

Quarterly Enterprise Survey

No. 3 (13)
September 2005

- The Industrial Confidence Indicator decreased from 0.01 in May to 0.06 in September.
- The managers' business climate expectations deteriorated considerably.
- Production growth in the 2nd quarter was as managers had expected.
- In the 3rd quarter, managers predict a slowdown of production growth.
- In the 3rd quarter, managers do not expect any increase in the number of new orders.
- In the 2nd quarter willingness of banks to provide credits did not change, whereas credits became more affordable for firms.
- The share of managers considering the regulatory climate to be impediment to production has decreased.
- In the 3rd quarter managers expect the growth of input prices and sales prices but at lower rates than in the 2nd quarter.

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 from July 22 till August 10, 2005

Firms' performance: Q2'05 vs. Q1'05

Firms' expectations: Q3' 05 vs. Q2' 05

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

GENERAL INDICATORS

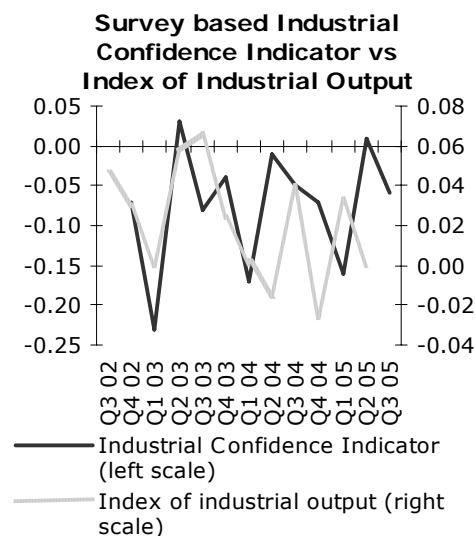
Industrial confidence indicator

Industrial confidence indicator makes up -0.06. After the rise in April by 17 points comparing to January its August value decreased by 7 points comparing to April. This happened due to deterioration of production plans of firms for the following 3 months (see PRODUCTION INDICATORS). Impact of this component was stronger than that of two other components of the total indicator. The decrease in the value of "stocks of unsold products" and considerable improvement of "portfolio of orders evaluation" have been recorded. These trends observed for the above two indicators could lead to increase of the total indicator, if production expectations were more optimistic.

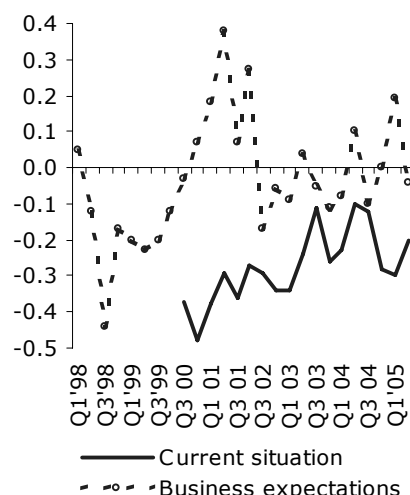
Business climate

Business climate estimates of managers have slightly improved. The respective index value grew up from -0.30 in April to -0.20 in August. This was due decrease in the share of managers estimating the business climate as poor from 35.5% in April to 25.9% in August. At the same time there was an increase in the share of those who consider the climate as satisfactory (from 59.3% to 69.1%), whereas the share of those who estimate the climate as good has not changed and remained very small (5.1% in April and 5.0% in August). This is typical for enterprises in all industries, ownership type and size. Besides, the smaller the firm is the lower their assessment of business climate is.

At the same time, expectations of changes in the business climate have deteriorated considerably. *Index of business climate expectations* has decreased from 0.19 in April to -0.04 in August. The upward trend we discussed before was not observed. The index decline results from a significant drop in the share of managers expecting positive changes (from 29.8% to 8.3%). Nevertheless, it is encouraging that optimists preferred to "wait and see" rather than grow pessimistic. The share of managers expecting deterioration of business climate almost has not changed (14.8% in August vs. 15.8% in April). However, the share of those expecting neither positive nor negative changes has risen from 54.4% in April to 76.9% in August.



