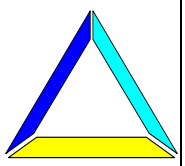
INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING IN UKRAINE
GERMAN ADVISORY GROUP ON ECONOMIC REFORM

Reytarska 8/5-A, 01034 Kyiv, Tel. (+38044) 228-6342, 228-6360, Fax 228-6336
E-mail: institute@ier.kiev.ua, http://www.ier.kiev.ua



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Should a "Strong Ukrainian Grain Trader" be Established?

Executive Summary

In the wake of the most recent developments in Ukrainian grain markets (volatile prices and export volumes) the activity of foreign grain trade companies is being observed with mistrust, assuming that these companies charge Ukrainian farmers low prices and realise huge profits which are drained outside the country. At the same time the idea of establishing a "strong Ukrainian grain trader" has been revived. KHLIB UKRAINY would probably be a candidate organisation for becoming something as the "Ukrainian Wheat Board". However, grain markets in Ukraine as well as in other places in the world are highly competitive, which causes profit margins to be relatively small. This means that the opportunities for grain traders to exploit farmers or consumers are strongly limited as long as they are **not** granted a monopoly position by the state. Since such a monopoly is exactly the idea behind establishing a grain board, neither farmers nor consumers or taxpayers are likely to benefit from such a "strong Ukrainian trader".

Recommendations

1. The government should resist the temptation to turn Khlib Ukrainy into a monopoly grain board. Such institutions tend to become a burden to both farmers and taxpayers.
2. Most importantly, the state has to ensure that contracts between private agents have to be fulfilled. This decreases the uncertainty component in trade margins.
3. In the case of the grain, the government has to make sure that competition governs the market, thereby preventing both domestic and foreign companies from exercising pricing power and realising excessive profits. Some current problems are caused not by too much but rather too little competition, i.e. by continued formal and informal intervention on grain markets in Ukraine by regional authorities.

4. The agricultural ministry should establish and constantly improve market information systems for farmers and other agents in the market. Better market information ensures a level playing field for all market participants and ensures that all can make better decisions for the future.

1 Introduction: The Situation on the Ukrainian Grain Market

During the spring period of 2003 rising prices for wheat have lead to political irritations due to the fear of rising bread prices. Even though increasing grain prices benefit grain farmers, they hurt animal producers and consumers. At the same time the strong winter 2002/2003 combined with a drought in the spring have driven down the harvest forecasts for Ukrainian grain in 2003 considerably. In the case of wheat, a production shortfall of more than 60 % is expected in comparison to the previous year, with a harvest of 6 to 8 mln t after 19.5 to 20 mln t in 2002.

On the other hand, when grain prices were falling in 2001 and 2002, fear of too low prices led to the initiative to introduce a pledge price system for grain.[1] This creates the impression to the independent observer that it is not so much the direction of the price movements but rather the movements themselves which puzzle Ukrainian politicians, and the resulting grain price levels which are regarded as inappropriate. Unstable ("volatile") prices indeed make life harder for both producers and consumers, since they obstruct the future planning of production, investments and consumption. This explains why many politicians have the constant desire to stabilise prices and exercise more control over commodity markets. Moreover, it is feared that grain traders make excessive profits by paying low prices to farmers and selling the grain for unjustified high prices. Especially foreign trade companies are suspected of making huge profits from grain trade.

In order to fight price volatility, to ensure a "reasonable price level" for grain, and to prevent the draining of trade profits to third countries, the establishment of a strong Ukrainian grain trade company is discussed from time to time. Most prominently, some politicians would favour to turn Khlib Ukrainy into something similar to the Canadian Wheat Board (CWB), a state monopolist operating in Western Canada and at the same time one of the biggest wheat and barley exporters in the world. This paper intends to contribute to this discussion and is organised as follows. First, the

[1] Advisory Paper S6 "Grain Market Regulation in Ukraine: Options and Evaluation" from July 2002 of the German Advisory Group.

tasks of grain trading companies in international markets are described with the underlying question whether there are Ukrainian companies which could compete in these markets. Second, the international experience with parastatal grain trading organisations is illustrated using the example of the Canadian and Australian Wheat Boards. Third, the general question about the welfare impact of foreign ownership of capital working in Ukraine will be answered.

