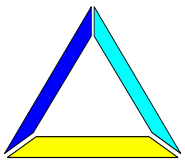
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Grain Market Regulation in Ukraine: Options and Evaluation

1. Introduction

In recent months there has been much talk of grain market regulation in Ukraine. The words 'pledge price' and 'intervention system' can be found in a variety of statements by policy makers and analysts and in several decrees, resolutions[1] and the recently adopted law "On grain and the grain market in Ukraine"[2]. Despite this activity, it is still quite unclear exactly what type of grain market regulation will be implemented in Ukraine, what impact it will have and how much it will cost.

The aim of this paper is to contribute to the debate on grain market regulation in Ukraine based on experience in other countries, primarily the EU and the US. In the following we:

I. Attempt to clarify the terminology used in discussions of grain market regulation. What is generally understood when one refers to an 'intervention system' or a 'pledge price system' for grain?
II. Discuss the possible goals of grain market regulation and whether different policy instruments (such as pledge prices) can contribute to attaining such goals.
III. Derive a series of policy implications for the regulation of Ukrainian grain markets.

2. Terminology: What is grain market regulation?

Most countries regulate their grain markets in some manner. Regulation can range from a simple system of quality standards to strict control of the entire production and marketing chain such as was exercised under central planning in the Soviet Union. In most industrialised countries, regulation generally refers to policy instruments designed to **stabilise and support grain prices received by farmers**. This seems to be the main thrust of the grain market regulation that has been discussed in Ukraine in recent months. For example, in a recent publication the Deputy Chief of the Presidential Administration Pavlo Gaidutskiy has stated that the main goal of introducing a pledge price system for grain in Ukraine is to decrease monthly price fluctuations that have hurt farmers in past years.[3]

As Ukrainian grain production recovers and the country (re-)establishes itself as an important net exporter of grain, it is only natural that policy makers look at other grain exporters such as the EU and the USA for inspiration. What exactly do the EU and the US do to regulate their grain markets? Explaining EU and US grain market regulation in detail would take far more space than is available here, but the following

[1] See, Cabinet of Ministers of Ukraine Resolution No. 590 (April 29,2002) "On determination of pledge prices and financial support of pledge purchasing of grain".
[2] This law was approved in final reading by the Verchovna Rada on July 4, 2002.
[3] Gaidutskiy, P. (2002): Agricultural Markets: The Lessons and Targets. In: *Economics of AIC*, Vol. 5, pp. 6-8.

brief overview will help clarify some terminology that is often used in discussions of Ukrainian grain market policy, but not always used carefully.

2.1 Grain market regulation in the EU

The EU's grain market regulation is difficult to characterise because it has changed considerably over the last decade, and recent policy proposals made by the EU Commission in Brussels indicate that it will continue to change in the future (see below). The 'classic' EU grain market regulation is the so-called **'intervention' system**. According to this system, farmers receive a minimum price – called the intervention price – for their grain. To guarantee this price, the EU's member states maintain a network of intervention centres that stand ready to purchase grain from farmers at the intervention price. Grain must fulfil certain quality standards to qualify for intervention, and over time these standards have become stricter.

The aim of the intervention system is to stabilise and support the prices that farmers receive for their grain. Nevertheless, the intervention price for grain in the EU has been reduced progressively since the mid-1980s. Over long stretches of the 1970s, the intervention price was as much as 50 to 60% higher than the world market price. At the moment the basic intervention price is equal to 101,31 €/t for all varieties of grain except oats and triticale. This is less than the current world market price of roughly 125 €/t. However, if we add marketing costs of roughly 30 €/t to this intervention price, we arrive at an EU fob price of perhaps 130 €/t. Since this fob price is higher than the world market price, grain from the EU's intervention stocks can only be sold at a loss on world markets. To compensate for this loss, the EU provides exporters with an **export subsidy** (referred to euphemistically as a 'restitution'). The export subsidy is currently equal to roughly 5 €/t, which corresponds to the difference between the EU fob and world market prices (130 – 125 = 5 €/t).

As intervention prices have been reduced, so has the price support provided to farmers in the EU. Intervention prices were reduced especially sharply (30%) in 1993-1996 in the course of the so-called 'MacSharry Reforms'.[4] To compensate farmers for this reduction, the EU introduced fixed **hectare payments** in 1993. These payments vary across the EU according to historical yields; farmers in Germany currently receive roughly 350 €/ year for each hectare of land that is used to produce grain. Recently, the EU Commission has proposed a further reduction of 5% in intervention prices for grain and cuts in the fixed hectare payments of 3 %/year over the next 6 to 7 years.[5] The pressure on the EU to reduce its support for farmers is immense, as this support already costs a great deal of money and will cost a great deal more when it is extended to as many as 10 new members in Central and Eastern Europe. Furthermore, the EU's use of export subsidies is limited by an agreement reached at the end of the Uruguay round of WTO negotiations. The lower the intervention price, the less export subsidy is required to dispose of a ton of grain on world markets.

2.2 Grain market regulation in the US

Grain market regulation in the US is also in flux. US grain market regulation is legislated in so-called '**farm bills**' that are passed by the US Congress. Farm bills generally cover a period of 6 years; the so-called 'Freedom to Farm Act' was passed in 1996, and several weeks ago it was replaced by the 'Farm Security and Rural Investment Act of 2002'.

