INVESTMENT BEHAVIOR OF ENTERPRISES IN 2004-2005

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1. General Indicators of the Investment Process

In 2004, as the REB surveys show, investment activity of industrial enterprises remained very high. 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% by 2002; to 42% in 2003 and to 41% in 2004. Consequently, the remaining 59% were buying their equipment regularly. This is the record high level of investment activity in the whole period of its measurement (since 1993).

Shifting from equipment investment to TOTAL CAPITAL INVESTMENT (in 12-months intervals), we find more modest results. In 2004, 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 25%. This was 1 percentage point more than a year ago.

THE DEGREE OF FULFILLMENT OF INVESTMENT PLANS is an indirect measure of investment activity in the REB investigation. In 2004, the degree of fulfillment of the plans rose by 3 percentage points and appeared to be a record high over the whole period of market-oriented reforms: 71% (total volume of planned investment at an enterprise is taken as 100%). Meanwhile, the 75%-mark was surpassed for the first time in the 4th quarter of 2004.

2. Factors Limiting Capital Investment

"Shortage of financial resources" is still holding the first place among the FACTORS TO RESTRAIN CAPITAL INVESTMENT at the

enterprises. In 2004, 78% of the respondents on average pointed at this reason. This is 2 percentage points lower than in 2003. 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" - 52% - is the next and already a routine factor. This figure is just 1 percentage point lower than in 2003. Nevertheless, in this case we can perhaps declare a downward trend. 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 - 30%. Here we have a long-run (ongoing since 1997) tendency towards increase in the rating. At first sight, this trend may look like a paradox, since nominal borrowing rates went conspicuously down in recent years. However, this paradox can be explained in a very simple way: the number of industrial enterprises using bank borrowings to finance their capital investment has become remarkably larger (see below for a more detailed discussion of this phenomenon).

The rating of such unfavorable for capital outlays factor as "high indebtedness" of enterprises is unchanged - 17%. However, it has declined to less than a half from 1997-1998. A record healthy financial condition of enterprises in 2004 has contributed to this considerable decline. In turn, robust financial condition is making bank credit more affordable, regardless of the fact that terms of borrowings are still very hard.

Another important factor is "uncertainty of the situation in general". Its rating remains practically the same in the recent four years - 13%. However, in 2004, a much larger than usual number of enterprises - 14% - has pointed at "low rate of return on investment projects". This is almost twice as high as it was in 2003.

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

	1997	1998	1999	2000	2001	2002	2003	2004
1. Shortage of financial resources	73	81	82	81	81	84	80	78
2. High prices of equipment and construction works	50	46	54	58	58	55	53	52
3. High borrowing rate	22	24	24	24	25	28	26	30
4. High indebtedness	40	38	27	23	22	22	17	17
5. General uncertainty	21	24	18	15	13	13	14	13
6. Excess of production facilities	20	16	16	13	12	13	11	11
7. Low rate of return on investment projects	7	4	5	5	7	5	8	14

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

Differentiation of the ratings by industry has increased from the preceding year. This is especially true for such factors as high prices, and interest rates. For example, "high borrowing rate" has restrained capital investment at 48% of food enterprises, and only at 17-18% of enterprises in chemicals and building materials (see Table 2). In turn, the respondents belonging to the two latter industries have showed the largest gap in their assessments of "high indebtedness": only 6% of enterprise directors have mentioned their indebtedness in chemicals, but 23%, in building materials.

There is only one case when the range of assessments has notably narrowed from last year: it is the assessment of the role of "shortage of financial resources". It has narrowed quite significantly, almost to a half. Moreover, in this case the 2004 assessments happened to be the most close to each other ("congested").

Table 2

Factors to Limit Capital Investment by Industry, 2004

(Share of respondents having pointed out each point as important, %)*)

	1.Shortage of financial reaources	2.High prices of equipment and construction works	3.High borrowing rate	4.High indebtedness	5.General uncertaintly	6.Excess of production facilities	7.Low rate of return on investment projects
Iron and steel and non-ferrous metals	84	50	33	19	28	10	21
Machinery and metalworking	78	50	29	19	11	14	11
Chemicals arid petrochemicals	73	32	18	6	20	3	25
Logging, woodworking, pulp-and-paper	79	48	38	9	16	5	12
Building materials	74	37	17	23	10	21	15
Light industry	80	62	36	18	13	10	11
Food industry	78	55	48	17	15	9	12
Gap between highest and lowest ratings (percentage points)							
2004	11	30	31	17	18	18	14
2003 (reference)	21	19	25	11	18	22	6

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

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, 42% of the respondents identify accumulated earnings of their enterprises. This is 1 percentage point lower than in 2003. However, this indicator has been generally rather stable during 1999-2004 - 41-44%.

