

# Wheat Market Research 2003

## *Findings and recommendations*

### **Abstract**

Due to severe climate conditions in 2003 Moldova faced a wheat crisis. Crop production failed, and wheat yield was only 102 thousand tons as compared to 1181 and 1113 thousand tons in 2001 and 2002 correspondingly. For the first time in the last five decades a need for large-scale import of wheat and flour emerged. The situation though was aggravated by a swift rise in the prices of bread, wheat, and flour on regional and world markets, which finally affected Moldova's poorest population by the sharp growth of prices for bread (by 39.8%) and flour (as much as 2.5 times).

In the paper there is assessed the situation of the country's wheat market in 2003 as regards both quantity indicators (production, consumption, export/import, prices) and quality of the state regulation measures, competitive environment, territorial aspects of the "bread issue" and the impact of the bread price increase on the poor. Recommendations include proposals to improve the legislation and mechanisms regulating the wheat market, to form a state reserve fund and an intervention wheat fund, to improve the system of wheat procurements and storage, and social support for the vulnerable groups of the population.

*This paper is based on the Wheat Market Research carried out by the Center for Strategic Studies and Reforms (CISR). The initiative of this study belongs to the EC – Food Security Programme (EC FSP – Moldova). The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors (CISR's members and consultants) and should not be attributed in any manner to the EC FSP – Moldova or the Government of the Republic of Moldova.*

### **Introduction**

Does a wheat market really exist in Moldova? After 13 years of transition – from a planned economy to a market one – it would seem that an affirmative answer to this question is obvious. Indeed, private property and the private sector have started to dominate in the country's economy (more than 70% GDP falls on their share), enterprises, land and dwellings were privatized, internal and external trade became liberalized. At the same time, even as the first wave of reforms ended, many segments of Moldova's market economy (labor market, land market, communications market, etc.) are still in the making with inherent quite contradictory processes, including those appeared not without state participation. Such an assessment can be fully applied also to the wheat, flour and bread markets, its legal and administrative regulation, as well as to the efficiency of market instruments in the field of production, export-import transactions, prices and consumption and the situation of the 2002/2003 marketing year can only prove these.

The present study is realized at the request of the EC Food Security Programme – Moldova, which is its primary audience. It aims to provide a comprehensive analysis of the situation, which has developed in the Moldovan wheat, flour and bread market in 2003 (production, reserves and consumption). It will also assess results of the state regulation measures, the price evolution, quality of the competitive environment in the sphere of import of wheat, flour and bread production, as well as the impact of the bread price increase upon the poor. As the research was being prepared its executors oriented themselves to its practical utility and made policy recommendations for the Government. These would be impossible without reliable information and expert consultations. Thereupon, the CISR team would like to express its thanks to the officials of the Ministry of

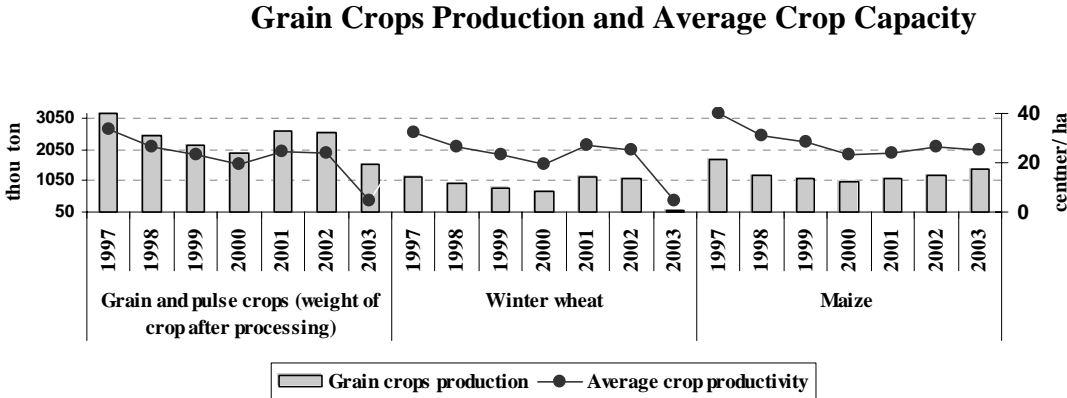
Economy, Ministry of Agriculture and Food Industry, Customs Department, Department of Statistics and Sociology, whose cooperation, comments and inputs made the report possible. While evaluating territorial aspects of the problem we used data from JSC Franzelutsa (Chisinau), the Administration of the Transnistria and the findings of the PFAP/CISR sociological research carried out in 302 rural settlements of 32 raions and ATU Gagauzia.

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**I. Wheat Market Development during the Transition Period**

Traditionally, Moldova satisfies its need for food, including bread, through domestic production, while agricultural and food production account for the major part of its export. During the 70’s and 90’s the dynamics of wheat production as the main grain crop for bread-making had the following average annual production volumes: in 1971-1980 – 983.0 thousand tons, in 1981-1990 – 932.7 thousand tons, in 1991-1995 – 1062.2 thousand tons and in 1996-2000 – 860.2 thousand tons. Record-breaking yields of wheat for 90’s took place in 1990 (1129 thousand tons), 1993 (1393 thousand tons), 1995 (1126 thousand tons), 1997 (1153 thousand tons) and also later – in 2001 (1181 thousand tons) and 2002 (1113 thousand tons).

*Graph 1*



Despite all the difficulties of the transition to a market economy and transformation of agriculture (land privatization, transition from large collective enterprises to private entrepreneurship), grain production has remained one of the key sectors of agriculture and, moreover, it was in the 90’s when grain, including bread-wheat, became an important and profitable product of Moldova’s export, since the internal prices were much lower than the international ones. This showed mostly during the productive years. Thus, in 2002 wheat export from Moldova was 376.7 thousand tons, the total value being 25.5 million USD or 1/3 of the total plant products export of that year.

Recently, a great volume of wheat production was obtained mostly because of an increase in area from 220 – 280 thousand ha in the 80’s to 340 – 370 thousand ha in the second half of the 90’s and even more than 400 thousand ha in 2001 and 2002 (433.9 and 442.7 thousand ha respectively). The share of wheat went up noticeably in the structure of grain crop areas: from 34.6% in 1985 to 38.7% in 1995 – 2000 and up to 40-41% in 2001 and 2002. Results for wheat crop capacity and quality were less impressive. Thus, if in 1971-1980 the average annual wheat crop capacity made up 32.8 centner/ha, in 1981-90 – 34.4 centner/ha, then from 1991-2000 – only 28.5 centner/ha, and in succeeding years even less. One unfavorable feature of the structural dynamics of wheat production during the last few years is a decrease of the share of bread wheat from 68% in 1998 to 44% in 2003 and thereafter an increase in the share of lower-grade fodder-grain.