[4] MacSharry was the EU Agricultural Commissioner who proposed this reform.
[5] Commission of the European Communities (2002): *Communication from the Commission to the Council and the European Parliament: Mid-Term Review of the Common Agricultural Policy*. Brussels.

US grain market regulation has several important ingredients. The first of these is the so-called '**loan rate**'. Farmers can receive a loan from the US Government at a specified loan rate per unit of production by pledging production as collateral. In other words, farmers receive a loan in return for providing a US Government bureau (the Commodity Credit Corporation) with grain as collateral. For 2002-2003, the new farm bill stipulates a loan rate of 2,80 $/bu (roughly 102,5 $/t). Farmers can choose to keep this money and forfeit the pledged grain to the US Government, or they can repay the loan with interest and receive their grain back in return. Farmers will only choose the latter option if market prices are higher than the loan rate; otherwise the loan rate acts as a minimum guaranteed price.

The next ingredient in US grain market regulation is the so-called '**direct payment**'. These are payments per unit of production that are paid to farmers according to base yields and acreages. The new farm bill stipulates a direct payment of 0,52 $/bu or roughly 19 $/t of wheat. The direct payments are what is referred to as 'decoupled', which means that they are not linked to production. For example, a farmer will receive direct wheat payments for a historical base acreage of wheat on his farm, regardless of whether he currently produces wheat on this area or not. The only requirement is that this land remain in agricultural use (crops, grazing, haying or fallow).

The final key ingredient in the US grain regulation system is the '**counter-cyclical payment**'. Counter-cyclical payments are equal to the difference between a commodity's target price and its effective price. The **target price** is fixed in the farm bill; for 2002-2003 the target price for wheat is equal to 3,86 $/bu or roughly 141 $/t. The **effective price** is equal to the direct payment discussed above plus the annual average farm price for the commodity in question or the loan rate for this commodity, whichever is higher. The counter-cyclical payment therefore ensures that farmers receive at least the target price for their commodities by 'topping up' the sum of the loan rate (or market price) plus direct payment to the amount of the target price. As with the direct payment, the counter-cyclical payment based on historical acreages and yields (provided the land in question remains in agricultural use), so it is not linked directly to current production.

2.3 Grain market regulation in Ukraine?

As stated above, there is much talk of grain market regulation in Ukraine, and many statements and legislative acts that refer to different types of grain market regulation.

First, Resolution No. 590 (see footnote 1) stipulates that a '**pledge price**' is to be set equal to 50% of the weighted average daily price on agricultural exchanges for the commodity in question. The new law "On grain and the grain market in Ukraine" (the 'new grain law') refers to this pledge price, stipulating that it is to be determined by the Cabinet of Ministers by the 31st of March of each year for the next crop year (from the 1st of July to the following 1st of March).

The use of the term 'pledge price' in Resolution 590 and the new grain law the suggests that what Ukrainian policy makers have in mind is a system like the US loan rate system, whereby farmers can receive a payment in return for pledging grain as collateral. If the pledge price defined in Resolution 590 (i.e. 50% of the daily exchange price) is finally implemented, however, a key difference between the US and the Ukrainian version will be that the US loan rate is fixed over an entire year while the Ukrainian pledge price will fluctuate according to market conditions. Furthermore, the US loan rate is set at a level (102,5 $/t) that provides farmers with a certain

amount of price support. The Ukrainian pledge price, at 50% of the daily average market price, is certainly much less attractive.

Actually, it is not clear why farmers would be at all interested in the option of pledging grain in return for the pledge price that is defined in Resolution 590; i.e. for a price that is only one-half as high as the price that can be obtained on the same day on agricultural exchanges. This option would only be attractive to farmers who expect that prices will increase considerably in the future but have limited storage capacity and would otherwise be forced to sell immediately post-harvest at a low price. In this case, the pledge price would provide a minimum of liquidity in the short run, and later, when prices have increased, farmers could reclaim their grain, sell it on the market and repay the pledge. In other word, the Ukrainian pledge price system is a system for providing farmers with short-term credit so that they are not obliged to sell their harvest immediately in order to finance fall fieldwork. Any farmer who takes advantage of this system will do so fully expecting to reclaim his grain at a later date. If farmers take advantage of the system, it will have the effect of removing some grain from the market immediately following the harvest, increasing prices at this time, and adding this grain to the market later in the year, reducing prices reducing prices at this time. This may or may not have the effect of stabilising prices, as is discussed in section 3 below.

Clearly however, farmers will only voluntarily pledge grain if they are certain that they will be able to reclaim this grain (the same quality and quantity, with no bureaucratic delays etc.) in return for repaying the pledge at a later date. Resolution 590 makes no mention at all of whether or under what conditions farmers will be able to reclaim their pledged grain. However, the new grain law does guarantee that the state pledge agent (the Ukrainian equivalent of the US Commodity Credit Corporation) will be required to return pledged grain (the same quantity and quality) to any farmer who wishes to reclaim it. This grain must be returned to the farmer within three banking days of the repayment of both the pledge price and all elevator costs that have accumulated.

