SAC

Rural Policy Centre

Outlook for 2009

Contents

Acknowledgments

The authors would like to thank all members of SAC staff who contributed with their comments and assistance in the production of this document.

Foreword

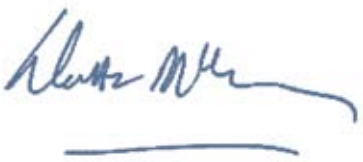
Our world has been subject to dramatic change over the past year. We have witnessed economic turmoil that is virtually unprecedented in modern times. We have seen our climate change in ways which begin to bear out the predictions of scientists that were dismissed by many only a few years ago. And we have seen the general public and politicians wake up to the fact that food supplies, even in the West, are vulnerable.

In this context, the SAC Outlook Report for 2009 examines the prospects for the livestock and crop sectors and highlights the key emerging issues with regard to the environment and rural development. It highlights just how dynamic the current situation is, which is perhaps unsurprising given the current global economic turmoil. Coming at this time of upheaval, this report is both critically important and timely, as it helps to provide stakeholders with the knowledge they need for policy appraisal and business development.

The report highlights how the livestock sector remains dependent on EU support and is significantly influenced by the dominance of retailers, global markets, consumer trends and social prosperity. Although prices have risen, many farmers still face difficulties in achieving profitability. In the crop sector, the cyclical pattern of boom and bust was strongly in evidence during 2007/08. Many Scottish farmers have been left frustrated as a record world harvest has brought prices down at the same time as a poor harvest in Scotland limited output and quality. As we face the prospect of recession, many farmers will have to cope with a challenging year ahead.

More broadly, the increasing worries about food security are forcing fresh appraisals of environmental policies and the degree to which we can accommodate the complex social and political demands of these changing times whilst still producing affordable food. The problems of rural poverty and the lack of affordable housing in rural areas also present very real policy challenges in a time of economic downturn.

Facing these difficult times will not be easy, not least because farming and related rural businesses are already under considerable financial pressure. But as we move forward to address these challenges, SAC and its staff will be here to support the industry, providing the knowledge and advice people need to develop sustainable businesses and thriving rural communities.



Professor Bill McKelvey

Chief Executive and Principal

Food security in a climate of change: new priorities for Scotland's environment?

Andrew Midgley and Alan Renwick

Summary

- High food prices are pushing the issue of food security up the policy agenda, potentially at the expense of the environment.
- High food prices can make agri-environment schemes unattractive.
- Debates about the future of the Common Agricultural Policy are increasingly polarised between those that focus on the delivery of 'public goods' and those that focus on production.
- The declining livestock numbers in the North West present some complex and interconnected socio-economic and environmental issues that may be addressed in policy reform over the coming year.
- Agriculture and forestry will come under pressure to reduce greenhouse gas emissions.

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In the gradual process of reform, the environment continues to secure an important place in agricultural policy. The tenor of reform is focused on ensuring that agriculture is multi-functional; that it not only produces quality food, but that it also provides 'public goods' in terms of quality landscapes, healthy watercourses and flourishing biodiversity. The 'Health Check' of the Common Agricultural Policy (CAP) is also designed to help tackle new challenges, notably climate change. But high commodity prices are highlighting the issue of global food security and causing many to call for an increase in productivity. Thus while the environment has attained a central place in the European model of agriculture, new circumstances mean that place is not necessarily secure.

The future of the CAP: food security and the environment

Although the CAP was established to increase agricultural productivity, ensure a fair standard of living for the agricultural community, stabilise markets and ensure certainty of food supplies at reasonable prices, the gradual process of reform has slowly put more and more emphasis on environmental management. The food production role of agriculture is still central, but the importance of agriculture in delivering 'public goods' (in the form of landscape, biodiversity, access and water management) has also been put at the heart of the CAP. The emphasis on environmental management even led to a growing consensus that agriculture was shifting from a 'productivist' to a 'post-productivist' era.

Recent high food prices, however, have put food security back at the top of the agricultural policy agenda and have prompted some to question the emphasis on environmental management. Consequently, the tenor of agricultural policy debates has shifted, with many emphasising the importance of increasing production in order to feed a growing global population.

Although prices have fallen, recent high commodity prices have highlighted a potential tension between, on the one hand, increasing production to ensure supplies and affordable prices, and, on the other, securing public goods. Although environmental protection and increased food production are not necessarily mutually exclusive—it is common for stakeholders to refer to dual objectives of 'food and environmental security'—the recent concentration on food production has the potential to relegate the environment to a back seat. The environment lobby already point to the effective abolition of set-aside as an example of

the way that the environment can slip down the list of priorities. Although they recognised that set-aside was no longer tenable as a means of intervention and that it was never intended as an environmental measure, they note that the removal of set-aside was primarily about increasing production in a tight market – the environmental benefits were marginal to the main concern of production. The environment lobby claim that it was only after the production-oriented decision to remove set-aside had been made that the environmental consequences were considered, hence the long gap between the set-aside rate being set to zero and any mechanism to re-capture the environmental benefits of set-aside being introduced.

But high prices and food security potentially represent a double whammy for the environment. Not only is the environment at risk of falling down the policy agenda, it is also at risk because as prices rise environmental options could also appear less attractive to farmers on the ground. In reality, payments for environmental management are only attractive when the rate is higher than the alternatives and as the prices for most agricultural products have risen it can be much more profitable to focus on production for the buoyant market. This problem may be alleviated to some extent by increasing the payments to reflect the increase in income foregone (i.e. make the payments more attractive), however, since there is a fixed pot of money, this would entail a decline in the amount of environmental activity that could be bought.

Finding ways of resolving this potential tension between production and environment will be at the heart of agricultural and environmental policy debates in the coming months. It is already possible to see a degree of polarisation in the policy responses proposed by the various stakeholders. Defra and the environmental NGOs are broadly in favour of a route forward that would see an end to Pillar 1 payments and the direct support offered by the Single Farm Payment. They would prefer to see the funds currently available in Pillar 1 transferred to Pillar 2 so that the funds would still be available but more clearly targeted at delivering public goods. Industry bodies, on the other hand, argue for the retention of Pillar 1 on the basis that it is vital to keeping farmers in business and because, they argue, retaining a viable farming sector to supply our food is itself a public good. There are emerging, then, starkly contrasting positions on the future of agricultural policy and whether food security or the environment should be central. It is a debate that is currently being played out at the level of the nation state within the EU as the UK and the Netherlands argue for a move away from direct payments and a transfer of Pillar 1 funds to Pillar 2, while France argues for the retention of direct support.

But in addition to the broad principles about where money should be targeted, there are also more practical considerations, not least because there is a complex set of competing issues and competing claims on land that are not necessarily compatible. It may not be possible, for example, to increase productivity at the same time as using land for flood alleviation or for housing or forestry. In a similar way to agriculture, forestry is shifting to a multi-functional model where it too is looking at the 'public goods' it delivers. Proposals to expand the forest area from 17 to 25 per cent of Scotland's area are therefore couched in terms of economic, rural development and environmental benefits. It may be that forestry can deliver greater public good benefits than agriculture, so it will be necessary to identify which issue is the priority for Scotland and set the policy course accordingly. The Scottish Government's 'Rural Land Use Study', launched in September 2008, will have to consider how to resolve these tensions.

Ultimately, the food security issue raises difficult moral questions. Can we afford to have an environmentally-oriented agricultural policy that potentially restricts supply at the same time as being concerned about limited supplies of food? While many will complain that this is too simplistic an equation, finding solutions that will assist farmers in responding to the market while also attempting to meet biodiversity and other environmental targets will be a difficult balancing act.

The environmental impact of the retreat from the hills

Several recent reports—including SAC's *Farming's Retreat from the Hills*, the Royal Society of Edinburgh's *Inquiry into the Future of Scotland's Hills* and Islands and the *NFUS Manifesto for the Hills*—have highlighted the decline in livestock numbers in the North and West (figure 1). The issue of declining livestock numbers in the hills and the appropriate policy response is therefore likely to retain a high profile in agricultural policy debates over the coming year.

Although assessing the *environmental* impact of the retreat from the hills is complex—not least because a reduction of grazing will benefit some species but be detrimental to others—experience in Europe has shown that as land has been abandoned, so biodiversity has suffered. Several potential policy solutions have therefore been proposed. It has been suggested, for example, that the Scottish Beef Calf Scheme (SBCS) could be retained, that the non-competitive Land Managers' Options could be amended to offer more options to farmers in the hills and islands and that the Less Favoured Area Support Scheme (LFASS) could be more specifically tailored to support the delivery of environmental public goods. Yet none of these possible solutions is without its problems. The SBCS, for example, failed to deliver significant environmental benefits because of its lack of targeting. Those areas that the SBCS would have benefited most—such as the North West—only received a small proportion of the total SBCS funding because of the lower stocking densities. Equally, enhancing the Land Managers' Options would require funding and, since there is no limitless budget, money that is found to fund measures to deliver environmental benefits in the hills would have to be taken from elsewhere. Thus difficult decisions about priorities would have to be made.

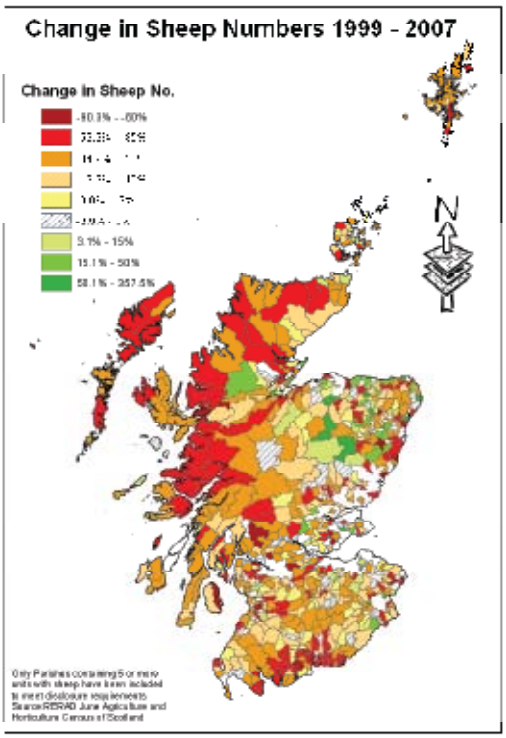

Figure 1 *Parish level data for changes in sheep numbers between 1999 and 2007 (Source: Scottish Government)*

Making alterations to the LFASS is another alternative. Over 80 per cent of Scotland is classed as Less Favoured Area and LFA payments account for nearly 30 per cent of total expenditure of the SRDP. These payments are intended to support farmers that are subject to severe natural and structural disadvantage and were originally focused on preventing rural depopulation and the decline of the farming sector in less favoured areas. Gradually, though, the emphasis has shifted towards supporting land management that contributes to maintaining the countryside and to maintaining and promoting sustainable farming systems. LFA support is therefore evolving in line with the developing European model of multi-functional agriculture. LFA support is increasingly conceived as sustaining agriculture that delivers public goods, especially valuable landscapes and biodiversity.

