

BUSINESS PERFORMANCE

INVESTMENT BEHAVIOR OF ENTERPRISES IN 2003-2004

S.P Aukutsionek

1. General Indicators of the Investment Process

In 2003, as the REB surveys show, investment activity of industrial enterprises has remarkably increased from 2002. This is evidenced, first of all, by declining SHARE OF ENTERPRISES NOT BUYING EQUIPMENT. While in 1999, about 58% of all surveyed enterprises did not buy any equipment for two and more successive months, this indicator went down to 45% in 2002 and to 42% in 2003. Consequently, the remaining 58% were buying their equipment. This is the record high level of investment activity for the whole period of observation (since 1993).

Shifting from equipment investment to TOTAL CAPITAL INVESTMENT (in 12-months intervals), we find more modest results. In 2003, the average share of enterprises having made *no* capital investment in the preceding 6 months and expecting not to make any in the following 6 months (relatively to the poll moment) was 24%. This was 1 percentage point more than a year ago. Certainly, that former result (23%) was record high over the whole period of market-oriented reforms (except 1992 and 1993. when the share of the enterprises that had made no investment was only 15 and 12%, respectively).

THE DEGREE OF FULFILLMENT OF INVESTMENT PLANS is an indirect measure of investment activity in the REB investigation. In 2003, the degree of fulfillment of the plans rose by 4 percentage points and appeared to be a record high over the whole period of market-oriented reforms: 68% (total volume of planned investment at an enterprise is taken as 100%). Meanwhile, the 70%-mark was surpassed for the first time in the 4th quarter of 2003 - 1 * quarter of 2004.

2. Factors Limiting Capital Investment

"Shortage of financial resources" is the first influential FACTOR TO RESTRAIN CAPITAL INVESTMENT at enterprises, a constant for several years. In 2003, 80% of the respondents on average pointed at this reason. This is 4 percentage points lower than in 2002. However, it is yet very difficult to draw a conclusion from this fact that financial constraints have become easier, because even though getting lower, this indicator stays practically at the same level as where it stood during the whole post-default period of 1998-2001 (see Table 1).

"High prices of equipment and construction works" - 53% - is the next and already a routine factor. This figure is just 2 percentage points lower than in 2002. Nevertheless, in this case we can declare a downward trend, because this decline has been observed for the third consecutive year, and it keeps pace with the actual inflation slowdown in this country.

"High borrowing rate" is the third in terms of frequency of mentioning - 26%. Rating of this factor has lowered for the first time since 1997. Let us hope that this is also a non-random decline, being a reflection of a long-going reduction in prices of bank lending.

Steady decline in the rating of "high indebtedness" of enterprises, which is an unfavorable factor for capital investment, is a matter of special attention. The share of the respondents having singled out this point of the questionnaire has declined from 22% in 2002 to 17%. While their indebtedness to banks is rising in absolute and relative terms (and all other types of indebtedness are on the decline), the downturn of this rating is a demonstration that financial condition of enterprises is improving, and last year indicators of the improvement have broken all former records. Having gained financial strength, producers can afford to borrow from banks at lower risk and under less strain, regardless of the fact that terms of borrowings are still very hard.

The role of such a curious factor as "uncertainty of the situation in general" has also substantially declined. In 2003, 14% of the REB respondents have marked this point - almost a half of their share in 1998. At the same time, the impeding role of this factor in the Russian

economy is still regrettably strong. As seen from Table 1, this factor has been far from being the last one in 2003 rating.

Table 1

Factors to Limit Capital Investment (Share of respondents having pointed out each point as Important, %)*)

	1997	1998	1999	2000	2001	2002	2003
1. Shortage of financial resources	73	81	82	81	81	84	80
2. High prices of equipment and construction works	50	46	54	58	58	55	53
3. High borrowing rate	22	24	24	24	25	28	26
4. High indebtedness	40	38	27	23	22	22	17
5. General uncertainty	21	24	18	15	13	13	14
6. Excess of production facilities	20	16	16	13	12	13	11
7. Low rate of return on investment projects	7	4	5	5	7	5	8

**) Respondents were offered to choose no more than three factors.*

In the present review, we give for the first time the factors that limit capital investment by industry (see Table 2). In general, their ranges by industry are almost uniform. However, several peculiar details can attract our attention. For example, look at "high borrowing rate": it was mentioned by only 13% in light industry, but by 38% in logging, woodworking and pulp-and-paper industries. The role of "high indebtedness" was symmetrically reverse: it was a limiting factor for investment in 23% of all cases in light industry, and almost a half as frequently (12%) in logging, woodworking and pulp-and-paper industries.

