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Reform of Sugar Market Organization in the EU: Lessons for Ukraine

1. Introduction

With the Mac Sharry reform in 1992 the EU began its long march away from support of over-production towards a market-oriented, environmentally friendly policy leading to an efficient and sustainable farming. The radical overhaul of the Common Agricultural Policy (CAP) in 2003 was just the next logical step towards a policy that supports not just farming, but also the long-term livelihood of the rural areas.[1] Farm support has become increasingly dependent on meeting quality, environmental and food safety guarantees.

In June 2005 the European Commission prepared the proposals to reform the last bastion of old CAP – the **sugar market organization (SMO).** This reform intends to bring the SMO in line with the CAP reform process, in particular the new orientation given with the introduction of decoupling and the singe payment scheme. The driving forces of this reform originate both internally and externally. Internally, European consumers and taxpayers have become increasingly concerned of their losses incurred due to farm subsidies in general and SMO in particular, and many consumers' groups and NGOs urge to align the SMO to objectives of the reformed CAP. Externally, the reform of the SMO has been challenged by the recent findings of the WTO panel challenging the EU export trade regime and an anticipation of enforcement of "Everything but Arms" (EBA) agreement. The EU has delayed the reforms to the point where it is difficult to gradually reduce the state support. The support must be cut rather radically. Ukraine finds itself in the similar situation, where in spite of serious structural problems Ukraine waits and does not pursue the gradual reforms. Thus, in the near future it will have to make more radical steps.

The European Commission proposes the substantial cuts in sugar and sugar beet prices. It also proposes to introduce compensations for sugar processors, who opt to cease sugar production, and decoupled payments to beet growers to compensate for price reductions. The SMO reform will inevitably reduce the incomes of beet growers and sugar factories, redistribute the income among market players in the Member States, and lead to the reorientation and even closure of many sugar factories in the EU.

The SMO reform in the EU *per se* and its driving forces present interesting lessons for Ukraine. Ukraine's SMO emulates the EU regime and although the agricultural policy makers in Ukraine call it successful and thus aggressively protect it, the SMO suffers from the similar weaknesses and is likely to be challenged by external forces similarly to the EU.

[1] Historical evolution of reforms of CAP is described in the recent German Advisory Group Advisory Paper U2.

The recent surge in sugar prices raised the concerns among consumers, sugar producers and policy makers about the future of the SMO in Ukraine.[2]

This policy paper aims at discussing the driving forces of the SMO reform in the EU, presenting the key elements of the proposed reform, anticipating the constraints for future SMO in Ukraine and suggesting the directions for Ukraine's SMO, taking into account the lessons from the EU. The paper is structured as follows. Chapter 2 briefly describes the SMO and key economic indicators of the EU sugar industry. In Chapter 3 the driving forces of the reform are discussed and Chapter 4 presents the reform proposals of the EU Commission. In Chapter 5 the SMO in Ukraine is analyzed and Chapter 6 presents the future constrains for the future SMO in Ukraine. Chapter 7 concludes with the policy recommendations.

2. Sugar market organization in the EU

The sugar market organization in the EU was set up in 1968. Since then, the SMO was subject to only minor changes and in general it stayed out of the CAP reform process. The SMO is budget neutral, because sugar refineries finance the export subsidies. Hence, for many years it remained untouched by budget cuts taken place in other CAP areas. Over time the sugar quota was threatened by cheaper sugar substitutes, quick development of which was caused by high sugar prices in the EU. In response, the EU introduced the isoglucose quota in 1980. Finally, the EU has the preferential import agreements with ACP[3] and Western Balkans. In 2001 the EU also signed the EBA agreement, which will come into force in 2009.

The key features of the current SMO include:

- Intervention price of sugar
- Minimum price of sugar beet
- Quota system with differences between A sugar for domestic market, as well as B and C sugar for world market
- Border protection
- Export refunds financed by sugar refineries.

Currently the intervention price of sugar equals 632 €/ton, and derived minimum sugar beet price equals 43.6 €/ton. The sugar quota A is limited to 11.894 mill tons with full intervention guarantee. Moreover, the owners of quota A are obliged to pay 2% of their revenue to the central fund designed to finance the export refunds. The sugar quota B is limited to 2.588 mill tons at lower intervention price and 39.5% of payment to the export refund fund. Finally, the sugar refineries may produce unlimited quantities of sugar C but it must be exported without export refunds (DZZ, 2002).

