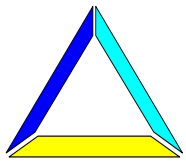
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T9

The Situation on Ukraine's Grain Market: Crisis! What crisis?

Executive Summary

Due to a poor grain harvest this year Ukraine has become a net importer of food grain in 2003/2004. This has lead to an increase in grain prices and generated a sense of 'crisis' among the public. However, taking into consideration the measures that the government has undertaken it may be more appropriate to speak of a crisis in agricultural policy making in Ukraine than of a crisis in Ukrainian agriculture:

- By emphasising individual responsibility the government has sustained the myth that people can control markets and created an atmosphere in which each bureaucrat is eager to appear active in monitoring the market and eliminating alleged market failures. The result has been more, not less market failure.
- Government interference in the form of price, profitability rate, mark-ups and grain movement controls has done nothing to correct the situation on the market but, on the contrary, has further disbalanced and fragmented markets.
- Announcements that the government intends to purchase grain are counterproductive. What Ukraine needs now is not more demand on its grain markets, but rather more supply.
- Opacity and vagueness of government policy regarding grain imports has slowed down imports by private firms, thus reducing supply and increasing prices even more.
- In general, many recent measures cast doubt on Ukraine's continued commitment to market-driven agricultural reform and restructuring. If administrative controls continue to be tightened, then the 2003 harvest will be remembered no only for the immediate hardship that it caused.

The inescapable fact is that Ukraine will have to import food grain in the 2003/04 season. In essence, policy makers should adopt the maxim 'less is more'. The last months of hectic and often counterproductive activity have

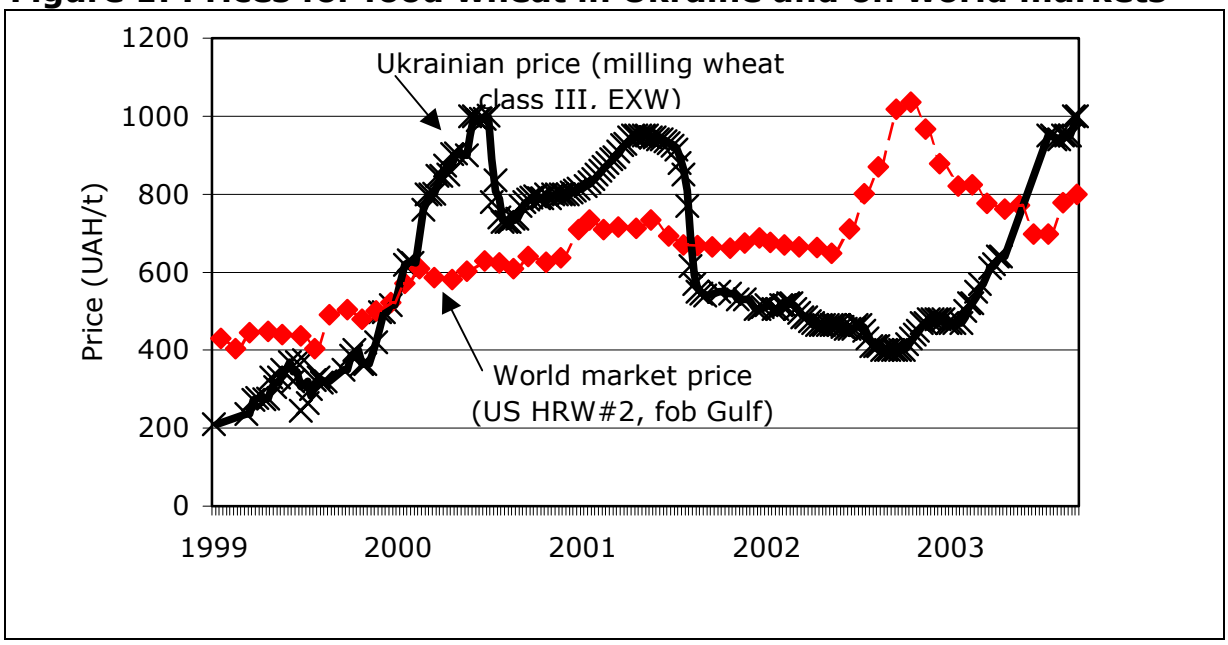
done nothing to correct the fundamental problem that Ukraine has brought in a bad harvest, that it must therefore import grain, and that this grain is currently expensive on world markets. Indeed, there is nothing that any policy maker or any number of emergency meetings can do to change any of these basic facts. Hence, all that agricultural policy can do is to ensure that prices in Ukraine do not increase any more than necessary by facilitating imports, and to ensure that as much help as possible is channelled towards those individuals and households for whom the current situation creates true hardship.

