Article Commentary: *"The Coffee Quandary"*

[Newsweek, June 25, 2001]

Article with highlighted relevant portions & Suggested Response

THE *COFFEE QUANDARY*

Why does a vente latte still cost $4 when bean prices are plunging?

Drinking exotic coffee may be the new national pastime, but producers are fighting off one serious caffeine headache. In the past year, overproduction has caused the price of unroasted coffee to plunge more than 40 percent, devastating the small farmers who produce most of the world's crop. In Colombia, some predict destitute farmers will turn to growing coca or poppies, and the plight has even created coffee refugees. The 14 Mexican migrants who died crossing the Arizona border a few weeks ago were mostly failed coffee pickers. "This thing is a disaster for these countries," says Starbucks president and CEO Orin Smith.

But as suppliers suffer, Starbucks is having a blockbuster year, recording $629 million in sales in the second quarter. In fact, while the price of unroasted coffee beans fell, Starbucks raised its rates. "Why in the hell aren't farmers getting more if we're paying four bucks for a cup of coffee?" asks Robert H. Bates, a coffee expert at Harvard. According to Starbucks, the answer is simple: coffee beans account for only a minuscule fraction of the price. The biggest expenses are paying salesclerks and rent bills. Still, some say big coffee companies like Starbucks, which has aggressively sought to position itself as a socially conscious firm, should do more to make sure small producers share its good buzz.

Blame the weather for the crash in prices. In Brazil, a major frost in the mid-1990s cut supply and encouraged runaway planting. At the same time, Vietnam and Indonesia have undertaken ambitious development programs, flooding the market with cheap coffee. "In a lot of poor societies they think coffee will be their salvation," says Judy Ganes, a coffee analyst at InterCommercial Markets. "But it just drives the prices lower." Meanwhile, consumption has been relatively flat. A Starbucks on every corner doesn't mean people are drinking more coffee; the proliferation of gourmet offerings has come mostly at the expense of instant brands. And tastes are continuing to get more rarefied. One coffee retailer in Atlanta sells something called "luwak" coffee, which it claims is picked by a civet, an Indonesian bobcat-like animal. The beans ferment in the civet's stomach, and then are collected from its droppings. The price: $300 per pound.

Starbucks is eager to avoid the impression that it's shortchanging farmers. In October the company began selling "Fair Trade" coffee, the product of a network of suppliers that guarantees farmers a good price. And Starbucks' Smith points out that the company has never paid less than a dollar for a pound of coffee (current futures price: about 60 cents). Yet producers in some countries are already starting to rip out their coffee plants and replace them with other crops, which would eventually prop up prices--though even Smith admits that's "a very harsh" solution. In the meantime, here's one suggestion for remaining coffee farmers: buy a civet.

Suggested Response

PLEASE NOTE THAT THE FOLLOWING ARE *SUGGESTED RESPONSES ONLY*. ECONOMIC REASONING MAY BE USED TO DEVELOP ALTERNATIVE RESPONSES WHICH ARE SUITABLE. IF UNCLEAR, SEE MR. MESSERE.

Summary:

Growers of unroasted coffee are seeing the price for coffee plummet by 40 percent as a result of overproduction. This has devastated small farmers. Despite the falling price of unroasted coffee, Starbucks still charges more for a cup of coffee as a result of higher rental and labor costs.

Key Economic concepts:

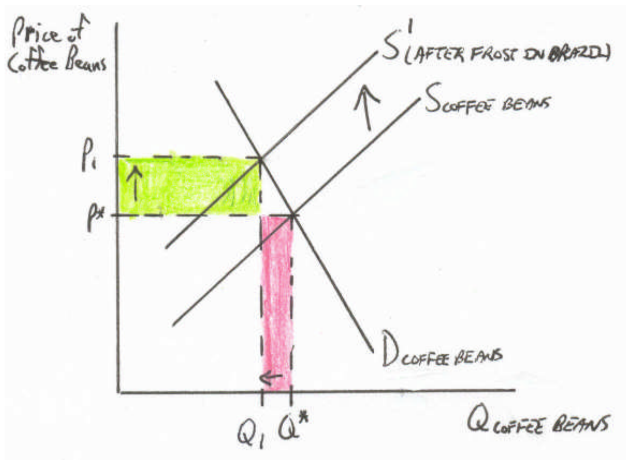
- *demand and supply -- market equilibrium*
- *elasticity of demand for coffee*
- *oligopolies - cartel*

Application and Analysis:

Please remember to define at least *three* to *four* key terms within each commentary. Definitions for key terms have been italicized and are shown in a different font colour below.

