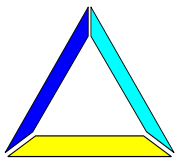
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Agricultural policy in Ukraine in mid-2005: Two steps forward, three steps back

Introduction

Recent weeks have witnessed a series of agricultural policy decisions and pronouncements in Ukraine that have shocked and disappointed those who hoped that the new, post-orange-revolution Government would accelerate the economic reform process and Ukraine's transition towards full membership in the world agricultural trading community. In the following we first consider recent policy developments on meat and grain markets, which represent the two most important examples of this disturbing turn of events. We next briefly consider the "Increased Welfare through Agricultural Development" concept that has recently been drafted by the Chamber of Agriculture. This concept, if adopted as official policy, would bring what is left of market oriented reforms in Ukrainian agriculture to a screeching halt. We close with recommendations for putting the agricultural reform process in Ukraine back on track.

1) Meat markets

In May 2005, in response to meat price increases, price and margin controls were announced.[1] This populist response conveniently overlooked three things. First, it overlooked the fact that the meat price increases in question did not come as surprise to those who understand how markets function. Herds in Ukraine were reduced significantly following the 2003 drought as feed prices skyrocketed.[2] Young animals were slaughtered earlier than usual, as was breeding stock that would otherwise have produced offspring in the meantime. It was therefore inevitable that the supply of meat would fall after a period of time determined by biological production lags. Second, it overlooked the fact that price and margin controls are usually counterproductive. Instead of lowering prices they drive suppliers into the shadows, making an already scarce commodity even scarcer. Official prices in the stores may appear lower, but there is no supply behind these prices as what supply there is has been shifted into

[1] These meat price increases contributed considerably to a significant surge in inflation. See German Advisory Group Paper U1: *High inflation in Ukraine: Roots and Remedies*.

[2] Note that the impact of the drought in 2003 was exacerbated by ill-advised Government policy at the time (see German Advisory Group paper T9: *The Situation on Ukraine's Grain Market: Crisis! What crisis?*). As a result, grain prices climbed more than they should have, leading to a greater reduction in livestock numbers than would have otherwise been necessary. In this way, inappropriate policy response to one crisis helped set the stage for the next crisis.

back rooms and onto the backs of trucks. Those who do manage to find the commodity in question end up searching, standing in lines and, more often than not, paying more and not less.[3] Third, it overlooked the fact that Government policy, specifically the dramatic recent increases in pensions and public sector salaries in Ukraine, was significantly boosting the demand for meat and was thus itself partially responsible for the meat price increases.

Alternative and more market-compatible policy responses to deal with the situation were also overlooked. These include measures that could have been taken years ago such as easing import restrictions on breeding stock, something that would have improved the quality of Ukraine's meat production overall and helped to rebuild herds following 2003. Another measure would have been to reduce or eliminate the slaughter premiums paid by the State, as these actively contributed to today's supply shortage. These measures also include replacing the diffuse VAT exemption for meat producers, which has obviously had little useful impact, with targeted spending to improve breeding herds, deal with the chronic shortage of quality protein feeds, etc. More immediately, lowering or removing import duties on meat would have allowed imports to enter and reduce the shortage of meat on Ukrainian markets, thus limiting the scope for price increases. As it is, the recent closing down of free economic zones and stricter border controls meant that import duties that could be circumvented in the past suddenly became binding, an effect that should have been anticipated and could have been avoided.

The fundamental problem on meat markets in Ukraine is that farm gate prices are very low while retail prices are generally quite high. Obviously, a government that would like to be popular is interested in higher farm gate prices, to please farmers, and lower retail prices, to placate consumers. The old 'planned economy' solution to this problem was to control marketing margins. This functioned as long as the State controlled all the resources that go into marketing, and as long as the State was able to absorb the losses that resulted.[4] Neither condition holds today. Marketing services (slaughtering, processing, packaging, transportation, storage, etc.) are mainly provided by private enterprises, and even where they are not, public enterprises must also pay the going rates for capital, labor, fuel and other inputs, and these enterprises cannot count on huge subsidies to 'hide' this fact if they operate at a loss. Nevertheless, the impulse to control prices and margins remains strong in policy making circles.