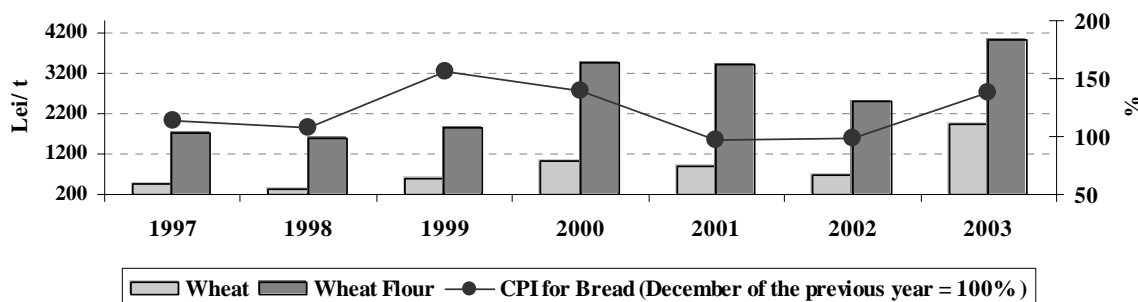
During the transition period the whole system of grain production, distribution and consumption has changed radically. The most important of these changes are: land reform; privatization of means of production and allotment of land to peasants; formation and rapid expansion of the private sector; large collective farms break-up; privatization of the territorial network of grain storehouses, mills and bakeries; marketing spin-off of export oriented branches, grain traders and service companies. At the same time as the above-mentioned processes took place, transformation and self-destruction of state bodies “patronizing” the grain sector went off quite quickly: Ministry of Grain Products → State and Cooperative Association of Grain Purchase and Processing “Moldhlebprodukt” → State Association “Cereale” (before 1998). Then, the private sector became firmly established within the whole system with the exemption of coming of granaries and JSC Franzelutsa, the largest bread baking enterprise. State interests on the grain market mainly show through purchase of grain for the “state reserve” and “state resources”, as well as through regulation of export-import operations.

But despite such radical changes *the legislation regulating production and commercialization of grain and state participation in these processes is still uncoordinated*. Thus, unlike other countries – neighbors and foreign trade partners of Moldova (Romania, Ukraine, Russia and Kazakhstan), it still does not have a law on grain and the grain market, which would regulate production, formation of reserves, processing and trade in grain, its quality control, etc. Such a draft has been “currently being developed” for a long time.

Under these conditions, the Government has consistently tried to use *administrative instruments* in order to limit competition among manufacturers and maintain state regulation of prices and foreign trade in this field. Depending on the annual situation with grain (bumper crop or crop setback) the Government makes relevant decisions, including setting indicative prices for export, recommendations concerning trade through the stock exchange, etc. As a rule, these actions provoke objections from the International Monetary Fund and the World Bank, as happened in 2003. Under their pressure the Government had to issue two (!) decisions “on elimination of official and non-official barriers to operations of economic entities”.

*Government policy regarding state grain reserve* and relations with the external grain market was built up depending on the specifics of a given year. Thus, on July 5, 2001, the Government issued Decision # 588 on actions to provide for the needs of state institutions on bread and bread products, *bar their deficit on internal market*, as well as unjustified increase in prices for these products. It stipulated: formation of a state bread grain reserve of 50.0 thousand tons; recommend local bodies to form together with economic units wheat reserves in regions; establish reference purchase prices; recommend commercial banks to grant bread-baking enterprises credits on favorable terms for bread wheat purchases; establish reference prices for exported wheat of no less than 95% of prices on regional and international markets. Later, in 2002 – a bumper-crop year for wheat – the Government adopted Decision #86-d *on promotion of grain export*; it required a specially established commission comprised of the representatives of the Ministry of Agriculture and Food Industry, Ministry of Economy and Ministry of Foreign Affairs, «to carry out on-going monitoring of situations in foreign grain markets, take active measures related to export of domestic grain, proposing, if necessary, changes in the current normative and legal acts depending on the market conditions, and to inform permanently the President of the country, Chairman of the Parliament and top Government officials of the situation in the relevant area». As the next year – 2003 (a lean year for wheat) – showed, implementation of this intention was far from being perfect both in terms of monitoring the situation and formation of the state grain reserve and in terms of the grain import, and especially in the first half of 2003 when the world prices were relatively good.

### Evolution of prices for wheat, flour and bread



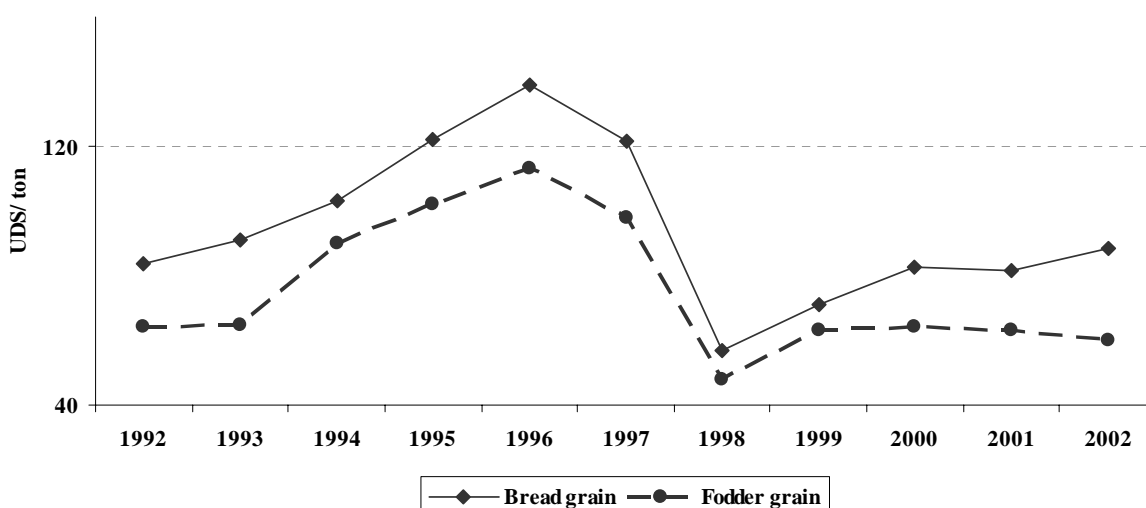
Source: DSS, Buletinul informativ al prețurilor

Bread consumption of the population, according to the HBS data, reduced over the last decade approximately 25% (from 173-175 kg to 133-139 kg per capita). This can apparently be explained through financial problems of the population (income reduction, price growth - see Graph 2).

Production of the export oriented wheat in the 90's was mainly concentrated on large leasehold land areas. As internal prices for wheat were lower than the international ones, a large share was exported to the CEE countries, along with the neighboring countries of Romania and Ukraine.

Wheat/flour import to Moldova is due to two causes: to replenish local reserves during less productive years and (this occurs every year) to improve the quality of baking through import to the country of wheat of a higher quality. One should mention that prices for wheat imported to Moldova – both bread and fodder grain – have been rather stable during the whole decade of 1992-2002, but for a slight rise in prices during 1994-1997 (see Graph 3).

### Wheat import price evolution, 1992 – 2002



Source: Ministry of Economy of the RM

Wheat import price analysis during the decade before 2003 shows that, on the whole, these prices corresponded to the wheat market conditions in the Central and Eastern European region and were not speculative, which, coupled with sufficient internal wheat production (on average) during these years allowed it to hold prices for bread at a level acceptable for the population.

## II. 2003: Wheat Failure, Bread Crisis Danger

Moldova is a country with a small open economy. Its annual level of openness – percentage of external trade turnover (export + import) to GDP – was more than 90% in the 90's (111.7% in 2002 and 106.0% in 2003), which is much higher than in such big countries as Romania, Ukraine (62-76%) or Russia (30-53%). That is why food security of a small country under unfavorable internal conditions – both natural and social – is also very vulnerable to external factors. This is exactly the situation Moldova got into in 2003: limited internal resources of wheat and flour and high prices for these goods on external market. *A situation has developed that requires state intervention, rational and coordinated actions of state's bodies and the swiftness of commercial agents operating in the wheat market.*

The results of agricultural year 2003 on the whole can be considered rather satisfactory. According to the DSS estimate, the gross agricultural production is 86% of the level of 2002. The year was good for grapes, fruits, vegetables, and sunflower. However, 2003 proved to be extremely unlucky for winter crops (wheat, barley). It was caused by a hard winter frost without snow on the fields and a drought in spring and summer. That is why grain crops gross yield with its crop capacity of 6.8 centner/ha was only 118 thousand tons, including bread wheat – 101.5 thousand tons which is less than 10% of the crop of 2001 or 2002. This situation was partially compensated by re-sowing more than 40% of the areas and using them for corn and sunflower. Corn crop was 1402 thousand tons (17.4% more than in 2002) and sunflower – 389 thousand tons (22.7% more). Common data on areas and the grain crop of 2003 are shown in *the Table 1*. Most of the wheat was harvested in the Northern zone of Moldova (42.3%) and in lower areas of the Prut River (Ungheni, Nisporeni, Cantemir, Leovo and Cahul – 23.9%) where the drought was less severe.