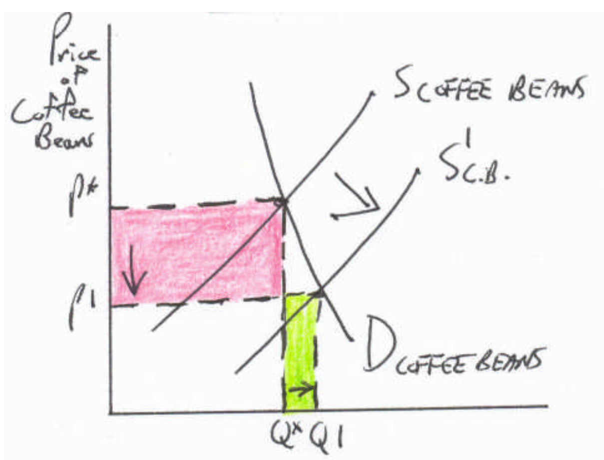
A major frost in Brazil in the mid 90s drove coffee bean prices higher as supply *(the relationship between the various possible prices of a product and the quantity supplied by producers at each price, ceteris paribus)* decreased due to unfavourable weather conditions. (see fig. 1) Because demand *(the relationship between the various possible prices of a product and the quantity demanded by consumers at each price, ceteris paribus)* for coffee tends to be price inelastic *(goods that are insensitive to price or income changes such that a change in price or income leads to a less than proportional change in the quantity demanded)* as a result of its habit forming properties and few close substitutes, total revenue increased from P* x Q* to P^1 x Q^1 (see fig. 1); also shown by the revenue gained in the green area in figure 1 which exceeds the revenue lost in the red area. For underdeveloped countries, the attraction of higher export revenues undoubtedly led to the entrance of new producers in the coffee market - mainly Vietnam and Indonesia - in the mid 1990s.

Figure 1



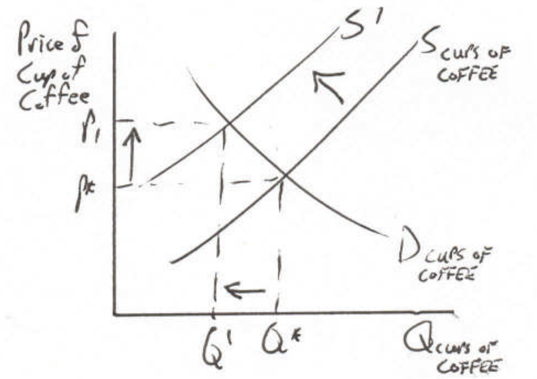
The higher coffee bean prices acted as double edged sword in that encouraged overproduction which increased supply and thus shifted the supply outwards. This drove down coffee prices and increased the quantity traded on the coffee market. (see fig. 2) Since demand for coffee is price inelastic, as prices fell so did total revenue (from P* x Q* to P^1 x Q^1) for coffee bean growers as shown (see fig. 2) by the loss in revenue (red shaded area) compared to the gain in revenue (green shaded area).

Figure 2



Despite falling coffee bean prices, Starbucks (a major coffee bean purchaser) has continued to increase the price of a cup of coffee and continually reaps higher profits. It claims that "coffee beans account for only a minuscule fraction of the price. The biggest expenses are paying salesclerks and rent bills." These higher production costs reduce the supply of cups of coffee and allow Starbucks and other coffee specialty houses to justify price hikes as can be seen in figure 3.

Figure 3



Note: An optional, though more sophisticated analysis, could examine the writer's claim that 'the proliferation of gourmet offerings has come mostly at the expense of instant brands. And tastes are continuing to get more rarefied.' This could be represented by a more segmented coffee market and potentially higher costs as coffee houses attempt to cater to individual consumer tastes.

Evaluation:

Students could address some or all of the following issues in order to ensure an adequate to very good evaluation:

- Starbucks buys coffee at a fair price, but does not indicate what a fair price per pound of coffee is [is $0.60 per pound a fair price?]
    - Is Starbucks as interested in a fair price or a 'fair return' - recall: with increased supply and falling coffee bean prices, input costs fall for Coffee Houses like Starbucks and Second Cup while profits rise as the price of a cup of coffee remains unchanged or is increased
- the expert in the article indicates that producers are ripping out coffee plants to raise the price of coffee by reducing the supply available on the market -- farmers perhaps could act as a cartel *(a group of producers who act together to restrict the output and/or the price of a good)* to maintain a higher price for coffee beans and collectively earn more revenues (see fig.1)

- the main problem with a cartel (especially a coffee cartel) is enforcing an agreement between the various producers as to appropriate quotas and price levels; the temptation is always present for a producer to cheat on the agreement in an effort to undercut other producers and extract more revenues

- the writer's concern with respect to poverty in underdeveloped countries, while admirable, does not mitigate the fact that coffee growers are too reliant on a single crop for the majority of their incomes despite what the theory of comparative advantage (*the notion that if a country is more efficient in the production of one good relative to another country then it should specialize in the production and subsequently export of that good while importing the other good*) dictates

- Coffee exhibits little value added in terms of its production and its price inelastic nature makes it subject to volatility with changes in global demand and supply. In other words, diversification is needed to promote economic growth and development in underdeveloped parts of the world reliant on primary products for the bulk of their export earnings

- Fair trade principle doesn't reflect the reality of free trade obstacles - subsidies for developed country farmers and other non-tariff trade restrictions which underdeveloped nations cannot afford continually depress export earnings and reinforce the unfair trading relationship between the rich industrialized countries and poor underdeveloped nations