2) Grain markets

In many regards, the situation on grain markets in Ukraine is similar. In recent weeks markets have been rocked by the announcement that the entire grain crop is to be marketed *via* the State this year, and that the State will assume responsibility for all grain exports *via* its agents *Khlib Ukrainy* and the Committee for State Reserves. This announcement took place against a flurry of sometimes contradictory remarks from a variety of Government officials regarding the volume of State purchases and the amount of money that is (or is not) available

[3] Note that policy makers made the same mistake on automotive fuel markets this year in Ukraine as well.

[4] These losses were so massive that they contributed significantly to the demise of the Soviet system.

to make such purchases. At the same time, the Government announced high minimum mandatory prices for grain in excess of the relevant f.o.b. prices. The Government expects its agents to purchase grain at these high prices and also urges traders and millers to do so, promising to subsidize the interest rate on commercial credits as a form of compensation. What is unclear is whether interest rate compensation will really take place (the grain harvest is beginning and it would appear highly unlikely that an effective system can be installed immediately). It is also unclear, in the absence of a legal enforcement mechanism, whether traders and millers will be penalized if they purchase grain below the minimum mandatory prices. If past experience is a guide, the Government's 'recommendations' will be used selectively as a means of forcing grain into certain channels and favoring certain traders (public or private) over others.

The Government claims that theses measures are designed to increase the grain prices received by farmers. Note first that to the extent that grain prices do increase due to these measures, the costs of feeding livestock will increase, thus reducing the supply of meat and exacerbating current problems on that market! In other words, supporting grain prices has the same effect as a tax on meat prices. This type of link between markets is often overlooked by policy makers who react from one crisis to the next rather than pursuing a consistent strategy.

In all probability, however, the ultimate of these measures on grain markets will be to reduce rather than increase farm gate prices. In the short run the announcement of these measures has greatly increased uncertainty on grain markets in Ukraine. Increased uncertainty increases the risk premium that traders must include in their margin calculations when negotiating with farms to purchase grain. The impact will be to lower the prices that farmers receive, as larger marketing margins are deducted from given fob export prices. Furthermore, to the extent that these announcements are backed up by action and grain volumes are shifted from private traders to State agents, a larger proportion of the grain marketed in Ukraine will be marketed *via* less efficient, State managed channels. The resulting higher average costs of marketing will also end up being deducted from farm gate prices. After all, it is the private traders who have invested in improved grain storage and handling capacities in recent years, while State agents such as *Khlib Ukrainy* have continued to make losses and stand accused of a wide variety of abuses – such as thefts of grain and oilseeds stored in company facilities – that have also hurt rather than helped farmers.

In the long run, these measures send a clear message to the rest of the world that Ukraine's commitment to market-oriented reform of its grain markets is wavering. The result will be reduced investments, less efficient marketing systems than would otherwise be the case and, hence, lower grain prices for farmers. When they visit international conferences and trade shows, representatives of Ukrainian Governments always stress how much their country needs and welcomes investment to modernize its grain sector. However, once they are back at home in Ukraine, these representatives hardly miss an opportunity to blame investors for whatever happens to be ailing grain markets in Ukraine at the moment. When the harvest is bad and prices climb, grain traders are accused of exporting too much. When the harvest is good and prices fall, grain traders are accused of colluding and driving down prices. Whatever happens, traders are a convenient scapegoat.

What is to be made of the argument that grain traders dictate prices to farmers? First, the fact is that world market conditions dictate prices to grain traders. Based on these prices, traders calculate how much they can afford to pay farmers in a country such as Ukraine after covering marketing costs and allowing for a reasonable profit. The more efficient the trader, the lower the costs that he must deduct from world market prices in these calculations. Of course, if there are few traders, they may be able to collude in a specific market such as Ukraine, and in this way drive down the prices that they pay farmers for grain, thus inflating their profits. Generally speaking, the fewer traders there are, the easier and the more likely this collusion becomes.[5] Second, however, the only sensible way of reducing this risk and combating possible collusion is to open markets and encourage competition and investment, not suppress it. For years, analysts have been calling on the Government of Ukraine to improve market information systems so that farmers everywhere have access to accurate and current information on prices, production and stocks. If such information was available – and making it available would not be prohibitively expensive – grain traders would have a much more difficult time of manipulating prices (if they are doing so in the first place). Third, regional controls and even bans on grain movement are another example of Government policies that have increased rather than reduced the potential for traders (both public and private) to depress farm gate prices. A regional ban on grain movement means that farmers in that region who have grain face less potential buyers than would otherwise be the case. In other words, such bans reduce local competition for grain and therefore strengthen the market position of traders *vis-à-vis* farmers. Finally, when similar accusations were raised against traders following the poor harvest in 2003, the Anti-Monopoly Commission carried out a thorough investigation and failed to find evidence of significant abuse of market power by grain traders.

