Quarterly Enterprise Survey

No3 (9)
September 2004

- **The Industrial Confidence Indicator decreased from -0.01 in May to -0.05 in July.**
- **The managers' expectations about future changes in the business climate became more optimistic.**
- **As expected by the managers, significant increases in production have been recorded during the 2nd quarter.**
- **Managers expect continued production increases during the 3rd quarter, but less so than during the 2nd quarter.**
- **In the 3rd quarter managers expect demand growth to slow down.**
- **The accessibility and affordability of short and long term loans have improved.**
- **Competitive pressures have increased significantly.**
- **During the 3rd quarter managers expect continuing purchase price increases. Sales prices are expected to increase 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 July/ August 2004

Firms' performance: Q2 04 vs. Q1 04

Firms' expectations: Q3 04 vs. Q2 04

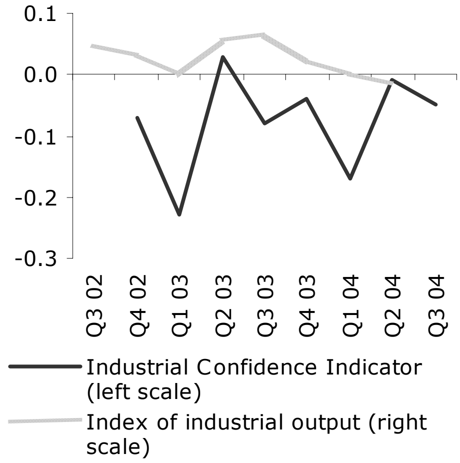
Business climate: Assessment for August '04, expectations for the next 6 months.

GENERAL INDICATORS

Industrial confidence indicator

The *Industrial Confidence Indicator* has decreased by 4 points, falling from −0.01 for the 2nd quarter to −0.05 for the 3rd 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).

Survey based Industrial Confidence Indicator vs. Index of Industrial Output

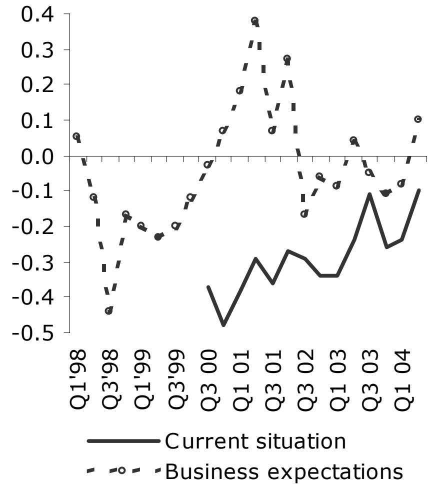


Business climate

A positive movement of the *index of the current situation* was observed: the index value continued to increase (from -0.26 in February to -0.23 in May and to −0.1 in August). Yet, the absolute level remains negative, indicating that more managers perceived the business environment to be insufficient than those that did not.

However, managers became more optimistic regarding the possibility of positive changes in the situation over the next 6 months. The share of the respondents expecting the situation to improve increased from 15.5% to 26.4%, and the share of those who think that the overall business climate will deteriorate decreased from 27.6% to 16.9%. This is reflected in the value of the *Index of business expectations*, which increased and changed sign: from -0.08 in May to 0.09 in August. This applies to all industries, except heavy industry and printing where pessimists exceed optimists: -0.05 and -0.04 respectively. A zero value of the index was recorded for machinery building.

Indices of Overall Business Climate



Regulatory climate

The percentage of firms considering the regulatory climate to be a significant impediment to business development remained without a significant change: 39.9% in August vs. 39.7% in May. However, the shares of the three components making up this indicator — high regulatory burden, frequent changes in economic legislation and corruption — have changed. The importance of high regulatory burden has risen from 22.1 points to 34.5 points while the importance of frequent legislative changes has declined from 21.7 to 7.2 (See IMPEDIMENTS TO PRODUCTION).

Lending Climate

The indicators for the lending climate have significantly improved,

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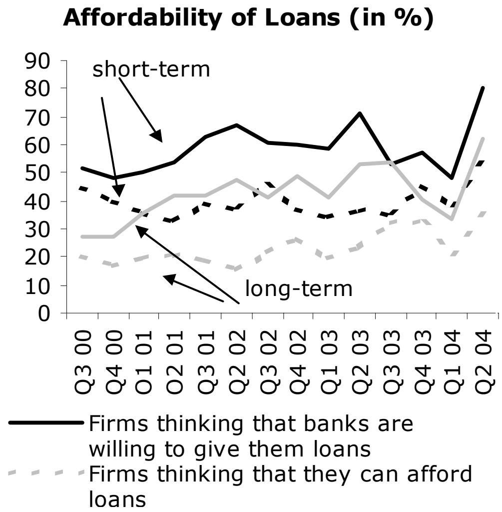
which applies to both short- and long-term loans.

