

**Possibilities for consumer government actions
to support coffee producers**

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Introduction

This is the final report of a study commissioned by the Belgian Secretary of State for Development Co-operation, with the purpose of outlining possible actions to be adopted by the European Union to ensure a better share of total coffee revenues to producers in developing countries.

The way to improve the participation of coffee producers in the economic gains accrued in the world coffee market translates, ultimately, in their receiving a *fair* price for the commodity they supply. A fair price is not an abstract entity in itself, but - in the competitive world economy - is perhaps better defined as a market price that *results from fair market conditions in the whole coffee producing chain*. Because of this, as will be seen below, for improving the lot of coffee producers, this reports outlines proposals to take place *in the consuming countries, particularly Europe*.

At first sight, it might seem a contradiction acting in one region to directly impact others, far away. The key to the logic of the argument lies in the definition in the previous paragraph. As we try to demonstrate, *market conditions in the consuming-countries side of the coffee producing chain are not fair*; the market failures and distortions ingeniously created there are responsible for the enormous asymmetry of gains in the two sides. Radical positive measures for the coffee farms must begin, ironically, in Brussels.

The structure of this report is as follows. Section 2 introduces preliminary background considerations. A summary of the past and present experiences in the application of supply management schemes is the content of Section 3. Section 4 is an introduction to the main issues in the analysis of the coffee market. Finally, section 5 presents the proposals for consumer government supporting actions, and suggestions for a series of detailed studies to support the actions.

1 Preliminary Considerations

Coffee is one of the most important agricultural export commodities of developing countries, grown and exported by over 70 developing countries, with a 1995-2000 value of exports of \$ 10.6 billion, employing between 20 and 25 million people throughout the world. Most of the coffee produced and exported by developing countries is consumed in industrialised countries.

The relation between developing (producer) and developed (consumer) countries has been subject to changes in the last two decades, affecting the identity, the market share and the organisation of the actors involved in commodity markets. Since coffee has been a vital medium of exchange for developing countries, allowing them to earn the necessary foreign exchange to import basic capital and consumer goods, these new transformations in the global coffee marketing have clear unfavourable redistribution implications for developing countries. In many least developed countries (especially in Africa and Central America¹), coffee plays a key role in rural development and incomes earned by the industry have an important impact on the quality of living conditions of many small farmers. Hence, central to the development challenge is the search for sound policies and their implementation to revert the unfavourable redistribution of income, introducing market structural changes to directly enhance income-earning capacities of poor groups and less developed countries.

The institutional framework of the world coffee market has been analysed by Ponte (2001) in terms of the distinctive changes that have been taking place in the global coffee chain before and after the signature and implementation of the International Coffee Agreement (ICA) during the period 1962-1989.

The combination of large price cycles in the world coffee market, with instability and uncertainty in the coffee export earnings of producing countries, was the major incentive for searching an effective stabilisation scheme. After a series of one year agreements among producing countries to deal with the problem of instability and oversupply, a long-term agreement, with the supporting action of importing countries was negotiated and signed in 1962.

The ICA agreement basically set a target price (or a price band) for coffee, together with a system of export quotas as the principal mechanism to maintain prices within an agreed range. When the International Coffee Organisation (ICO) indicator price rose over the set price, quotas were relaxed, while a drop below this price implied the tightening of the quota. To avoid diverted or resold coffee to circumvent the quota with shipments to non-quota markets, a system of controls, using certificates of origin, was instituted. Although not excepted of problems, the agreement achieved its objective of raising and stabilising coffee prices (Akiyama and Varangis 1990; Bates 1997; Daviron 1996; Gilbert 1996; Palm and Vogelvang 1991).

¹ In 2000 the value of coffee exports as a percentage of total commodities exports were the highest for four African countries (Burundi, 77.3 %, Rwanda, 68.4 %, Ethiopia 55 % and Uganda with 52.8%). Central American countries with higher coffee dependence ratios were Nicaragua with 25.8 %, Guatemala, 24.5 %, El Salvador, 21 % and Honduras 20.5 %.

The relative success of the ICA regime has been attributed to different factors, among which: the key role of governments in producing countries monitoring decision concerning exports, the willingness of Brazil to contract market share, the recognition of import substitution strategies which required maximisation of export earnings through high commodity prices and the effective participation of importing/consuming countries in monitoring and control the quota system.

During the ICA regime, the global coffee chain was characterised by a relatively stable institutional environment, with politically negotiated rules, regulated markets in producing countries, with entry barriers in farming and regulated trade by local governments, and a balanced distribution of generated value added between consuming and producing countries. Coffee was considered a strict commodity by definition and there were limited possibilities for product upgrading. The Global Commodity Chain literature, characterises this period as not particularly “driven by any actor” neither controlled in producing or consumer countries (Ponte, 2001).

Fundamental disagreements in the actors perceptions (coffee-consumer countries argued for a reduction in the agreed price range due to changes in the market situation, while producers wished to restrict supply further on to safeguard the minimum price of the range), together with a period of vast global surplus, concentrated in countries that had not heretofore been coffee powers, and falling prices, resulted in the collapse of the ICA in 1989.