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 decreased from 23.6% in April to 19.3% in August. This has resulted from a decrease in two components of the "unfriendly regulatory climate" indicator – a "high regulatory burden" and "frequent changes in legislation". The changes of the latter are especially interesting because it reflects predictability/unpredictability of the business climate. The share of firms considering "frequent changes in legislation" as impediment decreased to 6.8% in August from 13.1% in April. This indicates a decline in the level of business climate unpredictability. It should be noted here that the level of unpredictability of business climate is different for different business segments:

- Firstly, this indicator is not the same for differently sized firms: it is the lowest for medium firms (1.7%), the highest for large-sized firms (11.9%), and for the small firms it amounts to 8.8%.
- Secondly, the changes of this indicator are different for differently sized firms. The most significant decrease in the number of managers considering frequent changes in legislation to be an obstacle to their business was observed in medium firms (from 9.6% in April to 1.7% in August). Among large-sized firms the respective share decreased from 21.0% to 11.9%, whereas the indicator is rather constant for small firms (9.9% in April and 8.8% in August, 2005).

The third component of the "unfriendly regulatory climate" indicator – the "corruption" has not changed practically. (See IMPEDIMENTS TO PRODUCTION).

Lending Climate

The lending climate is characterized by no changes in the demand for bank loans, on the one hand. The percentage of managers perceiving that banks can provide short-term loans to their firm made up 58.3% in the 1st quarter and 58.2% in the 2nd quarter. The values for long-term credits amounted to 35.9% and 35.4% respectively.

On the other hand, the respondents indicated a higher availability of credits for their firms. This can be explained by enhancement of the financial and economic situation at their firms (see PRODUCTION INDICATORS). Particularly, the share of respondents considering their firms can afford a loan increased from 35% to 41.8% for short-term loans and from 14.6% to 23.2% for long-term loans respectively.

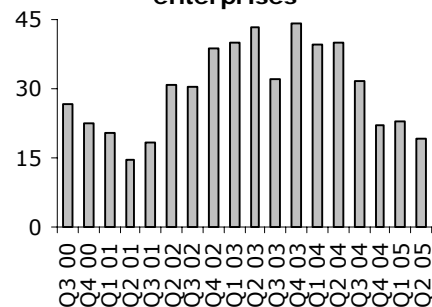
PRODUCTION INDICATORS

As managers expected, the production growth accelerated in the 2nd quarter. The *index of production* increased from -0.06 to 0.41. The managers' expectations came true completely: *index of production* in the 2nd quarter was 0.41, the *index of production expectations* in the 1st quarter made up 0.41 as well. The trend towards slowdown of industrial production observed since the mid of last year was brought to a halt.

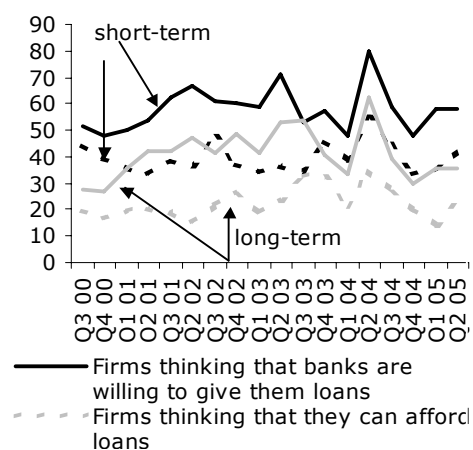
The highest value of *production index* was registered for wood processing (0.65). The lowest value was reported in the heavy industry (0.16). The growth of production was recorded for firms of all sizes. It was traditionally the lowest in the group of small firms (0.10). There was no significant difference between the values of *production index* for private, privatised and state-owned firms: 0.32, 0.38, and 0.34 respectively.

