

Quarterly Enterprise Survey

No1 (7)
February 2004

- The Industrial Confidence Indicator decreased from -0.04 in the 3rd quarter to -0.17 in the 4th quarter.
- The managers' assessments of the current overall business situation as well as expectations about future changes in the business situation have deteriorated.
- A significant increase in the production index for small firms (from 0.17 to 0.31) was recorded for the first time.
- For the 1st quarter 2004, managers expect the usual seasonal slowdown of business activity: the production expectations for the 1st quarter 2004 are close to zero.
- The rankings of impediments to production growth have changed: low demand and unfriendly regulations increased in importance, while tax pressures decreased.
- The frequency of one impediment to production growth, namely "frequent changes to the economic legislation", has dramatically increased from 3.4% in October to 27.3% in February.
- The affordability of short-term loans has increased, while that of long-term loans, which reached its highest level in October 2003, has remained without significant change.
- Increasing purchase prices continue to alarm managers: the index of purchasing price expectations increased during the 1st quarter 2004. Sales prices are expected to grow too.

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 January / February 2004

Firms' performance: Q4 03 vs. Q3 03

Firms' expectations: Q1 04 vs. Q4 03

Business climate: Assessment for February '03, expectations for the next 6 months.

GENERAL INDICATORS

Industrial confidence indicator

The *Industrial Confidence Indicator* has decreased from -0.04 in the 4th quarter to -0.17 for the 1st quarter of 2004. This reflects lower production plans by the enterprises at the beginning of the year as well as a deterioration of the assessment of the volume of new orders. The third component of the indicator (assessment of the stock of finished goods) remains without significant change.

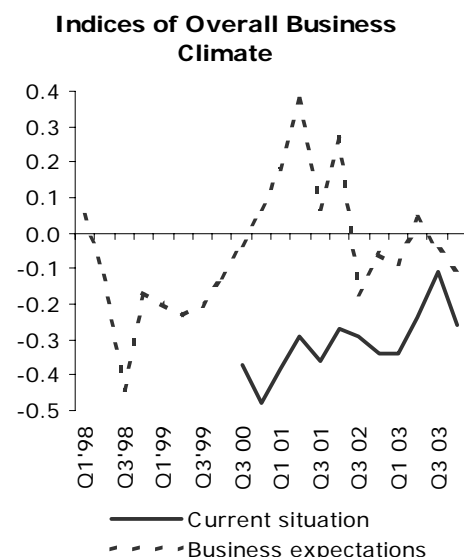
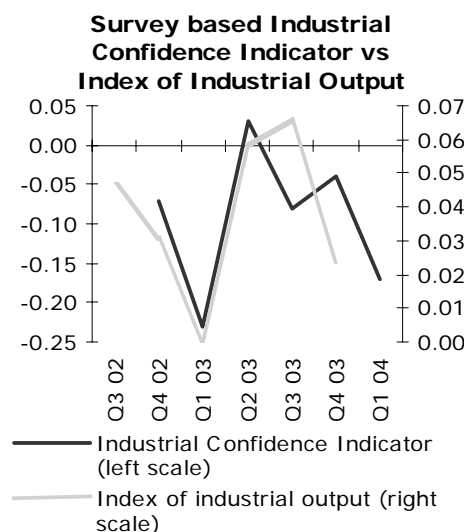
Decreasing production plans for the first 3 to 4 months of the year, and deteriorating assessments of the new order volumes are seasonal tendencies that are observed every year. However, compared to 2003, the value of the *Industrial Confidence Indicator* was higher (-0.17 vs. -0.23 for the 1st quarter of 2003). This is a positive signal implying increased confidence with respect to business development in the industrial sector compared to 2003.

Business climate

After improving for two quarters in a row, the managers' assessments of the current overall business situation have deteriorated. The *index of the current situation* decreased from -0.11 in October 2003 to -0.26 in February 2004. The index value is negative for all industries; the food industry recorded the lowest (-0.34) and printing the highest one (-0.09). The managers expect future changes in the business situation within a 6-months prospective to have deteriorated, too. This has been observed for two quarters in a row. The *Index of business expectations* dropped from -0.05 to -0.11 indicating that more firms have negative expectations rather than positive ones. This was observed in all industries, excepting construction materials (0.11). The values of both indices changed because the share of respondents with positive assessments/anticipations decreased, while negative assessments/anticipations increased.

