Quarterly Enterprise Survey

No4 (14)
November 2005

- **The Industrial Confidence Indicator decreased from -0.05 in August to -0.07 in October.**
- **The managers' expectations about future changes in the business climate remain without changes.**
- **As expected by the managers, decreases in production have been recorded during the 3rd quarter.**
- **Managers expect continued production increases during the 4thquarter.**
- **In the 4th quarter managers expect demand growth to slow down.**
- **The accessibility of loans has increased while affordability has deteriorated.**
- **High interest rate 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/November 2005

Firms' performance: Q3 05 vs. Q2 05

Firms' expectations: Q4 05 vs. Q3 05

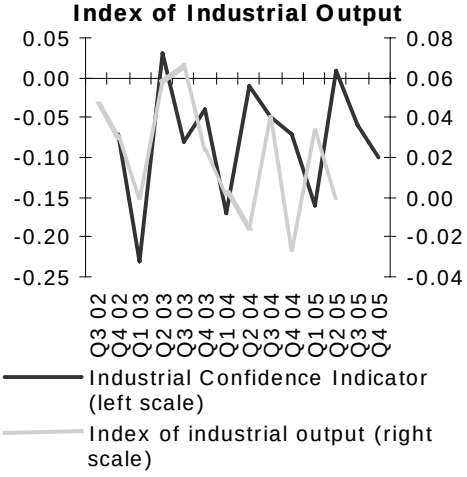
Business climate: Assessment for October '05, expectations for the next 6 months.

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 2005. 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

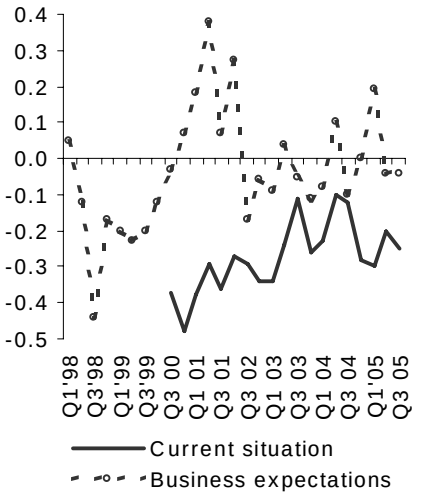


Business climate

The index of business climate assessment went down from –0.20 in August to –0.25 in October. 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



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).

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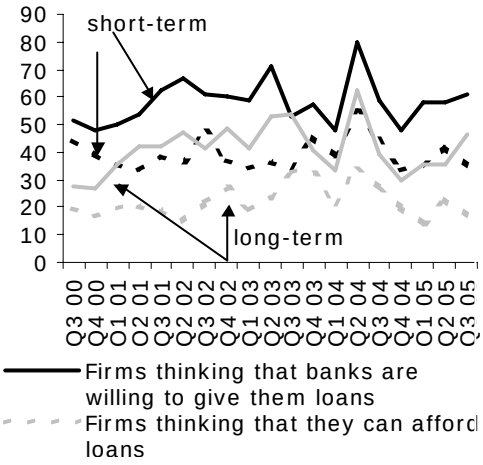
Lending climate

The lending climate in general remains favourable. 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-terms 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.

Affordability of Loans (in %)

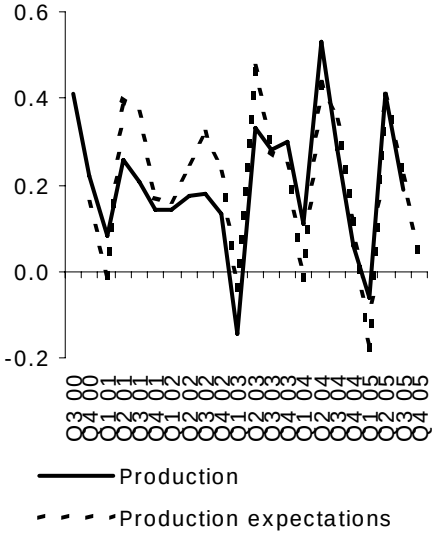


PRODUCTION INDICATORS

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).

Production Indices



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

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 mangers estimating the volume of orders as normal increased from 32.7% in the 2nd quarter to 37.0% in the 3rd quarter.

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 Production[1]

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 significance of 6 from 13 impediments to production has increased compared to the previous quarter. Liquidity problems increased in its importance and moved to forth place in the list (+12.3). Also significant incense in importance has been observed for outdated technology (+12.7). The impediments like high interest rate, shortage of skilled workforce, high competitive pressure, and political instability became more significance for managers also.

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).

FINANCIAL PERFORMANCE INDICATORS

Prices

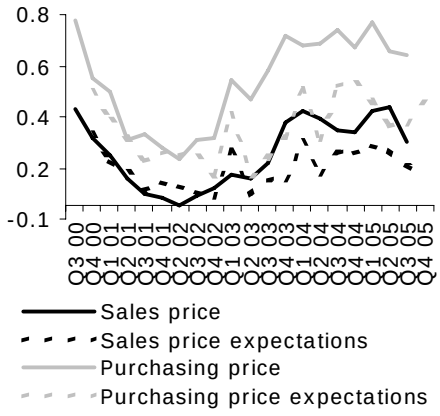
Purchase and sales prices continued growing. But it should be noted that managers reported about some growth deceleration of sales prices against the background of growing purchase prices. The respective indices are equal to 0.69 and 0.30 respectively. This is typical for food processing and printing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

Impediments to production

	Q1 05	Q2 05	Q3 05	Q3 05 vs. Q205
Shortage of demand	56.9	62.5	57.7	**-4.8**
Excessive taxation	51.1	50.4	49.1	**-1.3**
High competitive pressure	35.4	38.6	41.3	**+2.7**
Liquidity problems	37.6	27.9	40.2	**+12.3**
High interest rate	30.7	27.1	35.2	**+8.1**
Shortage of raw materials	27.0	26.8	25.6	**-1.2**
Outdated technology	21.2	11.1	23.8	**+12.7**
Unfriendly regulatory climate	23.6	19.3	17.6	**-1.7**
High regulatory burden	**15.0**	**13.2**	**11.4**	**-1.8**
Changes in economic legisl.	**13.1**	**6.8**	**5.7**	**-1.1**
Corruption	**0.4**	**1.4**	**2.1**	**+0.7**
Shortage of skilled workforce	13.9	11.4	15.3	**+3.9**
Access to credits	9.1	7.5	6.0	**-1.5**
Unstable political situation	4.0	3.2	5.0	**+1.8**
Shortage of capacities	3.6	5.4	5.0	**-0.4**
Problems with energy supply	1.8	0	2.5	**+2.5**

Price 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.

Profitability

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.

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 PRESSURE[2]

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.

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

[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.

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).

[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.