

IMPACT OF THE COFFEE CRISIS

Introduction

An acute coffee crisis threatens millions of small coffee farmers around the world and is putting economic growth, as well as social and political stability, at risk in scores of coffee producing countries in Central and South America, Africa and Asia. The United States also has vital economic, political and security interests in Mexico, Colombia, Costa Rica, El Salvador, Guatemala, Nicaragua, Peru, and other major Central and South American coffee producing countries that have been among the hardest hit by the crisis. The implications of the crisis for the U.S. economic, foreign and social policy are very serious.

- ? When 44,000 coffee growers in Nicaragua cannot recoup their production costs and now face the loss of their lands, it threatens Nicaragua's political stability.
- ? When over 100,000 coffee farmers in Mexico may not harvest their crop because they would lose money doing so and peasants in Mexico's coffee growing regions of Chiapas and Veracruz look to migrate to the United States, it retards Mexican development and puts even greater pressure on U.S. immigration policies.
- ? When coffee farmers in Colombia, Peru and Ecuador have a strong economic incentive to switch from coffee production to illicit crops, it exacerbates an already serious regional concern about the spread of narco-terrorism.
- ? When Colombia, Mexico and Central America, which together import more U.S. made products than any country except Canada, lose significant coffee export earnings, it harms U.S. industries and workers who manufacture the products exported to those countries.

When an agricultural sector is dysfunctional, it represents a potential long-term disaster for the economic, social and environmental stability of the region. Today coffee has become an economic disaster for the people who grow it. If left unchecked, this disaster in the coffee farm sector will lead to severe social and environmental problems. In order to fully understand the nature of the crisis, one must recognize that: (1) it is severe; (2) it is worldwide; and (3) it is structural.

The severity stems from two aspects – time and degree. First is time. We are entering the third year of depressed prices with economic signs indicating it will extend for at least another two to three years. And second is degree. Price levels are not just depressed to the point at which coffee farming is unprofitable, the price levels have reached the point where coffee harvesting is no longer feasible. When it costs more to

harvest the crop than the crop is worth, then the rational choice is to leave it on the trees and abandon the farm. This is a course of action many farmers are now taking. More than the revenue lost, the real calamity comes when jobs are lost, even low paying jobs.

The coffee crisis is worldwide. It is affecting farmers in Central America, South America, Africa, and Asia. While the Arabica farmers in Costa Rica may be getting 40 cents per pound for their coffee cherries, the Robusta coffee farmers in Viet Nam are only receiving 15 cents a pound for theirs. Even the low cost producers are not benefiting from the current situation. This condition is created because the market place does not view coffee as a true commodity. It places premiums and discounts on both coffee types and coffee grades. While both markets may move up and down in tandem, the arbitrage, or spread between one Arabica and Robusta, does not give one farmer an economic competitive advantage over another. This fact tends to get glossed over in most economic discussions on the coffee crisis.

The coffee crisis is structural. It was not caused by the cyclical nature of coffee agriculture that has produced the “boom-bust” cycles of the past. The change in the market place has been brought about by the concentration of buying power in the hands of a few firms that present coffee to the consumer as a “blended and branded” product, void of any links to type and grade. This has led to intense price competition for market share that has rewarded increased market share to low cost products in the short run at the expense of stability in the supply chain in the long run.

The Problem

- ? On the producing side, coffee is grown in more than 50 countries and on more than 11 million hectares of land, a remarkable 1 % of the world’s land area. It generates nearly \$7 billion in export earnings for developing countries and is second only to oil as the largest globally traded commodity.
- ? The coffee industry provides employment to over 25 million people in some of the poorest countries in the world, and smallholders on farms less than 5 hectares produce about 70 % of the world’s coffee.
- ? On the consuming side, as the world’s largest coffee consuming nation, importing about 20 million bags annually or approximately 25 % of world exports, the US is a major factor in international coffee commerce. When combined with the import volume of the European Union, which represents roughly 50 % of world exports, and Japan, which accounts for an additional 8%, the major industrialized countries consume over 80% of world coffee exports.
- ? Also on the consuming side, the industrialized countries that consume more than 80% of world coffee production are providing over \$360 billion dollars in farm subsidies annually, almost \$1 billion dollars per day, to protect their own domestic farm industries. These subsidies often prevent

developing countries from venturing into agricultural products other than coffee.

