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Weather and Policy Risks - Are the Grain Export Restrictions Unavoidable to Achieve Food Security in Ukraine?

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Executive Summary

The long lasting drought and very high temperatures this spring created unfavourable conditions for crops in Ukraine, and 2007 grain crop is expected to be lower than last year. **The Government of Ukraine (GOU) has already** reacted by publishing a resolution No. 794 as of 4th of June **"On immediate measures for mitigation of drought effects and forming grain supply for 2007".** This resolution, among other measures, calls for the introduction of grain export quotas. On the 20th of June the GOU adopts another Resolution No. 844 **"On amendments of the Cabinet of Ministers of Ukraine resolution No.1852 as of 25th of December 2006"** introducing export quotas for wheat, barley, corn and rye from July 2007 until October 2007. For each of these products the export quota will be 3,000 t starting July 1 until there is enough grain in the State Reserves. **The amount is very small and the resolution is actually a grain export ban. A grain export licensing system and grain export quotas were already introduced in October 2006.** They have been abolished for corn and barley in spring 2007 and for wheat only recently on June 8, 2007. Thus, with the introduction of new quotas expected early July 2007, export restrictions will remain in the new season.

The main concern of the GOU is to keep domestic grain prices under control during the period of public purchases for the state grain reserves. By doing this, the GOU aims to ensure food security and price stability for bread.

The grain and bread price developments receive significant public attention in Ukraine, and the export restrictions are supported by many Ukrainians. This is why the GOU wants to achieve basically two objectives:

1. **Food security**, i.e. controlling the amount of grain exported out of the country.
2. **Price stability**, i.e. keeping domestic grain prices low, which otherwise would reflect the world market developments.

In fact, with the planned grain export restrictions the GOU can achieve these goals. **However, the economic costs of this policy are very high**, and we argue that there are better options available to achieve the goal of food security in Ukraine.

1. **It is often believed that without grain export restrictions too much grain would be exported out of Ukraine leaving nothing for the domestic market**. **However, as in most other countries, price mechanisms will ensure** that the exports are restricted. If the domestic supply is endangered, prices will rise domestically and exports out of Ukraine will no longer be competitive and feasible. However, the problem is that Ukrainian official statistics are notoriously unreliable, politically motivated and often not publicly available in time. This is why the market participants cannot assess the situation properly and in a timely manner, and this is also why the Ukrainian market is sometimes overreacting.
2. **The Ukrainian market does not have a supply problem but a price for the poor problem**. On average Ukrainians spend a considerable share of their disposable income on food with the poor spending most of their income on food. The Ukrainian government should help the poor by using targeted cash transfers. Grain export restrictions keep certain food prices low for both the poor and the rich.
3. **Export quotas effectively decrease farm-gate prices as well as farm profits.** Since farm employees' income depend on farms' profits, export quotas indirectly decrease the income of the population employed in the farm sector as well, where salaries are practically the lowest in the economy. Therefore, the resulting loss in income of the farm sector employees would cancel out the benefit coming in the form of lower bread prices.
4. **The measures taken by the Ukrainian Government in 2006 were not consistent with the WTO policies**. This does not mean that the Ukrainian government is not allowed to impose grain export quotas. The WTO provides clear application and implementation rules. It provides so-called safeguard clauses and the exporting country, which faces a food shortage, can apply export restrictions. Measures can be introduced only after evaluation by the WTO. Existing contracts of market participants need to be

respected. Thus, an introduction of grain export quotas was not the major problem for grain traders in 2006, but the manner in which they were introduced.

5. **The grain export restrictions decrease farm profits and investment growth in Ukraine.** This year farmers will not only suffer from drought but as a consequence of the export ban also from much lower prices. It is most likely that farmers will react accordingly in the fall of 2007 and will reduce the acreage planted with wheat – a market that has been heavily influenced by the politics. They may switch to other crops like rapeseed, where exports are still unrestricted..