The EU-25 is a key player on world sugar market, producing 14%, consuming 14%, exporting 12% and importing 5% of world sugar (Veits, 2005). The sugar balance of the

[2] During February-June 2005, the retail sugar price in Ukraine grew by 34%. Further 10-12% of increase is expected by the end of year (Schmidt and Tatarenko, 2005).

[3] The ACP is composed of developing countries that were former British, French and Portuguese colonies. The ACP Sugar Protocol countries are: Barbados, Belize, Guyana, Jamaica, Trinidad and Tobago, St Kitts and Nevis, Fiji, Republic of Congo Cote D'Ivoire, Kenya, Madagascar, Swaziland, Tanzania, Zambia and Zimbabwe.

EU-25 is shown in Table 1. In 2004/2005 marketing year, the EU-25 produced 21.6 mill tons of sugar and imported 2.3 mill tons, including 1.6 mill tons from ACP countries, 0.3 mill tons from SPS countries, and 0.2 mil tons from Western Balkans. The ACP countries have the privilege to export their sugar to the EU at 500 €/ton (USDA, 2005).

In 2004/2005 the domestic consumption totaled to 17.7 mill tons, meaning sugar surpluses of 10.8 mill tons. The public interventions absorbed 5.3 mill tons, and the rest was exported, largely with the use of export refunds. In 1995, the WTO Agreement on Agriculture limited the exported quantities and the volumes of export refunds for sugar. The EU committed to export up to 1.273 mill tons of sugar with the use of export subsidies, and the export subsidies were limited to €499 mill. Recall that EU had no limits on export of C sugar without export subsidies. In spite of these commitments, in 2004the EU subsidized exports equaled 2.9 mill tons with the use of €1275 mill of export refunds. The EU re-exported 1.6 mill tons of the ACP sugar using €776 mill of refunds claiming that this was not subsidized exports, but rather development aid to the ACP countries.

Table 1: Sugar balance in the EU-25, thousand tons, marketing year

	2004/2005	**2005/2006**
Beginning stocks	4699	5339
Beet sugar production	21311	20157
Cane sugar production	300	288
Total sugar production	21611	20445
Raw imports	1757	1757
Refined sugar imports	500	500
Total imports	2257	2257
TOTAL SUPPLY	**28567**	**28014**
Raw exports	3	3
Refined sugar exports	5500	5360
Total exports	5503	5363
Human domestic consumption	17701	17765
Other disappearance	24	24
TOTAL DISAPPEARANCE	**17725**	**17789**
Ending stocks	5339	4889

Source: USDA Foreign Agricultural Service (2005).

3. Driving forces of the SMO reform in the EU

Since the SMO has become unsustainable, in 2003 the European Commission began preparing the ground for presenting first SMO reform options, and in July 2004 it outlined its official proposal for the future of the EU sugar regime. However, the recent findings of the WTO panel, challenging the EU SMO in April 2005, urged the European Commission to prepare more radical reform proposals (European Commission, 2005). These proposals appeared at the end of June 2005.

The WTO case against the EU regime was brought by Australia, Brazil and Thailand, all major exporters of cane sugar, who argued that the EU subsidies made it difficult for them to compete on global markets. The WTO appeal body panel decided:

- "that C sugar exports are cross-subsidized out of profits on EU supported quota sugar and that they should be regarded as subsidized export, and

- that the EU is not entitled to deduct a quantity equivalent to the 1.3 mill tons of sugar imported at the full EU price from ACP countries from its subsidized export total notified to the WTO" (Agra Europe, 2005).

What is important for the modification of the SMO is that the contested export quantity amounts to almost 4 mill tones a year, i.e. 2.7 mill tones greater than the EU's agreed total volume of subsidized exports of 1.273 mill tones according to 1994 Uruguay Round Agreement on Agriculture. On the basis of the WTO rules, the EU's notifable spending on export subsidies increases to €1.3 bill a year, compared with the official ceiling of €499 mill. The Australian trade minister wholeheartedly welcomed this verdict. "The EU will be required to cut its sugar exports and expenditures on export subsidies… Removing up to 4 mill tons of subsidized sugar from the world market will make a significant difference to Australian sugar producers who compete on the world stage" (Agra Europe, 2005a).

In addition to the WTO appeal verdict, the EU anticipates increased imports of sugar under the EBA Agreement, which comes into force in 2009. In 2001, the EU signed this agreement with least developing countries to allow the duty free unlimited access of their products to EU market. The EBA Agreement is called to stimulate the development of least developing countries and discourage their trade with arms. Since many least developing countries are sugar cane producers, they will be able to export sugar duty-free to the EU, making the current EU SMO fully unsustainable.

