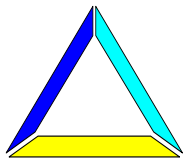
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S30

Drawing the right conclusions from the current situation on Ukrainian grain markets

1. Introduction

Grain markets in Ukraine have taken an unexpected turn in recent months, with prices increasing considerably and rumours of milling wheat shortages making the rounds. In response, President Kuchma has instructed the General Prosecutor's Office to investigate the reasons for these price hikes and surprisingly low wheat stocks. Grain trading enterprises have been subject to rigorous investigation, and some arrests have even taken place.

The atmosphere is charged, therefore, and events are unfolding on a daily basis. In the following we would like to draw attention to several basic principles that are being forgotten in the midst of this excitement. The topic is important because Ukraine runs the risk of doing considerable damage to its fragile international reputation as a potential power on world agricultural markets. Agricultural newsletters and trade journals worldwide are commenting on the current situation in Ukraine and closely following Ukrainian policy makers' responses. International grain markets are hard-fought, and competitors will certainly shed no tears if Ukrainian policy makers draw the wrong conclusions from the current situation.

2. Recent developments on grain markets

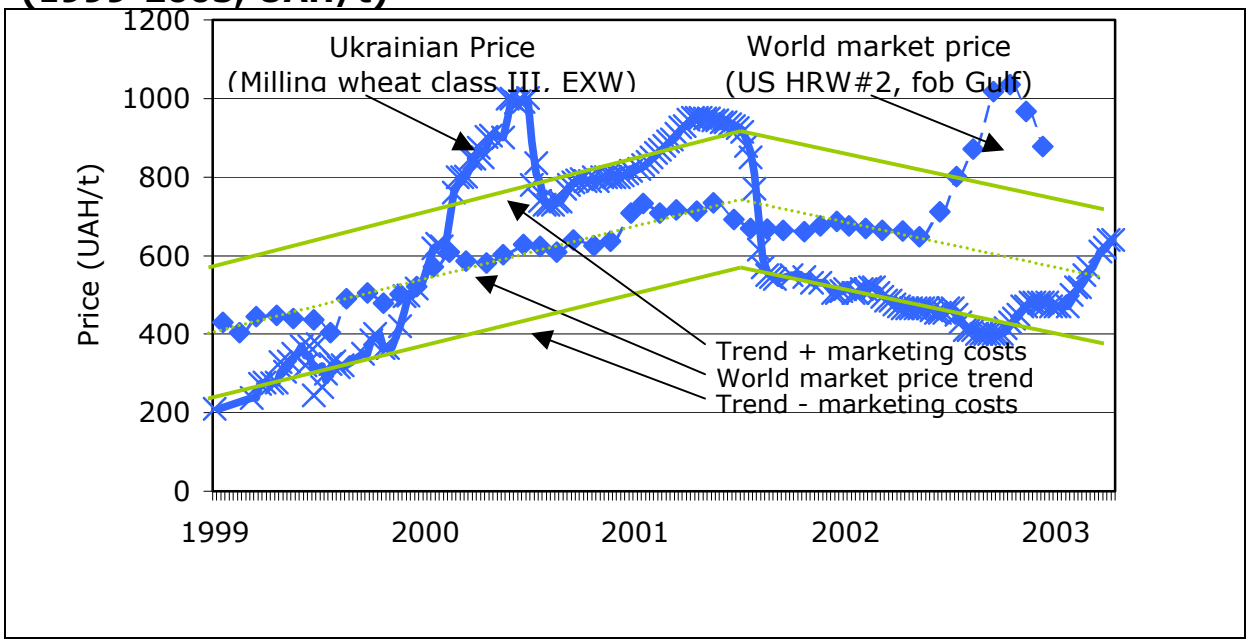
Figure 1 illustrates how prices for milling wheat have evolved in Ukraine since 1999. We use the average weekly EXW price for milling wheat reported by UkrAgroConsult, an independent, private information service provider with a reputation for unbiased reporting. Prices on individual regional markets differ from this average, and prices for feed wheat are considerably lower (more on this later), but Figure 1 nevertheless provides an indication of the underlying trends.