Thus, the Ukrainian government misses the chance to get a bigger crop next year and prevents Ukrainian producers to realise agricultural potential that Ukraine is said to have. After a meagre 0.5 % growth rate of the Agricultural GDP in 2006, the 2007 growth rate will be very small also, lagging far behind the overall growth rate of the Ukrainian economy.

Are the Grain Export Restrictions an Appropriate Measure to Achieve Food Security in Ukraine?

The long lasting drought and high temperatures this spring resulting in unfavourable conditions for crops in Ukraine. Most affected is the barley crop followed by wheat. Currently, there is a number of grain harvest estimates available with substantial differences. Until the crop is harvested the exact damage is therefore difficult to assess. However, the Ukrainian government has already reacted by publishing resolution No. 794 as of 4th of June **"On immediate measures for mitigation of drought effects and forming the grain supply for 2007".** This resolution, among other measures, calls for the introduction of grain export quotas. On the 20th of June the GOU adopts another Resolution No. 844 **"On amendments of the Cabinet of Ministers of Ukraine resolution No.1852 as of 25th of December 2006"** introducing export quotas for wheat, barley, corn and rye starting July 2007. For each of these products the export quota will be 3,000 t starting July 1 until there is enough grain in State Reserves. For comparison, wheat exports are expected to be 2.3 mln. t. in 2006/07 marketing year compared to 6.4 mln t in 2005/06. Barley exports are expected even higher at 5.3 (4.2) mln t. The draft resolution was already published in early June as the government is required to publish the law 30 days prior to application of the quota. **A grain export licensing system and grain export quotas were already introduced in October, 2006. They have been abolished for corn and barley in the spring of 2007 and only recently for wheat on June 8, 2007.** Thus, with the introduction of new quotas early July, 2007, export restrictions will be practically extended into the new season.

With these measures, the Government of Ukraine wants to achieve basically two objectives:

1. **Food security,** i.e. controlling the amount of grain exported out of the country.
2. **Price stability**, i.e. keeping domestic grain prices low, which otherwise would reflect the world market developments.

In Ukraine, grain export restrictions receive a wide public acceptance. Part of this is related to the Ukrainian history. The Ukrainian Holodomor in 1932-1933, often referred to as the Ukrainian Genocide, was a famine caused by the policies of the government of the Soviet Union under Stalin. The direct loss of human life was huge, with estimates varying between 5 and 16 mln. Less than ten years later the German occupation triggered another hunger. This happened in a country that is well known as the breadbasket of Europe. Furthermore, trust in market mechanisms did not completely develop and government intervention into the economy is often preferred.

On average, food accounts for approximately 45 % of the total expenditures of the Ukrainian population.. Thus, any food price increases considerably affect the real income of the population and also impact inflation, as the food share in the Consumer Price Index (CPI) of Ukraine is comparatively high.

The Ukrainian government is correct in its assessment that the export quota has achieved both, food security and price stability. Starting October, 2006 Ukrainian grain prices were significantly lower than they would have been with a free export regime since October 2006. While it is safe to assume that the domestic Ukrainian grain price was 20 to 40 US$/t lower than it would have been without the export quotas on grain, the precise effect is difficult to measure.

However, the economic costs (welfare losses) of the introduction of grain export quotas are huge. Farmers and trading companies accrue significant losses, reputation of Ukraine as a reliable and transparent country for investments and trade suffers, leading to more losses in the future. Farmers generate less income, investing less in new technologies and switching to less "policy-sensitive" crops. The result is that growth of Agricultural GDP remains far behind GDP growth of the economy in general. Loss of income and investment this year leads to reduced growth in the following years.