The firms plan no significant acceleration of their economic activities in the 3rd quarter. *The index of production expectations* for the next quarter went down from 0.41 (2nd quarter) to 0.21 (3rd quarter). Every second firm (54,0%) plans no changes in the volume of production for the 3rd quarter compared to the 2nd quarter and only

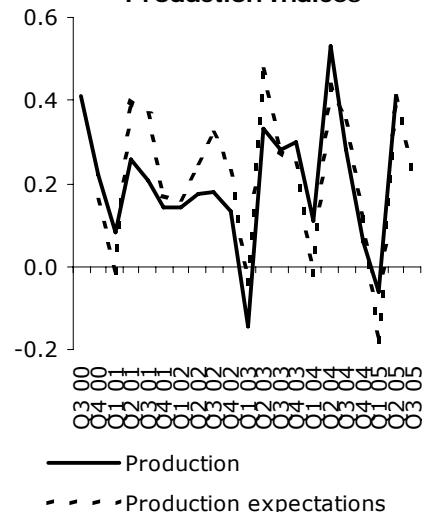
Unfavorable regulatory environment, % of enterprises



Affordability of Loans (in %)



Production Indices





33.6% plan to increase their production (compare: in the 2nd quarter the output gained in 54.4% of firms).

Decline in the index of production expectations was registered in all the industries. The optimism of managers does not depend on the size of the firm: the indices of production expectations for small, medium and large-sized firms are equal to 0.20, 0.21, and 0.22 respectively. State-owned firms have the least optimistic production plans compared to other types of ownership: their index of production expectations is equal to 0.12, when the respective values of privatized and private firms make up 0.25 and 0.20.

Demand, Sales, New Orders

The increase in domestic demand was observed after the decline lasting since May 2004. The firms reported more new orders. The index of new orders went up from 0.04 in the 1st quarter to 0.23 in the 2nd quarter. The index of sales increased from -0.09 to 0.40 for the same period. The share of managers assessing the portfolio of orders as normal grew up from 33.1% to 43.6%.

Against the general background of growing demand, an exception is the heavy industry, where the share of firms with fewer new orders exceeded the share of firms with more new orders (-0.04).

The respondents believed that the trend towards higher a demand was temporary. The managers expect that already in the 3rd quarter all the demand indicators will deteriorate. The indices of demand expectations are the worst for the past 3 years regarding this part of the year. The managers in the wood processing industry are most optimistic about receiving new orders in the 3rd quarter (0.35). Most pessimistic are the managers in the heavy industry (0.04).

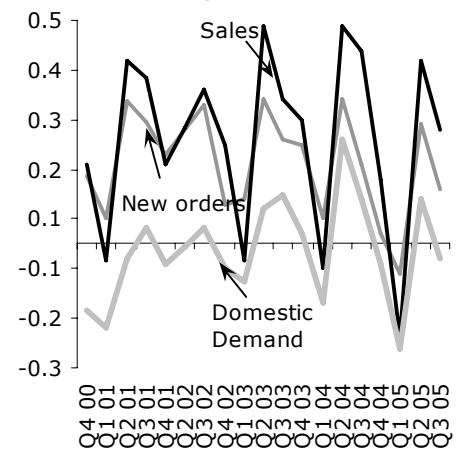
Impediments to production¹

As usual, the list of impediments to production is opened by low demand and tax burden and closed by lack of production capacities. There were no significant changes in the list of impediments to production in August compared to April except two things: (1) lower rate of liquidity problems to firms – decrease in production compared to the beginning of the year might have contributed to improvement of the financial situation of firms, and (2) lower rate of the outdated technology problem, what may reflect the growth of investment activity last year.

The absolute value of the "low demand" impediment opening the list of impediments has slightly increased. Nevertheless, we do not think that this indicates deterioration of the demand situation (direct demand indicators such as assessment of the portfolio of orders and the development pattern of new orders show the opposite direction. See DEMAND, SALES, AND NEW ORDERS). The rate of "high interest rates" and "access to credits" impediments has decreased. However, they are still more significant to firms compared the end of the last year.

The rate of the unfriendly regulatory climate has further diminished for the third quarter in a row. In August, it was in the lowest point for 9 years since the survey is conducted: only 19.3% of the interviewed managers have mentioned at least one component of the regulatory climate. However, it should be noted that this indicator considerably depends on the size of the firm. Its value is the lowest for medium firms (12.9%) and slightly higher for small ones (18.8%). At the same time, the regulatory environment is a most significant problem for large-sized firms: this is confirmed by 28.6% of managers.

