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Policy errors: They can't be eliminated, but can they be reduced?

by Dale E. Hathaway and G. Edward Rossmiller

"The past is prologue" is the inscription over the portals of the National Archives Building in Washington, D.C. Makers of policy will do well to take heed.

In this spirit we take a brief but sweeping tour of key events and policies which affected the food and agricultural system during the two very different decades of the 1970s and the 1980s. We show how wrong assumptions, unexpected events, and policy responses led to policy errors that, taken together, compounded the adverse effects of individuals operating in what they believed to be their own self interest. Our conclusions can, we hope, help future policy makers avoid some of the pitfalls of the past.

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Dale E. Hathaway is director and senior fellow at the National Center for Food and Agricultural Policy and president of Hathaway International, Inc.; George E. Rossmiller is director of the Situation and Outlook Division of the Food and Agriculture Organization of the United Nations in Rome. He is former director of the National Center for Food and Agricultural Policy at Resources for the Future.

The world food crisis

The food crisis that rocked the world in the 1970s is probably one of the most vivid examples of the interaction of unexpected events, wrong assumptions, and policy responses with unexpected and unintended consequences. What happened and the policy responses to the crisis is a case study of unintended side effects.

In general, the facts are briefly as follows: in the 1972–73 crop year in the northern hemisphere, world wheat and coarse grain production declined by some 32 million tons, or about 3.5 percent. The same year, the Soviet Union changed its long-standing policy of self-sufficiency in grain and entered world markets as a major grain importer to make up for its internal shortfall. As a result, there was a 50 percent increase in international trade in wheat and coarse grains between 1971–72 and 1972–73.

The combination of a modest shortfall in world output and the entry of the Soviet Union into world markets caused a market price explosion for grains and oilseeds. For instance, between 1972 and 1973 the nominal price of food commodities in world markets, according to the IMF, rose 80.4 percent (53.5 percent in real terms).

It is easy to be coldly analytical about the world food crisis in retrospect. It is important to note, however, that the world utilization of wheat and coarse grains actually increased between 1972 and 1973 and again through 1973–74 as stocks were reduced. It was not until 1974–75 that world wheat and coarse grain consumption actually fell below the previous year for the first time in more than a decade.

The immediate policy response of many countries was to take actions that exacerbated the situation. A number of exporting countries limited exports to avoid domestic price inflation. Wealthy importing countries scrambled wildly to lock up supplies well in advance of their needs. Thus, national trade policies made matters worse, not better, because the shortfall was spread unevenly among countries.

Despite these facts, all sorts of assertions

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were made by responsible people. They included the following:

(1) a world food shortage loomed and food shortages would be a semi-permanent feature of the future because of significant adverse changes in the weather, (2) millions of people, especially in developing countries, would starve, and (3) the world needed all-out agricultural production, or as it was once put vividly by former agriculture secretary Earl Butz, we needed to plant "from fencerow to fencerow." It was concluded both at the national and international level that policies were needed to encourage agricultural output expansion on a world wide basis.

The World Food Conference in Rome in November 1974 concentrated almost exclusively on how to expand agricultural output in developing countries. Participants gave the highest priority to output expanding investments and practices, relatively little attention to the barriers to open trade in agricultural products which had contributed significantly to the "world food crisis," and no attention at all to the possible adverse side effects of policies to expand agricultural output.

The food crisis and rise in commodity prices reinforced advocates of expanding high-cost agricultural production in industrial countries. Before the crisis, high levels of support and protection in industrial countries had to be defended as temporary programs to ease adjustments. Now such support could be justified as necessary to insure use of scarce food production resources. The Congress readily took the opportunity to guarantee higher prices to farmers. The administration quickly removed all production restraints and encouraged the planting of crops "from fencerow to fencerow" as urged by the former U.S. Secretary of Agriculture.

Perhaps one of the most serious and long lasting policy shifts was cheap agricultural credit policies followed by the U.S. public lending institutions and the private banking sector. These lending policies together with the erroneous expectations regarding future prices which were created by the predictions of permanent food shortages, led to serious land price inflation in the United States. This land price inflation was the root of the subsequent financial distress in American agriculture in the 1980s.

OPEC, monetary policy, and LDC debt

The great world food crisis was intensified by the first oil shock. In 1973, the OPEC cartel doubled the price of oil just as the crop shortfall appeared. Food production became more costly as the prices of fuel and petroleum based agricultural chemicals and fertilizers were affected directly and prices of other agricultural inputs such as farm machinery were affected indirectly.