Weights of other secondary factors (excess of production facilities, low rate of return etc.) also notably differed by industry.

Table 2

Factors to Limit Capital Investment by Industry, 2003 (Share of respondents having pointed out each point as important, %)¹⁾

	1. Shortage of financial resources	2. High prices of equipment and construction works	3. High borrowing rate	4. High indebtedness	5. General uncertainty	6. Excess of production facilities	7. Low rate of return on investment projects
Iron and steel, non-ferrous metals	84	45	26	13	22	0	6
Machinery and metalworking	80	50	27	16	17	9	8
Chemicals and petrochemicals	93	64	32	22	22	4	11
Logging, woodworking, pulp-and-paper	77	53	38	12	13	6	6
Building materials	76	49	17	15	4	22	12
Light industry	72	49	13	23	20	18	6
Food industry	83	56	28	21	11	10	9

¹⁾ Respondents were offered to choose no more than three factors.

Reliance of capital investment on barter can also substantially affect the above-mentioned limitations. However, the role of exchange in kind has been rapidly declining in the Russian economy in recent times. In 2003, the share of investment based on barter was only 8% of total capital investment, 4 percentage points down from 2002 (see Table 3). In 2004, measurement of this indicator in the framework of the REB program was suspended.

Table 3**Share of Capital Investment Based on Barter In Last Six Months
(Industry, %)**

	1 st quarter	2 nd quarter	3 rd quarter	4 th quarter	Average annual
1998	-	-	46	43	-
1999	40	36	30	35	35
2000	27	25	19	18	22
2001	15	14	16	13	14
2002	10	16	10	11	12
2003	8	8	11	7	8

3. Sources of Funds for Capital Investment

Speaking about the most plausible SOURCES OF FUNDS FOR CAPITAL INVESTMENT in the next two or three years, 43% of the respondents identified accumulated earnings of their enterprises. This is 1 percentage point higher than in 2002. However, this indicator has been generally rather stable during 1999-2003 - 41-44%. The number of enterprises hoping to get investment loans from banks is growing fast. In 1998, only 10% of them hoped for borrowing; in 2000, their share rose to 24%; in 2002, to 30% and finally, in 2003, to 37%. The share of pessimists who do not believe to be able to get any funds for capital investment at all in the next two or three years, is gradually declining. While in 2002, the share of such respondents was 32%, it was 27% in 2003. This was the lowest share of pessimists in the whole period of observation (see Table 4).

Table 4

Sources of Investment Funds In the Next Two or Three Years (Share of respondents having pointed out each source as the most plausible one, average data of two surveys, %)*)

	1996**)	1997	1998	1999	2000	2001	2002	2003
1. The enterprise will make savings	18	22	27	42	41	44	42	43
2. Borrowings from commercial banks	13	15	10	18	24	26	30	37
3. From a domestic partner	7	9	8	8	12	10	9	9
4. From a foreign partner	7	8	7	4	4	4	2	2
5. From selling shares	5	5	4	3	5	3	4	3
6. From the government	9	7	8	8	8	6	3	4
7. Other sources	2	10	5	2	4	4	5	3
8. Funds will come from nowhere	49	41	44	37	30	28	32	27
9. Hard to answer	19	19	18	12	10	10	9	8

*) Respondents were offered to choose no more than two versions of answer.

***) Second half-year.

4. Borrowing from Banks

The ROLE OF BANK BORROWINGS IN FINANCING OF CAPITAL INVESTMENT has been on the rise for already five years. Nevertheless, it is still insufficient. The vast majority of producers still make no attempt to seek investment loans. Moreover, their share is surprisingly stable. Since 1999 till 2003, it was fluctuating in the narrow range of 63-69%.