These raise the question whether Are export restrictions are unavoidable and whether there are better alternatives to achieve food security in Ukraine. The following arguments in favour of the Grain export restrictions are scrutinised and alternatives presented below:

1. **Would grain deficit prevail without quotas? In the 2006/07 marketing year Ukraine would not have suffered a grain deficit without the introduction of grain export quotas**: Although the government is constantly claiming that exporters would have shipped too much grain out of the country without the introduction of the grain export quota, this is not true. A transparent price mechanism is regulating grain exports. If grain exports create a shortage at the domestic market, the prices go up preventing further exports. Thus, markets work, and **Ukraine does not have a grain availability problem, but a grain price for the poor problem.**

2. **Are the grain statistics reliable? Reliable, independent and publicly available grain supply and demand statistics would facilitate operation of market mechanisms. Currently there is a shortage of good market data. Although many projects were** initiated by international organisations, Ukraine does not have a good market information system. Production, supply and demand statistics still entail politically motivated figures. It is especially difficult to obtain data on domestic grain use, grain stocks, etc. This, however, is what grain traders rely on. Currently only private information is available. A good market information system, similar to the USDA system, would provide the necessary information to avoid food shortages. It would also increase market transparency and predictability of grain markets.

3. **Are public and private stocks available?** With the lack of **reliable statistics, the grain availability in private stocks is rather difficult to assess.** There are three major market information agencies operating in Ukraine, which all provide slightly different data on the grain crops, the domestic demand, the expected exports and therefore the ending stocks. Thus, it is a difficult task to count tons available and it is hard to give a preference to a specific source. It is also uncertain whether the Ukrainian government is able to do this, as it has no means to measure the crop, internal demand and stocks properly.

4. **Should grain import taxes be reduced? Grain imports are not a national catastrophe**. Policy makers and some Ukrainian media argue that the country should not export too much wheat that would create an import demand later. However, this situation is quite common in many countries. Germany, for example, exports and imports wheat simultaneously. In Ukraine it would probably make sense to import some wheat into western Ukraine from Poland or Hungary and simultaneously export grain from southern regions. However, Ukraine imposed prohibitively high import duties and the recently published plans to abolish them would be an important step to mitigate price increases on the domestic market once imports are necessary.

5. **Can food security for the poor be achieved through export restrictions? Ukraine does not have a grain availability problem but a price for the poor problem and the Government of Ukraine should not focus solely on food availability, but on food security.** Food security of a person or a country depends on many factors. Income is the most important one.
   In Ukraine poor include pensioners, single mothers, and unemployed, just to name a few, which would not afford to pay for higher bread prices. These people need direct support from the government, for example targeted cash-income transfers or probably food stamps. This would reduce the negative impact of price increases on these groups and at the same time allow farmers benefiting from high world market prices.
   The grain export quota does not target the poor only. It provides the same subsidy to the poor and the rich. The grain export quota does not cover food grains only. It also provides a large implicit subsidy to the livestock producers. Meat and dairy products, for example, are the type of food that is mainly consumed by high-income consumers. **Thus, the implicit subsidies initiated by the grain export quotas favour the rich much more than the poor.**
   Farmers pay the quota bill. **Export quotas effectively decrease farm-gate prices, and farm profits accordingly. Since farm employees' income depend on farms'**

profits, export quotas indirectly decrease the income of the population employed in the farm sector as well, where salaries are among the lowest in the economy. Therefore, the resulting loss in income of the farm sector employees cancels out the benefit coming from the lower bread prices.

6. **Are grain quotas consistent with the objective to join WTO? The measures taken by the Ukrainian Government in 2006 were not consistent with the WTO policies.** The introduction of grain export quotas in 2006 were criticized due to their sudden introduction and the effect that they had on the existing contracts. This triggered significant losses for grain traders, as ships were waiting in ports, existing contracts were not be fulfilled, grain prices dropped and grain rotten in storages.
   This does not imply that the Ukrainian government is not allowed to impose grain export quotas. The WTO provides a set of quota introduction and application rules. It provides so-called safeguard clauses and the exporting country, which faces a food shortage can apply export restrictions. Once a food shortage situation is evaluated by the WTO, measures can be taken. However, existing contracts need to be respected. Introduction of grain export quotas was not the major problem for grain traders. Instead, the manner in which they were introduced was more problematic.