*Table 1*

<b>Effectiveness of Grain Sector in 2003 as against Preceding Five Years</b>							
	<i>Units</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>
<b>Grain - total</b>							
Area	thousand ha	937.4	935.7	987.6	1076.8	1072	579.3
Crop capacity	centner/ha	26.6	23.5	19.6	24.4	24.1	19.4
Gross yield	thousand t	2500	220.0	1934.3	2627.9	2587	1125.4
<b>Winter wheat</b>							
Area	thousand ha	356.7	341.7	373.0	436.8	445.3	149.3
Crop capacity	centner/ha	26.8	23.5	19.6	27.2	25.1	6.8
Gross yield	thousand t	951.9	978.0	724.9	1181	1113	101.5
<b>Winter barley</b>							
Area	thousand ha	42.0	41.3	50.8	61.0	68.0	15.8
Crop capacity	centner/ha	22.1	19.6	15.5	27.0	21.9	7.9
Gross yield	thousand t	93.2	81.0	78.6	165.0	148.8	12.5
<b>Spring barley</b>							
Area	thousand ha	65.7	66.7	54.8	37.1	44.3	11.8
Crop capacity	centner/ha	18.6	15.4	9.9	17.9	16.1	7.9
Gross yield	thousand t	12.4	101.3	54.4	66.4	71.7	9.3
<b>Maize</b>							
Area	thousand ha	400	403.2	441.5	471.1	446.7	557
Crop capacity	centner/ha	31.0	28.3	23.4	23.7	26.7	27.1
Gross yield	thousand t	1239	1140.3	1031.0	1118.0	1194	1402

When the Ministry of Agriculture forecasted a wheat crop of 1.3 million tons for 2003 it planned to utilize the grain in accordance with the following proportion: seed stock – 85 thousand tons; consumption (bread) – 400 thousand tons; cattle breeding needs – 450 thousand tons; and export – 335 thousand tons. The country entered 2003 with a certain grain reserve after the previous bumper-crop year: in stock there was 438.1 thousand tons of wheat including 229.1 thousand tons of bread-wheat (*Table 2*).

Table 2

**January – March 2003: Wheat Stocks, thousand tons**

Product	Stocks as of 1.01.2003	Utilization in January-March			Stocks as of 1.04.2003	Required for the population's consumption for April-August	Surplus, deficit
		Consumption (bread)	Export	Forage			
Wheat - total	438.1	114.0	8.9	78.0	237.2	190.0	+47.2
Bred-wheat	229.1	84.0	6.7	-	138.4	156.7	-18.3
Class 5 (forage)	209.0	30.0	2.2	78.0	98.8	33.0	+65.5

In spring, as can be seen, the situation did not yet cause any alarm and plans to provide the country with wheat till the next crop (July-August) were as usual based on the following estimates: Moldova's (3.6 million people) monthly demand for wheat is 38 thousand tons for ration consumption including 28 thousand tons of bread-grain and 10 thousand tons of Class 5. Animal husbandry demand for fodder grain is estimated monthly at 26 thousand tons for November-April and by 40% less (16 thousand tons) for May-October.

The first signs of the Government's concerns over the grain situation appeared in April-May when it became clear that the frosty winter with little snow followed by a drought in the spring may make the grain gross yield in the country insufficient. By that time state reserves of wheat were not more than 16-18 thousand tons.

Under these circumstances, in May the question of stimulation of wheat import into the country was raised for the first time. Such measures were taken by neighboring Romania, which not only froze wheat export but exempted it from customs duties which in the first six months of 2003 allowed them to import to the country 337.1 thousand tons of wheat at the rate of 115 USD per ton including grain from Moldova – 13.6 thousand tons for 1.48 million USD i.e. at the price of 109.4 USD per ton. This wheat export was carried out by private firms in accordance with bilateral contracts based on their own interests. But peasants in villages stopped selling grain and flour in May, reasoning: “till I see a new crop I will keep last year's grain”.

*The Government reaction was behind* and it was only the mid-summer that it appealed to Russia, Kazakhstan and China to supply humanitarian wheat to Moldova or to sell it “at reasonable prices”. Then, a Law was passed (31.07.2003) to exempt grain import to the country from VAT and the government authorized more than 60 economic entities to import grain. Official estimation of the wheat situation for the time when those decisions were taken can be seen in *Table 3*.

Table 3

**Wheat Demand for Domestic Market for August 2003 – August 2004, thousand tons**

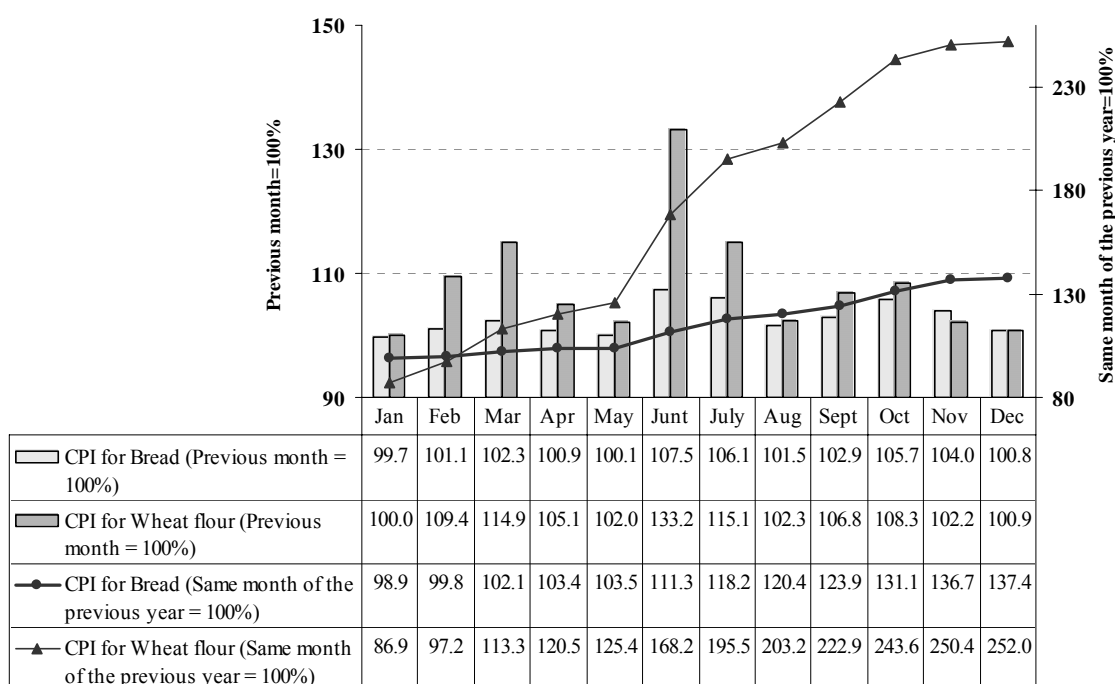
Crop 2003	Seed stock demand	Potential volume of consumption	Demand for the period till August 2004			Deficit	Import required
			Total	including			
				town	village		
101,5	58	43	450	158	292	-407	407

Then the Government and commercial agents took steps on external markets to find out the most efficient ways and methods to provide the country with wheat for the forthcoming period till the next crop.