The Scottish Government is currently consulting on a further interim scheme to 2013 (given that the nature of the support offered to farmers in LFAs is currently under review in the EU) and is seeking views on how best to secure environmental public good benefits. Although recent reports concluded that the LFASS has provided tangible socio-economic benefits and contributed to maintaining livestock numbers (especially cattle), there are also factors that have limited the degree of environmental benefit. For example, it could be argued that the environmental impact has not been great because the LFASS was not targeted at particular regions that could deliver the greatest environmental benefit, or those areas that needed support the most. This is related, in part, to the broad objectives and arguable lack of focus: the LFASS is a broad support tool and is potentially an important mechanism for shaping land management, but it is a blunt tool for dealing with specific issues.

There are a range of potential options that could be adopted for improving the environmental benefit delivered by the LFASS. It would be possible, for example, to link LFASS payments to livestock-related activity (in a way that does not re-couple payments to animal numbers). It would also be possible to bolster cross-compliance to enhance the environmental conditions for payment or to introduce conditions such as minimum and maximum stocking densities or a minimum percentage of permanent

pasture. This would help ensure the delivery of environmental benefits that previously occurred as a result of the cattle top-up payments. Changing LFASS, however, will mean that funds have to be reallocated to some extent, creating both winners and losers.

Dealing with the issue of the retreat from the hills therefore raises several big issues. If the issue is to be dealt with seriously, it will require an element of targeting, which may in turn require an element of re-distribution of support. The current asymmetrical distribution is highlighted in table 1 which presents the proportion of payments that recipients in different areas received in 2007. Most striking is the fact that the three areas that cover the North West account for 39 per cent of all support payment recipients, but that they currently receive 19 per cent of the total payments. One route to re-distribution is through increased flexibility in the use of the National Envelope (currently proposed in the CAP 'Health Check'), which will allow funds raised from top-slicing Single Farm Payment to be spent in other sectors. Instead of beef farmers having their SFP top-sliced to fund schemes to help the beef sector, all SFPs could be top-sliced to fund schemes in particular places or sectors i.e. arable farmers could see their SFP reduced to help support hill farmers in the North West. Table 1 highlights that the three areas that cover the North West currently account for only 16 per cent of total payments under the Single Farm Payment Scheme, with 84 per cent occurring elsewhere. Alternatively, a refinement of LFASS in an interim scheme to 2013 could see a degree of re-distribution if the scheme is targeted at helping hill farmers. But to what extent will this be supported?

SGRPID Area	Percentage of payments under SFPS (inc ECS, PCP)	Percentage of payments under SBCS	Percentage of payments under LMCMS	Percentage of payments under LFASS	Percentage of recipients (all schemes)	Percentage of total payments (all schemes)
Argyll and Western Isles	3.7%	4.9%	8.5%	12.4%	13.9%	4.9%
Highland	5.1%	6.5%	4.6%	9.8%	9.7%	5.7%
Northern and Northern Isles	6.8%	11.0%	12.4%	15.9%	15.1%	8.2%
Total	**15.7%**	**22.4%**	**25.4%**	**38.1%**	**38.7%**	**18.8%**
Central	19.2%	13.7%	17.8%	11.1%	14.0%	18.0%
South Western	12.1%	13.6%	13.4%	11.7%	9.8%	12.1%
South Eastern	20.0%	17.6%	20.1%	17.5%	12.8%	19.6%
Southern	11.4%	12.4%	7.0%	11.3%	7.3%	11.3%
Grampian	21.7%	20.3%	16.3%	10.3%	17.4%	20.1%
Total	**84.3%**	**77.6%**	**74.6%**	**61.9%**	**61.3%**	**81.2%**

Table 1 *Percentage of payments under the Single Farm Payment Scheme (SFPS), Scottish Beef Calf Scheme (SBCS), Land Management Contract Menu Scheme (LMCMS) and the Less Favoured Area Support Scheme (LFASS) by Scottish Government Rural Payments and Inspections Directorate Area, 2007*
(Source: Scottish Government)

Furthermore, the degree to which this sort of re-distribution will be seen to be necessary will depend, in part, on the view taken with respect to whether the delivery of environmental 'public goods' is greater in the hills and islands than the lowlands. Should public money be targeted at an already extensively managed landscape, or at the intensively managed farmland where environmental considerations are, arguably, peripheral to the focus on production? Where are the greatest biodiversity benefits? To be sure, the North and West hold a substantial proportion of Scotland's sites covered by nature conservation designations, but if funds are directed at these sites what does it mean for the wildlife value of the wider countryside? All these questions highlight the difficulties facing policymakers as a result of the retreat from the hills.

Climate change: the pressure will be on agriculture to respond

During 2008 the UK and Scottish governments consulted on proposals for Climate Change Bills that will include ambitious targets to reduce greenhouse gas emissions. Both governments propose to reduce emissions by 80 per cent (from 1990 levels) by 2050. In this context, the UK Committee on Climate Change (CCC) has been asked to propose national carbon budgets that are part of an overall strategy of reducing emissions by adopting the most cost-effective emissions reduction measures. The Committee will consider opportunities for future emissions reductions across different sectors including the agriculture, land use, land use change and forestry sectors (ALULUCF). Given that the Agriculture and Climate Change Stakeholder Group, in its report *Climate Change and Scottish Agriculture*, suggested that agricultural emissions account for 25 per cent of Scottish emissions, there are likely to be high expectations on agriculture to find ways of reducing emissions.

Reducing emissions will be challenging. The Irish Government has recently claimed that reductions in emissions from agriculture in Ireland of greater than three per cent will be virtually impossible to achieve without widespread destocking. There are also concerns that adopting stringent emissions reduction strategies in Scotland might simply put Scottish farmers at a competitive disadvantage to their counterparts in countries that do not have such stringent measures in place and that as a consequence emissions will be exported to other parts of the world. In this context, SAC has been commissioned by the CCC to look at the greenhouse gas emissions abatement opportunities within the ALULUCF sectors (due to be published at the end of 2008). This work has analysed both the potential to reduce emissions and the costs of such reductions. It has also considered wider environmental impacts such as water pollution. Abatement opportunities may exist both for livestock and in fertiliser application. In line with previous studies, some of the measures considered were found to reduce emissions whilst saving money. This suggests that in some instances farmers should be able to improve business performance and reduce emissions – a win-win situation.

There are a range of policy tools available. One option is to create a price and a market for carbon in the agricultural and land use sectors (similar to the European Emissions Trading Scheme, which introduces a scheme of priced tradable emissions entitlements). This is the approach adopted by New Zealand where there is a commitment to bring agriculture into a trading scheme in 2013. Although the details are yet to be finalised, concern is already being expressed by farmer representatives that currently there seems to be no allowance within the scheme for changes in management practices that reduce emissions. Credit can only be effectively gained by reductions in stock numbers. Although trading is unlikely to be introduced in the UK in the short-term—one stumbling block is the large number of small emitters which would make the costs of administration very high, thus limiting the cost-effectiveness of undertaking such as scheme—if the costs of climate change were to increase, this approach could gradually become more cost-effective and attractive as a policy solution.

The discussion on climate change mitigation returns us to the initial discussion in this section on the role of Scotland as a food producer and the potential conflicts between improving agricultural productivity and the environment. In the case of climate change, it will be necessary to decouple the link between increased production and emissions from the sector.

Rural development in a climate of change

Leaza McSorley, Andrew Midgley, Cesar Revoredo Giha and Sarah Skerratt

Summary

- Economic turmoil presents new challenges for dealing with the problems of rural development.
- Food poverty has risen up the policy agenda as the inflation rate for 'food and non-alcoholic drinks' has outstripped the rate for 'all items' included in the consumer price index.
- High food inflation is felt disproportionately by low income households, but in the medium-term lower energy and food prices may alleviate some of these difficulties.
- Although the number of people living in poverty in rural and urban areas is broadly similar, the experience of living in poverty in rural areas is distinct and requires different policy responses.
- The lack of affordable housing remains an important issue in rural areas as lower than average earnings and higher than average house prices keep many out of the market.
- The current drop in house prices may alleviate some of the affordable housing pressures, but financial uncertainty may also exacerbate the problem as mortgages are harder to find and new house building slows.

During 2008 the rural development agenda has moved forward. Much better engagement with rural communities is being achieved through Community Planning Partnerships, LEADER Local Action Groups (under the SRDP) and in some cases through Local Authority Single Outcome Agreements. These initiatives are resulting in examples of partnership working, which is seen as an essential element in the sustainable development of Scotland's rural areas.

There are still, however, many challenges. The Committee of Inquiry on Crofting and the Royal Society of Edinburgh's Inquiry into the Future of Hills and Islands both made a series of recommendations on a range of issues including affordable housing, service provision, transport, tourism and community empowerment. The OECD also reviewed Scotland's rural policy and suggested that Scotland needs an integrated rural development policy with a de-centralised area-based delivery system and fewer government bodies involved in policymaking. Rural development therefore remains high on the policy agenda.

