

Mirzabaev, Alisher; Tsegai, Daniel

**Working Paper**

## Effects of weather shocks on agricultural commodity prices in Central Asia

ZEF Discussion Papers on Development Policy, No. 171

**Provided in Cooperation with:**

Zentrum für Entwicklungsforschung / Center for Development Research (ZEF), University of Bonn

*Suggested Citation:* Mirzabaev, Alisher; Tsegai, Daniel (2012) : Effects of weather shocks on agricultural commodity prices in Central Asia, ZEF Discussion Papers on Development Policy, No. 171, University of Bonn, Center for Development Research (ZEF), Bonn, <https://doi.org/10.22004/ag.econ.140769>

This Version is available at:

<https://hdl.handle.net/10419/84817>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*



Zentrum für Entwicklungsforschung  
Center for Development Research  
University of Bonn

# ZEF-Discussion Papers on Development Policy No. 171

Alisher Mirzabaev and Daniel Tsegai

## **Effects of weather shocks on agricultural commodity prices in Central Asia**

Bonn, November 2012

The **CENTER FOR DEVELOPMENT RESEARCH (ZEF)** was established in 1995 as an international, interdisciplinary research institute at the University of Bonn. Research and teaching at ZEF addresses political, economic and ecological development problems. ZEF closely cooperates with national and international partners in research and development organizations. For information, see: [www.zef.de](http://www.zef.de).

---

**ZEF – Discussion Papers on Development Policy** are intended to stimulate discussion among researchers, practitioners and policy makers on current and emerging development issues. Each paper has been exposed to an internal discussion within the Center for Development Research (ZEF) and an external review. The papers mostly reflect work in progress. The Editorial Committee of the ZEF – DISCUSSION PAPERS ON DEVELOPMENT POLICY include Joachim von Braun (Chair), Solvey Gerke, and Manfred Denich.

**Alisher Mirzabaev and Daniel Tsegai, Effects of weather shocks on agricultural commodity prices in Central Asia, ZEF - Discussion Papers on Development Policy No. 171, Center for Development Research, Bonn, November 2012, pp. 30.**

**ISSN: 1436-9931**

**Published by:**

Zentrum für Entwicklungsforschung (ZEF)  
Center for Development Research  
Walter-Flex-Straße 3  
D – 53113 Bonn  
Germany  
Phone: +49-228-73-1861  
Fax: +49-228-73-1869  
E-Mail: [zef@uni-bonn.de](mailto:zef@uni-bonn.de)  
[www.zef.de](http://www.zef.de)

**The authors:**

**Alisher Mirzabaev**, Center for Development Research (ZEF), University of Bonn. Contact: [almir@uni-bonn.de](mailto:almir@uni-bonn.de)

**Daniel Tsegai**, Center for Development Research (ZEF), University of Bonn. Contact: [dtsegai@uni-bonn.de](mailto:dtsegai@uni-bonn.de)

## **Acknowledgements**

This work has been financially supported by the IPSWaT Program of the German Federal Ministry for Education and Research (BMBF) under the PhD studies of the first author. The authors thank Prof. Dr. Joachim von Braun and Dr. Matthias Kalkuhl for insightful comments on the earlier drafts of this discussion paper.

## **Abstract**

Higher weather volatility may be reflected in higher incidences of weather shocks. Weather shocks could potentially affect the supply of agricultural commodities and their prices. In this study, the effects of weather shocks on agricultural commodity prices in Central Asia are investigated at the provincial scale using monthly data for the period of 2000-2010. The study uses an innovative estimation method, where the idiosyncratic components of the variables are analyzed using Feasible Generalized Least Squares (FGLS) panel regression in the presence of cross-sectional dependence and serial autocorrelation. The analysis indicates that weather volatility and, especially, the fluctuations in the availability of irrigation water have statistically significant effects on wheat and potato prices in Central Asia. Negative shocks, involving lower than usual temperatures and precipitation amounts, could create favorable conditions for higher wheat prices in the region. Lower availability of irrigation water may encourage irrigation-dependent countries of the region to aggressively raise wheat stocks to face expected supply shortfalls, thus leading to higher regional wheat prices. This effect could be further aggravated by negative impacts of lower irrigation water availability on wheat yields. In order to counteract such developments, it is necessary to devise effective grain storage policies. Regional free trade arrangements in agricultural commodities will also be important to minimize price volatility resulting from weather shocks. For protecting agricultural producers, weather insurance schemes could be introduced. It would be also necessary to make investments into crop breeding and agronomic research for developing new crop cultivars resistant to biotic and abiotic stresses, and on promoting water-efficient crop production technologies.

Key words: weather and price shocks, Central Asia.

## 1. Introduction

Weather shocks are considered to be one of the important sources of variability in agricultural commodity prices (Gilbert & Morgan, 2010). Although there is no evidence that weather shocks alone have played a major role in the food price spikes in 2008 (Headey & Fan, 2008), it seems, however, that they have contributed to the price spikes in interaction with other factors (Mitchell, 2008; von Braun & Tadesse, 2012). Climate change is likely to increase weather variability and incidences of extreme events (IPCC, 2012), potentially leading to growing impacts of weather shocks on agricultural and food price (Torero & von Braun, 2010; von Braun et al., 2008). This may have considerable influence on poverty levels and economic performances of developing countries dependent on agricultural and agro-food sectors, especially if they are net food importers. Most of the existing research on the impacts of weather shocks on agricultural prices studies earlier historic periods and there are only few studies covering more recent periods (Burgess & Donaldson, 2010; Fox, Fishback, & Rhode, 2011; Jolejole-Foreman & Mallory, 2011; Roll, 1984; Solomou & Wu, 1999). Arguably, this lack of research attention is perhaps influenced by the fact that modern farm management techniques and more globalized agricultural markets have noticeably reduced the impacts of weather shocks on agricultural prices, especially in developed countries. Even in developing countries, generally more vulnerable to weather shocks, a major research concern has been with market integration and price transmission effects *per se*, without specific attention to weather impacts. Climate change and related increases in the frequencies and magnitudes of weather shocks are likely to necessitate a paradigm shift towards increasing research efforts on the effects of weather shocks on agriculture and agricultural prices, especially in developing countries.

Therefore, the main purpose of the present study is to advance the current knowledge through three contributions. First, the agricultural price transmission is linked to specific weather variables such as temperature and precipitation, and availability of irrigation water. The previous literature on the interaction of weather shocks and agricultural prices did not link price transmission to specific marginal changes in these variables. Second, an innovative, yet straightforward, method of assessing the impacts of weather shocks on agricultural commodity prices is suggested exploiting the idiosyncratic components of variables in a long panel setting. This approach allows for disaggregating short-term shocks in prices from long-term trends, thus providing a theoretically consistent way to estimate the effect of weather shocks on agricultural prices. And third, a focused treatment of transmission of weather shocks on agricultural prices is provided by using more recent contemporaneous data. In spite of these contributions, the present research has certain limitations, the key among them being its inability to distinguish between varying responses of public and private stockholders to weather and price shocks due to data constraints. Data limitations also

concern commodity stocks and prices, as they were not always available at the needed scales and frequencies.

## **2. Relevant Literature**

The study of price dynamics in economic literature has been framed within two competing theories providing alternative explanations of price formation, namely: the cobweb model of adaptive expectations (Cochrane, 1958; Ezekiel, 1938; Nerlove, 1958) and the rational expectations model (Muth, 1961). The cobweb model posits that prices are formed by endogenous factors, namely, forecasting errors. For example, in response to high prices of a particular crop farmers increase their production which leads to lower prices for this crop in the next period. Responding to these lower prices, farmers reduce their production of this crop in the second period, only to see the rising prices in the third period as a result of this supply reduction, and so on (Barré, 2011). The second model assumes that economic agents rationally use all the available information and price dynamics are caused by exogenous factors, especially weather shocks (ibid.). These two approaches also differ in the solutions they propose for tackling price volatility. The rational expectations approach advocates methods that allow for spreading the risks among a larger number of economic agents such as insurance schemes, temporal and spatial arbitrage, including storage and free-trade policies. In contrast, the measures proposed by the cobweb approach for price stabilization usually involve production quotas and other Government interventions for managing the commodity supply within the country (Mitra & Boussard, 2012).

Both models were extended over time to account for their shortcomings. Nerlove (1958) extended the original cobweb model developed by Ezekiel (1938) and suggested that economic agents form their price expectations based on both the current prices and also their forecasting errors made during the last periods, i.e. they try to learn from their mistakes. Later on, the model was extended to include risk aversion (Boussard, 1996) and non-linear curves (Hommes, 1992). In spite of these improvements, Deaton & Laroque (1996) point out that the cobweb model still cannot reconcile its predicted negative first order autocorrelation in prices with the empirical evidence showing positive autocorrelation (Barré, 2011). The key implication of the rational expectations model is that economic agents do not make systematic forecasting errors. However, this would imply stationarity of price series around a steady state, which is against the empirical findings of non-stationarity of most commodity price series. To account for this shortcoming, Barré (2011) informs that competitive storage model was developed to explain positive autocorrelations in prices (Muth, 1961), as well as their kurtosis and positive skewness (Deaton & Laroque, 1992). Frankel (1986) extended the competitive storage model by adding the overshooting hypothesis, which links the price dynamics in the commodity markets to changes in the monetary policy. Deaton and Laroque (2003) showed that it is also possible to represent

positive autocorrelation, skewness, and kurtosis of observed data series with a rational expectations model without competitive storage. Other major challenges in empirical estimations are non-linear components, structural breaks or regime shifts.