With the demise of the ICA, from 1989 onwards, a movement towards liberalisation of coffee marketing systems took place in an institutional framework where market relations replaced the former system of political negotiations over quotas. The process of market deregulation has fundamentally changed main actor interactions, undermining local producer interests and the regulatory position of local governments at the expense of private traders, exporters and multinationals. The main implication of these new developments is a world market characterised by buyer-dominated relations and a value added shift in the coffee value chain from farmer-producer countries to consuming country operators (Pelupessy 1999, Talbot 1997).

2 Past and present supply management efforts to stabilise prices

In a framework characterised by depressed prices and large oversupply, the effectiveness of domestic policies can be improved by international producers’ co-operative actions in the form of joint supply management schemes. In addition, to ensure the effectiveness of the different supply management approaches, a well established programme should take the interests of consumer countries fully into account. Thus, the schemes, should exceed the limits of a simple cartel, with the only objective to raise prices, but rather aim to accomplish the more realistic objective of achiev-

ing a level of international prices somewhere in between the actual depressed prices and the existing levels during the early 1980s. Moreover, a higher and stable price level, would constraint the possibility of a damaging contraction of productive capacity , protecting consumers' interest in case of a future expansion of demand for coffee.

Maizels, Bacon and Mavrotas (1997) have clearly analysed the alternative approaches to supply management and the conditions under which their implementation would be most suitable for different beverage markets (coffee , tea and cocoa). The alternative approaches mentioned by these authors, which have all been applied in different periods and in combined forms, are: (I) stock reduction schemes, (ii) export quota schemes, (iii) production reduction schemes and (iv) the imposition of a uniform ad valorem export tax. The actual ICO plan for the establishment of a scheme designed to eliminate low-grade coffees from the market can be regarded as a programme combining elements of the above mentioned supply management schemes.²

The export quota scheme, and a variation of it, known under the name of retention schemes, are among the most traditional forms of supply management applied by producer (consumer) countries. The export quota scheme based on a control of export entitlements differs from a traditional export quota in the sense that its main objective is to promote confidence that prices are likely to improve with the reduction of stocks , influencing prices indirectly by improving market attitude. Negotiations for the establishment of an export quota scheme are likely to be more complex compared to production reduction schemes. While the latter has an advantage over the export quota, in so far as it is based on a uniform percentage cut in levels of production, the former involves an agreement on a price objective and a heavy negotiation process to allocate a global export quota among the various producing countries.

In addition to the most complex and time-consuming constraints for the negotiation of an export quota scheme, the design of this type of supply management scheme needs to appropriately incorporate changes in comparative advantage of member countries. Furthermore, a full participation of actual and potential major suppliers will avoid "free-rider" problems by increased exports of non-member countries. Although a production reduction scheme does not give rise to major disagreements about market share, as compared to export quotas, the lack of reliable statistics of crop outturn in developing countries may jeopardise the implementation of a production regulation agreement.

While the implementation of a stock reduction scheme holds no specific price objective, it is less costly in terms of negotiation efforts as compared to an export quota arrangement, the establishment of an ad valorem tax may have detrimental effects for the exporting country. Although the application of a uniform export tax would not discriminate among different producing countries, not affecting relative selling prices, to the extent that countries'

² Study on Improving the global coffee supply/demand balance through measures designed to eliminate low-grade coffees, EB 3778/01, International Coffee Organization.

short term price elasticities differ, their relative gains in export revenues could be affected. In addition, a successful implementation of an ad valorem tax scheme is closely linked to the relative size of the domestic market of the exporting country. In the case of a country with a relatively large domestic consumption market, the application of a uniform ad valorem export tax will raise export revenue by relatively less than the average, or even produce a falling off revenues, if the tax goes along with a diversion of potential exports to the domestic market.

After the suspension of the ICA in 1989, different supply management initiatives toward price stabilisation were undertaken by Central American countries in 1993, joined later by Colombia and Brazil with the objective to improve coffee prices through export retention schemes and production controls. In a similar manner the African producers took their own initiative to pursue similar retention mechanisms. In September 1993, an agreement was reached on the modalities of a retention plan under the umbrella of a newly established Association of Coffee Producing Countries (ACPC).

The declaration establishing ACPC states that the Association's aim is to balance world supply and demand to stabilise coffee prices at a fair level for producers, achieving at the same time increasing consumption levels. Signatories of the ACPC agreed to retain 20% of their stock when the indicator coffee price was below 75 US cents/lb, only 10 per cent would be retained for prices in between 75 and 80 cents, while above 80 cents, the retention plan would be suspended. In a similar way the more recent retention plan launched in October 2000 and abandoned in September 2001 had a price band in between 95 and 105 cents/lb to retain stocks.

A limitation of this type of agreements is its degree of difficulty in ensuring compliance if consumer countries do not participate in the schemes by requiring certificates of origin for all coffee imports entering their markets. In addition finding adequate finance to monitor the agreement, through an international control organisation, or financing the cost of stocking the additional coffee being held off the export markets, or simply destroying or diverting stocks to alternative uses, is particularly onerous for many developing countries.