The degree to which the problems can be addressed will, however, be complicated by the recent global economic turmoil. At present, there is great uncertainty about the way that the credit crunch and broader economic crisis will play out in rural areas. In broad terms, producers of commodities perform relatively well during economic downturns, compared with other businesses, because the demand for food tends not to decline dramatically. Those businesses that have diversified into wider economic activities, such as leisure and tourism, or the selling of higher value products are, however, potentially more vulnerable. Economic downturn also affects the wider rural population and local authorities as unemployment and poverty increase. The prospect of recession therefore provides an important backdrop to discussion about the outlook for issues of rural development and in what follows we focus on just three of the issues that are and could become increasingly important: food poverty, rural poverty and housing.

Food Poverty

Food poverty can be characterised as the inability to access healthy, affordable food and may come about because people lack shops in their area; the range of healthy goods in local shops is limited; healthy foods

are too expensive; or because there is a lack of knowledge about what constitutes a healthy diet. Food poverty varies between communities and individuals and can affect certain groups more than others. The most vulnerable are older people and people on low incomes.

Since July 2006 the issue of food poverty has become more worrying because the inflation rate for food and non-alcoholic drinks has outstripped the rate for all items included in the consumer price index i.e. the price of food and non-alcoholic drinks has increased at a faster rate than other items (figure 2). More important, though, is the fact that low income households face a higher inflation rate (figure 3). This is a consequence of the importance of food and non-alcoholic drinks in the total expenditure of low income households. Thus, if the population is ranked by gross income, the poorest and richest 10 per cent spend 17.9 per cent and 9.4 per cent of their income on food and non-alcoholic drinks respectively (table 2). This means that the poorest in society are more vulnerable to the rising price of food (and also to housing costs, fuel and energy prices).

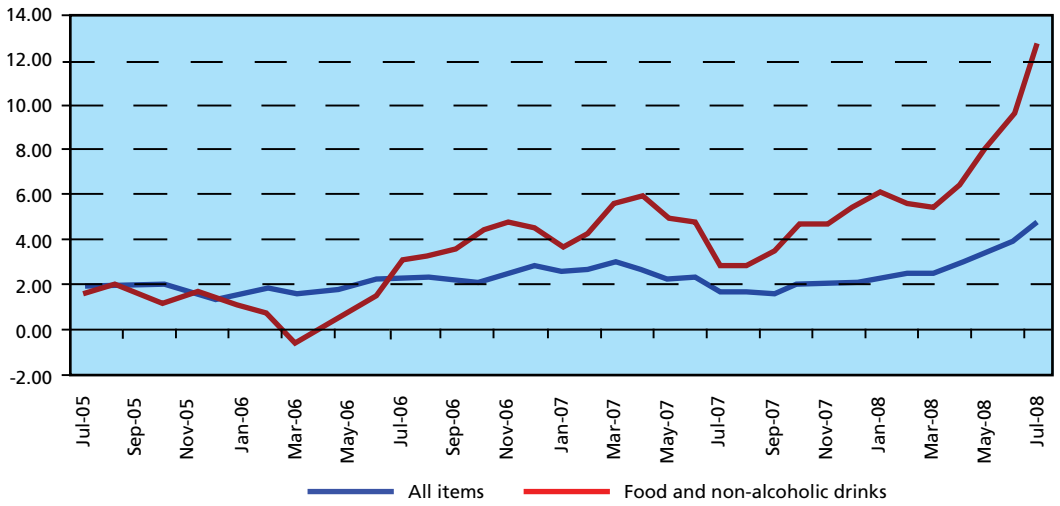

Figure 2 *Recent inflation rates for 'food and non-alcoholic drinks' (12.8% in July 2008) and 'all items' (4.7% in July 2008) in Scotland (Source: Office for National Statistics)*

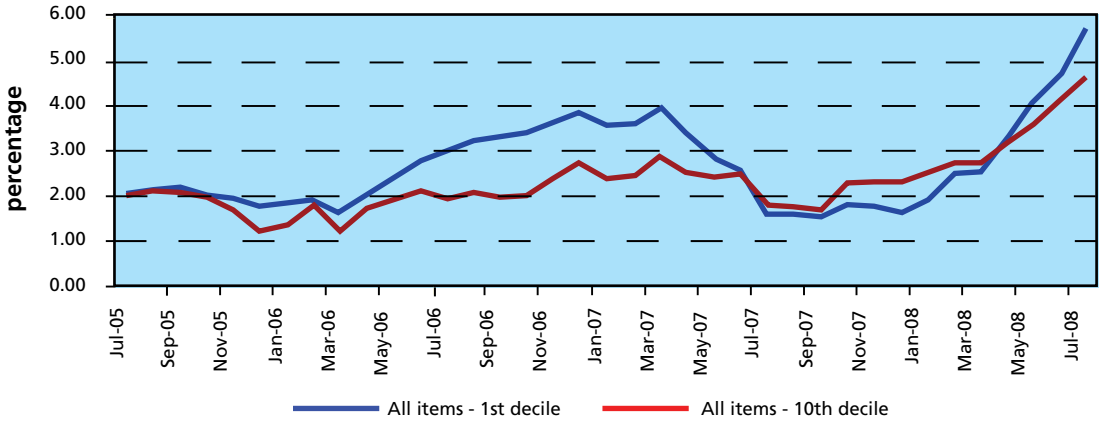

Figure 3 *Inflation: poorest (blue line) versus richest (red line) in Scotland: the poorest currently experience higher inflation than the richest (Source: Office for National Statistics)*

Average weekly household expenditure (£)				
	Poorest	Share (%)	Richest	Share (%)
Food & non-alcoholic drinks	24.50	17.90	71.90	9.40
Alcoholic drinks, tobacco & narcotics	6.60	4.90	19.00	2.50
Clothing & footwear	7.40	5.40	56.40	7.40
Housing, fuel & power	26.80	19.60	61.60	8.10
Household goods & services	11.10	8.20	64.00	8.40
Health	1.00	0.70	8.50	1.10
Transport	13.50	9.90	151.70	19.90
Communication	5.60	4.10	17.50	2.30
Recreation & culture	18.70	13.70	125.80	16.50
Education	1.30	1.00	25.80	3.40
Restaurants & hotels	10.70	7.80	90.20	11.80
Miscellaneous goods & services	9.40	6.90	70.80	9.30
Total	**136.53**	**100.00**	**763.00**	**100.00**

Table 2 *Expenditure on a variety of goods and services by the poorest and richest deciles of the population (Source: Office for National Statistics)*

The extent to which there is a geography to food poverty in Scotland—whereby people in remote rural locations are more vulnerable to food poverty than those in more accessible locations—remains unclear. In remote areas the costs of delivery are high with the result that food generally costs more and requires a higher proportion of an individual's income to satisfy basic needs. Small populations also affect the economics of food supply. It is often not profitable to transport many products to remote locations for a small number of sales, so residents in these areas have a limited choice. Since food poverty can result in a poor diet, which is associated with diet-related ill health and consequent personal, social and economic costs, it will be important to continue to examine the extent of the issue in Scotland.

Looking to the future, there are positive signs that inflation will fall in the medium term. Food inflation was arguably driven by rising oil and cereal prices, but as the price for these key commodities has fallen from their highs earlier in 2008, so the inflationary pressure is reduced. Crucially, though, if inflation does fall, it may appear that the problem disappears, but unfortunately the underlying issues remain. Food inflation only served to highlight more structural problems—such as lack of knowledge about healthy diets—that need to be addressed.

Rural Poverty

Rural and urban areas have different economic profiles. The average earnings of people in rural areas are lower than in the rest of Scotland and the cost of living is often higher. House prices, fuel costs, transport costs and food prices are all calculated to be higher in rural areas than the rest of Scotland. Yet recent statistics on poverty in rural and urban Scotland (table 3) suggest that the percentage of individuals in low income households is broadly similar in both rural and urban areas (the extent of 'poverty' is commonly measured by reference to the number of households with an income that is less than 60% of the UK median). There is, however, no clear understanding of what living in poverty in rural areas is like and how that might differ from the experience of living in poverty in urban areas. Research by SAC has identified the key factors contributing to rural poverty—employment, income, housing, health and access—and although these are also important elements of urban poverty, the evidence points to there being characteristics that are particular to rural areas which makes the experience of living in poverty in a rural area a distinct experience. Urban poverty, for example, is often geographically concentrated and visible in the form of run down areas, but in rural areas the low population densities mean that poverty is geographically dispersed with poor and affluent people living in the same area. Rural poverty is often hidden and the true extent of the problem is not so obvious as in an urban setting. Rural poverty is further hidden in Scotland's rural communities due to the particular socio-economic conditions, such as high labour market

activity levels, higher than average self-employment (22% compared to 9% for the rest of Scotland) and low unemployment, which contrasts with the lower activity rates and higher rates of unemployment and worklessness in parts of urban Scotland. Thus there is a danger that rural poverty can be overlooked.

RELATIVE LOW INCOME				
	Before Housing Costs		**After Housing Costs**	
	%	**Number (thousands)**	**%**	**Number (thousands)**
Urban areas	18	710	20	810
Rural areas	17	160	18	170
Total	**18**	**880**	**20**	**990**
ABSOLUTE LOW INCOME				
	Before Housing Costs		**After Housing Costs**	
	%	**Number (thousands)**	**%**	**Number (thousands)**
Urban areas	11	440	13	510
Rural areas	12	110	10	90
Total	**11**	**550**	**12**	**600**

Table 3 *Number and percentage of individuals in low income households by urban/rural classification, Scotland 2005/06 (Source: Scottish Executive: Family Resources Survey, Households Below Average Income 2005/06 dataset)*

Those experiencing poverty in rural areas are also differently affected by structural changes in the economy—economic down-turns, unemployment, housing problems, declining services and social amenities—and by the issue of accessibility. Access is not just about distance but is also about the barriers to full participation in economic, social and community life. The distinct socio-economic conditions of rural areas—such as limited affordable housing, restricted access to services and poorer public transport—limit the ability of people in poverty to participate in community life. Thus while the proportion of people in poverty in rural and urban areas is broadly similar, poverty will be experienced differently in different places.