Regulatory climate

The number of firms considering the regulatory climate to be a significant impediment to business development has increased to



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44.2% in February 2004 (from 32.0% in October 2003). This is due to a dramatic increase in the indicator for instability of the economic legislation, which rose from 3.4% to 27.3% (See IMPEDIMENTS TO PRODUCTION). The two other components of this indicator - namely high regulatory burden and corruption - also increased but to a lesser extent (by 1.9 and 1.3 percentage points respectively). An increase in the number of firms considering the regulatory climate to significantly impede business growth was noted for all business size groups. The number of large firms (more than 250 employees), which are unhappy about an “unfriendly regulatory climate”, has been increasing over the last four quarters, while among small and medium-sized firms the respective shares only increased sharply in the 4th quarter after having decreased earlier on.

Lending Climate

The indicators for the lending climate regarding short-term credits have improved. Managers reported that the banks became more willing to provide short-term loans in the 4th quarter compared to the 3rd quarter (57.2% vs. 53.1%). The affordability of short-term loans for enterprises has also increased: the share of firms considering short-term loans to be affordable has increased to 45.4% in the 4th quarter over 34.9% in the 3rd quarter.

The situation for long-term loans looks slight worse. The banks’ willingness to provide long-term loans has decreased: the share of managers that report banks to be willing to provide long-term loans has decreased from 53.5% to 40.4%. The affordability of long-term loans for enterprises remains without significant changes: as noted by 32.3% and 32.2% of respondents in the 3rd and the 4th quarters respectively. But one very positive finding must be noted: the difference between the affordability of long-term loans and the willingness of banks to provide such loans has decreased for the second quarter in a row, which indicates that the overall cost of long-term loans continues to be considered as lower.

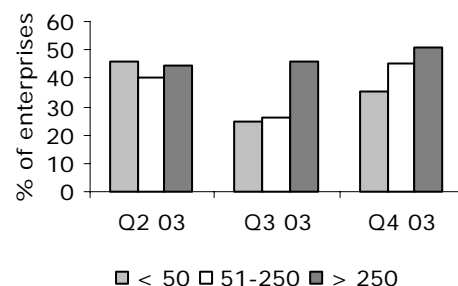
PRODUCTION INDICATORS

The values of the productions indices show that the industrial sector has continued to grow. The managers’ positive expectations were fulfilled for the second quarter in a row. The *index of production* for the 4th quarter was even higher than expected: 0.30 vs. 0.25. This is mainly due to the share of enterprises reporting increased production being even higher than what the managers had expected in the 3rd quarter (48.7% vs.40.7%). The value of the *index of production* is the highest one ever recorded for the 4th quarter in the survey’s history.

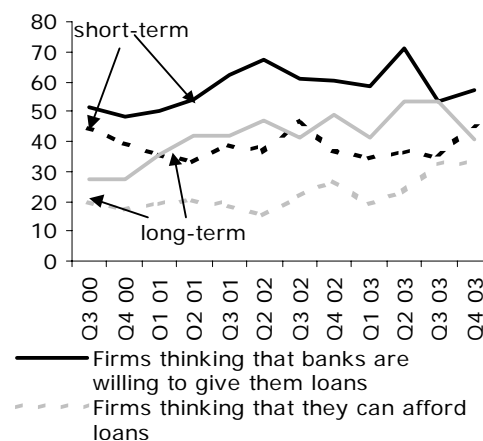
The highest values for the *index of production* were reported for the printing (0.55) and light industries (0.63). The biggest companies (more than 1000 employees) experienced the most significant growth (0.63). The index value for medium-sized firms was lowest (0.10). A significant growth of production in the small firms sector was recorded for the first time: the index value increased from 0.17 to 0.31. The value of the *index of production* for private firms is significantly higher than that for privatised and state-owned ones (0.58 vs. 0.25 and 0.27 respectively).