Figure 1 shows that until mid-2002, milling wheat prices in Ukraine followed a path that is directly related to the level of world market wheat prices, represented here by US fob Gulf prices. The derivation of prices in Ukraine from world market prices (as a function of grain marketing costs

and Ukraine's net import/export situation) has been explained extensively elsewhere and will not be repeated here.

What happened to the link between US and Ukrainian prices in late 2002? Essentially, due to special circumstances (drought and unusually low harvests in North America and Australia), the US price lost much of its relevance as an indicator of world market prices. The US authorities continued to report prices in their regular statistical bulletins, but the volume of export grain backing up these prices was much lower than in 'normal' years. Indeed, to some extent the Black Sea replaced the Gulf of Mexico as the locus of price determination on world grain markets in the second half of 2002.

Figure 1: Milling wheat prices in Ukraine and on world markets (1999-2003, UAH/t)



Source: UkrAgroConsult, Market Weekly Report, various issues; USDA Grain Market Outlook, various issues; own calculations.

While some analysts have interpreted this shift from the Gulf of Mexico to the Black Sea as a turning point in the history of the world grain trade, this may be somewhat premature.[1] Under normal circumstances grain production in North America and Australia will rebound in 2003. Furthermore, there are indications that a severe winter could reduce the 2003 harvest at least in Ukraine. Clearly, conditions for grain production in Ukraine were above average in 2001 and 2002.

Recent years have given us a glimpse of the impact that Ukraine could have on world grain markets in the future, but much remains to be done – both in restructuring farms and the grain marketing system, and in establishing a stable and benevolent agricultural policy environment –

[1] See for example Rylko, D.: *Is Russia to Become a Sustainable Grain Exporter?* Presentation to the EBC, February 28, 2003.

before Ukraine emerges as a sustained force on world grain markets. If policy makers draw the wrong conclusions from the current upheavals on Ukrainian grain markets, they will jeopardise this development.

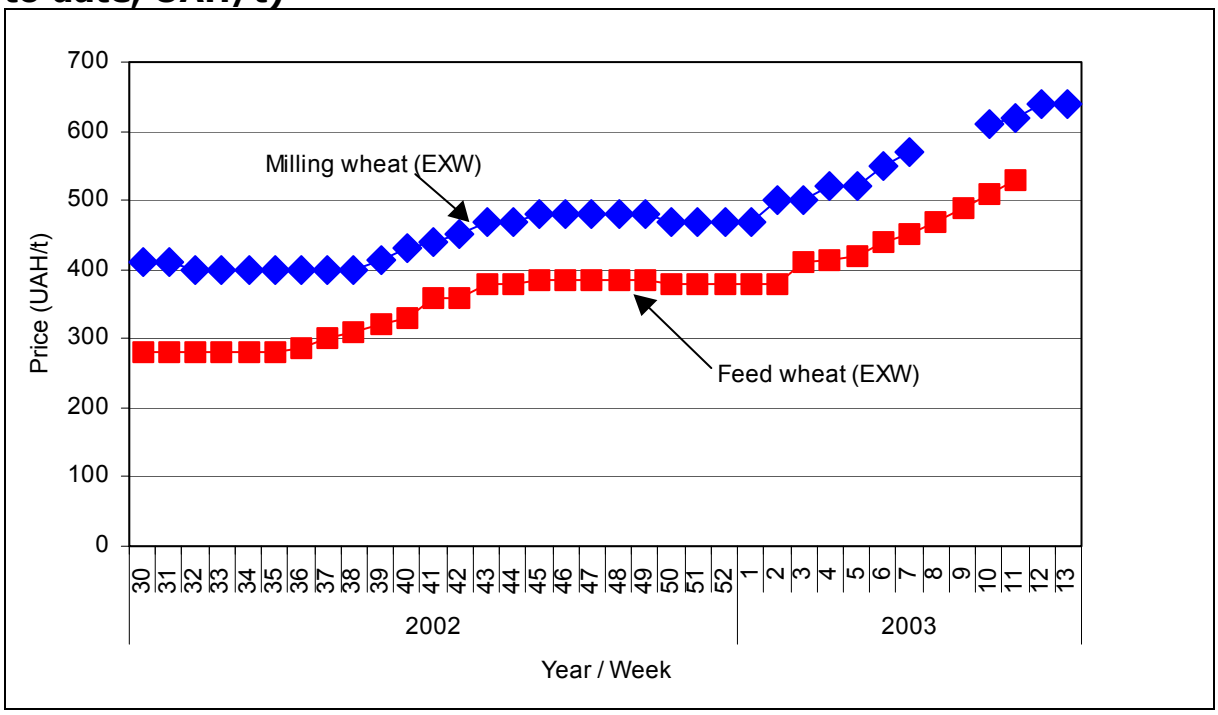
What has happened to domestic Ukrainian prices in this current unique situation? From a low of roughly 400 UAH/t in August of 2002, milling wheat prices in the Ukrainian market began to strengthen, reaching 480 UAH/t by the end of the year. Exports, especially to the EU were brisk, so much so that the EU announced that it would implement import quotas on grain.[2] Then prices began to increase quite suddenly, reaching almost 650 UAH/t in recent weeks. Feed wheat prices have followed in lockstep (see Figure 2), on average 100 UAH/t below milling wheat prices since the 2002 harvest. In March, analysts began reporting shortages especially of milling wheat.[3]