The different factors that contribute to the levels of poverty in rural areas will also be highlighted as we move forward and face the prospect of recession. Key industries such as tourism could be adversely affected if the number of visitors falls, although economic downturn may lead to more domestic visitors for shorter periods. Any rise in unemployment will also potentially be mitigated by the high proportion of people that work in the public sector—a sector that tends to be more resilient to economic downturn.

Rural housing

The population of rural Scotland is increasing. There has been a 6.3 per cent increase in accessible rural areas and a 4 per cent increase in remote rural areas between 2001 and 2006. While this is a welcome development—especially given the long history of declining population numbers in rural areas—it also creates problems in terms of a lack of affordable housing. A shortage of housing supply means that house prices have risen and that many people who either grew up in or work in rural areas can no longer afford to live there. Thus despite the recognition of the problem and the provision of funding through Rural Home Ownership Grants, the lack of affordable housing has therefore become one of the most important issues in rural Scotland today.

Bank of Scotland figures for a selection of Scotland's rural local authorities highlight that on average house prices are 13 per cent higher in rural areas compared to urban areas in 2008 (table 4). Higher prices combined with lower average earnings (expressed as a price to earnings ratio) means that housing is less affordable in rural areas. There are also far fewer first-time buyers in rural areas, where they account for just 20 per cent of all buyers in rural local authorities compared with 31 per cent in urban local authorities. Further, the difficulties faced by first-time buyers are compounded by the fact that there is a smaller proportion of social housing in rural areas compared with urban areas.

Local Authority	Mean House Prices in 2008 (£)	Average price earnings ratio	% house price change 2003 – 2008	% of market accounted by 1st time buyers	% Social housing in housing stock
Aberdeenshire	213,559	6.0	118	25	13
East Lothian	202,924	6.5	41	24	19
Scottish Borders	178,869	5.9	98	20	-
Perth and Kinross	183,600	5.5	80	21	12
Argyll and Bute	165,219	5.8	77	20	-
Highland	172,916	5.7	100	26	13
Moray	171,166	-	147	22	14
Dumfries and Galloway	149,936	5.5	80	24	-
East Ayrshire	138,724	4.6	132	26	25
Western Isles	137,319	5.7	172	39	-
Rural Scotland	**186,446**	**6.2**	**89**	**20**	**10**
Urban Scotland	**164,517**	**5.2**	**-**	**31**	**15**

Table 4 *Rural house prices by local authority, 2008 (Source: adapted from Bank of Scotland Scottish Rural Housing Review).*

Solving the problem of the lack of affordable housing in Scotland is no easy task—not least in the current economic climate. The Scottish Government has set out its plans for delivering more affordable housing and has recognised that there are distinct aspects of the problem in rural Scotland. The availability of land is, for example, an important issue. New housing requires land, but some landowners may not wish to sell land for housing and where landowners do want to sell, there is little incentive to sell the land for less than its market value to help deliver social or affordable housing. Planning is also important, with the length of time it takes for the planning process to work through being a particular concern.

The uncertainty in the financial sector and the slowing economy may alleviate some of the pressures on housing in rural areas as prices fall, in part due to a possible decline in demand for second homes. Therefore affordability may actually improve. However, improved affordability may not in itself solve the problem for two main reasons. First, if lending remains tight it will be hard for first-time buyers to meet the more stringent requirements (including higher deposits) required to secure loans. Second, a slowing economy also means fewer new house builds. There is already evidence of this occurring in Scotland. National House-Building Council statistics highlight that whilst new house building applications in Scotland increased by 7 per cent between 2006 and 2007, for the first six months of 2008 they were 28 per cent lower than for the first six months of 2007. More worrying is that for the second quarter of 2008 they were 46 per cent lower than for the same period last year. Fewer new builds not only means increased competition for existing stock but also that it is harder for planning authorities to increase the stock of affordable housing by placing requirements on private sector developments.

An assessment of the markets and prospects for the livestock sector

Douglas Bell and Nick Sparks

The last 12 months have seen dramatic changes in the economic environment in which livestock farmers conduct their business. Compared to this time last year, livestock commodity prices have increased significantly, but have been offset by major increases in fuel, fertiliser and other input costs. More recently the global financial crisis has increased the risk of recession, which has the potential to impact on the market and the availability of capital for reinvestment and growth.

Recent reports including SAC's 'Farming's Retreat From the Hills' and the RSE 'Committee of Inquiry into the Future of Scotland's Hill and Islands' have highlighted worrying trends for those farming in Scotland's remote areas. But while economic pressures may be most acutely felt in these regions, livestock farmers in the rest of Scotland face the same challenges to their future prosperity. Those businesses based in the lowlands or in more accessible upland areas potentially have more flexibility in terms of farming activity and alternative income sources. It could be argued, however, that downscaling of livestock farming in these areas, with the associated impacts on our stratified systems, could have proportionally greater consequences for the livestock industry as a whole.

As the various political reforms progress, there is no escaping that from a Scottish perspective, there is much at stake. Livestock farming accounts for half of our agricultural output (figure 4) and remains the only agricultural option for much of the 85 per cent of Scotland's farmland designated as Less Favoured Area.

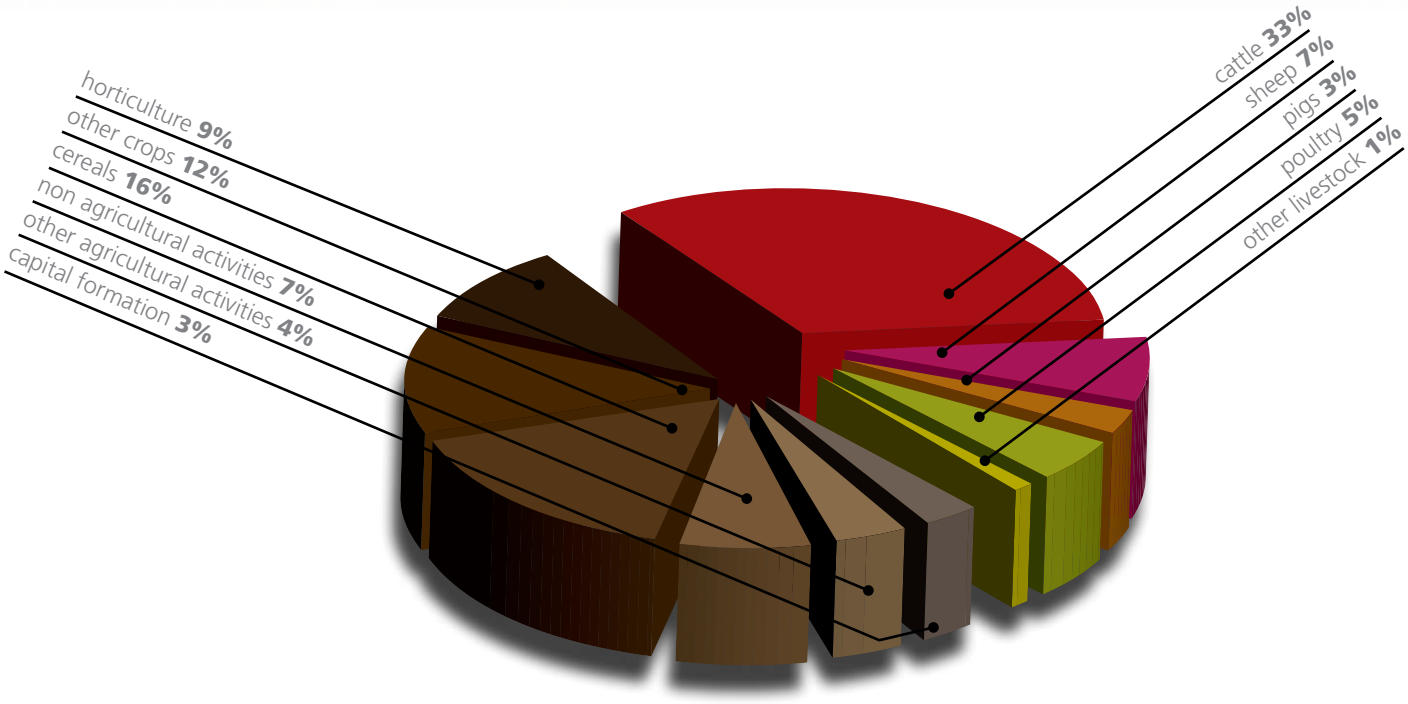

Figure 4 *Gross Scottish agricultural output by livestock sector, 2007*
(Source: adapted from Scottish Agriculture Output, Input and Income Statistics 2008)

beef

Summary

- Beef prices have experienced a significant improvement over the last twelve months with the best cattle achieving £3.00/kg in September.
- Economic downturn is already affecting sales with a decline in overall UK beef consumption, but the strength of the Scotch brand has given Scottish product some protection, resulting in the re-establishment of the Scottish premium.
- Despite reliance on support payments, optimism remains high as increasing supply in the cereals markets suggests a modest reversal of last year's 'up corn, down horn' scenario.

Beef production remains the biggest sector of Scottish agriculture and is often seen as a barometer for the rest of the industry. 'Scotch Beef' is considered by many to be a flagship product, coming second only to whisky in terms of recognition and reputation.

Beef prices have experienced a significant improvement over the last 12 months. By September, the best Scottish cattle were making 300p/kg dwt and, at the time of writing, this improvement appears to be filtering down to store producers with encouraging reports from the early suckled calf sales (figure 5). Cull cow prices have also continued to strengthen throughout the year (figure 6).

