



The Subsidy Habit

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WORLD AGRICULTURAL PRODUCTION EXPERIENCED ANOTHER tumultuous year in 2012. After a promising spring planting season, the United States suffered a severe drought, which pushed nominal prices of maize and soybeans in world markets to record levels. Some other large suppliers (Argentina, Brazil, China) increased their production of these two crops, but given the importance of the United States as a producer and the continued growth in demand, these increases were not enough to hold prices down. As a consequence, instead of declining from their peaks of 2008 and 2010/2011, feedgrain and oilseed prices remained high for a fifth consecutive year.

The agricultural policy response in developed countries has been bifurcated. The United States and other donor countries have increased their investments in overseas agricultural development projects and scientific research through initiatives such as the US Agency for International Development's Feed the Future program. Neither the United States nor the European Union (EU), however, has done much to expand productivity-increasing public agricultural research at home. The US Midwest and Great Plains, which helped feed Europe after World War II and have historically been a breadbasket for the world, are now responding to increased demand from biofuel production, which puts upward pressure on agricultural prices. The United States, the largest single producer of maize and soybeans, has at least refrained from limiting its food and feedstock exports, a welcome outcome that reflects a constitutional ban against export taxes¹ and the adverse consequences of earlier export embargos. Likewise, the EU has for the most part avoided using border policies to insulate the domestic market from rising world prices. This constraint on border policies has helped stabilize world markets.

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A Brazilian View of EU and US Agricultural Policy Reforms

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The US farm bill and the EU Common Agricultural Policy (CAP) have received surprisingly little attention in Brazil this year. In contrast to previous years when these policies were under review—especially 2001–2002 when prices were low—the Brazilian government, trade associations, and even the media have not given the issue due attention. Brazilian stakeholders believe that (1) food prices will remain high, which partially neutralizes the trade-distorting consequences of the US farm bill and (2) demand for agricultural commodities (including bio-fuels) will continue to grow rapidly, which diverts attention from the still-high trade barriers and export subsidies used in the European Union (EU). While government officials have expressed concern about the US farm bill, Brazil's private sector has not added the ongoing policy revisions in the United States and the EU to its agenda.

Much of the lack of interest in Brazil can be explained by the dormancy of the Doha Round, which essentially means US and EU legislators are not bound by any

international obligations regarding the agricultural support given to their farmers; rather they are limited only by their own budgets. Without a resolution to the Doha Round, Brazilian stakeholders have only the World Trade Organization Dispute Settlement Body to act as a disciplinarian when policies between third-party countries are violated. Not only does the settlement process take a long time, but the settlements themselves have little or no capacity to constrain policy decisions made by national governments. Therefore, Brazilian stakeholders have no incentive to follow the revision process underway in the United States and the EU.

In general, the private sector is driven by short-term results, and experience with Brazilian trade associations shows that they too have limited interest in working on issues that have concrete outcomes only in the long run, such as the revisions to the US farm bill. The problems that Brazil's policymakers have with CAP are related to trade barriers and export subsidies, not with focusing on short-term

issues, however. In the absence of EU export subsidies, the better strategy for Brazil is to pursue bilateral negotiations with the EU instead of waiting for multi-lateral solutions like Doha. On the other hand, the trade-distorting component of the US farm bill continues to be strong, and distorting payments only need lower prices to become harmful to the world market again, as they were in 1998–2002. The United States has been losing world market share, which reduces the negative effects of its policies on trade, but it is concerning from a Brazilian perspective that past Dispute Settlement Body findings are not being considered during the farm bill revision process. But in the event of lower world food prices and the absence of an agreement on the Doha Round, the Dispute Settlement Body is the only available way to resolve trade issues. Brazil will not hesitate to call on it if necessary.