2 The Role of Traders in Commodity Markets

Trade as an economic activity has the purpose to bridge the physical and temporal distance between producers and consumers, particularly in agriculture, where production is seasonal and dispersed over the countryside in almost the whole world. In the case of grain which is produced by a big number of farmers in a country and consumed by somewhat less flour mills at home or abroad, grain traders carry out some typical tasks:

- Collecting grain from farmers, selling the grain to domestic mills or foreign customers (**contracting** with many producers)
- Transport of grain (**logistics** with own or leased means)
- Cleaning, drying and storage of grain (capital-intensive **pre-processing** activities in own or leased facilities)

In order to be able to perform such functions in the international market, the big grain trading companies have become sophisticated organisations with considerable special skills:

- **Market information** on agricultural markets has to be collected, and not only for the specific product but also the close substitutes. Moreover, exchange rates and the freight rates have to be closely monitored.
- **Logistics:** To earn any profit grain traders have to be perfect in logistics. The faster a ship is loaded and unloaded, the less time and money is wasted. Grain trade has developed into a just-in-time business.
- **Regulations:** International law and country specific laws on import declaration, labelling, and taxes have to be closely observed. Examples for country-specific laws apply to the grain and oilseed quality, maximum residual levels of pesticides (sometimes dozens of substances have to be checked for), heavy metals, aromatic hydrocarbons, mycotoxins such as DON and ZEN, or approvals for Genetically Modified Organisms (GMOs). Within the next two years the EU will establish a complicated system of traceability, which has to be established by

grain traders. More examples like the Cartagena Protocol on Biosafty can be mentioned.

- **Trade finance:** Grain traders sometimes store the grain for up to several months. Therefore they need a very good reputation and international credit ranking in order to obtain the most advantageous trade credits.
- **Risk management** includes the price risk which makes hedging on international commodity exchanges necessary. Hence, somebody has to monitor these exchanges. Moreover, the exchange rate risk for all relevant currencies is hedged as well.
- All grain traders have special departments responsible for **financial and payment management**. Information on many countries in the world whether a client is creditworthy has to be gathered. A special problem is how to ensure payment discipline in developing countries which buy around 80 % of the world's grain traded (a Panmax ship with 50.000 tons of grain is worth more than 5 mln US$.)

All these activities are services which are necessary for a well-functioning grain marketing chain. This bundle of services constitutes the product which the grain trader implicitly sells to his customers by exploiting the margin between producer and processor prices. The list may not be complete, and we do not claim that every grain trader needs to be involved in all of these activities. A small local trader in Ukraine will probably not be involved in import/export operations; he may not organise the transport to customers or handle the grain himself in an elevator. But it can be taken for granted that most big grain traders will offer most of these services, as can be seen when looking at the most important players on the international grain market such as Cargill, Ramburs or Toepfer. Moreover, when a grain trader wants to expand his business, this inevitably means that his regional coverage (sources and destinations of grain) will have to increase. The big players on the world market are active on all continents. This requires them to maintain a network of agents and detailed knowledge of local conditions. Both networks and expertise have been developed over more than 150 years and constitute the main asset for the trading activities of the companies.

At the moment there is hardly any Ukrainian company which might be able to fully assume the role which the big companies are playing. One major problem is the smaller size of the domestic companies which requires them to charge higher margins in order to remain profitable. Moreover, Ukrainian trade companies do not have access to the wide network of agents and the experience on world markets, which makes it less likely for them to strike favourable deals. However, Ukrainian

traders such as the United Grain Group or Olimpeks have been learning quickly over the recent years and are on their way to challenge the predominance of the Cargill and Co. To some extent they are able to compensate their lack of international experience with better market connections within Ukraine.

