

THE NEW AUTHORITIES: BUSINESS ASSESSMENTS & EXPECTATIONS IN 2005

- At the beginning of 2005 business expected from the new authorities Complex and consistent measures aiming at (1) enhance the predictability of the business environment, (2) reduce social taxes and (3) establish equal rules of the game for all.
- The beginning of the 2005 the business confidence to new Authority was the greatest and it reflected to significant increase in business optimism
- In April the share of respondents expected improvement of business climate in the next half of a year amounted 29,8%
- In April firms planned to increase their production: 51,0% of respondents planned to increase their volume of production in the next 3-4 months
- 41% of managers positively evaluate the first 100 days of new Government activity, and only 17,2% of respondents were not satisfied with new Government's activity
- Business optimism significantly decreased in the second half of a year. In August the percent of respondents expected positive changes in business climate in the next half of a year amounted only 8,3%.
- Decrease in business optimism also influenced on production plans of enterprises, which were lower, than they could be with regard to the fact, that at the middle of the year one can usually observe the peak of business activity
- But former "optimists" did not become "pessimists". The majority of managers (76,9%) expect neither positive nor negative changes in business environmental during next six months.

A panel of 300 manufacturing firms is used to monitor their managers' perceptions about markets, the business climate, investment activity and the performance of their firms.

In this issue: Results of the surveys conducted 2005

New: Business assessment and attitudes to the Government economic policy

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Co-operation between the authorities and business on the principles of transparency, mutual trust and support is a key factor of effective reform of the national economy and transition of the country to the sustainable economic development. In this context, the position of the business circles, their trust in the authorities, assessment of the economic policy pursued by the state to regulate business activity are of particular importance. The analysis of the assessments and expectations of the business circles in 2005 reveals two periods in the business perception of the new authorities: colossal credit in the year beginning, and decline of optimism and wait-and-see position since mid-year, not reversed by the appointment of the new Prime Minister.

To be sure, the business optimism at the year end is affected by the factor of the future parliamentary elections, especially in view of the political reform. However, it may be assumed that optimistic spirits of the business faded away mainly because the new authorities did not meet their expectations. The problems that hindered the development of their business remain unresolved. Businessmen do not hope for positive changes in the business environment in the near future.

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Business and the authorities in the first post-revolutionary months: confidence and expectation

Business expected from the new authorities clear signals that they realise its needs and have the plans and resolve to implement reforms. It makes sense to remind what steps the business community expected from the authorities

At the year beginning, the business expected from the new authorities **comprehensive and consistent measures** aiming to enhance the predictability of the business environment, reduce social taxes and establish uniform rules of the game for all. The following economic policy measures were seen by businessmen as the most critical:

- creation of an effective mechanism of implementation of the passed legislative acts and guarantee of stable legislation;
- reduction of rates and simpler administration of duty payments to social funds;
- establishment of uniform rules of the game for all, including liquidation of tax exemptions and preferences;
- non-interference of local authorities in the activity of enterprises and administrative interference in pricing.

The beginning of 2005 saw colossal credit of the business in of the new authorities, witnessed by the significant growth of the business optimism. While in October 2004, the number of those who expected the improvement of the business environment made 11.5%, in April 2005 — 29.8%. The trend was reported at enterprises engaged in all kinds of activity, irrespective of their size and ownership. In April, businessmen had ambitious plans of production growth: 51.0% of the polled expected that in the next 3-4 months, production would grow, compared to the 1st quarter of 2005

Hence, April, 2005, saw a positive trend to the growth of the business optimism, last observed in 1999-2001, under the premiership of V.Yushchenko. The trend was evidently promoted by the high assessment of the new authorities' activity: 41% of enterprise managers assessed the first 100 days of the Government positively and only 17.2% — negatively⁹. However, the analysis of those results shows that the positive assessments were mainly based on the general trust in the new authorities, the polled who reported them at that time saw no positive effects for their business but pinned hopes for the better to the new authorities.

Such attitude of the business to the new authorities in the first months of their activity suggested that the authorities should promptly meet those hopes; otherwise positive and neutral assessments would yield to apathy causing the decline of support for the Government and the new authorities in the business community.