From a farmer's point of view, however, this guarantee in the new grain law may appear to be less than ironclad. First, the requirement that the pledge price be repaid before the grain is returned could catch farmers in a sort of liquidity trap. Second, elevator costs are very high in Ukraine and could be used to make the option of reclaiming grain unattractive to farmers. There is a provision in the new grain law by which the Cabinet of Minister will set maximum elevator costs. Nevertheless, based on past experience with elevators operated by the state or its agents, it is understandable that Ukrainian farmers are very sceptical about promises that they will be able to reclaim pledged grain.

Second, the new grain law also contains provisions for an **intervention system**. In other words, it provides for the implementation of key elements of the EU as well as the US grain regulation systems. Under the proposed Ukrainian grain intervention system, a state agent will be provided with a budget to buy and sell grain at an intervention price that must be approved by the Cabinet of Ministers. Grain sold into intervention, unlike pledged grain, can not be reclaimed by farmers at a later date. The new grain law forsees minimum intervention lots of 80 tonnes of grain. Whereas the Ukrainian pledge price system, if it functions as foreseen, will provide farms with short-term liquidity, the intervention price system is explicitly designed to support grain prices. Some implications of grain price support are discussed in section 3 below.

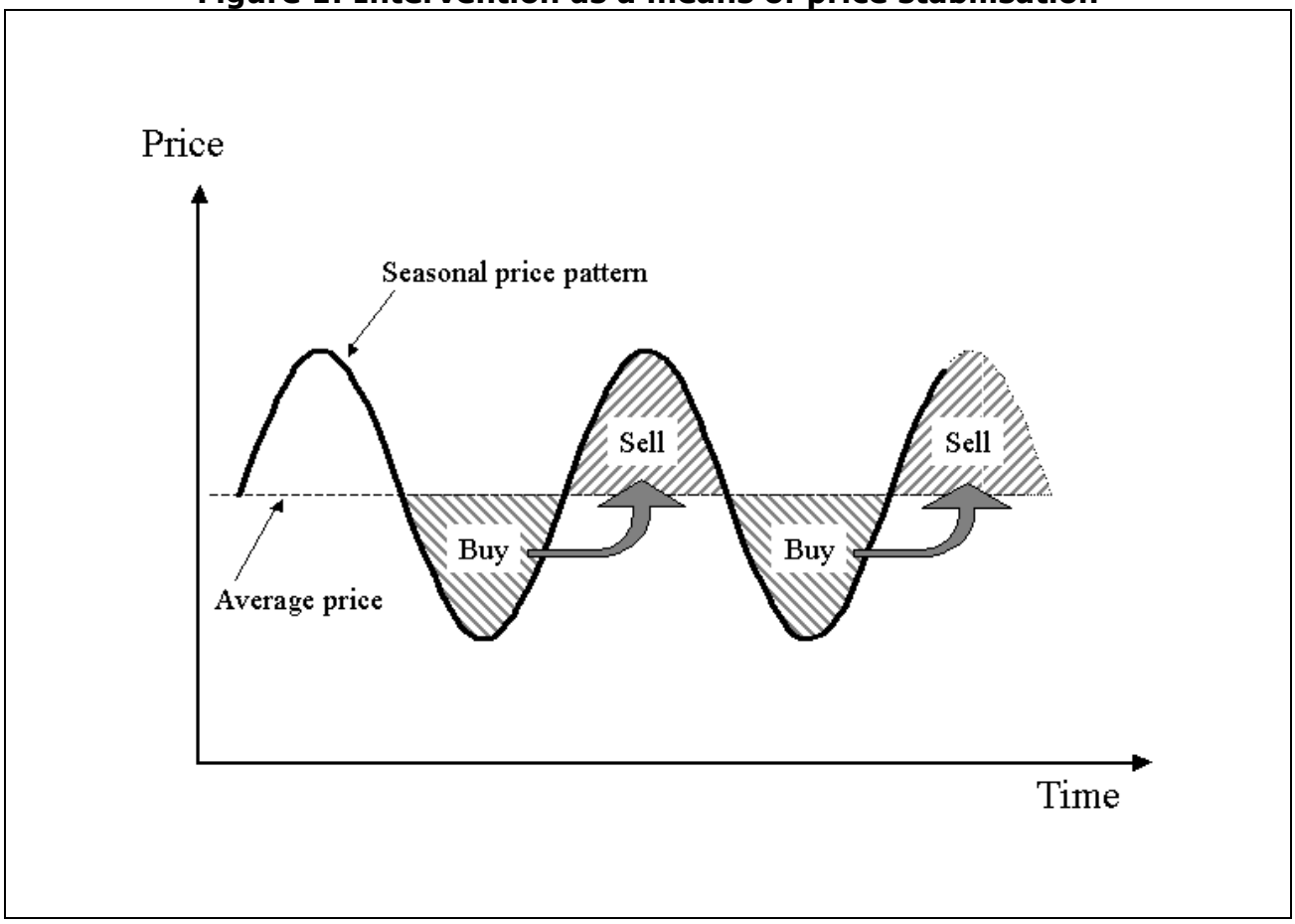
3. The goals of grain market regulation

As stated above, grain market regulation is usually justified by referring to two important goals: **price stabilisation and price support**. Each of these will be considered in turn below. As we will see, it is almost impossible to separate these two goals, and most grain market regulations (including those of the EU and the US) provide elements of both.