In general, ambitious initiatives regarding the producing side of the sector have not been very fortunate of late. As an example, since Palm and Vogelvang (1991)'s careful study, there is a reasonable consensus that the end of the quota system managed by the ICO (International Coffee Organisation), worked against the interest of the producing countries.

3 The key point

On the other hand, the analysis of the commodity chain ranging from the coffee cherries in the hands of the harvesters to the *expresso* cup in those of the final consumer has been done by many, and Ponte (2001) seems a lucid description of the process. A key finding is the general agreement that value added has moved “to the North”. Indeed, if in the seventies around 20 per cent of total income was retained by producers and 53 per cent stayed in the consuming countries, this changed to 13 and 78 per cent, respectively, between 1989/90 and 1994/95, Talbot (1997). Other detailed computations produce similar values, like Pelupessy (1999)’s for the Costa Rica – Germany flow, with 14.6 per cent staying in Costa Rica and 71.5 per cent in Germany.

Irrespective of whether the percentage that goes to producing countries is really at 13 or maybe has only slightly decreased from 20, *the main issue in the world coffee market is this great asymmetry in revenues.*

The inequality in the distribution of value added clearly signals to a highly concentrated market structure in all parts of the chain in the consuming countries, where high rents are being extracted. How to decrease this concentration is not an easy task. In broad terms, more competition must take place in these countries, making the different segments that lead to the final consumer more contestable. As, in spite of a few antitrust actions against the big producers, neither “competition cases” nor legal problems persist in the coffee market, injecting more competition in an established and stable structure is something not to be achieved by a single measure or in the short term. All the proposals below should then be regarded as different *enabling measures* to decrease concentration in the consuming-countries side and then, as a consequence, progressively transfer more value added to producers.

It is our belief that effective help to the CPC, and ultimately improvement of the lot of small producers in these countries, must begin not in the CPC themselves but in the consuming countries. Without properly and duly changing the present market structure, no significant transformation of the North-South terms of trade in this commodity will occur.

3.1 A closer look into the market structure

One of the central reasons of the asymmetric relation between the international price of coffee and domestic prices in the last 20 years, is found in the changes in the international coffee supply chain. According to a study by Morisset (1997), a possible explanation for the increasing spread in prices is described, among others, in the changing market structure of the transaction modes between producers and wholesalers, and between wholesalers and consumers.

The main changes in the coffee supply chain in the last two decades have taken place basically at the levels of intermediation, transformation and distribution (importing, roasting and retailing), which have been characterised by greater consolidation through mergers and acquisitions. While at the same time there has been a pronounced decrease in concentration at the levels of production and exporting.

Major cost in production are establishment cost (land preparation, seedlings, planting, irrigation systems), annual variable costs (weeding, pruning, pest/disease control, harvesting, processing, labour) and annual fixed costs. In general, production can be characterised with low barriers to entry, a fact that explains, after the recent liberalisation reforms in producing countries, the atomisation among domestic intermediaries (who buy the coffee from the farmer and/or export the coffee to foreign intermediaries). Needless to say that until this stage no implications are observed in terms of a change in the surplus structure in importing countries. A different reasoning applies in the case of vertical integration between domestic and international intermediaries.

The number of international traders importing coffee into consuming countries has grown in size and decreased in number. In clear contrast with the process of atomisation in producer countries, importers in consuming countries have increased their bargaining power vis-à-vis exporters. Translated into basic economics, this means that the price formation is now less related to world supply and demand and closer to the definition of 'transfer price' within the same trading firm. At this stage of the value chain we start to perceive a clear shift in surplus, since the importer has now more control over the amounts paid by the exporter. The four firm concentration ratio among international traders is 41 %, with Neuman Kaffee, Volcafé, Cargill and Esteve absorbing the lion share. The situation among roasters is even more consolidated. Concentration of ownership has increased rapidly in last 20 years in the production of processed coffee (roasted and soluble). Roasted coffee is concentrated in hands of major transnational food corporations, such as Nestlé, Philip Morris and SaraLee/Douwe Egberts (see Table 1). Sara Lee Corporation is a typical example of increasing consolidation in the coffee sector through mergers and acquisitions³.

³ Sara Lee made the following purchases from 1978 onwards: Van Nelle (The Netherlands) in 1989, Superior Coffee and Foods (US) in 1990, Balimny Praha (Czechoslovakia), Harris Coffee and Tea Company (Australia), Mc Garvey Coffee (US), and Compack Trading & Packing (Hungary, 51%), in 1991; Café de Ponto (Brazil), Continental Coffee Products Co. (US), Wechsler Coffee Corp. (US) and Chock Full O'Nuts Corp. (USA), in 1998, and Hils Bros., MJB, Chase & Sanborn from Nestlé (US) in 2000.

