



**DIRECTORATE-GENERAL FOR EXTERNAL POLICIES OF THE UNION**  
**DIRECTORATE B**  
**- POLICY DÉPARTMENT -**

**NOTE**

Challenges in the coffee sector - international trade and sustainability initiatives

**Abstract:**

**This note covers international trade and producer-consumer country relations in the coffee sector. It compares trade during and after the era defined by the International Coffee Agreements and briefly summarises the lessons of the "coffee crisis". It is suggested that classical trade policy instruments have very little scope to respond to the challenges and improve the situation of the producers; instead it is more useful to look at the global value chain for coffee and an alternative policy agenda. This is covered in the third part of the note, along with recent market developments, fair trade and other sustainability initiatives. Some policy options are listed at the end.**

Any opinions expressed in this document are the sole responsibility of the author and do not necessarily represent the official position of the European Parliament.

**DGExPo/B/PolDep/Note/2006\_076**

**25 April 2006**

**EN**



This note was requested by the European Parliament's Committee on International Trade.

This paper is published in the following languages: English

Author: Levente CSÁSZI

Manuscript completed in May 2006

Copies can be obtained through: E-mail: [ccalvo@europarl.eu.int](mailto:ccalvo@europarl.eu.int)

Brussels, European Parliament, 2 May 2006

## Introduction

Coffee is one of the oldest globally traded goods. Though there are over 80 different species of the coffee plant, coffee as most consumers know it is usually a blended mixture of **Arabica and Robusta**, the two types of coffee grown, traded, roasted and consumed worldwide. Arabica is the more ancient of the two, however Robusta is more resistant, somewhat less demanding to grow, has a stronger and slightly bitter flavour and can contain twice as much caffeine as Arabica. Arabica is regarded as the softer, more harmonious and sophisticated type that can be further divided into hard and mild Arabica.

Coffee is produced in about 50 countries. World production is about 105-120 million 60 kg bags a year and most of this amount is exported because only Brazil and Ethiopia have significant domestic consumption<sup>1</sup>. Roughly half of the 2004/05 world production originates from South-America (56.3 million bags), one quarter from Asia (27.4 million bags) and the remaining is divided over Africa and Mexico/Central America. The three main coffee producing countries are Brazil, (39.3 million bags), Vietnam (12.5 million bags) and Columbia (11.5 million bags) and cover together 55 percent of the world production.

The history of coffee trade can be divided into **two main eras**. Before 1989 global markets were regulated by the **International Coffee Agreement (ICA)** through a quota system and producing countries also used marketing boards to control production volumes and quality, as well as to undertake stock control and coffee exporting themselves. This system had serious weaknesses such as late payments to farmers, corruption, "free riding", flawed quality standards and slow reaction to market developments. This period was followed by deregulation and liberalisation and a move towards free trade in the coffee sector, often as part of the structural adjustment process prescribed by the IMF. This brought mixed results but certainly exposed the fragmented and often monocultural coffee farm sector to global market forces. In the 1990 the International Coffee Organisation lost its regulatory role in coffee trade but its coordination and research activities are still significant.

Since 1970 the prices have averaged a 3 percent per year price decline for Arabica coffees and a 5 percent decline for Robusta coffees. Starting in the late '90s the coffee market experienced a crisis, with drastically declining prices, mainly due to a large oversupply. The prices of coffee recovered in 2004 after a long period of decline and experienced growth rates again in 2005. Overall, between 1980 and 2000, world coffee prices fell by over 60 percent (Oxfam, FAO), and by the end of 2003 they were at levels below those received 30 years previously. Moreover, coffee prices have become increasingly volatile, so producers have been faced not only with falling prices, but more unpredictable ones as well.

Many different explanations have been proposed for the precipitous decline in coffee prices. These include the emergence of Vietnam as a major producer and exporter, the depreciation of the Brazilian real, "underconsumption", exploitation of market power by roasters and retailers, technological change in roasting, domestic market liberalization and the abolition of parastatal marketing agencies. In its last **resolution in 2003 on the international coffee crisis**, the European Parliament also pointed to the mixed effects of dismantling the international coffee agreement and the policies implemented by the international financial institutions. The most basic explanation lies in the market fundamentals of supply and demand. Specifically it is the recent rapid growth in global supplies against sluggish demand growth which has led to falling prices, and the low price elasticity of demand means that these price falls are severe.

---

<sup>1</sup> Brazilian consumption is nearly 14 percent of world production.

Suggested solutions to the crisis have been as various as the explanations. These have included supply control, demand promotion, guaranteed prices, product differentiation, support for diversification (and dismantling trade barriers in other agricultural products to provide opportunities for diversification), vertical coordination or integration through the value chain, raising the profile of commodity problems in international fora, fair trade initiatives (including obliging the main coffee roasters to pay a fair price to farmers and end "exploitation"), and even grower support funded by a windfall tax on roasters.

**The key issue is not that developing countries are not trading but the fact is that they are not benefiting from trade.** The case of coffee shows that increasing volumes of exports is not a guarantee of development if the terms of trade are deteriorating. It is argued here that the key to the coffee commodity problem is neither classical trade instruments such as tariffs or quotas nor market intervention in the form of artificial supply control. These are important factors but the coffee paradox is one that requires a "post modern policy agenda" that looks into quality standards, access to information, value chain governance, geographical indications and extending fair trade and other labelling initiatives.

## **1. The commodity problem and coffee**

### **1.1. What is a "commodity"?**

There is no commonly accepted definition of "commodity" but in general the term is understood as a good with a (potential) world market where most participants and actors use the same measurable standards and attributes to the product. At the extreme, a commodity can have a single global quality standard. Commodities can be agricultural products (sugar, soybeans, grains, coffee, etc.), but also minerals and metals, wood, or any other physical substance that is traded in the world with global attributes and quality standards. For a long time, coffee was the second most traded commodity after oil. This was the case during the period of high coffee prices, but since the late-1990s when coffee prices began to fall sharply the value of global exports has been exceeded not just by oil, but also by aluminium, wheat and coal due to increasing demand mainly by China and other emerging economies. Nevertheless, coffee remains a key commodity with 400 billion cups consumed every year and production in some 50 developing countries.