3.1 Price stabilisation

The case for government price stabilisation on grain markets is usually based on a simple conceptual model like that depicted in Figure 1. In Figure 1, the price of grain fluctuates seasonally about an average price, with prices falling at harvest time and peaking shortly before the next harvest. The seasonal price pattern is stable and repetitive, and the average price is stable. As a result, all elements of this model can be forecast with certainty, just as the biblical Joseph 'knew' that seven lean years would follow seven fat years. Under these conditions, government price stabilisation is a simple and riskless matter of buying grain while its price is below average, and selling it when its price is above. This is referred to as 'temporal arbitrage', and it allows the government to smooth the seasonal price pattern and thus stabilise grain prices. Under the Ukrainian pledge price system, the government would not actually buy and sell grain, but it would provide farmers with an incentive to delay the sale of their grain, which would have the same stabilising impact on seasonal prices under the conditions depicted in Figure 1.

Figure 1: Intervention as a means of price stabilisation



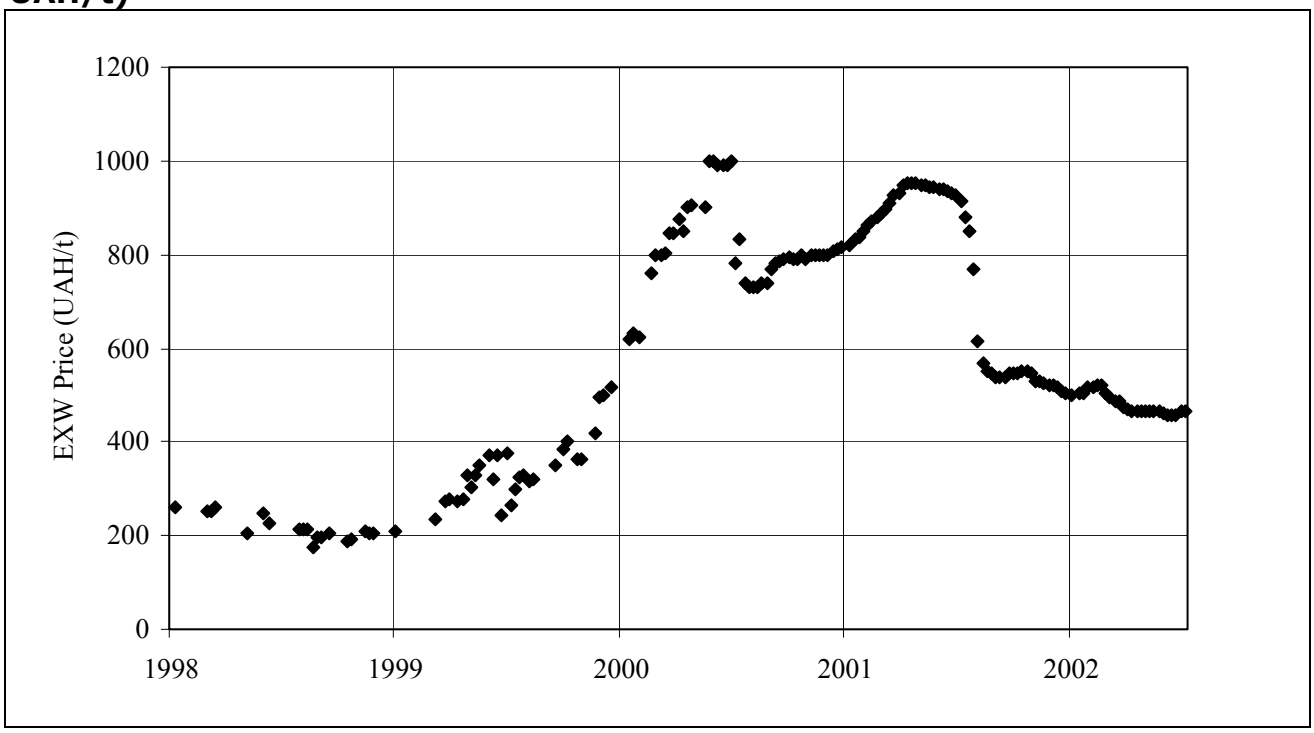
Source: Own depiction

Many policy makers in Ukraine appear to have the simple theory in Figure 1 in mind when they argue in favour of grain market regulation such as the proposed pledge price system. Unfortunately, they fail to realise that it is just that: a simple theory. In reality, the ideal conditions depicted in Figure 1 are highly unlikely, if not impossible. If conditions like those in Figure 1 were to present themselves, then private storage firms would also engage in temporal arbitrage, buying grain when it is cheep, and selling it when it is dear. This activity would have the same impact on the seasonal price pattern as the government stabilisation scheme is intended to; i.e. it would bid up low prices and bid down high prices. Private storers would continue to buy cheep and sell dear until the difference between high and low prices is just equal to the amount it costs to store grain over the span between the time of purchase and the time of sale. Hence, private firms would exploit all possible gains from storage, leaving behind a less pronounced seasonal price pattern that no longer provides any opportunity for profitable storage.[6] If the government then attempted to further stabilise prices by purchasing and later selling grain, it would inevitably lose money as storage costs would exceed any price increases that might be realised. A government could only intervene without incurring a financial loss if its costs of storing grain were lower than private firms' costs. A great deal of experience world wide suggests that this is seldom, if ever, the case.