Traditionally managers don’t plan significant production changes for the 1st quarter of the year. The 1st quarter of 2004 is no exception. The *index of production expectations* is close to zero (-0.02). 42.9% of managers report no change in the volume of production. The shares of enterprises that expect increases and decreases in production are roughly equal (26.3% and 30.8%). The decrease in value of the *index of production expectations* applies to all industries. An especially significant drop of the index was recorded for industries that are more “seasonally dependent”, such as construction materials (-0.27) and food processing (-0.13). Large enterprises have more optimistic production expectations. The production plans of the small firms are the lowest of all size groups (-0.23).

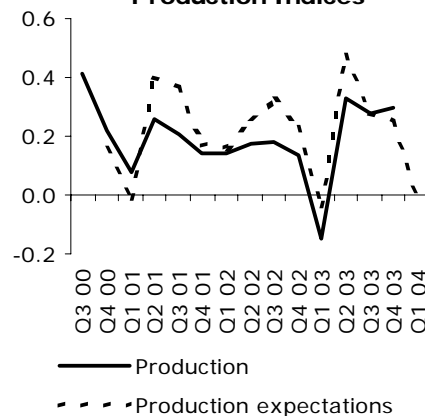
Unfriendly regulatory climate by size of firms



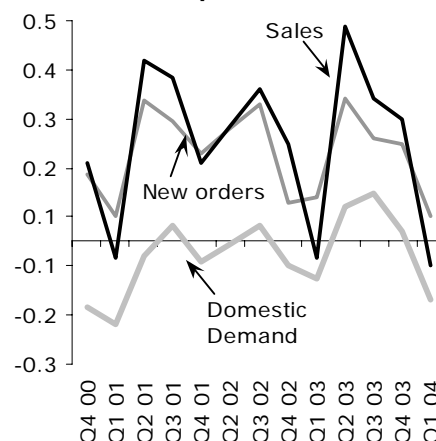
Affordability of Loans (in %)



Production Indices



Domestic demand: indices of expectations



Demand, Sales, New Orders

The *index of sales* increased from 0.31 to 0.33. Managers reported an increased number of new orders. The value of the *index of new orders* rose from 0.29 to 0.32. At the same time the volume of new orders did not satisfy the managers completely. The share of managers perceiving the new order volume to be low increased from 52.9% in the 3rd quarter to 70.2% in the 4th quarter. Also the *index of domestic demand* decreased from 0.12 to 0.02. This is a sign of the deterioration of the upward trend in demand, which respondents predicted for the winter season in the 3rd quarter.

For the 1st quarter of 2004, all demand indicators have decreased, and became close to zero, reflecting the seasonal deterioration in demand. Demand expectations differ across the industries. Managers in the printing industry are the most pessimistic with respect of getting new orders in the 1st quarter of 2004 (-0.32). While managers in the machine building and heavy industries do expect to receive new orders (the index values are 0.21 and 0.19 respectively).

Impediments to production¹

The first place in the list of impediments to production is the shortage of demand. This impediment increased in importance by 8.2 percentage points over the 3rd quarter. This reflects the typical first quarter's deterioration of the demand (see DEMAND, SALES, NEW ORDERS). Two important changes with respect to impediments characterizing the business environment were recorded:

- First, the importance of excessive taxation has decreased by 11.6 percentage points. For the first time this impediment has occupied third place in the list. Apparently this positive fact is the first reaction of businesses to the announced taxation system reform for physical entities and the decrease in the profits tax rate starting in January 2004.
- Second, the importance accorded to "unfriendly regulatory climate" has risen by 12.2 points. This is due to a perception that the frequency of changes to the economic regulations has changed dramatically. The share of managers that perceive changes in economic legislation to be an impediment to business growth is some 8 times higher than in the 3rd quarter (27.3% vs. 3.4%).

Though the first item noted is undoubtedly positive, the second one provides reasons for alarm: businesses are not likely to be very productive under conditions of increased uncertainty.