A related, but separate question concerns the farm managers with whom grain traders negotiate. Often these managers are accused of making side deals with traders, selling grain at a given price but invoicing a lower one so that managers and traders can split the difference while farms enterprises absorb the loss. In this case, again, transparency and market information is the solution, not Government intervention to dictate prices, margins or influence movements of grain. It would be much easier to make farm managers accountable for their actions if reliable information on market prices for grain was available. In this case a manager would have to explain why the prices that he/she had negotiated on behalf of his/her farm were so low.

3) The "Increased Welfare through Agricultural Development" concept

Further clouding the prospects for market-oriented reform and transformation of Ukrainian agriculture is a new concept entitled '*Increasing Welfare through Agricultural Development*' (hereinafter the *Concept*) produced by the Chamber of Agriculture, an organization that brings together agricultural producers, food processors, traders, input suppliers as well as the providers of research and extension services. While the *Concept* has not been drafted by the Government,

[5] Against this background, it is puzzling that some policy makers in Ukraine advocate a monopoly solution in the form of *Khlib Ukrainy*! Perhaps they are less concerned about the damaging effects of market power *per se* than they are about controlling who gets to enjoy the benefits of market power.

many of its authors are very influential and close to policy making circles. Hence, the *Concept* deserves to be taken very seriously. The *Concept* is long (110 pages) and divided into 5 sections: Land markets; Product markets; rural areas; research and education; and budget. A complete review of the *Concept* is beyond the scope of this paper, but a number of key issues deserve mention.

In general, the *Concept* is more a collection of special interests than a blueprint for a consistent and feasible agricultural policy. The five sections appear to have been written by largely separate groups, and while the usual lip-service is paid to the need to coordinate a complex set of interrelated measures, the actual measures proposed often contradict one another and betray a lack of consideration of inter-market linkages. One of the most fundamental problems with the *Concept* concerns funding: The spending levels proposed in the *Concept* are simply not realistic (although care has obviously been taken to keep within the bounds of Ukraine's AMS allowance), and if these levels of agricultural spending are nevertheless somehow reached, the impact on Ukraine's (increasingly threatened) fiscal balance and macroeconomic stability would be very negative.

Another key difficulty associated with the *Concept* is that it contains measures that are in clear contravention of the conditions for Ukraine's membership in the WTO. Although it has been stated time and again, it bears repeating that is it simply impossible to support prices for an export product such as grain without simultaneously either implicitly or explicitly subsidizing exports. If Ukraine wishes to join the WTO it will have to accept a zero limit on the use of export subsidies, and this is tantamount to a zero limit on price support for its agricultural export commodities such as grain. Hence, it must be made perfectly clear that policy makers who support the *Concept* are, whether they wish to state this explicitly or not, against WTO membership for Ukraine.

Specifically, the *Concept* contains a number of provisions that are difficult to reconcile with market reforms. Two of these are of particular importance.

- According to the *Concept*, the value of agricultural land is to be determined by *fiat*, based on 'objec!ive' formulae that some Ukrainian experts have been propounding for years. Agricultural enterprises are to be forced to include the resulting land values in their balance sheets. This will have the effect of further reducing farm profitability in Ukraine, which is presumably a convenient effect that will make it easier to justify subsidies. These provisions turn the agricultural land market on its head. In a market economy, agricultural land prices are a function of farm profitability, not the other way around; if land prices are low it is because farms are not able to make profits with land and are therefore unwilling to bid high prices for it.[6] Furthermore, in a market economy, land prices are much more complex than any formula; patterns of land prices over space and time depend on an ever-changing set of technological, management and logistical factors, and any formula will inevitably lead to serious distortions. Finally, the fundamental sense of making land more expensive in a situation in which capital is in short supply is highly

[6] This mechanism of land price determination has been understood by economists since Johann Heinrich von Thünen's work on land rents in the early 19th century.

questionable. If they do have capital, farmers should be spending it on machinery and equipment, not on land. These investments will increase profitability, and land prices will automatically increase as a result. Some proponents of the land price scheme suggested in the *Concept* may hope that by announcing a set of artificial land prices, farms will suddenly have collateral with which to borrow the capital needed for investments. Does anyone seriously believe that banks and other potential lenders will be fooled by artificially high non-market land values?