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In the high-price environment since 2008, one might expect that old policies of subsidizing farmers through price and income support would fade from the policy debate. But that is not the case. Both the United States and the EU are reviewing agricultural support policies and devising new options for supporting and protecting farmers, particularly in light of uncertainty about whether prices will remain high and volatile. Some of the resulting US and EU policy developments do not bode well for achieving the long-run policy goal of using undistorted markets to achieve global food

security at the least cost. Assessing the effects of various countries' trade-distorting support and protection measures is often complex. Impacts are diverse among different groups of countries (exporters and importers), among different segments of their populations (net food producers and consumers), and under changing market conditions. In this intricate context, undistorted world markets, complemented with appropriate investments in a growing food supply and availability of social safety nets for those at nutritional risk, should be the centerpiece of the global food system.

By excessively protecting their own farmers from the risks of agricultural production, however, US and EU policies reduce the incentives for the world to cope with country-specific risk through a fair, efficient, and undistorted trade regime. They favor unilateral and noncooperative strategies instead of a multilateral, rule-based approach.

Movement toward the objective of undistorted markets suffered a blow with the lapse of the World Trade Organization (WTO) Doha Round negotiations after 2008. These negotiations, intended to build on the earlier 1994 WTO Agreement on Agriculture, aimed to reduce trade distortions by progressively reducing distortionary agricultural support and protection while giving countries latitude to support farmers in nondistorting ways. These could include government services, food security programs, and income support that is decoupled from production decisions (these acceptable support measures fall into the category known as the “green box”).

In the absence of a new WTO agreement, constraints on distortionary agricultural support remain lax. The new US farm bill under debate in 2012 may well be a casualty of the failure of the Doha Round. Its programs may make it harder in the future for the United States to agree to support reductions such as those envisioned but not locked in by the Doha negotiations. Likewise, the EU is planning to continue high subsidies and is considering distortionary new support options.

US and EU agricultural policy developments in 2012 will have direct effects on markets and indirect effects that set the tone for agricultural support and border policies worldwide.

UNITED STATES: PROVIDING NEW ASSURANCES TO FARMERS

The 2008 US farm bill expired on September 30, 2012, and subsequently the post-election Congress extended it through September 2013. Thus, debate over the farm bill will continue. Still, the likely direction of US policy was discernible in separate bills passed in July 2012 by the full Senate and the House of Representatives Agriculture Committee. Under these bills, the United States would eliminate annual fixed direct payments made to farmers

since 1996 and enact enhanced price or revenue protection that is more closely tied to production of specific crops. Total farm subsidy costs are anticipated to decline by 10 percent over the coming decade, but the new programs could make large payments in years of low yields or market downturns. Anticipated total expenditures over 10 years under the new law compared with continuation of past farm programs are shown in Table 1.

The new US farm bill would expand crop insurance subsidies. Driven by higher per-unit subsidy rates and expanded eligibility incorporated in previous legislation, as well as higher nominal costs correlated with higher crop prices since 2008, insurance payments (measured as total indemnities less farmer-paid insurance premiums) already exceeded the US fixed direct payments by 2011 (US\$5.6 billion versus US\$5.0 billion). With the drought-related losses in 2012, insurance payments will be even higher.

The new US farm bill would expand on the traditional insurance programs in two ways.² First, new subsidies are designed to make payments for specific crops when revenues for that crop decline below a targeted level within a production year. This new program is commonly called a protection against “shallow losses” that are less than the losses that trigger payments from individual farm

TABLE 1 Estimated effects of new US farm bill on expenditure levels, 2013–2022

Farm bill title	Billions of US\$ (10-year totals)	
	Estimated spending under 2008 farm bill	Range of anticipated increase or decrease
Farm support programs	152.8	-14.1 to -14.4
Commodity programs	62.9	-19.4 to -23.6
Crop insurance	89.8	5.0 to 9.5
Conservation	65.2	-6.1 to -6.4
Nutrition	771.8	-4.0 to -16.1
All other titles	4.8	1.7 to 3.2
Total	994.6	-22.5 to -33.7

Source: Authors’ summary based on US Congressional Budget Office estimates (March 2012 baseline and budget scores of farm bill proposals).