Business and the authorities in the second half of 2005: failed hopes

In the second half of the year, the pessimistic forecasts mentioned above began to come true. In August, the business optimism fell drastically, compared to April. The 2nd quarter of 2005 may be called a period of great disappointment of the business, first of all — the big business, over the new authorities. While in April, the growth of the business optimism was the greatest, in August, its decline was similarly great: the index fell from 0.41 in April to 0 in August, or by 41 points

Small enterprises were less optimistic than big, apparently, due to the uncertainty of the governmental policy towards small

At the year beginning, the business expected from the new authorities comprehensive and consistent measures aiming to enhance the predictability of the business environment

Hence, April, 2005, saw a positive trend to the growth of the business optimism, last observed in 1999-2001, under the premiership of V.Yushchenko

In the second half of the year, the pessimistic forecasts mentioned above began to come true



business. Respectively, the disappointment was not so deep: its index fell by 22 points — from -0.08 to -0.14

Respectively, **the index of expected changes in the business environment sharply (by 23 points) declined** — from 0.18 in April to -0.04 in August. Such a decline occurred due to the sharp decrease in the number of managers expecting positive changes – from 29.8% to 8.3%. Previously, the disbelief in positive changes (index decline) was observed at the beginning of the premiership of V.Yanukovych (in November 2002, compared to August, 2002) — then, the business optimism fell by 44 points, and after the resignation of the Government of V.Yushchenko, the index fell by 31 points.

Encouragingly, “optimists” did not turn “pessimists”: the share of managers expecting deterioration of the business environment actually did not change (15.8% in April and 14.8% in August), and of those who expected neither positive nor negative changes (“indifferent”) increased from 54.4% in April, 2005, to 76.9% in August, 2005. Evidently, the reason was that businessmen after all felt some improvement of the business environment in the 2nd quarter, compared to the 1st. The relevant index increased from -0.30 in April to -0.20 in August, **but the absence of the expected steps on the part of the authorities and the authorities’ actions in May-August, 2005, made business disappointed over the possibility of prompt positive changes.**

The decline of optimism affected the production plans of enterprises that also were lower than they could be — given that the middle of the year normally sees the peak of the business activity¹¹.

Hence, in August, 2005, the situation reversed, compared to the year beginning. While in April, the assessments of the business climate were low but expectations were high, in August, despite the “high season” of the business activity, both expectations and production plans of enterprises were much more modest than they could be.

Expected changes in the business environment and situation at the end of year

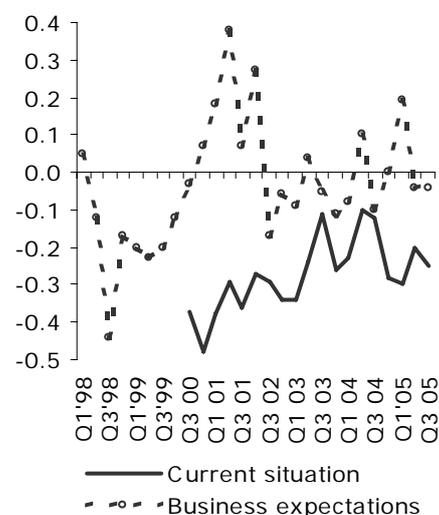
Business environment

In November, the business environment assessment by enterprise managers somewhat deteriorated, compared to August: the relevant index fell from -0.20 to -0.25, but was higher than in April, 2005 (-0.30). The index declined due to the increase in the number of respondents describing the business environment as bad (from 25.9% in August to 29.6% in November). The number of those who termed it good actually did not change and made almost 5%

Expectations of changes in the business environment, after the decline of the business optimism in August, did not change much, compared to April. The overwhelming majority (73.7%) of the polled enterprise managers expect neither positive nor negative changes in the next six months. The *index of business expectations* did not change compared to August and equalled -0.04

Apparently, one should not expect sharp changes in the business spirits before the parliamentary elections in 2006. According to the polls, the closer the elections are, the more cautious or even pessimistic businessmen feel. Such trends were observed on the eve of the presidential elections in 1999 and 2004, and may be attributed, first of all, to the uncertainty of business regarding the economic policy of the state after the elections. Although in 2006, Ukraine sees parliamentary elections that in the previous years influenced business spirits less than presidential, this time, **the business is probably worried by the political reform changing the configuration of the system of governance in the country.**

Indices of Overall Business Climate



The index of business expectations did not change compared to August and equalled -0.04

Apparently, one should not expect sharp changes in the business spirits before the parliamentary elections in 2006.



Demand, sales, new orders

The decline of the business optimism influences the situation in industry and production plans. In the 3rd quarter, production was slowly growing, and demand – declining, just as the managers expected.