In this larger context, the strand of literature that considers the impact of weather shocks on prices is relatively thin. Roll (1984) finds that cold weather shocks in central Florida, where virtually the entire US orange production occurs, affect the futures prices of frozen concentrated orange juice, though cold weather shocks seem to explain only a small share of the futures price variation. Webb, von Braun & Yohannes (1992) find that the upward effect of droughts on food prices in Ethiopia during 1980s was strongly exacerbated by infrastructural and administrative constraints to spatial arbitrage. Solomou and Wu (1999), in their comparative study of the effects of weather shocks on agricultural prices in Britain and Germany between 1870 and 1913, conclude that weather shocks had larger impacts on the German economy, because Germany was more dependent on agriculture, and German agriculture was more protected than British agriculture operating under virtually free trade conditions. Similarly, using historic data on weather and crop prices for the US during 1895-1932 under “unfettered” agricultural commodity markets, Fox, Fishback & Rhode (2011) find that local weather did not have a significant effect on the prices of internationally traded crops, namely, cotton and wheat. However, weather shocks significantly influenced the prices of maize and hay, which were mostly locally consumed. Burgess & Donaldson (2010) indicate that openness to trade and better transport infrastructures (construction of railroads) in colonial-era India lowered the vulnerability of agricultural prices and incomes to rainfall shocks, and also dramatically reduced the incidences of famines. Jolejole-Foreman & Mallory (2011) show that positive rainfall shocks are associated with higher margins between farm-gate and retail prices, and reduced imports of rice in the Philippines.

Efficient price transmission between spatially separated markets and unhindered opportunities for spatial arbitrage (law of one price) are believed to lead to more competitive markets and hence more efficient allocation of resources and long-run growth (Samuelson, 1952; Takayama & Judge, 1964). Better market integration can allow for mitigating the impacts of weather shocks on local agricultural prices. Market integration may also reduce the need for food self-sufficiency (Fafchamps, 1992). Several factors such as trade barriers, subsidies, exchange rate policies, poor infrastructure and non-competitive market structure are believed to impede price transmission (Rapsomanikis, Hallam, & Conforti, 2003).

Methodologically, the early research on price transmission was based on examining bivariate correlation coefficients of prices in different markets, where high correlation coefficients were regarded as a sign of price transmission (Rapsomanikis, et al., 2003). Another widely used approach was regressing the prices on each other, where coefficients closer to unity

would imply a stronger co-movement of the prices (Mundlak & Larson, 1992). Ravallion (1986) suggested an improved approach which also incorporated price lags in the regression analysis thus enabling to segregate short- and long-term price transmission effects, and relaxing the assumption of instantaneous adjustments in different markets. Webb, von Braun & Yohannes (1992) have further nuanced the notion of price co-movements in different markets, in the example of food prices in Ethiopia, indicating that these co-movements could be caused by covariate weather shocks even in the absence of market integration. Non-stationarity of much of the time series data and invalid tests of statistical significance resulting from applying simple regression techniques led to the development of the Error Correction Model (Engle & Granger, 1987), which were later advanced to the Vector Autoregressive Model (VAR) and the Vector Error Correction Model (VECM). Non-linear aspects of price adjustments led to development of the Asymmetric Error Correction Model (Granger & Lee, 1989) and threshold co-integration models (Enders & Granger, 1998). Von Cramon-Taubadel (1998) applied the cointegration methods to testing for asymmetric price transmission, thus accounting for non-stationarity of price time series. Von Cramon-Taubadel, Loy, & Meyer (2003) also highlight the importance of the level of aggregation in price series while testing for asymmetric transmission. In their analysis of retail and wholesale prices of chicken and lettuce in Germany, Cramon-Taubadel, Loy, & Meyer (2003) use weekly individual store prices and average retail prices during 1995-2000 and find that the individual store data reveals asymmetric price transmission, whereas the aggregated average retail price series do not show any sign of asymmetry. Relatively more recently, switching regime models and dynamic panel causality models were applied to test for price transmission.

### **3. Conceptual Framework**

The theoretical model follows the rational expectations approach to price transmission which assumes that exogenous shocks, such as weather shocks, are potentially important determinants of price dynamics. Spatial and temporal arbitrages are expected to smoothen the effects of weather shocks on prices by stabilizing the supply of agricultural commodities and also calming down exuberant price expectations. However, storage may also result from hoarding behavior, especially in less developed markets, in which case, storage may actually play a destabilizing role on prices (von Braun & Tadesse, 2012).

In general, factors affecting price dynamics can be classified into short- and long-term. Long-term factors include income levels, changes in tastes and preferences, technological change, population growth, and other similar trend-setting variables. Short-term factors are idiosyncratic shocks around the long-term trend. Extreme weather events are a major example of these idiosyncratic shocks. The extent by which short-term idiosyncratic shocks affect agricultural commodity prices depends on the institutional setting made up of

national policies on trade, exchange rate, market structure, net food trading position of the country, amount of commodity stocks at the time of the shock and others. Weather shocks can affect crop prices through impacting their supply and by changing people's perceptions and expectations about the future price dynamics, which is reflected through their storage decisions.

Time series can be decomposed into trend, seasonal, cyclical, and idiosyncratic components using unobserved-components method (Harvey, 1990). This decomposition method can be usefully exploited in the current analysis. Weather shocks are expected to have random distribution and their effects on agricultural prices are only short-term. Although there are studies demonstrating that the effects of weather shocks on agricultural price volatility could potentially lead to long-term effects, for example, on children's health in poor countries (Jensen, 2000), it may be safe to accept that weather shocks do not have permanent long-term effects on agricultural prices *per se*. Consequently, the effects of weather shocks on agricultural prices are fully captured by the idiosyncratic components of agricultural price series. Weather shocks themselves represent the idiosyncratic components of specific weather variables such as temperature and precipitation. Long-term factors affecting the prices such as income levels and population growth; or climate change in the case of the weather variables, are captured by the trend component of the time series. Hence, a straightforward way of assessing the effects of weather shocks on agricultural prices would be to decompose the variables in the model into their latent components, and look into only the idiosyncratic components of the variables in the regression analysis.

The analysis of weather impacts on agricultural prices using the panel data whose both cross-sectional and time dimensions are quite long (T-132 and N-38) effectively precludes from applying the conventional workhorse methods of price analysis such as VAR or VECM, but may necessitate the use of methods from the newly developing field of panel cointegration to account for potential non-stationarity aspects of very long panel data. The proposed approach is based on the idiosyncratic components of individual time series and hence the analysis is greatly simplified since the idiosyncratic components are by definition stationary and can be effectively tackled by simpler and time-proven panel regression techniques.

The conceptual approach is summarized in Figure 1. All the variables are represented by their idiosyncratic components. The conceptual framework schematically represents the following functional relationships between the employed variables of interest.

$$Y = f(T, R, Ir, E, In, P_{int}, d) \tag{1}$$

$$S = f(T, R, Ir, E, In, P_{int}, d) \tag{2}$$

$$P = f(\hat{Y}, \hat{S}, E, In, P_{int}, d) \tag{3}$$

where,

Y – shocks, or deviations from trend, in wheat or potato yields

S – shocks in commodity stocks

P – provincial prices for potato or wheat

T- shocks in mean monthly temperature

R- shocks in monthly accumulated rainfall amounts

Ir- shocks in the availability of irrigation water

E – shocks in national exchange rate

In - province level inflation rates

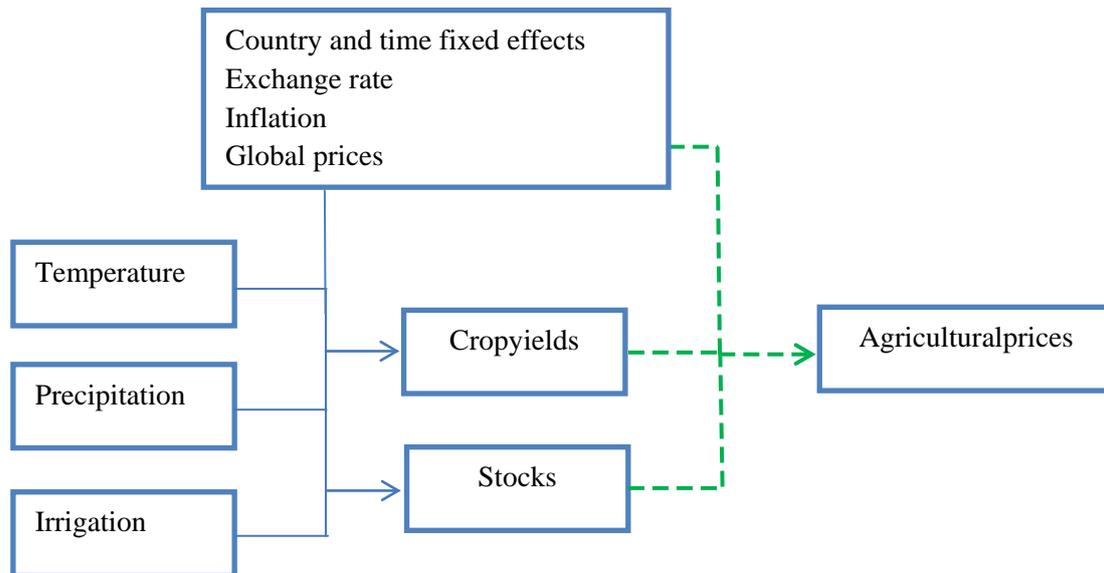
d – dummies standing for other country and time-specific unobserved shocks

$\hat{Y}, \hat{S}$  – fitted values for yield and stock shocks from the first stage of the model

Throughout this paper, the shocks are defined as deviations from trend in the variables. For example, mean temperature in a specific month could be 2°C higher than what is otherwise expected based on the temperature trend. In the analysis this is considered as positive shock of 2°C, where the term “positive” is used in its strictly mathematical meaning, i.e. more than zero, without any normative connotations.