- ? In addition, there is a growing imbalance between the behavior of export and retail prices. In the 1980's, the final consumer spent around \$30 billion annually on retail coffee sales; of this total, exporting countries took in \$9-10 billion, representing 30-33%. Today, the latest estimates indicate that final consumption now accounts for around \$55 billion in annual retail sales, with exporting countries receiving approximately \$7 billion, representing only 15%.

Impacts on Countries in the Western Hemisphere

The magnitude of the economic and social crisis facing coffee-producing countries in Latin America is staggering. Years of little to no natural asset investment (soil, land, water, flora, fauna) have left many coffee producing areas to become the poorest, most economically degraded, and socially unstable regions in their countries. As the price of coffee continues to drop in real dollar terms, many coffee producing areas are ripe for conflict, natural disaster, environmental collapse, and diversion into illicit activities. In attention to this "disadvantaged and left-out rural sector" has affected the competitiveness of other industry sectors in these regions, such as tourism and commerce, and it has exacerbated ethnic, regional, and class conflicts that affect the political stability and economic growth in many coffee producing countries.

An international crisis of this magnitude has political implications for the US, has potential for elimination of traditional coffee sources in Latin America for the US coffee trade, and has the probability of extreme price volatility for US coffee consumers. As the crisis continues to affect countries in Latin America, particularly Mexico, Guatemala, Honduras and Nicaragua, it has the potential to cost jobs for those Americans working in export oriented markets. The kind of poverty provoked by the coffee crisis promotes economic instability in Central American countries that leads to illegal immigration and costs US taxpayers in the Southern Border States from Texas to California billions of dollars annually in order to deal with the crime, health care, and educational demands of this displaced workers. In addition, as coffee and coca compete for the same land, crop substitution for increased exports of illegal drugs into the US becomes an increasing social problem and criminal justice cost to the US Government.

The root cause of the coffee crisis can be linked to three factors: (1) over production; (2) under consumption; and (3) market oligopoly. In short, these are all problems associated with the economics of coffee farming. Without resolution, they will lead to both social and environmental breakdowns.

The problem of over production needs to be viewed in the context of a market that has more than doubled in size during the past five decades. In the 1950's world coffee production was approximately 50 million bags. By the turn of the century, world production exceeded 100 million bags. During this period, in spite of periods of over supply, world stocks diminished from roughly 40 million bags in the 1960's to 20 million

bags in the 1990's. But during this same period, production also shifted away from traditional Arabica type coffees to Robusta types coffees, as both Brazil and Vietnam dramatically increased their Robusta production: Brazil with some standards for grade, and Vietnam with virtually no standards for grades. (In this context grades refer to permissible levels of defects.) This over production of low grade coffees led to the inevitable fall in coffee prices, bringing down both the Arabica and Robusta markets, as the New York "C" contract and the London Robusta contract reached historic lows.

According to economic theory, low prices should have led to increased consumption. Unfortunately this was not the case. Consumption in most of the developed markets, particularly in Europe and the United States, is declining, as consumers have no real desire for those products containing low grade Robusta coffees. Thus under consumption is one of the important root causes of the problem. In short, consumers are shifting away from the types of coffees that are in over supply, clearly extending and exacerbating the problem. One can make a strong case that without the growth in the specialty coffee market, consumption down turns in developed markets would have been far greater. Unfortunately many people in the market chain have tended to ignore this strong but simple consumer message that growers are now producing the wrong type and grade of coffee products desired by consumers. The message is getting lost behind the facades of "blends and brands," because there is a vested economic interest to maintain the status quo.

Market oligopoly by its very nature limits transparency in the market place. The conditions for a successful "free market" require many buyers and sellers as well as a reasonable disclosure of choices for consumers related to differences in prices and grades. While the majority of coffee production still rests in the hands of the small-holder farmer, buying of green coffee is now concentrated in the hands of less than a dozen companies. This concentration has the consequence of limiting consumer information on choice, as the value judgments in selecting types and grades are retained as proprietary company information. This "asymmetrical distribution of information," characterized by farmers not knowing where their coffee is sold and consumers not knowing where their coffee comes from prevent proper market signals from ever reaching the farm gate.