But there is another reason why it is unlikely that a Ukrainian trader will completely drive out foreign companies from business. Due to the relatively volatile yields in Ukraine the excess grain supply for exports – varies greatly from year to year. Hence, a trader who operates exclusively with Ukrainian grain will see his volume fluctuate considerably from year to year and will have a difficult time establishing a reputation as a dependable supplier year in, year out.

3 The Economic Effects of Foreign Companies operating in Ukraine

To give an impression about the activities a foreign grain trader in Ukraine, the examples of Cargill and Toepfer are presented in the following. **CARGILL** started its activities in Ukraine in 1991 with the establishment of a Corn Research Institute in Dnipropetrovsk. After having opened a permanent representative office in Kiev in 1994, the company started to merchandise grain, oilseeds, petroleum, steel, sugar, fruit juice concentrate and cocoa. Cargill has also invested in a modern seed plant, fertiliser warehouse facilities, and grain elevators. **TOEPFER** has launched a project with the assistance of the EBRD, whereby a revolving credit facility will be used to originate (i.e., purchase directly from farmers), transport, store and then either export agricultural commodities or process them on a tolling basis in Ukraine, with the finished goods sold locally or exported.

What do these activities mean for the national economy of Ukraine, and for farmers, consumers, and other market participants? Two aspects shall be pointed out, arbitrage and investment.

3.1 Arbitrage

Arbitrage means that by moving grain from surplus to deficit world regions, an international trader contributes to the stability of prices and supplies of grain world-wide. Imagine, for instance, what would have happened if the exports in 2002 had not occurred. The prices for producers would have dropped much further than they already did when Ukraine moved into the net export position.

On the other hand, when a harvest fails, grain traders are the one to supply the affected country with surplus grain from elsewhere. Of course traders charge a

margin for their services. But as long as competition works, there will be no excessive profits from grain trade. It can be fairly assumed that grain trade is one of the less profitable businesses in the world, because there is a sufficient number of competing firms, markets are comparatively transparent, and the commodities are quite homogeneous. On the other hand, small price and profit margins benefit all customers of the traders, i.e. farmers, processors, and also consumers after all. The activity of competitive traders eases both regional scarcities and surpluses, and provides certainly more price stability than a situation without trade.

Nevertheless, the discussion about excessive profits of grain and food traders is not typical for Ukraine only, but can be found in almost all countries of the world. In Germany, for instance, people always think that prominent food retailers (such as ALDI) earn huge profits. But the truth is that in a transparent market the margin as a percentage of the turnover is seldom higher than 3 %.[2] Given a sufficient turnover, this still can facilitate the owners of such a company to earn a fortune in the course of the decades, but the assumption that consumers have been squeezed during all that time is not justified.

Can we expect that a Ukrainian trader could carry out arbitrage as efficiently as one of the big foreign grain traders? The answer can be yes only under quite restrictive conditions. If highly specialised, well-experienced, big international grain companies only manage to achieve quite narrow profit margins under working competition on the world market, their less experienced Ukrainian counterparts would most likely need assistance (i.e. either state subsidies, and/or the ability to exercise market power) from the Ukrainian government to become profitable. A grain trading monopoly similar to, e.g., the Canadian Wheat Board would need to be established. However, the performance record of such grain boards is poor, and therefore they tend to harm the economy as a whole. This matter will be discussed in the next section.

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[2] Many grain trading companies are still "private" companies in a sense that their capital shares are not traded at the stock exchange. This means that they are not obliged to publish their balance sheets, which makes it hard to determine their real profitability. BUNGE, a major grain and oilseeds trader with a focus on Latin America, has nevertheless published its figure for the most recent year in the internet. BUNGE'S return on sales was 1.8%, and 3.05% on total assets for 2002. It has to be kept in mind that Bunge is a company which has been quickly expanding during the recent years.