A second, more fundamental reason why the simple stabilisation scheme in Figure 1 is not realistic is that in reality grain prices simply do not follow regular, predictable patterns. Consider, for example, the Ukrainian wheat prices depicted in Figure 2. Obviously, these prices do not follow the sort of regular seasonal pattern discussed above. While it is true that prices did fall both in mid-2000 and mid-2001, it is well-known that this was largely due to an inconsistent policy of import duties and tariff rate quotas for grain imports in 2000, and greatly exacerbated by the shift from a net import to a net export situation in 2001 (see below, footnote 6). The situation in 2001 was especially unique and, therefore, does not provide a sound basis for predictions of future seasonal price movements.

[6] Note that the lower the storage costs, the smoother the price pattern that will remain. Increasing competition on the market for grain storage services is therefore a means of stabilising grain prices.

Figure 2: Ukrainian milling wheat prices (January 1998 – June 2002, EXW in UAH/t)



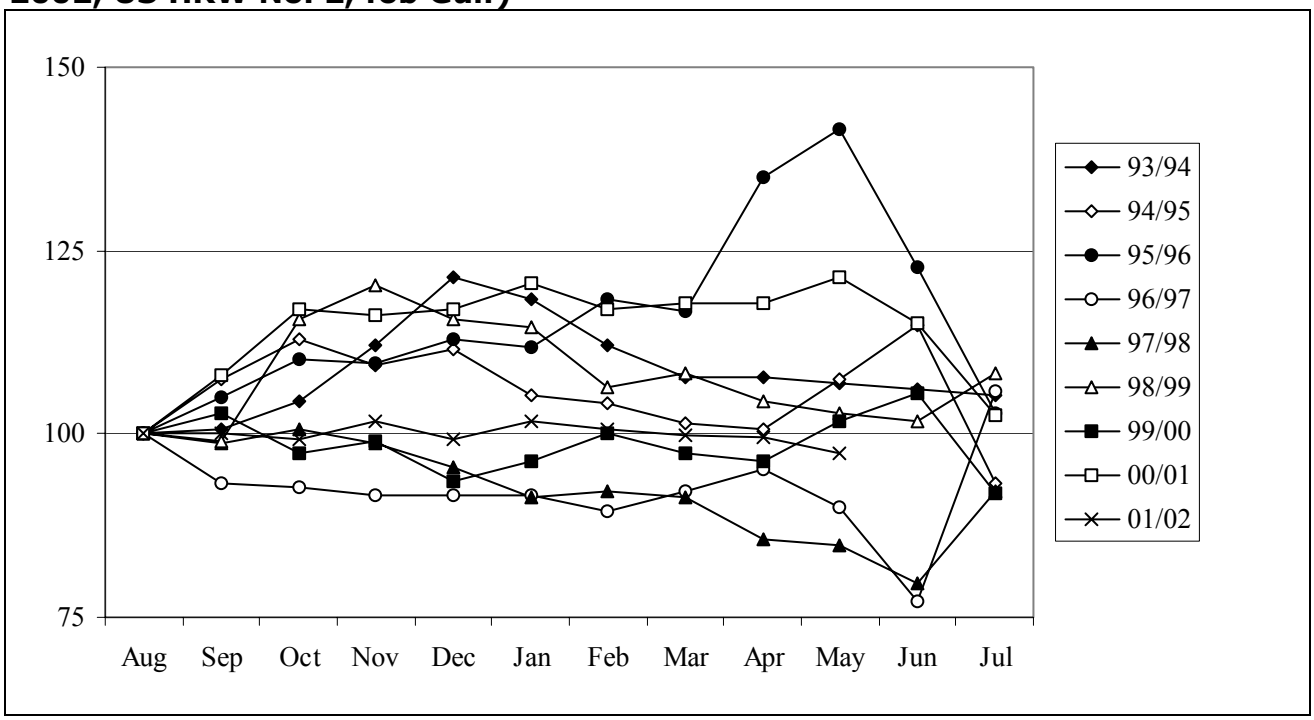
Source: Ukragrokonsult, *Agrinews Kyiv Weekly Market Report*, various issues.

It is not surprising that Ukrainian grain prices to not follow a regular seasonal pattern. To see this, consider the information of world market prices for wheat in Figure 3. In Figure 3, annual fluctuations in world market prices are illustrated by setting the price in August of each year equal to 100. We see that world market prices are anything but seasonal; sometimes they increase in the course of the year, sometimes they fall.

Why do world market prices for grain not follow a regular seasonal pattern? The reason is simple. At any point in time, grain is being harvested somewhere in the world. It is true that the Northern Hemisphere, where grain is harvested mainly in the months of July to September, accounts for the dominant share of world grain production. Nevertheless, multiple cropping in some tropical and semi-tropical countries such as China, and Southern Hemisphere countries such as Argentina, South Africa and Australia ensure that an important harvest is always taking place somewhere in the world. Each of these harvests is subject to fluctuations due to factors such as the weather and policy changes. The demand side of the world grain market is also subject to fluctuations as, for example, new information on oilseed harvests has an impact on the demand for grain as animal feed.

As a result, world grain markets are in a constant state of flux as traders react to an uninterupted flow of new information, each piece of which has an impact on prices. Since each year is characterised by a unique flow of information on production, consumption and policy around the world, each year is also characterised by a unique seasonal price pattern.

Figure 3: The (lack of) seasonality of world market prices for wheat (1993 – 2002, US HRW No. 2, fob Gulf)



Source: United States Department of Agriculture, *Wheat Market Outlook*, various issues.