As rumours of shortages mounted, the recriminations began. Suddenly government officials were being accused of releasing over-optimistic estimates of the 2002 grain crop, and traders were being accused of exporting too much grain too quickly and paying farmers too little for it following the harvest in 2002. Some so-called specialists have even argued that recent efforts to reduce marketing costs for Ukrainian grain – for example by encouraging investment in new storage and grain handling facilities – have made it 'too easy' to export grain. What is to be made of these accusations?

[2] These quotas, effective as of Jan. 1, 2003, were especially designed to limit imports of grain from the Black Sea region. The total quota per year has been fixed at 2,981 million tons of low and medium quality wheat, of which 0,038 and 0,572 million tons have been allocated to Canada and the US, respectively. The remaining 2,372 million tons is open to all third countries. Within the quotas, imports are subject to a levy of 12€/t, while imports in excess of the quota are subject to a 95 €/t levy that is so high as to be prohibitive.

[3] There is no universal agreement on these shortages; some analysts argue that many farms and traders have stored more grain than is known at the moment.

Figure 2: Milling wheat vs. feed wheat prices in Ukraine (late 2002 to date, UAH/t)



Source: UkrAgroConsult, Market Weekly Report, various issues.

3. Analysis

1) Grain was exported too quickly. This accusation is not tenable. First, based on official crop estimates of 38.8 million tons (see below), it seemed clear that a considerable amount of grain would have to be exported. Given the limited capacities for exporting grain in Ukrainian ports, there was no question of storing all this grain for several months and exporting it all later. Instead, the question being asked was whether the existing infrastructure, working at full capacity over the entire year, would suffice to move all this grain and the expected transit exports from Russia and Kazakhstan.

