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On the Issues

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When the Price of Bad Policy Is Hunger

By Adam Lerrick

The past year has seen an explosion in the price of food that has plunged hundreds of millions of people into poverty and privation throughout the developing world. Protest in thirty-four countries—from Mexico and Indonesia to Egypt and Côte d'Ivoire—has followed. In fourteen nations, violence has erupted. This tragedy is the result of neither a natural disaster nor an inability to produce sufficient food at reasonable cost. Bad policies in rich nations have restricted output, diverted crops from food to energy production, and stopped emerging-nation farmers from increasing capacity.

Prices for the world's staple crops—corn, rice, wheat, and soybeans—have doubled in one year. For a decade, growth in the world's demand for food has greatly outstripped the increase in supply. Global food stocks have collapsed to fifty days—their lowest level in more than half a century—down from one hundred days just six years ago. These trends are illustrated in figures 1 and 2 on pages 2–3.

The rise in prices is a concern for the citizens and policymakers of rich nations, which spend 15 percent of their income on food. But in poor countries, whose people spend up to 75 percent of their earnings on food, it is a matter of survival. The doubling of food prices has cut the wages of the poorest by more than one-third, wiping out a decade of progress in reducing global poverty.

The rise in hunger is not the result of a crisis in the global supply of food but of the impact of price increases on the lives of the poor. Markets are full of food that developing-country consumers do not have the money to buy. To protect their people, developing-country governments are being forced to make choices that will further delay the path to prosperity. Food subsidies are eating up their scarce funds needed for schools, hospitals, roads, and electricity. To rein in an inflation imported from international markets, central banks are raising interest rates and sacrificing growth to prevent a price-wage spiral.

Leaders are imposing price ceilings and export restrictions that keep domestic prices down but reduce incentives to plant and expand production. One-third of the world's population now lives under food price controls. India and Vietnam—respectively the world's second and third biggest exporters of rice, which provides the core diet for half of the globe's people—have banned foreign sales. One-third of the world's wheat suppliers, from Australia to Argentina, have restricted shipments. China has imposed massive export tariffs on fertilizer to contain domestic costs.

In addition to the human tragedy of hunger, the food crisis is contributing to global instability and endangering our national security. In Pakistan, a crucial frontline nation in the war on terrorism, almost one-half of the population (77 million people) now lacks access to affordable food.