This approach at evaluating weather shocks as deviations from trend rather than deviations from the mean is based on the assumption that economic agents continuously update their cognitive perceptions so that their actions are shaped by changing trends in climate rather than long-term mean climate values which could become no longer relevant for their decision-making, especially in the context of accelerated climate change.

In the first stage of the analysis, the effects of shocks in temperature, precipitation and availability of irrigation water on yield and commodity stock shocks are estimated. The regression model also controls for the concurrent shocks in inflation, exchange rate, the international price for the corresponding agricultural commodity and for other unobserved time and country-specific idiosyncratic shocks that may have influence on stocking and production decisions.



**Figure 1. The conceptual framework of effects of weather shocks on agricultural prices**

Note: The first stage of the regression is depicted with connected lines, while the second stage with dashed lines.

Weather shocks could influence agricultural prices through two channels: i) through influencing expectations about the future prices, which gets reflected through stocking decisions, ii) through directly impacting the yields and hence the production of agricultural commodities.

The first channel, which can be called as expectations link, operates through both private and public decisions on stock holdings for the affected commodity. Both private and public agents utilize all the available information in their decision making process. In this regard, when confronted with weather shocks and their potential effects on future supply of agricultural commodities, economic agents respond to these shocks by adjusting their storage decisions. If a negative weather shock happens, for example, drier than usual weather or outright drought in the rainfed areas, private economic agents, seeking to maximize their profits, would expect a lower future harvest and thus future higher prices, which would lead them, *ceteris paribus*, to increase stocks, or at minimum, decelerate their destocking levels – which would put an upward pressure on the prices. On the other hand, the public agent's (i.e. Government) major political interest involves maintaining stable and affordable prices. Any upward movement in the prices that would be deemed excessive would result on releases from public stocks to bring the prices down. The final outcome would depend on the interaction between the private and public stockholders (Jayne & Tshirley, 2009). Due to limitations on the availability of separate data on public and private stockholdings, the current analysis could not distinguish between these two types of stockholdings, but traces only the effects of weather shocks on aggregate stock levels.

In addition to the expectation link, there is also a direct production link between weather shocks and commodity prices through the effect of weather shocks on crop yields. Higher than usual rainfall amounts in rainfed areas (positive shocks), for example, could lead to bumper harvests thus increasing the supply of agricultural commodities, and potentially leading to lower prices.

The weather variables and availability of irrigation water are entered into the regression models both in their levels and also in quadratic forms to capture potential nonlinearities. A little bit more of rain could be beneficial for crop production, but if there is too much rain it may retard field operations, may lead to occurrence of plant diseases, such as yellow rust in Central Asia, may cause floods and landslides in hilly areas, etc. A full set of interactions between temperature, precipitation and availability of irrigation water is also included in the first stage estimation to account for their joint effects. The first stage of the regression also accounts for the effects of idiosyncratic shocks in exchange rate, inflation, the international price for the commodity and other unobserved time- and country- specific shocks, since they may also have influence on the stocking and production decisions, and their omission will bias the coefficient estimates (Baltagi, 2002). For example, the Central Asian countries pursue various and numerous policies on import and export tariffs for agricultural commodities, on stabilizing domestic prices for key staple foods through stocks, production quotas, trading permits, etc – which the model does not capture explicitly, but strives to account for the effect of these factors implicitly through the inclusion of time- and country-specific dummy variables.

The second stage of the model has wheat and potato prices as dependent variables, and looks into how the latter are impacted by the fitted values of shocks in stocks and commodity yields, shocks in the global prices for the commodity, exchange rates and inflation. For tradable commodities, such as wheat, international price fluctuations are important factors in determining the domestic prices, especially in small open economies. For this reason, the shocks in the global prices of commodities are included to capture the effect of exogenous price shocks on commodity prices inside the country. Sensitivity of internal prices to changes in global prices also shows the level of integration between domestic and international markets, as well as the extent of national barriers for price transmission such as price controls, subsidies and other kinds of government interventions. In addition to external shocks, the model also needs to account for internal macroeconomic shocks that may affect prices. Consequently, it also includes exchange rate and inflation fluctuations. The devaluation of the local currency against the US dollar decreases the local commodity prices in dollar terms if the major part of the national supply of that commodity is produced inside the country. However, devaluation would increase the prices of commodities if they are mainly imported from outside. Regarding inflation, including the current levels of the inflation directly into the model may create endogeneity problem

between the dependent variable – commodity price, and inflation as the explanatory variable, as commodity prices may actually drive the inflation dynamics. This is true especially in the case of food commodities in the poor countries, where food constitutes a major portion of aggregate consumer demand. To avoid this potential endogeneity problem, the lagged values of inflation are included in the model. The relationship between stocks and commodity prices, between commodity prices and yield shocks may also be endogenous. The use of the two stage model provides with a key advantage of instrumentalizing these endogeneities by using fitted values of stocks and yield shocks conditioned on weather and other variables. Following Roberts & Schlenker (2009) the model includes the interaction of stock and yield shocks in order to capture any possible joint effects. It is expected that that larger stocks, bumper harvests and their interaction terms are negatively associated with commodity prices. The model also includes country and time dummies to account for the effect of directly unobserved country- and time-specific idiosyncratic shocks. Finally, in both stages of the estimation, the lag structure of all the explanatory variables is considered, where the selection of the number of lags is guided by Akaike Information Criterion (Akaike, 1974).

#### 4. Econometric strategy

The empirical estimation consists of three steps. First, all variables in the model are decomposed into their idiosyncratic components. Secondly, the idiosyncratic components are tested for the presence of unit root to make sure that the series are stationary and linear panel regression methods can, thus, be used. Finally, the parameters are estimated using Feasible Generalized Least Squares (FGLS) panel regression.

To decompose variables into their latent components by separating trend, cyclical, seasonal and idiosyncratic components, the unobserved-components model (UCM) approach is applied. The general form of the UCM is written as:

$$T_t = \alpha_t + \beta_t + \phi_t + \delta X_t + \epsilon_t \quad (4)$$

where,  $T_t$ , is the dependent variable,  $\alpha_t$  represents the trend,  $\beta_t$  seasonal component,  $\phi_t$  cyclical component,  $\delta$  regression parameters for exogenous variables  $X_t$ , and  $\epsilon_t$  idiosyncratic components. UCM does not have to have all these specified elements at the same time. Following Harvey (1990), the time series data are modeled as random walk. Separate unobserved components regressions are run for each of the variables in each of the cross-sectional units, i.e. provinces, and then the idiosyncratic components of these variables are collected for further analysis.

The second step in the analysis is to test the idiosyncratic components for the presence of unit root to make sure that the series are stationary. For this purpose, the recent developments in panel unit root tests are availed of. These methods allow for better handling of the cross-sectional dependencies and serial autocorrelations obviously present in spatial distribution of weather events and regional price dynamics. In addition, the use of panel approach in testing for the unit root, as compared to separate pure time-series based unit root tests, provides with a larger number of observations, thus increasing the degrees of freedom (Erdil & Yetkiner, 2004). There are several methods of panel unit root tests. They can be broadly classified into two categories: those which account for cross-sectional dependence and those which do not. Such test as those developed by Choi (2006), Pesaran (2003), Bai & Ng (2004), Chang (2002, 2004), Moon & Perron (2004) are in the first category, and those developed by Maddala and Wu (1999); Breitung (2000), Hadri (2000), Choi (2001), Levin, Lin & Chu (2002) and Im, Pesaran & Shin (2003) are in the second category (Barbieri, 2006). To be able to choose the right unit root test, the panels are first tested for cross-sectional dependence using the test developed by Pesaran (2003). After having identified the presence of cross-sectional dependence in the panels, testing for panel unit is conducted by accounting for cross-sectional dependence. Specifically, the Pesaran panel unit root test in the presence of cross-sectional dependence is applied (Pesaran, 2007)).

The final step involves estimating the model described earlier in the conceptual framework using FGLS panel regression. Econometrically, the first and second stages of the model are specified as follows (with appropriate lags):

**1st Stage:**

$$Y = T + T^2 + R + R^2 + Ir + Ir^2 + T^{**}R^{**}Ir + T^{**}R^{**}Ir^2 + E + In + P_{int} + d \quad (5)$$

$$S = T + T^2 + R + R^2 + Ir + Ir^2 + T^{**}R^{**}Ir + T^{**}R^{**}Ir^2 + E + In + P_{int} + d \quad (6)$$

**2<sup>nd</sup> Stage:**

$$P = E + In + P_{int} + \hat{Y} + \hat{S} + \hat{Y}^2 + \hat{S}^2 + \hat{Y} * \hat{S} + \hat{Y}^2 * \hat{S}^2 + d \quad (7)$$

where,

- Y – shocks, or deviations from trend, in wheat or potato yields
- S – shocks in commodity stocks
- P – provincial prices for potato or wheat
- T- shocks in mean monthly temperature
- R- shocks in monthly accumulated rainfall amounts
- Ir- shocks in the availability of irrigation water
- E – shocks in national exchange rate

In - province level inflation rates

d – dummies standing for other country and time-specific unobserved shocks

$\hat{Y}, \hat{S}$  – fitted values for yield and stock shocks from the first stage of the model

The choice of the FGLS panel regression method is based on its several advantages. As we shall see further, decomposition of the variables into their idiosyncratic components, in addition to being theoretically sensible approach in this context, also resolves the issue of non-stationarity in the variables, since idiosyncratic shocks are expected to be stationary. However, there still remain several problems in the data series for which the estimation approach employed should account for. These problems are dependence in the cross-sectional units, autocorrelation and heteroscedasticity. Feasible generalized least squares approach is the technique that is capable of adequately handling all these remaining problems, which motivates the choice of the technique for the empirical estimation.