Understandably, most EU sugar beet growers and sugar factories are against the EU reform. High protection has slowed down the structural change of the beet growers. While other farm sectors in the EU have gradually gone through painful restructuring and consolidation, high profits from sugar beet production sheltered the small-scale sugar beet farms from serious adjustments. The pain is, however, has been only delayed and now many inefficient farms will face significant competitiveness pressure. The situation with sugar factories is similar, and some are likely to find it more profitable to abandon sugar production than produce sugar at half of the current price. Moreover, sugar cane producers in the ACP and other countries also oppose the sugar market reform due to the anticipated reduction of benefits because of lower EU prices. The fight against the SMO reform continues, but the EU does not have any longer the room for serious maneuver.

4. Reform proposals

Taking into account these problems, the European Commission presented the revised reform proposal in June 2005. The major elements of the reform proposal are the following:

- Cut of institutional price of sugar
- Voluntary restructuring scheme for the sugar factories
- Creation of restructuring fund through the payments of all sugar factories
- Top-up payments for sugar beet growers
- Decoupled single compensation payment to beet growers
- Introduction of private storage, and
- Fulfillment of international commitments.

Table 2 shows the proposed cuts in institutional price of sugar and correspondent sugar beet price. To boost EU competitiveness and lessen the gap between domestic and prevailing world sugar prices, from 2006 to 2008 the **institutional price of sugar** will be reduced by 39% or from 632 €/t in 2005 to 386 €/t in 2008. As a result, the minimum sugar beet prices will decline by 43% to 25 €/t.

Table 2: Proposed institutional prices in the EU sugar sector

	Reference period	2006/07	2007/08	2008/09	2009/10
Institutional/reference sugar price (€/t)	631.9	631.9	475.2	385.5	385.5
Institutional/reference sugar price, net of restructuring amount (€/t)	631.9	505.5	385.5	385.5	385.5
Restructuring amount (€/t)	-	126	90	-	-
Cummulative reduction in institutional sugar price, net of restructuring amount	-	20%	39%	39%	39%
Cummulative reduction in effective sugar price, net of restructuring amount	-	41.1%	41.1%	41.1%	41.1%
Minimum sugar beet price (€/t)	43.63	32.86	25.05	25.05	25.05
Cummulative reduction in minimum sugar beet price	-	24.7%	42.6%	42.6%	42.6%

Source: European Commission (2005).

In reality these cuts equal 41.1%, because the reform proposal foresees the creation of **restructuring fund** from contributions of all sugar factories. This fund will be used to encourage sugar factories to abolish the sugar production voluntary. The mandatory contributions to the restructuring fund will equal 126 €/t in 2006/07 and 90 €/t in 2007/08 marketing year. It means that actual sugar price reduction will equal 41.1%.

The EU producers of sugar, isoglucose and insulin syrup, who agree to abandon the sugar production, will be granted the **degressive restructuring aid**. In the first year, the aid will be set at 730 €/t of quota, falling gradually to 420 €/t of quota in year 4. In order to encourage an early uptake of the scheme, sugar factories closing as from July 1 2005 will be eligible for the restructuring aid. In this way the new reform proposal intends to reduce the sugar quota, because compulsory quota cuts and transferability of quota between Member States were found to be unviable propositions (European Commission, 2005).

Through the restructuring scheme budget, sugar beet growers will be entitled to benefit from an additional **top-up payment**, provided they have ceased the delivery of sugar beet to a factory that has abandoned the sugar production during the marketing year 2006/2007. The amount of additional payment is set at 4.68 €/t of the quantity of A and B sugar beet quotas.

Moreover, all sugar beet growers will receive **direct payments** based on sugar beet production in the historical reference period, 2000-2002. These decoupled payments will bring the SMO in full compliance with the 2003 CAP reform. The direct payments will represent 60% of the estimated revenue loss from the two-step, 39% institutional price cuts. The revenue loss is estimated taking into account the change in the weighted minimum sugar beet price in each Member State, multiplied by the quota level.

The European Commission also proposes to abolish the intervention mechanism and intervention price for sugar. The intervention price will be replaced by a **reference price of sugar**, which will establish the trigger level for **private storage**. The sugar producers will be able to compensate their costs of storing sugar in the private storage facilities. If the market price falls below the reference price, the European Commission allows the withdrawal of sugar by the state, and in this case quantities withdrawn will not be eligible for private storage support.