As for the observed consolidation of ties between industrial and banking sectors, until recently this happened only in the remaining one third of the enterprises. Since 1998, we have been seeing that the producers who made attempts to borrow were becoming more and more likely to successfully negotiate their loans. While in 1998, only one or two in each ten seekers could get their investment loans, their number increased to five in 2002. In 2003, the chance for success stopped rising, but it still stayed at the achieved level of 1/2 (see Table 5).

Table 5

Distribution of Enterprises by Activity and Success In Seeking Investment Credit In Last Twelve Months (Average share from two semi-annual surveys)

	Enterprises seeking no bank credit for financing investment within a year (%)	Enterprises seeking bank credit for financing investment for a year		
		Of which:		
		Got no credit (%)	Got credit (%)	Share of successful seekers in total number of seekers (4)= (3):[(2)+(3)]
	(1)	(2)	(3)	(4)
1998	58	35	7	0,17
1999	66	28	5	0,15
2000	69	22	9	0,29
2001	63	21	16	0,43
2002	67	16	17	0,52
2003	65	17	17	0,50

High interest rate was mentioned in the first place among DIFFICULTIES IN NEGOTIATING CREDIT AGREEMENTS. This is the key problem at the stage of conclusion of the majority of credit agreements. On the other hand, this problem is gradually losing importance. In 2003, it was referred to by only 48% of respondents seeking investment loans. The problem of collateral has become almost equally important - 45% of the total number of mentioning. Term of borrowing is in the third place - 25%. The problem of risk of failure to repay has shifted to the fourth place. Only five years ago it was mentioned by more than a half of the respondents, but in 2003, by only 21%. Most probably, this issue is losing importance, being the reverse side of growing attention to the issue of collateral. The issue of volume of the loan, which was mentioned by 16% of all seekers of investment credit, is at the bottom of our list (see Table 6).

Table 6

Main Difficulties In Concluding Credit Agreements with Banks for Financing Capital Investment (Share of enterprises having singled out this point in total number of seekers of investment loans in the last 12 months, %)

	Main difficulties in concluding agreements				
	High interest rate	Risk of default on loan	Term of loan	Problem of collateral	Loan volume
1998	66	60	37	26 ^{*)}	17
1999	75	46	36	29	18
2000	91	55	36	36	18
2001	53	24	27	34	18
2002	49	27	26	27	13
2003	48	21	25	45	16

^{*)} *Second half of 1998.*

5. Rates of Return and Purposes of Investing

In the REB surveys, the respondents evaluate potential profit rates and risks of investment in an indirect way, using a MARGINAL INTEREST RATE (MIR), which is defined in the questionnaire as the highest interest rate on bank loans in rubles for a term of 2 to 3 years, affordable to an enterprise to finance its capital investment.

On the average of four 2003 surveys, the marginal interest rate was 9.0%. This is practically the same as in 2002 (8.9%). However, there is one substantial difference from the situation of 2002. Let us remind that then the average actual rate of short-term lending to enterprises was 19%, whereas in 2003 the actual rate went down to 16%. In other words, the gap between marginal affordable rates (in the eyes of enterprise directors) and actual rates has narrowed from 11 to 7 percentage points. This closing in is certainly encouraging. Especially if we remember that several years ago the above mentioned gap reached 14 (2000) and even 22 percentage points (1999).

At the same time, the MIR is still much lower than the average price increase, as it was expected in 2003 (14%). Consequently, as well as in 1996-2002, the great majority of enterprises were willing to borrow from banks for investment purposes no more costly than at a negative real interest rate.

The MAIN PURPOSE OF INVESTING was to improve quality of products. This purpose was reported by 29% of the respondents. Interestingly, this point had gained the same 29% in 2002. However, this score had then been insufficient for the first place.

The second place was taken by the longstanding leader, mastering of new products, which gained 27% (a year ago, 33%). Cost reduction - 20% - took the third place, the same as in 2002.

Expansion of productive capacities was named one of key purposes by just 16% of the respondents (in 2002, 14%). It is not surprising, because excessive capacities are still quite sizeable in the industry in general, as well as in most large-scale industrial sectors. And another 16% (14%) of the surveyed enterprises named the need to enhance productivity of the existing capacities as one of the main purposes of investing.