**III. State Regulation Measures**

The wheat failure, which has not happened for about half-a-century, limited volumes of the state wheat reserve and the progressive increase of domestic prices for flour and bread (*see Graph 4*), from the beginning of 2003, preconditioned the state intervention – legally, economically and administratively, but proceeded from the realities of market economy.

### Dynamics of the Consumer Price Index for Wheat, Flour and Bread in 2003



Source: DSS, Buletinul informativ al prețurilor

As long as the state did not have any possibility (i.e. enough state reserves) to intervene in the grain market, the only way-out was to stimulate import, and in extremely great volumes – no less than 200 thousand tons of bread-wheat and 100 thousand tons of fodder grain - into the country. Wheat and flour import of the previous years was quite small (see Table 4). Reasoning from the apparent threat of failure to provide food security for the state, July 31 2003 the Parliament of the RM adopted amendments and alterations to article 3 of the Law on Carrying into Effect Title III of Tax Code # 417-X III of December 1997: “in August-December 2003 grain import of commodity items 1001, 1002 00 000 and 1003 00 100 in volumes agreed with the Government as well as its selling in the country territory are exempt from value added tax”.

The Government Decision #1037 of August 26 2003 approved quotas on grain import exempted from VAT: 500 thousand tons of wheat including 300 thousand tons of bread-grain, 20 thousand tons of barley and 10 thousand tons of rye. Regulation on Import and Selling of Grain with Preferential Tax Treatment was developed to implement the above decision. According to the Regulation only those enterprises that received proper certificates from the Ministry of Agriculture and Ministry of Economy could import or sell grain during 30 days.

Adopted by the Parliament, the Law on exemption of grain import from VAT and organizational measures of the Government resulted in more active supply of grain to Moldova. From January-August import of grain was 22.0 thousand tons including 13.8 thousand tons of bread-grain, and in September-November it was 73.1 and 67.1 thousand tons respectively.

However, there is another important aspect of the problem – price. On deciding to exempt grain supplies from VAT, the Government expected to eliminate the current deficit of grain, and thus to curb a possible rise in bread prices. Yet in reality the situation turned out to be different. The decision taken by Parliament limits the commodity (grain) price only when it “enters” the country, while it does not regulate selling inside the country. Then the following question is open: what selling prices will firms-importers assign for imported grain? The bread-wheat is not considered to be a good of social importance unlike flour and bread, for which an additional markup is limited

and controlled by the state in conformity with the Government decision. Under these conditions, with the grain deficit that occurred in the second half of 2003 and disarray of normative basis, promotion of the imported wheat remained out of the state control.

*Then, the following question arises: how positive was the influence on bread prices from the exemption of grain import from VAT? It is known that the product of grain processing, flour, is liable to VAT at the rate of 20% and bread, a product produced of flour, is liable to VAT at 8% rate in conformity with the law.* In order to estimate the consequences of the decision made on wheat import exemption, CISR analyzed several schemes: a firm-importer – a mill house – a bread-making plant. The conclusion is as follows: the state that contented itself with exempting VAT firms-importers of bread-wheat alone failed to receive the expected result – retaining the bread price level.

A short time later, the crisis situation was reflected through the following events:

- On 15.11.2003 JSC “Franzelutsa” the first-rate producer of bread in the country (55.2% of stocks owned by the state) – suddenly announced 30.0-62.8% increase for all the types of bread except one (“Chisinau”, 0.8 kg – at the price of 2.75 MDL);
- On 19.11.2003 the President of the RM demanded from the Government and top-managers of “Franzelutsa” reduction of the prices for three “social” types of bread down to their previous level and entrusted Ministry of Internal Affairs and Center for Combating Economic Crimes to ensure that this cheap bread would not become an object of profiteering;
- The same day 19.11.2003 at the Government meeting there was taken a decision to decrease the maximum commercial markup for bread and dairy products from 20% down to 10%; and *there was created a special working group for working out measures on social protection of individuals with low-income.*

The measures taken eased, to a certain extent, the acuteness of the “bread crisis” but as long as the grain and flour import price continued to grow, the prime cost increased as well and the 10% markup did not cover the expenses of shops, and bread became unprofitable both to make and to sell. In the meantime, already in December it was clear that the flow of wheat import into the country in spite of the undertaken measures decreased. It was caused by wheat export restrictions introduced in Russia and Kazakhstan, a drastic rise in wheat prices, financial considerations of Moldovan firms-importers in light of increased expenses for the purchase, transport, processing and storage of grain.

At the end of 2003 in the country, according to the official estimate, there were approximately 30-35 thousand tons of bread-wheat (at firms-importers and in the state reserve), and some more 15-20 thousand tons of grain, mainly of Class 5, in the rural households. State reserve of bread grain was estimated at 16,0 thousand tons as of 1.01.2004.

The following step was made on 24.12.2003: the Government addressed Parliament with a proposal: *a) to extend till July 1 2004 the exemption of wheat import from VAT; b) to exempt from customs duty import of bread, forage wheat, barley and flour.* Unlike the summer (31.07) VAT privileges for wheat import, this decision should touch those importers that import from the states with which Moldova has no agreement on free trade. The next day, 25.12.2003 the Parliament approved in two readings the bill proposed by the Government.

The consequences of this decision are likely to show in full measure during the second quarter of 2004. *Contrary to expectation, in January the wheat import decreased rather than increased, and traders reoriented themselves to the flour import; this tendency will apparently linger during the next months.*



At the beginning of 2004, the Government resumed its attempts to buy circa 100-150 thousand tons of bread grain in Russia at “prices lower than the market ones”. By that time though, prices for bread in Russia had increased, and its government introduced grain import restrictions (customs fee of 25.0 euro/ton) and undertook an intervention of 2.0 million tons of wheat on its grain market.

On the whole, in 2003, according to the Customs Department data, wheat import was 124.0 thousand tons and wheat flour – 41.0 thousand tons. Earlier, the Government had no experience in realization of such large-scale import operations (*see Table 4*). Against this background, one could expect from the very beginning that the task set forth by the Government for economic agents to import 500 thousand tons of wheat to the country, including 300 thousand tons of bread grain would be very hard to fulfill, taking into account the brevity of the term (less than a half a year!), private status of companies-importers (except for JSC Moldresurse and JSC Franzelutsa), as well as the quick increase in prices for wheat in exporting regions by the end of the year (twice as much as in the first half of 2003).

Table 4

**Import of wheat and flour in 1994-2002, thousand tons**

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Bread grain	38.6	62.7	31.1	9.0	2.5	5.8	7.4	11.9	0.1
Wheat flour	0	0	0	1.8	0.5	8.5	23.6	15.6	25.6

According to the data of the Ministry of Agriculture and Food Industry certificates for import of wheat were issued to more than 60 economic agents, but only some of them made considerable use of the VAT exemption privilege. The largest importers were: LTD Trans Oil, National Agency of Material Resources, G.T. Petru Tarlev, Picom, SRL Tego Grup, SRL Agrotera-Impex, JSC Franzelutsa and Moldresurse. Thus, the aforementioned eight companies imported to the country 52.3 thousand tons of bread grain, or 51.3% of the total wheat import during September-December of 2003.

