International Political Economy of Ukrainian Steel Industry

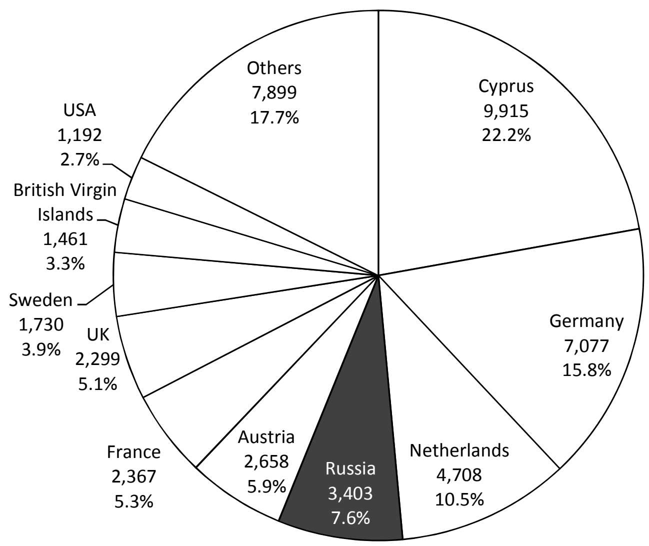
Michitaka HATTORI
Institute of Russian & NIS Economic Studies

1. Introduction

As of the beginning of 2011, Russia accounts for mere 7.6% of Ukraine's accumulated foreign direct investments (FDI), ranking only at 4th position (see figure 1). That does not mean, however, that the role in Ukraine economy played by Russian investors is small. To the contrary, presence of Russian capital is more than significant. We must pay attention to the fact that Russian big companies tend to invest abroad, including in Ukraine, through tax havens like Cyprus or British Virgin Islands, rather than directly from the mother nation. Many experts agree that, with investments via these tax havens counted, the overall picture would be rather different. Then Russia would be the biggest investor-country for Ukraine and Ukraine the biggest destination-economy for Russia's outward FDI[i].

Figure 1 Ukraine's accumulated FDI by Investing Countries

(as of the beginning of 2011, million US dollars)



Source: Державна служба статистики України.

There have been discussions about the nature and implications of Russia's investments in CIS countries in general and in Ukraine in particular. Some fear that Russian capital may threaten national interests of neighboring countries. Some even suspect that Russian investors must represent Kremlin's imperial ambitions. Many neutral observers agree, however, that in most cases Russian companies try to achieve purely business purposes and that political motivation may override economic ones only in rare cases like when state-run energy companies (i.e. Gazprom and Rosneft) are involved[ii].

In this short essay I will survey the case of Ukrainian steel industry and Russia's involvments there in an effort to find implications from international political economy viewpoint.

2. Ukrainian Steel Industry

On one hand, steel industry is by far the most important industrial sector for Ukraine. As of 2010, Ukraine was the eighth largest steel producer and third largest steel exporter of the world. Iron steel and products accounted for as much as 32% of Ukraine's merchandise export in 2010.

On the other hand, Ukraine's ferrous metallurgy is faced with a lot of problems. Ukrainian mills badly need investments for modernization, because from technological point of view they are over aged, obsolete and with low energy efficiency. Their products are primitive and with very low added value. They are too much dependent on overseas markets, especially spot ones, which leads to high vulnerability to fluctuation of international commodity prices. Some corporations lack their own raw material basis and depend on supply of iron ore and coke from others. No wonder that Ukrainian mills are financially unstable, making them vulnerable to M&A attacks, especially after Lehman shock of 2008.

Figure 2 Production of Crude Steel by Main Ukrainian Mills in 2010 (1,000 tons)

Figure 2 compares the size of production of main Ukrainian mills. They can be categorized into following three groups.

(1)mills belonging to Renat Akhmetov's System Capital Management (SCM) group: Azovstal, Ilyich, Zaporishstal and Yenakieve.

(2)mill under a global transnational corporation: Arcelor Mittal Kryvyy Rih.