- The *Concept* proposes that all agricultural products produced in Ukraine be divided into three categories: competitive, potentially competitive, and not competitive. Depending on the respective category into which a product falls, its production is to be subsidized briefly, temporarily or permanently. This section of the *Concept* reminds the reader of countless 'concepts', 'plans' and 'programs' that have been produced in the past in Ukraine. It reflects the old style of thinking in terms of tons and norms. It suggests that bureaucrats can control markets, that they can foresee technological change and comprehend the endless complexity of patterns of relative costs and profitability from region to region and farm to farm. It fails to recognize that while there may be statistics on average costs, yields and profitability, there is no such thing as an 'average farm' that conforms to these statistics. A product that is competitive in one region of Ukraine under modern, efficient management will simultaneously be uncompetitive in a less suitable region or under less efficient management. In this case, is the product competitive or not, and what level of subsidies should be paid if it is not? Moreover, the boundaries between competitive and non-competitive are constantly shifting. A new breed of corn may make production possible in regions that were excluded in the past; the development of a new processing technology (e.g. biofuels) will make production systems profitable in ten years that we can barely imagine today. The so-called 'experts' who determine what is profitable and what is not will always be years behind this process of innovation and change. Indeed, their interference in markets, their artificial prices and quantity goals will stifle this process, reducing the overall profitability of Ukrainian agriculture in the long run. Ukraine's competitors on world markets will be very pleased and relieved when they read the agricultural market provisions contained in the *Concept*.

Conclusions and recommendations

The transition of agriculture is an immense and daunting task, but it is also a task that grows with each day that it is postponed. With the exception of a few brief episodes over the last 14 years, Ukraine's commitment to transforming its agriculture into a modern, dynamic sector that generates wealth for rural areas and the country as a whole has never been particularly strong. Recent events suggest that what little commitment there remains is in danger. Key players in the policy formulation and implementation system either do not understand how markets function and what careful doses of policy can do to enhance this function, or they do understand but choose to ignore this understanding in pursuit of short run political gains.

Instead of being guided by a clear set of goals and principles derived from a realistic picture of the sector's strengths and weaknesses, agricultural policy experience worldwide and international commitments, Ukraine's agricultural policy is based on outdated, discredited models, populist impulses, and faulty

analysis. If Ukrainian agriculture was not so fundamentally fertile, the result of this massive, sustained policy failure would be a humanitarian crisis. As it is, nature's gifts and hard working farmers compensate for the worst excesses. It nevertheless remains a tragedy that these gifts and the hard work have been entrusted by history to policy makers who lack the skills and vision that is needed to harness them effectively.

The main problem that agricultural policy in Ukraine has never come to terms with is the fundamental tension between the goals of increasing farm gate prices on the one hand and maintaining low retail prices for consumers on the other. Between these two prices lies the marketing margin. According to the old Soviet way of thinking, marketing is a necessary logistic evil at best, and a parasitic activity at worst. As a result, policy makers reflexively blame 'traders' and attempt to implement price and margin controls whenever farm gate prices are perceived as being too low and/or retail prices too high. This response is tempting because it creates the illusion that it is possible to increase farm gate prices, reduce consumer prices and punish wrongdoers at the same time – a win-win-win solution. This response is counterproductive, however, because it overlooks the fact that marketing an essential productive activity that adds time, form and location utility to agricultural commodities. It is also counterproductive because it sends a very clear message to potential investors: Danger – stay away!

The only sustainable way to reduce meat, grain and other agricultural margins in a market economy is to increase the efficiency of the agricultural marketing sector. The key ingredients in this process are competition, transparency and investment. Competition ensures that the providers of marketing services cannot abuse market power. Transparency and market information ensure that the competitive response to market opportunities is rapid. Investment ensures that innovations are introduced quickly so that the marketing sector is efficient and margins are as small as possible.

We therefore recommend that the Government of Ukraine take immediate steps to increase competition in agricultural marketing. To this end:

- All remaining public enterprises in this sector – including *Khlib Ukrainy* - should be privatized as soon as possible.

- All implicit barriers to competition (e.g. 'recommendations' that force farmers to deliver to certain traders or processors, restrictions on regional movements of agricultural commodities) must be eliminated.

- The temptation to blame traders and other providers of marketing services whenever something goes wrong must be suppressed. If abuses of market power are suspected, sober and objective analysis by the Anti-Monopoly Commission is the appropriate response.

- The creation of a dependable, public market information service should be an absolute priority in Ukraine.

SvCT, Lektor SZ