Note: Estimates are for fiscal years 2013 to 2022.

insurance. Although the drought of 2012 demonstrates the systemic weather-related risks associated with farming, and systemic risk provides one rationale for government intervention to address a market failure, existing within-year US crop insurance subsidies are already high.³ Adding new insurance against shallow losses adds to this imbalance.

Second, the new bill would strengthen protection of farmers against multiyear losses for supported crops (feedgrains, soybeans, wheat, rice, cotton, and peanuts), such as when prices decline for several consecutive years. Two approaches dominated the debate on this part of the bill. A traditional approach would raise the nominal values of target prices that trigger payments to farmers when market prices fall below these fixed levels. The target prices set in the 2008 farm bill have been so far below market prices that they have offered essentially no farm support. The new higher levels would create a fixed price floor much more likely to generate payments in downturns from recent price levels. Such fixed price floors have a long tradition in US farm policy.

In the competing approach, the triggering mechanism for payments to farmers is not a fixed price level but a moving average of past revenue. Farmers would receive payments if revenue in a year dropped below some percentage of the moving average (proposals in 2012 were in the range of 75–89 percent). Proponents of this approach argue that it has a built-in policy design benefit.⁴ Because the revenue support trigger moves with the market, if prices decline and stay at lower levels for several years, the level of revenue support will also move down. In contrast to the more traditional approach, farmers, while protected against too sharp an initial year-to-year revenue decline, would have to adjust over time to the lower revenue levels. However, initiating a moving average revenue program after a period of high prices, and particularly the very high prices of 2012, means that farmers would receive protection against the first revenue decline that might occur—for example, if prices come down from 2012 levels in 2013 or 2014.

Eliminating the fixed direct payments and strengthening price or revenue support based on current production of specific crops runs counter to

efforts to reduce trade-distorting subsidies through the WTO. The fixed direct payments arguably fall within the WTO green box of programs agreed to have “no, or at least minimal, trade-distorting effects or effects on production.”⁵ In contrast, US crop insurance subsidies and the new shallow-loss and multiyear-loss protection programs are subject to an annual nominal support limit of US\$19.1 billion. In the Doha negotiations that faltered in December 2008, a limit as low as US\$7.6 billion was under discussion.

In the absence of a Doha agreement, US farm policy is evolving in a direction counter to the long-run objective agreed to multilaterally in the WTO. The new support programs will make it harder for the United States to agree to tighter constraints that may be negotiated in the future.⁶ And other countries may feel little motivation to limit their own distortionary support or protection if the United States adopts a new farm bill along the lines that seem likely.

EUROPEAN UNION: CAP CONTINUITY AND MODIFICATIONS

The EU Common Agricultural Policy (CAP) is subject to the renewal of the seven-year Multiannual Financial Framework for the 2013–2020 period. This renewal process also provides an opportunity to revise the CAP. The Council of the European Union, incorporating the agriculture ministers of each member state, and the European Parliament, which share responsibility for determining the CAP, are currently discussing the proposal tabled by the European Commission on October 11, 2011.

From the early 1960s to the early 1990s, the CAP was characterized by market intervention. Most of the EU agricultural sectors were subject to administratively set prices, and authorities had to purchase excess production when market prices were lower than these fixed levels. High levels of price support kept EU production growing, while technical change raised yields and lowered costs. As a result, in the 1980s managing government-held surpluses became a substantial problem. The EU subsidized the disposal of surpluses abroad, which led to both large budget expenditures and world

An African View of EU and US Agricultural Policy Reforms

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The agricultural policies of the United States and the European Union (EU), which were both under review in 2012, help agricultural development in Africa, but they also subsidize their own farmers and impose stringent requirements for imports. Such policies tend to keep African agricultural goods out of US and EU markets.

US AGRICULTURAL TRADE AND AID POLICIES

The US farm bill gives policymakers an opportunity to assist US farmers, but it also has implications for farmers and consumers in developing countries, especially in the absence of an agreement on the Doha Round of multilateral negotiations. It provides commodity price support and other payments to US farmers that tend to suppress world prices and distort market conditions. Such situations serve as disincentives for African producers.