Idiosyncratic components of the variables can have positive or negative signs, signifying that fluctuations in the variables are either above or below the expected trend lines, respectively. When using squared terms or interactions of the variables, unless due care is taken, multiplication results could artificially change the sign in the squared variables or interactions. Addressing this issue is quite straightforward for quadratic terms: all what is needed to do is to specify that squared terms should be of the same sign as the levels being squared. However, it is more complicated to adequately handle the signs in the interactions, since one variable may have a positive sign whereas the other may have a negative sign. To account for this situation, before interacting the variables, i.e. multiplying them, I added to the variables being interacted a number sufficiently large to bring the entire distribution above zero while keeping the relative magnitudes of the numbers exactly the same. For example, the lowest number in the precipitation shocks was -91.4, while in the temperature shocks the lowest number was -9.89, so + 91.5 was added to the precipitation variable and + 9.9 to the temperature variable to bring the entire distributions above zero, so that when interacting these two variables, there is no problem with changing signs. In other words, the intercept of the distribution was shifted, without any change in the slope of the distribution. This data treatment procedure was used specifically for creating the interacting variables; the variables themselves enter the regressions in their original values. This procedure will ultimately have some effect on the constant term in the regression models, but in no way would bias the coefficient estimates. However, if no care is taken to address the artificial sign change while interacting the variables, the coefficient estimates will be biased.

## 5. Data

The dataset used consists of monthly panel variables for the 38 provinces in Central Asia for the period of 10 years between 2000 and 2010 as described in detail in Table 1 below.

**Table 1. Information on the variables used in the analysis**

<b>Variables</b>	<b>Sources</b>	<b>Notes</b>
<b>Wheat and potato prices</b>	National Statistical Committees, local non-governmental organizations, price sections of various local newspapers, as well as the international databases such as FAO's Global Information and Early Warning System (GIEWS).	Converted to US Dollar using the average exchange rate for the corresponding month
<b>Global wheat prices</b>	Index Mundi online database ( <a href="http://www.indexmundi.com">www.indexmundi.com</a> ). Original source: United States Department of Agriculture (USDA) Market News	Wheat, No.1 Hard Red Winter, ordinary protein, FOB Gulf of Mexico, in USD Dollars per metric ton
<b>Global potato prices</b>	National Statistics Committee of Kazakhstan	Potato is not a globally traded commodity. Russia is an obvious candidate for potato trading for Central Asian countries because it is one of the leading potato producers in the world, and the most accessible country in terms of transport infrastructure and common customs procedures. So the monthly prices for potato in Kurgan, the center for Kurgan province of Russia, bordering with Kazakhstan is used as the international price for potato. The prices were originally available in USD.
<b>Exchange rates</b>	National central banks as well as international online databases such as	National level exchange rates were assumed to be the same for all provinces within the country

<b>Variables</b>	<b>Sources</b>	<b>Notes</b>
	www.oanda.com	
<b>Inflation rates</b>	National central banks, national statistics agencies	Province-specific Consumer Price Index (CPI) was used. Whenever province-level CIP was not available, national CPI was used.
<b>Weather variables</b>	Williams & Konovalov (2008), NASA's Global Summary of the Day, national hydro-meteorological services and other online sources such as www.rp5.uz and its sister websites for each country of Central Asia	Monthly mean temperature and total accumulated monthly rainfall. From about 400 weather stations across Central Asia. Mean monthly temperature and total monthly rainfall data from individual weather stations were spatially projected to the digital map of Central Asia using spatial interpolation technique of inverse weighted distance. Following this, the pixel-level weather variables were averaged for each province. However, before the spatial interpolation, all the weather stations located at 1000 meters above the sea level were removed from the dataset to avoid potential bias in the analysis that may be caused by high-altitude weather stations located in areas with little or no agricultural production and population settlement. However, in cases where the entire region is located in high mountain altitude areas, specifically the Gordo-Badahshan Autonomous province of Tajikistan, all the weather stations were kept.
<b>Monthly amount of available irrigation water</b>	Scientific-Information Center of the Interstate Coordination Water Commission of the Central	For some provinces of Kazakhstan with overwhelmingly rainfed agriculture, there were data only on annual amounts of irrigation

Variables	Sources	Notes
	Asia (SIC ICWC) available at <a href="http://www.cawater-info.net">http://www.cawater-info.net</a> and the reports of national water management authorities	water applied. These annual amounts were disaggregated into monthly using within month distribution of available irrigation water in the neighboring provinces for the corresponding year.
<b>Wheat and potato stocks</b>	National statistical agencies as well as international databases, such as FAOSTAT	The data on stocks was not always available in monthly frequencies at provincial level. In some cases it was available only at national level on annual basis. To correct for this discrepancy, the annual data disaggregated into monthly frequencies using the intra-monthly distribution of stocks from the other years when monthly data were available or from neighboring countries with similar cropping calendar, farming systems, and net trading position, and the share of the province in the production of wheat and potato was used as the weight to calculate the provincial share of the stocks.
<b>Yield shocks</b>	National statistical agencies	The annual wheat and potato yield series were decomposed into their idiosyncratic components. The corresponding values of these annual idiosyncratic shocks in crop yields were assigned to all the months of the same cropping year. In applying this procedure, it was assumed that crop yields at the point of harvest are influenced by all previous events that have taken place throughout the immediate cropping year.

Although this dataset is the first such a relatively rich and detailed long-term monthly dataset available for Central Asian countries, it has limitations and contains gaps, primarily in the stock and price variables. Therefore, in cases of provinces where there were missing points in any of these variable series, the missing data were imputed using the fitted values from the OLS regressions involving the variables for the neighboring provinces for which these data were available. There were fewer gaps in the available price series for the provinces of Kazakhstan, Tajikistan and Kyrgyzstan, while more gaps were in the price data for the provinces of Uzbekistan. The major underlying assumption behind the applied imputation method for missing data is the existence of strong price co-movement between the neighboring provinces. This seems to be a valid assumption, especially in the case of Uzbekistan where differences in agricultural prices within the provinces inside the country are small (Grafe, Raiser, & Sakatsume, 2005). This assumption is also corroborated by our own analysis of a separate dataset of retail prices for major 24 agricultural commodities between 2009 and 2010 in Uzbekistan. The average provincial cross-correlations in retail prices for these 24 agricultural commodities range between 0.81-0.98, and are reported in Table 2. Moreover, there is some evidence that the level of integration in agricultural consumer prices among the countries of Central Asia is also high (ibid.). As with most available cereal stock data (Wiggins & Keats, 2010), there may be unknown measurement errors in the stock variables, especially in terms of accurately estimating the extent of private stocks in the country. Importantly, the available data, unfortunately, does not allow for separating private and public stocks in order to econometrically account for differing aspects in the behavior of public and private stockholders, thus constituting a limitation of this study.

**Table 2. Average cross-correlations of major 24 agricultural commodities among the provinces of Uzbekistan between January, 2009 and January, 2010\*.**

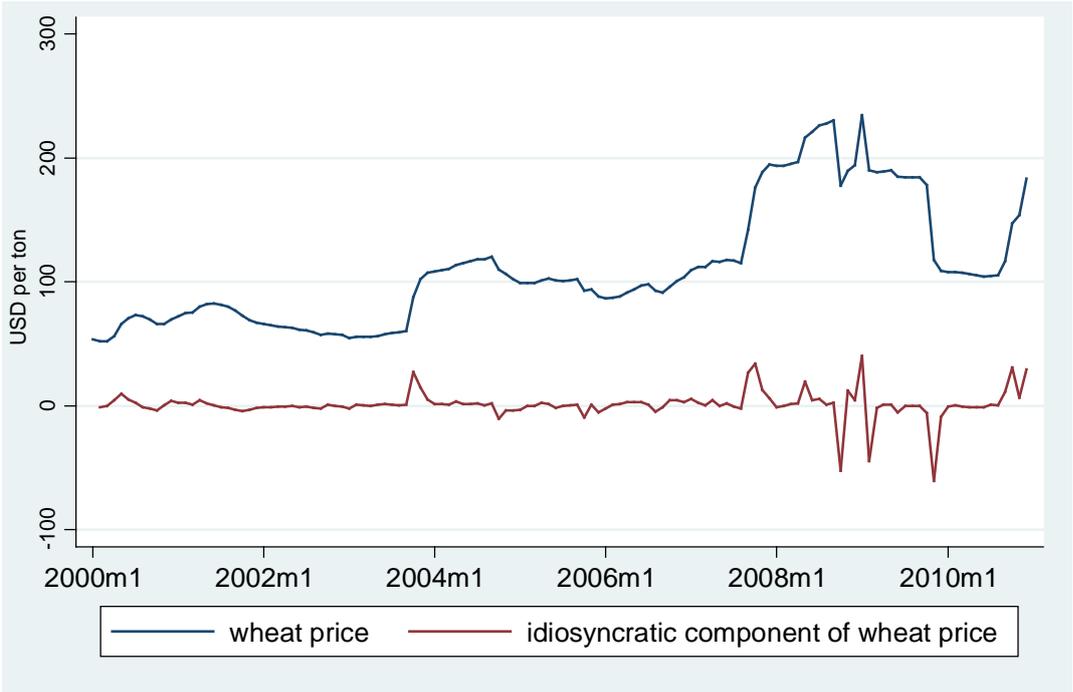
Provinces	Kar	And	Buh	Jiz	Qash	Nav	Nam	Sam	Sur	Sir	Tosh	Far	Hor
Karakalpakstan	1.00												
Andijon	0.88	1.00											
Buhoro	0.88	0.95	1.00										
Jizzah	0.83	0.92	0.89	1.00									
Qashkadaryo	0.84	0.96	0.96	0.88	1.00								
Navoi	0.91	0.96	0.95	0.86	0.96	1.00							
Namangan	0.86	0.98	0.96	0.91	0.95	0.93	1.00						
Samarqand	0.83	0.95	0.96	0.92	0.98	0.93	0.95	1.00					
Surhandaryo	0.83	0.95	0.97	0.90	0.97	0.93	0.95	0.97	1.00				
Sirdaryo	0.83	0.98	0.95	0.92	0.96	0.94	0.98	0.97	0.97	1.00			
Toshkent	0.81	0.96	0.95	0.92	0.96	0.92	0.97	0.97	0.96	0.98	1.00		
Farg'ona	0.87	0.98	0.96	0.93	0.97	0.95	0.98	0.97	0.97	0.98	0.97	1.00	
Horazm	0.88	0.93	0.96	0.94	0.93	0.93	0.94	0.95	0.96	0.94	0.94	0.96	1.00

\* The names of the provinces are abbreviated in the top row to fit the table into the page. The sequence of the provinces in the top row is the same as in the leftmost column.