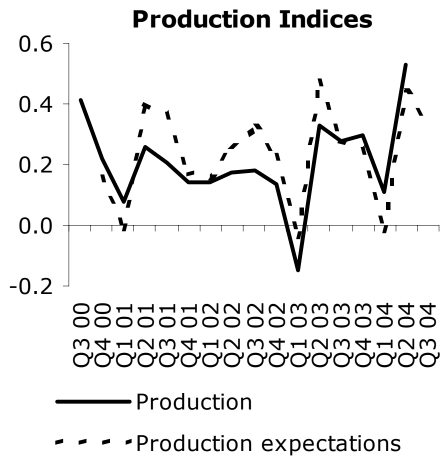
Managers reported that the banks became much more willing to provide short-terms loans during the 2nd quarter of 2004 compared to the 1st quarter. (80.1% vs. 48.0%). The affordability of short-term loans for enterprises also increased: the share of firms considering short-term loans to be affordable rose to 54.5% in the 2nd quarter of 2004 from 39.1% in the 1st quarter of 2004.

A similar situation was noted for long-term loans. The trend of a deteriorating indicator for long-terms loans that was recorded for a second quarter in a row has broken. According to managers the willingness of banks to provide long-term loans has increased: the share of managers reporting banks to be willing to provide long-term loans has increased from 33.2% (1st quarter of 2004) to 62.4% (2nd quarter of 2004). The affordability of long-term loans for enterprises was also seen to have improved: from 21.1% (1st quarter of 2004) to 35.0% (2nd quarter of 2004).



PRODUCTION INDICATORS

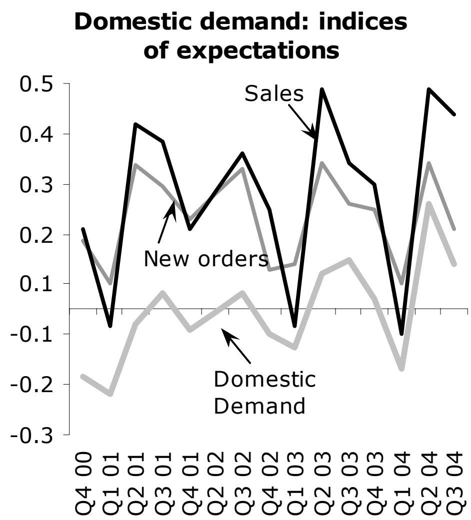
As the managers had expected, business activity during the 2nd quarter did accelerate. The results of the July/August survey have confirmed the seriousness of the enterprises' intentions regarding increased outputs. 61.9% of managers reported increased production in the 2nd quarter compared to the 1st. This represents one of the highest values of the production index in the history of this survey, namely 0.53. A similar performance was previously recorded during the middle of 2000.



The highest value for the *index of production* was reported for construction materials (0.90), indicating a boom in the industry. The lowest one is recoded for heavy industry (0.26). As usual the large companies (more than 250 employees) experienced the most significant growth (0.62). The index value for medium firms is close to the large one (0.58), while the lowest index value was recorded for small firms (0.19). The value of the *index of production* for state-owned enterprises was significantly lower than that for privatised and de novo private firms (0.31 vs. 0.50 and 0.60 respectively).

Enterprises expect to increase production yet further during the 3rd quarter but to a lesser extent than during the 2nd quarter. The *index of production expectations* is 0.35. The index is lower than it was for the 2nd quarter (0.44), because fewer enterprises expect to experience increasing production: 48.6% rather than 61.9%. The decrease in value of the *index of production expectations* applies to all industries except the light and food industries and printing. Medium-sized enterprises have the most optimistic production expectations (0.42). For the first time this quarter, the production plans of large firms are worse that those of small and medium ones. State-owned firms again have the most pessimistic production plans; their *index of production expectations* is 0.28. For privatised and private firms the respective index values are 0.35 and 0.48.

Demand, Sales, New Orders



The *index of sales* increased from 0.12 to 0.49 confirming a seasonal acceleration in business activity. But the demand issue causes some concern. The following findings are noteworthy:

- The number of new orders has increased to a lesser extent than managers had expected in May: only 26% of managers reported an increase in new orders in the 2nd quarter comparing to the 1st; at the same time 33.9% of respondents expected to receive new orders during the 2nd quarter.
- The same situation was observed with regards to total demand. 27.4% of managers expected demand to increase during the 2nd quarter, but only 15.9% actually reported an increase in demand.
- The share of firms experiencing decreases in demand exceeded

the share of firms with increases in demand.