The flood of petrodollars into the OPEC treasuries began to pile up, even as these countries tried in vain to spend the newfound wealth both on serious development and on opulent and frivolous consumer goods and services. Soon OPEC officials turned to commercial banks in Europe and North America to recycle petrodollars.

Developing countries took advantage of this newfound source of international liquidity at low or negative real interest cost. Western bank lending to the less developed and (then) centrally planned economies increased at the rate of 20 percent per year throughout most of the 1970s. Rather than tighten their belts to adjust to the higher prices of almost everything brought about by the high price of oil, developing countries expanded spending based on borrowed petrodollars. While some of these borrowed funds were put to sound investment use, significant amounts were invested in projects where the payback terms could not meet prudent debt service requirements. Moreover, significant numbers of these loans were used for consumer goods from which no payback revenues were generated. The presumption made by borrower and lender alike was that the petrodollar cash cow would continue spreading its largess forever, with payback in ever-inflating and cheaper currency. Latin America alone accumulated an external debt of nearly $400 billion.

In the early 1980s, the bubble burst. After the second oil shock in 1979, developed country monetary authorities abruptly reversed their cheap money policy. This time, concern about inflation, already at unprecedented levels in many countries, outweighed the desire to maintain high economic growth. Monetary policy was tightened throughout the developed world, economic growth slowed and in many cases turned negative, real interest rates soared, and the world was plunged into a recession.

Banks abruptly choked off further petrodollar lending. By 1982, many heavily indebted developing countries saw a reversal in their net international capital flows as debt service, particularly with the high real interest rates, overwhelmed the much lower levels of new lending. As developing-country growth ended, import demand contracted and export earnings fell. Foreign exchange for imports of goods and services by developing countries suddenly became very scarce. Since 1983, the developing countries have been net exporters of capital, with present transfers reaching nearly $50 billion per year. Trade growth, including that in agricultural products, lost momentum and in many cases declined absolutely.

The sharp changes in macroeconomic policies had a major impact on agriculture in countries heavily dependent upon agricultural trade. For the first time since the Great Depression, the agricultural sector found that macroeconomic events were more important than sector-specific policies. During the boom period of the 1970s, long-term trends were obscured and policy actions exacerbated the subsequent adjust-

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ment. In the 1980s, the end of the artificial growth in world consumption, which had been due in part to the credit boom of the 1970s, brought world commodity prices to the lowest level in decades despite the huge increases in spending for farm price and income support in most developed countries.

The farm problems created by international commodity and credit markets were exacerbated in the United States by domestic policy, as we show later. One general result, however, was increased competition for available markets and increasing trade tensions, particularly between the United States and the European Community. The rising use of export restitutions by the EC prompted the U.S. Congress, in the spirit of "fighting fire with fire," to legislate and appropriate funds for the Export Enhancement Program (EEP) to subsidize U.S. commodities into world markets in an effort to "regain" U.S. market share. The result has been mainly to further reduce international commodity prices, to exacerbate tensions with the EC, and to create new tensions between the United States and other exporters (Australia, Canada, Argentina).

The drive to expand and intensify agricultural production in the 1970s to meet export demands met with little or no resistance from groups concerned with conservation and environment, which at the time had little influence in any case. Ironically, it was not until the export boom had collapsed that environmental interests began to exert pressure to change agricultural policy to be more environmentally friendly.

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The common agricultural policy (CAP)

The CAP of the European Community was developed initially by the original community of six countries in the 1960s. It was based on some significant assumptions, which have turned out in error, and led to a policy that in retrospect appears a mistake.

The first assumption that went into the formulation of the CAP was that the EC was a food deficit area and would remain so indefinitely. This assumption led the EC to devise a policy that depended upon the maintenance of high internal prices by the use of variable border protection, and which depended largely upon revenue received from the import levies for financing.

A second assumption was that the EC was an area of small, inefficient farms that could not compete with the rest of the world, either then or in the future. Thus, they needed permanent protection against more efficient outside producers.

A third assumption was that because of farm structure and other reasons, European agricultural output was not very price-responsive. Therefore it was both possible and desirable to achieve income equity goals for farmers by the use of high internal agricultural prices.

The crucial elements of the Common Agricultural Policy were put in place in the early 1960s. The internal price levels for agricultural products were set well above world price levels to achieve adequate incomes for farmers in the highest cost producing areas within the Community. Moreover, as time passed, the Community attempted to maintain real agricultural prices in the face of moderate inflation, even though on a world level the experience had been that real commodity prices had a long-term downtrend.

The policy was designed to completely isolate the internal producers from world market price movements, either up or down. Therefore, EC farm output was not expected to react to changes in world markets.

