

Quarterly Enterprise Survey

No2 (12)
May 2005

- Industrial confidence indicator increased from -0.16 in January to 0.01 in May.
- The managers' expectations about future changes in the business climate improved significantly.
- The slow-down of production in the 1st quarter was lower than expected by managers.
- Managers expect a significant growth of production in the 2nd quarter.
- Managers expect an increase in new orders in the 2nd quarter.
- Banks became more willing in the 1st quarter to provide loans and affordability of loans for firms continued deteriorating.
- The percentage of firms considering the regulatory climate to be an impediment to production remained without change after significant reduction in January.
- During the 2nd quarter managers expect a continued increase of purchase and sale prices.

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 April 2005

Firms' performance: Q1 05 vs. Q4 04

Firms' expectations: Q2 05 vs. Q1 05

Business climate: Assessment for April '05, expectations for the next 6 months.

GENERAL INDICATORS

Industrial confidence indicator

The industrial confidence indicator increased. Its value grew up by 17 points in April compared to January (from -0.16 to 0.01). It is explained by a significant improvement of firms' production plans for the next 3 months (see PRODUCTION INDICATORS). Finished goods stocks increased, however the value of this index continues to be negative. The third component of the industrial confidence indicator – assessment of order books – remained practically the same low.

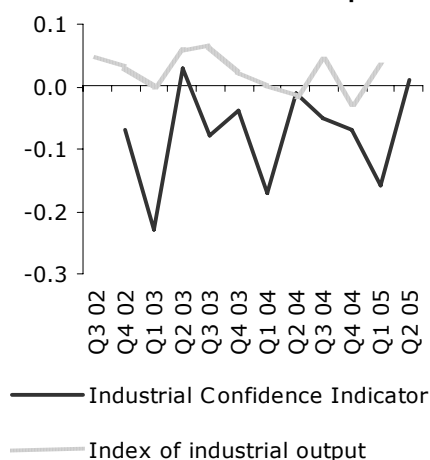
Business climate

The assessment of business climate by firms remained unchanged and low. The respective index value was equal to -0.28 in January and -0.30 in April. This is attributed to the seasonal trend: during the whole period of observations a decrease of business climate assessment is observed in the 4th quarter compared to the 3rd quarter persisting in the 1st quarter as well. This is typical for firms of all industries, ownership types and sizes. Furthermore, the smaller is the enterprises, the lower are assessments of business climate.

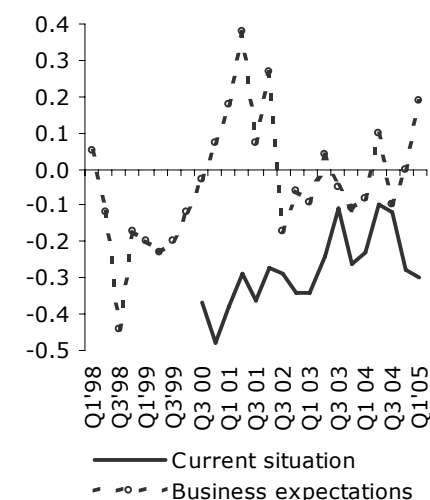
At the same time, expectations of changes in the business climate significantly improved. The index of business climate expectations increased from 0.0 in January 2005 to 0.18 in April 2005. This index has such a high value with an upward trend for the first time since July 2002. This increase was due to a significant growth in the percentage of managers expecting positive changes (from 19.1% to 29.8%) and a significant drop in percentage of "pessimistic" managers (from 23.6% in January to 15.8%). Traditionally, the worst expectations are those of small firms (-0.08) and the best are of large ones (0.35).

As experience of business expectation monitoring suggests, this indicator of business expectations has no significant seasonal dependency on demand and other purely economic factors as it reflects rather the current political environment and trust of business to the government. Subsequently, the current growth in the index value might argue for a trust credit to the new government as well as firms' expectations for the better in this respect.