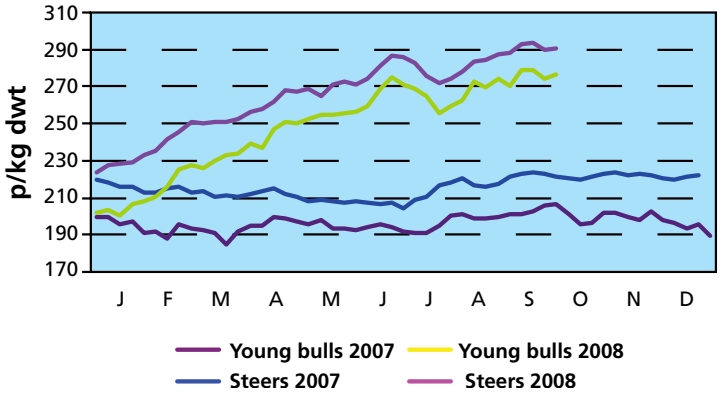

Figure 5
Scottish deadweight prices
(Source: QMS)

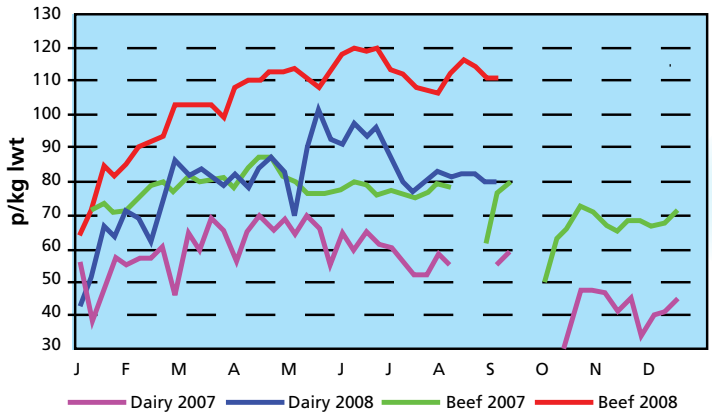

Figure 6
Auction prices for Cull Cows
(Source: QMS)

Supplies are tight. In the first half of 2008, total UK beef production decreased by 3 per cent compared to 2007. While production from cows and bulls increased by 11, prime beef output dropped by 6 per cent. The provisional 2008 June census results suggest that both Scotland and the UK are bucking the EU trend of modest growth with a continuing decline in suckler cows and beef cattle numbers. Imports into the UK continue to grow, while imports into the EU as a whole have declined due to a combination of trade restrictions and increased demand from developing markets mainly in Asia.

Early reports suggest consumer responses to the credit crunch include switching away from roasting cuts in favour of mince and steaks, the former to reduce spending on meat and the latter as an alternative indulgence to eating out. Overall UK beef consumption has been declining but the strength of the Scotch brand has given Scottish product some protection, resulting in the re-establishment of the Scottish premium. However, the same cannot be said for the organic premium which appears to have been squeezed to less than 10p/kg, as shoppers cut back on 'luxuries'.

In common with other livestock sectors, market gains have been eroded by high input costs. However, the reported increase in grain supply coupled with a lower proportion making malting quality may result in a modest reversal of last year's 'up corn, down horn' scenario. Nevertheless, net of support payment returns, beef producers are at least as fragile as those in sheep enterprises, but confidence amongst beef farmers continues to appear higher than their counterparts in the sheep sector.

sheep

Summary

- There has been a welcome price recovery following last year's collapse, however the majority of sheepmeat still leaves the farm at well below the cost of production.
- The national decline in sheep numbers is continuing with a 4.9 per cent reduction since 2007, but in some regions this decline represents an exodus.
- Further downsizing of the industry, with wider social and environmental repercussions, appears inevitable without significant, targeted public support.

This season's higher lamb prices (figure 7) have provided a much needed boost for the sheep sector. At the time of writing, the majority of finished lambs were making approximately £10 per head more than the equivalent average of the last three years. While there is little corroborative evidence, anecdotal reports suggest marginal improvements in profitability, even with elevated input costs. Despite the improvement however, the stark reality is that the majority of sheepmeat leaves the farm at well below the cost of production.

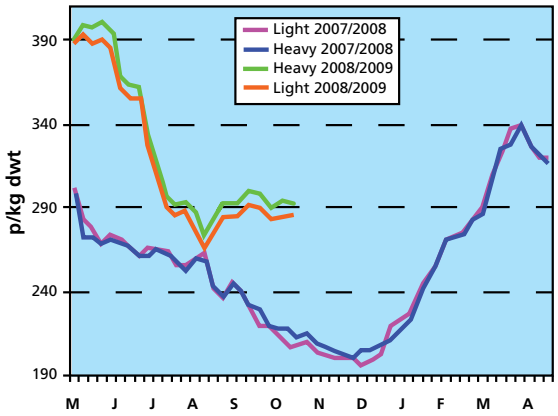

Figure 7
Deadweight Lamb Price (R3L)
(Source QMS)

SAC has recently highlighted that farmers are increasingly voting with their feet as a response to the economic reality of sheep production. Figure 8 illustrates the percentage change in total sheep numbers from 1997 to 2007 by region. The national flock decreased by 22 per cent but with no indication of an accelerating decline post CAP reform. However in the majority of regions where the overall decrease was above average, the rate of decline increased markedly after 2005. This suggests that in regions where sheep production was already declining, decoupling of support has indeed accelerated the trend.

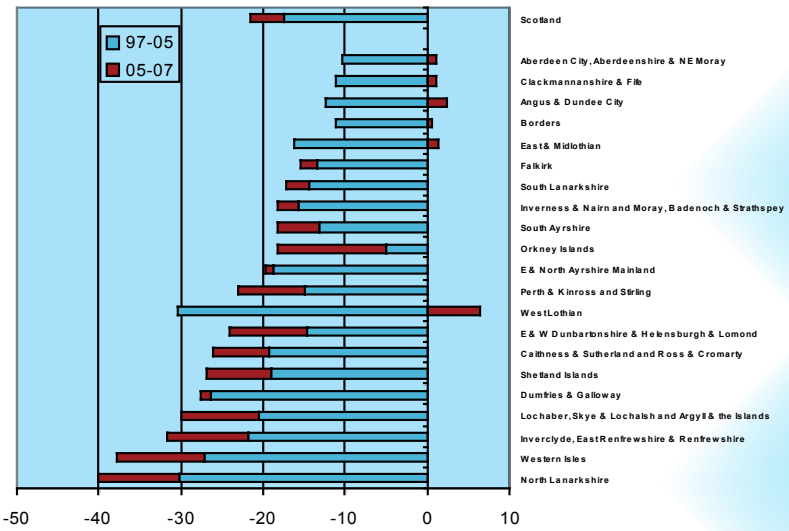

Figure 8
Percentage change in total sheep numbers across NUTS III regions (Source: Scottish Government June Agricultural Census).

While a regional breakdown is not available, the provisional June census results for 2008 indicate a further 4.9 per cent reduction in the national sheep flock since 2007, with Defra reporting a UK reduction of 2.4 per cent.

So where is it all going to end? The RSE Inquiry into the future of hill and island areas states that 'the survival of this sector of farming depends both on a sustained upturn in prices and the continued provision of public support'. In reality this statement is equally pertinent to much of Scotland's sheep industry, whether in the hills or the uplands. A recent 'crisis summit' called by the French agriculture minister reported similar findings and conclusions for Europe's main sheep producing countries.

Is a sustained increase in price likely against the current financial backdrop? Competition appears to be dwindling with significant flock reductions also being reported in New Zealand and Australia. Closer to home, lamb slaughtering in Ireland, France, Spain and Italy are all reported significantly down on last year. As a result, and also on the back a favourable exchange rate, exports of lamb are running above last year's level. Clearly some sheep farmers on the continent are reacting to their own economic signals and disease problems by coming to the same conclusion as their Scottish counterparts. In theory at least, this should create opportunities for a uniformly high quality product from Scotland. The challenge which continues to face the industry is to ensure that consistency and effective marketing reverses the declining appetite for lamb on the continent and strengthens consumption levels at home.

Since 2000, the average annual net farm income for specialist sheep farms has been £5200, with direct support payments equating to 450 per cent of that figure. While efficient production systems and creative marketing have the potential to improve returns, further major downsizing of the industry, together with the associated social and environmental repercussions, appears inevitable without significant, targeted public support. With regard to the current debates on the future of Single Farm Payments and LFASS, the stakes could hardly be higher.

dairy

Summary

- Milk prices have increased but rising input costs have reduced the predicted improvement in dairy margins.
- Dairy farmers are continuing to leave the industry with the consequence that production has dropped to a 37 year low, raising the prospect of a production deficit against quota in excess of a billion litres.
- While there is hope that reduced UK supplies will lead to higher prices, recent high street competition may make supermarkets reluctant to see significant increases.

Trading conditions over the last 12 months have taken some of the shine off last year's optimism for the dairy sector. While ex-farm prices have increased, last year's jump in value for milk commodities was slow to feed through to farm level. This, coupled with unprecedented increases in input costs, has reduced the predicted improvement in dairy margins.

Despite higher prices, dairy farmers continue to leave the industry and while the average herd size continues to increase, the latest June census data reveal a continuing decline in the Scottish dairy herd by almost 3,500 cows since 2007. Domestically, UK production levels have continued to fall. UK milk production for 2007/08 was the lowest recorded for 37 years and this year's cumulative production for April to September is already 161 million litres (2.4 per cent) lower than the equivalent period last year. The combination of reduced production and increased milk quota creates the real possibility of a production deficit against quota, in excess of a billion litres.

While predictions of world population growth and increasing westernisation of diets continue to suggest a healthy long-term demand for dairy products, the current 'credit crunch' has driven down economic growth levels and world market demand. Coupled with a global production response to last year's high prices, this has resulted in downward price pressure on dairy commodities. To an extent, the high proportion of Scottish milk going into the liquid market provides a buffer from this downturn, but other exporting countries will be looking to target the under-supplied UK market with milk products and indeed liquid milk.

Given the prospect of reduced UK supplies, dairy farmers are hoping that processors and retailers will lift farm gate prices to stimulate production and secure supplies. Those with pricing models based on the cost of production will also be optimistic that increased input costs will result in better returns from the market. However, recent high street competition in terms of retail price may make supermarkets reluctant to see significant increases. Tight market conditions have, in effect, created an intriguing power struggle with all sectors of the supply chain being squeezed to some extent.

