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“Insourcing” the recovery: maximizing engagement of Ukrainian manufacturers in reconstruction efforts

Policy Brief

Volodymyr Vlasiuk & Brian Milakovsky

30th May 2023

PeaceRep's Ukraine programme

PeaceRep's Ukraine programme is a multi-partner initiative that provides evidence, insight, academic research and policy analysis from Ukraine and the wider region to support Ukrainian sovereignty, territorial integrity and democracy in the face of the Russian invasion. PeaceRep's Ukraine programme is led by the London School of Economics and Political Science (LSE) partnering with the Kyiv School of Economics (KSE) in Ukraine, the Leibniz Institute for East and Southeast European Studies (IOS) in Germany, the Institute of Human Sciences (IWM) in Austria and Jagiellonian University in Poland. Through our collaboration with KSE we work closely with researchers, educationalists and civic activists in Ukraine to ensure that policy solutions are grounded in robust evidence and are calibrated to support democratic outcomes.

This research is supported by the Peace and Conflict Resolution Evidence Platform (PeaceRep), funded by the UK Foreign, Commonwealth & Development Office (FCDO). The information and views set out in this publication are those of the authors. Nothing herein constitutes the views of FCDO. Any use of this work should acknowledge the authors and the Peace and Conflict Resolution Evidence Platform.

Country Director's note

PeaceRep's Ukraine programme are extensively involved in providing analysis, evidence and data to prepare discussions at the London Ukraine Recovery Conference, 21st – 22nd June 2023. As part of this work, we are pleased to present data from our collaborators, Ukraine Industry Expertise and US Aid Economic Resilience Activity. Their analysis underlines the problem of underutilisation in the Ukrainian domestic economy – which is experiencing a war-related demand crisis – and demonstrates the need for policies to be effectively calibrated to supporting Ukraine's domestic industrial production and war-economy. War-related demand and reconstruction can kick-start this activity if policies are orientated to supporting Ukraine's domestic producers, thereby mitigating the downstream risk of a balance of payments crisis. Donors must be alert to the need for tailored assistance, recognising the unique problems facing Ukrainian producers and the risks that international competitors gain an unfair advantage in the domestic market simply by virtue of operating in peacetime conditions 'at home'. This calls for flexible policies that adapt existing frameworks in a manner that is conducive to supporting the Ukraine's resilience, reconstruction and war-effort.

Dr Luke Cooper is an Associate Professorial Research Fellow in International Relations at the LSE Conflict and Civiness Research Group and Director of PeaceRep's Ukraine programme.

About the Authors

Volodymyr Vlasiuk is the CEO of Ukraine Industry Expertise (UEX). UEX is engaged in research and consulting services in various sectors of the economy, particularly in industrial production and international trade, power engineering, logistics, and transportation. The company participated in developing the "Ukraine export strategy" (2016), "Ukraine Processing Industry Strategy" (2018), and elaborating the "Ukraine Recovery Plan" (2022). The established competencies allow the company to elaborate policy proposals for the development of the processing industry and the economy of Ukraine as a whole. This year UEX has performed research, commissioned by USAID, and prepared the policy proposals to maximize the insourcing of Ukraine's post-war reconstruction. Mr. Vlasiuk holds a Ph.D. in Economics, is a senior expert at the Economic Recovery Council, and an adviser of the Economic Development Committee of Verkhovna Rada.

Brian Milakovsky is deputy chief of party (technical) at the USAID Economic Resilience Activity. Begun in 2018, the Activity was supporting economic recovery and resilience among micro, small and medium enterprises (MSMEs) in eastern Ukraine and the Sea of Azov region. Since Russia's full-scale invasion of 2022 USAID ERA has received a national mandate to support displaced MSMEs, support Ukraine in its efforts to export agricultural commodities to world markets, improve conditions for industrial recovery and advocate for inclusive and sustainable models of Ukraine's reconstruction and economic recovery.

“Insourcing” the recovery: maximizing engagement of Ukrainian manufacturers in reconstruction efforts

The full-scale Russian invasion of Ukraine in February, 2022 led to widespread destruction of housing, production facilities, energy, social, and transport infrastructure. As of November, 2022 the Kyiv School of Economics calculated damages to housing and critical infrastructure at around \$105 billion¹, and this figure has certainly increased significantly since then due to continued Russian hostilities.

In order to repair, or replace, the homes and infrastructure encompassed by the damage estimate above, around \$62.8 billion worth of construction materials will need to be purchased. Given the dire economic impacts of Russia’s invasion, including a 29.1 % decline in Ukrainian GDP in 2022, it would be desirable to purchase the needed materials domestically as a significant stimulus to recovery of Ukraine’s industrial economy.²

Interviews with diverse industry players and associations conducted for the report “Activating and Strengthening Ukraine’s Reconstruction Capacity”³ demonstrate that **Ukraine’s domestic construction materials sector could provide around 90% of the needed materials for the damages accrued as of November, 2022.** Although around 15% of construction material factories experienced damage during the invasion, the sector’s non-centralized distribution across Ukraine means that most of its capacity is intact. Some important producers are irreversibly damaged and/or occupied (for example AzovStal and Ilych steelworks in Mariupol, Knauf gypsum plant in Soledar), but others are undergoing renovation after Russian shelling, such as the country’s only two PVC window frame factories in the north of Kyiv Oblast.

In addition, some producers are investing in production enhancement in expectation of enormous future demand, or even in greenfield projects to provide deficit construction materials. After the occupation of Luhansk Oblast by Russian forces in 2022 Ukraine has no operating sheet glass factories, but ground has already been broken in Berezan (Kyiv Oblast) for a facility that should be able to cover a significant part of the country’s needs. Other examples include new production facilities for aerated concrete and dry building mixtures in Lviv Oblast.

