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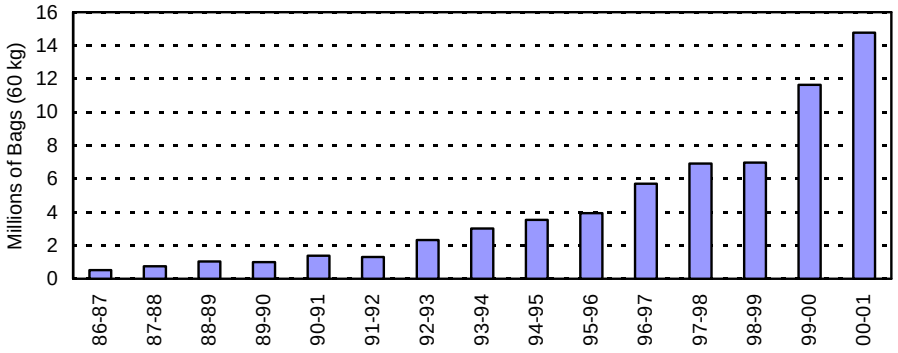
WHY CHEAP GREEN COFFEE DOES NOT MAKE CHEAP CAPPUCCINO?

After oil, coffee is arguably the second most important commodity as it constitutes an important source of foreign income for several some developing countries. Coffee, like any other agricultural products, is a cyclical crop. When the supply of coffee is large, the world price of coffee falls. Many farmers then go out of business, or they switch from coffee to other similar crops. Consequently, the world supply of coffee falls, and so prices rise again. Once again, it becomes financially worthwhile for farmers to produce coffee instead of those other crops.

To counter this cyclical pattern, several major coffee-growing countries set up the Association of Coffee Producing Countries (ACPC) in 1993. The members of the ACPC were Angola, Brazil, Colombia, Costa Rica, Ivory Coast, DR Congo, El Salvador, India, Indonesia, Kenya, Tanzania, Togo, Uganda, and Venezuela. The purpose of this organization was to control coffee prices by adjusting coffee supplies from the member countries.

However, just as the coffee producing countries were debating the idea of a coffee cartel like OPEC, other countries, which never produced coffee before, started developing huge new coffee plantations. Among these new comers was Vietnam, which produced as little as 1.2 million bags of green coffee in the 1990-91 season. The 1990s saw a sharp increase in Vietnam's coffee production, resulting from the massive expansion of growing areas in its Central Highlands; and from productivity improvements. The total area of Vietnam's coffee plantations increased from 200,000 hectares in the mid-1990s to 500,000 hectares in 2000 / 01. During the same period, the average productivity increased from 1 ton per hectare to 1.8 tons per hectare. In 2000 / 01, Vietnam's production of coffee reached 15 million bags.[1] This made Vietnam the second-largest coffee producer in the world after Brazil, accounting for a tenth of the total global coffee production.

Figure 1: Vietnam's Coffee Production



Source: ACPC, "Review of the market situation", October 2001.

[1] A bag of green coffee is equivalent to 60 kilograms net.

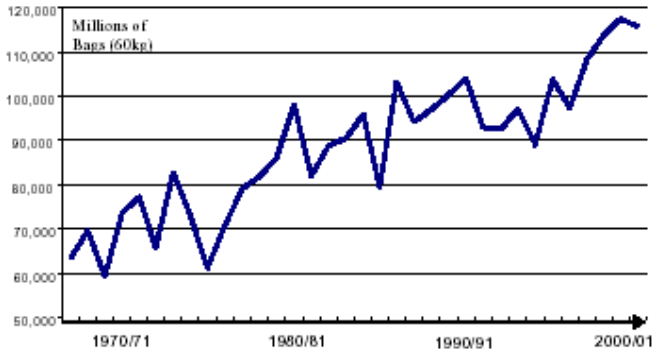
This case study was prepared by Nguyen Xuan Thanh, lecturer at Fulbright Economics Teaching Program. Fulbright Economics Teaching Program's cases are intended to serve as the basis for class discussion, and not to make policy recommendations.

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It was also revealed that although various ACPC's production restriction programs were in place, they were not complied with by the members. Even Brazil, the largest coffee producer and the most rigorous enforcer of ACPC's "retention" plan (the withholding 20-percent of coffee production), eventually gave up its commitment and started selling its reserves of coffee by August 2001.

As a result, many countries had been expanding their coffee production while the global demand for coffee was flat. An estimate by ACPC, shows that the supply of coffee increased 3.6 percent a year on average, while the demand for coffee only increased by 1.5% a year throughout the 1990s. Total production of green coffee in 2000 / 01 was about 115 million bags. This exceeded total consumption (105 million bags), by about 10 percent..