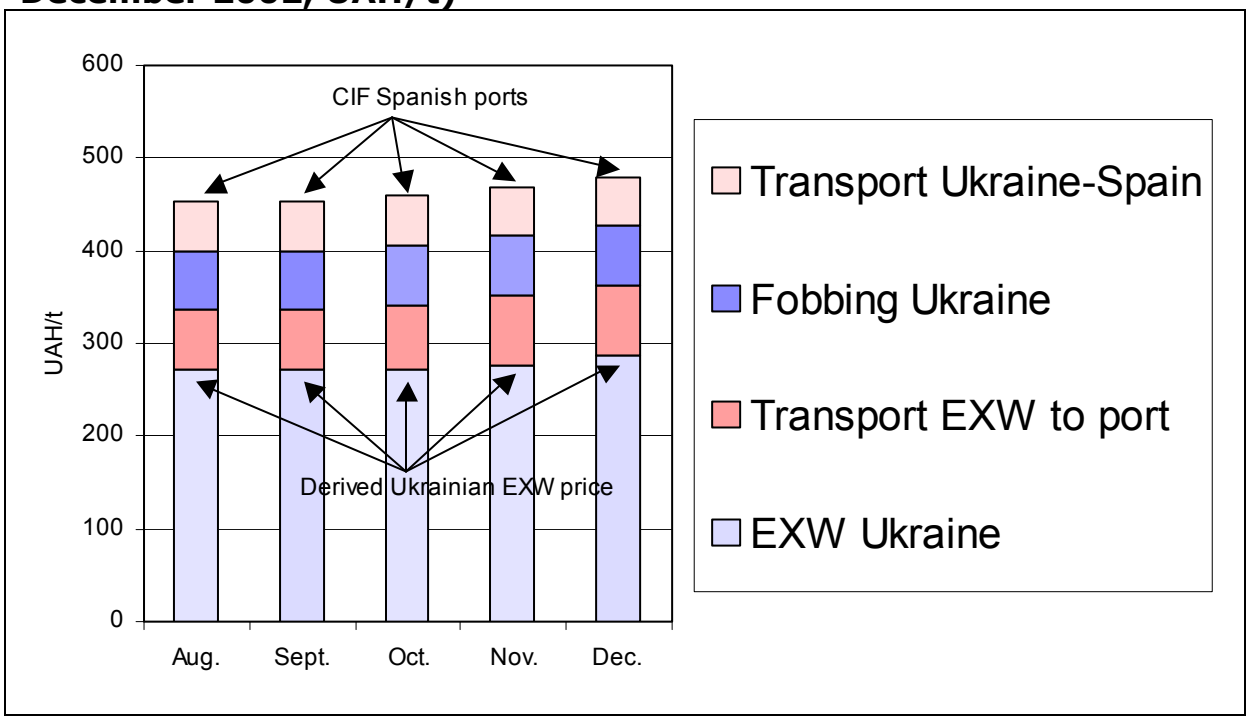
Second, the EU was the major export destination. As US prices increased rapidly in the second half of 2002, the EU's import levies on grain, which were based on the difference between US and EU prices, fell to zero.[4] This provided Ukraine (and Russia) with a golden opportunity to sell large amounts of grain into a nearby market. However, as the EU's imports from Russia and Ukraine mounted, member states began pressuring the EU Commission to impose import barriers. By September 2002 at the latest it was more or less clear that the EU would impose import these quotas (see above and footnote 3). There were even rumours that the EU would do so unilaterally as early as November or December 2002. So

[4] Specifically, they reached zero for medium quality wheat in July 2002, and for feed quality wheat in September 2002.

exports had to take place quickly to take advantage of a window of opportunity that threatened to close quickly.

2) Ukrainian grain was sold under value. This accusation is also untenable. First, since the lion's share of Ukraine's exports were destined to the EU, the EU's cif prices provide the relevant benchmark. Taking the EU import destination Spain as a representative example, we see that cif prices there increased from roughly 450 to 480 UAH/t from August to December 2002 (see Figure 3). Subtracting transport costs from Ukrainian ports to Spanish harbours, as well as fobbing costs in Ukrainian ports and transport costs within Ukraine from EXW positions to these ports, we are left with a derived EXW price that increased from roughly 270 to 290 UAH/t from August to December 2002.

Figure 3: The derivation of Ukrainian wheat prices (August-December 2002, UAH/t)



Note that actual average feed wheat prices in Ukraine were actually higher than this according to UkrAgroConsult, increasing to 370-380 UAH/t by the end of 2002 (see Figure 2). This may be due to quality differences (see below) and the fact that fobbing costs and transport within Ukraine are not identical for all locations. Regardless, based on Ukraine's main export opportunities, the grain prices that were observed in Ukraine in the second half of 2002 were by no means too low.

Second, when judging grain prices, Ukrainian observers generally make reference to Ukrainian grain quality standards. However, these GOST-based standards – which were inherited from the Soviet Union and focus on protein content – are largely irrelevant in international grain trade. What is considered milling wheat in Ukraine (grades 2 and 3, with protein

contents of >13% and 12-13%, respectively, according to Ukrainian standards) may not qualify as such elsewhere in the world, where other dimensions of quality (amylograph, falling number) matter more. Traders especially complain that Ukrainian standards do not take proper account of damage caused by insects. For all of these reasons, what may seem to be low prices from a Ukrainian perspective simply reflect an accurate assessment according to established standards on world markets.

4. Lessons

Policy makers in Ukraine should avoid taking action just for the sake of appearing to do so, especially if this action threatens to do significant long run damage. The current search for scapegoats (traders, individual policy makers, etc.) is one such action that could put a major dent in Ukraine's agricultural investment climate. Greater government intervention on grain markets (increased purchases of grain, for example) is another such action.[5] What conclusions should be drawn from the current situation?