While making predictions in these volatile times is perhaps foolhardy, ultimately market forces should dictate the outcome. With long-term confidence still lacking and shortage of replacement heifers predicted until the increased use of sexed semen impacts in 2-3 years time, widespread expansion seems unlikely. Therefore the decline in production looks set to continue, exacerbated by culling of herds south of the border. This, coupled with continuing favourable exchange rates, should create conditions for better returns from the marketplace. However, how those further up the food chain choose to react remains to be seen.

pigs

Summary

- High input costs during late 2007 and early 2008 presented major challenges to the industry with 10-15 per cent of the sector going out of business.
- The declining size of the Scottish herd raises difficult issues around the degree to which the industry will retain the critical mass required for processing.
- The recent lowering of feed prices combined with rising deadweight prices does, however, leave room for a little optimism.

Pig production is the smallest of the red meat sectors in Scotland—with an output of approximately £55 million in 2007—but it is nevertheless an important sector that directly employs between 2500 – 3000 people and has strong links to other parts of Scottish agriculture.

Although the industry operates without subsidy and is oriented to the market, it has been subject to severe challenges over the last year. In late 2007 and early 2008 rising input costs—not accompanied by increases in the prices received for outputs—seriously eroded the profitability of many in the sector. The global increases in cereal prices pushed feed costs extremely high with the ex-farm price of barley doubling from approximately £80/tonne in 2006 to £160/tonne in September 2007 (figure 9). The consequent difficulties experienced by many in the sector prompted the Cabinet Secretary for Rural Affairs and the Environment to establish a Pig Sector Task Force. This Task Force reported that, since retail prices had not reflected the increases in input costs, many producers were losing £6-7 per finished pig and that between September 2007 and May 2008 between 10-15 per cent of the industry had gone out of business. Indeed, high feed costs early in the year resulted in high sow cullings as producers sought to reduce costs. As a consequence the provisional results from the 2008 June census indicate a further contraction in the Scottish herd in the last year from 456,670 head to 426,430 head (figure 10). If this trend is allowed to continue it raises difficult issues around the degree to which the industry will retain the critical mass required for processing.

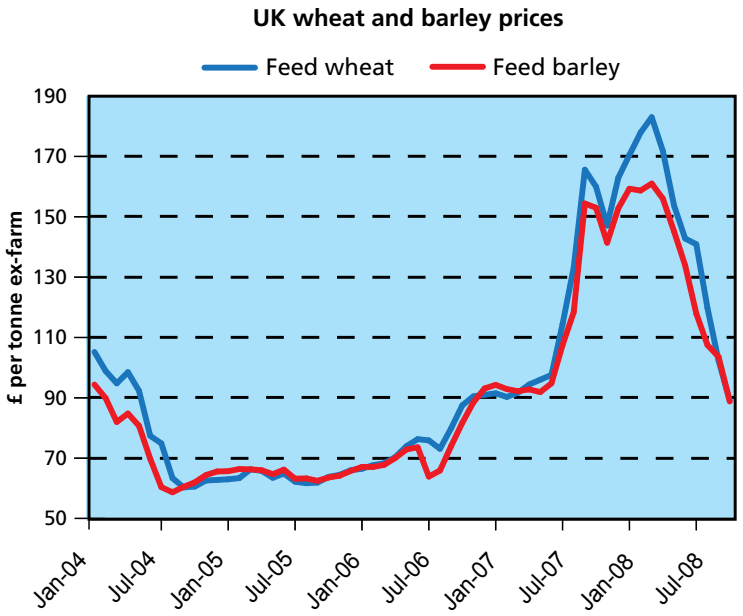

Figure 9
UK feed wheat and barley prices (Source: HGCA)

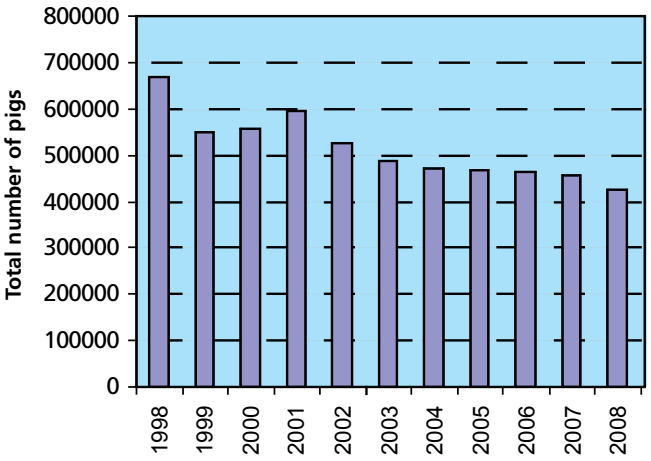

Figure 10
Total number of pigs between 1998 and 2008 (Source: Scottish Government).

There is a little room for optimism, however, because the intense pressure on producers has been relieved somewhat as the price of cereals has dropped from the highs of early 2008. The high commodity prices were arguably a result of a restriction of supply, but with a good harvest in the EU it appears that prices may not reach previous heights again at least in the short-term. However, it must be recognised that since a high proportion of the Scottish herd is fed on home-mixed feed, the prices of other inputs such as fuel and fertiliser, used in the production of cereals, are also important considerations.

There is also room for optimism in the rising Deadweight Average Pig Price. After three years of relatively stable deadweight prices, 2008 has seen a welcome rise from 110p/kg in January to 137-139p/kg in September. Prices are 25 per cent higher than at the same time last year (figure 11). Although price increases have flattened off since August, expected lower throughputs are likely to restrict supply and put further upward pressure on prices over the short-term. Retail prices have also increased significantly in recent months (figure 12), although this potentially restricts demand.

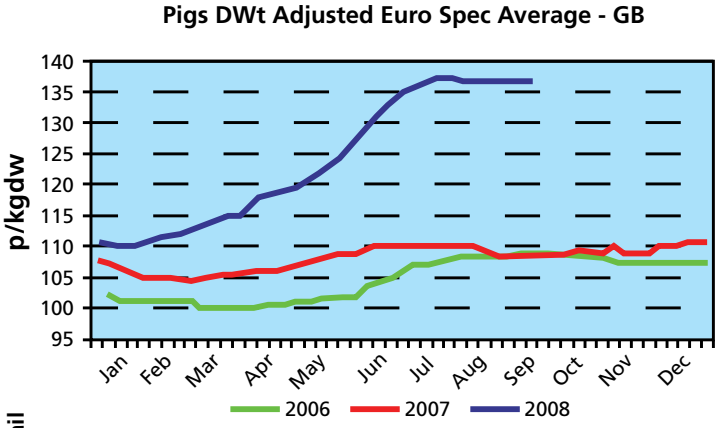

Figure 11
Pigs deadweight price (Source: QMS)

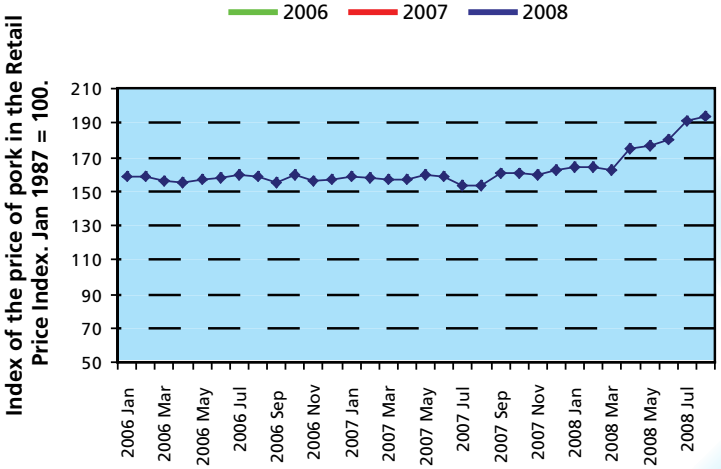

Figure 12
Index of the price of pork (Source: Office of National Statistics)

As we move forward, government support is very welcome but the sector must also address several issues if it is to benefit from higher prices. Development priorities must be to enhance cost savings across the industry by improving benchmarking on financial and environmental performance; enhancing the workforce through better training and recruit retention; and enhancing marketing and labelling as a means of improving public understanding of the quality of Scottish produce.

chicken and egg production

Summary

- The decline in the cost of rations is welcome, but offset by the decline in consumption of poultry meat and eggs and the rise in imports.
- Demand for free-range eggs has increased but economic downturn suggests a future increase in demand for 'value' eggs.
- The poultry meat sector has seen an increase in value on the back of increased demand for meat from extensive systems.
- Both the egg and meat sectors remain vulnerable to high energy and feed costs.

The poultry sector has emerged from a particularly difficult year only to face yet more uncertainty. The impact of new regulations, the continuing rise in imports and a decline in the consumption of poultry meat are just some of the challenges that the sector faces over the coming year.

Egg producers will be pleased to see that the cost of rations has fallen back to levels last seen in the summer of 2007. Egg consumption in the UK has increased from 10,230 million eggs in 2004 to 10,460 million eggs in 2007, but there has also been a relentless increase in imports, from 1,200 million in 2004 to 1,900 million in 2007.

Producers face increasing demand for free-range eggs, and this, combined with the implications of EU Directive 1999/74/EC (that will require egg production from conventional cages to cease by 2012), has helped the recent gradual year-on-year growth in the free-range market. However the future for free-range producers is less than assured. While many retailers will not stock eggs from caged hens (Tesco and Asda being notable exceptions), there are concerns that with the downturn in the UK economy the demand for 'value' eggs will increase. This could put greater pressure on the retail price of free-range eggs, reduce the market share for free-range eggs and potentially open up the market for more imports. The fragile nature of the free-range market is already evident with it not being unusual for excess free-range eggs to be sold as cage eggs to balance supply and demand.

Caged egg production now accounts for approximately 61 per cent of the market share and, for the reasons outlined above, has been slowly declining in recent years. Whether the current economic situation will impact on this situation is uncertain.

Producers are being required to comply with legislation ranging from IPPC to the recently introduced Zoonoses National Control Programme, which is the UK's response to the EU's Zoonoses Regulation (EC) No. 2160/2003 requiring Member States to take effective measures to detect and control Salmonellas of public health significance in, among other species, poultry. The impact of this programme has yet to be fully assessed, but the egg sector has expressed concerns about monitoring costs as well as the loss of income that may result from positive results. Other Government initiatives under consideration include the concepts of shared responsibility and cost sharing for animal health and welfare policies and programmes. It is notable that the trade bodies for the egg and meat sectors are equally concerned about the financial impact that this may have on poultry producers.