Introduction

The current situation on the Ukrainian grain market began to take form early this year as severe winterkill took its toll on grain crops. When this was followed by a prolonged drought in the late spring and early summer, it became apparent that Ukraine was likely to become a net importer of food grain in 2003/04. Concern and alarm has deepened in recent months as harvest data point to a total grain crop of perhaps 20 million tons (mt), down from about 36 mt in 2002.[1]

The situation is especially critical for wheat, with roughly 5 mt harvested this year vs. some 20 mt in both 2001 and 2002. After exporting roughly 5,5 and 6,5 mt of wheat in the 2001/02 and 2002/03 marketing years, respectively, it is estimated that Ukraine will have to import between 2,8 mt (Ukrainian Grain Association) and 3,7 mt (UkrAgroConsult) of food wheat in 2003/04. As a result, prices for food wheat in Ukraine have exploded, and the current relation between Ukrainian and world market prices resembles that which prevailed in 2000 and early 2001 when Ukraine was last a net importer (see Figure 1).

Figure 1: Prices for food wheat in Ukraine and on world markets



Source: UkrAgroconsult (Market Weekly Report, various issues) and USDA/ERS (Wheat Market Outlook, various issues).

How have policy makers responded to this situation? The Cabinet of Ministers of Ukraine issued Decree #1150 on July 24, 2003. This decree contains a variety of provisions including personal consequences (several policy makers are relieved of their duties or subject to investigations) as well as a call for a detailed inquiry by the Anti-Monopoly commission. It

[1] There is considerable disagreement about grain harvest figures in Ukraine, past and present. Figures from UkrAgroConsult are used throughout this paper.

also empowers regional authorities to "thoroughly monitor food grain movements and prices on regional markets" and "to pay a closer attention to monitoring of staple food prices, mark-ups [and] profitability rates, and undertake measures to keep them from rising if there are no reasons for price increases" (Articles 28 and 33, respectively). Finally, it contains provisions for intervention purchases by the State Reserve Committee.

Beyond Decree #1150, agreements to purchase grain from Kazakhstan and Russia have been announced, as have plans to introduce an export tax for feed grains. In addition, the Verhovna Rada is considering a draft law "On financial support of agro industrial industry in Ukraine" in which state price regulation is secured and developed. Finally, traders report that they have been subject to intense scrutiny, and the press has been full of rumours about new and intensified regulation of grain markets in Ukraine, including reports that the government intends to reintroduce the state order system.[2]

In the following we evaluate these measures with respect to two important criteria: 1) whether they are suited to relieve the current tensions on Ukrainian grain markets, and 2) their impact on the overall direction of agricultural policy making in Ukraine.

Crisis! What crisis?