That being said, many investment projects to increase construction material production are limited by the critically low availability of credit in wartime Ukraine. The state-supported “5-7-9” subsidized credit program is functioning through state banks, but it’s maximum project size of \$2 million limits its applicability for capital projects.

Producers have also been limited by availability of electricity during Russia’s concerted attacks on Ukraine’s energy infrastructure. **A steep decline in domestic demand in 2022 meant that many factories were only operating at around 30% capacity, which understandably allowed them to conserve power.** But once demand rebounds and is potentially massively increased by donor-supported reconstruction projects, electricity availability could become a limiting factor for construction material production. Stabilization of electricity supply in Ukraine in the first three months of 2023 is a positive development in this regard, but targeted interventions may be needed to address lingering shortages.

¹ Report on Direct Damage to Infrastructure from Destruction as a Result of Russia’s Military Aggression Against Ukraine as of September 1, 2022. This report was prepared within the framework of the National Council for the Recovery of Ukraine from the Consequences of the War by the analytical team of the Kyiv School of Economics (KSE) together with the Ministry of Development of Communities and Territories of Ukraine, the Ministry of Infrastructure of Ukraine, the Ministry of Health of Ukraine, under the coordination of the Ministry of Reintegration of the Temporarily Occupied Territories of Ukraine

https://kse.ua/wp-content/uploads/2022/10/Sep22_FINAL_Sep1_Damages-Report.pdf

² “Ukraine’s GDP fell 29.1% in 2022 during Russia’s invasion.” Reuters, April 13, 2023.

³ USAID Economic Resilience Activity, 2023

Using Ukrainian-made construction materials could benefit around 100,000 workers in the sector whose livelihoods are precarious after 16 months of war, facilitating \$5.6 billion in wages and \$4.4 billion in tax revenue. Production increases to meet the increasing reconstruction needs will surely result in increased employment as well.

Importantly, a policy of “insourcing” construction materials for Ukraine’s reconstruction will direct tens of billions of dollars to its war-affected economy, which will need to perform exceptionally well in order to repay international debts accrued before and in the course of Russia’s 2022 invasion, and also to begin catching up with peer countries such as Poland in such indicators as nominal GDP (\$688 billion in Poland in 2022, while in Ukraine it decreased to \$160 billion)⁴ and percent of GDP contributed by industry (17% in Poland⁵ versus 10.4% in Ukraine⁶).

Through their actions donor countries and international financial institutions can influence the extent of “insourcing” of construction materials. First of all, they can **avoid imposing conditions on credit or grants to the Ukrainian government that require purchase of materials from the donor country**. Conversely, donors could signal active motivation to support Ukraine in procuring domestically produced materials, setting target proportions that reflect the domestic sector’s production capacity.

Reaching such targets might require technical assistance, such as training programs for Ukrainian producers to be prepared for tendering requirements of donor-funded programs. Poor understanding of and compliance with such requirements has proven a common barrier to Ukrainian businesses in competition with international peers.

Donors and IFIs can provide funding for access to finance programs, either through Ukrainian state banks or directly through international development banks, which can provide credit at rates attractive to construction material manufacturers that wish to invest in production improvements. Existing instruments such as the “5-7-9” subsidized credit program could be adjusted to serve more significant investment needs, for example by raising the current \$2 million loan cap to \$10 million, but for larger investment needs new programs would likely be necessary.

As many other sources have pointed out, international funding of wartime risk insurance for investments in Ukraine (including in the construction materials sector) could stimulate foreign direct investment where the business case is strong but excessive risk is a barrier.⁷

If these various approaches are adopted simultaneously, it **may be possible to develop a virtuous circle in which commitments by the Ukrainian government and donors to “insource” construction materials make banks more inclined to provide credit to domestic producers** (potentially drawing on donor- or IFI-funded access to finance programs). In turn, as production increases “insourcing” will become even more realistic and viable as an option.

In conclusion, a strategy of maximizing the use of Ukrainian-made construction materials in the reconstruction process could make international funding of the Ukrainian recovery work two-fold: first for meeting urgent needs for reconstruction of housing and infrastructure, and second as tens of billions of dollars of stimulus for the country’s war-ravaged economy.

⁴ Reuters 2023

⁵ World Bank. <https://data.worldbank.org/indicator/NV.IND.MANF.ZS?locations=PL>

⁶ Calculated by dividing the value added generated by processing industry by the entire value added of the Ukrainian economy. Source data: https://www.ukrstat.gov.ua/operativ/operativ2021/vvp/vvp_kv/vvpf_21_ue.xls

⁷ For example, Ganster, R., Kirkegaard, J., Kleine-Brockhoff, T., & Stokes, B. (2022). Designing Ukraine’s recovery in the spirit of the Marshall Plan.

About PeaceRep

PeaceRep is a research consortium based at The University of Edinburgh. Our research is re-thinking peace and transition processes in the light of changing conflict dynamics, changing demands of inclusion, and changes in patterns of global intervention in conflict and peace/mediation/transition management processes.

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PeaceRep.org | **peacerep@ed.ac.uk** | Twitter **@Peace_Rep_**

School of Law, University of Edinburgh, Old College, South Bridge, EH8 9YL

PeaceRep is funded by the Foreign, Commonwealth and Development Office (FCDO), UK

Consortium members include: Conciliation Resources, Centre for Trust, Peace and Social Relations (CTPSR) at Coventry University, Dialectiq, Edinburgh Law School, International IDEA, LSE Conflict and Civicness Research Group, LSE Middle East Centre, Queens University Belfast, University of St Andrews, University of Stirling, and the World Peace Foundation at Tufts University.



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