Table 5

**Import of wheat and flour in 2003, thousand tons**

	Jan. – Aug.	Sept.	Oct.	Nov.	Dec.	Jan. – Dec. (30.12.2003)
Total wheat	22.0	9.4	19.5	44.2	28.9	124.0
<i>including:</i>						
Bread grain	13.8	8.4	16.1	42.5	28.9	109.7
Fodder grain	8.2	1.0	3.4	1.7	0.0	14.2
Wheat flour	7.6	2.6	12.6	11.5	6.7	41.0

*Wheat flour import* during September-December of 2003 was 33 thousand tons. More than fifty companies imported flour, and the largest quantities were imported by JSC Franzelutsa, SRL Unicaps, Triluna-UCAY and Danova-Prim. The main countries – exporters of wheat to Moldova in 2003 were Russia, Kazakhstan and Lithuania, while regarding flour – Russia, USA, Romania, Kazakhstan, Ukraine and Turkey.

At the end of the year, wheat resources that baking enterprises themselves oriented to were mainly concentrated in 12 grain elevators – out of 29 operating, including bread grain of the state reserve – in grain elevators of Floresti (6.1 thousand tons), Causeni (5.1 thousand tons), Cahul and Comrat (0.6 thousand tons), while regarding JSC Franzelutsa – in Edinet, Iargar and Drochia.

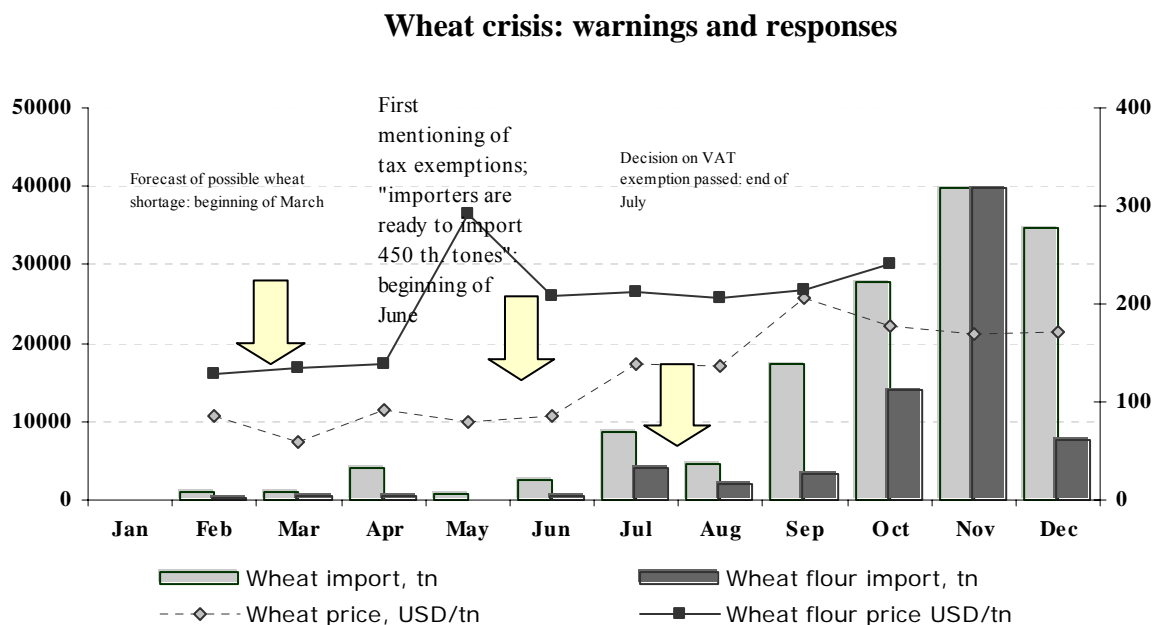
Unfortunately, the import quota of 300 thousand tons of bread grain till the end of the year approved by the Government was used by importers only by 1/3. The most probable causes of this are:

- difficulties that grain-traders encountered in Russia and Kazakhstan and other markets related to purchase of necessary quantities of wheat at acceptable prices;

- financial aspect – doubling of import prices for wheat as compared to the first half of the year;
- increased expenditures on transportation, processing and storage of grain inside the country;
- confidence that “for the sake of the people” the VAT exemption privilege will be prolonged after January 1, 2004.

But the main cause consists of the following: there were missed the time and the most favorable prices for import of wheat and flour (see: *Graph 5*).

*Graph 5*



#### IV. Competitive Environment, Prices and the Territorial Aspect of the Problem

Government measures to brisk up import of wheat and flour to Moldova were aimed to avoid acute lack of bread and a sharp rise in prices. They were undertaken under such conditions when, on the one hand, *the state* had no reserves for intervention into the grain and flour market (moreover, at the end of November 2003 JSC Franzelutsa was about to be shut down), and more than 80% of the wheat and flour delivered to the country, as well as production and realization of bread were done by commercial agents of *the private sector*.

Under these conditions, rapid and coordinated actions both by the Government and by the business community based on the monitoring of the situation were extremely important, as well as optimal proportion between state regulation and the freedom of actions, the initiative of private agents on the wheat, flour and bread markets.

*Wheat.* It was in the spring that private grain traders showed initiative to import wheat to Moldova, which was restrained by the prospective Government’s introduction of wheat and flour import benefits. There were such measures taken in Romania and Ukraine and discussed by Moldova’s Government in May 2003. Nevertheless, the practical decision (exemption of the wheat import of VAT by the Parliament) was made only on July 31. And it was August-September when the Regulation on Preferential Tax Treatment of Import and Realization of Grain took effect and certificates were issued to traders. As a result, from January to August only 13.8 thousand tons of bread wheat and 7.6 thousand tons of flour were imported, or 11.1% and 18.5% of their total annual import during 2003. In the meantime, prices for wheat and flour have doubled during September-December in areas of their purchasing (Russia, Kazakhstan) and, then, there were also introduced

high customs fees. All this restrained the grain traders' actions as refers to finances and their private interests did not fully correspond to the Government intention to stimulate large grain import.

The bread grain import expected by the Government at 300 thousand tons was provided only for 1/3, which conditioned the Parliament to introduce new, higher wheat and flour import benefits (25.12.2003). One can judge their efficiency in the forthcoming "critical period": March-May 2004.

*Wheat flour.* The production of flour in Moldova is completely provided by the private sector. Out of 150 mills there are only 3 with state participation; JSC Franzelutsa has no flour-milling of its own. The total production capacity of the flour-milling industry is circa 40-43 thousand tons per month. The domestic and imported flour consumption ratio in the first half of 2003 was 3:1 and in the second – 1:1. Over January-September the highest-rate flour price increased from 2.04 to 5.09 MDL and as refers to the first-rate flour – from 1.62 to 3.20 MDL/kg. By the end of the year the price reached 4.6-5.0 MDL/kg. According to the DSS data during the year 2003 the wheat flour prices increased 2.5 times.

*Bread.* Bread is mainly produced by the private sector and the population of rural areas. There are 232 bakeries registered in the country that consume 500-520 tons of flour daily. 35 towns have bakeries, including *Chisinau*, which has 17 of them. At the same time, unlike the wheat and flour production the state presence in bread production is quite perceptible due to its control (55.2% of shares) of the JSC Franzelutsa. This enterprise is not formally a monopoly in the bread market (that is does not produce more than 35% – maximum for a non-monopolist– bread in the country, but only 15-17%), but its position – both economically and "politically" – is a key one for the Government in controlling bread prices, especially in the capital municipality with its population of more than 700 thousand people.