Survey based Industrial Confidence Indicator vs. Index of Industrial Output



Indices of Overall Business Climate



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Regulatory climate

The percentage of firms considering the regulatory climate to be a significant impediment to business development remained without change compared to January making up 23.6%. At the same time, it is quite alarming that a component of the combined indicator "unfriendly regulatory climate", namely frequently changes in legislation, is growing. The share of firms pointing to "frequently changes in legislation" as an impediment increased from 5.0% to 13.1% suggesting the growing uncertainty of future business environment (see IMPEDIMENTS TO PRODUCTION).

Lending climate

The lending climate is characterised by higher supply of bank loans, on the one hand. The share of managers considering banks as willing to provide loans to a firm like their increased from 47.7% to 58.3% for short-term loans. The respective indicator for long-term loans increased from 29.4% to 35.9%.

On the other hand, the respondents think that the availability of loans for firms rather decreased than increased. In particular, the interest rates are quite high according to managers: high interest rates moved from the 8th to the 5th position in the list of impediments to production (see IMPEDIMENTS TO PRODUCTION). Besides, another indicator of the lending climate – the willingness of firms to take loans – did not increase for short-term loans and rather reduced for long-term loans. Thus, the share of managers who agreed that their firm can take a short-term loan accounted for 33.6% in January and 35% in April 2005. The respective value for long-term loans was equal to 20.4% in January and 14.6% in April.

PRODUCTION INDICATORS

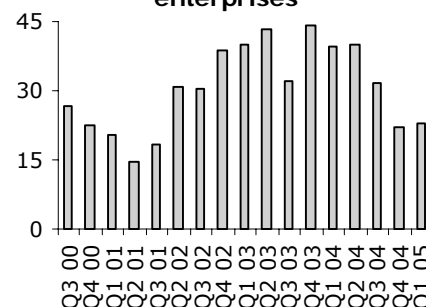
As expected by managers, the production growth rates decreased in the 1st quarter, however the situation was not as bad as they predicted. Although the *index of production* decreased from 0.06 in the 1st quarter 2005 to -0.06 in the 4th quarter 2004 and became negative (meaning that the share of firms with decreased production was higher than the share of firms with increased production), its value is higher than the *index of production expectations* for the 1st quarter (-0.18). Decrease in the *index of production* is observed every year during this period and results from the seasonal trend towards slow-down of economic activity during winter months. And the fact that the slow-down of activity was smaller than expected is a positive signal that can suggest suspension and a possible turning point in the trend towards reduction of industrial production rates observed since the mid of the last year.

The highest *index of production* values were recorded for light industry (0.14) the third quarter in a row. The lowest value was recorded for the construction materials industry (-0.35). Reduction of production was reported by firms of all sizes excluding the biggest ones – the share of "growing" firms exceeded the share of "falling" ones (0.17) in the group of firms with over 1000 employees. The value of the *index of production* for de novo private firms was the highest compared to privatized and state-owned firms (0.01 vs. -0.11 and -0.13).

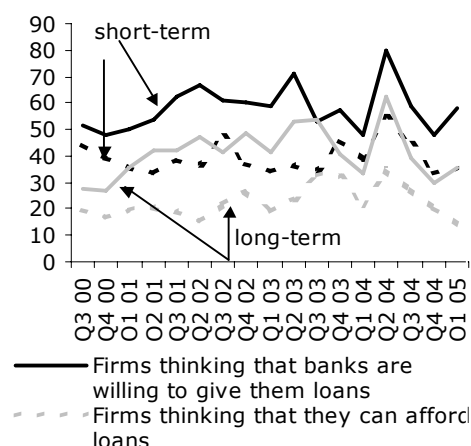
Firms plan to intensify significantly their economic activity in the 2nd quarter. The *index of production expectations* increased from -0.18 in the 1st quarter to 0.41 in the 2nd quarter. Every second firm (51.0%) plans to increase production in the 2nd quarter compared to the 1st quarter and only 9.9% intend to reduce production.