Finally, the European Commission will continue ensuring the fulfillment of the EU **international commitments** in terms of preferential sugar imports from the ACP countries and EBA agreement. The major beneficiaries of this EU SMO reform will be cost-effective sugar exporters, while sugar beet growers and sugar producers in the EU, as well as APC and other developing countries sugar producers will incur losses due to lower EU prices. Over time, the sugar production in the EU will significantly decline and only those sugar factories will remain which are able to compete with the major low cost competitors (Table 3).

Table 3: Average cost of sugar production for country aggregates (in US$ per ton)

Product	**Country group**	**Cost period 1989-94**	**Cost period 1994-98**
Refined beet sugar Low cost producers	Belgium, Netherlands, Chile, Turkey, UK, US	456 (437-479)	450
Refined beet sugar Major exporters	EU, Turkey, Ukraine	656 (566-713)	710
Refined beet sugar High cost producers	Bulgaria, Kazakhstan, Moldova, Romania, Russia, Ukraine, Japan	989 (791-1221)	n.a.
Raw cane sugar Low cost producers	Brazil, Colombia, Malawi, Guatemala, Zambia	198 (177-219)	197
Refined cane sugar Low cost producers	Brazil, Colombia, Malawi, Guatemala, Zambia	280 (258-303)	n.a.
Raw cane sugar Major exporters	Australia, Brazil, Cuba, Columbia, Guatemala, Thailand, Mauritius, South Africa	277 (246-329)	335
Refined cane sugar Major exporters	Australia, Brazil, Cuba, Columbia, Guatemala, Thailand, Mauritius, South Africa	366 (332-429)	n.a.

Source: Hazeleger (2001).

5. Sugar market organization in Ukraine

As it was already mentioned in the introduction, the SMO in Ukraine emulates the EU's SMO, but without export subsidies. The sugar quota was introduced in 2000[4], thereby the overall national quota is allocated to regions, and then to sugar factories and sugar beet

[4] The Law of Ukraine No. 758-XIV "On State Regulation of Sugar Production and Marketing" as of June 17, 1999.

growers within each particular region. Every year the Government sets the minimum price of white sugar and derives the sugar beet price. Minimum prices are mandatory and if any agent diverts from minimum prices, he is substantially fined. In fact, the volume of quota and minimum prices remained unchanged since 2002.[5] Domestic market prices usually equaled minimum prices, which are twice over the reference border prices (Table 4). During 2002-2004, the world market price of white sugar (in refined equivalent) equaled 1.2 UAH/kg and Ukraine's domestic price equaled 2.4 UAH/kg. Due to various reasons, in the first half of 2005 domestic market sugar prices grew to 4.5 UAH/kg.

Table 4: Basic characteristics of SMO in Ukraine

	Units	2002	2003	2004	2005
Domestic marketing quota	mill tons	1.8	1.8	1.8	1.8
Minimum fixed prices:					
Sugar beet	UAH/ton	165.0	165.0	165.0	165.0
White sugar (wholesale, including VAT)	UAH/ton	2370.0	2370.0	2370.0	2370.0
Reference price (at farm gate, refined equivalent):	UAH/ton	1215.2	1140.6	1269.1	1318.1
Border reference price (f.o.b. or c.i.f.)	US$/ton	228.0	214.0	239.0	261.0
Official exchange rate	UAH/US$	5.3	5.3	5.3	5.1
Market price differential	UAH/ton	1154.8	1229.4	1100.9	1052.0
TRQ	1000 tons	-	360.0	260.0	0.0
Import Duty: in-quota	€/ton	5.0	5.0	5.0	-
Over-quota	€/ton	300.0	300.0	300.0	-

Source: State Statistics Committee of Ukraine (2004), World Bank and OECD (2004), and FAS/USDA (2005).

In order to protect high domestic prices, the import tariffs are set at prohibitively high level (300 €/ton). The fundamental difference between the situation in the EU and that in Ukraine is that the former has a net sugar surplus, while the latter is a net importer of sugar. Since domestic sugar production in Ukraine is lower than domestic consumption, from year to year the Government set temporary tariff-rate quotas with very lower in-tariff rate. For example in 2004, the tariff-rate quota equaled 260 thousand tons of raw sugar cane, but in 2005 so far the Parliament refuses to introduce the tariff-rate quota in spite of the surge in sugar prices. Also raw sugar can get to Ukraine on tolling contracts, with further mandatory re-export of refined cane sugar. For example, in 2003/04 marketing year Ukraine imported 646 thousand tons of raw sugar using the tolling scheme (Business 44 from November 1, 2004), but only 299 thousand tons was re-exported, leaving 347 thousand tons in the country. It is achieved by re-exporting "empty" wagons of refined sugar or by artificially lowering the extracting coefficient from raw sugar (which is normally 95%). Finally, high domestic prices in Ukraine and high out-of-quota tariffs encourage sugar smuggling. The amount of illegal import fluctuates in a range of 200-400 thousand tons of cane sugar per year (see Table 5).

