GEA

Group of Applied Economics

GEA Industrial Bulletin No. 2/2005

The results presented in this bulletin are based on the interpretation of the answers to the GEA Economic Conjuncture Questionnaire 2/2005. We have preserved the number of respondent companies from the first GEA Industrial Bulletin (170 companies). From the 170 companies, 64,7% (110 companies) have answered the first questionnaire, the rest being new respondents. The classification of the sample by activity sector, turnover and number of employees has registered insignificant changes (see details in the methodological note at the end)

The questionnaire was delivered during 4-18 of April 2005. The interpretation of the material was done by a GEA team consisting of Liviu Voinea and Laura Simionescu, with the collaboration of Dragos Pislaru, Laurian Lungu, Florin Citu, Diana Spiridon and Iulia Serb. GEA Industrial Bulletin, part of a broader GEA project, was financed from the Global Opportunities Fund program, through the Embassy of the United Kingdom; the coordinator of the project being Daniel Daianu. We wish to thank the Businessmen's Association of Romania (AOAR) for the support provided in the database construction as well as in the questionnaire management.

Main results

- ***The GEA Index of Industrial Confidence has dropped to almost half its value in Q1 2005. This result points to a drop in industrial confidence, though this indicator still holds at a positive level (+7,4 in Q2 compared to +14,5 in Q1)***

- *The orders cover on average 4,1 months of production, on a descending trend from 4,3 months in Q1.*

- *A workforce reduction is expected (the conjectural balance is negative).*

- *The flat tax is seen as a positive factor (conjectural balance +55%), but its effects are diminished by the difficulty encountered in obtaining profit, in the current conjuncture.*

- *The negative influence the appreciation of the ROL has on company competitiveness has deepened (conjectural balance -38,8% in Q2 compared to -16,5% in Q1).*

- ***The average exchange rate the industry firms consider necessary for obtaining profit (the profit threshold) is 37800 lei for 1 Euro.***

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GEA Index of Industrial Confidence

As we have also stated in the previous issue of GEA Industrial Bulletin, the industrial confidence index is calculated as following:

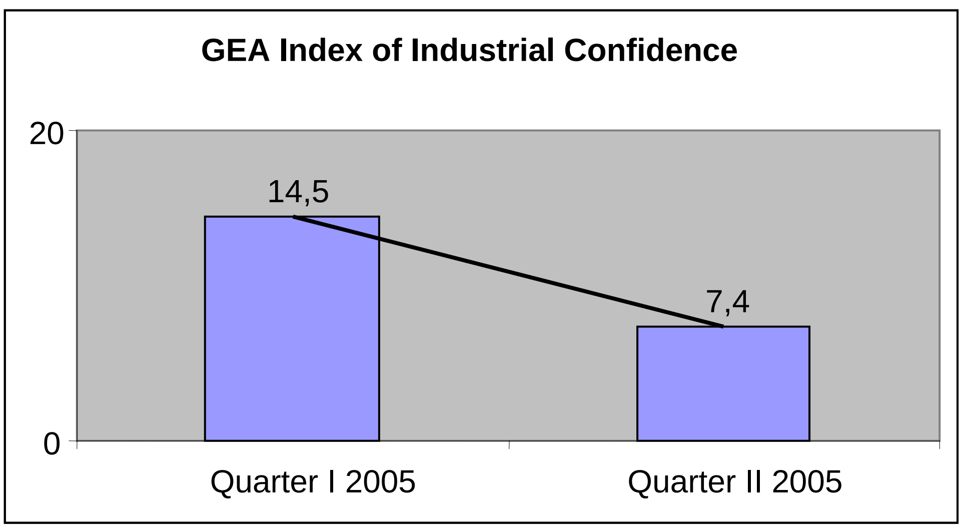
GEA index = (P+C-S)/3

where **P** represents the expectations regarding the evolution of production, **C** – the current volume of orders and **S** – the current volume of stocks. **P**, **C** and **S** are calculated as a conjectural balance (the difference between positive and negative evolutions) reported to the total number of respondent companies on each of the 3 variables.

It is a standard methodology recommended by OECD and used by Eurostat. The contribution of GEA stands in its application on a representative sample of industrial companies and especially in the quarterly public announcement of the results and their interpretation.

GEA Index of Industrial Confidence for Q2 2005 = 7,4
(on a scale from -100 to +100).