- The share of managers perceiving the order stock to be low increased from 61.8% (1st quarter of 2004) to 65.5% (2nd quarter of 2004).

For the 3rd quarter of 2004, all demand indicators were predicted to decrease. Demand expectations differ across the different industries. The managers in the printing industry are the most pessimistic with respect to demand growth during the next quarter (0.21), while the wood processing industry managers are the most optimistic (-0.11).

Impediments to production[1]

Shortage of demand, excessive taxation and high competitive pressures are at the top of the list of impediments to production. Shortage of demand is one of the three main obstacles for enterprises of any size. Its importance increased by 10.7 points. The highest absolute value of this indicator was recorded for medium-sized firms (70.3%).

The greatest change recorded is the dramatic increase in the share of managers perceiving competitive pressures to be an impediment to production: the increase from 35.9% to 58.6% moved this item to the third position in the rating! This assessment of competitive pressures reflect increased competition (see COMPETITIVE PRESSURE).

An unfriendly regulatory climate is fourth in the list. The importance of this impediment has remained stable: 39.9% of respondents perceive the regulatory climate to impede business growth.

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 increased from 0.10 to 0.50. 49.1% of all enterprises have excess production capacities.

The managers plan to increase capacity utilization in the 3rd quarter to a lesser extent: the respective *index of expectations* equals 0.25.

Inventories

The share of enterprises that consider their output stocks to be low decreased from 48.2% in May to 18.1% in August. The vast majority of enterprises are satisfied with their stock of finished goods (77.1%). The *index of finished goods stock* decreased from -0.12 to -0.16. The negative index value indicates that more firms decreased rather than increased their stocks. This applied to all industries. The most significant decrease in the stock of finished good was recorded for wood processing (-0.61).

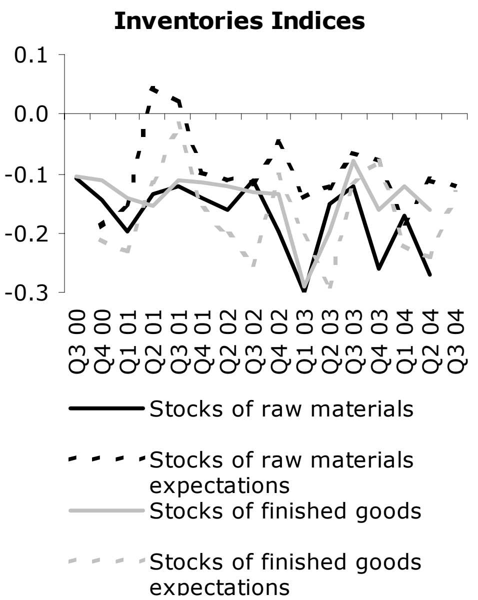
During the 3rd quarter enterprises are not planning to increase their stocks of finished goods: the index of expectations is -0.12.

During the 2nd quarter of 2004 the stock of raw materials decreased to a greater extent than during the 1st quarter: the *index of raw material stocks* decreased from -0.17 to -0.27. The lowest values of the index were recorded for the wood processing (-0.39) and printing industries (-0.33).

The slowing tendency for raw material stocks to decline will continue during the 2nd quarter of 2004: the index of expectation is -0.12. In line with normal seasonal fluctuations, the food processing industry expects the largest increase in raw material stocks; its index of expectation has a positive value (0.21).

Impediments to production

	Q4 03	Q1 04	Q2 04	Q2 04 vs. Q1 04
Shortage of demand	61.2	56.9	67.6	**10.7**
Excessive taxation	42.1	59.4	63.7	**4.3**
High competitive pressure	32.0	35.9	58.6	**22.7**
Unfriendly regulatory climate	44.2	39.7	39.9	**0.2**
High regulatory burden	29.5	22.1	34.5	**12.4**
Changes in economic legisl.	27.3	21.4	7.2	**-14.2**
Corruption	5.8	1.7	2.2	**0.5**
High interest rate	18.0	25.4	31.3	**5.9**
Shortage of raw materials	24.8	21.7	25.2	**3.5**
Outdated technology	23.0	22.8	18.0	**-4.8**
Shortage of skilled workforce	16.5	14.5	10.1	**-4.4**
Liquidity problems	10.4	10.0	12.6	**2.6**
Access to credits	9.0	8.7	11.5	**2.8**
Shortage of capacities	7.9	6.5	6.5	**0**
Unstable political situation	6.8	3.6	1.4	**-2.2**
Problems with energy supply	3.2	1.8	2.5	**0.7**



[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.