(3)mills recently acquired by Russian capital: Alchevsk, Dzershynsk, Petrovsky and Donetsk Electrical Metallurgy Kombinat (DEMK).

3. A Case Study (1) : Metinvest as a Case of Collaboration of Ukrainian & Russian Business Tycoons

Two Ukrainian steel manufacturers, System Capital Management (SCM) and Smart Holding, announced a merger agreement in September 2007. Through this move Rinat Akhmetov, known as the owner of SCM and as one of the main figures of Party of Regions, gained not only additional production capacities but, crucially, direct access to greater iron ore resources. Under the agreement, Smart was merged into Akhmetov's Metinvest holding (Akhmetov's SCM is the principal stakeholder in Metinvest). SCM held 80% and Smart 20% of Metinvest. The Smart Holding brought Makiivka steel plant, Inhulets iron ore complex, and the Bulgarian Promet rolled goods plant to the Metinvest holding. Inhulets, situated in the Kryvyy Rih iron ore basin, was the most attractive asset passing from Smart to Metinvest and thus in practice to SCM control. The absorption of Smart gave Akhmetov control of 70% of the existing production of iron ore in Ukraine. This meant that Akhmetov's SCM steel plants would enjoy privileged or exclusive access to larger iron ore resources and that his competitors would have to buy a large portion of the iron ore for their steel plants from Akhmetov[iii].

Smart Holding is often referred to as a 'Russian' conglomerate because Vadim Novinsky, principal owner of Smart Holding, moved from Russia to Ukraine in 1990s to find business chances in the new frontier. Nobody, however, really cares about his and its nationality. Novinsky may be a Russian citizen and controlling his Ukrainian business from Lukatl North-West, a company registered in Russia, but his business group largely consists of Ukrainian assets. Therefore, we may regard Smart as a 'Ukrainian' business group and even call the leader not 'Новинский' in Russian but 'Новинський' in Ukraine.

During the last two or three decades of the 20th century, when interdependence of nations deepened and multinational corporations expanded their presence globally, people began to realize that the meaning of nationality of companies was losing importance. Collaboration of SCM and Smart is a typical case. It would be naïve to believe that the fact that Smart is of Russian origin would harm interests of Ukrainian national economy. It is noteworthy that post-soviet 'oligarchs' like Akhmetov or Novinsky tend to be all the more borderless, not bound by framework of nation-states, because they usually seek short-term profits, moving their capital from one sector, wherever it may be, to another promptly.

4. A Case Study (2) : SCM as a Champion of Ukrainian National Economy VS Kremlin?

There are, however, cases in Ukrainian Steel Industry, which make us suspect that 'classic' nation-to-nation struggles may be still actual. For past several years, especially after Lehman shock of 2008, Russian capital, supposedly encouraged by Russia authorities, rapidly expanded presence in the sector.

At the end of 2009, in a deal that were allegedly brokered by Vladimir Putin, who served as head of the supervisory board of Russia' state-owned Vnesheconombank, Alexander Katunin and a group of other Russian investors bought control of one of Ukraine's largest industrial holdings, Industrial Union of Donbas (ISD). The deal was the result of ISD's financial distress brought about by plummeting demand for metals combined with ISD's heavy debt load from acquisitions. Putin and Vnesheconombank were involved in the situation since Vnesheconombank held a considerable amount of ISD's debt. Katunin-headed group would hold 50 percent plus two shares of ISD stock, while 49.99 percent of stocks would remain in the hands of Taruta and Mkrtchan. ISD, founded in 1995, had acquired over the years a considerable stable of properties in Ukraine and Eastern Europe that include the Alchevsk Iron & Steel Works (AMK), Alchevsk Coke-Chemical Plant and Dzerzhynsk Iron & Steel Works (DMK) in Ukraine, as well as Dunaferr in Hungary and ISD-Huta Czestochowa in Poland[iv].

In May 2010, two men claiming to represent offshore companies registered in Cyprus announced the sale of Ilyich, Ukraine's 3rd largest mill, to an unknown Russian investor. No banks were involved in the alleged transaction, which valued the $2 billion factory at only $30 million. Shortly thereafter, Ilyich CEO Volodymyr Boyko announced a merger between his company and Metinvest through a share capital increase, thus blocking the raid attempt[v].