As the world food crisis appeared, EC policymakers' views as to the unreliability of world markets were confirmed. Their isolation from world markets saved their producers and consumers from the extreme shocks of the early 1970s and the need for high-level production in the EC was argued from the high world prices. Expanding output to meet world food needs became a goal.

By 1980 the EC was a surplus producer of several agricultural products. In the 1980s they became large net exporters of dairy, beef, poultry, grains, and other products just when the international prices of these products were collapsing. Because of their high internal prices, they were forced to export these surplus products at declining world prices via the use of increasingly expensive export subsidies. These subsidized exports were immensely disruptive to world markets already suffering from a collapse in import demand. And domestically the high internal prices, together with improved technology, provided great incentives for intensification of European agriculture, and lead to severe environmental pollution problems and increasing budget costs. As a consequence, the European Community policy became highly objectionable both at home and abroad.

Finally in 1991, in a landmark paper, officials of the European Community admitted that their Common Agricultural Policy was based upon principles that were no longer valid, assumptions that no longer held, and that a major revision of the policy was required in order to reduce excess production, reduce program costs, and diminish adverse environmental impacts, as well as to reduce the substantial disruption of international markets by European surplus dumping.

U.S. agricultural policy in the 1970s and 1980s

U.S. agricultural support policy shifted in the 1970s away from high price support and tight controls on output toward greater reliance on market determined commodity prices, with income support provided as needed through target prices and deficiency payments. A major effect of this policy shift

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was to make U.S. agriculture competitive in world markets, just as those markets began a period of unprecedented growth.

During this period, world commodity prices remained strong, and direct government price support outlays averaged only about $3.4 billion per year. During the 1970s, U.S. loan rates were below world prices and were adjusted upward during the period to keep pace with rising production costs. The strong world prices allowed these adjustments without difficulty.

By 1981, when the farm bill renewal was being debated, the agricultural community was euphoric, exports were booming, real interest rates were low, inflation was in double digits meaning that land values were rising (at least on paper) and loans were being paid off in ever cheaper dollars. In this environment, the drafters of the 1981 farm bill made two wrong assumptions: first, that the export boom would continue indefinitely into the future, and second, that inflation would continue, while perhaps not in double digits, at relatively high rates throughout the four year life of the bill. They then converted their erroneous assumptions about the future into bad policy by scheduling yearly increases in loan rates and target prices through the life of the bill.

Given the tightening of U.S. and other developed countries' monetary policy, which had already taken place, the predictable happened. Inflation dropped, real interest rates rose, the value of the dollar soared, U.S. agricultural exports dropped precipitously, and world commodity prices fell below the U.S. loan rates. These events precipitated a rapid build up in CCC stocks as farmers forfeited crops in lieu of paying off commodity loans. The United States lost competitive position in world markets as world prices fell below the loan rates.

Although concern had been raised in the late 1970s by some environmental and conservation groups about the soil loss associated with intensive export production, the 1981 farm bill, while alluding to this issue, proposed little to alleviate or solve the problem. The expectation of continued high export demand and a favorable economic climate to increase production overshadowed the conservationist and environmentalist concerns.

It is instructive to note that the 1981 farm bill passed just before Christmas by only one vote in the House of Representatives, in part because it was seen as not generous enough to farmers. In fact, it was to be the most expensive farm bill in history up to that point, with an average annual outlay for farm commodity price support of $13.9 billion.

The environment for the 1985 farm bill debate was much different from that in 1981. Three objectives were sought: first, to restore U.S. agriculture competitiveness in international markets; second, to not exacerbate the financial problems of debt burdened farmers; and third, to accomplish the first two objectives at minimum budget cost.

U.S. competitiveness was restored by two actions—a sharp reduction in loan rates and a widespread resort to the use of export subsidies on a variety of commodities. In the case of cotton and rice, support loans were dropped entirely, and the government made direct payments to bridge the gap between a stable target price and fluctuating world prices.

In order to maintain producers' incomes, target prices were held high. Target prices were frozen for the first three years of the bill at 1985 levels and then reduced slightly, about 10 percent over the last two years of the bill. Widening the spread between target prices and support levels assured that the budget objective would not be met, and sure enough, the average annual budget cost of farm support over the five year life of the 1985 Food Security Act was $15.6 billion, with an all time record peak in budget spending in 1986 of $25.8 billion.

For the first time, in 1985, environmentalists appeared to get their foot in the door on agricultural legislation. During the early 1980s, chemical and fertilizer contamination in groundwater was detected. Further, the evidence of erosion on fragile lands from intensive production had become compelling.