Table 1. Processed Coffee Industry: Market Shares of Leading Firms, % of developed countries, 1999

Leading Firms	Country Origin	Market Share (%)
Nestlé	Switzerland	25
Philip Morris (Kraft Jacobs Suchard)	US	24
Sara Lee/Douwe Egberts	US	7
Procter & Gamble	US	7
Tschibo/Eduscho	Germany	6
Four Firm Concentration Ratio		63

Sources: Food World R & C

Table 2. Concentration of Roasters in the European Union in 1995 and 1997

Country	1995		1997	
	Companies/Brand	Shares	Companies/Brand	Shares
Germany	Kraft Jacobs Suchard	28	Kraft Jacobs Suchard	30
	Tchibo	23	Tchibo/Eduscho	25
	Eduscho	15	Aldi	12
	Melitta	10	Melita	10
France	Kraft Jacobs Suchard	45	Kraft Jacobs Suchard	45
	Douwe Egberts	15	Douwe Egberts	15
	Lavazza	8	Lavazza	8
Netherlands	Douwe Egberts	69	Douwe Egberts	69
Spain	n/a		Kraft Jacobs Suchard	21
			Douwe Egberts	21
			Nestlé	20
UK	Nestlé	51.6	Nestlé	51.3
	Kraft Jacobs Suchard	19.8	Kraft Jacobs Suchard	20.8
	Own Label	19.0	Own Label	19.4
	Douwe Egberts	2.7	Douwe Egberts	2.8
	Pauling	2.0	Pauling	1.6
	Van den Bergh	2.2	Van den Bergh	1.7
Belgium (1)	Douwe Egberts	50	Douwe Egberts	52
	Own Label	29	Rombouts	10
	Rombouts	6	Nestlé	7
Austria	Eduscho	25	Eduscho	22
	Jacobs	21	Jacobs	24
	Hofer	14	Hofer	15
	Meinl	9	Meinl	10
Sweden			Kraft J. Suchard	53
			Lofbergs Lilla	17
Finland	Pauling	45	Pauling	44
	Meira Oy	29	Meira Oy	28
	Viking	13	Viking	13
	Tukospar	11	Tukospar	12

Source: Coffee and Cocoa International's «Coffee International File», (1) in Verstraete N. (1998) "Nicaragua en de Internationale KoffieMarkt: Zijn Max Havelaar en de Wereldwinkels een reëel alternatief voor de kleine boeren?", University of Antwerp.

Table 2 reports data on the concentration of European roasters in 1995 and 1997. The high levels of concentration in several of the European countries (higher than 50 in the Netherlands, United Kingdom, Sweden and Belgium) have raised the mistrust of consumer organisations and triggered a number of antitrust actions against transnational corporations but not enough to affect their operations. The most popular in the literature (Talbot, 1997) is the antitrust action undertaken by the United Kingdom Monopolies and Mergers Commissions (MMC) initiated against Nestlé to investigate Nestlé's pricing practices following the 1989 crash in prices, after which retail prices

of instant coffee remained at their pre-crash levels in the UK. on instant coffee prices. Although the MMC report found no evidence that Nestlé's market position enabled it to gain an unfair advantage over its competitors, the fact that the public version of the report removed most of the data on Nestlé's profits is a clear example of limited access to information on margin costs and production in the sector.

Similar to the developments in roasting, the retail coffee distribution industry has become increasingly large in scale and concentration. Coffee retailing is currently moving away from small independent outlets into large scale distribution chains such as supermarkets and hypermarkets. The largest retail distribution chains market their own private labels and also sell labels of other roasters. Own labels have the advantage of saving in advertising and outside-promotion costs and retail at a substantial discount rate as compared to traditional roasters. To avoid possible supply shortages with coffee suppliers, large retail firms have established their own soluble/roasting coffee processing plants. The increasing concentration in the retail distribution has changed the balance of power vis-à-vis large processors, allowing them to direct invest in production facilities or simple reject trade operations.

In addition to the consolidation in specific levels of the coffee value chain (importers, roasters and retailers), transnational corporations are emerging as powerful actors operating at other levels of the value chain, through upstream or downstream vertical integration. Vertical integration is particularly strong among exporters and importers. Such a trend implies that the same TNC exports the coffee from the producing country and imports it into the consuming country. This trend has direct implications on the structure of value added in the producing country and on the meaningfulness of international prices. As mentioned above vertical integration also occurs to a certain extent between retailers and roasters, especially as a result of the increasing popularity of the own private labels.

Since the structure of the coffee industry is clearly characterised as oligopolistic at various levels of production, transnational corporations will be in a position to control the surpluses to their own favour and hence the retail prices of coffee regardless of international price movements. In the present situation of market failure, the oligopolistic structure of the coffee market precludes new entrants to the market either through barriers to entry inherent to the coffee market organisation or in a deliberate way imposing enter detention.

Typical barriers to entry take the form of Sunk Costs⁴. A pertinent sunk cost to a roaster would be the costs prior to entry to build up a brand image, or in the case of retailers, investment in physical assets for warehousing facilities. Most of the larger firms operating in the coffee production chain have already reached a considerable size and operate at lower costs due to economies of scale. A small roaster, unless he deliberately targets a specific market niche, will not be able to meet the minimum cost competitive

⁴ Sunk costs are costs for which the investment associated with its payment can not be rescued for other purpose, or be resold to cover alternative investment costs. Examples of sunk costs are expenditure in legal advice, market surveys or expenditures on non convertible plant equipment.

requirements to conduct business in the industry. For similar reasons, larger incumbent firms have easier access to credit vis-à-vis smaller ones.

