The Ukrainian ferrous metal industry

by Vladlen Mykhnenko

The economic performance of Ukrainian iron and steel industry during the post-communist transformation has been characterised by a sharp, deep, and long decline in ferrous metal output. The industry has also suffered from deteriorating efficiency, falling labour productivity, and mediocre profits. Recent attempts by the public authorities and private corporate entities to resolve the industry's problems have been unsuccessful. This paper gives a brief description of some of the structural and institutional reform proposals elaborated by the 'State Capacity and the Leading Economic Sector in Post-Socialist Eastern Europe' Working Group of the CEU/Open Society Institute Centre for Policy Studies.

The Ukrainian ferrous metals sector is of overwhelming importance for the national economy, currently producing about 7 percent of Ukraine's gross domestic product and employing 420,000 people. Ukraine exports annually over US$ 6 billion worth of crude steel, while ferrous metals account for approximately 40 per cent of the country's total exports. The steel industry entered the post-communist transformation as a fully-grown and densely-located manufacturing sector. One of the main outcomes of this transition has been a serious decline in ferrous metals output and yet, the remarkable export expansion has been undertaken under the highly volatile conditions of the international steel market. Since the end of 1998, the Ukrainian iron and steel industry has followed an upward growth path.

Nonetheless, the steel industry has been growing in a rather haphazard way. Export sales revenue and profit earnings reported by the Ukrainian ferrous metals companies have also been erratic. Moreover, while a small number of Ukraine's steel works have recently taken leading market positions, the majority of the ferrous metals companies are clearly lagging far behind, while some enterprises have apparently been reduced to rubble.

In the early 1990s, the Ukrainian domestic market for steel was as large (on a per capita basis) as that of any industrially advanced economy of the West, by 2002, it had contracted by 80 per cent. The current level of Ukraine's crude steel consumption is half the world's average. Export opportunities of the Ukrainian iron and steel producers have been badly damaged by a wave of anti-dumping sanctions, import tariffs, quantitative restrictions, and other protectionist measures imposed by the European Union, the United States, and a number of other steel-producing countries. The Ukrainian ferrous metals sector is currently the only industry in the world that still heavily relies on the open-hearth furnace production technology. The Ukrainian steel industry has also been the worlds slowest in up-grading its production capacities and in diversifying its product assortment.

The loss of management and co-ordination during privatisation has had a detrimental effect on the economic performance of most Ukrainian steel works. A number of large iron and steel combines, iron ore mines and coal-coking plants have been partially privatised by or put under the joint private management control of several competing Ukrainian industrial holding companies. The subsequent establishment of fragmented property arrangements has created a number of major difficulties with regard to the reliability of input and output provisions. A large number of steel works also suffer from acute shortage of raw materials and natural resources.

Thus, there are five major challenges the Ukrainian iron and steel industry has faced since the beginning of the 1990s. The idustry's long-term challenges are:

- the collapse of the domestic steel market;
- the resultant dependence of Ukrainian iron and steel producers upon volatile and politically unstable overseas markets;
- obsolete production capacities, an out-dated technological style, and an undeveloped steel product assortment.

The short-term problems of the Ukrainian ferrous metals sector are:

- the protracted privatisation and ownership transformation process, which has produced a fragmentary property structure and an unclear delineation of public and private property rights;
- the growing shortage of raw materials within the ferrous metals sector.

The objectives of the policy proposals included in this paper are as follows:

- to ensure the transformation of the Ukrainian ferrous metals sector into an efficient, technologically advanced, internationally competitive, and environmentally conscious industry;
- to improve the current industrial policy framework;
- to encourage the broader policy community to evaluate and reformulate the industrial policy agenda vis-à-vis the new challenges faced by the Ukrainian iron and steel industry.

Apart from addressing the challenge of technological gaps, the current public policy environment has not provided an adequate response to the industry's central transformation challenges. The drastic collapse of the domestic market for Ukrainian ferrous metals has not been reversed. Furthermore, the Ukrainian government has not been able to adequately address the detrimental effects emanating from the disproportionate discrimination faced by the country's steel producers abroad. The Ukrainian government has so far failed to secure its membership in the World Trade Organisation or, at least, to negotiate the granting of market economy status for the country. The Ukrainian authorities have addressed the problem of fragmentary ownership transformation of the industrial sector by facilitating the establishment of large national conglomerates based on ferrous metals. While this strategy has provided a certain incentive for industry consolidation and overall management improvement, it has also led to a number of highly damaging conflicts between different conglomerates concerning particular steel works and other ferrous metals enterprises.