After the decline in demand observed since May, 2004, in the first half of 2005 it increased, along with the number of new orders. The *index of new orders* rose from 0.04 in the 1st quarter to 0.23 in the 2nd. The *index of sales* in the same timeframe increased from -0.09 to 0.40. However, since the 3rd quarter, opposite trends are observed. Managers spoke about the transience of the trend towards the growth in demand yet in the 2nd quarter, expecting that in the 3rd quarter the index of demand would fall (Diagram “*Domestic demand: indices of expectations*”). These were the worst indices of expected demand for that time of the year over the past three years.

The forecasts of enterprise managers came true, although not entirely: in November, the demand did not fall as deep as respondents predicted in August. In particular, the *index of new orders* in the 3rd quarter neither increased nor decreased, compared to the 2nd, and was equal to 0.22. The *index of sales* fell to 0.16. The number of managers assessing the backlog of orders as satisfactory that increased from 33.1% in April to 43.6% in August, in November fell to 38.1%. Managers of machine-building enterprises were the most pessimistic: there, the share of enterprises whose sales fell in the 3rd quarter exceeded the number of companies whose sales increased (-0.01).

Production

Without the growth in demand, the rate of production growth also declined. Just as the enterprise managers expected, in the 3rd quarter the production growth rate slowed down, as witnessed by the decrease of the *production index* — from 0.41 to 0.19.. I.e., the trends towards a decline of industrial production growth reported since mid-2004 reappeared after a short pause. It should be noted however that the 4th and 1st quarters witness the winter seasonal slowdown of production activity.

The highest *index of production* was reported in the staple and food industries (0.41 and 0.34, respectively), the lowest — in machine-building (-0.03). Lower than the 2nd quarter production growth was reported by managers of enterprises of all size, but for small. It was the highest at the biggest enterprises (the *index of production* fell from 0.61 in the 2nd quarter to 0.16 in the 3rd). Substantial differences were observed among *production indices* at private, privatised and state enterprises. They were the lowest at state and privatised enterprises (0.20 and 0.16, respectively), at private — 0.42.

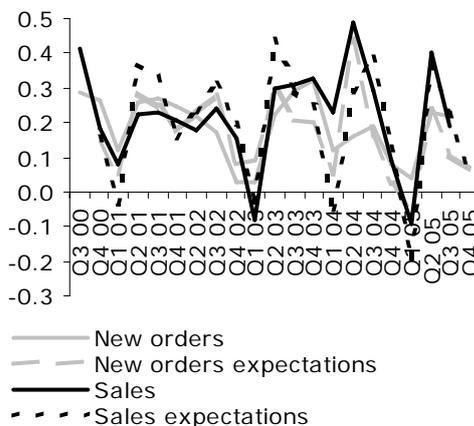
Demand expectations and production plans

In the fall, managers expected further reduction of the domestic demand and therefore had modest production plans for the 4th quarter (Diagrams “*Domestic demand: indices of expectations*”, “*Production indices*”). Managers of the light industry enterprises were the most optimistic regarding new orders in the 4th quarter; manufacturers of construction materials were the most pessimistic (0.04).

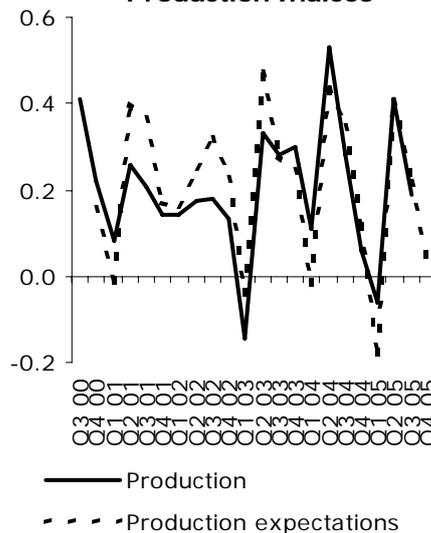
The *index of production expectations* for the following quarter fell from 0.22 (for the 3rd quarter) to 0.03 (for the 4th). 43.4% of the polled had no plans of changing production in the 4th quarter, compared to the 3rd; 28.5% planned to increase production (for comparison: in the 3rd quarter, production increased at 40.3% of enterprises).