Turning to the poultry meat sector, like the egg sector, producers will have benefited in recent months from falling feed prices and, although the number of birds being placed in the UK has fallen in 2008 compared with 2007, Mintel report that that the value will increase by 6.5 per cent (to £2.7 billion). This reflects in part the increase in meat sales from extensive systems, an interest that has been fuelled by the publicity

surrounding television programmes made by various celebrity chefs. However, for any other than small-scale producers, the growth area in extensive production is likely to be free-range rather than organic, both being perceived to be welfare friendly but the latter incurring significantly higher costs.

The publicity surrounding extensive meat production can obscure the fact that over 90 per cent of chicken continues to be produced using non-extensive systems. Here again though, in response to demands from retailers, producers have modified some production units to produce what is perceived to be a premium product. Changes include increasing levels of natural light in the rearing house and reducing the stocking density in the house to a maximum of 30kg/m^2. Importantly, producers have been compensated for reducing the number of birds per unit area of floor.

Like the egg sector the meat sector remains vulnerable to high energy and feed costs and companies are dependent upon markets responding quickly to increased costs of production in the price paid for the product.

While there has been growing interest in developing premium products within both the intensive and the free-range sectors it remains to be seen how the current downturn in the economic climate will affect these product lines. It might be predicted though that so-called 'value' products will increase their market share at the expense of premium intensive and extensive products, with growth in organic products, in particular, stagnating.

food security - livestock farming's role

Despite a background of increasing world demand for animal products, the livestock industry in Scotland continues to face significant challenges in terms of business competitiveness. Against this background there is an urgent need to provide a coherent framework of measures to preserve production capability and let Scottish livestock farmers play their part in the environmentally sustainable up-scaling of UK food production now being called for by politicians. Despite views that it is long overdue, the subject of food security is now high on the political agenda both at Scotland and UK level.

The 2005 reforms of the CAP decoupled support in the expectation that markets would deliver higher prices for quality products and over time fill the subsidy gap. Ultimately, food production systems, profitable in their own right, were envisaged with interim transitional funding provided by the Single Farm Payment. Many industry organisations favoured this approach, recognising the need to move away from trade distorting subsidies and, importantly, for society to reassess the value of food and farmers' role in its production. In the event, after three years of 'transition', food prices have increased both at the farm gate and in the supermarket. However, high input costs, particularly for livestock farmers, have left farm incomes as reliant as ever on direct support while food inflation is now a major concern for European governments.

For some, particularly the French government, the collapse of the latest round of WTO talks is seen as an opportunity to rethink the current direction of the CAP and re-examine the role of coupled support. Against the advice of its chairman, the European Parliament's agriculture committee recently voted in favour of CAP Health Check measures that would maintain some support payments linked to production. This stance contradicts the desired direction laid out by the EU farm commissioner in the CAP Health Check proposals.

Others fear that without the WTO, individual countries or groups of countries will strike the type of bilateral deals that are often far from fair, especially for those countries excluded. Currently, there are approximately 200 such trade agreements in place around the world. Some industry experts suggest that in the absence of a WTO agreement this figure could rise to more than 400 by the end of the decade. Determining the potential impacts on the EU, British and Scottish livestock industry is beyond the scope of this document, but it is clear that such agreements (and other protectionist measures such as export restrictions and fertiliser subsidies) can have major worldwide impacts. With the WTO talks unlikely to resume in earnest until at least 2010, it will be interesting to see how the CAP develops given the increased room for manoeuvre the breakdown in trade talks affords.

Scotland's livestock farmers remain keen to play their part in the food production revolution that many predict will be necessary to cope with population increase and climate change. In order to do that effectively, short-term protection of the businesses that represent current capacity would seem a prudent first step. Empowering them with the latest techniques and technologies together with the associated advice will be a requirement to ensure progress. Most importantly, however, clear signals that the industry will be capable of delivering reasonable rewards, commensurate with the efforts expended and the risks taken will be the key to a thriving industry in the future.

Feast or famine – prospects for the year ahead?

Julian Bell

Summary

- Scotland has suffered one of the worst harvests since 1985 and many growers have lost malting quality and suffered higher drying costs.
- World wheat prices have fallen on a record harvest, though rising demand has helped limit the increase in stocks.
- Harvest price pressure has been increased by the credit squeeze and rising fertiliser prices.
- With coarse grain stocks falling, the world's grain stocks remain close to historic lows and a good harvest will be needed next year to meet demand.
- A combination of rising fertiliser costs and falling grain prices could result in lower world grain plantings for harvest 2009. However, grain demand could also fall if global economic growth slows sharply.
- Oilseed rape plantings are likely to fall in Scotland but rise elsewhere on better prices relative to grain.
- GM restrictions are raising feed costs for livestock producers and reform of the EU approval process is being urgently sought.
- Scottish farmers planting crops for harvest 2009 are faced with forward grain prices below the costs of production.
- Maximising yields, fallowing uneconomic poor land, managing costs and keeping a balanced grain marketing strategy will be required if arable enterprises are to generate a positive return in the year ahead.

The arable sector in Scotland has seen the fastest turn around in fortunes that almost anyone can recall. Just a few months ago grain prices were at record levels (figure 13) and world demand was expected to continue growing strongly. Roll forward to harvest 2008: spot grain prices have fallen £100/t, fertiliser prices have reached record levels and to cap it all large swathes of Scotland suffered the worst harvest weather since 1985. This turn-around prompts some difficult questions: are low grain prices just a short term blip or will they be sustained? With forward prices now below production costs for many, should farmers be planting at all?

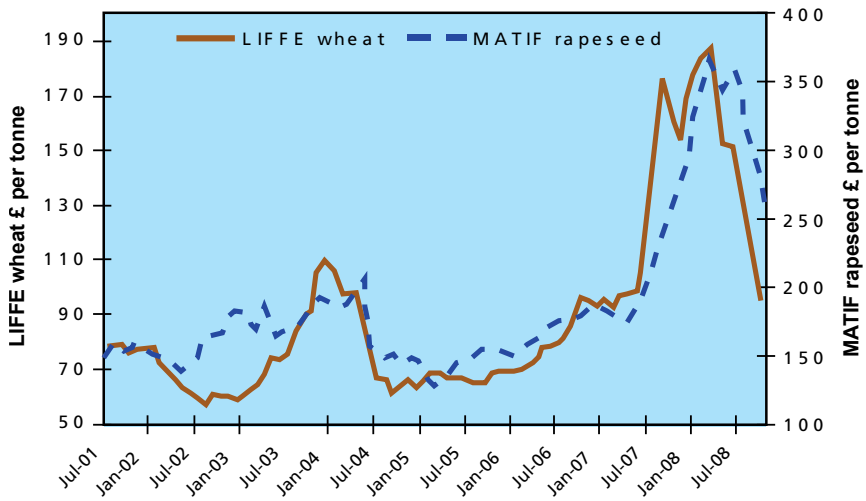

Figure 13
UK wheat and rape prices have dropped £100/t in 6 months
(Source: HGCA)

2008 – Scotland's harvest horribilis?

2008 was the harvest that could have been. Forward prices, yield and quality potential were all favourable as summer approached. Once harvest arrived, however, it turned out to be one of the wettest in recent years. In southern and central areas it was almost on a par with the disastrous harvest of 1985. The only consolation was that crops generally remained standing eventually permitting most crops to be harvested. Aside from the high costs of harvesting and drying, the main problem has been loss of grain quality. In some areas sprouting has led to a loss of malting quality in barley and a severe drop in specific weights, especially in wheat. As a result, a significant tonnage will not be marketable without a significant price discount. Farmers who had signed contracts to deliver malting barley at £180/t found they have been left with feed barley worth less than half this. Further north in Scotland, weather conditions were better, helping to moderate the overall impact on Scotland as a whole.

Wheat and feed grains

After reaching record levels last season, world wheat prices have tumbled in recent months on a record world wheat harvest. A combination of increased world plantings (+3%) and higher yields (+8%) have delivered a record crop of 680mt (+11% or 70mt). In Scotland, wheat prices have halved to around £95/t in the last 6 months. Lower wheat prices have led to a sharp rise in world wheat demand, which has risen 38mt, driven by a sharp rise in animal feed usage as wheat undercuts other more expensive feeds such as US maize. The overall impact has been a rebuilding of world wheat stocks for the first time in 4 years and these are set to rise 20 per cent (+25mt) to 144mt, the highest level since 2006.

World coarse grains production (maize, barley, rye), on the other hand, has seen a much more modest increase in production (+2%) to 1094mt which is expected to fail to meet demand and lead to further falls in stocks this year. Tightening US maize supplies are likely to reduce US maize exports by 16 per cent (10mt) to 50mt, the lowest level in 4 years, boosting world import demand for other grains, especially wheat.

In the EU, a grain crop of 303mt is expected this season which represents a 13mt increase on early estimates and a 47mt increase on 2007. This increase stems from higher plantings (removal of set-aside) and from good yields. Output of wheat, barley and maize have all risen strongly. Rising grain production has seen the EU swing from a net importer to a net exporter this season (figure 14).

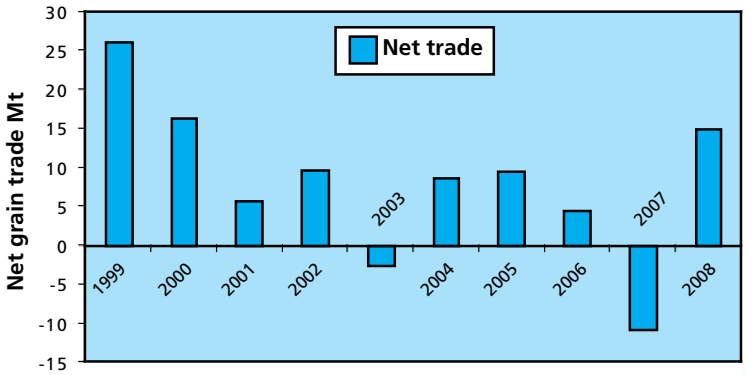

Figure 14
EU balance of trade rises 26mt to become a major grain exporter (Source: USDA)

Turmoil in the financial markets has seen a sell off in commodities and may have contributed to short-term weakness in the grain and oilseeds market. However, market fundamentals remain the main driver of commodity prices and the main impact would be if global economic growth were to slow sharply, reducing demand for grain and oilseeds. Already oil prices have plummeted leading to weaker maize (ethanol) and oilseeds (biodiesel) prices. Could meat demand be next?