[5] Resolution of the Cabinet of Ministers of Ukraine # 1977 "On State Regulation of Sugar Production and Marketing", as of December 25, 2002 (with amendments).

Table 5: Sugar balance in Ukraine, 2002-2005 marketing years, mill tons

	2002/03	2003/04	2004/05
Beginning stocks	0.14	0.12	0.18
Production of refined beet sugar	1.41	1.44	1.80
Import of cane sugar	1.34	0.59	0.25
Production of refined cane sugar	0.74	0.68	0.24
Total domestic production	2.15	2.12	2.04
Legal import of white sugar	0.08	0.06	0.05
Illegal import	0.30	0.32	0.05
Total import	1.72	0.97	0.35
TOTAL SUPPLY	**2.67**	**2.62**	**2.32**
Legal export	0.34	0.31	0.05
Illegal export	0.16	0.02	0.01
Total export	0.50	0.33	0.06
Domestic industrial consumption	0.57	0.63	0.67
Domestic human consumption	1.48	1.48	1.47
TOTAL DOMESTIC CONSUMPTION	**2.05**	**2.11**	**2.14**
TOTAL DOMESTIC CONSUMPTION	**2.05**	**2.11**	**2.20**
Ending stocks	0.12	0.18	0.12

Source: APK-Inform (2005).

Despite high sugar beet prices, Ukrainian farmers have reduced the seeding areas under sugar beet, choosing more profitable and less capital intensive commodities such as grains and oil seeds. Despite slightly increased yields, sugar beet production has decreased (Table 6). Although the official data shows an 18% increase in beet yields in 2004, experts believe that this data is overestimated for political reasons (Schmidt and Tatarenko, 2005).

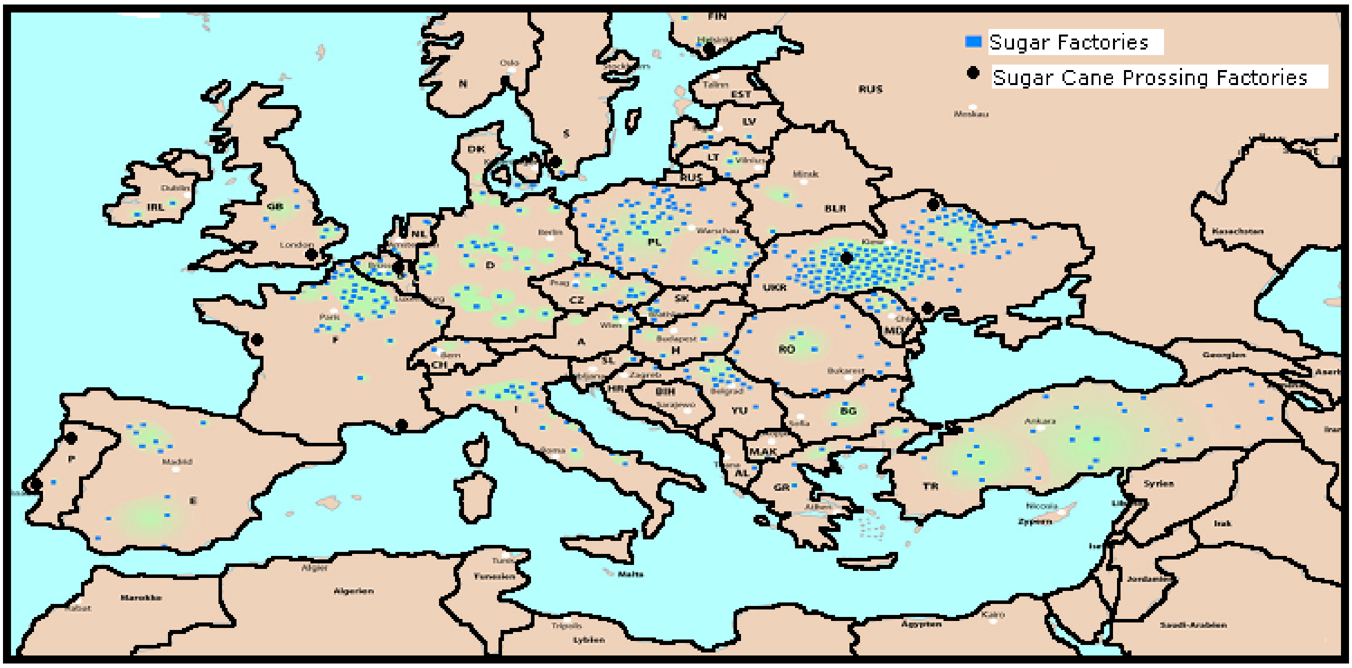
Table 5: Production of sugar beet in Ukraine, 1999-2004

