

Insight: Russian grain could help ease food crisis

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A decade back, the public perception of the agriculture industry was one of subsidies, trade distortions and rigged markets. More recently, public awareness has focused on concerns over food security, price inflation and shortages.

The demand factors are easily identifiable – population growth, urbanisation, rising incomes, changing diets and fuel requirements. With the exception of bio-fuels, these factors combined present a picture of unrelenting demand for grains – gradual, paced and persistent.

Supply remains variable and volatile. The loss of 50 per cent of the Australian winter wheat harvest during last year's drought had a dramatic impact on wheat prices. Yet, those losses only accounted for some 3 per cent of global wheat output in a normal year, while wheat prices rose by 30 per cent between September and November. This was a clear indication that prices had become highly sensitive not to the factors driving demand but to historically low inventories.

Inventories have halved in seven years. Fifty days of cereal consumption in stock begins to look more like a crisis than an isolated statistic. Lower inventories can partly be attributed to fewer distortions in the agriculture system and improved supply-chain management.

However, as some price distortions disappear others appear. Export restrictions have been implemented by the likes of Australia, Russia, Ukraine, Argentina and Kazakhstan. Therefore, the rise in the wheat price from \$8 a bushel to over \$12 a bushel in the first two months of 2008 can be largely attributed to political decisions as grain-exporting countries seek to protect their own food supplies.

The Ukrainian government's decision to lift its restrictions hopefully negates the possibility these short-term panaceas become permanent fixtures. Recent price declines taking wheat back to US\$8/bushel can be largely attributed not only to the possibility of a half-decent harvest but also to the perception that the grain-exporting nations will remove trading restrictions as fast as they imposed them.

A similar theme has emerged in the rice market, but expect prices to

decline sharply from the recent \$25 a hundredweight level once the current frenzy ends.

We noted that grain supplies are volatile. However, fundamental demand increases will likely be met by countries with highly fertile but under-utilised land. Russia, Ukraine and Kazakhstan top the list of beneficiaries of this changing landscape.

Consider Russia. In 1992 the country had 120m hectares of farmland under cultivation. The change from public to private ownership ensured that one of the few advantages of communal ownership – access to plant and equipment – was lost.

Multiple ownership resulted in a “free rider” dilemma for the new owners of land ie, the efforts of individual contributions are shared equally. Consequently, in the last 15 years, some 40m hectares of rich farmland have lain fallow. And what is farmed is low yielding. Russia grows some two tons of wheat per hectare when it has the potential to produce five tons of wheat per hectare.

The ramifications are significant. From 75m tons of cereal output in 2007, Russia could multiply its grain output several-fold simply by enhancing yield management and bringing fallow land back into production. It could produce some 300m tons of cereals without the necessity of producing on virgin land.

This requires long-term planning and investment. Transferring ownership from inefficient multiple parties with no access to capital to large-scale corporate entities with long-term funding is time-consuming, while repairing fallow land is expensive. To attain higher yields needs lengthy investment in crop rotation. Overall the process can take 4-6 years.

These changes will help restore supply and demand imbalances across key cereal markets. That said, the entrepreneurial zeal transforming the Russian agricultural landscape will only restore some equilibrium to a dynamic market. So, while wheat at \$12 a bushel might prove to have been a temporary blip, \$4.50 a bushel is unlikely to be seen any time soon – even if it rains again in Australia one day.

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