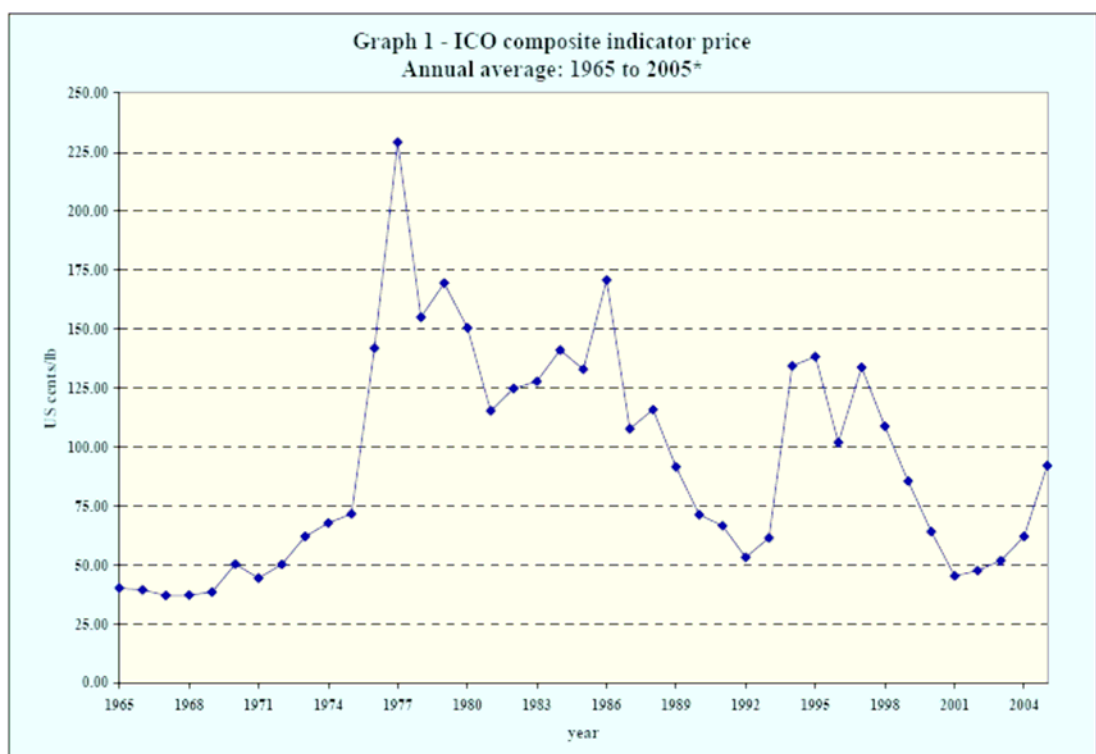
### **1.2. The most important features of commodity trade**

#### **Price volatility and depressed prices**

Price volatility is one of the major concerns of players in the world commodity market, particularly in the case of coffee. For exporters it is a source of uncertainty with regard to export earnings and creates difficulties in carrying out effective sales policies. Market prices are determined by a number of factors but it is important to note that they are not merely a reflection of the equilibrium of physical transactions. The **fundamental factors determining coffee prices are production, consumption and stocks**. However, less fundamental factors come into play in trading activities such as **financial speculation** and they influence commodity prices and volatility. For agricultural commodities, "weather shocks" were more common in the past and still play a role, while for minerals it is mainly international demand that influences the price. The graph below shows the "composite indicator price"<sup>2</sup> of coffee (source: International Coffee Organisation).

---

<sup>2</sup> Annual average taking into account the various types of coffees, Arabica and Robusta



While volatility is important on a yearly basis, coffee prices also vary and fluctuate month by month and according to type. In fact, while volatility is basically determined by specific events that affect the coffee industry, several studies show that it is increasingly **influenced by investment fund activities**.

While the general economic fundamentals of supply and demand prevail, the following factors are worth pointing out since they influence global commodity prices and may contribute to price volatility:

- Climate and weather conditions: especially in the case of agricultural commodities (frost, draught, extreme temperatures trigger "weather shocks" and directly influence prices). In the '90s, Brazilian weather conditions often played a major role by suddenly increasing prices, followed by a period of depressed prices on the world market<sup>3</sup>.
- New entrants to the market: in the case of coffee new producers such as Vietnam in the last 10 years may contribute to price volatility. Prices had an almost constant downward pressure due to the ever increasing volumes and mixed quality of Vietnamese coffee.
- Financial markets - these days most transactions linked to commodities take place usually as commodity futures contracts. World prices usually change far in excess of coffee trends itself, which makes it very difficult to estimate if price changes are due to real markets shocks or anticipation of trends in the speculative futures market. Experts estimated that already in the early '90s the virtual coffee trade registered at the coffee exchanges (the value of the speculative financial transactions) was 10 to 15 times the turnover of the coffee that was "physically traded"<sup>4</sup>. Speculative trade of coffee in the futures markets has greatly increased since mainly due to online

<sup>3</sup> There was one serious frost in Brazil in 1981, leading to a drop in world production of nearly 16%, followed by a price rise in annual average terms of 8% the following year. As is normally the case, with replantings, production rose after a 5 – 6 year lag by 27% in 1987 relative to 1981 with a corresponding drop in prices relative to that year of 14%.

<sup>4</sup> Kaplinsky mentions that in 1992 for instance, the amount of coffee traded on stock markets was equivalent to 11 times the actually traded amount.

transactions and it has been widely claimed that it impacted heavily on price volatility. Coffee is mainly traded on the New York and London futures (terminal) markets, which exert a strong influence on world coffee prices. These prices are notoriously volatile - they vary daily, hourly and even by the second, depending on factors such as the size of coffee stocks worldwide, the weather forecast, insecure political conditions and speculation on the futures markets.

**Specific circumstances of the global coffee market have kept prices low for producers:**

- Cheap and efficient production in Vietnam and Brazil: new technologies, economies of scale and know-how enable producers to provide better quality or more efficient supplies at very competitive prices, especially in Vietnam and Brazil;
- Few producers are consumers: coffee is grown in more than 50 countries but only Brazil and Ethiopia have substantial domestic consumption which contributes to the oversupply trends and increases the vulnerability of most producers. Coffee production has very strong “poverty links” since it is very often the growers’ only source of income in developing countries such as Guatemala or Uganda.
- No real product alternatives: there are very few products that could substitute coffee (only tea and soft drinks to a very limited extent)
- Low price elasticity: in lack of substitute products price changes do not substantially alter consumption patterns (few consumers give up drinking coffee because it has become a little more expensive and few start drinking it because it has become cheaper).
- "Decommoditisation" of coffee in consuming countries: customers are not really concerned with the material qualities of coffee (unlike in the case of cocoa, bananas or wine) and the information flow about the product is controlled by the (mainly European) roasters. The consumers are not in a position to value quality. Growers are not linked to the consumers and have no control over marketing. (The only notable exception is the niche of speciality coffee chains). In other words, when a consumer orders a "double decaf latte", they are not aware of the material qualities of the coffee and what they really pay for is not the coffee but the service and the "atmosphere" of the cafeteria and perhaps the method of preparing the drink.
- Slowly increasing global demand: economic growth leading to increased purchasing power in consuming countries (e.g. growing coffee consumption in Eastern and Central Europe).

