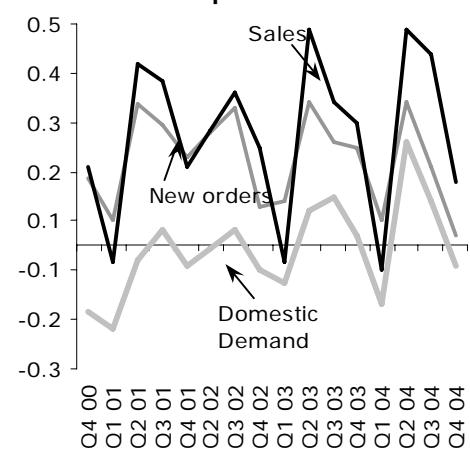
Affordability of Loans (in %)



Production Indices



Domestic demand: indices of expectations





Negative trends of decline in domestic demand observed since May 2004 have continued. The *index of sales* decreased from 0.49 to 0.29. In the 3rd quarter, the firms did not feel a growth of demand for their products. The *index of new orders* has not changed virtually compared to the 2nd quarter and makes up -0.19. At the same time, the decline of demand was predicted by managers. The share of managers estimating the volume of orders as normal increased from 32.7% in the 2nd quarter to 37.0% in the 3rd quarter.

Against the general background of declining demand, exclusion makes the construction materials industry and food processing, where the volume of new order was higher than expected by managers. However, if in the former industry the demand on the domestic market was the main source of new orders, managers in the food processing informed about increase of new orders from the foreign market.

Managers expect that the demand indicators will significantly deteriorate in the 4th quarter. Managers in the construction materials industry are most pessimistic about new orders in the next quarter (-0.20). Managers in the pharmaceutical industry are most optimistic (0.30).

Impediments to Production¹

The significance of 4 from 13 impediments to production has decreased compared to the previous quarter.

Low demand and high tax burden are still two major impediments to production according to managers. The third place is filled by high competitive pressure the second quarter in a row. The fourth place is filled by unfriendly regulatory climate. All of them enter the list of impediments with decreased significance. The impediments like shortage of inputs, shortage of skilled workforce, shortage of production capacities, and political instability gained more significance for managers.

Capacity utilization

As usual, the patterns of the *capacity utilizations index* and the *capacity utilization expectations index* are similar to those of the *production and production expectations indices*. Thus, the value of the capacity utilization index has decreased from 0.50 to 0.23. 42.2% of all the firms report about excessive production capacities. The managers plan to decrease capacity utilization in the 4th quarter to a lesser extent: the *index of expectations* value amounts to 0.25.

Inventories

The share of firms that consider their output stocks to be low increased from 18.1% in August to 30.5% in October. The *index of finished goods stocks* has decreased for the second quarter in a row (from -0.12 to -0.16, and to -0.24). This is due to the higher share of firms reducing their stocks in all the industries. The most significant cut in the stock of finished goods was recorded again in wood processing (-0.56).

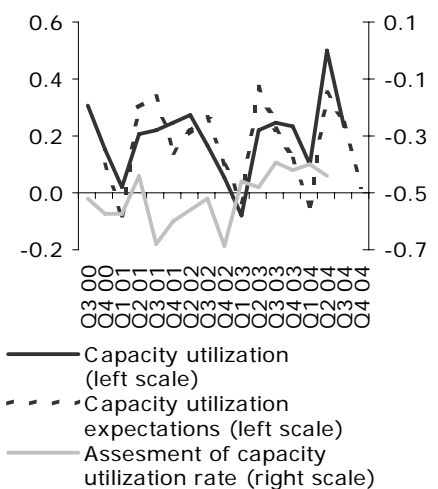
For the 4th quarter firms are planning a further decrease in their stocks of finished goods: the *index of expectations* is -0.12.

During the 3rd quarter of 2004 the input stocks decreased to a higher extent than during the 2nd quarter: the *index of raw material stocks* increased from -0.27 to -0.19. The lowest values of the index were recorded for wood processing (-0.59).