Taking into account that more than 1/2 of the annual volume of bread in the country is made by rural population (54.7% of the population of the RM) then the share of JSC Franzelutsa within the total production volume of bread exceeds the 35% "monopolist indicator". Therefore, when the state owns the controlling stock of the enterprise and the enterprise gets replenishments of grain from the state reserves, *the financial situation and price practices of this entity in many respects determines the stability of the country's bread market.*

In the meantime the financial situation of JSC Franzelutsa had become critical by the end of 2003 and continued getting worse in 2004. The rise in prices for wheat and flour has affected the financial situation of JSC Franzelutsa very negatively. If based on the 2001 totals the enterprise's net profit made up 18.6 million MDL and 22.2 million MDL in 2002, the second half of 2003 ended with losses of 12.0 million MDL, the total losses over the year being 7.4 million MDL. Despite the price increase as regards most sorts of bread (by 30.0-62.8%) announced by JSC Franzelutsa on 17.11.2003, the enterprise concurrently continues to produce, under the Government decision (no less than 1/3 of the total output), and sell so-called "cheap bread", which results in losses at 52%, or 70.0 thousand MDL per day.

It is not excluded that the Government will help the enterprise financially in an attempt to prevent its bankruptcy and provide it with wheat from state reserves, including those from the new procurements. At the same time, the issue remains open as to whether bread targeted compensations will be rendered to the poor and some of state-budget institutions.

Unlike the municipality of *Chisinau* where the situation is under control, *small towns* (about 400 thousand inhabitants) are in the most unfavorable situations as refers to bread; there are circa 200 bakeries but the bread is more expensive and its delivery to baker's shops is irregular.

In *rural areas* the population mainly takes care of bread on its own. The sociological research by PFAP/CISR carried out in 302 villages in November 2003 showed that households that had leased

out their land received about 300 kg of wheat on average. Besides that, 1/3 of households have partially kept reserves of wheat from the previous year's yield. Lack of bread as a rule is compensated in most rural families by use of corn meal, as well as the legumes and potatoes.

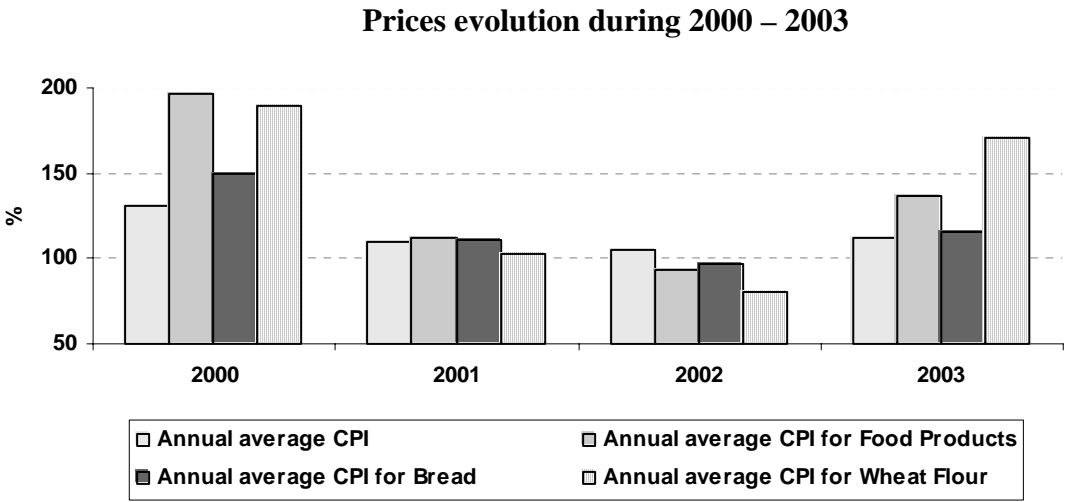
In *Transnistria*, despite strict state regulation of grain import and flour and bread prices it happened in 2003 three times when the bread prices increased: June, July and November. Administrative regulation of the bread prices applies only to its production by state enterprises of flour from the centralized fund. Along with this, there is available more expensive "commercial bread" produced by private bakeries, the profitability and prices of which are not regulated.

**V. Bread Prices Shocks and the Poor**

*The poor spend the major part of their incomes for food.* Based on household budget surveys (DSS) 40.4% of the population is below the poverty line, including 26.2% - below the extreme poverty line; *the most vulnerable social groups to bread price increases* are: families with many children; families with one parent and single people; families with unemployed parents; certain categories of pensioners. Despite the fact that there has been a recent tendency for the share of expenditures for food to decrease within the available income of the total Moldovan population: from 69% (Q4 of 1999) to 57% (Q4 of 2003); *20% of the poorest persons spend 60% of their available income for buying foodstuffs.*

The cost of minimal consumer basket in 2003 increased by 19.5%; inflation rate was 15.7%. As compared to the rise in prices for nonfood goods and services, prices for foodstuffs grew the most. The trend of the bread prices to increase has intensified after stopping the state subsidies in the mid-90's continued in 2003 through rise in prices for bread by a yearly average of 15.5% and by the end of the year (December as compared to the December of 2002) – by 39.8%.

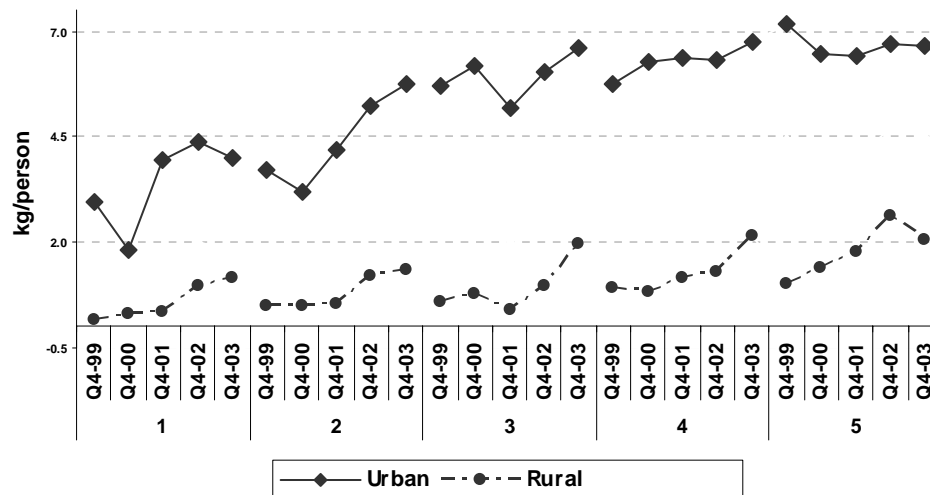
Graph 6



Source: DSS, Annual Price Bulletins for 1999-2002, Monthly Price Bulletins for 2003, CISR calculations

The group belonging to the two poorest quintiles suffered from bread prices increases the most, because the bakery takes the main part of their food allowance. And, first of all, these are people living in small towns.

**Average monthly bread consumption during 1999-2003**

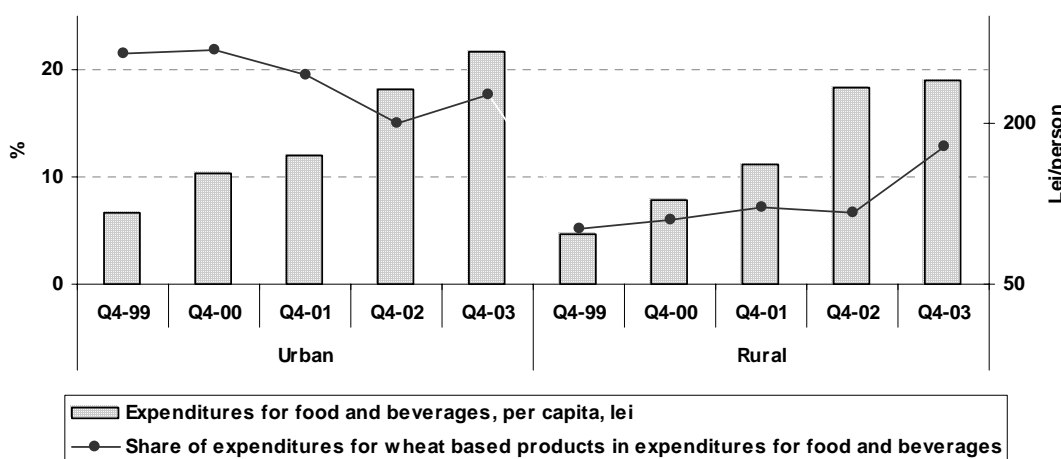


Source: DSS, Household Budget Survey

The bread prices increase in Q4 of 2003 mainly influenced the bread consumption of the poorest urban population (quintile 1), which is circumstantial evidence of the fact that the existing social assistance system is not targeted well, and the “social”, cheap bread is consumed not only by those for whose sake this low price is being maintained.