Decline of the *index of production expectations* was reported in all branches. Among managers of enterprises of different size, the worst production plans were reported at medium enterprises (-0.12), the best — at big ones (0.17). At small enterprises, it equalled 0.00. Among the enterprises of different forms of ownership, private enterprises had the least optimistic

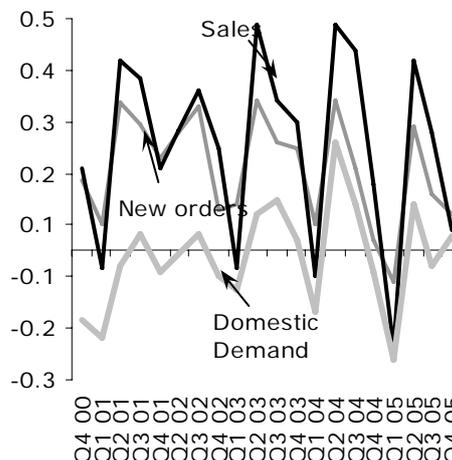
Sales Indices, New Orders Indices



Production Indices



Domestic demand: indices of expectations





production plans (-0.20), state enterprises were the most optimistic (0.10). At privatised enterprises, the relevant index equalled 0.20.

Financial performance

The production decline led to the deterioration of financial performance of enterprises. The *index of profitability* fell from 0.12 in the 2nd quarter to 0.02 in the 3rd. Managers suggest that in the 4th quarter, the financial performance of enterprises will not substantially change: 66.8% of respondents expect that the financial performance of their enterprises will not change, 15.7% expect deterioration, 17.5% — improvement.

According to 32.5% of the polled, the financial-economic standing of enterprises in November deteriorated, compared to April, 42.0% — did not substantially change, only 25.5% reported its improvement. The dynamic of quarterly assessments of the current financial standing of enterprises witnesses the improvement of the situation in the mid-year and its gradual deterioration in the fall (Diagram "Financial-economic standing of enterprises").

This trend is also witnessed by the expectations of enterprise managers: at the year beginning, they were highly optimistic: the number of those who expected the improvement of the financial-economic standing in the 3rd quarter exceeded the number of their opponents by 26%. The *index of expected changes in financial-economic standing* equalled 0.26, but as soon as in the 2nd quarter, it fell to 0.05 — i.e., the number of optimists exceeded the number of pessimists by only 5%. In the 3rd quarter (expectations for the 1st quarter of 2006), the index fell to 0.03.

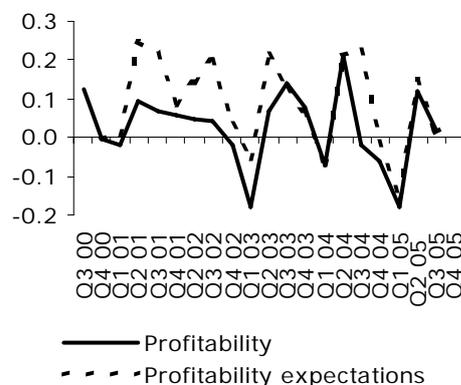
Regional specificity

In course of the year, the trends of demand, production and financial performance in the regions where polls were held were similar: the improvement of expectations at the year beginning and gradual deterioration from mid-year. However, the November poll revealed serious differences in the spirits of the Kyiv enterprise managers, compared to others. In particular, they reported more optimistic expectations regarding production and financial performance at the year end (Diagram "Regional distribution of indices of expectations for the 4th quarter of 2005"). Expectations for the 4th quarter are better than the results of the 3rd quarter — while in other regions, the situation is just the opposite: expectations for the 4th quarter are worse than the results of the 3rd quarter (either the lower growth rate or even decline was reported).

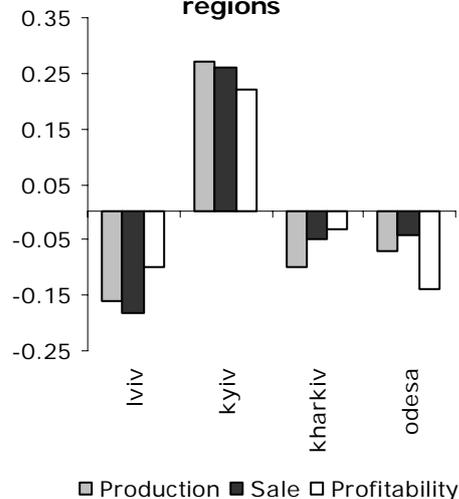
Therefore, the short-lived upswing of the business activity and growth of the business optimism terminated in the 3rd quarter of 2005. As of the year end, businessmen reported cautious production plans and expected no substantial changes in the business environment in early 2006. The reasons for that include both seasonal factors slowing down the business activity and the forthcoming parliamentary elections, pending which, business will not demonstrate activity, not being sure of the future economic policy of the state.