Increase in the *index of production expectations* was reported in all the industries. Optimism of managers grows with the size of the firm: *indices of production expectations* for small, medium-sized and large firms are equal to 0.35, 0.40, and 0.48 respectively. Among the firms of different types of ownership, the privatized firms have the most optimistic production plans: their *index of production*

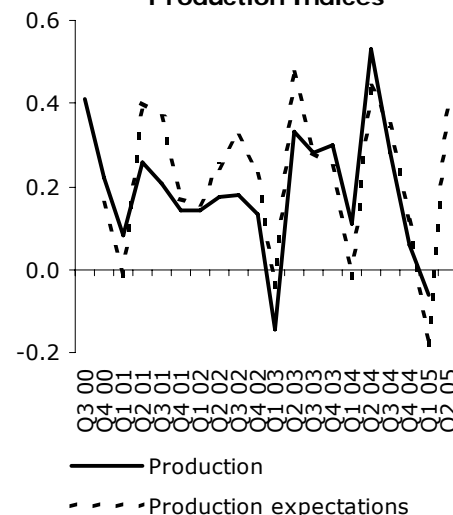
Unfavorable regulatory environment, % of enterprises



Affordability of Loans (in %)



Production Indices





expectations is equal to 0.44, whereas the respective values for state-owned and de novo private firms make up 0.29 and 0.36.

Demand, sales, new orders

Negative trends of decline in internal demand observed since May 2004 have continued. Reduction of production volumes resulted from declining demand. Firms reported a drop of new orders. The *index of new orders* decreased from 0.08 in the 4th quarter 2004 to 0.04 in the 1st quarter 2005. The *index of sales* for the same period decreased from 0.09 to -0.09. It should be also noted as a positive fact that the decline of demand was lower than expected by firms at the very beginning of the year. The share of managers estimating the volume of orders as normal accounts to 33.1%.

On the general background of declining demand, exclusion makes the light industry, where the share of firms that received more orders was significantly higher than the share of firms, where the volume of new orders decreased (0.42).

Managers expect that all the demand indicators will significantly improve in the 2nd quarter. Managers in the construction materials industry and wood processing are most optimistic about obtaining of new orders in the 2nd quarter (0.60 and 0.44 respectively). Managers in the light and heavy industry are most pessimistic (0.13 and 0.16 respectively).

Impediments to production¹

The major impediments to production continue to be the low demand, tax burden and the liquidity problem. Compared to the 4th quarter, the last two ones switched their positions in the list: the tax burden gained weight (+9.4%) and the problems with liquidity and finances slightly diminished for firms (-9.5%).

The fourth position in the list of impediments to production has been taken by the high competitive pressure the fourth quarter in a row. It has even gained some weight in the 1st quarter 2005 compared to the 4th quarter 2004.

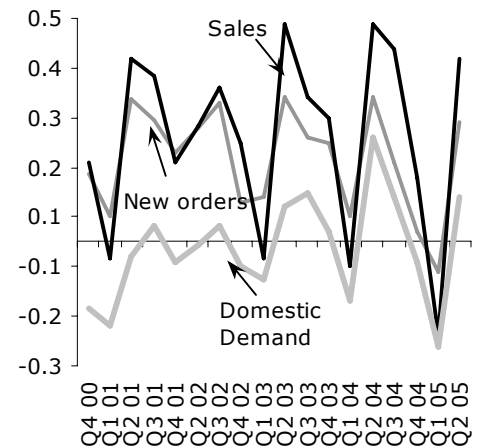
A drastic gain of weight for such a problem as high interest rates is also worth of noting. The share of firms considering this to be an impediment to production increased from 21.2% to 30.7%, and the problem moved up from rank 8 to 5. At the same time, the respondents speak about problems with access to loans (the absolute value and the rank of this impediment went up too).

The share of enterprises considering the unfriendly regulatory climate as an impediment to production practically has not changed. Though a significant growth of a component of this combined indicator is rather alarming. In particular, the share of firms pointing to "often changes in regulations" as an impediment increased from 5.0% to 13.1% suggesting the growing uncertainty of future business environment. After the "orange revolution" the political situation in the country has stabilized. The share of respondents considering the unstable political situation as a barrier to production has dropped from 10.1% to 4.0%.

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 0.01 to -0.10. 41.3% of all the firms inform about excessive production capacities.