	1999	2000	2001	2002	2003	2004
Seeding areas, thousand hectares	1022.1	855.6	970.3	896.6	773.4	732.0
Yield, dt per ha	156.3	176.7	182.6	189.3	201.2	238.0
Gross harvest, mill tons	14.1	13.2	15.6	14.5	13.3	16.6

Source: State Statistics Committee of Ukraine (2005).

The number of sugar factories in Ukraine is extremely high compared with other European countries (Figure 1). This is the inheritance of the Soviet planning system when the small group of planners decided that Ukraine should supply the whole Soviet Union with sugar. Of the existing 162 factories, only 120 continue operating, and 30 sugar factories were already liquidated. The remaining factories effectively operate only 1-3 months a year, mainly after the sugar beet harvest, which implies huge fixed costs of production and thus lower competitiveness. Figure 1 shows that further reduction and consolidation of sugar factories is urgently required to use the economy of scale and preserve any sugar production in Ukraine.

Figure 1: The map of sugar factories in Europe



Source: DZZ (2002).

Recent developments on the domestic sugar market revealed how Ukrainian SMO is unsustainable. Over the last four months sugar prices in Ukraine surged by unprecedented 34%, though the world sugar price increased only marginally (Figure 2). Wholesale prices reached 3.3 UAH/kg and retail prices even 4.5 UAH/kg. Despite different speculations about the driving forces of this situation, the sugar deficit is the main reason for that the price hikes. Domestic production and carrying stocks do not satisfy domestic consumption. The Sugar Association continues insisting that the actual domestic sugar consumption equals the production quota A (1.8 mill tons), while private market information agencies report the domestic consumption to be up to 2.2 mill tons (Table 5). Moreover, the Verkhovna Rada did not agree to allow the privileged sugar cane imports in 2005[6]. Over the last years this import and some smuggling sugar through Free Economic Zones made supply of sugar sufficient for the domestic market. But since the tax privileges to the most Free Economic Zones were abolished[7] and border controls strengthened, the estimated sugar deficit reaches 400 thousand tons (Schmidt and Tatarenko, 2005).

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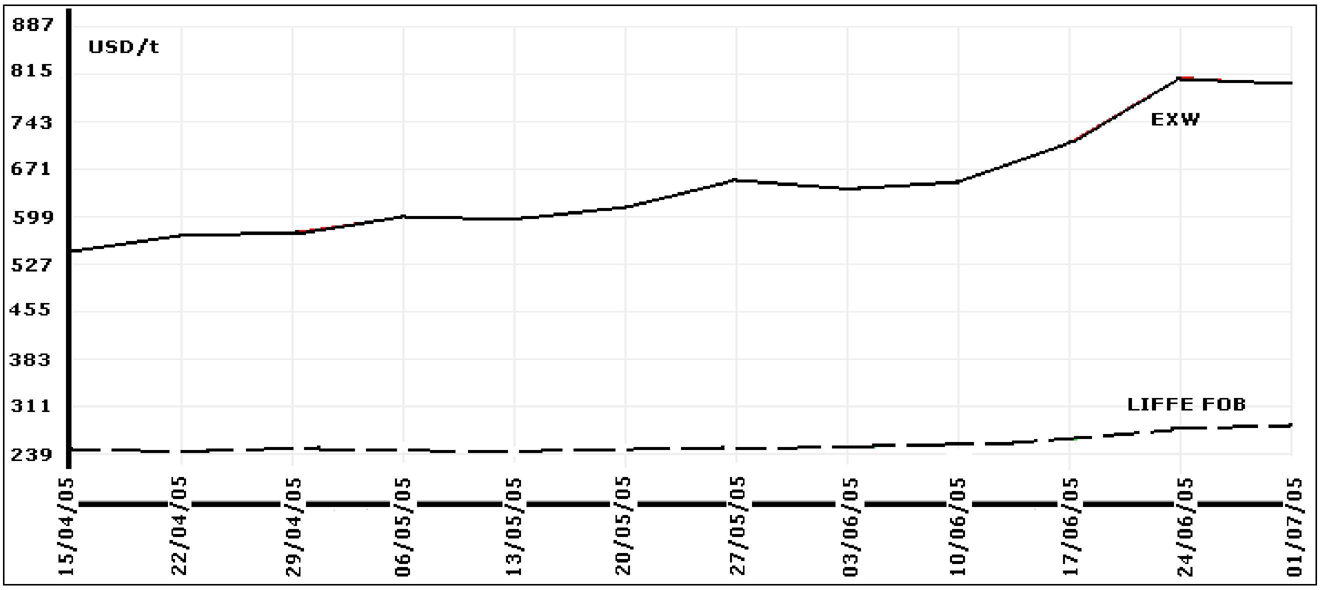
[6] Even though the draft law "On the State Budget 2005" envisaged the import of raw cane sugar.