The number of enterprises hoping to get investment loans from banks has gone down to 31% (which is 6 percentage points lower than in 2003). However, this is still one of the highest ratings since 1996.

The share of pessimists - those who do not believe to be able to get any funds for capital investment at all in the next two or three years -

continued to decline. While in 2002, the share of such respondents was 32%, it was 27% in 2003 and only 23% in 2004. This was the lowest share of pessimists in the whole period of our observation (see Table 3). We can suggest that a certain part of them is gone to the line of those who have found difficulty in answering (the lowest line in the Table 3). However, even if this is true, we still get the lowest share of these answers if we sum up the figures in these two lines (#8 and #9) - 35%.

(Nevertheless, if we look at this result from another point of view, we have to acknowledge that 35% of directors finding hard to answer about plausible sources of funds for capital investment at their enterprises is still a sign of an abnormal situation).

Table 3

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	2004
1. The enterprise will make savings	18	22	27	42	41	44	42	43	42
2. Borrowings from commercial banks	13	15	10	18	24	26	30	37	31
3. From a domestic partner	7	9	8	8	12	10	9	9	9
4. From a foreign partner	7	8	7	4	4	4	2	2	3
5. From selling shares, bonds	5	5	4	3	5	3	4	3	4
6. From the government	9	7	8	8	8	6	3	4	4
7. Other sources	2	10	5	2	4	4	5	3	3
8. Funds will come from nowhere	49	41	44	37	30	28	32	27	23
9. Hard to answer	19	19	18	12	10	10	9	8	12

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

***)Second half-year.*

4. Borrowing from a Bank

As in earlier years, the vast majority of the surveyed producers don't make even any attempt to seek BANK BORROWINGS TO FINANCE THEIR CAPITAL INVESTMENT. Moreover, their share is surprisingly

stable. Since 1999 till 2004, 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 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 2004, the chance for success kept rising, and it has surpassed 1/2 once again (see Table 4). As a result, the share of the enterprises that acquired investment loans has become record high - 20% (in 2002-2003, it was 17%).

Table 4

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
2004	63	17	20	0,54

As before, high borrowing rate was mentioned in the first place among DIFFICULTIES IN NEGOTIATING CREDIT AGREEMENTS. As follows from Table 5, this very problem is the key issue at the stage of conclusion of the majority of credit agreements. Moreover, its rating has stabilized at 48-49% in recent three years. The problem of collateral has

gained an equal rating - 48% of the total number of mentioning. Term of borrowing is in the third place, as before - 24%. The problem of risk of default on a loan has gone to the fourth place - 22%. Understandably, lower importance of this problem is the underside of growing attention to the issue of collateral. The issue of volume of the loan, which was mentioned by 15% of all seekers of investment credit, is at the bottom of our list.

Table 5
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
2004	48	22	24	48	15

*) *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 2004 surveys, the marginal interest rate was 7.7%. This is 1.3 percentage points lower than in 2003, and is record low in recent nine years.

Meanwhile, the MIR is still remarkably lower than the anticipated annualized rate of price increase in 2004 (14%). Consequently, as well as in 1996-2003, the great majority of enterprises were willing to borrow from banks for investment purposes no more costly than at a negative real interest rate. Moreover, while since 1999 till 2002 the marginal "real interest rate" followed an upward trend (although it was in negative territory throughout this period), it has become practically stable since 2002 (see Table 6).