Compared to Q1 2005, GEA index has dropped to almost half the value, which reflects a drop in industrial confidence. This erosion of industrial confidence is confirmed by other institutions' calculations. Thus INSSE's monthly industrial confidence index for Romania is +5 (compared to +6 in December 2004), and Eurostat's index for UE in March 2005 was -6 (compared to -4 in December 2004).



It is the proper moment to mark the distinction between a negative index and a positive, but decreasing one. The GEA index for Q2 is dropping, but still holds a positive value. It

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is a lower result in relative terms (compared to the previous quarter), but not a low one in absolute terms.

The significant drop of the industrial confidence index may seem surprising considering that Romania signed the Accession Treaty to UE, has recently gone through a fiscal reform, reducing the income taxation and has committed to taking measures towards corporate environment enhancement. What is then the explanation for this decrease? In our opinion, several explanations for the drop in the industrial confidence index can be put forward:

- The evolution of the national currency exchange rate.
- The utilities prices increase.
- The intensification of market competitiveness, as a result of the approaching accession to the Single European Market.
- The limitation of possibilities to access state financial aid, as a consequence of the commitment Romania made to comply with the aquis regulations.
- The fact that many companies are forced to undergo a restructuring period, due to the reasons listed above;
- Uncertainty regarding the target and extent of the fiscal reform, considering that the significant change of the Fiscal Code in Q2 took place only a few months after it had already been substantially revised.
- The increase of the commercial deficit, reaching the record level of 1,5 billion euro in Q1 2005.

At sector level, there are important variations in comparison to Quarter 1. Thus, the textile industry has the most pessimist expectations, most probably due to the unfavorable conjuncture for exports, brought on by the exchange rate appreciation. Another sector – the information technology, with a high share of the total turnover represented by foreign trade, is also marked by a considerable degree of pessimism. The metallurgy and chemical industry, two energy consuming sectors, have slightly smaller indexes in comparison to the previous quarter, probably due to the utilities prices increase.

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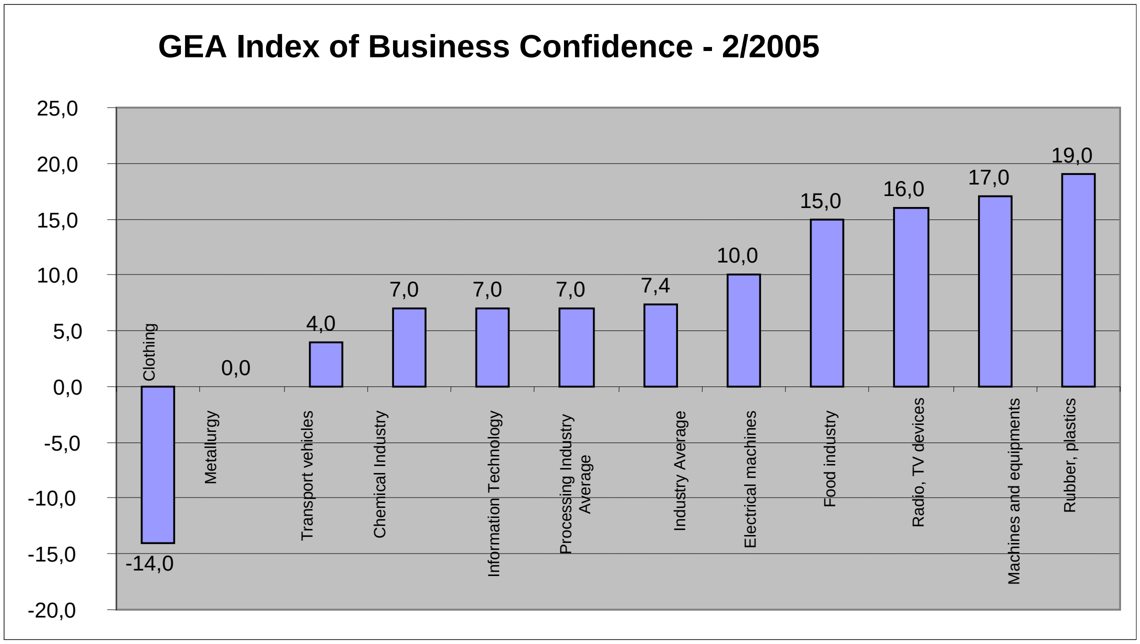

In opposition, the rubber and plastics industry, as well and the food sector have more optimistic expectations, ranking above the average in Q2. This evolution of the two sectors, with a high share of the total turnover represented by internal trade, can be explained by the anticipation of increased domestic consumption, especially during the Easter holidays. The oil processing industry was not included in the sector based analysis, due to the lack of response from the market leader. Among the industries which display the same level of optimism as in the previous quarter, we can distinguish: the machines and equipment industry, the machines and electrical devices sector, the radio and TV equipments industry.