Ukraine's current public policies vis-à-vis the domestic steel industry have also failed to adequately address the problem of raw material shortages suffered by a number of largest steel companies. The acuteness of the resource shortage problem has not been anticipated, while the monopolisation of the industry's resource base has not been properly tackled.

The alternative to a substantial agenda-setting reform would most likely be the worsening of the current situation, and in particular:

- a stagnating domestic market for ferrous metal products;
- continued weakness of the Ukrainian steel exporters vis-à-vis increasing protectionist pressures overseas;
- a slow pace of technological change within the industry;
- an unfinished ownership rights delineation;
- increasing shortages of raw materials and natural resources.

Revising the current industrial policy strategy

The 'State Industrial Development Programme for 2003 – 2011' approved 28th July 2003 should be revised with an aim to accentuate the accelerated development of Ukraine's steel consuming sectors of manufacturing and construction.

Establishing a Foreign Trade Office

A special authoritative Foreign Trade Office headed by Ukraine's Foreign Trade Representative should be established within the Ukrainian Ministry of Industrial Policy. The creation of a powerful Ukrainian foreign trade negotiator shall improve the country's bargaining capacities on the international arena and facilitate the WTO accession talks.

Financial engineering

Special and transparent guarantee funds and leasing operation schemes for Ukrainian iron and steel companies should be established with an aim to facilitate technology improvements and product line development through the purchase of foreign patents and licences and equipment leasing.

Investing in physical capital

Direct private investment into the Ukrainian iron and steel industry should be co-financed by the state up to 50 per cent of total investment. Investment into Ukraine's ferrous metals plants and equipment should be aimed at closing the industry's production technology gap.

Supporting environmental-friendly and economical energy technologies

Tax allowances, customs duty exempts, and financial support should be provided to introduce environmental technologies and to develop energy efficient production techniques.

Expediting privatisation

The State Property Fund of Ukraine should accelerate in a fully transparent way the delayed and protracted privatisation of the remaining state-owned assets in the ferrous metals sector.

Regulating the resource base

The current governmental method of regular resource balancing should involve all the parties concerned: the owners and managers of iron ore mines, coal mines, ore processing factories, coal-coking plants, steel works, tube mills, scrap metal firms, natural resources and steel exporting firms shall be assembled along with the governmental ministers to facilitate the co-operation aimed at resolving the increasing resource shortage pressures.

Currently, inadequate industrial policies and overseas market restrictions jeopardise the economic recovery, technological adjustment, and overall sustainability of the Ukrainian iron and steel industry. The costs of action will eventually increase as overseas markets saturate and property conflicts intensify. It follows that the policy agenda reform needs to be taken without delay. The costs of the structural changes described above – in particular the financial support for fixed capital investment, international patent leasing, environmentally-friendly and economical energy technologies – should be covered directly from the consolidated state budget. Other measures, including the institutional changes in the industrial policy and foreign trade bodies, i.e. the establishment of the Foreign Trade Office within the existing Ministry of Industrial Policy, the facilitation of the ferrous metals privatisation process, and the effective and transparent regulation of the industry's resource base, would not induce substantial costs, and should even prove economical on the long run. A public cofinancing of direct private investment into the Ukrainian steel industry up to 50 per cent (or at the current level of UAH 1400 million) should cost additionally less than 2 per cent of the consolidated state budget expenditure and would eventually restore the 1998 level of state assistance given to the domestic industry. Such an amount of proposed public financing provided to the profit-making Ukrainian iron and steel industry is substantially smaller than the amount of state support currently provided to Ukraine's loss-making coal mining industry.

The policy measures proposed in this study imply state intervention in the status quo. They would necessarily conflict with the interests of some political forces and business groups in other industries and economic sectors and, to some extent, with the interests of the business groups within the Ukrainian ferrous metals industry itself. Therefore the success of the implementation depends largely on the quality of the communication strategy and pressure, which the broader industrial policy community can exert upon those interested in maintaining the current state of affairs and the decision-making bodies, ministries, and the legislature. It is therefore vital that the stake-holders get familiar with the challenges faced by the Ukrainian ferrous metals sector and have an idea of what solutions can be applied. Public awareness could be raised by a series of publications and public information campaigns, which would point out employment, health, environmental safety, and other widely beneficial implications of the steel industry's transformation.

Article referred to
Vladlen Mykhnenko 'Rusting Away? The Ukrainian Iron and Steel Industry in Transition'
http://pdc.ceu.hu/archive/00001877/