The US policies on biofuels—which cover assistance for the production, marketing, and processing of biofuel

feedstocks—reduce the amount of cereals and pulses on the world market and raise their prices. In turn, African countries pay higher prices for their food imports, which ultimately raises concerns for food security in Africa. On the flip side, the US Food for Peace program provides food aid to many African countries in an effort to reduce vulnerability in food insecure households. The program was very helpful during the droughts and accompanying famines that struck the Horn of Africa and the Sahel in 2011–2012 and during previous years when high prices made food inaccessible to many people in Africa.

EU AGRICULTURAL TRADE AND AID POLICIES

Although the EU has opened up its markets to African producers through the Cotonou Agreement and the Everything But Arms agreement, among others, the EU Common Agricultural Policy (CAP) makes it difficult for those producers to be competitive. The EU protects its markets by (1) keeping prices artificially low

through subsidies for farmers, processors, and exporters of agricultural produce and (2) imposing nontariff barriers such as strict health and safety regulations (for example, restrictions on maximum residue levels). By subsidizing their own farmers at the current magnitude, European agricultural produce (primarily beef, poultry, and tomatoes) can be sold in Africa at prices so low that African producers cannot even compete in their own countries despite the advantage for low-cost production. The food safety regulations in the EU make it difficult for African countries, which typically rely on smallholder producers who use unsophisticated technologies, to export to Europe and can wipe out any benefits the producers gain from not having to pay tariffs. Such consequences have already been observed for horticultural produce from many African countries. For African farmers to take advantage of the EU's preferential treatment, they need better capacity to increase productivity and maintain food safety. The EU can provide assistance to make this possible.

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market distortions that triggered international disputes and retaliation. In the 1990s the cost of storing commodities and subsidizing exports became so high that the EU engaged in reforms. Since then, continual reforms (in 1999, 2003, and 2008) have led to the progressive dismantling of the intervention system and the de facto end of export subsidies, as shown in Figure 1.

Farmers have been compensated for lower EU price supports by direct payments. In the 2000s

these payments were decoupled from production to the extent that farmers are no longer required to produce crops or animals to receive support. The payments are considered to fall into the WTO's green box and thus are exempt from a nominal cap. However, the €42 billion handed out each year necessarily indirectly raises output by keeping some farmers in production (even though they do not need to produce to get support), easing credit constraints, and lowering risk aversion. The EU farm

support policy is now based almost entirely on the direct payments, which have been made conditional on requirements regarding the environment, animal welfare, workers' safety, and other social regulations.⁷

The European Commission's proposal does not depart significantly from the CAP reform movement initiated 20 years ago but would remove most

of what is left of market management. Because of the new institutional power of the European Parliament, which gained full joint decisionmaking power with the Council in 2010, the proposal also reflects the concerns of elected representatives and their farm constituents. In particular, ministers of agriculture and the Agriculture and Rural Development Committee of the Parliament expressed

A Chinese View of EU and US Agricultural Policy Reforms

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Grain security is ensured when the quantity of total grain supplies can adequately satisfy national needs and when, domestically, grain is priced such that those who need it can afford as much as they need. It is always a top priority in Chinese agricultural policy. To fulfill demand, China has become a net importer of major cereal crops, bringing in an estimated 5.5 million metric tons of corn, 2.9 million metric tons of wheat, and 2 million metric tons of rice in the 2011/2012 crop year alone. In order for China to grow as much grain (including soybeans) domestically as it currently imports, it would need to increase the areas currently sown to grain crops by more than 30 percent. At the same time, Chinese consumers have been struggling with high food prices, which increased by nearly 7 percent in the first half of 2012—a spike that is higher than any seen throughout the entire previous year. As both grain imports and prices increase significantly in a seemingly irreversible trend, China is beginning to more carefully evaluate the farm policies of its major trading partners to assess how they impact food security within China's borders. Accordingly, China's farm policy may move either toward more openness to

imports or away from it by placing greater emphasis on a self-sufficient domestic food supply.