The table below summarises the **most important changes in the coffee sector since the end of the ICA regime in 1989** and shows how the coffee chain governance has been restructured (see also part 3 on value chains).

	<b>ICA regime (1957-89)</b>	<b>Post-ICA regime 1989-present</b>
<i>Geography of production</i>	At first concentrated in a few large countries like Brazil and Colombia, later increasingly dispersed	Fragmentation continues, Vietnam gaining 2nd place in production, around 50 producing countries
<i>Entry barriers to production</i>	low, due to government intervention (input and credit supply, cultivation campaigns, price stabilisation)	increasing, due to government withdrawal from services previously offered to farmers
<i>Entry barriers to trade</i>	<i>domestic trade and export</i> . high barriers, due to monopoly of marketing or domestic trade quotas but risk limited by price stabilisation	<i>domestic trade and export</i> . first decreased entry barriers due to liberalisation, later higher barriers following the strengthening of international trader operations, the lack of domestic credit and limited access to futures markets <i>international trade</i> : increasing barriers in mainstream market but decreasing in the speciality market due to fragmentation and
	<i>international trade</i> : increasing due to consolidation	

		the growing importance of e-commerce sales
<i>Distribution of total income generated along the chain</i>	relatively stable, farmers getting up to 20 percent of the total, consuming country operators around 50 percent	shifted to the advantage of consuming country operators
<i>Geography of consumption</i>	concentrated in North America, Western Europe and Japan	quite stable (stagnation) with slow emergence of some new markets (Eastern Europe, China, East Asia)
<i>Typology of consumption</i>	segmented by group of countries (different types and blends catering for US/UK markets, Southern Europe, Scandinavia, Japan, etc) but relatively homogeneous consumption within these areas	increased fragmentation, multiplication of types of products and blurring of distinctive lines of preference between different groups of countries, increasing importance of single-origin and sustainable coffees
<i>Governance structure of the chain</i>	producing countries have influence in governing the value chain, increasing concentration in roasting and trading segments raises entry barriers but roasters are not in a position to set inclusion/exclusion thresholds	buyer-driven (specifically roaster-driven); further consolidation in roasting and retail, oversupply, adoption of supplier-managed inventory system forces traders to integrate upstream, vertical integration made easier by market liberalisation in producing countries
<i>Vertical integration</i>	not common, sometimes in processing and trade	increasing, international traders integrate into export, processing and sometimes even estate production
<i>Producer-consumer country relations</i>	in relative equilibrium, mediated through the ICAs	absence of formalised relations, consuming country domination
<i>Institutional framework</i>	<u>Strong</u> : international trade regulated by ICAs; markets monopolised by marketing boards or regulated by stabilisation funds and producer associations	<u>Weak</u> : end of ICA; futures market increasingly de-linked from market fundamentals; government retreat into oversight function or completely eliminated, trade associations fill only partly the vacuum
<i>Control and ownership of stocks</i>	producing-country marketing boards and stabilisation funds (or <i>istitutos</i> ) are in control of large quantities of stocks	stocks move to consuming countries; stocks still in producing country controlled by private sector, often consuming-country based actors, roasters outsource stock management to international traders, overall quantity of stocks increases
<i>Quality evaluation</i>	<i>International level</i> : product based, set in negotiations with producing-country sellers (and/or marketing boards), maintained via testing and inspection, cup testing and certification  <i>Domestic level</i> : set by regulatory agency	<i>International level</i> : increasing importance of quality attributes defined by buyers, process monitoring becomes important for fair trade, organic and shade-grown coffees, quality increasingly assessed by buyers ex-ante  <i>Domestic level</i> : increasingly set by buyers, formal rules of control remain but are increasingly disregarded
<i>Upgrading possibilities</i>	limited, undifferentiated trade; producing countries achieve product valorisation through higher and stable prices provided by the ICA	potentially increasing through the marketing of sustainable coffee and direct e-sales opening in speciality markets more suitable for estates than smallholders

source: Daviron and Ponte

## 2. The coffee crisis and recent trends

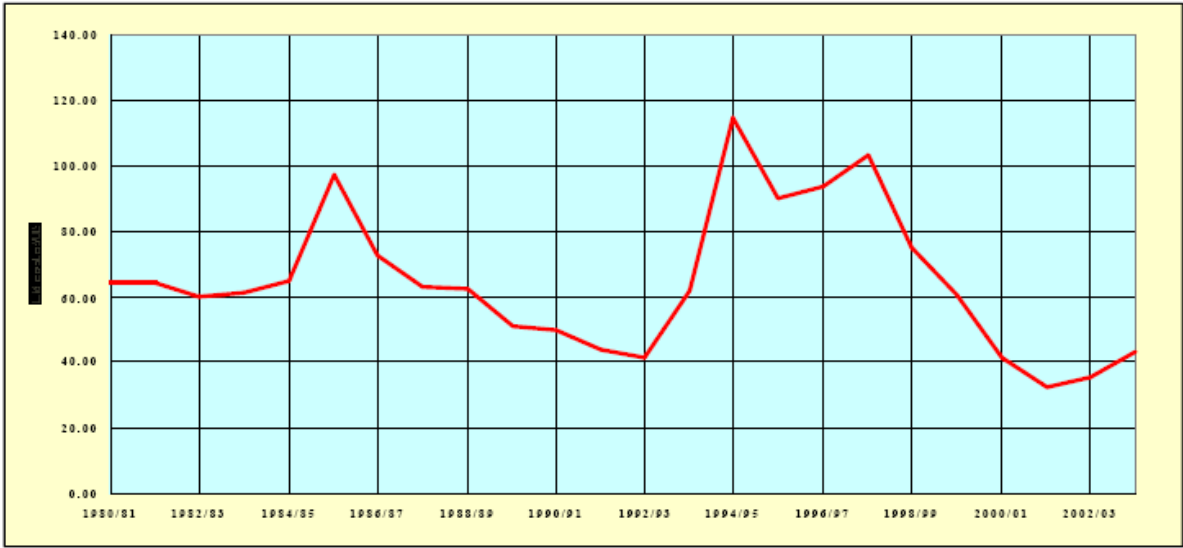
### 2.1. The price crisis

The coffee price crisis began in 2000 and continued until the end of 2004. During these five years a large number of coffee producers were unable to cover their production costs and many only continued to produce coffee because of the lack of alternatives or because they still cultivated subsistence food crops. The effects on farmers have been clearly documented by



the ICO and various researchers and include an exacerbation of poverty in coffee communities worldwide, with additional social effects such as migration to urban areas, illegal emigration, and cultivation of illicit drugs.