Industrial production volume

The prediction we made in the GEA Bulletin 1/2005 has been confirmed, as the industrial production increased, but at a lower pace than in Q4 2004. Thus, a conjectural balance of only 8,2% of the companies have registered an increase in production volume during Q1 2005. Still, during Q2 2005, a more rapid growth of this indicator is expected (conjectural balance 43,5%). As a matter of fact, it was not the industrial production volume to stand out as the most negative factor in the composition of the industrial confidence index, but the disappointingly low level of orders (conjectural balance -20,6%).

Level of orders

The orders cover on average, at the level of the entire industry, 4,1 months of production, decreasing from 4,3 months in Q1 2005. The number of companies whose orders cover a year of production has also gone down (11,2% in Q2 compared to 16,5% in Q1), while

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the number of companies who have enough orders for just one month of production has risen (38,8% in Q2 compared to 34,5% in Q1). It is worth noticing that, compared to the first GEA Bulletin, the standard deviation for this answer has lowered (from 4,48 to 4,42), but the slightly greater than the average value still indicates a large variety of situations. The answer to this question is compatible with the BNR Conjectural Bulletin 4/2005, according to which, poor demand (reflected in the level of orders) is the main obstacle companies have to face.

The evolution of industrial production prices

The expectations of Q2 anticipate a price increase of 3-5% in comparison to the price level of Q1, a higher value than that of the first quarter, which the GEA Bulletin has correctly estimated at 1%. The official releases show that industrial prices have registered a cumulated growth of 1,1 % in the first two months of 2005.

This result is confirmed by the BNR Conjectural Bulletin 4/2005, in which the expectations regarding prices' increase have a conjectural balance far greater than the previous months (+22%).

In the first GEA Bulletin, we stated that the moderate expectations of the time regarding prices' increase may result in the drop of profit rate for producers. This hypothesis has been confirmed, as showed by the following results.

Profit and turnover

	Conjectural balance
Profit Q1 2005 vs. Q1 2004	-12,4&
Profit Q1 2005 cr. Q4 2004	-27%
Profit expectations Q2 2005 vs. Q1 2005	+33,5%

It is quite easy to notice that, during Q1 2005, the number of companies who made a profit had substantially decreased compared to both Q4 2004 and Q1 2005. On the other hand, the expectations regarding the prices' increase on the internal market, make the Q2 profit related expectations take a more optimistic tone. This may certainly seem a surprising result, especially considering that the industrial confidence index has dropped. One explanation could be that companies are undergoing a restructuring period, which they expect to complete successfully and in a fairly short period. The BNR Bulletin 4/2005 also points to a shift in profitability rate expectations, from -3 in March 2005 to +27 in April 2005 (conjectural balances). Profit may also be gained from costs reduction measures, such as workforce reduction (see the next section).

The turnover has gone up in Q1 2005, as compared to Q1 2004, but only for 9,4% of the companies (conjectural balance). This diminished conjectural balance confirms the

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industrial turnover increase of no more than 0,7% for the first two months of 2005, as reported by INSSE.

Even under these circumstances, for the companies who made a profit, its main source was the turnover increase. Thus, 77,6% of the companies with growing profit have also reported a higher turnover. This reflects a multiplying effect economy with low added value and profit depending solely on turnover. Just as we underlined in *GEA Annual Survey Report on Research, Development, Innovation and Competitiveness in the Romanian Industry*, competition in Romanian industry is set by means of price, not innovation.