A key barrier to entry is product differentiation or ‘brandification’. It is on the basis of de-commodification that roasters and retailers build up brand loyalty and goodwill assets. Large roasters invest millions of dollars to establish and market new brands of coffee to capture specific markets. This product differentiation strategy has been a typical characteristic of the aggressive mergers and acquisition campaign of Sara Lee/Douwe Egberts which has built up an impressive brand variety.

Last, but not least, advertising and R & D, patents and technology control, make up a severe limitation to new entrants. Roasters dedicate substantial outlays in advertising and promotion as prerequisites for sustaining respectable market shares. Furthermore, the creation of new products and proprietary control of innovative processing technologies, such as the introduction of the freeze-dried method and vacuum packing, are crucial tools to gain market share.

The maintenance of a system with high barriers to entry gives the large coffee traders, roasters and retailers the necessary incentives and ability to respond asymmetrically to changes in world coffee prices. At periods when world prices rise, traders can easily transfer this increase to roasters, roasters transfer it to retailers, and retailers to consumers. On the other hand, when world prices fall, as in the present situation, any one of the three actors involved has enough market power to keep its sale prices constant, or even increase them. The retailer, being the last player in the game, is conscious of the possibility of transferring the mark-up to the consumer without any problem, given that the elasticity of demand for coffee is relatively low. Thus, ultimately it is the consumer who will have to bear the final burden. This implies that consumers will have to pay more for the same product with the same values added along the chain of production. In this kind of oligopolistic framework, where none of the actors involved suffer from mark-up increases, there is a relatively high level of understanding and co-operation in the industry.

A policy oriented towards the eradication of market failures in the international and consuming coffee markets, will eliminate the oligopolization of the various stages of the market, reduce the international power of TNC and will help to shift the surplus share from consumer to producer countries.

3.2 The coffee producing countries, with a little emphasis on Brazil

If coffee producers differ among them, Brazil is perhaps the most atypical producer. Beyond still ranking as the first world supplier it also has a large domestic market – actually the second, in a country basis -, what may turn proposals feasible for it meaningless for other, smaller producers.

However, this special situation may also be helpful in allowing, a priori, a wider set of measures that could later be adapted to less complex realities.

As most producing countries, Brazil has been suffering from the steady decay in international prices, the mix towards lower quality beans induced by the large trading companies and the entry of low quality Robusta suppliers, specially Vietnam, which compete with part of its produce. Moreover, as in many other coffee-producing nations, strong market deregulation and the exit of governmental operation and controls during the nineties eventually decreased the bargaining power of small farmers and co-operatives in the domestic trade.

Notwithstanding, being a Robusta and, like Ethiopia, a Natural Arabica producer, Brazil, thanks to its vastness and climatic diversity, is – within these two broad categories - a most diversified supplier, offering, not only in volume but in grades of quality and taste as well, a very wide range of coffees. This, together with the high domestic demand, makes for a much more competitive producer's market, than in most African, Asian or Latin American suppliers.

The differences between Brazil and other CPC (coffee producing countries) raise an important point usually absent in the discussions of solutions to improve the conditions of the producers. There is not an abstract, representative producing country. Producing countries can differ widely, what entails that no general, uniform solution exists to their problems. A serious analysis of the impact of different proposals should take into account a basic typology of the set of producers, what is unfortunately lacking.

4 The proposals

4.1 A Preliminary (and Old) Issue: Tariffs

Broadly, ways to revert – at least to a certain extent – the present situation could only be centred in two alternatives: i) re-install somehow a system of managed supply, with generalised adhesion, or ii) to transfer value-added activities in the chain to the producers.

The former seems unlikely, notwithstanding mixed successes of the recent ACPC (Association of Coffee Producing Countries) efforts. Nowadays manifold alternatives to produce the same blend through different combinations of beans and roasting degrees have substantially increased the probability of free riders to any conceived agreement.

As regards the second option, proposals for upgrading the coffee that will be exported must first of all deal with the tariff issue. Indeed, while the “green bean” enters the EU at zero tariffs, this is not the case for the coffee that has been somehow transformed, which can be taxed at values ranging from 7.5 to 9.0 for non-ACP countries. These tariffs are naturally protecting

the established processors – roasters and others in the chain -, that use the cheap green beans as major input. So, a first point is to accelerate the fall in the tariff structure for derived-coffee goods in order to allow for the entrance of higher value products at competitive prices. These changes may depend on the design of what is going to be transferred to producers' countries and are not necessarily unpalatable.

4.2 Proposal One

The next issue is on what to transfer and how. The two bottlenecks in the producing chain are, in sequence, the trading companies and the roasters. Both constitute clear oligopolies, with more concentration on the side of roasters. Bypassing or countervailing their operations is not easy; scale and flexibility are key elements of their daily practice and sensible alternatives must match these conditions to qualify for market share. In the former ICO-administered supply system, with state market regulators, producing countries were able to have scale and scope economies that gave them some clout on purchasers. Given the apparent impossibility to return to this system, one idea would be to help the creation of domestic trading companies – not necessarily government supported – that could achieve a considerable export volume. These trading would be associated to roasters that, depending on the final product envisaged, would perform the roasting in the country and export the roasted – and sometimes ground – coffee. This would also break the importers-exporters verticalisation structure described in section 4.1.