Domestic demand: indices of expectations



Impediments to production

	Q3 04	Q4 04	Q1 05	Q1 05 vs Q4 04
Shortage of demand	57.6	65.5	56.9	-8.6
Excessive taxation	54.9	41.7	51.1	+9.4
Liquidity problems	11.7	47.1	37.6	-9.5
High competitive pressure	44.0	33.1	35.4	+2.3
High interest rate	23.7	21.2	30.7	+9.5
Shortage of raw materials	29.5	33.1	27.0	-6.1
Unfriendly regulatory climate	31.8	22.2	23.6	+1.4
High regulatory burden	26.5	15.8	15.0	-0.8
Changes in economic legisl.	7.4	5.0	13.1	+8.1
Corruption	2.3	2.9	0.4	-2.5
Outdated technology	18.7	21.9	21.2	-0.7
Shortage of skilled workforce	15.2	12.6	13.9	+1.3
Access to credits	5.8	6.5	9.1	+2.6
Unstable political situation	4.7	10.1	4.0	-6.1
Shortage of capacities	7.4	4.3	3.6	-0.7
Problems with energy supply	2.7	3.2	1.8	-1.4

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.



In the 2nd quarter, the managers expect a growth of output and, accordingly, they plan to increase capacity utilization: the value of the *expectations index* makes up 0.26.

Inventories

The share of managers estimating their stocks of inputs as low remains rather high, however it decreased from 59.2% in January to 47.2% in April. But the problems with raw materials have still a relevance to firms. The *index of raw materials stock* is declining the second quarter in a row: from -0.27 in October 2004, through -0.29 in January 2005 to -0.37 in April 2005. This is due to the higher share of firms reducing their stocks in all the industries. The most significant decrease in the stock of inputs was recorded for wood processing (-0.56) and printing (-0.55).

However, the firms expect a breaking point in this trend in the 2nd quarter 2005: 23.0% plan to increase their stocks of inputs, and 48.7% plan not to decrease them at least, the *index of expectations* is equal to -0.05.

In the 1st quarter 2005, the stocks of finished good decreased similarly to the 4th quarter 2004: the *index of finished goods stock* was equal to -0.22 and -0.24 respectively. Light industry reported the lowest index value (-0.43). The share of firms estimating their finished goods stocks as low makes up 35.5%.

Decrease of finished goods stocks will continue accelerating in the 2nd quarter: the *index of expectations* decreased from -0.29 to -0.35.

Employment

Against the background of abating production growth rates, a trend towards employment reduction is observed two quarters in a row. The value of the *employment index* is equal to -0.15. The share of managers perceiving the workforce level to be too high for available capacities has increased from 4.1% to 7.7%.

In the 2nd quarter, the firms forecast a significant slow-down of employment reduction rates planning to increase production. The *index of expectations* value remains close to zero (-0.05). This trend applies to all industries.

The share of firms reporting workers on forced leave reduced from 15.1% to 6.2% after growth in the 4th quarter 2004. The respective index value is close to zero. No significant changes for this indicator are expected during the 2nd quarter.

According to managers, it became more difficult to find qualified staff. This concerns non-qualified staff as well. The values of respective indices increased from 0.52 to 0.62 (qualified employees) and from -0.01 to 0.2 (non-qualified employees).

FINANCIAL PERFORMANCE INDICATORS

Prices

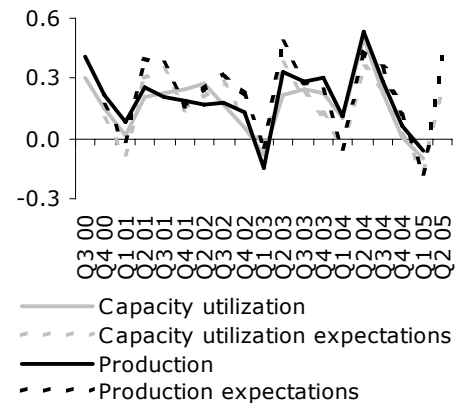
Prices for inputs and finished goods continued growing with higher rates than end of 2004. Compared to the 4th quarter, the *index of purchase prices* grew up from 0.62 to 0.72, and the *index of sales prices* grew up from 0.29 to 0.37.