Ukrainian grain prices ($P_t^{Ukraine}$) at any time '*t*' are derived from world market prices (P_t^{World}) according to the following relationship:[7]

$$P_t^{Ukraine} = (P_t^{World} * E_t^{UAH/US\$}) - (Marketing\ costs) \quad \Rightarrow \quad \text{Export situation,}$$
$$P_t^{Ukraine} = (P_t^{World} * E_t^{UAH/US\$}) + (Marketing\ costs) \quad \Rightarrow \quad \text{Import situation,}$$

where $E_t^{UAH/US\$}$ is the exchange rate between the Hryvnia and the US Dollar and 'marketing costs' refer to the costs of moving grain from Ukrainian farms to world markets (export situation) or from world markets to Ukrainian consumers (import situation). Hence, Ukrainain grain prices will be subject to the same fluctuations as world market prices, with additional fluctuations due to any changes in the exchange rate between the UAH and the US$ as well as any changes in relevant agricultural policies (for example, the Ukraine's import duties in 2000). If, as outlined above, world market prices do not follow a stable seasonal pattern, then there is no reason to expect that Ukrainian prices will.

This has important implications for the pledge price system that is being implemented in Ukraine. If it functions (i.e. if farmers choose to take advantage of it), then it will provide farmers with post-harvest liquidity. Farmers will be able to receive a minimum amount of money for their grain immediately and then wait for a better opportunity to sell this grain for a full price on the market. However, if Ukrainian prices do not follow

[7] This is the relationship that the German Advisory Group used to generate its forecast that Ukrainian grain prices would fall dramatically following the harvest in 2001. This forecast, first presented to Ukrainian policy makers in November 2000 (!) turned out to be very accurate. Now that Ukrainian grain production appears to be recovering from its crisis in the late 1990s, it is safe to assume that Ukraine will remain a net exporter of grain, i.e. that the first of these two equations will apply and the dramatic fall in prices witnessed in 2001 will not re-occur.

a stable seasonal pattern, then there is no guarantee that farmers will receive a higher price later in the year than they could have right after the harvest. With reference to Figure 2, note that after the harvest was completed in 2000, prices then rose over the course of the 2000/01 marketing year. Following the harvest in 2001, however, prices fell in the course of the 2001/02 marketing year. This is because world market prices weakened and the Hryvnia tended to strengthen vis a vis the US$. As a result, if the pledge price system had been in operation in 2001/02, farmers who decided to pledge their grain and not sell it immediately would have lost, and not gained revenue. Furthermore, by taking grain off the market after the harvest, and putting it back on the market later, the pledge price system would have increased rather than reduced seasonal price fluctuations.

Hence, farmers who pledge their grain will be **speculating**. They might hope, but they cannot be certain that prices increase in the course of the year. Depending on world market price development and the US$/UAH exchange rate, this may or may not be the case. It is not possible to know with certainty whether the future price will be higher or lower than the current price and, hence there is no guarantee that grain that is purchased today can be sold later at a profit (or at least without a loss). Large international grain trading companies, such as Cargill and Toepfer, despite large staffs of specialists and decades of experience on all of the major grain markets worldwide, are not able to predict future grain prices with certainty. They earn money by trading grain as efficiently as possible, not by speculating.[8] Is there any reason to expect that Ukrainian farmers, the Government of Ukraine or one of its agents – such as the State Material Reserve or Khlib Ukrainy – will be better at this game than the Cargills and the Toepfers?