Source of the Crisis

Today that coffee market is in grave danger – threatened by a vast a growing oversupply of ever-lower quality coffee that have driven green coffee prices to historic lows. This is not the temporary boom and bust cycle coffee cycle of the past. It is structural. It is not, and will not be corrected by market forces in the short run.

The crisis has been caused by a large increase in coffee production over the past several years by two countries - Vietnam and Brazil. In the case of Vietnam, within ten years this country grew from a relatively insignificant producer to the world second largest – ahead of Colombia but behind Brazil, now producing well over 10 million bags annually and accounting for approximately 12% of world exports. The unprecedented

growth of the Vietnamese coffee industry is the result of loans from the Asian Development Bank, the French Agriculture Development Agency, and the Government of Vietnam. The Vietnamese coffee trees were planted at a time when prices were relatively stable and coffee was a good cash crop. However, the funders lost sight of market economics and failed to consider the impact on prices of increasing supply by 10 to 15 % in so short a period. The problems with Vietnam's coffee production go way beyond the issue of volume. It is also one of export grades. Unlike Brazil, which has traditionally established minimum export grades, Vietnam has virtually none. The intractable nature of this crisis arises because much of the coffee that has been added to the world market is of an extremely low quality.

In recent years, explosive growth in production and sale of low quality coffee has set off a chain reaction of overproduction and falling prices. Low prices mean farmer invest in less of the quality control required to remove defects from coffee. Less quality control means MORE coffee on the market. If defective beans and foreign matter are not removed from coffee the defects and foreign matter are sold as coffee. More defects mean more coffee. More coffee means lower prices. Bad coffee is driving good coffee from the market.

Since the crisis is a structural problem and not a cyclical one, remedies are to be found by taking intervening actions. These actions would include a strengthening of coffee institutions, a realignment of market forces, a creation of suitable financial tools, and a promotion of sustainable agricultural practices. It must be emphasized that any direct market intervention, such as quotas or subsidies, would only be short term in effect and would not correct the structural problems. It must also be emphasized that what is required is a series of steps in a number of different areas, as no single step will produce the desired structural changes that are needed.

Strengthening institutions requires the building of public-private partnerships where industry and governments interface to address specific issues. A good example of this is the Private Sector Consultative Board that has become part of the International Coffee Organization. It is an effort to coordinate policy decisions on a governmental level that have market-based applications in commerce. This same type of international cooperation is needed on a national level so that governmental policy decisions go hand in hand with market building for both the producing country's internal market and export markets for coffee.

Realignment of market forces begins with creating greater transparency for coffee types and grades. While the specialty coffee market has made tremendous strides in establishing an awareness of coffee differences in the mind of consumers, particularly between Arabica and Robusta type coffees, there is still much work to be done. This is particularly true for coffee production at the farm and mill level, where producers are still uncertain as to the grades required and the marketing needed to access the specialty coffee market with value added coffees. This has become a major focus of the specialty coffee industry, and we are now involved in a public-private partnership with USAID to accomplish this task in Central America.

Creating appropriate financial tools continues to be one of the major roadblocks to solving the coffee crisis. With past credit problems evaporating the possibility for long term financing of farmer debt, and with market volatility diminishing any banking interest in short term financing of harvest costs, coffee farmers are forced into selling as the crop comes off the trees or out of the mills, causing them to sell at unfavorable times or under unfavorable circumstances. A possible solution for this problem may be found in multi-year direct contracts with roasters, which create a market instrument that has collateral value.

Without economic remedies to the crisis, it is difficult to promote sustainable agricultural practices in coffee farming. While niche markets within the specialty coffee industry can provide some relief, the size of these markets makes them too small to be an effective solution. A more practical approach to promoting sustainable coffee farming can be found in the Starbucks model of a “Preferred Supplier Program,” in which there are direct financial incentives for those farmers following both approved agricultural practices and providing socially responsible working conditions.

Policies to Address the Situation

The crisis is a structural one that is not going to resolve itself via market forces. Resources from outside institutions, coming from both governmental and private-sector agencies, need to be utilized in resolving the crisis. These strategies for correcting the situation include:

- ? Strengthen the mechanisms of cooperation and consultation between producing countries that allow the establishment of concrete solutions by inviting the United States of America and Canada to rejoin as members of the International Coffee Organization, so that within this forum, and in dialogue with producing countries, there is an analysis of the possible solutions to the coffee crisis.
- ? Instruct ministers to search for formulas for consensus, designed to confront the problem, including the organization of supply and demand for coffee, or measures such as the establishment of quality standards for coffee intended for export.
- ? Reach an agreement with multilateral, global and regional credit organizations that they will not grant loans or donations intended for further expansion of world coffee production.
- ? Promote the creation of suitable financial tools for the regional development banks, that will allow an orderly management of the world coffee supply, by way of, amongst others, instruments of price coverage and the financing of inventories in producing countries.