Purporting to respond to environmental issues the Conservation Reserve Program (CRP) was introduced in the 1985 bill. The CRP was designed to take up to 40 million acres of fragile and erosion prone land out of agricultural production on 10-year contracts.

But the compelling factor that pushed the CRP was simply that production from these lands was not needed and moreover would be a drag on the market. What happens when the 10-year contracts expire is anybody's guess. Sodbuster and swampbuster provisions of the 1985 bill, which prevent the opening of new, fragile land to agricultural production, struck more directly at environmental concerns.

The 1990 farm bill debate took place in yet a different economic environment. Agricultural exports had turned upward from their 1985/86 low, farm incomes were near an all-time high, farmers were generally happy with the 1985 legislation, and, with minor corrections, were ready to extend its provisions into the 1990s.

Environmentalists, having gotten their foot in the door in 1985, attempted to consolidate their foothold and extend their 1985 gains in the 1990 bill. It did not happen; only marginal tightening of environmental considerations occurred in the 1990 bill including stricter cross compliance on environmental practices to receive farm-support benefits and record-keeping requirements on the use of pesticides.

The big change in agricultural policy came, not in the 1990 farm bill but in the Omnibus Budget Reconciliation Act, because of pressures to reduce the budget deficit. Only two ways were available to reduce spending—reduce the target price

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(which was not politically acceptable) or reduce the amount of production eligible for benefits. The latter course was taken by establishing the so called "triple base," which limited the production eligible for deficiency payments to production from 85 percent of the acreage permitted to be planted. Because the 1985 bill had frozen program yields, this action capped the potential budget outlay and in effect "decoupled" U.S. farm programs at the margin. Early evidence indicates that reduced use of chemicals and fertilizer has resulted. Thus, the U.S. farm programs backed into improved conservation and environment positions in the process of other adjustments.

Conclusions

Viewing the major macro events and the policy response to them as a whole leads to several conclusions.

First, policymakers' actions are dominated by the immediate economic environment within which they make their decisions. Short-term phenomena, even aberrations, are treated as long-term trends. The world food crisis could only get worse. The petrodollars would flow forever. The EC would always be a food-deficit producer and the United States would capture an ever increasing share of a continually expanding export market. Given the fact that economic change and uncertainty are certain characteristics of world markets, as long as no change is assumed, the policy will almost certainly be wrong. Therefore, the first way to improve policy is to examine the impact of changing assumptions.

Second, agricultural adjustments to changing markets are often difficult and painful and thus are avoided if possible. Consequently, much policy-making energy is expended on attempting to maintain the status quo in the face of compelling economic and social trends that require adjustment and policy action. In most cases, an equivalent amount of energy spent to ease adjustments would produce less economic and political friction.

Third, in today's economically interdependent world, macroeconomic events and policies, particularly of the larger industrial countries, affect everyone. Isolationists can no longer hide. But macroeconomists who worry about inflation, growth, interest, and exchange rates in the aggregate, often do not consider the impacts of their policies on the real sectors of the economy where real people are affected. Moreover, agricultural policymakers often do not understand, or they simply ignore, the impacts of macroeconomic policy on their agricultural sectors.

Fourth, policies are often put in place with conflicting objectives and thus with conflicting results. Witness the one foot on the gas and one foot on the brake approach of the U.S. price support and acreage reduction programs. Policies interact, not only nationally, but also internationally to cause unintended and often unwanted effects. Note the resulting surpluses when all countries responded to the perceived world food crisis by planting "fence row to fence row;" or the trap the indebted developing countries fell into when the developed countries reversed monetary policy in the early 1980s.

Fifth, in trade-offs between economic self interest and the perceived public interest, self interest usually wins. For example, in most developing countries a clean and sustainable environment is often viewed as a luxury good. When trade-offs between the environment and development must be faced, environmental quality generally loses. In trade-offs between present and future consumption, especially if future consumption is intergenerational, present consumption wins. Such results are unfortunate, but all too common. When the perceived world food crisis hit, countries pulled out all stops and strove for self-sufficiency, often against their comparative advantages, unmindful of the environmental consequences and ignoring trade as a way of making up deficits. When petrodollars were plentiful and cheap, developing countries borrowed to purchase consumption goods, including food, to maintain current levels of living, with little regard to how the loan would be repaid.

Finally, and perhaps most importantly, the policy environment is a constantly shifting target. Conditions change, unexpected events occur. Instead of always reacting to crises, policy makers and their staffs could be much more effective if they made a practice of continually reviewing the fit of their policies and programs to the changing and projected situation, particularly in the context of whether their last set of assumptions are still valid. If not, what policy changes do their new assumptions suggest? If well understood and remembered, the past can, indeed, be prologue. ■

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