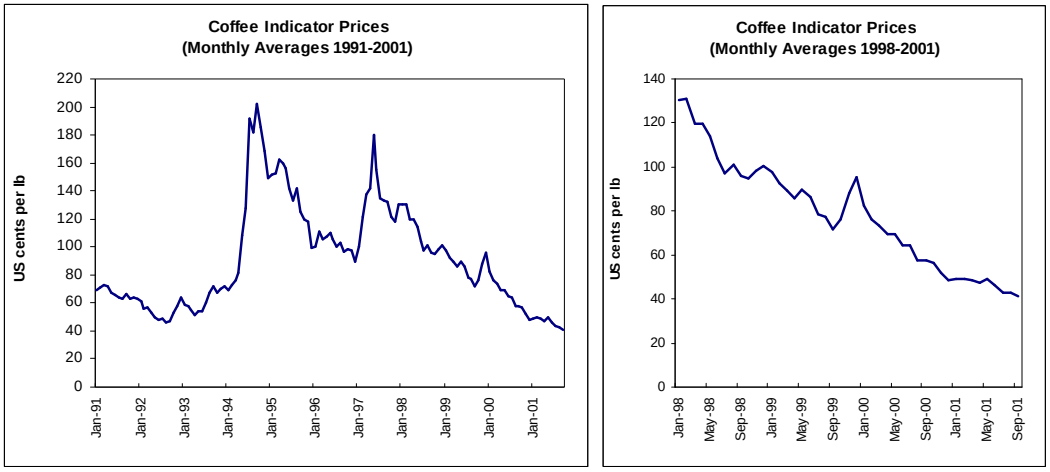
Figure 2: World's Total Coffee Production



Source: International Coffee Organization, 2002.

Consequently, the price of coffee beans in 2001 plunged to their lowest level for 30 years. Coffee farmers claimed that the coffee price had fallen below actual costs of production. Figure 3 below shows that the average price of green coffee by September 2001 was only 32% of that in January 1998.

Figure 3: Fluctuations of Coffee Prices



Source: The International Coffee Organization (ICO).

According to Oxfam, a non-profit organization, an immediate impact from the drop in coffee prices was felt by coffee farmers, who at the end of the 1990s numbered around 7 to 10 million people. The impact was especially harsh on small-scale farmers, who were unable to benefit financially from savings, during the good years of rising prices, to see them through the difficult times of falling prices. Oxfam predicted that the coffee farmers' economic difficulties would soon transform into education, health, and social problems.

Intriguingly, the price of processed coffee in supermarkets did not fall. And that was the reason why several non-profit organizations accused giant coffee sellers like Nestlé and Procter & Gamble, and fashionable coffee shops like Starbucks of reaping profits on the back of impoverished coffee farmers.

"No tabloid campaign was launched into why the likes of Starbucks can get away with asking £3.35 for a 'raspberry mocha chip cream frappuccino', when the price of coffee beans has never been cheaper", wrote the Observer newspaper in London.

Oxfam says the cost of coffee beans accounts for less than 7% of the eventual cost of a cup of coffee paid by Western consumers - the rest, over 90%, goes to coffee processors and retailers.

While sharing in the concern of falling prices of coffee beans, coffee roasters and retailers rejected Oxfam's claim of unfair trading practices. The British Coffee Association (BCA) says Oxfam "fails to address the fundamental economics of the coffee market in the long term."

"Simply increasing the prices for green coffee beans without implementing the appropriate controls on production would not help the livelihood of the growers in producing countries in the longer term," argues the BCA.

The coffee retailers' argument starts right at heart of Oxfam's claim. It is true that the cost of exported coffee beans accounts for only 7% of the final price of roasted coffee. The remaining costs come from processing, transport, storage, and taxes. Taxes, such as export duty and sales tax, are fixed expenses. Wages, insurance and freight, and storage costs have all increased over time. Thus, although the price of green coffee has been falling sharply, the price of roasted coffee has not.

The percentage share of the cost of actual coffee beans in the end price of a cup of cappuccino, is even less than 7 percent if one takes into account rising shop rents and staff costs. Coffee shops in countries like the UK typically make 42 cents for every $2.5 cup of coffee. Starbucks, therefore, said that the falling price of coffee had 'no effect' on pricing policy.

Various proposals had been suggested to overcome the problems of falling coffee prices. Oxfam called for an internationally-agreed minimum coffee price of $2.2 per kilogram - about doubled the 2001 level. Others favored output restriction solutions. One method was to destroy low quality beans before they reached the market. As estimated by the Natural Resources Institute, each million bags of low-quality coffee removed from the global market would raise global prices by two US cents per pound for coffee.