Assessing the EXISTING VOLUME OF PRODUCTIVE CAPACITIES AGAINST THE DEMAND EXPECTED WITHIN 12 MONTHS for their enterprises' production, directors of the latter used the term "excessive" (37%) three times more frequently than the term "insufficient" (12%). Nevertheless, 2003 brought about some improvement against 2002. The share of enterprises having excessive capacities has declined by 6 percentage points, while the share of those with shortage of capacities has increased by 4 points. So, the overall balance of valuation has become much better, although it is still negative (see Table 7).

Table 7

Distribution of Enterprises by Volume of Productive Capacities against Expected Demand for their Products In 12 Months (Average of four quarterly surveys, %)

Volume of capacities against future demand	1998	1999	2000	2001	2002	2003	2004 1st quarter
1. Excessive	60	50	43	42	43	37	36
2. Normal	35	40	45	48	49	51	56
3. Insufficient	5	10	12	10	8	12	8
4. Balance: (4)=(3)-(1)	-55	-40	-31	-32	-35	-25	-28

6. Innovative Activities of Enterprises

The share of respondents having answered in summer 2003 that in the last year and a half, there were TECHNOLOGICAL INNOVATIONS AT THEIR ENTERPRISES, was 77%. This was a little lower than in 2002 (80%), but generally corresponded to the level of 1999-2003. As in all preceding years, product innovations remarkably dominated over process innovations in terms of quantity (31% against 17%). The share of enterprises that introduce both types of innovations simultaneously is still relatively high (29%) (see Table 8).

Table 8**Distribution of Enterprises by Type of Innovative Activity (%)**

Time of survey ¹⁾	Share of enterprises having introduced innovations in past 1.5 years			
	Total	Of which, mostly:		
		Product innovations	Process innovations	Equally
1990-1992 ²⁾	58	31	27	⁴⁾
1993 ³⁾	62	38	24	⁴⁾
1994	60	38	22	⁴⁾
1995	63	46	17	⁴⁾
1996	62	41	21	⁴⁾
1997	52	35	16	⁴⁾
1998	68	41	15	15
1999	76	43	33	⁴⁾
2000	76	39	10	26
2001	76	33	14	28
2002	80	31	14	35
2003	77	31	17	29

¹⁾ Surveys are conducted once a year in August.

²⁾ Estimation in retrospect, obtained in the January 1993 survey.

³⁾ The July survey.

⁴⁾ This version of answer was not envisaged

The share of new products introduced no earlier than a year and a half ago (before the moment of the relevant summer survey) in total output was 12%. This was 4 percentage points less than in the 2002 survey, and a duplication of the record low level of this indicator in 2001. Indeed, this result looks discouraging against 1993-1994, when the share of new products was 19-26% (see Table 9). It appears that in spite of five years of economic growth and the increased innovative activities, the share of new products in the enterprise output is still gradually declining.

Table 9
Structure of Output by Type of Products (Data of yearly summer surveys, %)

	New products ¹⁾	Old products, output of which is ²⁾			Balance (5) = (1)-(4)
		Growing	Stable	Declining	
	(1)	(2)	(3)	(4)	(5)
1993	26	13	38	23	+3
1994	19	7	38	36	-17
1995	16	12	45	27	-11
1996	16	13	34	37	-21
1997	16	16	42	26	-10
1998	14	18	38	30	-16
1999	14	33	40	13	+1
2000	14	29	47	10	+4
2001	12	29	46	13	-1
2002	16	23	46	15	+1
2003	12	26	46	16	-4

¹⁾ Products that were introduced not earlier than in a year and a half before the survey moment.

²⁾ Products that were introduced not later than a year and a half before the survey moment.

At the same time, it should be taken into account that the Russian economy has changed so much in the last decade that it should be incorrect to expect that the indicator in question can swiftly go back to the value it had at the beginning of the period. As a rule, new products replace the old ones, which are losing demand. And success of this process at the enterprise level is revealed by the reverse sign of difference between the shares of the former and the latter. From this point of view, the last year product innovation (when the above-mentioned difference was minus 4 percentage points) was much better than it had been in 1994-1998 (minus 10 - minus 20 percentage points). While earlier, there was a physical shortage of new products to compensate for decline in output of old products, now the volume of new products is more or less sufficient to cover the gap.