Domestic demand: indices of expectations



Impediments to production

	Q4 04	Q1 05	Q2 05	Q2 05 vs Q1 05
Shortage of demand	65.5	56.9	62.5	5.6
Excessive taxation	41.7	51.1	50.4	-0.7
High competitive pressure	33.1	35.4	38.6	3.2
Liquidity problems	47.1	37.6	27.9	-9.7
High interest rate	21.2	30.7	27.1	-3.6
Shortage of raw materials	33.1	27.0	26.8	-0.2
Unfriendly regulatory climate	22.2	23.6	19.3	-4.3
High regulatory burden	15.8	15.0	13.2	-1.8
Changes in economic legisl.	5.0	13.1	6.8	-6.3
Corruption	2.9	0.4	1.4	1
Outdated technology	21.9	21.2	11.1	-10.1
Shortage of skilled workforce	12.6	13.9	11.4	-2.5
Access to credits	6.5	9.1	7.5	-1.6
Unstable political situation	10.1	4.0	3.2	-0.8
Shortage of capacities	4.3	3.6	5.4	1.8
Problems with energy supply	3.2	1.8	0	-1.8

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 political situation in August was not a significant barrier to production (place 11 in the rating, the absolute value is 3.2%) according to respondents. It was the first time when none of the respondents had problems with energy supply.

Capacity utilization

As usual, the patterns of the *capacity utilizations index* and the *capacity utilization expectations index* almost coincide with those of the *production and production expectations indices*. Thus, the *value of the capacity utilization index* has increased from -0.10 to -0.27. 39.1% of all firms have excessive production capacities. As the managers expect a slowdown in production growth, they do not plan to increase capacity utilization: the respective index of expectations equals 0.07.

Inventories

However, the firms do have problems with inputs. The share of managers estimating the stock of raw materials as low is still high. It practically has not changed compared to April (45.5% vs.47.2% in April). *The index of raw material stocks* has slightly increased: -0.20 in August vs. -0.37 in April. This is explained by the decreasing share of firms reducing their stocks and the increasing share of those that accumulated their stocks. The most significant decrease of reduction rates for stocks of raw materials was reported in printing and food industries. The *index* increased from -0.55 to -0.11 and from -0.40 to -0.07 respectively. On the contrary, the firms in the heavy industry and construction material industry have accelerated the reduction of stocks (from -0.08 to -0.28 and from 0.21 to -0.30 respectively).

Expecting a slowdown of production growth in the 3rd quarter, the firms do not plan any significant changes in stocks of inputs: the *index of expectations* is close to zero (-0.02).

Reduction of finished goods stocks in the 2nd quarter has followed the pattern of the 1st quarter: *the index of finished goods stocks* was equal to -0.19 and -0.22 respectively. The lowest index value was registered for the food industry (-0.32). The share of managers reporting low stocks of finished goods reduced from 35.5% to 25.4%. Managers do not expect any significant changes of this indicator in the 3rd quarter: the respective *index of expectations* equals -0.20.

Employment

Against the background of accelerating production growth, a higher level of employment is observed. The *index of employment* went up from -0.15 to -0.01. The share of managers perceiving the workforce level to be normal for available production capacities amounts to 72.4%. Firms do not expect any significant changes of employment in the 3rd quarter. The respective *index of expectations* is close to zero (0.01). This applies to all industries.

The share of firms still reporting workers on forced leave is equal to 7.2%. The respective *index of expectations* is close to zero. Managers do not expect any significant changes of this indicator in the 3rd quarter.

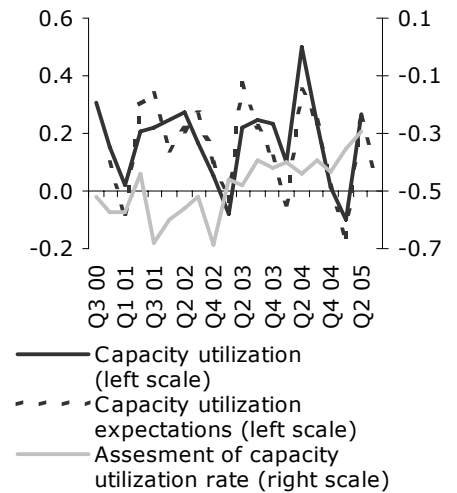
According to managers, it became more difficult to find workforce. This is valid for skilled workforce. The respective *index* values have increased from 0.62 to 0.68. On the other hand, finding unskilled workforce became slightly easier. The value of the respective *index* decreased from 0.2 to 0.08.