According to the household budget survey data, the trend that began to show during 2001-2002 of bread, flour, groats, etc. decreasing their share within the total household food expenditures did not develop in 2003. For all that nominal food expenditures increased and per capita consumption of these products decreased.

**Dynamics of average monthly food expenditures during 1999-2003**



Source: DSS, Household Budget Survey, CISR calculations

Given today’s rather low marketability of agricultural production, the impact that bread price changes have upon the poor differ depending on their position on the food market. Thus, according to the household budget surveys (2003) 92.8% of the urban population’s incomes are being formed of monetary receipts, while 50.7% of incomes in rural areas are due to agricultural employment. On this account, the most difficult situation is, after prices for bread have risen, for residents of small towns, whose household incomes from agricultural activities does not exceed 20.0%, which means

the buffer does not work in food provision, the unemployment rate is high, incomes are lower and prices for bread are higher than in the municipalities of Chisinau, Baltsi and rural areas.

In rural areas, as the sociological research of 302 villages revealed, most people have reserves of grain and corn. This is being confirmed by the data of household budget surveys. Thus, in Q4 of 2003 when, in fact, prices for bread and other wheat products grew, the cost of home-made wheat flour per one household member, even for the poorest strata of the population (1<sup>st</sup> quintile) was practically equal to expenditures for their purchase. That is why the situation of the non-poor rural residents after the prices increased will mostly remain rather stable in the nearest future, while the situation for the “risk groups” in towns and especially in small towns will be close to critical.

The food security of the poorest population strata can be corrected through resources arriving from outside, including *humanitarian food aid*. But the lack of transparency during the distribution of this food is the reason it often misses those who are really in need. Besides, distribution of humanitarian food aid flow results in the fact that their main part accumulates in the most financially well-off region – the municipality of Chisinau.

The population of the Chisinau municipality, given all the socio-political importance of a capital center, cannot be considered the most indigent group of the population from the economic point of view (as regards incomes). Therefore, administrative decision binding JSC Franzelutsa to produce no less than 1/3 of “cheap bread” and sell it in the municipality at prices lower than the market ones is rather a paternalist reaction of the authorities to the November, 2003, bread price shock. Economic consequences of such decisions for JSC Franzelutsa are not only ruinous (losses of 7.4 million MDL over 2003 and they would be even higher in 2004), but also fail to solve the problem of the provision of the poorest with bread at reasonable prices.

*How can state help the poor when the bread prices are growing?* Experience of other countries demonstrates different forms of state regulation in a such situation: general food price subsidies, food distribution policies, food rations, food/ ration cards and mechanisms of supplementary food supply. These measures can be used both to increase real incomes of direct beneficiaries and can provide safety to the poor against reduction of their real incomes.

In Moldova where no pronounced food distress regions are the solution apparently should be searched for through *temporary (till the new yield) introduction of targeted compensations for the poor*. If assess the November decision on the “cheap bread” based on three criteria: “*coverage*” (share of the poor receiving the “cheap bread”), “*targeting*” (share of the “cheap bread” delivered to the poor) and “*efficiency*” (share of expenditures for buying the “cheap bread” within the total expenditures of poor households), one could conclude that production of such bread, though having positive public echo, does not fully solve the bread problem for the critically vulnerable groups of the population.

And so, in case no decision on targeted compensations for the poor is made, and the practice of producing the “social bread” is further maintained, it is expedient at least *to provide better targeting of its distribution*: a) *risk groups* – families with many children, the elderly and invalids (based on coupons issued by regional bodies of the National House of Social Insurance); b) *specialized institutions* – medical, social, military, penitentiary, etc.

The food security can be, and has to be provided not only through efforts of state bodies alone. The private sector, which accounts for more than 70% of GDP and dominates on wheat, flour and bread markets, has also to participate in increasing resources and stabilizing prices for bread grain, flour and bread. For that, state suppressing any speculative activities should create adequate market competitive environment both in production and internal trade, as well as in external trade operations on the grain market.

## Conclusions and Recommendations

The situation that has developed in Moldova due to the corn failure in 2003 and threatens now food security is a result of a series of objective and subjective factors. The first, objective factors showed through extremely unfavorable climate conditions (winterkilling of most winter crops, dry spring and first half of the summer-time) and unfinished reformation of agriculture – the collapse of large collective enterprises and the sector's infrastructure was not accompanied by an adequate strengthening of market relations based on private ownership of land and means of agricultural production. The second, subjective reasons are characterized by the lack of proper efficient and professional actions of state bodies and economic agents bound to predict the situation and forestall its eventual negative consequences.

Traditionally, the Republic of Moldova is a country that satisfies its requirements for bread grain thanks to domestic production. Even during the transitional period, from a planned to market economy, Moldova's yearly grain production was about 1.0 million tons, including 1991-1995 – 1062.2 thousand tons and 1996-2002 – 951.8 thousand tons on average. One of the peculiarities of this period is that grain, including bread grain, became an important export item of Moldova. Thus, in the bumper-crop year of 2002, grain export was 376.7 thousand tons of the total value of 25.5 million USD or 1/3 of the total yearly crop production export. Bread grain and flour were imported during that period in limited amounts, mainly high-quality brands for improving the quality of bread. Thus, grain import in 2000 was 7.4 thousand tons, in 2001 – 11,9 thousand tons, in 2002 – 0.1 thousand tons, and flour – 23.5, 15.6 and 25.6 thousand tons correspondingly.

2003 turned out to be extremely unfortunate for grain crops due to weather conditions. The total yield of bread grain made up only 101.5 thousand tons, while 50-80 thousand tons is needed for seed-stock and circa 400.0 thousand tons – for food. For the first time in the last fifty years there emerged a necessity to import large volumes of wheat and flour. The situation has been additionally aggravated by the strained international grain market during the year of 2003/2004 – its world production decreased to 561.9 million tons, trading volume – down to 96.5 million tons and reserves – down to 128.3 million tons. Many European countries, including those adjoining Moldova – Romania and Ukraine – suffered heavy losses of grain due to the drought. Beginning in the spring of 2003 prices for grain and flour on the international market started to increase quickly and doubled over the year.

The threat that had emerged for the country's food security required state intervention in the form of legal, economic and administrative actions. Analysis of these actions – with reference to the specific situation of 2003 and based on the experience of the transition period as a whole allow one to draw some generalizations and recommendations.