**Graph 3: Prices paid to growers (weighted by exports levels) – 1980/81 to 2003/04**



It is also important to note that **the balance of payments of coffee producing countries suffered** considerably. Whereas in the late 1980s and part of the 1990s, earnings by coffee producing countries in terms of FOB exports were around US\$10 – 12 billion per year, during the crisis years they slumped to just over US\$5 billion. On the other hand, the coffee market in industrialized countries continued to be relatively healthy with steadily rising retail sales, particularly in terms of value.

It is worth noting however that this striking discrepancy was recognized by many organizations concerned with development in industrialized countries, and the consequences are now being seen in the form of a number of initiatives designed to promote greater sustainability in coffee.

As a result largely of the stresses on the productive sector worldwide caused by the crisis, the imbalance between supply and demand from 2000 - 2004 which led to the price crash has now gradually been reversed. The price recovered since the lowest level of August 2002 and the benchmark price applied to mild coffee now ranges from \$1.11 to \$1.14 per pound (roughly double its level of August 2002). ICO estimates for 2005/06 are for world production of around 107 million bags compared with world consumption of 114 million. At the same time there are **clear signs of a drawdown in stocks**, particularly in producing countries. This has led to a marked upward move in Arabica prices, though Robusta prices continued to be depressed.

For many, **the basic explanation for the coffee crisis is the global imbalance between supply and demand**. As the table below demonstrates production has systematically been higher than consumption.

### World Coffee Production and Consumption (million bags green coffee)

	1998-99	1999-00	2000-01	2001-02	2002-03*
World coffee production	108.5	113.0	115.3	111.2	122.0
World coffee consumption	102.0	103.0	104.5	105.6	107.0
Difference	6.5	10.0	10.8	5.6	15

Source: F. O. Licht, International Coffee Report, July 23, 2002.

Note: one bag = 60 kilograms, or 132 pounds.

However, another important feature is the **constantly diminishing returns to producers**. Studies suggest that there are a number of complex explanations for the imbalances in the coffee sector. Furthermore, neither dogmatic market fundamentalism, nor interventionist policy options seem to offer the best explanation or the solution.

## 2.2 Coffee trade - policy instruments

It is suggested here that the "commodity problem" in general and especially the imbalances of the coffee sector is not an area where "classical trade policy instruments" could provide a long term solution. Tariffs are very low or non-existent (except in South-South relations but their significance is marginal), with the notable **exception of soluble coffee** where the EU applies a 9 percent tariff, which mainly concerns imports from Brazil.

The main disruptions in the global coffee market are not a result of discriminatory policies such as too high or preferential tariffs or quotas. Subsidies hardly play a role and producers are all developing countries while consumers and importers are the developed world (with the notable exception of Brazil, Ethiopia, Colombia and a few other countries with significant domestic consumption). The main coffee traders, the roasting industry and retail chains (supermarkets and cafeterias/bars) are almost without exception in the hands of the North.

### *The trade profile of coffee as a global commodity (based on FAO)*

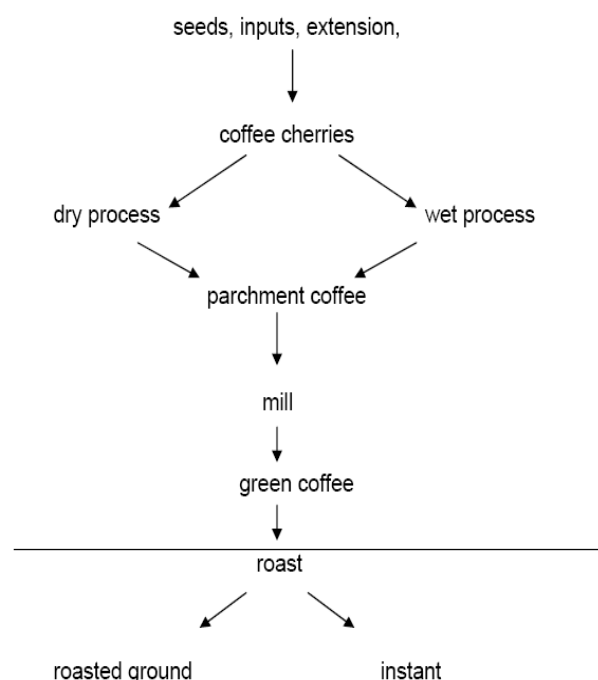
<i>Main policy areas</i>	<i>Remarks</i>
<i>Tariff escalation</i>	<ul style="list-style-type: none"> <li>Tariffs on processed coffee are generally low for the EU, the US, and Japan. The EU, for instance, applies an average duty of 9 percent for higher levels of processed coffee. Other markets such as, India, and Ghana have a duty on instant coffee of 35 percent and 20 percent respectively;</li> <li>Developing countries export mainly non-processed coffee. The largest amount of coffee is imported in its raw state, in the form of unroasted green coffee beans.</li> </ul>
<i>Tariffs</i>	<ul style="list-style-type: none"> <li>Generally low for developed countries, but high for developing nations.</li> </ul>
<i>Amber box</i>	<ul style="list-style-type: none"> <li>Coffee exporting countries have liberalized their coffee industry through the dismantling of national marketing boards. Prices are now determined by market forces.</li> </ul>
<i>Export subsidies</i>	<ul style="list-style-type: none"> <li>Not relevant</li> </ul>
<i>Export credits</i>	<ul style="list-style-type: none"> <li>Not relevant</li> </ul>
<i>State Trading Enterprises</i>	<ul style="list-style-type: none"> <li>Most state trading enterprises have made room for private exporting entities. The state has taken the role of a regulatory power, setting rules and regulations. For example, the government of Côte d'Ivoire established in 2000 the ARCC (Coffee and Cocoa Regulatory Authority) to regulate the activities of the coffee sector.</li> </ul>
<i>Export restrictions</i>	<ul style="list-style-type: none"> <li>n.a.</li> </ul>