Also in May 2010, Ukraine's 4th largest mill Zaporizhstal was sold to a group of Russian investors represented by Vnesheconombank. The price was $1.7 billion, with the sellers rejecting an earlier $50 million down payment by Rinat Akhmetov's SCM and agreeing to pay a fine of $50 million for having done so. SCM's lawyers filed suit in a London court, which put a stay on Zaporizhstal shares until the case could be heard. A market source confirmed that the Russian investors have come closest to the purchase of Zaporizhstal, saying the end buyers would be structures that had acquired 50% + 2 shares in the Ukrainian corporation ISD[vi].

But Akhmetov made a comeback a year later. Metinvest announced in July 2011 that it had signed an agreement to acquire a 50-percent stake in Zaporizhstal. In a statement, Metinvest said it had agreed buy the stake in Zaporizhstal from Industrial Group, which is reportedly owned by domestic businessmen. Metinvest said agreements signed also gave it an "option" over the remaining 50 percent stake in Zaporizhstal. As part of the deal, Metinvest also acquired, directly through Industrial Group or indirectly through Zaporizhstal, stakes in iron ore producer Zaporizhia Iron Ore, coke producer Zaporizhkoks and a number of smaller companies[vii].

Ukrainian journal *Forbes* says;

> They (unknown investors from Russia) obtained not only 50% of ISD stocks but also the same

amount of Zaporizhstal in the face of Metinvest. A former SCM top manager points out, 'The buyers of ISD and Zaporozhstal are identical. It is clear that they have a conductor in one room of Kremlin. That is why we expected that ISD and Zaporizhstal would be merged with Yevarz's properties in Ukraine so as to establish a real competitor of Metinvest'[viii].

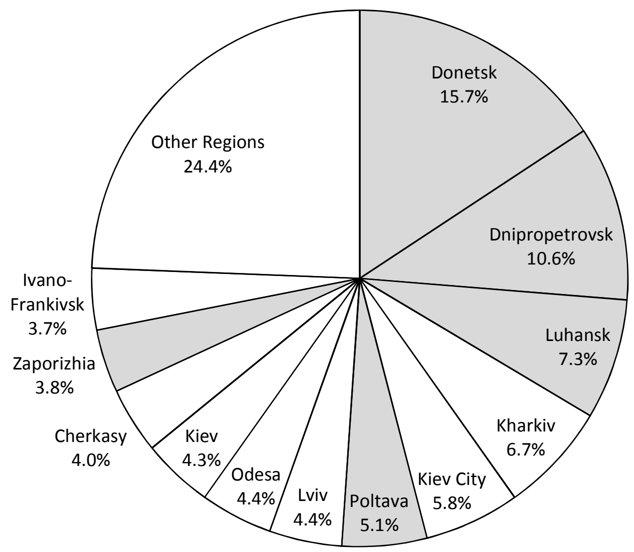
When unknown Russian investors, supported by state-run Vnesheconombank, attempted to acquire Zaporizhstal in 2010, not only Prime-minister Mykola Azorov condemned it as a typical raid[ix], but also opposition Tymoshenko Bloc fraction of Parliament expressed concern[x]. After all, Akhmetov's SCM saved Zaporizhstal from Russian capital. It almost seemed that SCM, champion of Ukrainian economy, was striving with Kremlin to preserve national interests.

Table 1 Ukraine's Consumption of Natural Gas by Economic Activities (2008)