In spite of all these actual and potential data limitations, it is believed that the results presented below can adequately serve as first, even if rough, estimates of the effects of specific temperature, precipitation and irrigation water availability shocks on agricultural prices, in the example of Central Asia. Crucially, the suggested new estimation method could be fruitfully used in future work involving less constraining datasets.

### 6. Results and Discussion

Following the first step of the empirical approach, the time series are decomposed into their latent components. Figure 2 shows an instance of this decomposition in the example of wheat prices in Akmola province of Kazakhstan. All other variables for the remaining provinces in Central Asia are also similarly decomposed. Following this preparatory stage, the idiosyncratic components of the variables are tested for cross-sectional dependence (Table 3).



**Figure 2. Decomposition of wheat price series into idiosyncratic components, Akmola province, Kazakhstan**

The Pesaran test (Pesaran, 2003) strongly rejects cross-sectional independence for all variables (Table 3), with p-values significant at less than 1%. The higher is the test statistic (CD-statistic), more strongly the panels are correlated. Similarly, the columns “corr” and “abs (corr)” show the estimated strength of the cross-sectional correlation. The test has shown

that idiosyncratic shocks in the variables are correlated across the countries of Central Asia. Further, for checking the presence of unit root the Pesaran panel unit root test in presence of cross sectional dependence is employed (Pesaran, 2007).

**Table 3. Pesaran test for cross-sectional dependence**

Variable	CD-statistic	p-value	corr	abs(corr)
Wheat price	77.61	0.000	0.255	0.349
Potato price	77.87	0.000	0.256	0.272
Precipitation	76.34	0.000	0.251	0.268
Temperature	168.99	0.000	0.555	0.555
Irrigation water	99.23	0.000	0.326	0.343
Wheat stocks	172.09	0.000	0.565	0.567
Potato stocks	262.26	0.000	0.861	0.861
Inflation rate	117.53	0.000	0.386	0.386
Exchange rate	118.11	0.000	0.388	0.388

The test confirms that the idiosyncratic parts of the variables are stationary (Table 4). The important references to look in the table are the p-values. Selection of the right number of lags can be crucial for the unit root tests. The stationarity tests were run with up to 12 lags and in all cases the presence of unit root was rejected at less than 1%. In Table 4, the results of the unit root test based on two lags are presented.

**Table 4. Pesaran panel unit root test in presence of cross sectional dependence**

Variables	t-bar	cv10	cv5	cv1	Z[t-bar]	P-value
Wheat price	-6.0	-2.1	-2.1	-2.2	-28.5	0.000
Potato price	-6.2	-2.1	-2.1	-2.2	-29.7	0.000
Precipitation	-5.9	-2.1	-2.1	-2.2	-27.6	0.000
Temperature	-5.2	-2.1	-2.1	-2.2	-23.2	0.000
Irrigation water	-6.2	-2.1	-2.1	-2.2	-29.8	0.000
Wheat stocks	-6.1	-2.1	-2.1	-2.2	-29.4	0.000
Potato stocks	-6.2	-2.1	-2.1	-2.2	-29.8	0.000
Inflation rate	-6.2	-2.1	-2.1	-2.2	-29.8	0.000
Exchange rate	-5.1	-2.1	-2.1	-2.2	-22.3	0.000

Note: 2 lags.

The tests confirm the theoretical hypothesis that idiosyncratic components of the variables are stationary. Thus, although non-stationarity is no longer a problem, there can be still other issues related with cross-sectional dependence, serial correlation and

heteroscedasticity. The Pesaran test for cross-sectional dependence carried out earlier has also confirmed the presence of cross-sectional correlation in the dataset. Moreover, Wooldridge test for autocorrelation in panel data (Wooldridge, 2002) and Likelihood ratio test for heteroscedasticity after FGLS confirm the presence of autocorrelation and heteroscedasticity in both wheat and potato models both at the first and second stages of the estimation. Based on these characteristics of the dataset, the feasible generalized least squares (FGLS) is adopted as the estimation method.

The first stage regression results using FGLS are presented in Table 5. They indicate that weather variables and availability of irrigation water may play a statistically significant role in storage decisions and yield shocks.

Shocks in temperature, precipitation and irrigation seem to have a convex relationship with shocks in wheat stocks. Higher than usual temperature and precipitation amounts, better than usual water availability could lead to expectations of higher wheat yields and lower future wheat price and thus provide incentives for lowering wheat stocks. This is also confirmed by statistically significant positive association between positive shocks in wheat yields (i.e., higher than usual wheat yields) and higher temperatures, precipitation and water availability. On the same token, lower water availability could encourage aggressive stock accumulation against expected supply shortfalls. Several interactions of temperature, precipitation and irrigation water availability are also statistically significant; however, mostly they are somewhat ambiguous. For example, the interactions generally have convex relationship with yield shocks when two variables such as temperature and precipitation, temperature and irrigation, and precipitation and irrigation are interacted. However, the relationship is concave when all three are interacted. In general, signs of the interactions in nonlinear models are strongly influenced by the nonlinearities in the model and should be taken with caution (Ai & Norton, 2003). Shocks in international wheat prices did not have a statistically significant effect on stock dynamics, however, they are positively associated with yield shocks, signifying that wheat producers may be responding to the changes in the international prices by modifying their production decisions, for example by applying more fertilizers when the prices go up. Kazakhstan is the only Central Asian country which may be considered as non-small supplier of wheat to the international market. Even allowing for this, the endogeneity between regional wheat yield shocks and international prices is unlikely to be a problem since under endogenous relationship the association between regional yield shocks and international prices should be negative and not positive as in the regression model. The exchange rate's impact on wheat stocks is ambiguous since the signs of the coefficients change with lags; however, it seems shocks in exchange rate seem to be positively correlated with yield shocks. Structurally, the link between exchange rate shocks and yield shocks passes through expected prices for exported output and changing prices for imported inputs, such as fertilizers and other chemicals.

In the case of potato, the key variable determining stock levels seem to be international prices for potato, whose coefficient signs are negative signifying that higher international prices for potato may lead to lower stocks of potato in the region. Since the potato prices in a neighboring province of Russia are taken as international potato prices, this signifies that higher prices for potato in Russia may be providing with incentives to export the potato instead of holding it in stock in the region. Weather variables have basically no significant effects on potato stocks. However, irrigation availability, precipitation and temperature have statistically significant convex effects on potato yield shocks. While the effects of the interactions in the weather variables on potato yield shocks are opposite of their effects on wheat yield shocks: generally concave when two variables such as temperature and precipitation, temperature and irrigation, and precipitation and irrigation are interacted, but convex when all the three are interacted.

One possible explanation for negative association with higher water availability and lower potato yields could be that potato is mainly grown in mountainous and higher-altitude areas of the region, thus higher water availability and excessive rainfall could imply higher incidences of flooding in these areas leading to lower potato yields. Another explanation, being located in high altitude areas, potato producers have “preferential” access to water resources and tend to over-irrigate, especially during periods with high water availability. Over-irrigation has been shown to reduce potato yields (for example, Stark, McCann, Westermann, Izadi, & Tindal (1993)). We first harvested the fitted values of shocks in stocks and yields for potato and wheat, which allows for instrumentalizing against potential endogeneity between wheat stocks and prices, yield shocks and prices, and also trace the link with weather variables. Then, wheat and potato prices are regressed on these fitted values, shocks in international prices for these commodities, in exchange and inflation rates. Country and time-specific effects are also included to account for unobserved shocks during the period. The results of the second stage are given in Table 6.

**Table 5. First stage of the model: impact of weather and other variables on yields and stocks (\*\*p<0.01, \*\* p<0.05, \* p<0.1)**

<b>VARIABLES</b>	<b>Potato yield shocks</b>	<b>Potato stocks (log)</b>	<b>Wheat yield shocks</b>	<b>Wheat stocks (log)</b>
<b>International price for the commodity</b>				
Level	2.95E-05	-0.000608***	0.000121**	0.000665
Lag 1	6.41E-05	-0.000236**	4.71E-05	0.000396
Lag 2	1.76E-05	-0.000201**	0.000110**	-0.000524
<b>Inflation</b>				
Level	0.00054	0.00697**	-4.05E-05	0.00777***
Lag 1	-0.00239	0.00514	-0.000168	0.00321
Lag 2	-0.00224	0.00351	0.000272	0.000756
<b>Exchange rate</b>				
Level	0.00101	-0.00159	0.000894***	-0.00320*
Lag 1	0.000946	0.000716	0.000602***	0.00504**
Lag 2	0.0015	0.000799	0.000447**	-0.00177
<b>Temperature</b>				
Level	-0.0838***	0.00376	0.0219***	0.00929
Lag 1	-0.0209	0.00168	0.0111***	-0.0113
Lag 2	0.00954	-4.03E-05	0.00195	-0.0529***
<b>Precipitation</b>				
Level	-0.0173***	0.000312	0.00157***	0.00315*
Lag 1	-0.00357	0.000334	0.000351	-0.00148
Lag 2	0.000716	5.39E-05	-0.00043	-0.00594***
<b>Irrigation (log)</b>				
Level	-0.0764***	-0.0043	0.0231***	0.0206
Lag 1	-0.00281	-0.00572	0.0122***	-0.0141
Lag 2	0.0113	-0.00739	0.00317	-0.0357**
<b>Temperature, squared</b>				
Level	0.00158***	-7.38E-05	0.000372***	0.00296***
Lag 1	0.000537	3.54E-05	5.14E-05	0.000693***
Lag 2	-0.000347	0.000114	-1.13E-05	0.000470**
<b>Precipitation, squared</b>				
Level	1.07e-05**	-6.24E-09	-7.28E-07	1.42E-06
Lag 1	8.61e-06*	8.78E-08	-9.29E-07	1.20E-06
Lag 2	-9.48E-08	-1.74E-07	-8.59E-07	2.52E-06
<b>Irrigation (log), squared</b>				
Level	-0.00262***	0.00114***	0.000170***	0.000741**
Lag 1	-0.00290***	0.000733**	0.000212***	0.000650**
Lag 2	-0.00141***	0.000443	0.000251***	-0.000471
<b>Interactions</b>				