It is a fact that weather conditions have devastated the harvest this year. Whether or not this amounts to a 'crisis' is a matter of semantics. For historical reasons, Ukrainians are understandably very attuned and sensitive to conditions in agriculture and especially grain production. On the other hand, it is important to realise that food security in Ukraine is not fundamentally threatened at the moment. Despite what some see as the worst crop weather of the last century, Ukraine's farmers have succeeded in producing at least 20 mt of grain. Furthermore, the current situation in Ukraine is not unique. Other countries have gone through similar situations in recent years, with the grain crop in Australia, for example, falling to 14,9 mt in 2002/03 from 37,5 mt in 2001/02, a reduction of just over 60%[3]

It is not our intention to downplay the gravity of the current situation. However, given agro-climatic conditions in the country, it is clear that Ukrainian grain production is vulnerable. It was, is and will always be subject to intermittent fluctuations. When these occur, policy makers can help most by displaying a steady hand and not unsettling markets further. We are concerned that some policy response to this year's grain harvest

[2] See the Friday September 12th issue of Kyiv Post Daily (p. 2), in which Agriculture Minister Serhiy Ryzhuk is cited as announcing government plans to "return to its previous system of crop management, whereby it instructs farmers to produce specific quantities of each agricultural commodity"

[3] The most recent projections indicate that the Australian crop will rebound to 35,1 mt in 2003.

has heightened the sense of crisis rather than lowering it. Some elements of this response have contributed to an atmosphere in which rumours multiply and individual policy makers and their institutions appear to be trying to outdo each other in 'crisis management'. This sense of crisis appears to be providing anti-reform forces with a pretext for the re-introduction of interventionist measures. As a result, it may be more appropriate to speak of a crisis in agricultural policy making in Ukraine than of a 'crisis' in Ukrainian agriculture. This policy crisis could have much more damaging long term repercussions for agriculture in Ukraine than the poor harvest itself.

Evaluating the response so far

A recurring theme in the policy response to this year's harvest has been that of individual responsibility. Policy makers at various levels have been dismissed, and some have been subject to criminal investigation. While there is no question that individuals should be held accountable for negligence and wrongdoing, the emphasis on individual responsibility with respect to the current situation on Ukrainian grain markets has done considerable damage in two respects. **First**, it has helped to sustain the myth that people can fine-tune markets. It suggests, falsely, that the right group of individuals pushing the right policy 'buttons' could have avoided the current situation. In fact, there is nothing any individual or institution could have done to change weather conditions and significantly increase this year's harvest.

Second, the emphasis on personal accountability has created an atmosphere in which bureaucrats, especially at the regional level, are very eager to appear 'active'. Consider Article 28 of Decree #1150, which calls for the regional authorities to both "thoroughly monitor food grain movements and prices" and at the same time to "eliminate any administrative intervention impeding free grain movement…". Clearly, these instructions are contradictory. With the fate of their former colleagues who have been accused of failing to take appropriate steps in mind, most regional authorities who still have a job are emphasising the first instruction to the detriment of the second. They are monitoring and controlling very closely, and in the process they have not eliminated but rather expanded and strengthened administrative intervention on grain markets.[4]

As a result, the Ukrainian grain market has effectively been **fragmented** into an collection of regional grain markets. In effect, by giving regional authorities both the power and the incentives to interfere, Decree #1150 has effectively eliminated one of the most important mechanisms by which markets can help to absorb or dampen shocks such as this year's poor harvest. This mechanism is market integration, by which trade and

[4] See Decree of the Cabinet of Ministry #475 on August 6, 2003 "On creation of the government working group for controlling of the situation on the food market"

arbitrage between regions can spread the impact of a shock evenly, ensuring that each regional market bears its share of the burden. It is somewhat ironic that Ukrainian policy makers are negotiating a common market arrangement with other states of the Former Soviet Union at a time when Ukraine has taken a big step away from being a common market itself.

The only direct policy intervention that might have helped to relieve the current pressure on food grain markets in Ukraine would have been the accumulation of public or private stocks in 2001 and/or 2002. The fact that **public stocks** were not accumulated is certainly not the fault of any of the individuals who have been reprimanded or relieved of their positions. Stocking 2 mt of milling wheat – enough to significantly relieve markets this year – would have cost somewhere between 0,8 and 1,0 billion UAH last summer and fall (2002), when prices ranged between 400 and 500 UAH/t. Handling as well as storage costs and losses would have added to this bill. However, despite repeated announcements made in 2001 and 2002 that the Strategic Reserve or other public institutions would accumulate stocks, the required funding was never made available.