Number of employees

The number of employees seems to have dropped, the conjectural balance registering a negative value for Q1 2005 in comparison with both Q1 2004 (-24,7%), and Q4 2004 (-15,3%). The expectations for Q2 are also pessimistic, but to a lesser extent (conjectural balance -4,7%). This result is confirmed by both INSSE report for April-July 2005, where expectations related to the number of employees are pessimistic (balance -9%), and BNR Bulletin 4/2005 (balance -16%). Although official unemployment figures do not reflect a drastic drop in employees number, but on the contrary, all questionnaires made public by INSSE from September 2003 until present reveal negative conjectural balances regarding employees number. The explanation may stand in the fact that a part of the people laid off can no longer integrate in the domestic traditional economy (and choose to work abroad or in the underground/ informal economy), and, after a period, they are taken out of the unemployment records. Another explanation could be that the positive effects of the fiscal reform, should they be represented by the recovery of the “underground economy”, are over passed in intensity by the effects of economic restructuring, which bring on workforce reductions.

Our calculations reveal an interesting aspect in economic agents’ behavior. Thus, in Q1 2005 compared to Q1 2004, only 36,2% of those who made a greater profit hired new employees, while 60,8% of those who suffered a depreciation of their financial position chose to dismiss employees. The same behavior is present in Q2 2005: 34,4% of the companies who expect a greater profit are ready to increase the number of employees, but 52,7% of those who expect a lesser profit (or even loss) are prepared to lay employees off. The companies enjoying a greater profit will invest only a minor fraction for developing their activity (which implies hiring), while the majority of those in financial difficulty will turn to dismissing employees, rather than cutting back on other operational costs or improving their management. Thus, the society at large participates in the economic agents’ loss, but not in their gains. Still, we should be cautions in drawing such conclusions, after only two quarters of observation.

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Fiscal matters

The flat tax was perceived by the vast majority of respondents as a positive factor, the conjectural balance having a value of +55,3%. Still, its effects appear to be diminished by the difficulty to gain profit, as the conjectural balance for profit has registered, as we have already stated, a negative value, at least for Q1 2005.

Under these circumstances, the budgetary incomes may be affected, starting with Q2 2005 (which contradicts the optimistic expectations companies hold regarding profit evolution in Q2). Moreover, a worrying result is that only 58,6% of the companies who made greater profits during Q1 2005 (in comparison to Q1 2004) have also paid a higher amount of taxes to the state during Q1 2005, as opposed to Q1 2004. So, almost half of the companies with a greater profit (41,4%) have actually "managed" to pay less taxes to the state. Even more so, from the 58,6% who did pay more taxes, practically just half of them (or 27,6% of the total) paid the state a tax volume 10% higher than the reference quarter of last year (so higher than the inflation rate).

The Labor Code

The business environment appears to be clearly in favor of the legislation changes proposed by the Labor Code. 57,1% of the companies have stated that these changes would increase their competitiveness, only 2,9% were of the opinion that they would hinder the competitiveness (conjectural balance 54,2%), while the remaining 20,6% estimated that the changes would have no effect whatsoever. It is worth taking into account the fact that one fifth of the companies (17,1%) stated that they have no knowledge of the proposed changes.

Finding solutions to enhance the competitiveness appears to be all the more necessary, as other external factors, such as the exchange rate, have an increasingly negative influence.

The exchange rate

The negative influence the ROL appreciation has on competitiveness deepened. And if at the beginning of Q1 the effects of only two months of appreciation were being felt (November and December), the results of Q2 reflect the cumulated consequences of no less than 5 months of appreciation (including the January-March period).

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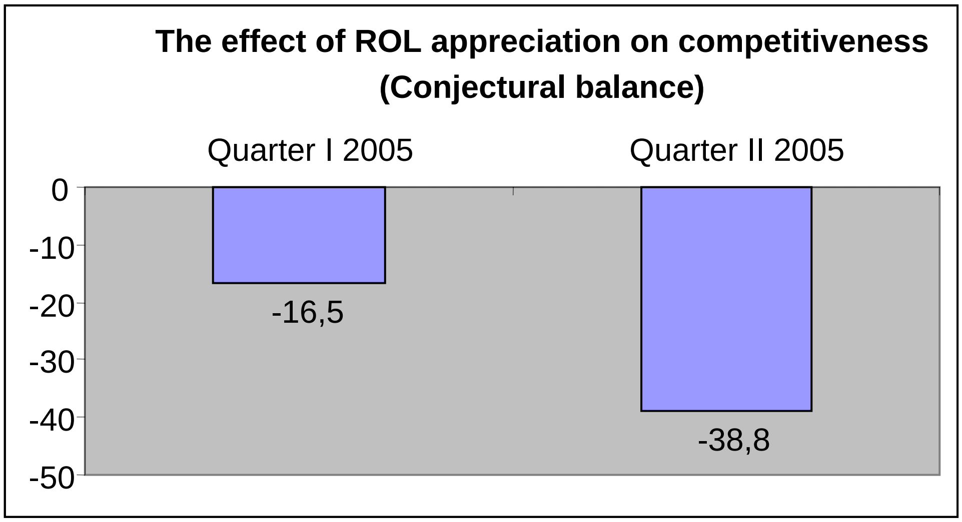