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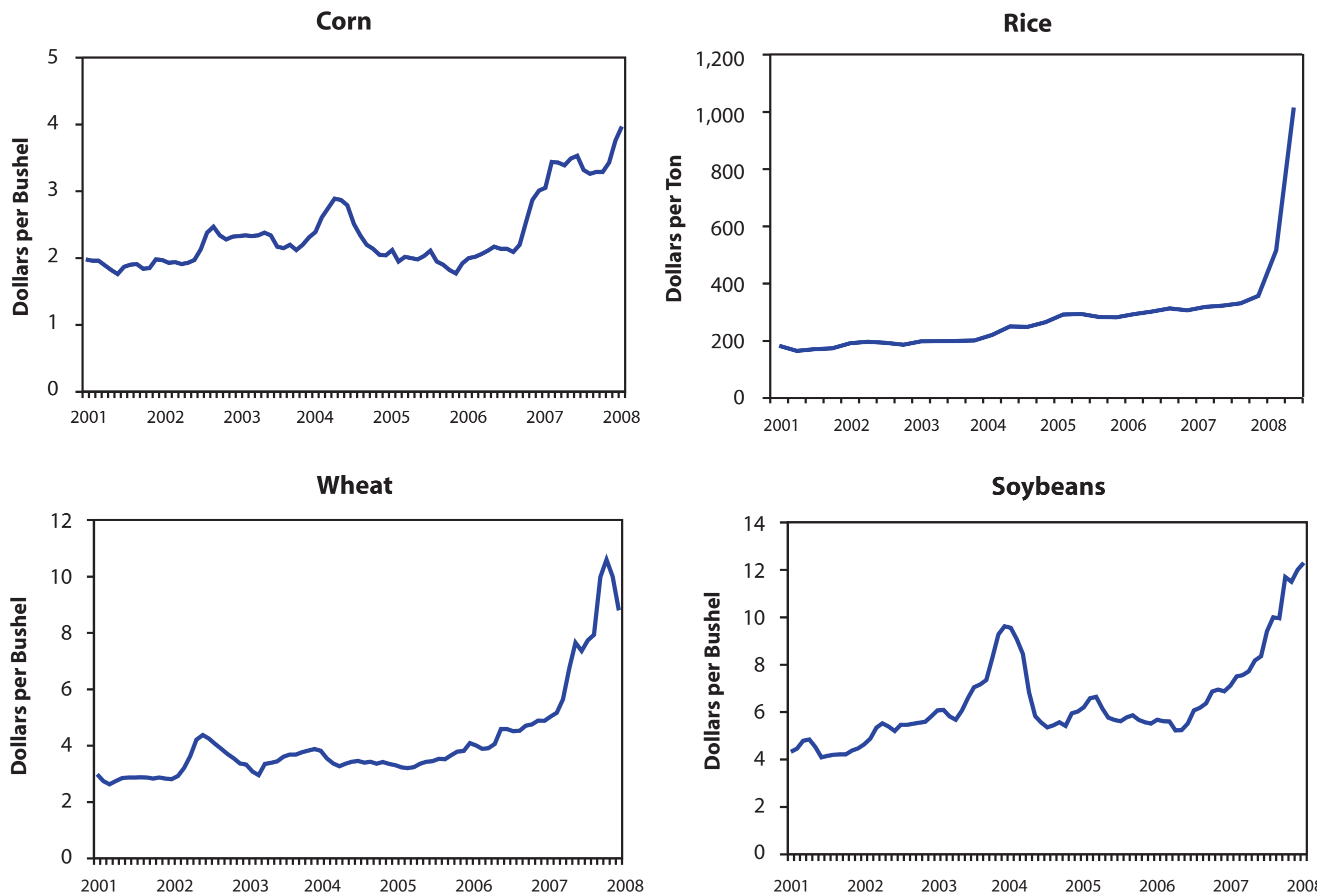
The Cause of the Crisis

The world's demand for food has grown as nations moving up the economic ladder—like

FIGURE 1

PRICES FOR THE WORLD'S FOUR KEY CROPS



SOURCES: U.S. Department of Agriculture (USDA), National Agricultural Statistical Service; and International Monetary Fund, International Financial Statistics.

Prices for the world's four staples have more than doubled since the beginning of 2007.

China, India, and Brazil—gain purchasing power, enabling them to eat more and to eat better. As figure 3 on page 4 illustrates, their consumption of beef and chicken has risen 40 percent since 2000. The shift from cereals to meat and dairy foods dramatically increases the grain content of their diets: seven pounds of grain are needed to produce one pound of meat. Eating one-third of a pound of beef requires more than double the cereal production of one pound of rice. In its last five years of growth, China has shifted from being a major food exporter to a large net consumer.