- ? The implementation of the initiatives and policies mentioned above would allow producing countries to promote the establishment of sustainable agricultural practices in the coffee sector.

Continuing to build differentiated markets is also a significant step in the right direction to resolve the coffee crisis. In short, the long-term key to success is to remove coffee from the “commodity trap,” because in fact coffee is not a commodity. It is a product that can be differentiated by type and grade. The specialty coffee industry has offered a highly visible demonstration of this fact, as consumers willingly pay premium prices for premium coffee grades. It is within this context that the issues of quality and certification need to be understood.

Specialty coffee should be viewed as a market segment, operating in conjunction with the other primary market segments of commercial coffees and soluble coffees. Specialty coffee has attained this position by virtue of its standards, which serve to differentiate it from commercial coffees. These standards require specialty coffees to “taste great” and have “no defects.” The defect standard is an objective one based on physical count, while the taste standard is a subjective one. However, the subjective nature of the “taste great” standard is also based on objective factors. These objective factors can be scientifically quantified as: (1) lower levels of chlorogenic acids; (2) lower levels of potassium; and (3) higher levels of organic acids, than their commercial counterparts. It is these physical properties of specialty coffees that underlie the premiums they receive in the market place.

Within the specialty coffee market segment are found many sustainable niches that reflect environmental and social concerns on the part of specialty coffee consumers. The most common niche, though still a relatively small niche within the segment, is “certified” organic coffee. This niche has grown through greater awareness and interest of U.S. consumers for organically grown products of all types. Dovetailed into this interest in organic farming practices are consumer awareness and interest in other farm practices that are viewed as environmentally friendly, such as shade grown or Eco-OK certification labels. When looking at these niches, however, it must be remembered that their success starts with the fact that their chemical properties make their taste profiles accepted for meeting the quality standards that define the specialty coffee market. It is this single aspect that qualifies them as a “value-added” product, not the other certifications.

Socially responsible coffees, as signified by the “Fair Trade” label, span both the specialty and commercial coffee segments. On the commercial side, their principle market is in Europe where the Max Havelor brand prevails. On the specialty side, their principle market is in the United States where the TransFair brand predominates. High levels of consumer awareness but low levels of consumer purchases typify the market demand for these coffees. So the market signal is mixed in terms of the message it sends to producers. While noble in purpose, this type of socially responsible certification does not appear to be an effective solution to the coffee crisis because of its limited economic impact.

In Conclusion

Finding economic solutions is the first priority in addressing the coffee crisis. Without the key building block of economic sustainability, no other solutions are possible. Due to the current severity of the crisis, economic solutions has meant direct food relief for millions of coffee farming families affected by low world coffee prices.

Long term solutions must first be developed for those countries whose coffee output has a potential reward as value-added products by consumers. This includes the majority of production in Central America and Colombia where the tradition has been to grow washed, mild Arabica coffees that are free from significant levels of defects. It is not a coincidence that the bulk of the coffees sold in the specialty coffee market are produced in these origins. However, these solutions will not appear by themselves. Rather they must be sought out by public-private partnerships that coordinate governmental policies with supply chains built around consumer demands.

Consumers' willingness to pay higher prices is directly linked to their perceived value of the products they buy. As an agricultural product, coffee readily lends itself to this type of economic model, which is very similar to the wine industry. However, capitalizing on this aspect of the product will require higher levels of standards, education, and ethics within the coffee supply chain than we have experienced in the past.

As the world's largest coffee consuming nation, the US has more than a role to play in resolving the coffee crisis. It has a responsibility. The cost of maintaining our current "laissez-faire" posture on international coffee policy is increasing exponentially. We are precipitating a worldwide economic and political crisis with ramifications far beyond the impoverished farmers in Latin America. We are fast approaching a critical juncture in coffee's future and sustainability in Latin America.