<b>and prohibitions</b>	
<b>Food security</b>	<ul style="list-style-type: none"> <li>During recent years, coffee prices have been the subject of severe fluctuations. In 1997, prices of Arabica coffee went up substantially then latter collapsed. More than any other cash crops from developing countries coffee prices exhibit high variability.</li> </ul>
<b>Food safety</b>	<ul style="list-style-type: none"> <li>Quite significant for the sector: contamination, toxic residues, quality of exported beans, use of molecular biology to improve coffee production, regulatory procedures at the processing level in developing countries, shipping and storage of coffee beans.</li> </ul>
<b>Rural development</b>	<ul style="list-style-type: none"> <li>Very critical as most of rural coffee beans producers rely on export earnings for their livelihood. For example, coffee is main source of income for farmers in Uganda. Three-quarters of the population earn money from coffee production export. Coffee earnings contribute to infrastructure development, roads, storage facilities, schools, hospitals, first-stage processing firms.</li> </ul>
<b>Geographical indications</b>	<ul style="list-style-type: none"> <li>Specialized coffee from Colombia (Milds), and Jamaica (Blue Mountain), do fetch premiums.</li> </ul>

**Soluble coffee** is the only coffee-related product subject to the **tariff escalation** problem. Soluble coffee exports to the EU face a tariff, which is mainly relevant for Brazilian soluble coffee. Previously the EU applied a quota system as part of an agreement with Brazil outside the WTO framework in 2001. Brazil objected to the EU giving special concessions on soluble coffee imported from several of its South American neighbours because of their efforts to combat drugs under the previous GSP scheme, while at the same time "graduating" Brazil's coffee exports from the GSP system. The two sides reached a deal giving Brazil duty-free access for up to 10,000 metric tons of soluble coffee but this quota system ended in 2004.

Brazil produces 40 percent of total world production in soluble coffee (3.6 out of 9 million bags worldwide) and a quarter of its production goes to the EU, reaching a 50 percent market share in the Union market. Brazil accuses the EU of imposing unfair burdens on Brazilian soluble in an attempt to create a captive market for soluble manufacturers in EU member states and Brazilian manufacturers fear that several years of tariff at 9 percent could cause irreparable damage to their coffee industry.

Apart from soluble coffee, classical trade instruments do not offer a plausible remedy. It is more important to look at the **coffee value chain and market developments**. The coffee chain breaks down into a number of major stages. After the coffee cherries are harvested, they can enter one of two basic processing routes – the wet or the dry process. This is invariably performed on or near the farm itself. The resulting parchment coffee then has to be milled. Here there are more scale economies, and milling tends to occur in the rural areas where coffee is grown, but on a more centralised basis. Both parchment and green coffee can be stored and location is thus technically possible anywhere after this stage. However, green coffee is less bulky and lighter than parchment, so milling tends to be undertaken in the growing country. The green beans are then roasted, and reach the market



either as instant coffee or in roasted ground form. Whilst instant coffee has a shelf life of six months or longer and production for export is feasible either in the producing or consuming economy, roasted ground coffee is by necessity almost always located near the final consuming market. The horizontal line in the figure shows the “normal” pattern in which coffee has largely entered global markets at the green bean stage.

### **2.3 The "latte revolution" and the coffee paradox**

In the last two-three decades coffee has developed "symbolic values" linked to certain types and methods of preparation. We are witnessing a proliferation of cafeteria chains, retailers specialising in speciality coffee types and a new demand in the fair trade and organic market segments. This phenomenon is often referred to as the “latte revolution”. Daviron and Ponte argue in their book (*The Coffee Paradox*) that **a coffee boom in consuming countries and a coffee crisis in producing countries can coexist because coffee as a material commodity and coffee sold as a final product are becoming increasingly different** (not the case of bananas or many other tropical products). What matters for the final consumer is not the material quality of coffee but increasingly the symbolic and in-person service quality attributes. Most of the value added is produced in this final “immaterial” phase of the value chain. Several experts argue that as long as coffee farmers and their organisations do not control at least part of this final section of the value chain, they will be confined to the “commodity problem” while coffee is moving away from “commodity status” in consuming countries.

Consumers are not aware of the real physical quality attributes of coffee (unlike in the case of banana or even cocoa, not to mention wine) and associate "value" with ambience, in person service quality and symbolic attributes associated with brand names. Few people know the difference between various strands of coffee and they have no knowledge or information on geographical origins or flavours linked to preparation methods. New consumption patterns have emerged with the growing importance of **speciality, fair trade and other "sustainable" coffees**. In consuming countries, coffee has become a fashionable drink and coffee bar chains have expanded rapidly.

Many argue that the **coffee paradox** (market expansion and new consumption patterns in consuming countries but lower returns to growers) is not simply a story of imbalance in supply and demand but one relating to changes in the governance structure of the global value chain for coffee, including the ownership of stocks.

## **3. Global value chains and recent market developments**

### **3.1. The changing notion of "market power"**

Today most commodities in the world have global markets and they are sold into global value chains, in which the basic commodities are transformed into a product through a number of transactions and intermediaries before they reach the final customers. Coffee reaches the final consumer not only as an ordinary product on a supermarket shelf but often as part of a **service** (e.g. cafés and restaurants).

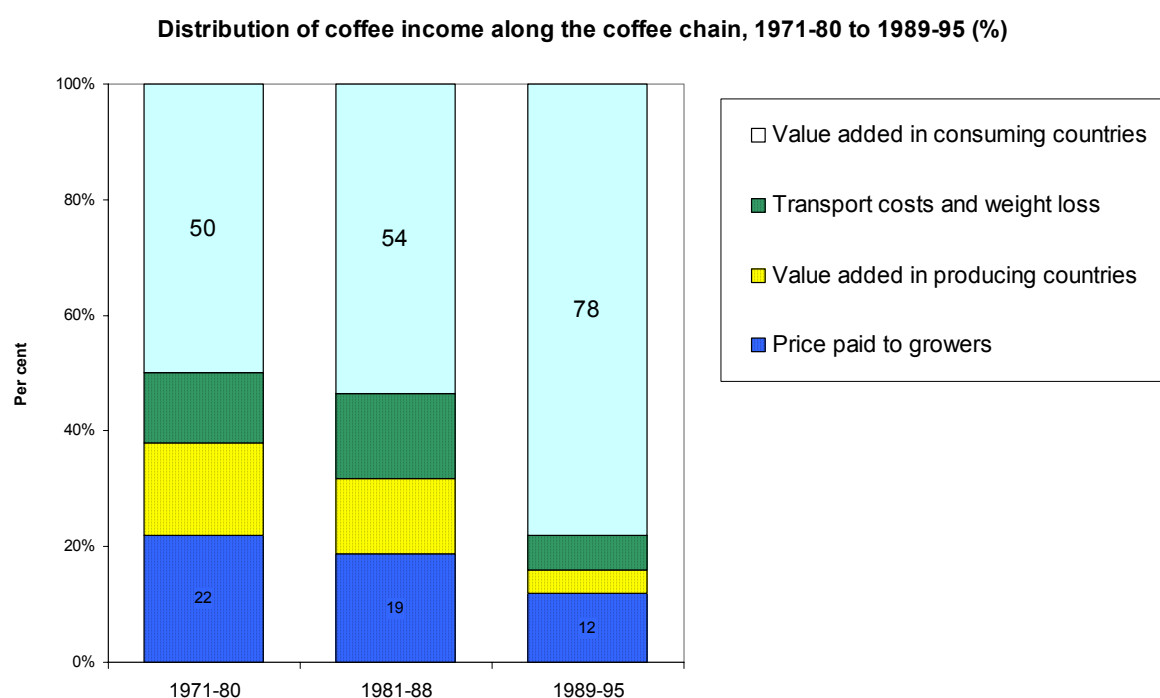
The last 25 years has seen two notable, and contrasting developments in the producing and consuming countries which defines today's global commodity markets.