Capacity utilization

As managers had expected, some firms experienced production growth without increased capacity utilization. In contrast to the *index of production*, which slightly increased from the 3rd to the 4th quarter, the values of the *capacity utilization index* and of the *index of capacity utilization rate* have slightly decreased (from 0.25 to 0.23 and from -0.39 to -0.42 respectively). Expecting a seasonal business activity slow-down in the 1st quarter of 2004, managers expect the capacity utilization to decrease. This is reflected in the value of the *index of expected capacity utilization* (-0.05).

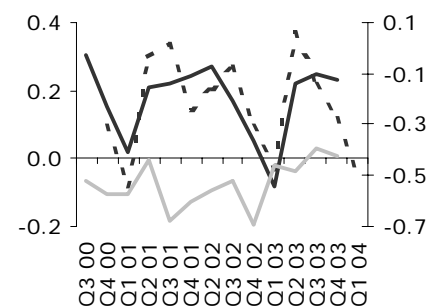
Inventories

In spite of the continued increase in output, the stock of finished goods of the enterprises did not to rise during the 4th quarter. The share of enterprises that consider their stocks of outputs to be low

Impediments to production

	Q2 03	Q3 03	Q4 03	Q4 03 vs. Q3 03
Shortage of demand	69.4	53.0	61.2	+8.2
Unfriendly regulatory climate	43.4	32.0	44.2	+12.2
High regulatory burden	35.6	27.6	29.5	+1.9
Changes in economic legisl.	10.7	3.4	27.3	+23.9
Corruption	3.6	4.5	5.8	+1.3
Excessive taxation	59.4	53.7	42.1	-11.6
High competitive pressure	37.7	27.2	32.0	+4.8
Shortage of raw materials	26.7	29.9	24.8	-5.1
Outdated technology	28.8	16.4	23.0	+6.6
High interest rate	28.8	21.6	18.0	+3.6
Shortage of skilled workforce	19.9	18.7	16.5	-2.2
Liquidity problems	13.5	11.9	10.4	-1.5
Access to credits	9.3	8.2	9.0	+0.8
Shortage of capacities	7.1	4.5	7.9	+3.4
Unstable political situation	10.7	13.8	6.8	-10.4
Problems with energy supply	3.9	3.7	3.2	-0.5

Capacity Utilization Indices



- Capacity utilization (left scale)
- - - Capacity utilization expectations (left scale)
- Assessment of capacity utilization rate (right scale)

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.



increased from 24.0% in October 2003 to 30.2% in February 2004. The *index of finished goods stock* decreased from -0.08 to -0.16. This applied to all industries with the exceptions of heavy industry and construction materials (0.08 and 0.0 respectively). The most significant decrease in the stock of finished good was recorded for wood processing, with the index dropping from 0.00 to -0.53. This tendency will continue during the 1st quarter of 2004 (-0.22).

The stock of raw materials decreased to a greater extent than was expected by the managers: in October 21.1% of managers forecast a decrease in the stock of raw materials in the 4th quarter, while 38.4% of them reported an actual decrease in February, which is reflected in the decline of the *index of raw materials stocks* (from 0.12 to -0.26). The reduction in the stock of raw materials has been observed across all surveyed industries. The lowest value of the index was recorded for wood processing (-0.47), machine building (-0.35) and the food processing industry (-0.32). In the 1st quarter of 2004 more than two thirds of all respondents expect neither a decrease nor an increase in the stock of raw materials.

Employment

No significant changes were recorded with respect to employment. The vast majority of the firms kept their workforce at the level of the previous quarter. The number of managers perceiving the workforce level to be satisfactory didn't change significantly (20.6% in October and 19.3% in February). During the 1st quarter of 2004 the managers do not plan to change the labour force: the *index* continues to be close to zero (-0.04).

The share of firms reporting workers on forced leave is 11.8%. No significant changes were recorded with respect to this issue (the index is -0.01). No change is expected for the 1st quarter of 2004 either (the *index of forced leave expectations* is at -0.02).