VARIABLES	Potato yield shocks	Potato stocks (log)	Wheat yield shocks	Wheat stocks (log)
<b>Temperature and precipitation</b>				
Level	0.00160***	-2.16E-05	0.000138***	-3.44E-05
Lag 1	0.000587*	-3.89E-05	-1.69E-05	0.000172
Lag 2	7.01E-05	-3.22E-05	4.16E-05	0.000641***
<b>Irrigation and temperature</b>				
Level	0.00752***	-0.000511	-0.00313***	-0.000654
Lag 1	0.00364	1.04E-05	-0.00189***	0.0015
Lag 2	0.000879	0.000252	-0.000711**	0.00470***
<b>Irrigation and precipitation</b>				
Level	0.00203***	-5.74E-05	-0.00023***	-0.000345**
Lag 1	0.000847***	-1.96E-05	-0.00013***	7.71E-05
Lag 2	0.000255	1.98E-05	-4.88E-05	0.000384**
<b>Temperature, precipitation and irrigation</b>				
Level	-0.000195***	5.96E-06	2.17e-05***	2.64e-05*
Lag 1	-0.000101***	3.79E-06	1.14e-05***	-6.66E-06
Lag 2	-3.34E-05	9.49E-07	3.96E-06	-4.67e-05***
<b>Temperature and precipitation, squared</b>				
Level	2.10e-07***	-9.39E-09	-3.12e-08***	-1.09e-07***
Lag 1	1.74e-07***	-1.92E-09	-2.89e-08***	-4.07e-08**
Lag 2	9.07e-08***	3.66E-09	-1.96e-08***	-3.63e-08**
<b>Irrigation and temperature, squared</b>				
Level	6.65e-06***	-1.07E-07	3.00e-06***	-5.88e-06***
Lag 1	1.62E-06	-8.48E-07	2.09e-06***	-3.45e-06***
Lag 2	-2.66E-07	-8.09E-07	8.66e-07***	-2.21e-06**
<b>Irrigation and precipitation, squared</b>				
Level	-2.15e-07***	5.15E-09	3.28e-08***	4.86E-09
Lag 1	-2.11e-07***	-4.80E-09	3.16e-08***	2.44E-08
Lag 2	-1.11e-07***	-7.02E-09	2.71e-08***	4.99e-08**
<b>Temperature, precipitation and irrigation, squared</b>				
Level	4.19e-10***	0	-6.93e-11***	0
Lag 1	4.66e-10***	0	-6.20e-11***	-5.34E-11
Lag 2	2.48e-10***	0	-5.41e-11***	-7.69e-11*
<b>Country and time- effects</b>				
Constant	<b>yes</b>	<b>yes</b>	<b>yes</b>	<b>yes</b>
Constant	<b>-3.368***</b>	<b>0.102</b>	<b>0.698***</b>	<b>-0.912</b>
Observations	<b>4,940</b>	<b>4,940</b>	<b>4,940</b>	<b>4,940</b>

<b>VARIABLES</b>	<b>Potato yield shocks</b>	<b>Potato stocks (log)</b>	<b>Wheat yield shocks</b>	<b>Wheat stocks (log)</b>
<b>Number of panel</b>	<b>38</b>	<b>38</b>	<b>38</b>	<b>38</b>

The results indicate that wheat and potato markets, as a whole, in Central Asia are affected by shocks in the international prices for the respective commodities. There is about 0.11 USD of contemporaneous price transmission to local prices for every 1 USD of price shock in the international potato and wheat prices. Similarly, lagged price transmission is also statistically significant with 0.08 USD and 0.09 USD for every 1 USD price increase for wheat and potato in the preceding month, respectively.

The effect of inflation on prices is positively signed on both level and lag; both for potato and wheat. Potato prices seem to be more sensitive to inflationary pressures (less “sticky”) than wheat prices, which may indicate that Government policies target price controls on wheat as a socially more important commodity. Exchange rate devaluation is negatively associated with local wheat prices, both in current and lagged forms, whereas for potato prices, although the association is negative in the current level, it becomes positive in the lagged form. Upward shocks in exchange rates make current local wheat and potato prices denominated in local currency cheaper in USD terms. For potato, however, during the next period prices tend to rise. This is perhaps for two reasons: cheaper local prices make it more profitable to export potato abroad or less profitable to import from abroad, thus in both cases reducing local supply. Wheat export and import are strongly regulated and usually conducted by the Governments themselves in Central Asia through their specialized agencies, whereas potato trading is conducted virtually without any barriers by individual entities. Secondly, upward exchange shocks increase prices of imported goods, including inputs, etc, thereby leading to higher prices for potato in the following periods. Inputs for wheat production to some extent are subsidized in virtually all countries of the region. Shocks in stock levels and crop yields have statistically significant effects on commodity prices. If for wheat current and lagged positive shocks in stocks and crop yields lead to price decreases, for potato the situation is more ambiguous as the signs change with lags. The effect of positive shocks in wheat stocks and wheat yields on wheat prices is convex, as the squared terms are also statistically significant and are positively signed. The interactions of yield and stocks shocks are significant for both potato and wheat, however, the signs of interactions are opposite to the signs of individual variables, but similar to the signs of their quadratic terms, implying that interaction of stock and yield shocks moderates any dynamic effects of the individual variables on the prices. The relationship between potato stocks, potato yield shocks and prices may point at imperfections in the potato markets in Central Asia. Thus, combining the two stages of the model, positive shocks in irrigation water, temperature and precipitation, i.e. warmer temperatures, more rainfall and irrigation water availability seem more likely to lead to lower wheat prices, whereas for potato the effects of

changes in weather variables and irrigation water availability are more ambiguous and would more strongly depend on other market conditions.

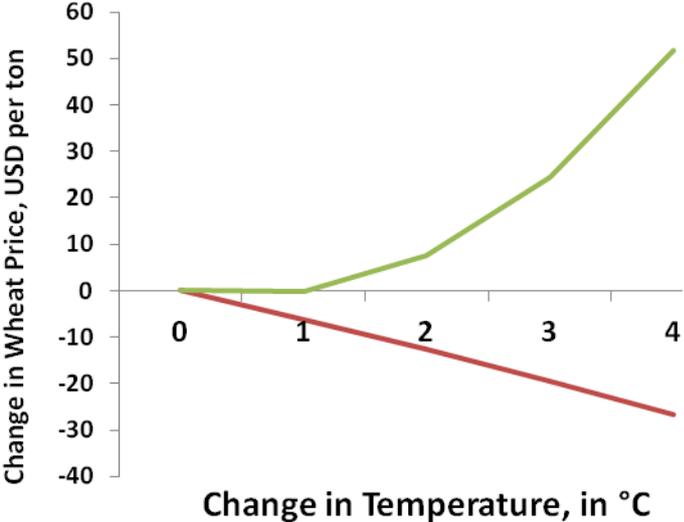
**Table 6. Second stage of the model: impact of shocks in stocks in yields and other variables on shocks in provincial wheat and potato prices**

VARIABLES	Wheat price	Potato price
International prices for the commodity (USD/t)		
Level	0.11***	0.11***
Lag 1	0.08***	0.09***
Inflation		
Level	0.1	.94*
Lag 1	0.65***	.45
Exchange rate (log)		
Level	-3.8***	-8.7***
Lag 1	-1.8***	5.2**
Yields (t/ha)		
Level	-249***	159***
Lag 1	-389***	-177***
Stocks (log)		
Level	-48***	167***
Lag 1	-63***	-216***
Interaction of stock and yield shocks		
Level	572*	-971***
Lag 1	2074***	1,247***
Yield shocks, squared		
Level	2,870***	-160***
Lag 1	915	214***
Stock shocks, squared		
Level	131***	-373*
Lag 1	-27	1356***
Interaction of stock and yield shocks, squared		
Level	-1,264	3.240***
Lag 1	-21,472***	-5,118***
Country and time effects		
	yes	yes
Constant	-33,1***	1.46
Observations	4,902	4,902
Number of panel	38	38

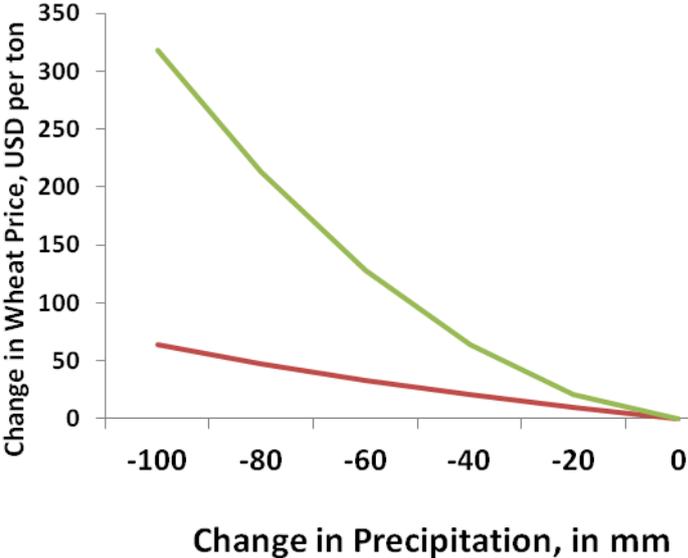
\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