Meanwhile, it should be noted that business continues to hold a wait-and-see position, demonstrating neither optimism nor pessimism — by contrast to the pessimistic expectations before the presidential elections in 2004. This witnesses the preservation of some trust in the authorities, at least, the business circles expect no steps deteriorating the business environment in early 2006.

Profitability Indices



Indexes of expectations for the 4th quarter of 2005 by regions





Regulatory climate and obstacles for production growth

Regulatory climate

The number of managers seeing the regulatory climate as a serious obstacle for business growth in course of the year went down: in August, compared to April, it fell from 23.6% to 19.3%, in November – to 17.6%, being one of the lowest over the entire period of monitoring

Meanwhile, it should be noted that the absolute value and dynamic of that indicator seriously differed, dependent on the enterprise size:

- for small enterprises, the indicator was going down every quarter, being the lowest in August (18.8%). However, in November, the number of managers seeing the regulatory climate as an obstacle for production growth increased to 26.3%;
- in the medium enterprise group, the number of managers seeing the regulatory climate as a major obstacle for business in course of the year was the lowest. It demonstrated a steady downward trend, equalling 12.1% in November;
- for big enterprises, the regulatory climate presented the main problem: in January, 29.8% of their managers shared that view, in April – 35.8%. In August, their number fell to 28.6%, but remained the highest, compared to other enterprise groups. However, in November, it fell to 16.5%, being close to the all-time low.

The reduction in the number of respondents viewing unfavourable regulatory climate as an obstacle for production growth occurred due to the decline of two out of the three components of the combined indicator of “*unfavourable regulatory climate*” — high regulatory pressure and frequent changes in the legislation. The dynamic of the latter is of particular interest, as it reflects the predictability/unpredictability of the business environment. The number of managers who mentioned “frequent changes in legislation” as an obstacle, after the increase from 5.0% in January to 13.1% in April, fell to 6.8% in August and to 5.7% in November, witnessing **some decrease of unpredictability of the national business environment**.

The third component of the combined indicator — “corruption” — in course of the year remained rather stable ranging from 0.4% in April to 2.1% in November.

Impediments to production

In course of the year, the list of the obstacles was topped by **low demand** and **tax pressure**; traditional problems with energy supply closed the list (Table “*Obstacles for production growth*”).

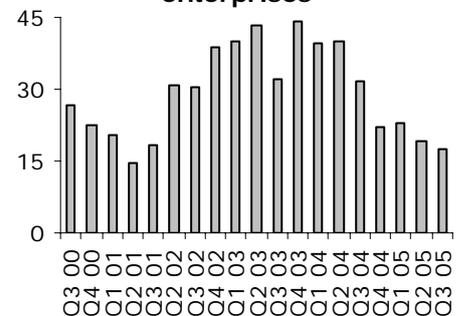
Liquidity problems and high competitive pressure ranked third and fourth. The importance of “liquidity problems” in mid-year somewhat decreased, probably, due to the growth of production at that time, which, in turn, improved the financial standing of enterprises. However, in November, the importance of the liquidity problem rose again: the number of respondents viewing the lack of the working capital as an obstacle for production growth increased from 27.9% to 40.2%.

The absolute value of the obstacle termed “high competitive pressure” was growing all the year long. In November, it was noted by 41.3% of respondents.

The absolute value of “low demand”, topping the obstacles list, after growth in August, somewhat declined in November.

Instead, in November, the importance of “high credit rates” increased, which, combined with the growing urgency of the lack

Unfavorable regulatory environment, % of enterprises



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



of the working capital, may point to the deterioration of the financial standing of enterprises in the forthcoming months.

In the conditions of competitive pressure, the urgency of the problem of obsolete technologies increases, i.e., businessmen realise that renovation of technologies and equipment is a pledge of success in the competitive struggle.

According to the polled, the political situation in November and throughout the year did not seriously impede production growth (ranking 11th) — although in November, its absolute value somewhat increased, compared to August (from 3.2% to 5.0%). Time will show whether this trend will take root on the eve of the elections.

In course of the year, the importance of the regulatory climate as an obstacle for production growth was gradually going down, certainly being a positive trend and witnessing some improvement of the business environment. However, the improvement of one of its components does not mean that the general business environment is optimal for business — its assessments presented above remain rather low.