3.2 Investment

In addition to pure trading, i.e. arbitrage activities, trading companies have also **heavily invested** in Ukrainian marketing infrastructure. This applies primarily to grain handling and storage facilities, but also transport infrastructure (port facilities). Moreover, funds have been made available for seed, fertiliser, and other input production. Traders invest partly to ensure a more steady (less seasonal) supply of grain, but of course also to capture a larger share of the marketing margin. When foreign companies invest their capital in Ukrainian infrastructure, they are of course interested in a certain profit rewarding the investment. Nevertheless, the effect for the Ukrainian economy is beneficial: scarce capital and know-how flows into the country, and jobs are created which are desperately needed in the countryside. Those who argue that Ukraine is being exploited by such investment may ask themselves why there have not yet been more significant Ukrainian investments in this sector if it is really so profitable? Apparently, such investments do not just need money[3], but expertise which the big grain traders can deliver.

4 Lessons learnt from National Grain Boards

In some countries domestic grain trade has been monopolised and entrusted to so-called grain boards. Two prominent examples are the Australian and Canadian Wheat Boards which are located in export countries, but also many African and Asian countries have been running grain boards for the purpose of monopolising imports. One basic idea behind a grain board is to provide the numerous producers with a degree of market power vis-à-vis grain traders and processors and, thus, the ability to negotiate higher prices. But while this goal could also be achieved by supporting the formation of producer co-operatives, all grain boards also allow the national government to influence market outcomes. Moreover, in most cases a government guarantee exists to underwrite possible losses of grain boards. There are some comments to be made on the performance of grain boards from an economic perspective:

1. Market power may help producers, but if it works, who will pay the bill? If higher domestic prices were achieved, this would mean that Ukrainian consumers would have to pay more for bread – certainly not a very desirable outcome when taking

into account the still low average incomes. However, this kind of monopoly power could only be exercised when the country were isolated from the world market. Otherwise, international grain traders would import cheaper grain from other countries.

2. For an export country such as Ukraine, the goal of a monopoly would be to charge higher prices for grain exported. But this would only be possible in a situation when Ukraine would really have a substantial share, e.g., in world wheat exports.[4]

3. The potential of a grain board to provide price stability is limited. The Canadian Wheat Board, for instance, offers an initial price for the grain it will accept; this price reflects the Board's assessment of market conditions. This payment functions as a floor price. If the CWB realises a higher export price during the season, the farmers receive an additional payment. If returns are lower, the government carries the losses of the CWB. Even though this arrangement provides some price certainty to the farmers *during* the season, the *inter-seasonal* price swings in Canada have proven to be not less than those on the world market.

4. Almost all grain boards in the World have turned into bureaucratic dinosaurs with very high operating and overhead costs. Endowed with government guarantees and monopoly power, nothing else can be expected. These costs would finally fall on the Ukrainian state budget. The establishment of a grain board can not be recommended from this perspective.

5. Taking the arguments before together, one must come to the conclusion that the market power of a Ukrainian grain board would rather be used to exploit producers. Moreover, it cannot seriously be expected that a parastatal organisation in Ukraine responsible for grain trade would work efficiently. The

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[3] Capital offered by investors lacking any expertise on the subject is also called "stupid money". Enterprises looking for investors often reject such funds because a trustful and productive co-operation between borrower and lender is less likely under such circumstances.

[4] The Canadian Wheat Board (CWB) claims that it is able to exercise a certain pricing power which raises the price of Canadian wheat exports. To be more precise, the CWB claims to be able to charge different customers different prices (price discrimination). This claim has been challenged by economists, and it is still not certain whether it is true or not. However, if the CWB would really manage to price-discriminate, it would expose itself to challenges in the framework of the WTO. In any case, the CWB's market power is not certain, and taking Canada's much higher world market share in wheat into account it is even less likely that Ukraine would ever be able to achieve pricing power internationally.

costs of such an agency would have to be carried by others in the economy, most likely taxpayers and farmers.

It is not surprising that the performance of grain boards in developed countries has been disputable at best, while it has been disastrous in developing countries. Therefore it is strongly recommended not to establish a national grain board or some similar monopolistic body. By doing this, Ukraine would damage its competitiveness in grain markets, the trust of farmers in the government, and its prospects to enter the WTO. To prove the arguments with some figures, the case of the Canadian Wheat Board is exemplified in the following.