As the effects of weather shocks on potato prices seem to depend more strongly on other market conditions rather than weather effects, we look at the elasticities of changes in

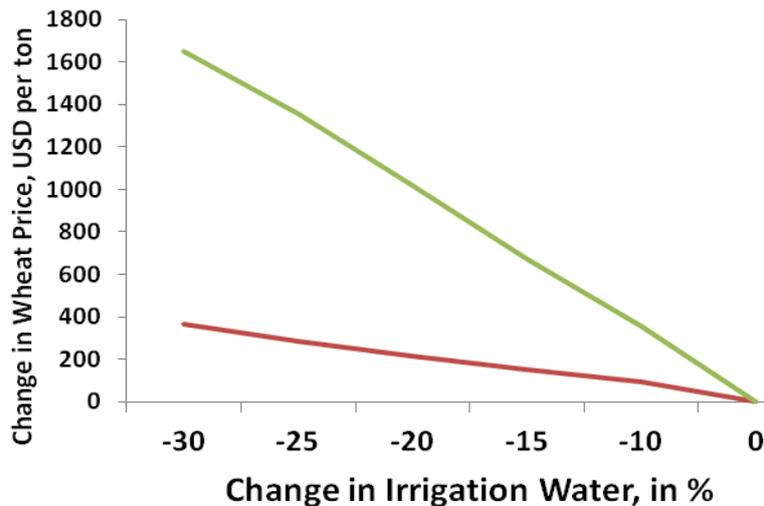
wheat prices with regard to changes in weather variables only. These elasticities, namely with regard to temperature, precipitation and availability of irrigation water, are striking (Figures 6). If the impact of higher temperatures on wheat prices is small and somewhat ambiguous with confidence intervals diverging at 0, the impact of lower precipitation and reduction in the availability of irrigation water are clear and, in fact, quite big. For example, reduction in precipitation by 100 mm may increase wheat prices by 64 to 318 USD per ton in the region.



**Figure 3. Impact of changes in temperature on changes in wheat prices**



**Figure 4. Impact of changes in precipitation on changes in wheat prices**

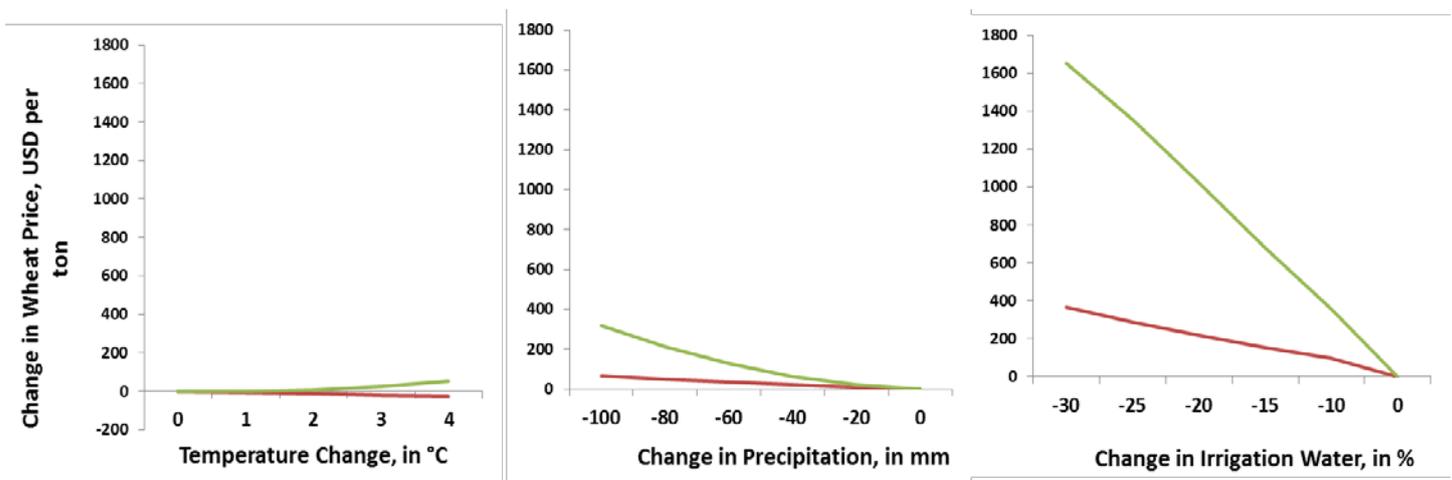


**Figure 5. Impact of changes in temperature, precipitation and availability of irrigation water on changes in wheat prices**

Note: Two lines represent higher and lower confidence intervals. Calculated based on the current lags.

Similarly, a 30% reduction in the availability of irrigation water may lead to dramatic price hikes, ranging from 364 to 1650 USD per ton, all other things being equal. The availability of irrigation water seems to have the biggest potential impact on wheat prices. To show this, Figure 6 homogenizes the relative scales of price changes.

The magnitudes of changes simulated in Figure 6 encompass the full range of potential negative climatic changes predicted by various global circulation models for Central Asia. The highest elasticity is shown by changes in the availability of irrigation water, implying that any sizable reductions in irrigation water could lead to dramatic increases in wheat price in the region.



**Figure 6. Comparison of the impacts of changes in temperature, precipitation and availability of irrigation water on changes in wheat prices**

Note: Two lines represent higher and lower confidence intervals. Calculated based on the current lags.

## **7. Conclusions and Implications**

Weather volatility and fluctuations in the availability of irrigation water have statistically significant effects on wheat and potato prices in Central Asia. Negative shocks in irrigation water availability and precipitation could create conditions for higher wheat prices, whereas for potato their effects are more strongly conditioned by other prevailing market factors. Lower availability of irrigation water could encourage irrigation-dependent countries of the region to raise wheat stocks to face expected supply shortfalls thus leading to higher prices. This effect could be further aggravated by negative effects of lower water availability on wheat yields. Moreover, the results show that wheat prices in the region are very sensitive to the availability of irrigation water, implying that hydrologic drought years have a strong potential to cause wheat prices spikes in the region. In order to counteract such developments, it is necessary to maintain storage policies and open trade arrangements in agricultural commodities in the region to minimize price volatility resulting from drought shocks.

## References

- Ai, C., & Norton, E. C. (2003). Interaction terms in logit and probit models. *Economics Letters*, 80(1), 123-129. doi: 10.1016/s0165-1765(03)00032-6
- Akaike, H. (1974). A new look at the statistical model identification. *Automatic Control, IEEE Transactions on*, 19(6), 716-723. doi: 10.1109/tac.1974.1100705
- Bai, J., & Ng, S. (2004). A PANIC Attack on Unit Roots and Cointegration. *Econometrica*, 72(4), 1127-1177. doi: 10.1111/j.1468-0262.2004.00528.x
- Baltagi, B. H. (2002). *Econometrics*. Berlin; New York: Springer.
- Barbieri, L. (2006). Panel Unit Root Tests: a Review. [UNIVERSITÀ CATTOLICA DEL SACRO CUORE]. *Economia – Quaderno*, 43.
- Barré, T. (2011). Price expectations and price dynamics: the case of the rice sector in developing Asia. *Post-Print and Working Papers, Universite Paris-1 Pantheon-Sorbonne.*, from <http://hal.archives-ouvertes.fr/hal-00630711>
- Boussard, J.-M. (1996). When risk generates chaos. *Journal of Economic Behavior & Organization*, 29(3), 433-446. doi: 10.1016/0167-2681(95)00081-x
- Breitung, J. (2000). The Local Power of Some Unit Root Tests for Panel Data. In: Baltagi, B. (ed.), *Nonstationary Panels, Panel Cointegration, and Dynamic Panels, Advances in Econometrics*, 15, 161-178.
- Burgess, R., & Donaldson, D. (2010). Can Openness Mitigate the Effects of Weather Shocks? Evidence from India's Famine Era. *American Economic Review*, 100(2), 449-453. doi: 10.1257/aer.100.2.449
- Chang, Y. (2002). Nonlinear IV unit root tests in panels with cross-sectional dependency. *Journal of Econometrics*, 110(2), 261-292. doi: 10.1016/s0304-4076(02)00095-7
- Chang, Y. (2004). Bootstrap unit root tests in panels with cross-sectional dependency. *Journal of Econometrics*, 120(2), 263-293. doi: 10.1016/s0304-4076(03)00214-8
- Choi, I. (2001). Unit root tests for panel data. *Journal of International Money and Finance*, 20(2), 249-272. doi: 10.1016/s0261-5606(00)00048-6
- Choi, I. (2006). Combination unit root tests for cross-sectionally correlated panels. *Econometric theory and practice : frontiers of analysis and applied research*.
- Cochrane, W. W. (1958). *Farm prices, myth and reality*. Minneapolis: University of Minnesota Press.
- Deaton, A., & Laroque, G. (1992). On the Behaviour of Commodity Prices. *The Review of Economic Studies*, 59(1), 1-23.
- Deaton, A., & Laroque, G. (1996). Competitive Storage and Commodity Price Dynamics. *Journal of Political Economy*, 104(5), 896-923.
- Deaton, A., & Laroque, G. (2003). A model of commodity prices after Sir Arthur Lewis. *Journal of Development Economics*, 71(2), 289-310. doi: 10.1016/s0304-3878(03)00030-0
- Enders, W., & Granger, C. W. J. (1998). Unit-Root Tests and Asymmetric Adjustment With an Example Using the Term Structure of Interest Rates. *Journal of Business & Economic Statistics*, 16(3), 304-311. doi: 10.1080/07350015.1998.10524769
- Engle, R. F., & Granger, C. W. J. (1987). Co-Integration and Error Correction: Representation, Estimation, and Testing. *Econometrica*, 55(2), 251-276.