FINANCIAL PERFORMANCE INDICATORS

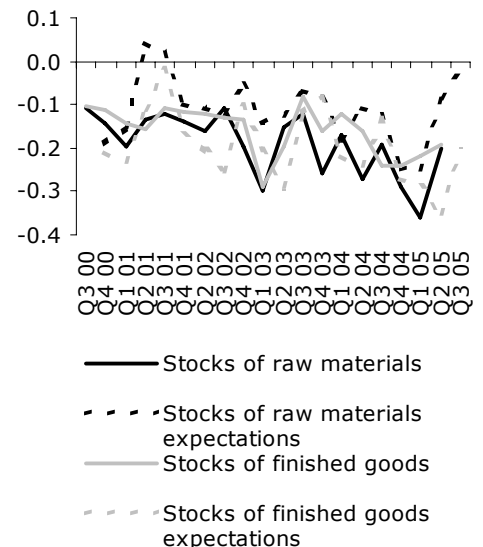
Prices

Prices for both inputs and finished goods continued growing with higher rates than managers expected. Thus, *the index of input prices expectations* for the 2nd quarter made up 0.31 and the *actual index* for the quarter equals 0.61. The respective indices of sales

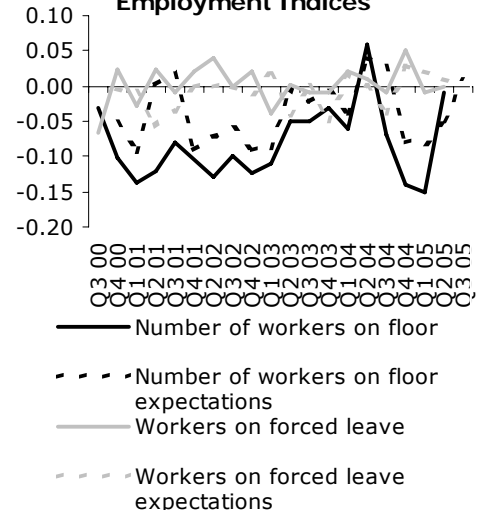
Capacity Utilization Indices



Inventories Indices



Employment Indices





prices are 0.22 and 0.39.

For the 3rd quarter managers expect continued purchase price increase but at lower rates. This applies both to sale and input prices. However it should be noted that in case of sale prices *the index of expectations* for the 3rd quarter is lower compared to the respective indicator of the 2nd quarter (0.16 vs. 0.22), and *index of input price expectations* has not changed practically (0.33 vs. 0.31).

Profitability

Production growth has certainly influenced the financial performance of firms. As managers expected, the *index of profitability* grew up last quarter from -0.18 to 0.12. That means prevalence of firms with improved financial performance over those with poorer results. 19.7% of respondents indicated a worse financial performance, 50.5% experienced no changes, and 29.7% of managers reported improved financial performance.

The positive value of *profitability index* was observed for all industries. The most significant improvement was observed in the wood processing industry (-0.40). In the 3rd quarter the managers, while expecting a slower production growth, predict deterioration of the financial performance: *the index of profitability expectations* is close to zero.

Barter

The share of firms reporting barter transactions is low (6.8%). That means that the barter as a phenomenon has practically vanished in the industrial sector. *The indices for barter and barter expectations* are close to zero, suggesting that no significant changes regarding barter transactions were recorded.

Arrears

The index of accounts receivable went up compared to the 1st quarter: -0.12 vs. -0.08. That means a slight cut in the receivables reduction rates. At the same time, *the index of accounts payable* has reduced from -0,09 to -0.12 indicating acceleration of payables reduction. During the 3rd quarter the managers will to attempt to further decrease the arrears. *The indexes* of payables and receivables are equal to -0.17 and -0.20 respectively.