The problem of finding highly qualified workers continues to increase in importance. The value of the *index of hiring highly qualified workers* increased again (from 0.69 to 0.72). Managers in the light industry, printing, and machine building are facing the most severe problems (the respective index values are 0.84, 0.80 and 0.80).

Finding unskilled labour is less difficult but has also become more difficult: the respective index value increased from -0.04 to 0.11.

FINANCIAL PERFORMANCE INDICATORS

Prices

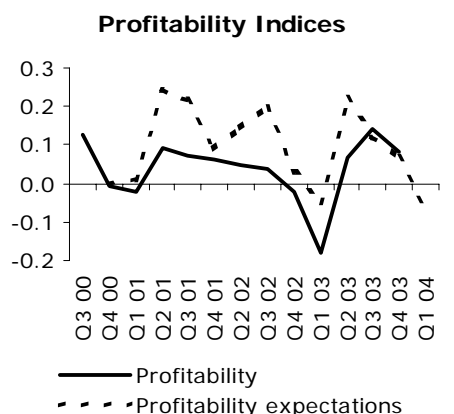
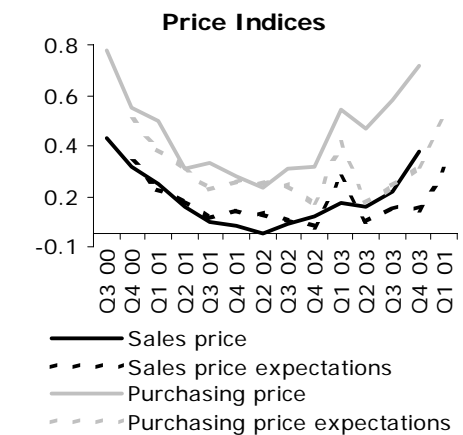
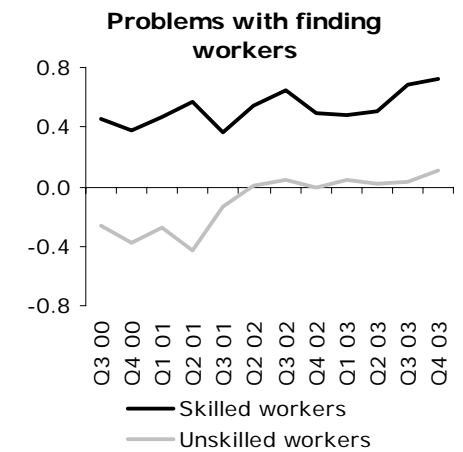
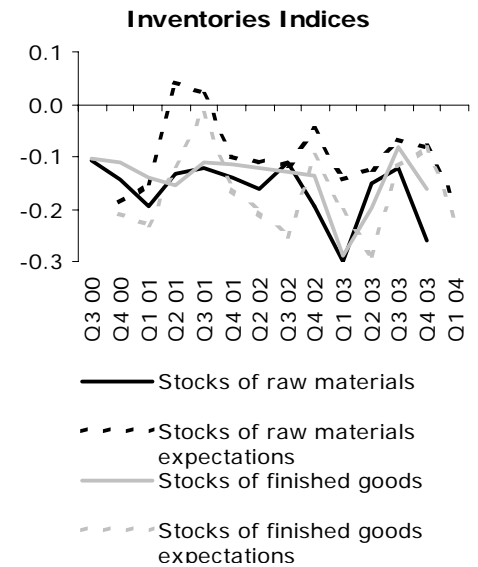
The managers' expectations regarding a growth of input prices were fulfilled completely. The *index of purchase prices* increased from 0.53 in the 3rd quarter to 0.67 in the 4th quarter. 66.8% of managers reported purchase price increases and only 0.7% noted decreases. The prices for outputs also increased. The *index of sales prices* increased to 0.33 from 0.17 in the 3rd quarter.

For the 1st quarter managers expect input as well as output prices to continue to rise. The *index of purchase price expectations* rose to 0.46 from 0.27. The *index of sales price expectations* goes up 0.25 from 0.10.