In logical terms, the above suggestion has no novelty at all; the question is how to make it feasible. We propose that these companies will be encouraged by the EC, especially in the form of joint ventures between producing groups and EU actors in the coffee business. There is nothing against that the European partners be members of – or have as major investors – one of the big European trading or roasters; provided a new venture is created, on an equal basis, involving the EU and one (or a group of) CPC.

The fact that a “North-South” partnership is created would mean that, part or the totality of the coffee sold to the trading, beyond receiving a fair price, could be roasted in situ creating a higher-value export. The mix of roasted and green beans exports would be the result of the strategy of the new company: it could have lines ranging from green beans exports to supply the traditional roasting chains to semi-finished products that would almost directly go to the final consumer. Of course, emphasis would be placed on the more elaborate or higher quality side of the range; help from the EC, for instance, being conditioned on a certain percentage of the product mix being of the more elaborate case. Anyhow, even the green beans business would be conducted under the lines of the fair-trade idea, with principles similar to the ones in the Max Havelaar initiative⁵.

The question of size and flexibility must then be addressed. As known, the supply managed inventories (SMI) strategy of the big roasters allowed

⁵ We do not necessarily sponsor all the criteria and procedures in the Max Havelaar initiative.

them to transfer the burden of the huge stocks to the tradings, while they, cleverly manipulating the different substitutions that give way to the same blend, gained flexibility and lower input costs.

The existing blends, which undoubtedly have educated – or rather, induced - the taste of millions of consumers, are sometimes raised as a barrier to entry. In fact, they have been purposely created as such, within the “de-commodisation of coffee” strategy⁶. Thanks to it – and massive advertising expenditures-, firm concentration, accompanied by a wider scope of brands offered, has been taking place. Notwithstanding, the “blend effect” depends on how market penetration is envisaged. The Starbucks, Café Gourmet and other experiences have shown that, as regards taste, good or at least decent coffee can be accepted provided the proper marketing and distribution take place⁷.

Thus, one idea would be to promote, through these joint-ventures, new flavours or coffees in the lines of the upgrading strategies that have been taking place worldwide: single origin, quality controlled simple blends, adequate roasting, etc⁸. Additionally, as coffee is not champagne, good-value-for-your money coffee, non-branded, should be supplied. The case study of Colombia, when it started to place its coffee (beans) in the international market by promoting “good quality coffee”, just this, is an example worth to be reminded in this strategy.

The European partner will be a key element in designing the mix, taking into account the market needs and realities. This is also crucial as regards distribution, the last key element in the coffee chain. Size will again be important here, to provide minimum supply quantities that would allow strong positioning in at least one regional, national or sub-national sizeable market. Agreement or establishment of the venture with a supermarket chain would be a plus.

The above points raise doubts on the feasibility of the idea in small producing countries. If, on one hand, maybe two companies of the type proposed could be created in Brazil, in many African producers, on the other hand, there would be neither scale nor scope for making the initiative sensible. Moreover, if “the blend” is not an entry barrier per se, it is however a tremendous cost-cutting strategy. Placing a roaster in a producing country, away from the great consumption markets and with much less flexibility than that of those established in the EU, even with some external help would have a strong possibility of being a failure, for lack of competitiveness with other market actors.

This seems at first to limit the idea to Brazil and to the segment of specialised, connoisseur coffees. However, if a Brazilian experiment is successful, the lower barriers and the transfer of technology implicit in it should enable other producers in the exporting countries to take a similar step ahead either by themselves. This could be made either in a regional basis, aggre-

⁶ Aimed at making it theoretically closer to a monopolistic competition good, like cars, for instance.

⁷ It is worth reminding that Starbucks Coffee Company is nowadays the leading retailer, roaster and brand of speciality coffee in the world. It employs 50 000 people and has more than 4 800 stores worldwide. As of November 2001, the company has made a partnership with Compaq to provide I.T. solutions to its business needs *and* offer Compaq internet services in its stores.

⁸ We are aware that “higher quality coffee” is not enough to have a considerable impact on the existing conditions. That is why it is only one component of the proposed product mix.

gating a number of small producers - or through the existing regional integration agreements already existing in Africa, for instance – or by securing similar ventures in the consuming countries (always in an upgrading trend). In this last case, Brazil could act as a third partner, enabling the ventures in the other countries. Given that, as said (in footnote 8), specialised coffees represent a small fraction of the market – less than 4 per cent -, making for a low impact initiative, the initiative must also contemplate more standard and traditional segments, instant coffee included.

But one must also ask whether, in the producing countries, there would be support for such enterprise, or rather, taking a big producer like Brazil, why such appropriation of the chain had not been conceived.