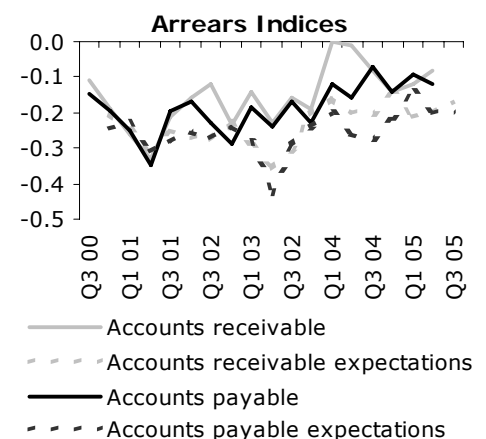
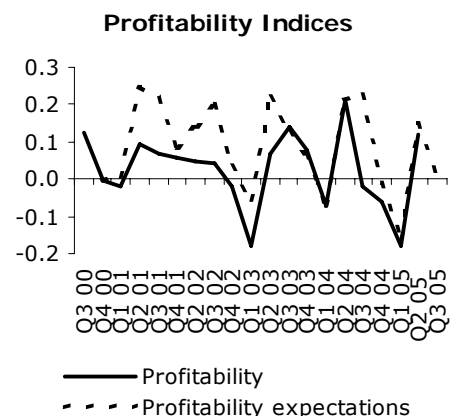
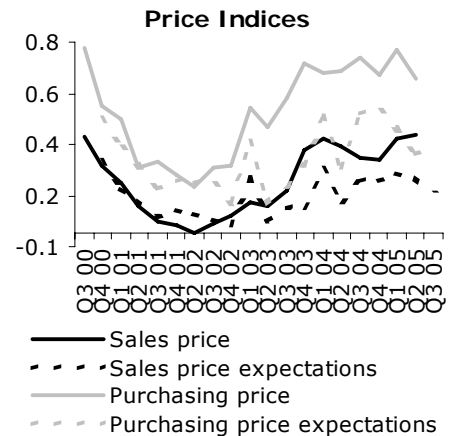
The share of respondents reporting tax arrears decreased from 15.4% in April to 10.8% in August. This results from high rates of tax arrear reduction in the 1st quarter, when the share of firms that reduced the tax arrears was 54,8%. The respective indicator for the 2nd quarter is 33.3%.

The share of respondents reporting wage arrears has decreased from 14.5% to 11.8%. Among the firms reporting wage arrears, 24.2% indicated reduction and 21.2% indicated the growth of wage arrears. Firms do not expect any significant changes in the 3rd quarter. *The index of expected changes in wage arrears* is close to zero.

COMPETITIVE PRESSURES ²

According to managers the competitive pressure from domestic producers became weaker: the *index of competitive pressure* from Ukrainian producers decreased from 0.36 in the 1st quarter to 0.18 in the 2nd quarter. This was observed in machine building, wood processing, heavy, and construction material industries. In contrast, managers in the food, light industries and printing feel an increase in the competitive pressure.

Unlike for domestic producers, the pressure from producers in Russia/CIS and other foreign producers has increased according to managers. The index increased from -0.66 to -0.47 and -0.76 to -0,49 respectively.



Index of competitive pressure from Ukrainian producers

Галузь	Q4'04	Q1'05	Q2'05
Heavy	0.46	0.38	0.12
Machine build.	-0.12	0.01	-0.25
Wood proc.	0.28	0.39	0.25
Construct. mat.	0.40	0.39	0.10
Light industry	0.47	0.39	0.56
Food processing	0.62	0.65	0.47
Printing	0.55	0.40	0.52

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



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).⁴

Appendix 2: Sample Characteristics

Number of employees, %		Regions, %		Industries, %	
	Q2'05		Q2'05		Q2'05
Fewer than 50	28.6	Lviv	26.8	Heavy ⁴ industry	9.3
51 – 250	41.4	Kyiv	31.1	Machine building	26.8
251 – 500	14.3	Kharkiv	32.1	Wood processing	7.1
501 – 1000	8.9	Odessa	10.0	Construction materials	7.1
Over 1000	6.8			Light industry	12.5
				Food processing	25.7
				Printing	8.2
				Other	3.2

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.