Thus, 59,4% of the companies stated that the appreciation of the ROL has had a negative impact on competitiveness, while only 20,6% have noticed a positive effect. The deterioration of this question's results proves the fact that companies have not succeeded in using this moment as a stimulus for competitiveness, in the manner some currency policy managers hoped for, but declined even more. As a matter of fact, the figures put forward by Eurostat for Q1 2005 show a loss in competitiveness registered by the Romanian companies on the domestic market itself (the conjectural balance drops from +28% to +20%).

It is worth noticing that 57,4% of the companies who considered the ROL appreciation to have negative consequences on competitiveness have also registered a drop in profit. The prediction made in the GEA Industrial Bulletin 1/2005 has therefore been confirmed: the first adjustment reaction consisted in the profit drop.

Another interesting question we asked refers to the minimum level of the ROL-Euro exchange rate companies need to make profit. A first observation revealed the large number of companies (22,4%) who didn't know how to respond, illustrating a dangerous lack of the activity planning capacity. An afterwards analysis of the valid answers only, illustrated by the histogram below, showed that the accepted average level is 37800 lei/euro, significantly greater than the previous month's average.

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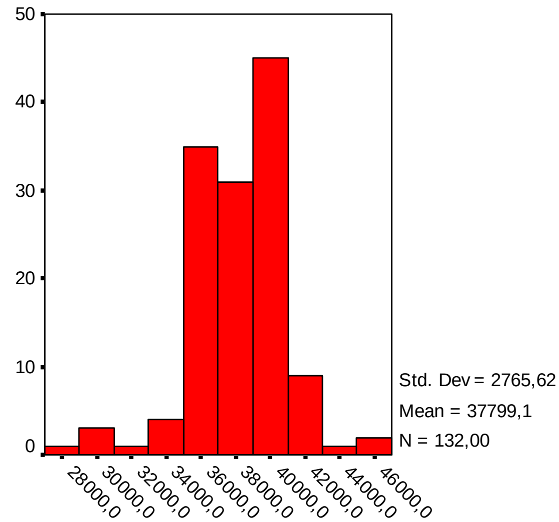

At which exchange rate ROL-Euro would the companies obtain profit?

It should be noted that there are no significant differences between the average values of various industrial sectors. Thus, the inter-sector standard deviation is only 240 lei. Therefore, the 37800 lei level appears to be wholeheartedly favored by the industry in general. And the fact that the difference between this profitability threshold and the current exchange rate is of approximately 1500 lei, partly explains the significant drop in the industrial confidence index.

On the other hand, a possible shift of the exchange rate evolution, which is not all that unlikely due to the growing foreign deficit, would favor the industrial companies, should it reach at least the mentioned profitability threshold. It is worth noting that this profitability threshold is not only the exporters' choice, as our sample is not organized by the criteria of foreign trade share in total turnover.

Methodological note

Main industrial sectors included in the sample, % of total respondent companies

	Q1 2005	Q2 2005
Machines and equipment industry	14.1	14.1
Machines and electrical devices industry	13,5	14,1
Clothing industry	12,9	12,9
Chemical Industry	12,4	11,2
Food industry	10,6	10,6

Turnover, % of total

	Q1 2005	Q2 2005
Under 1.000.000 euro	22,3	21,2
Between 1.000.001 – 10.000.000 euro	47,1	51,8
Between 10.000.001 – 50.000.000 euro	22,4	21,2
Over 50.000.000 euro	8,2	5,9

Number of employees, % of total

	Q1 2005	Q2 2005
Below 49 employees	15,3	14,1
Between 50 and 249 employees	27,6	31,2
Over 250 employees	57,1	54,7

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