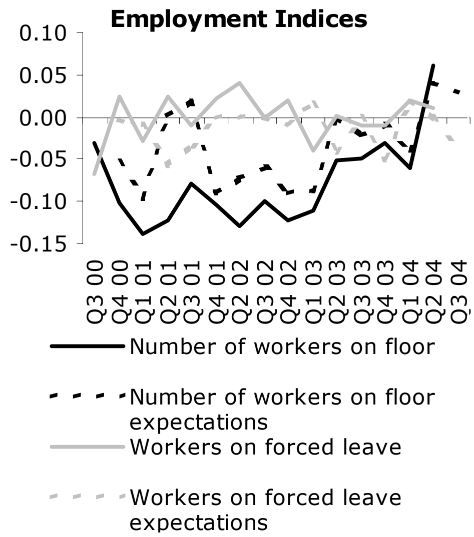
Employment

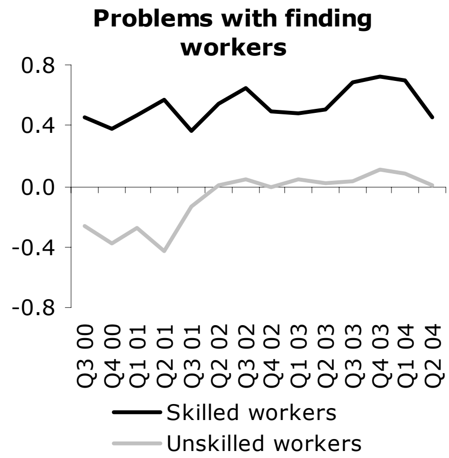
As managers had expected in May, employment actually increased in the 2nd quarter. Against a background of increased production, the share of firms increasing their workforces exceeded those that reduced employment levels. The respective index value is positive (0.06). The number of managers perceiving the workforce level to be satisfactory has increased from 79.5% to 83.8%.

The share of managers planning to increase their labour force during the 3rd quarter of 2004 also exceeds those planning reductions: the *index of expectations* is 0.03. The most hopeful plans regarding hiring of workers were recorded for heavy industry (0.13), construction materials (0.11) and food processing (0.13).

The share of firms reporting workers on forced leave is 9.4%. A decrease of this indicator is expected for the 3rd quarter (the *index of forced leave expectations* is –0.04).

The problem with finding highly qualified workers continued to decrease. The share of managers reporting increased problems with hiring skilled workers has reduced from 74.5% in May to 49.6% in August. Finding unskilled labour also became less difficult: the share of managers noting that the process had become more difficult decreased from 16.2% to 10.9%, while those who feel that hiring unskilled workers had become less difficult increased from 8.4% to 10.2%.



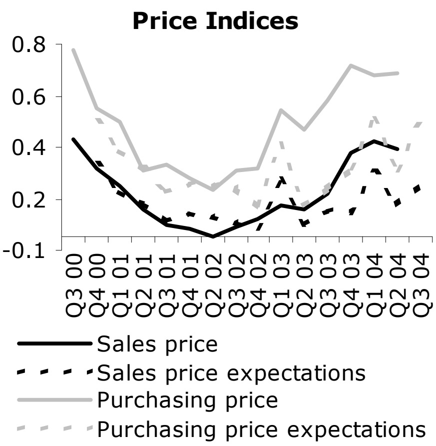


FINANCIAL PERFORMANCE INDICATORS

Prices

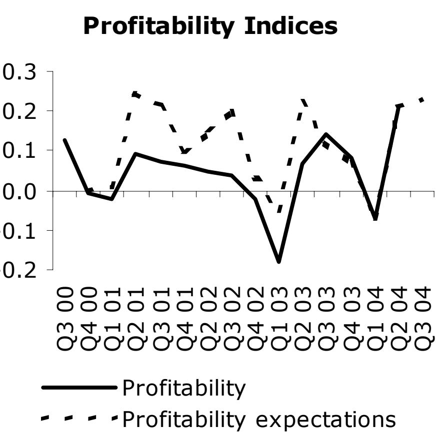
Again, the rise in purchase prices was much greater than managers had expected three months ago. Though in May only 28.5% of our respondents expected the input prices to grow during the following three months, 65.0% of all managers actually confirmed increased prices post-fact in August. The *index of purchase prices* is still high (0.64). A similar situation has been recorded for sales prices: 15.3% of all managers expected price rises, but 33.6% confirmed actual rises three months later. The *index of sales prices* is 0.34.