Case study: Farmers' losses under the regime of the Canadian Wheat Board

The case of the Canadian Wheat Board (CWB) is very illustrative in weighing the arguments in favour and against monopoly grain boards under public supervision. The CWB claims that it can grant farmers in Canada's Western Prairie provinces higher prices than US farmers get under competitive marketing conditions. This has allegedly been achieved by charging higher prices in world markets which are not the target of export subsidies from the USA or the European Union. KRAFT, FURTAN, and TYRCHNIEWICZ concluded that, from 1980/81 through 1993/94, the CWB received an average premium of CAN$13.35 per tonne for wheat sold to export markets.[5]

However, these results do not prove that such price premiums really benefited Canadian farmers who were forced to sell their grain to the CWB. A comparison of Canadian with US farm gate prices by CARTER, LOYNS, and BERWALD[6] from 1988-1995 reveals that for wheat Canadian farmers receive roughly the same as their US-American counterparts, meaning that the CAN$13.35 premium had probably been eaten up by inefficiencies during the CWB's marketing operations. In the case of barley, matters are even much worse: Canadian farmers receive only $91 compared to $122 which US farmers get. Furthermore, the costs to the Canadian federal budget from loss-making operations of the CWB during years with extremely low world prices are not reflected in these price comparisons.

The example of the CWB exactly points out the decisive factor which makes a marketing board a bad thing for farmers. It has only a domestic monopoly position, and not one on the world market. This makes it much more likely that the own farmers are exploited instead of the international customers. The other issue is that

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[5] KRAFT, FURTAN, and TYRCHNIEWICZ, "Performance Evaluation of the Canadian Wheat Board." Winnipeg: Canadian Wheat Board, 1996.

[6] CARTER, LOYNS, and BERWALD, "Domestic Costs of the Canadian Wheat Board", *American Journal of Agricultural Economics,* May 1998, pp. 313-324.

monopolies with state guarantees tend to become more and more cost-inefficient in their operations, and it is very likely that these costs burden farmers, as would appear to be the case in Canada.

5 Alternatives to a Direct Involvement of the Ukrainian Government in Grain Marketing

When we accept that grain trade is a necessary service within the marketing chain which benefits both consumers and producers, we also need to accept that this service is costly itself, and that for the time being Ukrainian traders have higher costs and thus a competitive disadvantage when compared with foreign traders, particularly when it comes to export operations. Foreign companies are operating in Ukraine because their supply of trade services is competitive, and not because they might be able to somehow "dominate the market" or "manipulate prices". Competition in grain markets is much too intense to allow for long-lasting excessive profits above the usual opportunity costs for the invested capital. Therefore the establishment of a national Ukrainian grain trade agency is not justified; it would reduce rather than increase competition.

But what else can the Ukrainian government do to address the problems in the grain market? First of all, the state has to provide the rules according to which markets function. Most importantly, the state has to **ensure that contracts between private agents have to be fulfilled**. This is a task of the legislative (by drafting appropriate laws), the judicial system, and the police to enforce such rules. A high proportion of the trade margin between farmer and processor consists of costs arising from the uncertainty as to whether the contract partner will stick to his obligations. The enforcement of contracts will therefore help farmers to get better prices.

Grain traders are often blamed for using their size to exercise pricing power. However, in a market economy competition between different traders limits the margins they can realise. Therefore the government has to **make sure that competition governs the market,** thus preventing both domestic and foreign companies from making excessive profits. If international traders have been able to exercise market power on some regional markets in Ukraine, it is due to lacking competition on these markets.

But there is more the state can do. Especially the agricultural ministry should establish and constantly improve **market information systems** for farmers and other agents in the market. Unfortunately Ukrainian agricultural market data are still

biased to a certain extent from time to time, and matters are further clouded by secrecy and possibly even deliberate misinformation concerning state reserves and other stocks as well as anticipated harvests etc. This is part of the explanation why more grain may have been exported in 2002 than was desirable. Not only the seasonal production figures could be improved; good data on supply, demand, and public and private storage on a monthly basis is still not available. A grain market situation as we have seen it in recent months could never have occurred with such a market information system.

A.K., Lector F.P.

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