Impediments to production

	Q1 04	Q2 04	Q3 04 vs. Q2 04	
Shortage of demand	56.9	67.6	57.6	-10.0
Excessive taxation	59.4	63.7	54.9	-8.8
High competitive pressure	35.9	58.6	44.0	-14.6
Unfriendly regulatory climate	39.7	39.9	31.8	-8.1
High regulatory burden	22.1	34.5	26.5	-8.0
Changes in economic legisl.	21.4	7.2	7.4	+0.2
Corruption	1.7	2.2	2.3	+0.1
High interest rate	25.4	31.3	29.5	+4.3
Shortage of raw materials	21.7	25.2	23.7	-7.6
Outdated technology	22.8	18.0	18.7	+0.7
Shortage of skilled workforce	14.5	10.1	15.2	+5.1
Liquidity problems	10.0	12.6	11.7	-0.9
Access to credits	8.7	11.5	7.4	+0.9
Shortage of capacities	6.5	6.5	5.8	-5.7
Unstable political situation	3.6	1.4	4.7	+3.3
Problems with energy supply	1.8	2.5	2.7	+0.2

Capacity Utilization Indices



¹ Since October 2002, the category “unfriendly regulatory climate” has been broken into three factors, namely (1) high regulatory burden due to a large number of inspections, unclear procedures etc., (2) frequent changes in regulations, and (3) corruption. The general indicator “unfriendly regulatory climate” now reflects the share of firms that have selected at least one of these three factors as an impediment to production.



The trend acceleration for the input stocks reduction will continue in the 4th quarter of 2004: the *index of expectations* is -0.25.

Employment

For the first time in the year, expectations of managers concerning employment in the next quarter have not come true. Against the background of decelerating production growth, a trend towards employment reduction was observed. The share of firms, where the number of employees increased, reduced from 21.5% in the 2nd quarter to 12.2% in the 3rd quarter and the share of those, where the employment level declined, increased from 16.0% to 20.9% respectively. The *index of employment* decreased from 0.06 to -0.07. The share of managers perceiving the workforce level to be satisfactory has reduced from 79.5% to 75.1%.

Next quarter, 83.9% of firms plan no changes in the number of the employed. The *index of expectations* is negative and equal to -0.08. This trend is observed in all the industries except wood processing (0.05).

The share of firms reporting workers on forced leave reduced from 9.4% to 8.3%. The respective index value amounts to -0.01. Some increase of this indicator is expected for the 4th quarter (the *index of forced leave expectations* is 0.03).

According to managers, it became more difficult to find skilled workforce. The index of difficulty to find workforce has grown up both for the skilled and unskilled personnel (from 0.45 to 0.75 and from 0.01 to 0.15).

