ECONOMY AND ECOLOGY 25.06.2024 | Brian Milakovsky

‘It’s the real economy, stupid’

Why FDI is not enough to save Ukraine

Investment in Ukraine’s productive economy is critical to its resilience in the war and the sustainability of its recovery. At the recent Ukraine Recovery Conference (URC), in Berlin, Ukraine’s economics minister Yuliia Svyrydenko said that her country will need $10-30 billion in annual investment to reach the GDP growth needed to recover from Russia’s destructive invasion. The high-powered audience of western leaders and development bankers certainly understood her to mean foreign direct investment (FDI) — as the topic of attracting external investors to Ukraine’s devastated economy absolutely dominated the conference.

While no one can deny the importance of FDI, focusing on it so intensely risks narrowing the horizons of economic policy for the country’s domestic enterprises and investors. ‘FDI-friendly’ policymaking usually comes in one ideological basket with maximal economic openness and the avoidance of local content and industrial policies. But Ukraine’s domestic enterprises face massive war-caused market failures and need active state policies to restore their competitive position with EU peers.

Even in these awful wartime conditions, Ukrainian companies appear to invest more actively in their country’s economy than foreigners. Minister Svyrydenko announced that her country had received $4.3 billion in FDI in 2023, a huge increase from the miserable 2022 level of $250 million and well on the way to the pre-war $7.95 billion. While data on domesticinvestment is not available for 2023, in 2022, Ukrainian enterprises reported $10.5 billion in capital investment, itself down from $20 billion in 2021.

Made in Ukraine

It should not be surprising that Ukrainian firms that have decades of accumulated investment in their existing facilities and significantly fewer alternatives for their money would be more willing to make further domestic investments. And their risk tolerance is truly remarkable; factories are investing in new production in rocket-scarred Kharkiv and

in Nikopol, just across the Dnipro River from a Russian-occupied nuclear power plant.

Even among FDI sources, the largest in 2023 were firms that already had facilities in Ukraine, such as Kronospan wood panels or Carlsberg brewing. The largest entirely new FDI project mentioned in Berlin is the same one lauded last year at the URC in London: the cluster of factories that the Irish construction materials firm Kingspan is erecting in the Lviv region. The next FDI success stories are likely to be in the defence sector, but most of this money is only committed, for the time being.

Ukraine has finally established incentives for industrial park development similar to its EU neighbours and is offering additional incentives to investors of more than $12 million.

Ukraine absolutely should be thinking about creating attractive conditions for future FDI and should facilitate any opportunity that comes along during this war to attract new investors. But given the enormous challenges associated, might it not make sense to prioritise activating the capital of domestic companies, the very same that are providing the lion's share of wartime investments?

The Ukrainian government deserves credit for its existing efforts to bring more resources to domestic companies under an umbrella of policies called Made in Ukraine. The 5-7-9 loan subsidised program through state banks (which refers to the preferable interest rates offered) has been well funded in wartime, and Kyiv is working vigorously with donors and international financial institutions to bring more financing into the banking system. Ukraine has finally established incentives for industrial park development similar to its EU neighbours and is offering additional incentives to investors of more than $12 million. Rebates are offered to Ukrainian farmers to buy domestically manufactured equipment.

The need for a Ukrainian development bank

But these excellent efforts should only be the beginning. There is an enormous funding gap for the large capital projects needed to revive and modernise Ukrainian industry and supply the reconstruction. For example, one Ukrainian investor is pursuing $180 million in financing to combine with his own $80 million to construct Ukraine's first sheet glass factory since Soviet times. Before the war, Ukraine imported most of its sheet glass from Russia and Belarus and now needs huge volumes to repair damaged homes. At an order of magnitude higher, the metallurgy giants Metinvest and Interpipe (owned by Ukrainian oligarchs Rinat

Akhmetov and Andrii Pinchuk, respectively) have announced their need for $3.6 billion in financing for green steel investments to avoid being locked out of the EU market by the Carbon Border Adjustment Mechanism. In all, Ukraine's metallurgy industry group has identified $15 billion of such decarbonisation investments needed across the industry.

Many policymakers and analysts point to a Ukrainian development bank as the right institution to bring the large sums of 'long' money needed for such ambitious projects. Kyiv should work with its Western partners to pursue the initial fund and guarantees needed to begin financing of this scale to Ukrainian enterprises.

Research shows that Ukrainian producers could provide 80 per cent of the building materials needed for the country's reconstruction (priced at nearly $40 billion!).

Beyond access to finance, Kyiv should investigate policy levers to direct more resources to domestic enterprises. For example, research shows that Ukrainian producers could provide 80 per cent of the building materials needed for the country's reconstruction (priced at nearly $40 billion!), but as state reconstruction tenders grow the proportion of imported materials being purchased is growing. The Ukrainian producers identify weak consumer demand as one of the primary barriers to their recovery, so government tenders are especially important for their survival.

The most radical way for Ukraine to counter this trend would be to declare a 'national security exemption' to its commitments to the European Union and the World Trade Organization, and pass a government tender localisation law that applied to all foreign companies. But such a unilateral approach could add tension to Ukraine's crucial relationship with the EU. Kyiv could attempt to negotiate a temporary local content requirement with the EU to apply during wartime and the early reconstruction period. Setting a minimum proportion (for instance, 60-70 per cent) of domestic sourcing of building materials and other key goods that Ukraine already produces well would increase confidence amongst Ukrainian companies about market access and spur more domestic investment. It would also speed the recovery of the tax base, which will, after all, be the source of funds to pay off Ukraine's reconstruction loans to the EU.

Ukraine strives to enter the EU common market

Ukraine's nascent raw minerals sector simultaneously shows the need for both increased financing and targeted industrial

and should not lurch towards unrealistic models of autarkic self-sufficiency.

policy. EU officials at the URC enthusiastically lauded Ukraine's huge supplies (by one estimate, 22 of the 30 critical minerals on Brussels' list), playing up their importance for the bloc's 'strategic autonomy' and even for 'European sovereignty.' All speakers agreed that the maximum amount of added value should be captured within Ukraine, but how to ensure the necessary enrichment, processing and manufacturing plants will be built? Will there be enough FDI and will its investors be motivated to do more than facilitate the flow of raw ore across the border?

A Ukrainian development bank could help ensure that domestic companies can become players in this infant industry and that value-added processing is prioritised, and local content requirements will be needed to ensure that the FDI that does enter this sector engages Ukrainian suppliers to push the effect deeper into the Ukrainian economy.

Ukraine strives to enter the EU common market and should not lurch towards unrealistic models of autarkic self-sufficiency. At the same time, a greater focus on domestic investors and enterprises is timely and logical at a time when Russia can easily spook foreign investors with new waves of destruction. Reinforcing domestic capacity at this juncture will help ensure Ukrainian businesses are prepared to compete and collaborate when foreign direct investors finally enter at the scale called for at the URC.



Brian Milakovsky
London

Brian Milakovsky is an associate researcher at LSE Ideas. He worked in humanitarian and development programs aimed at economic recovery in eastern Ukraine from 2015 to 2022 and now focuses on industrial recovery in Ukraine.