For the 3rd quarter managers expect input as well as output prices to rise more slowly. However, managers expect 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 August 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 input prices also predict increases: 46.5% of them think that prices will go up. The *index of purchase price expectations* increased from 0.26 to 0.47.



Profitability

As had been predicted, the *index of profitability* increased from -0.07 in the 1st quarter to 0.21 in the 2nd quarter due to a growth of the share of firms with increased profitability (from 19.4% to 37.1%), and a decreased number of firms with poorer financial results (from 29.5% to 20.1%). The most significant profitability improvements were noted for food processing (0.33), the worst financial results were reported for the second quarter in a row for printing (-0.21). Light industry also reported a negative index value (-0.11). The managers forecast continued profitability increases for the 3rd quarter. The value of the *index of profitability expectations* increased from 0.21 to 0.23.



Barter

The share of firms reporting barter transactions increased slightly: from 10.8% in the 1st quarter to 16.2% in the 2nd quarter. The *indices for barter* and *barter expectations* are close to zero, suggesting no significant changes regarding barter operations were recorded.

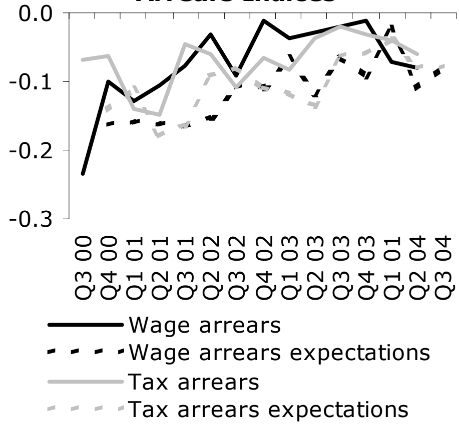
Arrears

Contrary to the managers' expectations of the 1st quarter the decrease of accounts receivable arrears has slowed during the 2nd quarter of 2004. The *index of accounts receivable* remained at the zero level. At the same time the *index of accounts payable* has slightly decreased from -0.12 to -0.16. During the 3rd quarter the managers intend to attempt to further decrease their arrears.

The share of respondents that reported tax arrears didn't change significantly (15.8 in August vs. 16.2% in May). At the same time the decrease in tax arrears has speeded up. The share of enterprises reporting decreased tax arrears has grown from 33.3% in May to 50.0% in August. The managers expect to continue this tendency during the 3rd quarter.

The share of respondents reporting wage arrears has decreased from 19.4% to 17.6%. But changes in this field were not as great as they had been expected three months ago. 71.4% of those who had wage arrears planned to decrease them during the 2nd quarter but only 59.2% actually did report decreases. During the 3rd quarter 57.1% of the "wage debtors" plan to decrease their wage arrears.

Arrears Indices



COMPETITIVE PRESSURES[2]

According to the managers, competition became stronger. Competitive pressures from all types of producers were reported: domestic, foreign CIS countries, and other foreign countries.

For the fourth quarter in a row the *index of competition pressure* from Ukrainian producers has increased. The *index* increased from 0.36 in May to 0.40 in August. This is true for all industries except for construction materials. As in the previous survey, the highest competitive pressure was recorded by the food industry (+0.79), the lowest one for machine building (-0.04).

The *index of competitive pressures* from Russian / CIS producers also continued to increase (from -0.50 in May to –0.41 in August). This trend started in October 2003. The *index of pressure* from other foreign producers has risen from -0.69 in May to -0.51 in August.

Index of competitive pressure from Ukrainian producers

Industry	Q4'03	Q1'04	Q2'04
Heavy	0.46	0.54	0.57
Machine build.	-0.11	-0.17	-0.04
Wood proc.	0.32	0.55	0.61
Construct. mat.	0.45	0.55	0.29
Light industry	0.50	0.28	0.43
Food processing	0.65	0.69	0.79
Printing	0.55	0.59	0.58

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).

Appendix 2: Sample Characteristics

Number of employees, %

	Q2'04
Fewer than 50	28.8
51 — 250	41.0
251 — 500	14.4
501 — 1000	9.7
Over 1000	6.1

Regions, %	Q2'04
Lviv	27.0
Kyiv	32.0
Kharkiv	32.4
Odessa	8.6

Industries, %

	Q2'04
Heavy[4] industry	8.3
Machine building	26.6
Wood processing	6.8
Construction materials	7.6
Light industry	12.6
Food processing	26.3
Printing	8.6
Other	3.2

[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.

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