- Erdil, E., & Yetkiner, H. (2004). A Panel Data Approach for Income-Health Causality. [Working Papers FNU-47, Research unit Sustainability and Global Change, Hamburg University].
- Ezekiel, M. (1938). The Cobweb Theorem. *The Quarterly Journal of Economics*, 52(2), 255-280. doi: 10.2307/1881734
- Fafchamps, M. (1992). Cash Crop Production, Food Price Volatility, and Rural Market Integration in the Third World. *American Journal of Agricultural Economics*, 74(1), 90-99. doi: 10.2307/1242993
- Fox, J., Fishback, P., & Rhode, P. (2011). The Effects of Weather Shocks on Crop Prices in Unfettered Markets: The United States Prior to the Farm Programs, 1895-1932. In: *Libecap, G. and Steckel, R. (eds.), 2011. The Economics of Climate Change: Adaptations Past and Present. NBER Books, National Bureau of Economic Research, Inc, number libe10-1.*
- Frankel, J. A. (1986). Expectations and Commodity Price Dynamics: The Overshooting Model. *American Journal of Agricultural Economics*, 68(2), 344-348. doi: 10.2307/1241436
- Gilbert, C. L., & Morgan, C. W. (2010). Food price volatility. *Philosophical Transactions of the Royal Society B: Biological Sciences*, 365(1554), 3023-3034. doi: 10.1098/rstb.2010.0139
- Grafe, C., Raiser, M., & Sakatsume, T. (2005). *Beyond borders reconsidering regional trade in Central Asia*. London: European Bank for Reconstruction and Development.
- Granger, C. W. J., & Lee, T. H. (1989). Investigation of production, sales and inventory relationships using multicointegration and non-symmetric error correction models. *Journal of Applied Econometrics*, 4(S1), S145-S159. doi: 10.1002/jae.3950040508
- Hadri, K. (2000). Testing for stationarity in heterogeneous panel data. *Econometrics Journal*, 3(2), 148-161. doi: 10.1111/1368-423x.00043
- Harvey, A. C. (1990). *Forecasting, structural time series models, and the Kalman filter*. Cambridge; New York: Cambridge University Press.
- Headey, D., & Fan, S. (2008). Anatomy of a crisis: the causes and consequences of surging food prices. *Agricultural Economics*, 39, 375-391. doi: 10.1111/j.1574-0862.2008.00345.x
- Hommel, C. H. (1992). Cobwebs, chaos and bifurcations. *Annals of Operations Research*, 37(1), 97-100. doi: 10.1007/bf02071050
- Im, K. S., Pesaran, M. H., & Shin, Y. (2003). Testing for unit roots in heterogeneous panels. *Journal of Econometrics*, 115(1), 53-74. doi: 10.1016/s0304-4076(03)00092-7
- IPCC, I. P. o. C. C. (2012). *Managing the Risks of Extreme Events and Disasters to Advance Climate Change Adaptation Special Report of the Intergovernmental Panel on Climate Change*: Cambridge Univ Pr.
- Jayne, T., & Tshirley, D. (2009). Food price spikes and strategic interactions between the public and private sectors: Market failures or governance failures? [Paper presented at the meeting "Institutions and Policies to Manage Global Market Risks and Price Spikes in Basic Food Commodities", Trade and Markets Division, FAO Headquarters, Rome, 26-27 October 2009].
- Jensen, R. (2000). Agricultural Volatility and Investments in Children. *The American Economic Review*, 90(2), 399-404.
- Jolejole-Foreman, M., & Mallory, M. (2011). Analyzing Market Price Transmission, Government Intervention and Weather Shocks for Rice Market in the Philippines. [Selected Paper prepared for Presentation at the Agricultural & Applied Economics Association's 2011 AAEA & NAREA Joint Annual Meeting, Pittsburgh, July 24-26, 2011].

- Levin, A., Lin, C.-F., & James Chu, C.-S. (2002). Unit root tests in panel data: asymptotic and finite-sample properties. *Journal of Econometrics*, 108(1), 1-24. doi: 10.1016/s0304-4076(01)00098-7
- Maddala, G. S., & Wu, S. (1999). A Comparative Study of Unit Root Tests with Panel Data and a New Simple Test. *Oxford Bulletin of Economics and Statistics*, 61(S1), 631-652. doi: 10.1111/1468-0084.0610s1631
- Mitchell, D. O. (2008). A note on rising food prices, from [http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469372&piPK=64165421&menuPK=64166093&entityID=000020439\\_20080728103002](http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469372&piPK=64165421&menuPK=64166093&entityID=000020439_20080728103002)
- Mitra, S., & Boussard, J.-M. (2012). A simple model of endogenous agricultural commodity price fluctuations with storage. *Agricultural Economics*, 43(1), 1-15. doi: 10.1111/j.1574-0862.2011.00561.x
- Moon, H. R., & Perron, B. (2004). Testing for a unit root in panels with dynamic factors. *Journal of Econometrics*, 122(1), 81-126. doi: 10.1016/j.jeconom.2003.10.020
- Mundlak, Y., & Larson, D. F. (1992). On the Transmission of World Agricultural Prices. *The World Bank Economic Review*, 6(3), 399-422. doi: 10.1093/wber/6.3.399
- Muth, J. F. (1961). Rational Expectations and the Theory of Price Movements. *Econometrica*, 29(3), 315-335.
- Nerlove, M. (1958). Adaptive Expectations and Cobweb Phenomena. *The Quarterly Journal of Economics*, 72(2), 227-240.
- Pesaran, M. H. (2003). *A simple panel unit root test in the presence of cross section dependence*. Cambridge: University of Cambridge, Dept. of Applied Economics.
- Pesaran, M. H. (2007). A simple panel unit root test in the presence of cross-section dependence. *Journal of Applied Econometrics*, 22(2), 265-312. doi: 10.1002/jae.951
- Rapsomanikis, G., Hallam, D., & Conforti, P. (2003). Market integration and price transmission in selected food and cash crop markets of developing countries: review and applications. In *FAO, Commodity Market Review, FAO Commodities and Trade Division, Rome*.
- Ravallion, M. (1986). Testing Market Integration. *American Journal of Agricultural Economics*, 68(1), 102-109. doi: 10.2307/1241654
- Roberts, M. J., & Schlenker, W. (2009). World Supply and Demand of Food Commodity Calories. *American Journal of Agricultural Economics*, 91(5), 1235-1242. doi: 10.1111/j.1467-8276.2009.01290.x
- Roll, R. (1984). Orange Juice and Weather. *The American Economic Review*, 74(5), 861-880.
- Samuelson, P. A. (1952). Spatial Price Equilibrium and Linear Programming. *The American Economic Review*, 42(3), 283-303.
- Solomou, S., & Wu, W. (1999). Weather effects on European agricultural output, 1850–1913. *European Review of Economic History*, 3(3), 351-373. doi: 10.1017/s1361491699000167
- Stark, J., McCann, I., Westermann, D., Izadi, B., & Tindall, T. (1993). Potato response to split nitrogen timing with varying amounts of excessive irrigation. *American Journal of Potato Research*, 70(11), 765-777. doi: 10.1007/bf02849104
- Takayama, T., & Judge, G. G. (1964). Equilibrium among Spatially Separated Markets: A Reformulation. *Econometrica*, 32(4), 510-524.

- Torero, M., & von Braun, J. (2010). Alternative mechanisms to reduce food price volatility and price spikes. [Paper presented at the International Food & Agricultural Trade Policy Council. May 2010. Barcelona, Spain.].
- von Braun, J., Ahmed, A., Asenso-Okyere, K., Fan, S., Gulati, A., Hoddinot, J., . . . von Grebmer, K. (2008). *High food prices : the what, who, and how of proposed policy actions*. Washington D.C.: International Food Policy Research Institute.
- von Braun, J., & Tadesse, G. (2012). Global Food Price Volatility and Spikes: An Overview of Costs, Causes, and Solutions. *ZEF Discussion Papers*, 161.
- von Cramon-Taubadel, S. (1998). Estimating asymmetric price transmission with the error correction representation: An application to the German pork market. *European Review of Agricultural Economics*, 25(1), 1-18. doi: 10.1093/erae/25.1.1
- von Cramon-Taubadel, S., Loy, J.-P., & Meyer, J. (2003). The impact of data aggregation on the measurement of vertical price transmission: Evidence from German food prices. [Paper prepared for presentation at the American Agricultural Economics Association Annual Meeting, Montreal, Canada, July 27-30, 2003].
- Webb, P., von Braun, J., & Yohannes, Y. (1992). *Famine in Ethiopia : policy implications of coping failure at national and household levels*. Washington, D.C.: International Food Policy Research Institute.
- Wiggins, S., & Keats, S. (2010). Grain stocks and price spikes. [Annex 2 of Agricultural Price Spikes 2007/2008: Causes and Policy Implications, London, DEFRA. <http://archive.defra.gov.uk/foodfarm/food/pdf/ag-price-annex%202.pdf>].
- Williams, M. W., & Konovalov, V. G. (2008). Central Asia Temperature and Precipitation Data, 1879-2003 [1990-2003]. [Boulder, Colorado: USA National Snow and Ice Data Center. Digital media].
- Wooldridge, J. M. (2002). *Econometric analysis of cross section and panel data*. Cambridge, Mass.: MIT Press.