1) There is no such thing as the right price. Much of the current excitement has been generated by flour mills and other processors who are faced with rapidly increasing prices for their primary raw materials. Many of these processors had expected grain prices to continue falling over the course of the 2002/03 marketing year – as they had the year before – and they therefore did not bother to accumulate stocks. In other words, these processors speculated – and when grain prices went up rather than down, they lost. If their speculation had bourn fruit, i.e. if grain prices had indeed continued to fall, these mills would certainly not have offered to share their profits with farmers and taxpayers. So why should farmers and taxpayers be expected to share their losses?

Furthermore, one should be explicit about the fact that farmers' and consumers' interests run in opposite directions. Unless the state is in a position to massively subsidise farmers and/or consumers (and the Ukrainian state is not), there will always be a conflict between farmers' desire for high grain prices and consumers' desire for inexpensive bread. In recent years, low and falling grain prices have made an important contribution to low (even slightly negative in 2002) rates of consumer price inflation in Ukraine. Given that real consumer incomes have increased significantly of late, it is perhaps an exaggeration to say that increasing bread prices will lead to widespread social hardship. In any event, helping needy consumers by controlling bread prices for all consumers is extremely inefficient, because most of the support that this entails ends up with consumers who are not really in need. Targeted

[5] See German Advisory Group Paper S6: *Grain Market Regulation in Ukraine: Options and Evaluation*.

assistance for the truly needy (pensioners, single parents with children, the unemployed) would be much more effective.[6]

2) Improved statistics. If markets had been provided with accurate estimates of grain production and storage over time, the current situation could not have developed. It is pointless to speculate on the reasons why government officials continued to insist on an crop estimate of 38.8 million tons long after other observers (UkrAgroConsult, the USDA) had released lower numbers. These reasons might include structural weaknesses in the reporting system (regional authorities probably still feel the urge to report inflated numbers as evidence of their 'effectiveness'), or a continued, exaggerated preoccupation with secrecy in some circles (grain production and grain reserves are 'strategic'). Whatever the reasons for past failures, accurate statistics and unbiased estimates are essential if markets are to function properly in the future; they are a vital service and should not be misused as a means of manipulating markets.[7] Many countries have extensive experience with the derivation and publication of crop estimates, export figures, domestic food and feed consumption and stocks. All major agricultural exporting nations provide these estimates on a monthly or quarterly basis and free of change. Ukrainian authorities should make a concerted effort to draw on this experience and improve the quality of this vital service.

3) Marketing infrastructure. Grain prices in Ukraine are derived from world market prices. Figures 1 through 3 above illustrate different dimensions of this derivation. Ukrainian prices are lower than world market prices depending on how 'distant' Ukrainian grain is from world markets, where 'distance' refers to location, time and quality. To bring Ukrainian prices 'closer' to world market prices requires investment in transportation infrastructure (the location dimension), in storage facilities (the time dimension) and in the production and maintenance of quality (varieties, storage and standards). It is imperative that investments in all of these areas continue along the path that has been taken in recent years. Attempts to blame (especially foreign) traders for current problems are counterproductive; they will reduce the flow of vital capital and know-how into Ukraine's grain marketing system. Ukraine's competitors on world grain markets would like nothing more than for Ukraine to disrupt this flow and reduce its own future competitiveness.

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[6] See STRIEWE, L., GALUSHKO, V. & VON CRAMON-TAUBADEL, S. (2001): Promoting Food Security in Ukraine. In: VON CRAMON-TAUBADEL, S., S. ZORYA & L. STRIEWE (eds.): *Policies and Agricultural Development in Ukraine*. Aachen, Shaker Verlag: p. 103-113.

[7] Why, for example, was the Ukrainian Ministry of Agriculture as late as mid-February predicting a wheat harvest of 10-12 million tons in 2003, before increasing this to 14-15 million tons at the end of March? These latter numbers are more in line with the estimates that were being released by all other reputable observers at that point in time; the former were quite obviously out of line. This suggests that either the official estimating procedure is flawed, or that estimates continue to be used in a manipulative manner (perhaps to generate expectations of problems in agriculture and thus secure more budget funding for agricultural programmes, or perhaps even to deliberately push up grain prices).