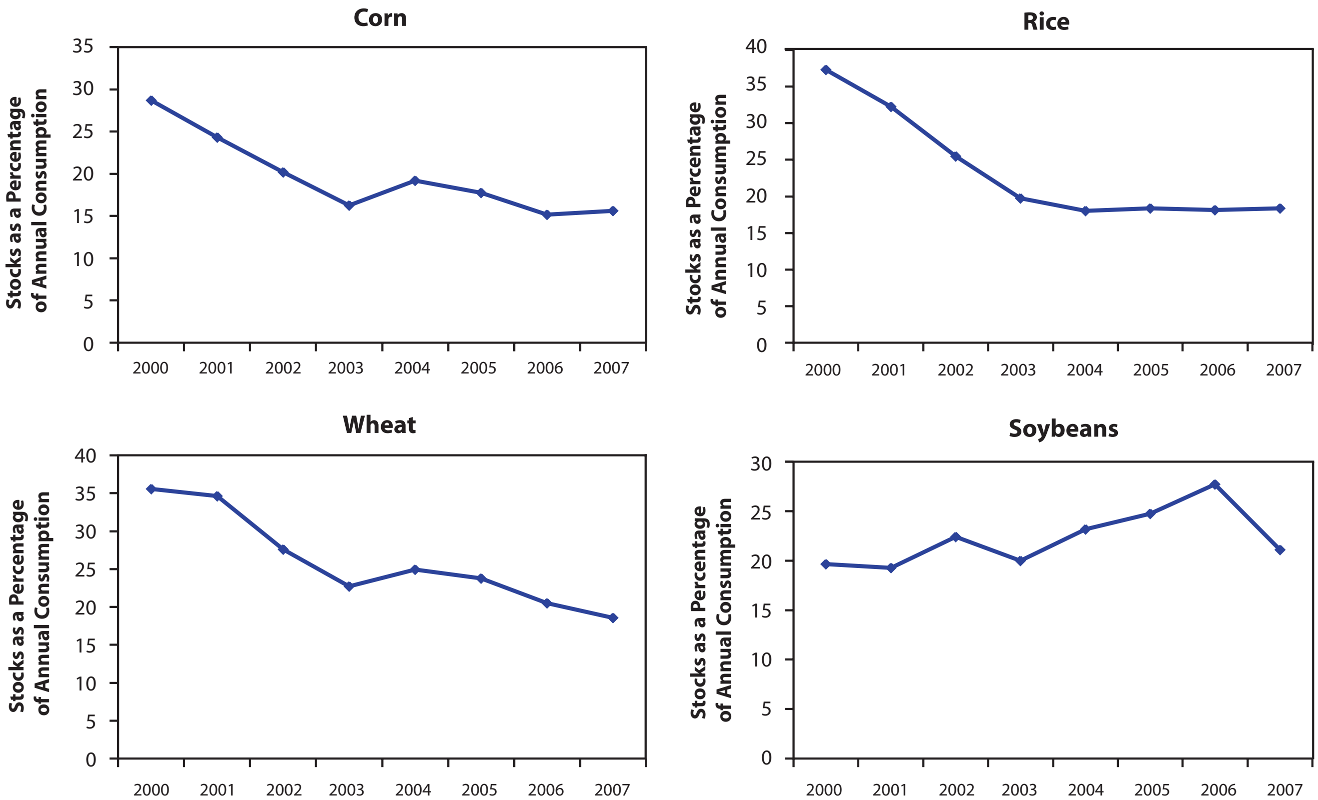
Globalization has moved hundreds of millions of people from the country, where they fed themselves, to the city, where they must buy their food.

The world has the ability to feed itself at affordable prices. There is no shortage of productive land. Large tracts in Ukraine, Kazakhstan, and Brazil offer huge potential. Putting fallow acres back into production could quadruple Russian cereal output to 300 million tons each year. The labor, technology, and capital are all at the ready.

So why has the market failed to respond to this most basic of human needs?

In the United States, we pay farmers $2 billion each year to put 36 million acres of cropland—an area the size of Iowa—out of production under conservation programs. In Europe, large, efficient farmers must leave 10 percent of their land idle. (In response to the food crisis, U.S. and European conservation programs have

FIGURE 2
DEPLETED FOOD STOCKS



SOURCE: USDA, Foreign Agricultural Service.

Showing the year-end stock of each crop as a percentage of annual consumption, these charts illustrate long-term trends in how consumption is outpacing production.

been suspended.) Biofuel subsidies and government production mandates force food and fuel to compete for crops and land. As figure 4 on page 5 illustrates, $7 billion of subsidies now divert one-third of the U.S. corn crop to ethanol production.