Table 6

Marginal Interest Rate, Anticipated Price Increase and Marginal "Real Interest Rate" (Percentage points)

		Annualized rate of price increase, anticipated by the respondents		Difference between MIR and anticipated rate of price increase	
	Marginal interest rate (MIR)	On inputs and outputs	Only on outputs		
	(1)	(2)	(3)	(4) = (1)-(2)	(5) = (1)-(3)
1996	15.0*)	34.4	25.4	-19.4	-10.4
1997	8.8	8.2	5.1	+0.6	+3.7
1998	9.4	22.7	17.0	-13.3	-7.6
1999	10.6	39.8	30.0	-29.2	-19.4
2000	10.0	28.8	22.1	-18.8	-12.1
2001	9.4	18.3	13.4	-8.9	-4.0
2002	8.9	15.0	11.3	-6.1	-2.4
2003	9.0	14.5	11.3	-5.5	-2.3
2004	7.7	13.4	10.2	-5.7	-2.5

**) 2nd- 4th quarters.*

The MAIN PURPOSE OF INVESTING was to improve quality of products. This purpose was reported by 33% of the respondents (this point had gained 29% in 2003).The second place was taken by the longstanding leader, mastering of new products, which gained 29% (a year ago, 27%). Cost reduction, as in 2003, took the third place - 22% (20%), as well as more efficient utilization of existing capacities (for the first time) - also 22%.

Expansion of productive capacities was named one of key purposes by just 19% of the respondents (in 2003, 16%). 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.

Assessing the EXISTING VOLUME OF PRODUCTIVE CAPACITIES AGAINST THE DEMAND FOR PRODUCTION EXPECTED WITHIN 12 MONTHS, directors of the enterprises used the term "excessive" (37%) almost four times more frequently than the term "deficient" (10%). Nevertheless, 2004 was one of the best years in this respect in recent years. Although the overall balance of valuations has deteriorated (by 2 points) and still remains negative, it was much worse in 1998-2002 (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	2005 1st quarter
1. Excessive	60	50	43	42	43	37	37	33
2. Normal	35	40	45	48	49	51	53	54
3. Insufficient	5	10	12	10	8	12	10	13
4. Balance: (4)=(3)-(1)	-55	-40	-31	-32	-35	-25	-27	-20

6. Innovative Activities of Enterprises

The share of respondents having answered in summer 2004 that in the last year and a half, there were TECHNOLOGICAL INNOVATIONS AT THEIR ENTERPRISES was 79%. This was a little higher than in 2003 *(77%),* and one of the best result in the whole period of our measurements. As in all preceding years, product innovations remarkably dominated over process innovations in terms of quantity (29% against 17%). The share of enterprises that introduced both types of innovations simultaneously is still *relatively* high (33%) (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	12
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
2004	79	29	17	33

[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 (since the moment of the relevant summer survey) in total output was 15%. This was 3 percentage points more than in the 2003 survey. Indeed, this result still looks discouraging against 1993-1994, when the share of new products was 19-26% (see Table 9). It appears that in spite of six years of economic growth and the increased innovative activities, the share of new products in the enterprise output is still extremely low.

Business Performance

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

	New products[1)]	Old products, output of which was [2)]			Balance
		Growing	Stable	Declining	(5) = (1)-(4)
	(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
2004	15	31	40	14	+1

[1)] Products that were introduced not earlier than 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.

Usually, new products replace the old ones which suffer from declining demand. The overall result of this change is measured by the sign of difference between the shares of the former and the latter. From this point of view, the situation in product innovation last year, when the above pointed difference was equal to +1 percentage point, was generally quite favorable.

This conclusion can be confirmed if we turn to the data by industry (see Table 10). The only industry to notably fall out of the overall positive picture is building materials (its balance indicator in 2004 was -12 percentage points). The leading industries were logging, woodworking, pulp-and-paper (+12) and light industry (+20).

Table 10
Structure of Output by Industry
(Shares in real volumes of output
by type of products; data of 2004 summer survey), %

	New products[1)]	Old products, output of which is a			Balance (5)-(1)-(4)
		Growing	Stable	Declining	
	(1)	(2)	(3)	(4)	(5)
1. Iron and steel and non-ferrous metals	17	40	26	17	0
2. Machinery and metalworking	15	24	46	15	0
3. Chemicals	1	39	57	3	-2
4. Logging, woodworking, pulp-and-paper	22	42	32	10	+12
5. Building materials	8	39	34	20	-12
6. Light industry	33	25	30	13	+20
7. Food industry	12	26	49	13	-1

[1)] Products that were introduced not earlier than 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.