	Consumption (thousand cubic meters)	Share (%)
Agriculture, hunting and forestry	665,474	1.0
Fishery	618	0.0
Industry	39,647,275	62.5
Mining	1,577,506	2.5
Manufactureing	22,644,242	35.7
Food, beverages and tobacco	1,797,877	2.8
Textile and textile products	49,650	0.1
Leather products and footwear	16,553	0.0
Wood and wood products	86,643	0.1
Pulp, paper and printing	249,499	0.4
Coke, oil refinery and nuclear fuel	394,215	0.6
Chemical	7,801,777	12.3
Rubber and plastics	125,654	0.2
Other non-metallic mineral products	3,140,204	4.9
Metallurgy and metal products	7,914,429	12.5
Machinery and equipment	515,196	0.8
Electrical and optical equipment	147,285	0.2
Transport equipment	366,555	0.6
Other manufacturing sectors	38,704	0.1
Electricity, gas and water supply	15,425,527	24.3
Construction	126,434	0.2
Retail and wholesale trade	226,147	0.4
Hotels and restaurants	28,389	0.0
Transport and communication	4,406,866	6.9
Financial activity	10,980	0.0
Real estate and business services	233,974	0.4
Public administration	390,106	0.6
Education	232,543	0.4
Public health and social services	198,502	0.3
Other communal, social and personal services	44,299	0.1
Economic activities total	46,211,607	72.8
Other consumption (e.g. household)	17,247,522	27.2
Total consumption	63,459,129	100.0

Source: Державна служба статистики України.

Figure3 Ukraine's Regional Structure of Natural Gas Consumption (2008)



Source: Державна служба статистики України.

4. From Ethnic to Economic Nationalism (then to a Dead End?)

When new Yanukovych administration was established in February 2010, Kost Bondarenko, a Ukrainian expert, predicted as follows; Yanukovych will develop relations with Russia on principles of pragmatism. It is not right to regard him as a marionette of Kremlin. He must rather promote multi-vector politics, which is only one possible way for today's Ukraine. There will be only two possible compromises which Ukrainian side can do to Russia, i.e. establishment of gas transport consortium and return of RosUkrEnergo to Ukrainian gas market. The question whether to give Russian second state language status or not will be actual for coming 20-30 years, so Yanukovych cannot solve it. The problem of Black Sea Fleet is that of 2017. Yanukovych's term will expire in 2015, so it is his successor who will solve it. Yanukovych will not put emphasis on history and cultural problems, which divide Ukraine and Russia. But as regards of economic priorities, protection of rights and interests of Ukrainian capital, the new President will be much tougher. Economic nationalism of Yanukovych will come, instead of ethnic nationalism of Yushchenko[xi].

Of course, some of Bondarenko's predictions did not come true, especially about the Black Sea Fleet. But it seems to me that in fact overall direction of political and economic policies of Ukraine shifted, as the expert predicted, from ethnic to economic nationalism.

Even in the case of the Black Sea Fleet, in which Bondarenko failed to guess right, his thesis that Yanukovych administration puts more emphasis on economic, not ethnic, interests, applies very well. As is well known, Ukraine and Russia signed so-called Kharkiv Agreement in April 2010, which allows Russia to continue to deploy its Black Sea Fleet in Sevastopol in Ukraine for additional 25 years in return for discounted price of natural gas sold by Russia's Gazprom to Ukraine's NaftoGaz. Many observers agreed that

Yanukovych's decision was intended to help domestic industry[xii].

It should be pointed out that Ukraine's industry structure, established in the Soviet era, is based on 'cheap gas' from Russia. The two industrial sectors of Ukrainian economy which are more or less competitive internationally, i.e. steel and chemical industries, consume natural gas in abundance. Its ferrous metallurgy is unique in that many mills use natural gas, not coke, as fuel and reducing agent, making them giant gas consumers. As is seen in figure 3, metallurgy and chemical industry together consume 25% of the total. Figure 4 is even more impressive, because 5 metal & mining Regions of Ukraine, i.e. Donetsk, Dnipropetrovsk, Lukhansk, Poltava and Zaporizha Regions, where business interests of oligarchs behind Yanukovych are concentrated, consume as much as 43% of the total.

The ruling Party of Regions, in a statement one year later, praised Kharkiv Agreement as 'an undoubted victory of Ukrainian diplomacy, the first in five yeas practical and undoubted success in the dificult task of protecting Ukranian national interests[xiii].' It is interesting that the ruling party talks about 'national interests' solely from economic point of view, while making no comments on its geopolitical consequences It is noteworthy that even former President Viktor Yushchenko admitted that Kharkiv Agreement had saved chemical and steel industries of Ukraine and therefore there had been no alternative to it. It may be, however, arguable whether Yanukovych, signing Kharkiv Agreement, really tried to save chemical industry and metallurgy which are so vital for national economy, or he simply wanted to favor oligarchs close to the regime.