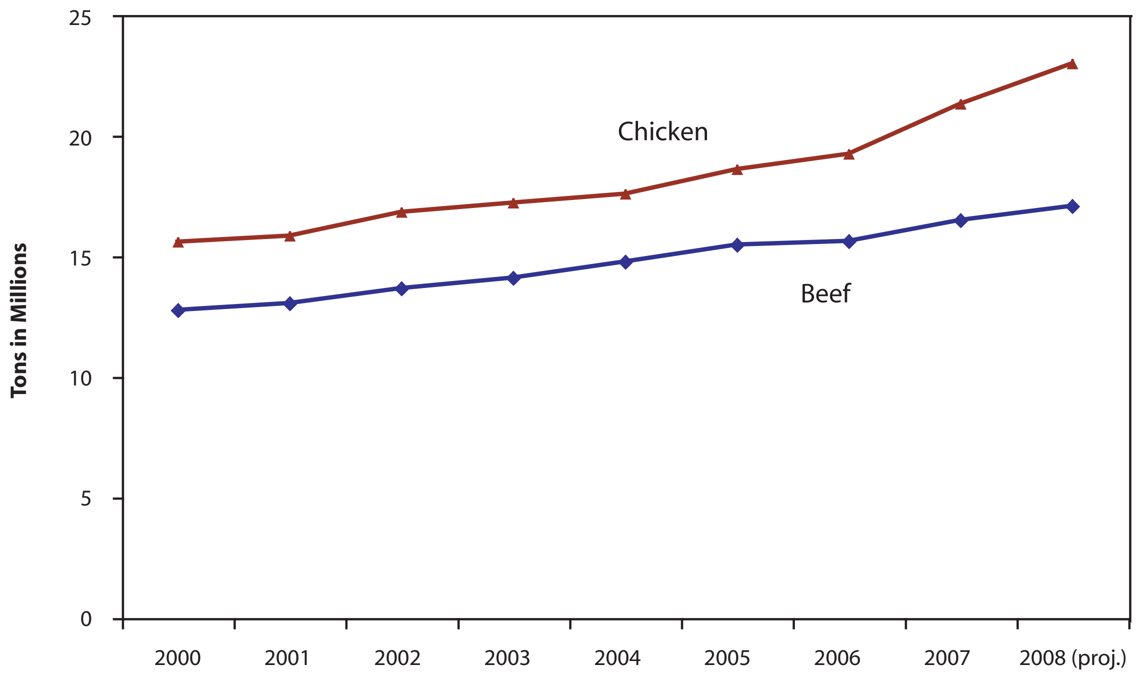
High corn prices have displaced 12 million acres of soybeans and reduced U.S. soybean acreage to its lowest level in a decade. At the same time, a 54¢ per gallon tariff on Brazilian sugar–based ethanol limits imports that are grown on low-grade pastureland and that do not divert food capability to energy production. The livestock industry claims that ethanol subsidies raise corn prices by 50 percent. The International Monetary Fund calculates that one-fifth of the rise in food prices is due to the use of crops for fuel.

The developing world cannot fight hunger in the face of a distorted global food market. Agricultural trade barriers on imports and subsidy programs in the United States and Europe dump crops on world markets, depressing prices below international costs of production and forestalling the growth of a healthy farm sector in emerging economies.

In agriculture, even medium-term supply response is slow, thereby amplifying the price increases. Whether in Nebraska or Thailand, farmers who have survived the boom-and-bust cycles of their industry are cautious. It is only after a perceived fundamental shift in demand that output increases.

FIGURE 3

EATING MORE AND EATING BETTER: BRAZILIAN, INDIAN, AND CHINESE MEAT CONSUMPTION



SOURCE: USDA, Foreign Agricultural Service.