FINANCIAL PERFORMANCE INDICATORS

Prices

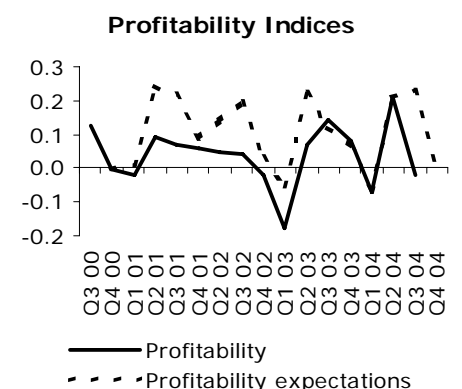
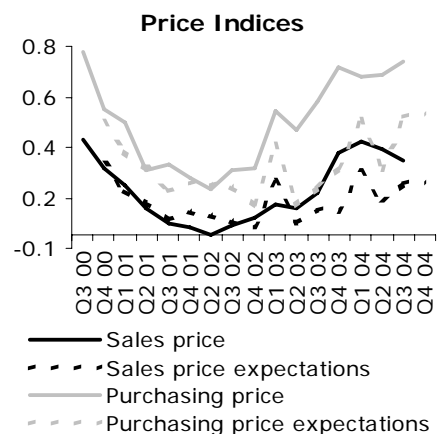
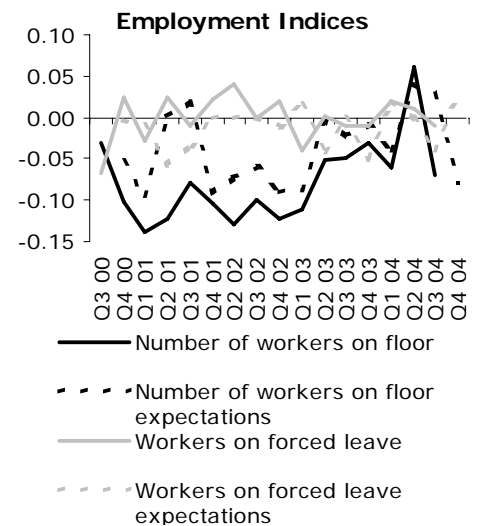
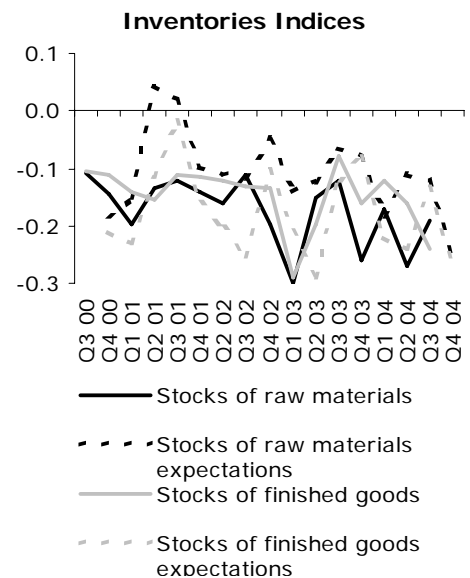
Purchase and sales prices continued growing. But it should be noted that managers reported about some growth deceleration of sales prices against the background of growing purchase prices. The respective indices are equal to 0.69 and 0.30 respectively. This is typical for food processing and printing to the highest extent: the difference between sales prices and purchase prices is here the highest.

During the 4th quarter managers expect increasing of prices. However, managers expected a greater price growth than they expected for the last quarter. Thus, in May only 15.3% of respondents intended to increase prices during the next three months, while in July 22.0% of managers forecast an increase in sales prices. The *index of sales price expectations* went up from 0.13 to 0.21. The managers' forecasts for purchase prices are also based on price growth assumptions: 46.5% of managers think that prices will go up. The *index of purchase price expectations* increased from 0.26 to 0.47.

Profitability

The profitability pattern is not like expected with the positive production pattern. The *index of profitability* has decreased and gained a negative value (from 0.21 to -0.02), that means predominance of firms that had the worse financial performance results over those that improved them. This situation was unexpected even for managers. In July, 35.5% of managers predicted an increase of profitability during the 3rd quarter compared to the 2nd quarter, 52.9% expected that financial performance results during the 3rd quarter will be at least not worse than in the 2nd quarter. In October, only 26.0% reported ex post about improvement of financial performance results, 30.4% about deterioration, and 43.6% noted that nothing changed.

The most significant profitability deterioration was observed in the heavy industry (-0.42), and improvement of the financial performance results was reported most often by food processing (0.11). During the 4th quarter managers expect no significant



changes. The *index of profitability expectations* is close to zero.

Barter

The share of firms reporting barter transactions made up 15.8%. The *indices for barter* and *barter expectations* are close to zero, suggesting no significant changes regarding barter operations.

Arrears

Reduction of the account receivable arrears accelerated. The *index of account receivables* decreased from -0.01 to -0.08. At the same time, the *index of account payables* has not changed compared to the 2nd quarter and is equal to -0.20. During the 3rd quarter the managers intend to reduce their arrears.