Interest arises if a clear picture of higher profits is presented, though two other difficulties might work against this. The first is location. Elementary economic geography tells that factories should in principle be close to their final markets. Given the present structure of the coffee chain in the EU, placing a significant roaster “in the South”, even if sensible in terms of volume and flexibility, may increase in a sub-optimal fashion transportation and logistic costs. Disregarding regional initiatives⁹, this seems to leave again, in a first screening, only Brazil as a viable location, given that its huge domestic market could act both as a hedge to adverse (foreign) demand movements and as a platform to cover fixed costs, guaranteeing competitive final prices. Nevertheless, margins are so high - and constant - in the consuming-countries side, that well chosen locations in other CPC, together with efficient operation, could place a product at competitive prices in Europe. Second, there might be protectionist moves from the EU firms or coffee lobbies, waving the banner of unemployment, against such location changes. As regards these arguments, the right thing to be said is that there is not enough public information on the consumption side of the chain to allow a analysis of these points – something that will be touched again below.

⁹ Dependent, beforehand, on a regional agreement of some sort.

Regarding the lack of similar initiatives in the producer’s side, a few explanations look sensible; the tariff and non-tariff barriers, specially in emerging coffee consumers - like Eastern European countries -, where new firms could have a chance, being a first negative incentive to further processing of the green beans. The lack of information and knowledge on the right channels where to place a more diversified product in the foreign markets - something the joint venture tries to solve - is also a deterrence. Finally, for large farms in CPC - which could have conceived something in this line -, even in a depression period, profits - given the quantities traded - can be sufficiently high as not to create incentives to improve their activities. So, for reasons different from those of small farmers, they also lie down and help in keeping the present market structure.

4.3 A comment on oversupply and elasticities

The suggestion sketched above is not a solution to the so-called oversupply problem, especially as regards low quality Robusta. In fact, the proposal has a bias towards higher quality outputs that, though acting as an incentive for a flight in this direction, is not enough to divert the desirable amount to solve the oversupply problem.

Taxes on lower quality imports can have a mixed effect, if passed to producers, lowering further prices at the farm gate. In principle, we do not favour such a solution; if applied, however, it should be later in the chain, taxing lower quality blends to roasters, for instance, after a specified volume, as will be also addressed later. Some form of production management, in the lines of the ACPC initiatives, seems difficult to be achieved without a controlling instance in the side of the importers¹⁰, particularly given the new recent failures. Nevertheless, the Commission could help in this, by trading some kind of concessions to those countries that participate in the agreement, provided the agreement has a size that counts. This, however, must be carefully studied so as not to violate a WTO rule or principle.

¹⁰ As happened in the past.

The oversupply issue, however, can also be looked at the other way round, and seen as something temporary, due not to excess in supply but to a fall in demand. This leads to a point that, in our view, might be a fallacy in the present analyses of the question. It is common to say that the price elasticity of demand for coffee is low, the market having already achieved a mature stage. Though this is likely to be true in an aggregate fashion, considering the whole of the US and EU consumption markets, we pose that the elasticity may be much higher for specific – and significant – market segments still unexplored. In the European case this segment would be made of a lower income population, with a large percentage of migrants from (traditionally) coffee-consuming cultures. In case a better quality, affordable product is offered to them, a reasonable increase in demand may take place. Moreover, as eyed by EU enterprises, the Eastern European market offers a new potential to be exploited, with certainly higher elasticities. This market is particularly attractive, not only because of the possibilities to increase consumption per se, but also of those related to the creation of distribution and point-of-sales strategies. The success of Project OGI in Russia, with its Pirogi, Club Project and Ulitsa OGI cafés is a good example of the unexplored potential in these new markets.

4.4 Proposal Two.

Beyond the previous idea, two other points are worth mentioning. The first is the great asymmetry in information regarding production and consumption. If the distribution of growing areas is fully known, according to almost every aspect of interest – namely output, productivity, quality, physical and environmental conditions, spatial dispersion (or concentration), economic and financial aspects, social and managerial organisation of the farmers -, the same does not apply to the consumption phenomenon. Apart from a few basic statistics, there is scarce knowledge on the structure and

key characteristics of consumption patterns. This poses additional difficulties to the producing countries, in organising not only their global policies but specific strategies as well. One thing of great help would be the systematic provision of basic intelligence on what happens in the consuming countries. Statistics of the quantities sold for household consumption and for other situations, by broad categories of “coffee” and point of sale could be produced in an annual basis, for each country, with perhaps the help of Eurostat. They should be matched by the exports/imports data and complemented by (aggregate) country statistics on the roasting sector, here included data on the workforce. This simple measure, practically costless, would extremely help producing countries design their own market and producing strategies.

4.5 Proposal Three

The second is the creation of a fund, backed by a common EU tax on roasted coffee. At present, there is a wide diversity, within the EU, as regards domestic taxes on processed coffee. They are applied, at different levels, in Germany, Belgium and Denmark, there existing no precise information about the other members. Within the framework of the single market tax harmonisation process, a common tax could be created¹¹. A percentage of these tax revenues would go to a European Coffee Fund.

¹¹ Of course, not at the highest present level.

The example of the Danish International Investment Fund, could serve as a useful example to be reproduced in an European scale. In fact, The Danish Fund (Industrialisation Fund for Developing Countries, IFU), was created in 1967 in part with the proceeds from coffee import duties and the internal tax, was originally known as the Coffee Fund. Its purpose of this Fund is the promotion of economic activity in developing countries, in collaboration with the Danish private sector.