During the 2nd quarter managers expect continuing price increases. This concerns both sales and purchase prices. However, it should be noted that in case of purchase prices the *index of expectations* for the 2nd quarter compared to the respective indicator of the 1st quarter is lower (0.31 vs 0.41), and the *index of sale prices expectations* remained practically without change (0.22 vs 0.24).

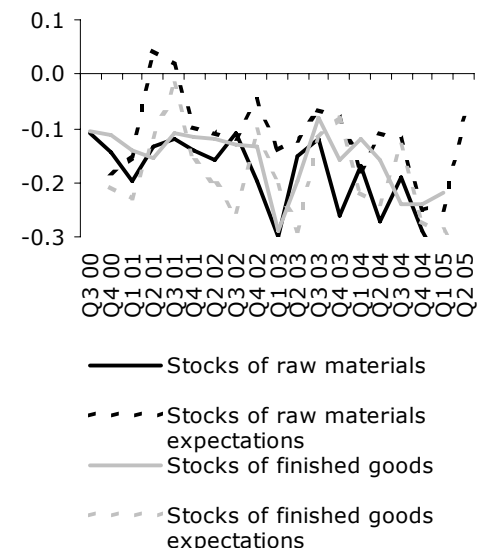
Profitability

Production decline has certainly affected the financial performance results of firms. As expected by managers, the *index of profitability* decreased last quarter from -0.06 to -0.18. This means

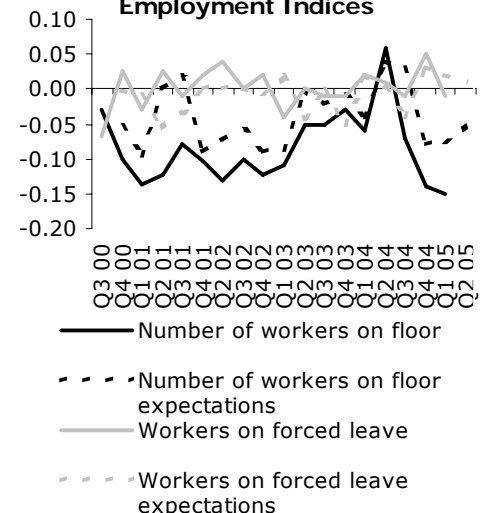
Capacity Utilization Indices vs. Production Indices



Inventories Indices



Employment Indices





predominance of firms that had the worse financial performance results over those that improved them. 38.8% of respondents reported worsening of financial performance results, 42.1% of firms had unchanged results, and only 19.0% of firms stated that their financial performance results improved.

Negative values of the *profitability index* were reported in all the industries. The most significant worsening of the situation occurred in the construction materials industry (-0.53). In the 2nd quarter, managers expect improvement of financial performance results planning the increase of production. The value of the *index of profitability expectations* is positive and equal to 0.15.

Barter

The share of enterprises using barter reduced from 10.4% to 4.7% meaning that barter as a phenomenon in the industrial sector has practically vanished. The *indices for barter* and *barter expectations* are close to zero, suggesting no significant changes regarding barter operations.

Arrears

The *index of accounts receivable* has not change virtually compared to the 4th quarter 2004 and makes up -0.12. At the same time, the *index of accounts payable* has grown up from -0.14 to -0.09 suggesting a drop in the arrears reduction rates. During the 2nd quarter the managers intend to attempt to further reduce their arrears. The *indices of expectations* for payables and receivables are equal to 0.20.

The share of respondents that reported tax arrears didn't change significantly (15.8 in January vs. 15.4% in April). At the same time, the share of enterprises reporting reduced tax arrears has grown from 45.2% in January to 54.8% in April.

The share of respondents reporting wage arrears has decreased from 20.1% to 14.5%. From among the enterprises that had those arrears, 32.5% of firms reported reduction and 40.0% reported increase of arrears. The rates of wage arrears reduction must be increasing during the 2nd quarter. The *index of wage arrears change expectations* is equal to -0.06.