The share of respondents that reported tax arrears has not changed practically: 15.8 in August vs. 15.1% in October. The share of firms that have reduced these arrears amounts to 52.4%. The managers expect this trend to continue during the 4th quarter.

The share of respondents reporting wage arrears has decreased from 17.6% to 12.9%. From among the firms that have those arrears, 41.7% of firms reported reduction and 25.0% reported increase of arrears. The wage arrears reduction must be decelerating during the 4th quarter. The *index of wage arrears change expectations* is equal to -0.02.

COMPETITIVE PRESSURE²

According to managers, competition from domestic producers somewhat decreased. After growing during four quarters in a row, the *index of competitive pressure* from Ukrainian producers decreased in the 3rd quarter from 0.40 in August to 0.30 in October. This was observed in all the industries except the light industry. As during the whole year, the highest competitive pressure was recorded in food processing (+0.61), and the lowest one in machine building (-0.08).

The pressure from Russian/CIS producers and other foreign producers unlike from domestic producer has been growing. The index values increased from -0.41 to -0.15 and from -0.51 to -0.18 respectively.

Appendix 1: Methodology

All indices are calculated using the same methodology. For each positive answer we score +1, for each negative answer -1, and for each answer indicating no change we score 0. For example, if 20 respondents report an increase in production, 50 respondents report a decrease, and 30 report no change, the corresponding index level would be -0.30. Thus, a positive (negative) value, for instance for the production index, indicates that the number of firms increasing their production is greater (less) than the number of firms decreasing it. Any score approximately greater than +0.09 or less than -0.09 is statistically significant at the 5% level.

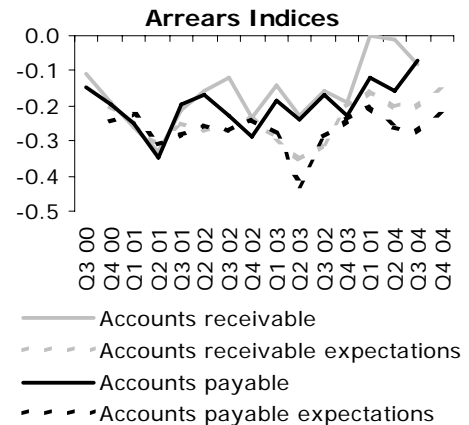
The industrial confidence indicator is defined as the arithmetic mean of the answers to the questions on production expectations, assessments of the order books and assessment of the stock of finished products (the latter with an inverted sign)³.

For further information concerning the sample characteristics, the questionnaire, the index methodology and full data sets please contact Oksana Kuziakiv (kuziakiv@ier.kiev.ua).

² The methodology of calculation for this index is similar to that for the other indices. Scale: -1 - no or weak pressure, 0 - moderate, 1 - strong.

³ For details see: The Joint Harmonized EU Programme of Business and Consumer Surveys.

⁴ The heavy industry sector includes energy, the chemical industry, metallurgy, and the fuel industry.



Index of competitive pressure from Ukrainian producers

Industry	Q1'04	Q2'04	Q3'04
Heavy	0.54	0.57	0.39
Machine build.	-0.17	-0.04	-0.08
Wood proc.	0.55	0.61	0.17
Construct. mat.	0.55	0.29	0.23
Light industry	0.28	0.43	0.44
Food processing	0.69	0.79	0.61
Printing	0.59	0.58	0.48

Appendix 2: Sample Characteristics

Number of employees, %	
	Q3'04
Fewer than 50	28.8
51 — 250	41.3
251 — 500	13.9
501 — 1000	10.0
Over 1000	6.0
Regions, %	
	Q3'04
Lviv	26.7
Kyiv	32.7
Kharkiv	32.0
Odessa	8.5
Industries, %	
	Q3'04
Heavy ⁴ industry	8.9
Machine building	26.3
Wood processing	7.1
Construction materials	7.8
Light industry	12.5
Food processing	25.3
Printing	8.5
Other	3.6