7. **Will bureaucracy and corruption increase? The administration of any export or import quota is complicated.** A good example is the grain import quotas of the EU. All details need to be regulated to make the management of the quotas transparent, practicable, reliable and non-discriminatory. To achieve this goal, a group of companies or individuals eligible to apply for quotas must be defined. The bidding process, timing, the allocation of quotas and other details have to be regulated. It took approximately half a year for the EU to design its third country import quota for wheat and barley before it was finally introduced on January 1, 2003. In 2006 the government of Ukraine, which has little or no experience in quota administration, established the quota within a few weeks. This accelerated introduction of the quota created many problems, particularly for the trading companies. The application procedure was quite unclear, numerous documents were required, some had little or nothing to do with the quota administration. Companies that received quotas later were not able to use them and exporting was impossible even with the quotas allocated! **Therefore, the quotas are not reliable.** The criteria on which the allocation process is based is neither practicable (i.e. they create large transaction costs), nor they are transparent. Criteria for quota allocation are not clear. **As the allocation process is non-transparent, whether quota allocation is non-discriminatory is difficult to assess.** However, the unclear allocation procedure points to the fact that they are most likely discriminatory. **Finally, quotas create opportunities for corruption.**

8. **How will farmers react? The grain export quota damages productivity and production:** The Ukrainian government prevents farmers benefiting from high world market prices. This reduces income and investment. High grain prices could foster investments in the sector, allowing Ukraine to produce 50 or even 60 mln t of grain, which is much more than today. Thus, the GOU prevents farmers to fully use agricultural potential. These policies contradict government plans to substantially increase production by 2015. **Farmers will most likely increase the oilseed acreage and decrease the grain acreage in the 2007 fall planting campaign.** During 2006/07 and 2007/08 seasons farmers realized that the grain market is highly political. Due to this political uncertainty they are forced to sell their crop well below world market prices. There are alternatives, i.e. rapeseed, soy beans and sunflower**. Winter rapeseed survived the drought much better than winter and spring grains and prices for both crops are very attractive. Therefore, farmers could increase the rapeseed acreage substantially and reduce the grain acreage. Similar behaviour of the** farmers is observed in other parts of the world. In Canada, for example, the Canadian Wheat Board (CWB) acts as a wheat export monopolist. The problem is that farmers are not getting paid by the CWB immediately after they deliver the crop, but sometimes months later. Rapeseed and barley exports are not restricted by a monopoly. Thus, farmers can sell the crop whenever they like and immediately receive the entire payment. This is considered to be one of the main reasons why Canadian farmers have decreased their wheat acreage to 9.7 mln ha down from last year's 10.7 mln ha and

have increased their barley and rapeseed acreage. **Another example is Argentina, where the government imposed high export tariffs for wheat and in some cases completely restricted wheat exports. Thus, most farmers are expected to switch to barley, rapeseed and soybeans this year, probably creating even greater problems next year.**

9. **How large is the impact on inflation? Grain prices have an impact on inflation, but this cannot justify export restrictions.** The share of food in the Consumer Price Index (CPI) of Ukraine is quite high. However, food prices have tended to keep the consumer price inflation lower rather than increasing it in 2006. Flour and bread represent 0.5% and 3.9%of the consumer price basket, respectively. Thus, higher bread prices are not a major contributor to the cost of living. Even if the recent rise in international grain prices had been fully passed forward to domestic consumers, this would have led only to a moderate increase in the CPI. Thus, even if the inflation is somewhat depressed by the grain export quotas, the effect is small and the cost is high.

Many parties involved respect and understand the position of the Ukrainian government to impose measures that ensure food security, especially for the poor. Nevertheless, the measures taken by the Ukrainian government are not in line with the objective to reach higher growth rates in the agricultural sector. There are better policy options available to help the poor.

Thus, it is very important for the Ukrainian government to develop a strategy that helps the Ukrainian people to cope with high grain prices. A social transfer policy targeting the poor (targeted cash income transfers) would avoid trade restrictions and would also be consistent with the WTO membership. **The greatest benefit is that it would allow farmers to freely sell their products. It would also reduce the politically induced uncertainty and would therefore help to fully use Ukraine's large agricultural potential.**

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