The fact that **private individuals and firms** did not stock enough in the past to relieve markets this year also comes as no surprise. Farmers in Ukraine are generally cash-strapped and obliged to sell their crops as soon as possible after the harvest for liquidity reasons. So even if they had the required storage facilities, which they generally do not, they could not be expected to store large amounts of grain. As it is, private individuals or firms generally have no alternative to using public (Khlib Ukrainy) storage facilities, and these are known to be prohibitively expensive. Hence, failure to privatise Khlib Ukrainy and foster competition on the market for grain storage services in the past has reduced the ability of market mechanisms to absorb the shock of this year's bad harvest.

In recent years, private traders have begun to invest in grain storage and handling capacity in Ukraine. However, many actions by policy makers in response to the recent 'crisis' have unsettled traders considerably. Traders have been subject to intense scrutiny and threats. For example, they have been threatened with a punitive tax of 10% on last year's profits if they do not supply food wheat for 900 UAH/t, a price which is certainly unrealistic (see Figure 1). Some traders have been told that their shipments of feed grain exports (for example barley) will only be cleared to leave Ukrainian harbours if the same ships return loaded with wheat within a certain period of time. Added to these specific forms of intervention, traders have been confronted with rumours that the government intends to establish a Ukrainian monopoly grain trader. These panic reactions by policy makers threaten to undo the progress that has been made over the last 3 years, scaring off the most important source of new capital and know-how in the Ukrainian grain sector.

These considerations, by the way, are also pertinent to the **unfounded allegations** that too much grain was exported too quickly following the 2002 harvest. With no realistic option for storing their grain, farmers were happy to sell it as quickly as possible. The best prices were being paid by traders. The state could have purchased grain for storage itself, but as outlined above it routinely failed to fulfil its announced targets. The pledge price system introduced last year could have helped some farmers withstand the pressure to sell their grain to traders right after the harvest, but this system, too, was under-funded. Moreover, the pledge system was also new and untested. After years of experience with confiscatory state orders, many farmers would rather not transact with state agents; they were sceptical that they will have a meaningful option to reclaim pledged grain at a later date and, hence, they were (and are) reluctant to pledge their grain to the authorities. In retrospect it may seem obvious that less of last year's harvest should have been exported and more stored, but hindsight is always perfect and Ukrainian agricultural policy has not succeeded in creating an environment that is conducive to public and private grain storage.

Decree #1150 also calls for the purchase of grain by state authorities. This is unlikely to help relieve the current situation on grain markets in Ukraine; in fact it is likely to create additional tensions. **First**, state purchases do not add a single kilogram to grain supply in Ukraine. Instead, they reduce supply in the short run, thus increasing tensions and prices. As outlined above, the time to store grain was last year, when supply was abundant and prices much lower. State purchases now simply increase the imbalance between demand and supply further, compounding the current situation. The argument that these purchases are required to correct imbalances in grain supply across regions and time is not convincing; if the authorities did not interfere in regional movements and storage of grain, the market mechanism would do a much more efficient job of correcting these imbalances than bureaucrats can. Moreover, in the draft budget for 2004 recently submitted to the Verchovna Rada there is no allowance for expenditure on state grain purchases.

Second, state grain purchases in Ukraine have a history of being unreliable (see above) and opaque. Many announcements are made, but it is never clear to market participants how much really has been and will be purchased, and under what conditions this grain will be released. Hence, state grain purchases to date have had the effect of increasing uncertainty rather than stabilising markets. Grain market stabilisation policy should not be seen as something that is highly political and 'strategic' and therefore secretive, but should rather be carried out in a open and transparent manner. This means that policy targets (i.e. at what prices purchases will take place and up to what amounts, and at what prices these amounts will be released) should be clearly stated, and the (single!) institution responsible for public stockholding should be obliged to regularly disclose what stocks it is holding. In this way market participants

can concentrate on 'normal' sources of risk (which are bad enough in agriculture), and do not have to worry about additional risk in the form of erratic policies. Policy makers who would like to try their hands at controlling or out-guessing grain markets (in other words speculation) should apply for jobs as grain trader for example with Cargill or some other grain trading firm at home or abroad.