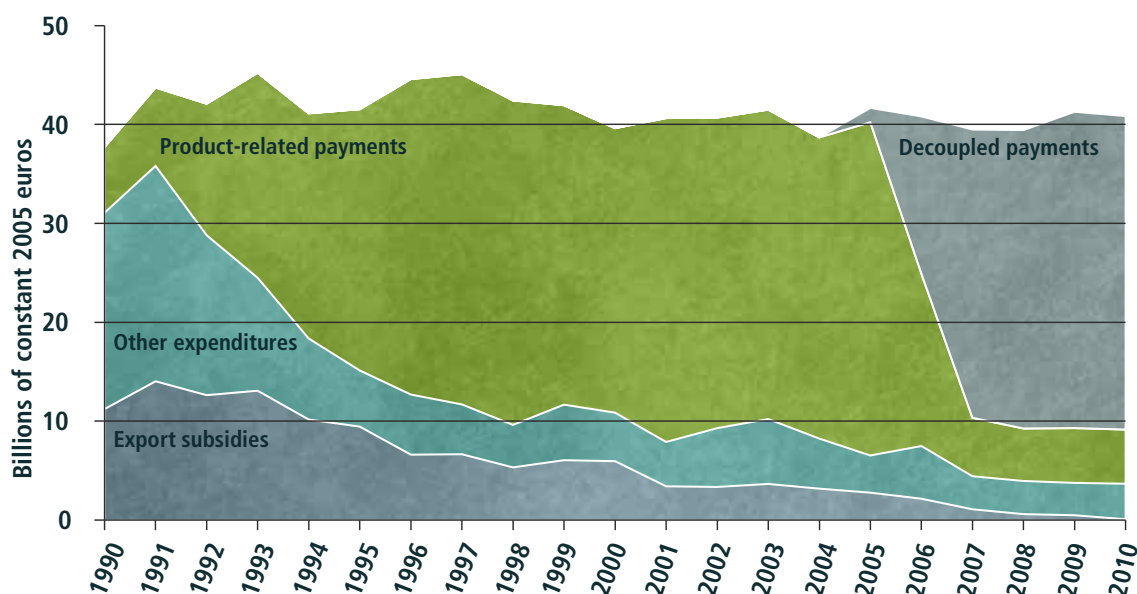
In 2012, the United States proposed its new farm bill, which may partially shift budget support from commodity programs to agricultural insurance programs. This could help stabilize production and, to some extent, prices for insured crops. While the proposed changes to the existing US farm policy would likely have only a moderate impact on prices themselves, they could have a lot of influence on reducing the fluctuation of those prices. As such, the potential outcomes do not go against China's policy goals. The farm bill also proposes that fixed direct payments are replaced with price or revenue support based on current production of specific crops. China may be able to tolerate these changes, however, because the basis for becoming a net importer of crops is the shortage in domestic food supply, not the necessity to compete with lower prices.

The European Union's (EU's) 2012 proposal for a new Common Agricultural Policy (CAP), on the other hand, may have negative implications for China's grain security. A significant reduction in the CAP budget as well as the "green

payment" stipulation (which states that farmers must meet certain requirements related to crop diversification, grasslands, and ecological focus areas before receiving direct payments) may lead to lower production levels of major EU crops. Although the EU is not a major source of imports for China, any significant reduction in production from such a major player in trade would inevitably lead to either a reduction in exports or an increase in imports. China also needs to keep a close watch on the greening trend and find ways to adapt to its outcomes. As more major trading partners take similar measures to reduce greenhouse gas emissions and protect the environment, the total food supply in the world market might be tightened as its prices increase. This will certainly put heavier pressure on China's grain security from a long-term perspective and could lead to the traditional self-sufficiency argument, which is currently regaining some support. In general, rather than taking further measures at its borders, China should enhance efforts to push and strengthen domestic production.