But even if Yanukovych administration sincerely adheres to Ukraine's economic interests, its style already created at least one scandal, which could threaten national interests of strategic level. In October 2011, Ukrainian court ruled that Tymoshenko, former Prime Minister, had acted against the national interest when she signed a natural gas deal with Russia in 2009, leading to $190 million in damages to Ukraine's state-run gas company. The judge sentenced her to seven years in prison and banned her from running in next year's elections.

Protest movement on Kiev main street.

Photographed by the auther in October 2011.

Accorging to a Russian expert's analysis, Yanukovych administration had two motives. First, they tried to get rid of a political opponent on the eve of Parliamentary elections of 2012. Second, under pressure from oligarchs, they intended to urge Kremlin to reconsider 2009 gas deal which they regarded as unfavorable to Ukraine[xiv]. But the case brought about opposite effects. After the scandal, Yanukovych's visit to Brussels was cancelled and the signing of association agreement with EU was postponed. On the other end, negotiation with Russia concerning gas deal became even more difficult than before.

Thus Yanukovych administration, with too close connections with favorite oligarchs, suddenly came to a dead end, and Ukraine to a crossroad.

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[i] T. Krushynska, "Украинско- российские экономические отношения, евроинтеграция Украины: проблемы, роль, перспективы," Electronic Publications of Pan-European Institute 5/2008. [http://www.tse.fi/EN/units/specialunits/pei/publications/Pages/default.aspx], p.21, 24; А. М. Либман и Б. А. Хейфец, *Экспансия российского капитала в страны СНГ*, М., Экономика, 2006, с.54; А. Кузнецов, "Два вектра экспансии российских ТНК - Евросоюз и СНГ," *Мировая экономика и международные отношения*, №2, 2006, с.97; Keith Crane, D. J. Peterson and Olga Oliker, "Russian Investment in the Common- wealth of Independent States," *Eurasian Geography and Economics*, Vol.46, No.6, 2005, p.417.

[ii] Deloitte 2008: Deloitte, *Russian Multinationals: New Players in the Global Economy*, Moscow, 2008 [http://www.deloitte.com/assets/Dcom-Russia/Local%20Assets/Documents/ru_Russian_Multinationals_en_230608.pdf], p.36; Keith Crane, D. J. Peterson and Olga Oliker, "Russian Investment in the Common- wealth of Independent States," *Eurasian Geography and Economics*, Vol.46, No.6, 2005, pp.432-433.
It is true, however, that a few experts emphasize that Russian multinationals do represent Kremlin's geopolitical ambitions with different degrees by sectors. See, Peeter Vahtra and Kari Liuhto, "Expansion or Exodus? —Foreign Operations of Russia's Largest Corporations," Electronic Publications of Pan-European Institute 8/2004. [http://www.tse.fi/FI/yksikot/erillislaitokset/pei/Documents/Julkaisut/Vahtra_Liuhto_82004.pdf], pp.94-95.

[iii] http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=33036

[iv] http://www.ukrainebusiness.com.ua/news/710.html

[v] http://www.kyivpost.com/news/business/bus_general/detail/76025/print/

[vi] http://goliath.ecnext.com/coms2/gi_0199-12847754/Zaporizhstal-sold-to-Russian-investors.html

[vii] http://www.kyivpost.com/news/business/bus_general/detail/108649/print/

[viii] *Forbes (Украина)*, №8(08), октябрь 2011, с.149.

[ix] http://economics.unian.net/rus/detail/49687

[x] http://economics.unian.net/rus/detail/50799

[xi] http://www.unian.net/rus/print/364059

[xii] http://www.unian.net/rus/print/373675; http://www.unian.net/rus/print/373580

[xiii] http://politics.comments.ua/2011/04/27/250388/partiya-regionov-rashvalila.html

[xiv] http://expert.ru/2011/08/16/podvela-realizatsiya/