In the UK, harvest quality was hit by the wet harvest but unofficial reports indicate that good yields are widespread including in Scotland. Initial estimates place UK wheat production between 16.5mt and 17.0mt. This is likely to give the UK a wheat surplus of between 3mt and 3.5mt, the largest such surplus since 2000.

But the recent sharp fall in grain prices should lift domestic livestock feed use while starch and ethanol use is also expected to rise. The net effect of a large surplus is that UK feed wheat will have to remain competitive, especially in Spain where it faces direct competition with Ukraine feed wheat and South American maize, all currently allowed in duty free. Given the large size and poor quality of the UK wheat surplus, more distant feed wheat markets such as South Korea may also be required.

Looking to the remainder of the season, the size of the EU grain surplus means that prices are going to have to stay competitive in order to encourage export demand. The sharp fall in EU grain prices has prompted the Commission to re-impose import duties to protect domestic markets. While offering some relief in domestic markets, this measure will not greatly assist the EU's grain export campaign and further price falls on the world market may require further steps such as the use of export refunds to protect EU prices.

There is also evidence that grain prices have been unduly depressed this harvest due to the sheer scale of the crop increase, an issue exacerbated by the sharp rise in fertiliser prices and restrictions on credit. For farmers selling grain at harvest and simultaneously buying fertiliser, they would have to sell almost half their crop just to pay for next year's fertiliser.

Despite this year's rise in grain output, rising demand has also curbed the growth in world grain stocks and absolute stock levels will remain below those seen just 3 years ago. In relative terms, world grain stocks will hardly climb at all from the equivalent of 58.5 days of world demand last season to just 60.5 days this season. This leaves very little cushion for any crop problems in the year ahead and world markets will soon start to focus on crop prospects for the 2009 harvest. Grain producers around the world are strongly aware of the impact of rising fuel, fertiliser and other costs and the question remains as to whether current forward values will be high enough to encourage sufficient grain to be planted in the year ahead. This year also brings additional uncertainty from the global economy. A severe fall in global economic activity could significantly depress demand for grain and oilseeds in the year ahead.

Malting barley

Spot prices for malting barley in Scotland are now around £130/t ex-farm which compares with £200/t a year ago. Significant quality problems have been experienced in central and southern Scotland including skinning, splitting and pre-germination. Oxbridge has been particularly badly affected. However, even in the south of Scotland some later cut spring barleys were harvested under reasonable conditions whilst further north weather conditions and harvest quality were reportedly much better. Despite the potential local shortfall, prices have failed to respond as maltsters turn to imports estimated at up to 50,000t. Heavy crops of decent quality malting barley in England and the continent are putting pressure on prices with English Optic for export trading at around £130/t FOB (Free on Board), helping set a cap on Scottish prices.

Looking to next season early indications suggest spring barley prices for harvest 2009 could be between £130/t and £150/t though maltsters have yet to come out with firm contracts. A wet autumn is likely to see sharply lower sowings of rapeseed and wheat plantings and could leave more land available for spring barley. The future of the sector remains closely tied to that of the whisky industry. A number of new plants are expected to boost demand for malting barley and wheat for distilling in the next few years. Maintaining grower confidence will therefore be essential if the industry is to secure sufficient domestic grain in the years ahead.

Oilseed rape

Good EU and world rapeseed yields, weakening world vegetable demand, falling mineral oil prices, higher US soyabean plantings and rising world oilseed stocks have all helped push rapeseed prices £100/t lower in the last 6 months to around £260/t delivered. The main concern at present is the dry conditions in South America which could threaten the all important soyabean crop currently being sown.

Looking to harvest 2009, Scottish and UK oilseed rape plantings are likely to be reduced by the difficult conditions at sowings. On the continent, conditions have been better and overall EU rapeseed plantings are likely to rise driven by the more favourable rapeseed prices relative to grain.

Biofuels and non-food crops

The pace of biofuels expansion has slowed due to higher feedstock costs, lower oil prices and growing environmental concerns. Despite this, further expansion in production has continued in several countries.

In the UK, the government introduced the Renewable Transport Fuel Obligation (RTFO) in April 2008. In the first quarter of 2008/09, obligated UK fuel suppliers delivered 2.61 per cent biofuels in their road fuel against an RTFO target for the year of 2.5 per cent. More biodiesel (84%) has been supplied than bioethanol (16%) with imports dominating. While UK biodiesel capacity now lies largely unutilised due to the poor economics of the industry, two large-scale wheat ethanol plants are under construction in the north of England with the potential to use over 2mt of wheat when completed. The economics of these plants will remain dependent on governement incentives, the price of wheat and Brazilian ethanol imports.

EU member states have agreed to raise compulsory biofuels targets to 10 per cent of all road fuel by 2020, however there are proposals to reduce this if this target creates exessive pressure on food prices and environmental concerns.

The GM issue and feed costs

Genetically modified (GM) crops are increasingly important worldwide, representing over 15 per cent of worldwide sowings of grain and oilseeds in 2007. Soya is the most important GM crop and 64 per cent of global soya plantings were GM in 2007 compared to 24 per cent in maize and effectively zero in wheat and barley.

To date the Scottish cereal and oilseeds sector does not appear unduly disadvantaged by restrictions on the importation and planting of GM varieties. EU restrictions on GM feed imports and consumer resistance to GM have led to higher grain and oilseed prices benefiting arable farmers. However, the fortunes of the arable sector are closely tied to that of its largest customer: the livestock industry. This sector faces an increased threat due to the introduction of non-approved Roundup Ready 2 soyabean varieties to the US in 2009. If the EU fails to speed up the GM approval process this could lead to sharply higher soya and feed costs starting in 2009 and 2010, threatening the viability of the livestock sector and potentially reducing demand for grain.

In terms of cultivating GM crops, there is currently an EU moratorium on planting new GM varieties. Based on SAC experience gained in previous GM crop trials, it seems that so far Scottish farmers have not lost out significantly. In the longer term, however, there may be greater benefit to Scottish growers in adopting GM varieties, particularly if it helps them respond more quickly to tightening environmental regulation (to combat the loss of active pesticide ingredients possible from adoption of EU9414), shifts in global climate patterns and growing exposure to global competition.

Arable business priorities

The prospects for the sector could scarcely be more different than they were a year ago. Current forward wheat prices in the Scotland are around £105/t for harvest 2009 which is £30/t below equivalent forward values a year ago. In addition, rising fertiliser costs on their own have added around £35/t to wheat production costs. Total variable costs, including fuel, could top £90/t for an average wheat producer which leaves precious little to cover fixed costs (figure 15).

The initial priority remains getting autumn crops planted after a difficult harvest. Given the lack of encouragement from forward prices, producers should think hard about cropping poorer land as they may not even get their variable costs back, never mind contribute to fixed costs. This also puts the emphasis back on first wheats as the main profit driver on many farms and this may justify greater use of fallow and break crops.

Where crops are being planted, then it makes sense to sell a proportion forward to justify the planting decision. However, with current forward prices below the costs of production, locking into a loss is not an attractive prospect. From a risk management perspective, it is important to stick to the same marketing strategy irrespective of market conditions. Selling a proportion of crop forward will therefore continue to make sense for most producers even if only to limit losses.

The high cost of fertiliser means that every effort must be made to maximize fertiliser use efficiency through soil sampling, variable rate application, use of manures and other wastes. Technology such as precision farming has a key role to play in reducing costs. As an illustration, the use of auto steer where it prevents the overlap of just one coulter on a 3m drill can save 5 per cent on all variable costs as well as saving fuel and time. On a 200 hectare cereal farm this can amount to £5,000 savings in variable costs alone giving a payback of under two years.

Probably the best news currently is increased Single Payments due to the more favourable sterling to euro exchange rate. Other than that the year ahead looks like being a difficult one for the arable sector and will require farmers to return to the basics of good technical efficiency, cost control and risk management if a positive business outcome is to be achieved.

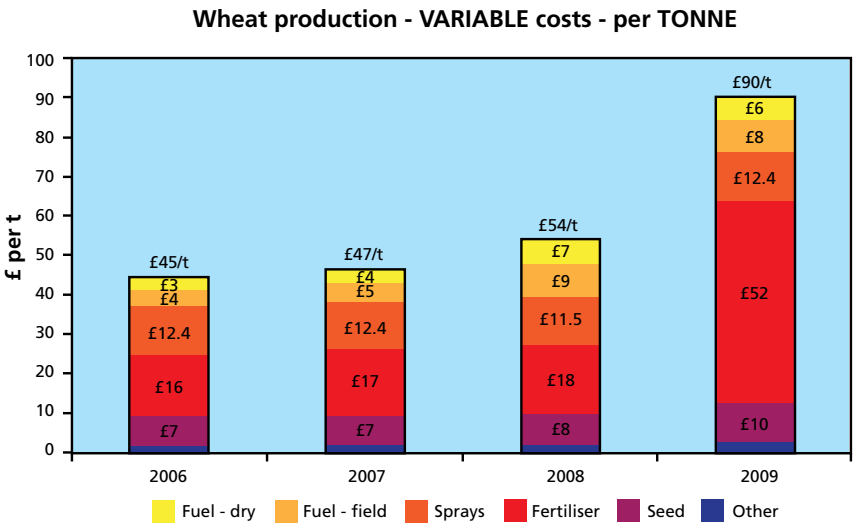

Figure 15
Variable costs of wheat production per tonne (Source: SAC)

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SAC receives financial support from the Scottish Government

ISBN 1 85482 870 3

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Printed on environmentally sound paper