Profitability

The *index of profitability* decreased from 0.14 in the 3rd quarter to 0.08 in the 4th quarter due to a growth of the share of firms with decreased profitability (from 21.3% to 25.1%). The share of firms with increased profitability remained unchanged (32.0% and 32.9% respectively). Significant differences across industries were noted. The most significant profitability improvements were observed for printing (0.50) and for the light industry (0.29), the worst financial results were reported for food processing (-0.15) and for heavy industry (-0.11).

Against the background of an expected slow-down of business activity in the 1st quarter of 2004 the managers forecast a decrease



in profitability too. The value of the *index of profitability expectations* dropped from 0.07 to -0.07.

Barter

The share of firms reporting using barter transactions has decreased from 22.5% in the 3rd quarter to 17.6% in the 4th quarter. The *indices for barter* and *barter expectations* have negative values, suggesting a continued decline in barter operations (respectively -0.15 and -0.10).

Arrears

The number of firms reporting decreased arrears exceeds those who reported increased arrears, indicating that inter-enterprise arrears continue to decrease. The share of firms reporting a decrease in accounts receivable has risen from 26.9% to 33.5%. The same situation has been observed regarding accounts payable: the share of firms with decreasing arrears rose from 27.3% to 34.6%. At the same time the managers do not plan to accelerate the decrease of their arrears during the 1st quarter.

The share of respondents that reported tax arrears as well as wage arrears dropped (from 19.3% to 17.2%, and from 22.1% to 15.8% respectively). Both indices are close to zero indicating little change compared to the previous quarter. During the 1st quarter of 2004 51.1% of those who have tax arrears expect no changes in tax arrears and 37.8% expect their arrears to decrease. The corresponding data for wage arrears are 57.1% and 28.6%.

COMPETITIVE PRESSURES²

Overall, firms reported increases in the level of competitive pressures from Ukrainian producers. The *index* increased from 0.16 in October to 0.34 in February 2004. The highest competitive pressure was recorded for the food industry (+0.65), the lowest one was noted for machine building (-11).

The *index of competitive pressures* from Russian / CIS producers also increased slightly (from -0.57 in October to -0.52 in February). The *index of pressure* from other foreign producers remained without significant changes (-0.62 vs. -0.63 in October).

Appendix 1: Methodology

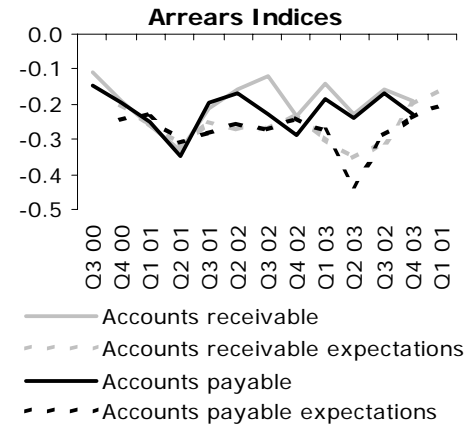
All indices are calculated using the same methodology. For each positive answer we score +1, for each negative answer -1, and for each answer indicating no change we score 0. For example, if 20 respondents report an increase in production, 50 respondents report a decrease, and 30 report no change, the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

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



Index of competitive pressure from Ukrainian producers

Industry	Q2'03	Q3'03	Q4'03
Heavy	0.36	0.08	0.46
Machine build.	-0.13	-0.26	-0.11
Wood proc.	0.30	0.10	0.32
Construct. mat.	0.25	0.29	0.45
Light industry	0.34	0.28	0.50
Food processing	0.52	0.53	0.65
Printing	0.60	0.44	0.55

Appendix 2: Sample Characteristics

Number of employees, %	
	Q4'03
Fewer than 50	28.9
51 — 250	38.9
251 — 500	14.6
501 — 1000	10.7
Over 1000	6.8
Regions, %	
	Q4'03
Lviv	26.8
Kyiv	33.2
Kharkiv	32.1
Odessa	7.9
Industries, %	
	Q4'03
Heavy ⁴ industry	8.9
Machine building	27.5
Wood processing	7.1
Construction materials	8.9
Light industry	11.8
Food processing	23.2
Printing	8.9
Other	3.6