The European Coffee Fund - ECF should be regarded as part of the EU initiatives to aid developing countries. It would be a European institution devoted to the CPC and with two main programmes.

The first would be, through the ICO, to support an advertising campaign on coffee in general, aimed at counterbalancing the increasing “brandification” of coffee. Brands are a major barrier to entry in the coffee market¹², and even the relatively successful new entrants, related to ideas like “speciality”, “shadow” or “organic coffee”, have spent quite an amount of money and effort in (conventional or unconventional) propaganda. The ads would make the case for coffee, the general drink, passing, for instance, basic information on the characteristics of the plant and the drink. This campaign could be extended to the future Eastern European members of the Union, as a further assurance that EU processors would not have privileged access to these new markets. An EU quality label, to be appended on every coffee sold in the Union could complement this initiative, helping to create a level playing field for products from outside the EU.

¹² An annual survey of the UK’s leading 100 grocery brands, conducted by A C Nielsen, found Nestlé’s Nescafé instant coffee as the *top third* (surpassed only by Coca-Cola and PepsiCo’s Walkers crisps). The Nestlé brands fetches £ 312,1m in annual sales in the UK. [Financial Times, November 22, 2001]

The second half of the Fund's budget would be used in a careful diversification effort, to take place in selected producing countries; this would help in streamlining and upgrading supply. Given the not very enthusiastic records of recent diversification attempts, these measures should be carefully designed to give a minimum consistency to the agricultural changes induced. Involvement of the ACPC could not only improve the knowledge of feasible measures as give wider support and visibility to them.

4.6 Suggested background studies to support the proposals.

The proposals outlined above must be complemented by a series of detailed studies. We describe six of them, leaving aside the question of creating and implementing the European Coffee Fund:

a) A Typology of Producing Countries: basic to a better understanding of the universe of coffee-producing countries, this is an economic-statistical project which, taking into account different characteristics of the countries, will define clusters of similar producers. Policy proposals could then be matched to these different groups.

b) The European Roasted Coffee Market: the purpose of this study is the production of intelligence on the roasted coffee market in Europe. The study can help in checking the possibilities of the market in terms of the share domestically produced (i.e., inside the EU) / imported roasted coffee, as well as evaluating the impact on the present roasters' structure of a greater penetration of imported roasted coffee. It can also help in the definition of the basic market statistics that should be produced every year.

c) Harmonisation of Coffee Taxes in the EU and A System of Coffee Statistics: These two studies should be commissioned and supervised by the EC. The first would suggest, within the framework of EC tax harmonisation measures, the design of a single tax system – stating the level, when and how to enforce the taxes – that would provide the resources for the European Coffee Fund. The second is self-explanatory and should be conducted by Eurostat.

d) Business Facilitation for EU-CPC Joint Ventures: without proposing distorting facilities or (new) subsidies, this study should get deeper into the available conditions that could be of help to middle-sized joint ventures as 7 proposed above. Analysis of potential obstacles to the operation of these ventures in Eastern European countries is a must. Of course, if low cost facilitation is possible, it should be taken into account. The final goal is to develop a guide to those interested in creating such ventures.

e) A Closer EU-ICO Partnership: As a UN organ the ICO is a natural institutional partner for a general initiative on coffee. This is more the establishment of a well-targeted co-operation than a project or study. Paramount in this co-operation is the design, under the proper legal and institutional framework, of a non-branded, coffee-promoting advertising campaign, in the EU and Eastern Europe.

f) Quantities sold for household consumption and for other situations, by broad categories of “coffee” and point of sale could be produced in an annual basis, for each country, with perhaps the help of Eurostat. They should be matched by the exports/imports data and complemented by (aggregate) country statistics on the roasting sector, here included data on the workforce. This simple measure, practically costless, would extremely help producing countries design their own market and producing strategies.

Annex: Institutions and Persons Visited

In Belgium:

Mr. Johan Declercq, Producenten Relaties, Max Havelaar België
Mr. Wendel Trio, OXFAM -Wereldwinkel
Mr. Yvan Robouts, Director Koninklijk Verbond van Kofiebranders

In Brazil:

Ambassador Jório Dauster; Former President of the Brazilian Coffee Institute (Instituto Brasileiro do Café - IBC);
Mr. Manoel Aranha Corrêa do Lago; Director, *Valorização, Empresa de Café S/A*;
Mr. José Sette, Coffee Expert ;
Selected small-size coffee farmers in the states of Paraná and São Paulo.

In Switzerland (Geneva):

Mr. Bertil Byskov; International Trade Centre UNCTAD/WTO
Mr. Morten Scholer, Gourmet Coffee Project; International Trade Centre UNCTAD/WTO

Mr. Mehmet Arda, Chief General Studies Sector, Commodities Division, UNCTAD

In the U.K.:

Mr. Celsius Lodder; Executive Director, International Coffee Organisation – ICO;
Mrs. Karen St Jean-Kufuor ; Senior Economist, Association of Coffee Producing Countries – ACPC;

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