- **In producing countries**, with the process of deregulation and the disappearance of regulatory forces such as marketing boards, the control of producers over the market (setting prices, controlling volumes) has diminished.

- **In consuming countries**, market power is increasingly concentrated in the hands of a few, increasingly transnational companies that often compete in an oligopolistic environment (this is true for almost many sectors where agricultural commodities are processed).

The result is that commodity **producers increasingly become price takers and market power is concentrated at the other end of the buyer-driven chain. In the case of coffee, roasters and retailers set the prices** and the quality standards and stock management is no longer in the hands of the producers either.

The returns to coffee farmers have been decreasing since the end of the ICO regime. While transport costs have been reduced drastically, value added in producing countries has been constantly shrinking. Growers today receive less than 10 percent of the final retail price and this percentage is typically around 5-7 percent for small farms that sell to middlemen in fragmented markets.



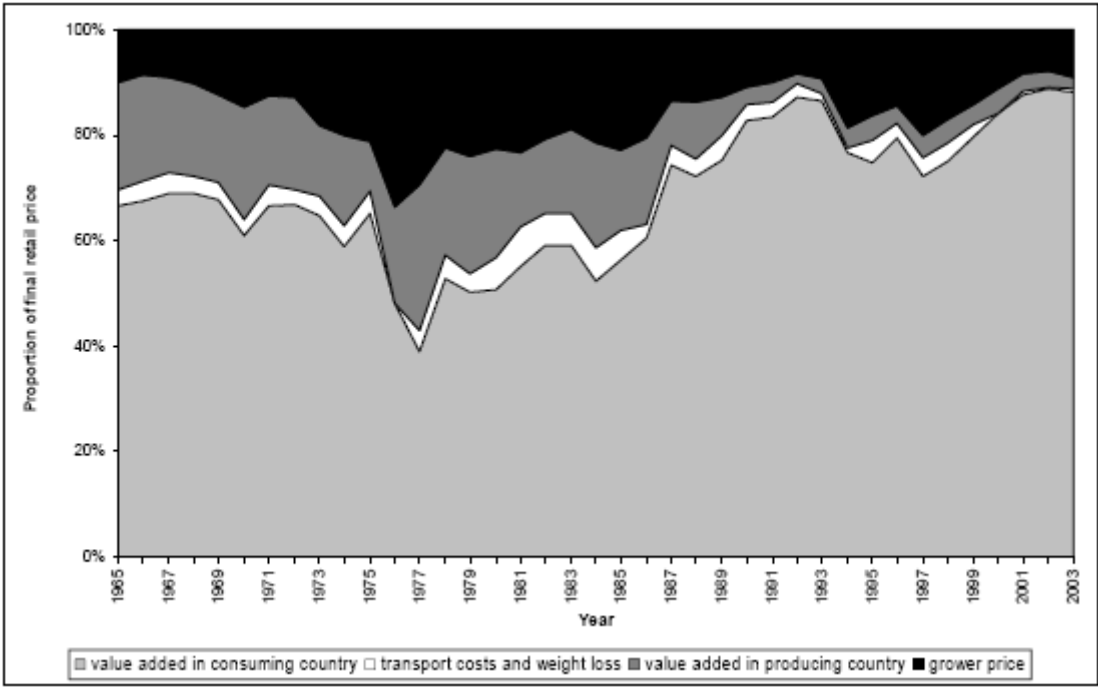
source: Daviron and Ponte (*The Coffee Paradox*)

These trends of diminishing returns for producing countries have been particularly apparent in food-based chains such as coffee which are not subject to inherent scale economies at the growing and primary processing stage. These developments began to emerge during the late 1980s, and gathered pace during the 1990s and early 21st century. At the growing stage, countries had **previously regulated production volumes and marketing using various forms of marketing boards<sup>5</sup>, which guaranteed set prices for growers. International commodity agreements also stabilised trade.** The Structural Adjustment Programmes of the 1990s involved a process of deregulation and liberalisation. The consequence has been that the private sector has played a growing role in increasingly deregulated production systems. The “aggregated producer power” of marketing boards weakened, and small and medium

<sup>5</sup> Marketing boards were typically under the control of the Ministry of Agriculture or Trade. In the past they often worked together with larger producer cooperatives that were responsible for growing and milling coffee while the marketing boards controlled quality, licensed producers, set the prices and exported the product. Some Latin American countries had a diluted form of the same system, referred to as the "Istituto" and the francophone equivalent was the "Caisse de Stabilisation".

scale producers, who previously linked to final markets through the various forms of marketing boards, increasingly found themselves selling directly into volatile global markets.

Distribution of income in the coffee chain: % share of final retail price of coffee



source: Kaplinsky

At the *consuming end* of these chains, there has been a growing tendency towards the **concentration of economic power into a decreasing number of increasingly transnational firms**. In the coffee sector the roasting industry have developed very strong market positions by having access to (and retaining) information on quality standards.