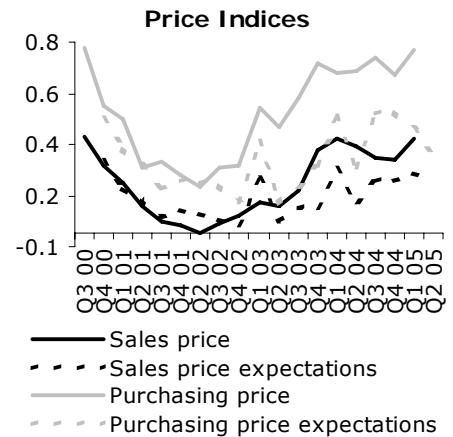
COMPETITIVE PRESSURE²

According to managers, competition from domestic producers somewhat strengthened: the *index of competitive pressure* from Ukrainian producers increased from 0.32 in the 4th quarter 2004 to 0.36 in the 1st quarter 2005. This was observed in machine building, wood processing, and food industry. According to managers, the competitive pressure weakened in the heavy industry, light industry, and printing. Managers in the construction materials industry have not perceived any changes.

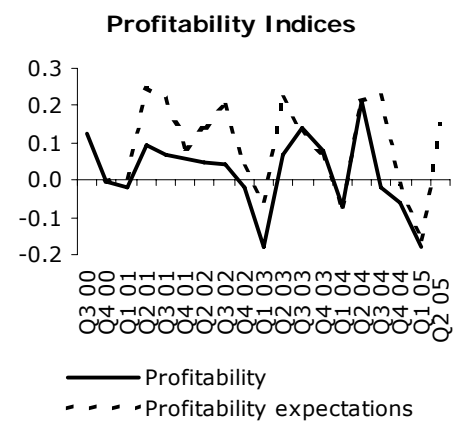
Managers think that the pressure from Russian/CIS producers and other foreign producers unlike from domestic producer has subsided. The values of indices decreased respectively from -0.49 to -0.66 and from 0.60 to -0.76.

Appendix 1: Methodology

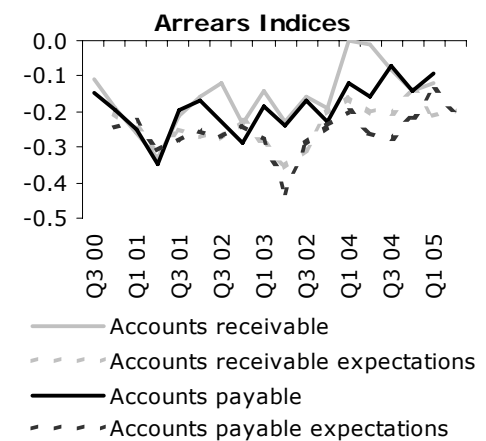
All indices are calculated using the same methodology. For each positive answer we score +1, for each negative answer -1, and for each answer indicating no change we score 0. For example, if 20 respondents report an increase in production, 50 respondents report a decrease, and 30 report no change, the 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



— Sales price
- - - Sales price expectations
— Purchasing price
- - - Purchasing price expectations



— Profitability
- - - Profitability expectations



— Accounts receivable
- - - Accounts receivable expectations
— Accounts payable
- - - Accounts payable expectations

Index of competitive pressure from Ukrainian producers

Галузь	Q3'04	Q4'04	Q1'05
Heavy	0.39	0.46	0.38
Machine build.	-0.08	-0.12	0.01
Wood proc.	0.17	0.28	0.39
Construct. mat.	0.23	0.40	0.39
Light industry	0.44	0.47	0.39
Food processing	0.61	0.62	0.65
Printing	0.48	0.55	0.40

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.



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).

Appendix 2: Sample Characteristics

Number of employees, %		Regions, %		Industries, %	
	Q1'05		Q1'05		Q1'05
Fewer than 50	29.3	Lviv	27.2	Heavy ⁴ industry	9.4
51 – 250	41.3	Kyiv	30.8	Machine building	27.5
251 – 500	14.1	Kharkiv	32.6	Wood processing	6.9
501 – 1000	8.7	Odessa	9.4	Construction materials	7.2
Over 1000	6.5			Light industry	12.0
				Food processing	25.7
				Printing	8.3
				Other	2.9

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.