[7] The Law of Ukraine "On Amendments and Changes to the Law of Ukraine "On the State Budget 2005" dated March 25, 2005.

Figure 2: Domestic and world sugar prices, April-July 2005, US$ per ton



Note: World sugar price is proxied by the white sugar price in London Future Exchange.

Source: APK-Inform (2005).

6. The future of Ukraine's SMO

The recent crisis raises the question about the sustainability of the current SMO in Ukraine. It seems that the protection of sugar industry does not lead to serious restructuring and improved competitiveness. This crisis shows the need of urgent reform, especially taken into account the future challenges of the WTO membership. According to the preliminary results of negotiation process, Ukraine is going to provide a tariff-rate quota for raw sugar at 260 thousand tons (although some countries has been insisting on 400 thousand tons) to be imported at 2% import duty. Out-of-quota tariff would decrease to 50%. Moreover, Ukraine together with other WTO members can already now anticipate further restrictions on its SMO in the case of a successful completion of the Doha round negotiations. Most likely the Swiss formula[8] of tariff reduction will be adopted, meaning a further sharp cut in sugar import duty. Furthermore, domestic support will be subject to reductions, meaning the 'amber' box constrains for Ukraine. All these future constraints imply that it is hard to imagine the SMO in Ukraine without changes, taking into account the low international competitiveness of the sugar factories.

As Table 3 demonstrates, Ukraine is rated among the high cost beet sugar producers, with production costs that are almost twice higher than, for example, in the EU or the USA. Moreover, cane sugar production has proved to be almost twice cheaper than even the most efficient beet sugar production, which makes Ukraine position at prevailing production costs on the world sugar market hopeless. Of course, Ukraine can still rely on Russian or other CIS markets, but this option is not sustainable in the long-run (von Cramon-Taubadel, 1999). Table 7 presents a simple calculation whether the Ukrainian SMO will withstand the world market pressure after possible joining WTO and current price situation on the domestic market.

[8] Swiss Formula means higher tariffs are cut more than lower tariffs.

Table 6: Current and future SMO position in Ukraine

	Units	WTO Scenario		Current Scenario	
		Lower Bound	Upper Bound	Lower Bound	Upper Bound
Wholesale price of sugar, EXW	UAH/ton	2370.00	2370.00	3300.00	3300.00
f.o.b. Europe, LIFFE	US$/ton	-	259.26	-	259.26
I.S.A., ISO	cts/lb	8.97	-	8.97	-
I.S.A., ISO	US$/ton	197.34	-	197.34	-
Exchange rate	UAH/US$	5.05	5.05	5.05	5.05
Exchange rate	UAH/€	6,1	6,1	6,1	6,1
Import tariff	€/ton	-	-	300.00	300.00
Import tariff	%	50.00	50.00	-	-
f.o.b. Europe	UAH/ton	996.57	1309.26	996.57	1309.26
fob Europe or ISA plus Import tariff	UAH/ton	1494.85	1963.89	2811.57	3124.26
fob Europe or ISA plus Import tariff & VAT	UAH/ton	1793.82	2356.67	3373.88	3749.12
Market Price Deferential	UAH/ton	576.18	13.33	-73.88	-449.12

Note: ISA – International Sugar Agreement.

Source: Own calculations.

One can easily identify the basic setup for each scenario considered in the table. One critical thing needs clarification first; it is the choice of the world price level. There is no such a term as "one world price" in the sugar world (von Cramon-Taubadel, 1999). There are many of them, which depend on different factors such as quality and refinement of sugar, marketing terms, etc. The most often used price as an indicator of the world sugar price is so called ISA price, being the average of several raw-sugar prices. Raw sugar is traded more intensively than white sugar, because white sugar is very sensitive to the long distance transportation. The current ISA price (as of July 2005) is 8.97 cts/lb[9] or 197 US$/ton. The ISA price is lower than the white sugar price on the London Exchange (LIFFE), which is about 259.3 US$/ton for the time being. But, since Ukrainian white sugar is of lower quality, it could be sold only at discount. That is why we can set ISA and LIFFE (fob Europe) prices as the lower and upper bounds for Ukrainian white sugar prices on the world market.