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FIGURE 1 Composition of the EU agricultural budget, annual expenditures, 1990–2010



Source: J.-P. Butault and J.-C. Bureau, based on EU Commission budget data.

concerns about further market liberalization because of a possible increase in price volatility. They also raised concerns about leaving European farmers dependent on market forces while their US counterparts benefit from systems of insurance and countercyclical support and while major emerging-market countries are raising production subsidies.

These concerns are reflected in the Commission's proposal for coping with potential "crisis" periods of exceptionally low prices. The proposed crisis package includes a tendering process for some products (barley, maize, rice, and beef stocks) and private storage aid for others (sugar, olive oil, flax, beef, butter, skimmed milk powder, pig meat, and sheep meat). These measures would be funded from a €3.5 billion reserve separate from the CAP budget. The Commission's proposal also authorizes member states to develop national-level insurance and income stabilization tools with some cofinancing from the EU budget, but with ceilings that ensure that these new programs will remain limited.

The EU budget for direct payments will remain high under the CAP, since the Commission

proposes maintaining this expenditure in nominal terms. National allocations ("envelopes") for direct payments would be adjusted so that those receiving less than 90 percent of the EU average payment per hectare would receive more, moving all EU member states toward more uniform payments per hectare by 2019. The largest gap would be reduced by one-third.

The most controversial issue is the Commission's proposal to reorient the direct payments, with an increased requirement for environmental measures.⁸ A basic payment scheme would replace the current single farm payment scheme. Under the new design, the basic direct payment would continue to be subject to relatively minimal requirements. An additional payment of 30 percent of the total would be conditional on farmers complying with three measures: (1) crop diversification (farmers would have to cultivate at least three crops a year on the land they do not set aside); (2) an "ecological focus" requiring that farmers devote 7 percent of their land to a conservation area where biodiversity is protected; and (3) maintenance of permanent pastures. The ecological focus is particularly opposed by farmers' organizations.

In addition to the management of markets and the support of farm income, the EU has over time developed a rural development component of the CAP, sometimes called the second pillar, which is cofinanced by member states. The Commission has proposed some changes in this policy, with new priorities. The rural development measures would include compulsory funding for climate change mitigation and adaptation and new land management measures, including organic farming.

There are many reasons for dissatisfaction with the Commission's proposal. Some fundamental inconsistencies of the current CAP persist. For example, maintaining basic direct payments means also maintaining the undesirable effects of the current system, in particular the capitalization of payments into land prices and the push toward specialization of farms. The Commission has introduced new payments to promote crop rotation and to help young farmers overcome barriers to entry, while the problems these measures address are actually caused or at least worsened by the system of direct payments itself. There is little left of the idea of reallocating support toward public goods, which was extensively discussed during the preparation of the proposal. And making 30 percent of the direct payments conditional on specified farm management requirements (for example, crop rotation with an ecological focus) is a high-cost policy compared with targeting payments directly to the provision of public goods, such as water management, carbon storage, or biodiversity preservation.⁹

The Commission's proposal does not change the basic direction of the CAP or address its most fundamental problems. It continues to shift support to direct payments and rejects attempts by parliamentarians and farmers' organizations to turn these payments into risk-based and counter-cyclical instruments, or to implement a large-scale, EU-wide farm insurance system. While many observers lament the proposed reform's lack of ambition, it has managed to keep most of the bad ideas proposed for CAP reform out of the agenda. Overall, the reform should not result in further market distortions.

Although 20 years of reforms have not lowered EU farm support, they have shifted the support to payment categories that have so far been exempted

from WTO-imposed reductions. While a new crisis package may, in a period of market collapse, call for export subsidies to support prices, it is clearly a policy of last resort in the proposed configuration. Even if a Doha agreement is eventually completed, there is no reason for the EU to withdraw from its 2004 commitment to end export subsidies (which it currently does not use). The EU's main concern about a Doha agreement concerns the prospect of increasing access to the European market and the need to lower tariffs, which is largely independent from the CAP reform. A sharp reduction in EU agricultural tariffs, in particular in the dairy, beef, and sheep sectors, would likely lead to large imports and hurt EU cow-calf producers and the extensive farming sectors that are still central to the rural economy of some European regions. Incomes are very low in these economically fragile sectors. It is unlikely that the EU will be willing to endanger so many farmers without substantial concessions from other countries.