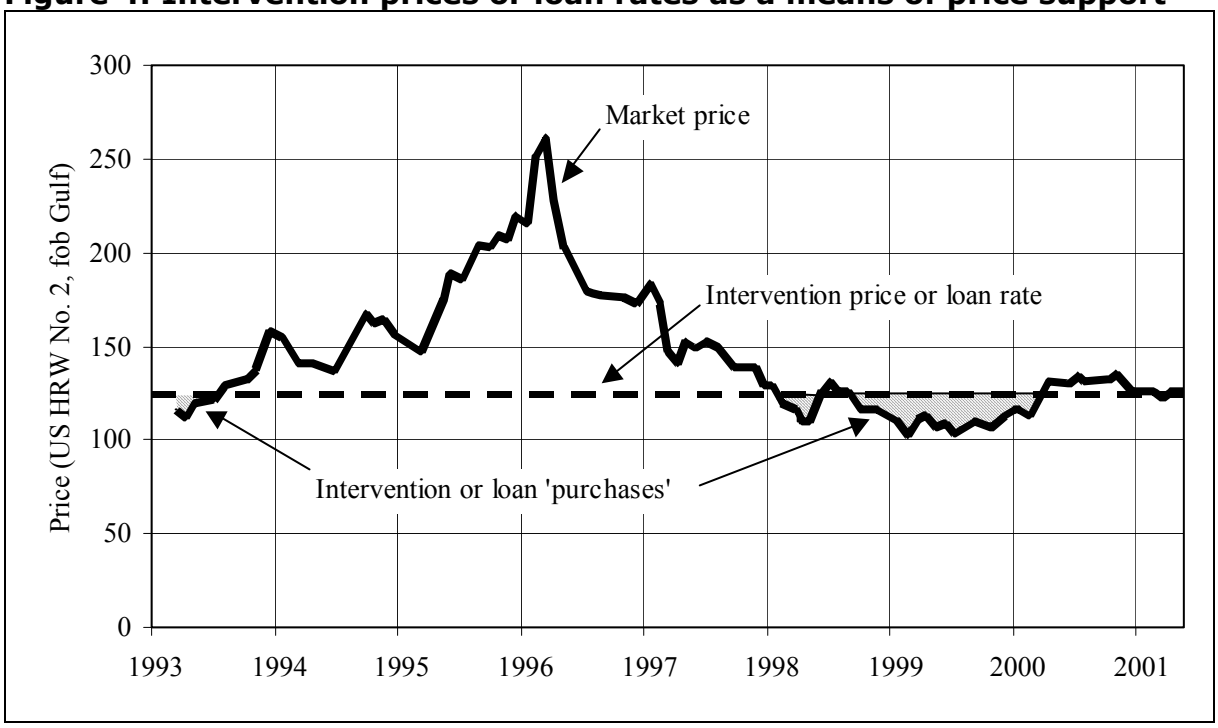
3.2 Price support

In practice, both the US loan rate system and the EU's intervention system operate as depicted in Figure 4. For illustration, we use the actual course of world market prices for wheat between 1993 and 2002 in Figure 4, and assume that a hypothetical intervention price or loan rate has been set at 125 $/t over the entire period.[9] Whenever prices fall below this level, farmers will sell wheat into intervention (EU) or deposit it with the Commodity Credit Corporation in return for the loan rate (US). Hence, the intervention price (or loan rate) acts as a price floor, eliminating price 'dips' or 'valleys'.

[8] These companies do sometimes store grain. However, they do so not with the goal of stabilising prices but rather as a natural part of buying and selling grain over time, in other words to compensate for the fact that grain supply and demand do not correspond perfectly in time. If they are forced to store large amounts of grain they employ forward or futures contracts to hedge against risk and avoid speculative positions (see the German Advisory Group's papers Q11 and Q17 on the functioning and uses of futures markets). The use of futures markets might also help the Ukrainian Government hedge intervention or pledge purchases, but only in years in which futures markets expect prices to increase.

[9] In reality, intervention prices and loan rates often change from year to year.

Figure 4: Intervention prices or loan rates as a means of price support



Source: Own depiction using data in Figure 3.

This has the effect of both stabilising prices (prices fluctuate less) and supporting them (the average price increases). Of course, it also leads to the accumulation of government stocks. Since these cannot accumulate without bound, and since grain cannot be stored indefinitely, the government must find some way of disposing of grain. This is usually accomplished via export subsidies as outlined in section 2.1 above for the EU.[10]

This has three important implications. First, **price support costs money**. It inevitably involves buying grain from farmers at a higher price than it can be sold for. Consumers can be forced to bear a share of the cost of price support that is equal to the share of domestic production that they consume. In the EU and the US one might conclude that consumers are rich and can afford to bear this cost. In a country such as Ukraine, where much of the population is poor, price support for farmers can significantly reduce standards of living for the population as a whole. Policy makers must be explicit about this; giving something to one group necessarily implies taking it away from another. Note that in this context, ‚consumers' includes livestock producers who use grain as feed. In other words, price support for grain does not support agriculture as a whole; it helps some farmers but it taxes others.

If policy makers prefer not to burden consumers, then taxpayers must bear the cost of price support. In any event, taxpayers (i.e. the budget) must bear a share of the cost that corresponds to the excess of domestic production over domestic consumption. This is usually where policy statements and policy reality drift apart in Ukraine. Support has often been promised in the past, but the required financial resources have rarely, if ever, been made available. Increasing Ukrainian grain prices by just 10% would cost 1,4 billion UAH, assuming production of 35 million tonnes and an average price of 400 UAH/t. Even if we assume that consumers bear most of this

[10] In a net import situation, price support can be accomplished by simply erecting import barriers such as tariffs. In a net export situation, however, export subsidisation is an inevitable consequence of price support (unless the government prefers to destroy the surpluses in question). We assume that Ukraine will consolidate and expand its status as a net grain exporter.

cost in the form of higher domestic grain prices, taxpayers would still have to bear the rest. Assuming exports and domestic consumption of 7 and 28 million tonnes respectively, taxpayers and consumers would have to finance 280 million and 1,12 billion UAH respectively. Note that these rough calculations account for neither the administrative costs of grain market regulation and possible speculative losses, nor the inevitable costs of inefficiency as well as the possible fraud and corruption that such regulations engender.

Resolution 590 and the new grain law both call for grain market regulation to be financed out of the state budget. As indicated above, however, providing only 10% price support to grain producers alone would cost taxpayers at least 280 million UAH.[11] Nothing even approaching this amount of money is available. Hence, as in the past, this year has begun with ambitious promises and plans for grain purchases by various state agents, and it will end with reports that these plans could not be realised. For example, one can already read reports in the media that the State Material Reserve Committee is cutting back its plans to purchase grain in 2002 from 500.000 to 200.000 tonnes.