***Leading roasters in the global market***

Company (nationality)	Brands
Nestle SA (Swiss)	Nescafe, Bonka, Ricore
Kraft Foods Inc (US)	Europe: Jacobs, Maxwell House, Carte Noire, Maxim, Blendy, Gevalia, Jacques Vable, Kenco, Hag, Saimaza. USA: Maxwell House, Yuba, Starbucks
Procter & Gamble (US)	Folgers (ground and instant) and Millstone.
Sara Lee Corporation (US)	Europe: Douwe Egberts, Maison du Café, Marcilla, Merrild Van Nelle and Senseo. US: Hills Bros and Superior (food service industry). Brazil: Café do Ponto and Pilao

Daviron and Ponte argue that

*"Roasters have complete information on quality when they buy coffee and release next to no information to their clients. This factor, together with increasing market concentration, has allowed them to gain a driving seat in the global value chain for coffee."*

For instance, in 2001 in Italy the four biggest branded roasters, Lavazza, Splendid/Kraft, Cafe do Brasil and Segafredo Zanetti, controlled over 75 percent of sales and the table below shows their dominant position in the value chain. There is also a gradual consolidation process in the European and North American retail sector (on most markets 4-5 supermarket

chains control over 75-85 per cent of the grocery market). Concentration in the bar consumption sector is similarly significant.

**Tanzania-Italy value chain (home consumption, sale at supermarkets, weighted prices depending on blend composition), 1999/2000**

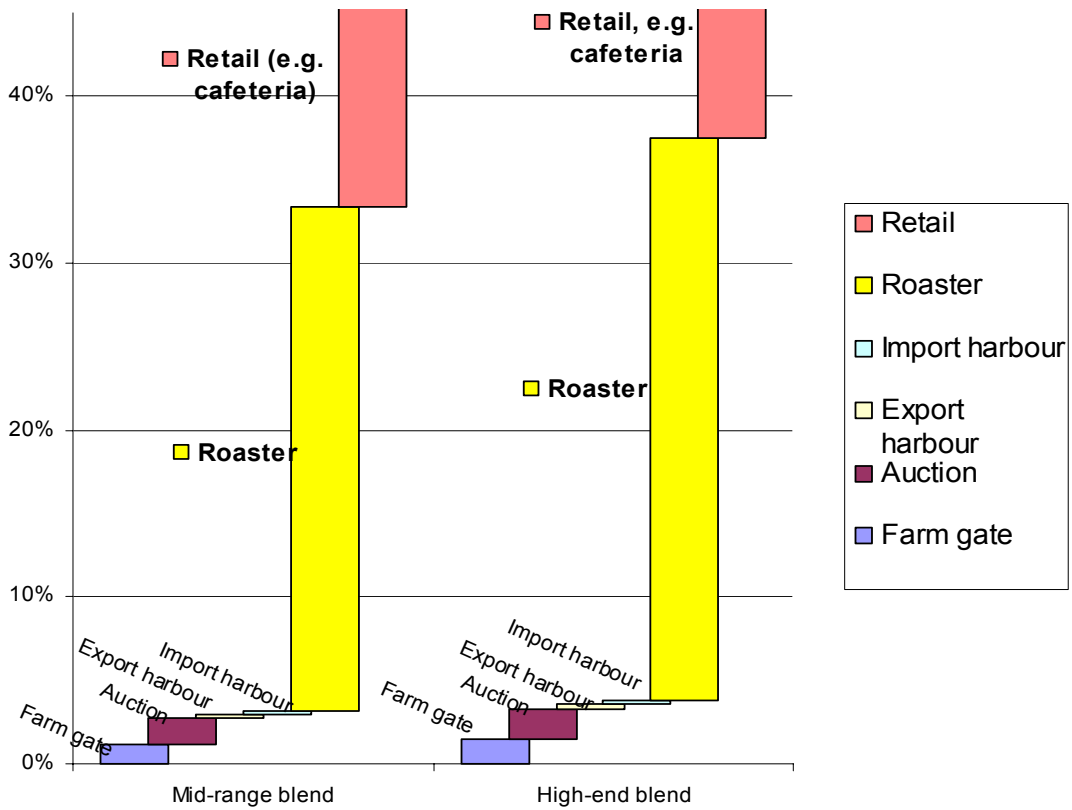
Value chain node	Details	Low-end blend (100 % Robusta)		Mid-range blend (50 % Robusta, 30 % Hard Arabica, 20 % Mild Arabica)		High-end blend (100 % Arabica, of which 60 % Hard Arabica, 40 % Mild Arabica)	
		US\$/lb*	Proportion of retail price (%)	US\$/lb*	Proportion of retail price (%)	US\$/lb*	Proportion of retail price (%)
Farm gate	Selling price to local trader	0.20	8.7	0.25	4.7	0.31	3.9
Auction	Ex-Moshi for Mild Arabica; ex-Kemondo Bay for Hard Arabica and Robusta	0.47	20.7	0.57	10.4	0.66	8.2
Export harbour	FOB (free on board): ex-Tanga for Mild Arabica; ex-Dar es Salaam for Hard Arabica and Robusta	0.53	23.3	0.63	11.5	0.72	8.9
Import harbour	CIF (cost, insurance and freight) ex-EU import harbour	0.56	25.0	0.66	12.2	0.76	9.4
Roaster	Selling price to the supermarket chain	1.99	88.0	4.61	85.0	6.51	80.0
Retail	Consumer price at supermarket**	2.26	100.0	5.43	100.0	8.14	100.0

\* Roasted coffee equivalent weight (conversion factors for Mild Arabica: green/parchment = 0.80; roasted/green = 0.80; conversion factors for Robusta and Hard Arabica: roasted/green = 0.80) Average exchange rate US\$1 = ITL/2,010 (October 1999-September 2000; source: [www.oanda.com](http://www.oanda.com)).

\*\* VAT excluded.

Source: fieldwork data in Daviron and Ponte (*The Coffee Paradox*)

**Distribution of coffee income (% of retail price) - cafeteria value chain**



Thus, there has been a **growing asymmetry in many commodity value chains – between the fragmentation at the producing end of these chains, and the concentration at the buying and retail ends.** Several experts point to the fact that this market power asymmetry is partly responsible for the diminishing return for producers (small scale farmers in developing countries). In some cases this may indeed amount to a possible abuse of dominant market position which often occurs in markets characterised by such inequalities in power.

It might be true that roasters have developed new techniques to make better use of cheaper coffee beans, and thereby have put downward pressure on prices. The other side of the coin is, however, that they also work to stimulate demand which, to the extent they are successful, acts to boost coffee prices.