DIVERGENT POLICIES BUT CONTINUED US AND EU SUPPORT

There are few areas of convergence between the 2012 US farm bill proposals and the European Commission proposal for 2013 CAP modifications. Both proposals share concerns about price and income volatility, but the EU responds to them with much more limited instruments than the existing and proposed US arsenal of measures. The new US farm bill is likely to enact increased protection of farmers against possible adverse events, moving it further from the spirit of previous multilateral negotiations, which aimed to reduce distortions in world markets. Meanwhile, EU policies will continue to rely largely on payments decoupled from direct links to production of specific crops and livestock. But its transfers to farmers will remain very high compared with the United States. The events and political momentum of 2012 perpetuate a global regime of support to farmers in the major developed countries.

Continuation of these support policies has detrimental direct and indirect effects on global food security. To the extent that these policies induce higher US or EU production and lower world

Grain Drain: Agricultural Policies in the Post-Soviet States

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Although there were no major changes made directly to the agricultural policies of the post-Soviet states in 2012, several external factors influenced agriculture in the region. For example, after becoming a member of the World Trade Organization in August, the Russian Federation increased subsidies for young breeder cattle purchases (to the equivalent of more than US\$30 million) in an effort to enhance the competitiveness of its livestock. Similarly, the Russian government introduced milk subsidies to help this sensitive sector adapt to the liberalized market. Payments were initiated for hectares of cultivated land based on the volume of crop yields, bioclimatic potential, and soil fertility. Some tax concessions have also been prolonged, including the zero-profit tax for agricultural producers. More specific to 2012, given the agricultural damage resulting from negative climatic conditions in the spring and summer, the government developed mitigation measures for the 20 regions affected and allocated 6 billion rubles (about US\$200

million) to compensate agricultural producers for their direct losses.

The Customs Union of Russia, Kazakhstan, and Belarus has also had an effect on agricultural policies in the region, especially as the union agrees upon and enforces its new technical regulations and health codes. Given Russia's World Trade Organization accession, the common market for these countries has high requirements to ensure that their agricultural products are competitive.

In Ukraine, milk, meat, and egg production increased in 2012 and managed to stabilize the livestock industry, but poor climate conditions led to decreased production of some crops, including grain, sugar beets, and sunflowers. Despite this reduced production, export levels were relatively high for major agricultural products such as cereals, oilseeds, and vegetable oil. In fact, Ukraine's total agricultural exports in 2012 exceeded the previous year's by 38 percent, and by the end of November 2012, total grain exports exceeded 11 million tons, with

wheat contributing almost 47 percent of that total. This provoked concern about national food security and a discussion on the possible limitation of grain exports (by introducing quotas, administrative barriers, or bans) to refocus attention on domestic food needs while maintaining high rates of nongrain export crops.

Grain exports have also been relatively high in the Russian Federation and could exceed 12 million tons by the end of the year. The high volume of exports has not been discussed in Russia, however, because the country has carryover grain stocks to ensure national food security and restricting exports at present would have potential negative consequences.

It was also a difficult year for Kyrgyzstan, where grain yields were more than 50 percent lower than in 2011. Achieving food security there and in other Commonwealth republics, such as Moldova, will require an increase in either grain (mostly wheat) imports or food aid.

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prices, and increase uncertainties for overseas producers, they reduce incentives for agricultural development elsewhere. They contribute to a concentration of world production in a limited number of countries, increasing the risk exposure of the global food system. For the United States, these distortionary effects will be larger if prices decline from recent high levels; that is, the distortions will

be greater just as other producers face more adverse conditions. For the EU, distortions arise from the sheer amount of income transfers. In reaction to the continued agricultural subsidies in the United States and the EU, other countries will maintain protection and develop unilateral support programs for their own farmers, lessening hopes for achieving a world food system that effectively provides for global food security at the least cost. ■