Lending Climate

The lending climate in 2005 revealed two trends. One is the growth in bank credit supply. The number of managers who believe that banks are ready to extend short-term credits to an enterprise like theirs increased from 47.7% in January to 58.3% in April and 60.8% in November. For long-term credits, the relevant index increased from 29.4% in January to 46.7% in November.

On the other hand, enterprises showed no greater readiness to take credits. The number of managers who admitted that their enterprise could take a short-term credit in January equalled 33.6%, in April — 35.0%, in August — 41.8%. For long-term credits, the relevant indicator also increased from 14.6% in April to 23.2% in August. However, in November, the affordability of credits (both short-term and long-term) fell again. The number of respondents who reported that their enterprise could afford a short-term credit made 35.3%, long-term — 17.3%.

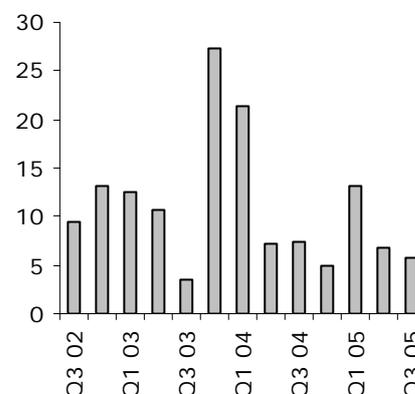
The yearly dynamic of assessments of the capital market, increasing acuteness of the problems of credit rates and liquidity point to the possible deterioration of the financial standing of enterprises in late 2005 - early 2006. At the same time, such deterioration may be of a seasonal character.

Conclusions

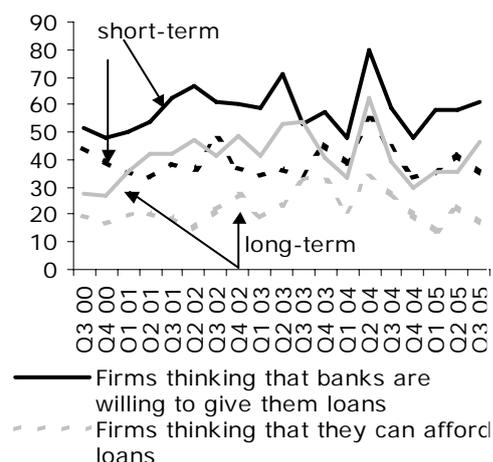
The analysis of the business assessments and expectations shows that in course of the year, the new authorities in general did not justify the huge credit they enjoyed on the part of the business community at the beginning of their activity. This conditioned the growth of disbelief in the possibility of prompt positive change of the business climate. The number of respondents expecting positive changes fell from 29.3% in April to 9.8% in November. The authorities cannot restore the trust of the business without practical steps on their part. The authorities should be aware that it is time to act — considerately and carefully.

It should be noted that although the business perception of the authorities deteriorated, the situation is not disastrous. Businessmen, although disappointed over the possibility of prompt positive changes (especially in view of the election campaign that actually started in September, 2005), did not turn pessimists, that is, they do not expect negative changes.

Changes in economic legislation as impediment to production, % of enterprises



Affordability of Loans (in %)





Hence, the development of a plan of measures for the improvement of the business environment with concrete terms of their attainment remains the main task for the authorities. The sooner the better, both for the relations of the business and the authorities, and for entire Ukraine. This is the only way to restore businessmen's trust in the new authorities, their belief that those authorities are able to fulfil their promises — create proper conditions for business.

The national business' idea of such conditions is presented at the beginning of this article: (1) creation of an effective mechanism of implementation of the passed legislative acts and guarantee of stable legislation; (2) reduction of rates and simpler administration of duty payments to social funds; (3) establishment of uniform rules of the game for all, including liquidation of tax exemptions and preferences; (4) non-interference of local authorities in the activity of enterprises and administrative interference in pricing

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)¹.

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, %	
	Q3'05
Fewer than 50	28.8
51 — 250	41.3
251 — 500	13.9
501 — 1000	10.0
Over 1000	6.0
Regions, %	
	Q3'05
Lviv	26.7
Kyiv	32.7
Kharkiv	32.0
Odessa	8.5
Industries, %	
	Q3'05
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

¹ For details see: The Joint Harmonized EU Programme of Business and Consumer Surveys.

² The heavy industry sector includes energy, the chemical industry, metallurgy, and the fuel industry.