4) Competition. In the figures and analysis above, reference is made exclusively to EXW prices in Ukraine. But farmers themselves are one further step removed from world markets; they receive a price that is lower than the EXW price depending on the costs of transporting grain to elevators, handling costs, grading, etc. There is much anecdotal evidence that in some regions there is only one place or trader to whom farmers can sell their grain, i.e. that farmers are faced with traders who have regional monopoly power. Traders are not charities; their goal is to generate profits. The government's responsibility is to ensure that markets are competitive so that traders' pursuit of profit will generate benefits for all participants in the grain marketing chain. To ensure competition, it is imperative that producers be free to sell their grain whenever, wherever and to whomever they wish. Regional export bans or pressure by regional authorities to sell to certain traders reduce competition and lower prices and farm revenues.

5) Price discovery and risk management. Along with dependable statistics, Ukrainian grain markets also need an improved mechanism for price discovery and risk management. It would be a great setback if plans to establish a futures market for grain in Ukraine were to be cancelled as a result of the current turbulence. A functioning futures market would have increased transparency and competition on Ukrainian grain markets, it would have signalled an emerging shortage of grain in Ukraine much earlier than was the case, and it would have provided users of grain (for example flour mills) with a means of insuring themselves against unexpected price increases. While it is clear that establishing such a market will take time, every month that is lost today means an additional month of waiting in the future.

6) Exports, imports and transit grain. Much of the current excitement seems to derive from the fact that some observers in Ukraine simply cannot accept the fact that Ukraine produces so much grain but nevertheless ends up requiring imports. In fact, this is not unusual and it is not necessarily inefficient. For example, the EU exports significant amounts of rapeseed early in the marketing year and later imports to cover domestic demand. Depending on the seasonal pattern of worldwide production and storage costs, this can be much more efficient than storing the products in question at home over the entire year. And since domestic demand for feedstuffs such as feed grain is very difficult to predict (it can fluctuate considerably as the prices of substitutes such as oilseeds etc. change), it is an illusion to think that the authorities can somehow determine exactly how much to export and how much to store after the harvest. Moreover, the EU has always imported high quality milling wheat from other countries such as Canada and Australia, even back in the 1970s and 1980s when EU protection was at its very highest.

So it is not necessarily a problem that Ukraine has exported a great deal early in the marketing year and is now faced with imports. It may minimise overall storage and transportation costs to export grain from the grain producing regions in Central and Southern of Ukraine and simultaneously supply regions such as Kyiv or parts of Western Ukraine with imports, for example with (high quality) Kazakh and Russian grain that must move through Ukraine on its way to export markets anyhow. This is something that competitive markets can sort out best; it is not a matter of national pride or security that needs to be regulated by the state.

5. Conclusions

Recent years have given us a glimpse of the impact that Ukraine could have on world grain markets in the future, but much remains to be done – both in restructuring farms and the grain marketing system, and in establishing a stable and benevolent agricultural policy environment – before Ukraine emerges as a sustained force on world grain markets. If policy makers draw the wrong conclusions from the current upheavals on Ukrainian grain markets, they will jeopardise this development.

- If there is genuine concern with the impact of increasing grain prices on consumers (and not just political grandstanding), then targeted aid for the most needy is the appropriate response. Grain processors who speculated and lost in recent months should be responsible for their own mistakes.

- Misleading statistics, due to either flaws in the system or deliberate manipulation, bear a large responsibility for the current situation. Policy makers should draw on international experience to produce an agricultural statistical service that is worthy of a major player on world markets.

- The current situation should not be allowed to hamper steps (i.e. private investment) to reduce marketing costs for Ukrainian grain. Competitors on world markets would like nothing more than for Ukraine to 'tie one hand behind its own back'!

- Competition between traders on regional markets in Ukraine should be guaranteed and, where necessary, enforced. Regional export bans and interference – formal or informal – in grain marketing by regional authorities hurts farmers and reduces the ability of markets to regulate themselves.

- A functioning futures market could make a significant contribution to improved transparency and competition on Ukrainian grain markets. This is a long term goal, but one that becomes even more long term if its development is hampered today.

- It is not unusual that a country both export and import grain in the course of a marketing year, sometimes even simultaneously. Even if it is true that there is now a shortage of milling wheat in Ukraine, this does not necessarily point to past mistakes or inefficiency.

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April 2003