The same transparency imperative applies to import and export regimes as well. On the import side, efforts to secure grain supplies from Kazakhstan and Russia could have the effect of stabilising Ukrainian grain markets. But initial announcements that these countries will supply a combined 2,2 mt did not have this effect because they were vague and the stated price (550 UAH/t) was considered unrealistic. Why should Russia and Kazakhstan provide Ukraine with food wheat at this price, when world markets are tight and corresponding prices (135-140 US$/t or roughly 750 UAH/t)?[5] Is this essentially a 'present' from old friends, or will Ukraine somehow repay the difference between 550 UAH/t and the true value of the grain in question. Or will, in the end, less Kazakh and Russian grain than announced be delivered at higher prices? Without clear answers to these questions, the announcement of the deals with Kazakhstan and Russia actually added to uncertainty. Traders were afraid to arrange necessary commercial imports because they were worried that they might have to compete in Ukraine with 2,2 mt of inexpensive preferential imports from Kazakhstan and Russia. World market prices have increased in the meantime, and now Ukraine will have to pay more to satisfy its demand than would have been the case if imports has been arranged sooner.

This situation was exacerbated by the delay in removing import restrictions for food grain.[6] Indeed, one must question why Ukraine needs such restrictions in the first place. In an export situation they are certainly not necessary because export parity prices in Ukraine are so much lower than world market prices (see for example the year 2002 in Figure 1) that no trader in his right mind would want to import in the first place. And in an import situation when imports are desperately needed, import restrictions make grain more expensive, which is counterproductive to say the least. Furthermore, the political procedure of removing import restrictions takes time which, as outlined above, has this year had the effect of increasing the cost of Ukraine's food grain imports. Import restrictions also bind policy making capacity as individuals and firms with influence try to benefit from the rents associated with a partial removal of import restrictions (tariff rate quotas, for example).

[5] Indeed, according to a recent announcement (Business Week, Sept. 8-14), a firm in Poltava (Kernel Group) has purchased 50.000 tons of Kazakh food wheat for 47,5 million UAH, which corresponds to a price of 950 UAH/t

[6] The law providing for duty free imports of food grain was not passed until the third week of July, 2003.

In summary, initial policy responses indirectly impeded required imports. Why is this being eliminated? Now policy makers have noticed that world market prices are increasing and are calling on the regions to step up their imports before prices increase yet more. This is yet another example of what can happen when policy makers attempt to second-guess market outcomes rather than ensuring that markets function smoothly.

What can be done?

The inescapable fact is that Ukraine will have to import food grain in the 2003/04 season. How much will have to be imported is not clear; many different figures are being bandied about, but all are based on a series of unknowns such as the exact size of this year's harvest, the exact composition of the harvest (qualities), the qualities and prices of available imports (which influence blending possibilities in Ukraine's flour mills) and, of course, domestic demand (which is not, contrary to what some experts would have us believe, a universal constant!).

There is no need for policy makers to determine the exact amount of required imports or to somehow manage and control imports. Their first responsibility is to ensure that imports are subject to as little friction as possible (no restrictions, no need for approval or the collection of rubber stamps, as little registration and bureaucracy as possible). The only interference that is required is the observation and publication of data on individual transactions (a simple weekly published list of what qualities and quantities or grain arrived at what harbours from what sources, including complete disclosure of any government or inter-government transactions) and, of course, internationally accepted phyto-sanitary testing at the border. The publication of data on import flows will help the market find the right dosage that brings supply and demand in line with one another, and elimination of unnecessary frictions will ensure that prices in Ukraine increase no more than is absolutely necessary.