While market critics often blame multinational coffee roasters and retailers for profiting at poor farmers' expense, Lindsey argues that there is nothing unfair or exploitative or wrong about roasters' practices. She claims that

*"it is simply foolish to blame roasters and retailers for the suffering of distressed coffee farmers. Most of the factors that have contributed to the current coffee slump are entirely outside their control. They had nothing to do with millions of coffee farmers' decisions to plant new trees in response to the high prices of the mid-1990s. They had nothing to do with the depreciation of the real or the productivity improvements of the Brazilian industry. It's not their fault that growing costs in Vietnam are so low."*

source: <http://www.freetrade.org/pubs/briefs/tbp-016.pdf>

### **3.2. New market trends: fair trade, organic and "speciality coffee"**

As a result of consumer awareness and as a possible response to the coffee problem, new speciality coffee brands as well as fair trade and organic coffee are expanding rapidly. The emergence of sustainable and speciality coffees also facilitate a change in ideas of what content should be valued in coffee among consumers. These new schemes appear to support more direct relationship between producers and consumers, a better flow of information on markets and prices and increasing customer demand for "sustainability" and "territoriality" (names of origin). Fair trade and sustainability premiums improve the distribution of value in coffee chains to the advantage of producers, at least in comparison to mainstream coffees. Producers are also involved in the standard setting process and receive better feedback on quality and have a better bargaining position. In an attempt to control marketing, some producer cooperatives have also set up retail outlets and thus sell directly in consuming countries, bypassing roasters and European/American retailers.

#### **Speciality coffee**

Speciality coffee appeared in North America as a reaction to the declining quality of coffee offered by mainstream roasters in the 1970s. The Speciality Coffee Association of America defined it as "good preparation from unique origin and distinctive taste". This has created a purchasing trend that focuses on product variety and quality. Bars, roasters and retailers generated a "taste revolution" and new operators emerged on the market, contributing to the two-way exchange of information on preparation methods, roasting styles and origins of coffee. The main difference from mainstream markets is the more open exchange of information and better "market signals": this niche offered producers (and independent small roasters and chains) an opportunity to bypass the main traders and roasters, a better feedback from consumers and it valued and encouraged quality.

#### **Fair trade and organic coffee**

Fair trade initiatives aim at correcting the imbalances in the buyer- and roaster-driven value chain. Intensive coffee farming can also lead to pesticide pollution and deforestation. Fair trade schemes work to reduce the imbalances by guaranteeing a **minimum wage** for small



producers' harvests and by encouraging organic and sustainable cultivation methods. The best fair trade initiatives manage to **return between 12 and 21 per cent of the final coffee price to producer cooperatives**, which is similar to the levels achieved by farmers in the mainstream markets before the coffee crisis (currently producers often receive less than 5-7 percent of the final retail price). Fair trade farmers are also provided badly needed credit. With the profits generated from receiving fair wages, coffee growers can invest in health, education, and environmental protection.

Sustainable coffee initiatives work through various certification and labelling schemes. The most important types are as follows:

- **Organic coffee** is produced with methods that aim at promoting a viable and sustainable eco-system.
- **Fair trade coffee** is based on a trading relationship between stakeholders that has both market-based and ethical elements and its objective is sustainability and fair returns to growers. It is based on partnerships between alternative trade organisations (e.g. Twin Trading, Oxfam Trading, Equal Exchange) and producers and the labelling is done by organisations such as the Fairtrade Foundation or Max Havelaar Foundation. Fair trade coffee is now to be found in several mainstream supermarkets in most EU member states. (The European Parliament cafeterias serve Max Havelaar labelled coffee). Umbrella organisations such as the Fair Trade Labelling Organisation (FLO) have also been set up to coordinate the activities of labelling organisations and to draft general guidelines. FLO has established detailed standards for ten products.
- **Shade-grown coffee** is a relatively recent sustainable coffee certification initiative. Its main aim is to conserve forest cover through the production of coffee under the shade of forest canopy, thus contributing to biodiversity and saving the habitat of wild birds. Labels offering independent certification are the Smithsonian Migratory Bird Center (SMBC) for “bird-friendly” coffee (since 1997) and the Rainforest Alliance-certified coffee (since 1996).
- **Utz Kapeh** (meaning “a good cup of coffee” in one of the Mayan languages) is the name of a foundation based in Guatemala and the Netherlands. It has developed a *code of conduct* for growing sustainable coffee, based on a number of criteria from soil management to workers’ safety and welfare. It is now one of the most successful schemes that has penetrated mainstream supermarkets in Europe and it guarantees better conditions for growers despite the fact that it only pays a small premium for Arabica coffee (but not for Robusta).

Coffee operators in consuming countries (traders, roasters, retailers) are involved in sustainability issues by buying/selling certified coffees, contributing to projects in favour of coffee-growing communities and by establishing and applying **codes of conduct** either on their own (e.g. by Nestlé) or together with sectoral organisations, public/private initiatives and NGOs. An example for the latter is the *Common Code for the Coffee Community* (“4C”), which was elaborated with the participation of the German Coffee Association, the Ministry of Development and Cooperation, NGOs (Oxfam and Greenpeace), roasters (Nestlé, Tchibo, Sara Lee and Kraft) and producing country representatives and trade unions. This can be seen as an attempt to mainstream sustainability.

Fair trade and sustainable coffee schemes only account for around **1.5 percent of the global coffee trade**, however this segment grows by between 10 and 15 percent every year and Europe is the main driver of these market developments.

## 4. Policy options

The list below is a non-exhaustive account of the various policy options presented and recommended by researchers and operators to reduce price fluctuations, respond to the quality concerns and offer producers a fairer and more predictable price. It is worth noting that there is a broad consensus that returning to the previous system of governance with state intervention (e.g. marketing boards and price stabilisation) is neither an economically desirable nor a politically realistic option. Recommended policy responses include:

- Support of quality control and product improvements;
- Support of fair trade/sustainable schemes that guarantee a set price for producers;
- Reinforce support to labelling schemes in the fair trade, organic and other rapidly growing niche markets in Europe;
- Reducing or removing tariffs on processed coffee (soluble) to encourage creating more added value in developing countries;
- Supporting diversification of coffee farms into mixed production that allows for flexibility when market conditions change;
- Support monitoring schemes and access to market information which would contribute to sustainable farming and discourage planting in sub-optimal areas wherever possible;
- Establish and support training schemes for diversification;
- Support initiatives aimed at raising the reputation of individual origins and introduce protected Geographical Indications;
- Promote e-commerce of coffee sales (auctions) which link producers to consumer country markets more directly;
- Raise awareness about sustainability and the material quality attributes of coffee so that consumers can value quality and, thus, influence the market.

-----

### Useful links and sources

[www.ico.org](http://www.ico.org)

<http://www.positivelycoffee.org>

<http://www.coffeeresearch.org>

<http://www.freetrade.org/pubs/briefs/tbp-016.pdf>

<http://www.adamsmith.org/pdf/groundsforcomplaint.pdf>

Benoit Daviron and Stefano Ponte: The Coffee Paradox, Zed Books, 2005

European Parliament resolution on the crisis in the international coffee market (P5\_TA(2003)0189)