Brazil, India, and China—three of the fastest-growing emerging economies—are using their new prosperity to upgrade their diet, increasing the amount of meat they consume.

Policy Responses

There are several simple measures that will eliminate protection of special interests, promote free markets, and help the agriculture sector meet the world's rising demand for food, thereby dramatically improving hundreds of millions of lives and saving many from malnutrition.

Convert U.S. Food Aid to a Cash-Based System. The United States gives one-half of world food aid, but it is the only major donor that provides assistance in kind and not cash. Not only is American aid almost entirely restricted to U.S.-grown and processed crops, 75 percent must be shipped on U.S.-owned vessels that charge some of the industry's highest prices. The cost of freight frequently equals the cost of the commodities.

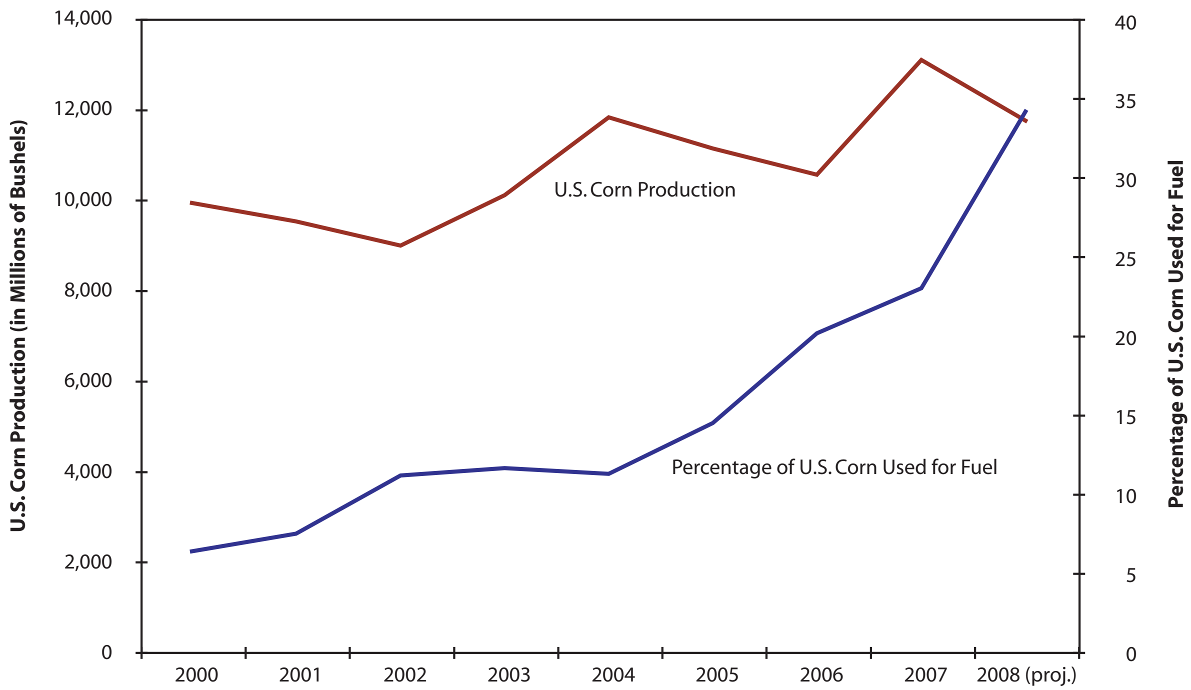
In the past, thousands of tons of cereals have been transported by barge along the Mississippi River, packaged into fifty-five-pound bags, loaded onto American ships, navigated across the world, transferred to railroad cars, and delivered by truck in Ethiopia and Uganda while stockpiles of locally produced grain lay rotting only miles from the recipients for lack of a market. Reforming our aid program to be cash-based allows the local purchase of food for distribution in recipient countries. The impact would be the same as doubling our annual spending by $2 billion.[1]

Not only would a cash-based reform double our ability to help the poor, local purchases would provide a market for crops and encourage the development of viable agricultural industries in developing nations. Last year, the United Nations World Food Programme bought over 1 million tons of food in Africa.