Policy makers should be candid about the implications of the current situation for grain prices and, hence, consumers and producers. Milling wheat costs between 900 and 1000 UAH/t at the moment in Ukraine (see Figure 1). This export parity price makes sense, given recent world market quotes of perhaps 140-150 US$/t and fobbing and handling costs of perhaps 25-30 US$/t. Announcements that the domestic price can be stabilised at 750 or 800 UAH/t are counterproductive in the sense that they create expectations that cannot be fulfilled and, hence, undermine credibility. Farmers and traders cannot be forced to provide grain at below-market prices, at least not in a market economy. The simple fact is, making 2 mt of imported grain available for 750 UAH/t on domestic markets would cost the government 0,5 billion UAH. Such amounts of money are probably not available and, anyhow, they could be spent much more effectively than on a blanket subsidisation of grain prices.

The current situation calls for a targeted rather than a blanket approach. Artificially capping wheat, flour and bread prices benefits all consumers, including the many in Ukraine who have done comparatively well recently as the economy has grown and real incomes have increased over three consecutive years. These consumers can afford to pay higher prices for bread without any threat to their food security. This means that in terms of social justice, blanket controls on grain and bread prices result in considerable waste. **Policy should instead focus on identifying and helping those poor consumers for whom the current situation really does represent a crisis** at the household level, for example *via* a food stamp program for pensioners, the unemployed and those on social security.

Blanket controls on grain and food prices also have the effect of reducing farm earnings. From a Ukrainian farmer's point of view, grain markets have a built in stabiliser; when the crop is low, prices are higher, and *vice versa*. Of course, this stabiliser is not perfect and for those farms that have next to nothing to sell this year, high prices provide little comfort. But why should farmers, who have already been extremely burdened by higher costs (reseeding, wasted inputs etc.) and a lower harvest this year, be burdened even more by indirect taxes in the form of price controls or export restrictions for feed grains? It is imperative that next year's harvest be better. While weather conditions remain beyond human control, and the government does not have the financial resources to provide significant direct financial support, it can at least see to it that it does **not unnecessarily add to the farm sector's problems by taxing farmers** to provide untargeted support to consumers.

Government purchases of grain cannot help to improve the current situation. If there was a time to store grain, it was last year when prices were at less than half the current level. At the moment, government purchases of grain only add to the demand for grain at a time when demand is already too high with respect to supply. If the government wishes to purchase grain in order to supply it to needy groups or major population centres, it should do so at the current market price (which is in excess of 900 UAH/t for class III milling wheat) and not coerce farmers to sell for less. And before it takes such steps it should consider that **integrated markets** (in recent months, regional barriers to trade have flourished in Ukraine) **and direct income support to the needy are much more effective and targeted ways of ensuring food security**. Government storage is a topic for the future when grain harvests rebound. Steps should be taken now to ensure that if and when the time for government storage returns, it is done in a transparent and open manner by a single operator so that it does not destabilise markets.

In essence, policy makers should adopt the maxim 'less is more'. The last months of hectic and often counterproductive activity

have done nothing to correct the fundamental problem that Ukraine has brought in a bad harvest, that it must therefore import grain, and that this grain is currently expensive on world markets. Indeed, there is nothing that any policy maker or any number of emergency meetings can do to change any of these basic facts. The food grain prices facing Ukraine on world markets are beyond its control. Hence, **all that agricultural policy can do is to ensure that prices in Ukraine do not increase any more than necessary, and to ensure that as much help as possible is channelled towards those individuals and households for whom these prices create true hardship**.

By focussing on these basic tasks, policy makers could begin to **repair the considerable damage that has already been done**. The current impression both within Ukraine and abroad is that Ukrainian agricultural policy making is as much in crisis as Ukrainian agriculture itself. Many recent measures (or at least the announcements thereof) have cast doubt on **Ukraine's continued commitment to market-driven agricultural reform and restructuring**. Many observers are concerned that Ukraine's agricultural policy makers are beginning to backtrack and re-introduce some of the controls and mechanisms that did such damage in the 1990s. If this is permitted to happen, then the 2003 harvest will be remembered not only for the immediate hardship that it caused.

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September 2003