This chronic under-funding of price support is interesting in relation to the ongoing difficulties with VAT refunds in Ukraine. Failure to refund VAT to grain exporters (on time or at all) effectively increases grain marketing costs. Hence, for a given world market price, failure to refund VAT depresses domestic prices in Ukraine (see the equations in section 3.1) and therefore has the same impact as a tax on farmers. It is rather odd that policy makers are discussing the need to support grain farmers on the one hand, and taxing grain farmers on the other. Rather than making promises of support that probably cannot be kept, maybe it would be more effective to eliminate existing taxation first.

Second, price support could create difficulties for Ukraine's goal of quickly and successfully completing its negotiations to join the WTO. As mentioned above, price support by a net exporting nation automatically implies the use of export subsidies. Ukraine has not used agricultural export subsidies in the past and will probably have to commit itself never to use them in the future as a condition for joining the WTO. Furthermore, price support must be accompanied by effective import barriers. Otherwise foreign products could be attracted into the domestic market by higher prices. This is currently the case on Ukraine's sugar market, where high domestic prices have created incentives for (often smuggled) imports from neighbouring countries such as Russia. Import protection is also regulated by the WTO and Ukraine would have to request permission to increase its import barriers. Altogether, the grain market regulation in Resolution 590 and the new grain law will make it **more difficult for Ukraine to join the WTO**.

A **third** important implication of price support concerns the interaction between price support schemes in different countries. If the EU supports grain producers, for example, they will produce more grain. The EU is forced to export this grain using export subsidies, thus depressing the world market price for grain. Assume, for example, that the EU wishes to provide its farmers with a grain price that is 10% above the world market level. As a result, farmers in the EU produce more grain, and dumping this extra grain on world markets depresses world market prices by, say, 2%. Therefore, to achieve the goal of 10% support with respect to the original world market price, the EU will have to provide its farmers with 12% (= 10% + 2%)

[11] Of course, if grain producers receive support, then other farmers will want some as well. This would inflate the total cost of agricultural support to levels that are even less realistic than 280 million UAH.

support. This is only true for countries that account for a major share of the world market such as the EU and the US; a small country such as Luxembourg could double its production tomorrow and world markets would hardly notice. If several large countries try to support their farmers simultaneously, this effect (referred to by economists as the 'terms of trade effect') is amplified: The EU must increase its support to account for the impact of US support on world market prices, and vice versa.

Seen in this way, a significant amount of the money that countries spend in attempts to support their farmers is effectively spent to compensate for the fact that other countries are doing the same thing. If the EU and the US were not supporting their grain farmers, world market prices would be higher and there would be less pressure for support in Ukraine. In other words, grain market regulation in the EU and the US effectively taxes grain producers in Ukraine.

How should Ukraine react to this situation? The course of action that Ukrainian policy makers seem to have chosen is to copy price support measures in the EU and the US. As indicated above, however, Ukraine does not have the financial resources to provide meaningful support to its grain farmers; it is not in a position to compete with the EU and the US on the market for agricultural support. So this is not a very promising course of action. As a potentially major agricultural exporter, Ukraine should not join a 'dirty' game that it cannot win. It should instead do everything possible to ensure that the unfair use of subsidies by 'bullies' such as the EU and the US is reduced and eliminated as soon as possible.

This is where international rules and disciplines such as those administered by the WTO come in. Such rules are especially important for small countries that cannot afford to subsidise their farmers to the extent that large, rich countries can. Ukraine would be well advised to join the WTO and, together with allies such as Canada, Argentina and Australia, use this institution to push for fair conditions on world agricultural markets. While this course of action will require patience and will not provide fast, dramatic returns, it is the only course of action that will enable Ukraine to take advantage of its significant comparative advantage in agriculture in the medium to long term.

4. Conclusions and policy recommendations

I. There is much talk of grain market regulation in Ukraine, but not enough clarity concerning exactly what type of regulation is planned, how it will be implemented, how much it will cost and who will foot the bill. Policy makers lose credibility if they continue to make promises and plans that are never translated into reality.

II. Grain market regulation is usually aimed at stabilising and supporting farm prices. The EU and the US have developed very sophisticated and expensive grain market regulations. It is doubtful whether Ukraine currently has the financial and administrative capacity to implement regulations such as these.

III. If Ukrainian policy makers wish to implement a system based on the US loan rate policy, then farmers will need concrete assurances that they will be able to reclaim pledged grain at a later date. Farmers are concerned that they may be coerced into 'pledging' grain at this low price, and that they will not have a practical option of reclaiming this grain at a later date. Given Ukraine's history

and experience with state orders and storage at the central and oblast level in Ukraine, this concern is understandable.

IV. Advocates of price stabilisation schemes often base their arguments on the unrealistic assumption that prices follow predictable seasonal patterns. This is not the case on Ukrainian or world grain markets. As a result, price stabilisation is not a simple, cost-neutral matter of buying cheep and selling dear, or of storing now and selling later. Instead, price stabilisation is speculative and can prove very costly. If the new pledge price system had functioned in the 2001/02 marketing year, many farmers would have lost, not gained revenue as a result, and Ukrainian grain prices would have been destabilised, not stabilised.

V. If Ukrainian policy makers are seriously interested in helping grain producers, then they should see to it that VAT payments are refunded to grain exporters. Failure to refund VAT on grain exports, like the export tax on oilseeds, has the same impact on farmers as a tax on their production. The fact that the VAT problem is real and ongoing, while every year promises to support grain markets remain critically under-funded, demonstrates conclusively where policy makers' true priorities lie.

S.v.C.-T.,

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