If Ukraine succeeds in joining the WTO, the import tariff on sugar will be bound at 50%. Will this import regime enable Ukraine to keep current minimum sugar and sugar beet prices unchanged? The answer is clearly no! At the current white sugar minimum price (2370 UAH/ton), the price differentials between domestic wholesale and corresponding world prices (accounted for import duty and 20% of import VAT) will be 577 UAH/ton and 13 UAH/ton for the lower and upper bound. It means that in this situation it will be profitable to import sugar even at out-of-quota tariff. Of course one may argue that raw sugar first needs processing before to be consumed on the domestic market, but the final sugar from the raw one will not be more expensive than the white one, because Ukrainian

[9] 1 cts/lb=22 US$/ton.

sugar factories would incur only 35 US$/ton to process raw sugar, which is much less than 577 UAH/ton (see Business 48, November 29, 2004).

At this stage, as was mentioned above, Ukraine is experiencing a price shock for sugar, caused by its deficit on the domestic market. The wholesale prices surged to 3300 UAH/ton level, making world sugar nearly lucrative to be imported even at 300 €/ton import duty. Current scenario in Table 7 reflects this situation. Interestingly, that if sugar price in Ukraine continues to grow, 3750 UAH/ton will serve the minimum upper bound price at which the import of white sugar becomes profitable.[10]

7. Policy recommendations

The sugar market organization in Ukraine stays at the edge of the reform. The experience of EU SMO has shown that delay in reform does not eliminate the problems but make them deeply entrenched, requiring external forces to push reforms forward. Once these external forces became concentrated, the country has little alternative but substantially cut support. Ukraine faces similar problems and prospects. The approaching WTO accession and the recent price shock serve as a perfect reason to initiate serious structural reform of the sugar sector, otherwise Ukraine will sacrifice its sugar industry for good. Huge amount of time to restructure the industry has been already lost and every delayed year will increase the economic losses.

Many Ukrainian experts think that the sugar sector can be saved by increased support and import protection. But we think that this is exactly the protection which causes the key problems in the sugar sector. High protection allows all sugar factories to survive, e.g. both efficient and inefficient. Over time the efficiency of even good factories declines, and the sugar sector as a whole becomes even less competitive. In the open economy the protection cannot last forever. Each country wants to sell its products to other countries, but it is often forgotten that trade is about both export and import. Ukraine must enter the WTO to promote its exports. If the WTO membership is sacrificed by unreformed sugar sector, we can forget about the qualitative economic growth in Ukraine. Even the EU with much bigger political influence than Ukraine agreed on reforming its SMO in order to stimulate its more competitive exports. For Ukraine, similar to the EU, it is better to have less sugar factories than lose the whole industry.

Agricultural policy in Ukraine should take into account the probable commitments to the WTO as soon as possible. There is no sense to keep the sugar quota in Ukraine, because the WTO membership will make current minimum sugar and sugar beet prices unsustainable. It means that these prices must be reduced. Based on our estimations (Table 7), upper bond of minimum sugar price can be only UAH 1794 per ton (2370-576). And if the farmers decrease the sugar beet production at current prices, they will certainly produce less at future lower prices.

The winners of this reform are consumers, including the processing industry, while the losers are sugar factories and some sugar beet producers. Specialized sugar beet producers will loss more than more diversified agricultural producers. In order to ensure the weaker opposition to the reform, we suggest establishing the restructuring fund similarly to the EU financed by the budget and sugar factories. Under such a fund, sugar factories which opt to abandon sugar production would obtain compensation to begin new more sustainable

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[10] Some publications, e.g. Business 21 from June 13, 2005 claim that at 3300-3500 UAH/ton the legal import becomes profitable in Ukraine, which is basically quite close to our estimations.

activities. The liberalization of trade would allow the rest of the factories to process domestically produced beets and imported sugar cane. Such a practice would smooth factories' operation cycles over the marketing year, thereby decreasing their fixed costs and improving international competitiveness.

The EU is being obliged to sacrifice its SMO to open better trade opportunities for competitive agricultural products and non-agricultural exports. This is a good example to follow for Ukrainian SMO! If it is not followed now, the unnecessary delays will make future inevitable reforms just more costly and painful.

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