1. *Legislation, institutions and economic mechanisms providing for the food security of the Republic of Moldova did not develop into a uniform system.* Their incomprehensive and uncoordinated nature as refers to the situation of 2003 have shown insufficient state grain reserves, lack of an intervention fund, inefficient monitoring of the situation on external grain markets, slow reaction of state bodies to adjust the taxation of the wheat and flour import, of state bread prices regulation, including accordance of targeted compensations and humanitarian aid to the most indigent strata of the population.
2. *Actions of state bodies during the crisis situation of 2003 were not anticipatory or optimal from an economic point of view.* At the same time, most Central and Eastern European countries, including Romania and Ukraine, since the spring of 2003 have made anticipatory actions: banning export and introducing preferential treatment of bread grain and flour import, purchasing large amounts of wheat on external market, using resources of intervention grain funds to stabilize the bread prices situation. Real actions of the Moldovan state bodies to attract

wheat to the country in the form of humanitarian aid (from Russia, Kazakhstan and China) were made only in the mid-2003, and those to stimulate grain import (its VAT exemption) – only after the August of 2003 when prices for grain had already become high and Russia and Kazakhstan, the main potential grain exporters to Moldova, had introduced customs and administrative restrictions to its exports.

As a result, the goals to import no less than 300 thousand tons of bread wheat to the country and hold internal prices for bread in position set by the Law #356-XV of 31.07.2003 on exemption of the grain import of VAT during August-December of 2003 failed to materialize. Effectiveness of the broadening of benefits that has followed (Law #568-XV of December 25, 2003) – exemption of the import of bread and fodder grain, fodder barley and wheat flour of VAT and customs duty – was weakened to some degree by further rise in prices on regional and international grain markets and all this made the wheat import to Moldova less-profitable.

3. Inadequate reaction of state bodies to the emerging and growing “bread crisis” during 2003 is due to *inefficient monitoring of the condition of the regional grain market, lack of state grain and flour resources sufficient for price intervention, lack of approved methods of food protection of the poor*. Concurrently, market mechanisms and competition on the grain market were underused and the capabilities of administrative measures to settle the “bread crisis” were overestimated, which has negatively affected the business environment both related to the grain market and bread production.
4. Based on the year 2003 experience, it is important not only to consider the current situation critically, but to establish structure and order of both immediate and middle-term actions to ensure food security.

Actions in the nearest term are mainly socially oriented, as follows:

- a) introducing temporary, till July 1, 2004, *bread compensations* for some categories of the population with low incomes (elderly, families with many children, invalids). Funds for this task can be found through both grants from international organizations and stopping state support of the “cheap bread” production by JSC Franzelutsa that is not oriented well at the poorest part of consumers;
- b) starting utilization of a special *social insurance fund* a little earlier than envisaged by the pensions indexation budget (1.04.2004);
- c) setting a *minimum wage increase* for state officials, workers of health care, education, culture according to the bread price increase and recommending private structures to provide for a similar raise for their workers; introducing a *scholarship increase* for students of high and higher schools pro rata to the bread price increase.

Besides this, in *the production sphere* it is expedient to:

- a) examine economic expediency of further maintaining the monopolistic situation of JSC “Franzelutsa” on the bread market or its breakdown into 3-4 competing enterprises;
- b) stimulate bread and bakery producers by raising profitability standard as regards production of cheap sorts;
- c) activate a system of grain procurement from farmers and peasants using a mechanism of secured public grain purchases. Because of the fact that in March-April the peasants will need money for the spring field work, while the state needs grain, the following scheme could be implemented (drawing on experience of other countries): there is concluded a multilateral agreement between a state agent (National agency for material resources, „Moldresurse”), an insurance company, a bank and an agricultural enterprise or a farmer who obtain a credit on the security of grain, but remain its owner and can mortgage it at any moment, and sell it at a higher price.



5. Taking into consideration the country's interests, it is necessary to elaborate a food security programme for a mid-term (5-7 years) period, scientifically substantiated and practically acceptable for the state, is an urgent task, including the following components.
  - a) *Improvement of legislation and mechanisms regulating grain market relations.* First of all, as the experience of other countries shows, it is expedient to issue a *Law on Grain and Grain Market* oriented at creation of legal, economic and institutional conditions for competitive production and formation of a grain market that would provide for the country's internal needs of bread, seed and fodder grain, as well as for its export. The main aspects of the law should be: subjects of the grain market; state support of production and processing of grain; formation and utilization of grain resources; control over quality of grain; grain storage; organization of grain purchases for the state reserve; intervention fund for prices stabilization; grain export-import operations. This law should ensure the overcoming of the negative trend of the last decade, when the country is mainly provided with grain at the expense of constant expansion of areas used for grain crops on the background of their decreasing yield. It is obvious that from the point of view of a long-term and even mid-term perspective, such an extensive approach to the sector's development will not be able to ensure stable provision of the population with bread.
  - b) *Grain funds, their formation and utilization* should be permanently controlled by the state. The experience of the 70-90's shows that under Moldova's conditions the optimal volume of *the state grain reserve fund* is 45-50 thousand tons. In practice, over the last years it was much smaller: as of 1.01.2003 the state grain reserve made up 18.0 thousand tons; as of 1.01.2004 – 16.0 thousand tons. Drawing on other countries' experience, Moldova should also form *an intervention grain fund* to undertake state commodity interventions on the grain market and support stability of prices. Meanwhile, multiple proposals of the Ministry of Agriculture and Food Industry to create such a fund were not supported by the Ministry of Finance "due to lack of state budget funds for this goal".
6. *The grain market development* should ensure that the interests of the main subjects of such a market will be taken into account: grain producers, enterprises that store grain, purchase it for state needs and realize intervention operations, commodity exchanges. For the sake of stable development of the grain market it is necessary to take the following actions:
  - a) consider expediency of *formation of a state holding*, with the right of the shareholder of state property at enterprises of the sector. The main task of the holding should be purchase, replenishment and renewal of state grain reserves. At that, there should also be elaborated a mechanism of their utilization – who and at what price will get "state grain";
  - b) it is necessary to *conduct monitoring and certification of grain elevators*, elaborate a proposal to issue a storage receipt – a document that would guarantee the safety of grain owned by specific farmers or companies. Storage receipts should become mortgage certificates facilitating access of agricultural producers to short banking credits. And it is necessary to settle issues related to valuation of the security with the NBM and commercial banks. Support in "running in" of such mechanism (as in Ukraine and Kazakhstan) could be rendered by the EBRD through, for example, establishing a specialized credit line for a start, in one of commercial banks;
  - c) improve standards of *financial service* as soon as possible (monetary and technical credits, credit guarantees, development of commodity exchanges with wide utilization of futures contracts);

- d) develop a service providing producers regularly with reliable *information* on demand, prices and supplies on internal and external markets, rules of concluding contracts, organizing auctions and trade fairs;
  - e) use *support prices* set by the state. They are to pay off producers average expenditures per product unit and ensure a certain minimal profit. During the sale of grain at prices lower than this level the state will pay producers the corresponding difference;
  - f) develop systems of storage, processing of grain *on commission*, create a territorial network for *grain purchases from farmers and the population*.
7. It is expedient to establish a specialized credit line in one of the commercial banks („Moldova-Agroindbank”? „Banca socială”?) with support of the EBRD for financing secured grain purchases by grain elevators with state participation. And, obligatory insurance of the secured grain received from peasants and enterprises should be guaranteed.

Starting from the aspiration of the Republic of Moldova for a productive participation in the processes of European integration, harmonization of legislation and government actions in spheres related to food security of the country has to be realized as close to the practice of the European Union as possible. The experience of the EU accumulated during the process of realization of the Common Agricultural Policy is evidence of the necessity of a system approach to development of agricultural sector as regards goals and methods of their achievement through liberalization of the market, the corresponding tax and tariff policy, and granting subventions and compensation of losses.

Therefore it is appropriate during elaboration and implementation of the *Action Plan EU-Moldova 2004-2006* to improve the legal basis, forms and methods of the grain market development in the Republic of Moldova taking into account rules and procedures regulating grain market in the EU, specifically the *Council Regulation (EC) on the Common Organization of the Market in Cereals* of September 29, 2003, brought into effect beginning from the marketing year of 2004/2005.