Eliminate Incentives That Restrict and Divert Food Production. Conservation programs that pay farmers to

Figure 4

U.S. Corn Production versus the Percentage Used for Fuel



Source: USDA, Economic Research Service.

While U.S. corn production has risen 20 percent since 2000, the share that goes into fuel production has increased nearly sevenfold.

leave productive land idle, subsidies that divert food crops and arable land to energy production, import tariffs that restrict the use of sugar-based ethanol, and carbon credits based on food crop biofuels all contribute to the food crisis and should be scrapped.

Increase Acceptance of Genetically Modified Seeds That Raise Productivity. Monsanto, a multinational agricultural biotechnology company, has promised new seeds that will double already-improved corn and soybean yields by 2030.

Improve the Collection and Storage of Crops in Developing Countries. Post-harvest losses from waste and spoilage can average 35–65 percent of output. Efficient supply chains could increase dramatically effective production with existing agricultural capacity.

Improve Developing-World Farmers' Access to Markets. Through technology transfer, the dissemination of price information, the creation of forward contracts that guarantee prices for future produce, and the provision of credit, farmers in emerging economies can be connected to world markets, ensuring a growing food supply.

Eliminate Trade Barriers and Agricultural Subsidy Programs in Rich Nations. These policies deter the growth of a productive food industry in the emerging world. They have stymied further international trade integration as the Doha round talks have ground to a halt. By opening their markets and eliminating their subsidy programs, rich nations will resurrect the march toward free trade and do more to help the world's poor than any quantum jump in aid could.

The Role of Investors

Soaring prices have elicited a public outcry. Politicians have sought to deflect blame, so speculators and investors are tarred as manipulators and hoarders. In response to popular protest, the Indian government closed futures markets in food crops while announcing that they had no effect on prices. In the U.S. Congress, calls for increased regulation have surfaced from members of both parties.

Commodity index funds, whose holdings now reach $260 billion, and other investors in futures contracts are not the primary cause of rising prices. Over the last two years, the market has reached the conclusion that a structural long-term increase in emerging-world demand for raw materials and food ranging from oil and iron ore to rice and corn will meet a slow supply response. Because commodities are priced in U.S. dollars, the currency's 20–30 percent decline has amplified the rise in prices.

Though investors have not reduced the physical supplies in the market, their actions have accelerated the unavoidable price increases. Even a pension fund or university endowment that passively allocates a percentage of its assets to a commodities futures index fund for diversification will, mechanically, cause cash prices to rise.

Financial markets are driving today's prices to match expectations of tomorrow's values. Each time a fund buys an additional futures contract, there must be a producer who is willing to sell its output forward or a speculator who believes prices will fall. As market expectations of future prices increase, the price of the futures contracts is driven up to elicit the necessary offer response. As futures contract prices rise, cash prices follow upward, because today's physical stocks can always be stored and turned into future supply.

The market is groping toward a new equilibrium. Investors are accelerating the price discovery and sending signals to producers to elicit a faster supply increase. Of course, rapidly changing markets often overshoot their ultimate target, but, as Milton Friedman observed, speculators must on average be right—otherwise they lose money and disappear.

The mere signal of a reversal of G8 countries' protectionist policies down the road would immediately increase projections of future food production, lower expectations of future values, and cause prices to start dropping at the neighborhood grocery store by morning.

Note

1. The Bush administration has attempted to shift 25 percent of the food aid budget to a cash basis since 2005 but has been thwarted by a coalition of agricultural interests, shipping companies, and NGOs. In the president's May 1, 2008, proposal for $770 million of additional funding for food aid and development programs, approximately $200 million could be used for local purchases in recipient countries.