INTERNATIONAL COFFEE ORGANIZATION
ORGANIZACIÓN INTERNACIONAL DEL CAFÉ
ORGANIZAÇÃO INTERNACIONAL DO CAFÉ
ORGANISATION INTERNATIONALE DU CAFÉ

OPPORTUNITIES AND CHALLENGES FOR THE WORLD COFFEE SECTOR

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I. INTRODUCTION

Coffee is remarkable for being produced in almost all non-arid countries in the tropics. Over 50 countries produce coffee in significant amounts; in many of these, foreign exchange earnings from coffee exports are of vital importance to the balance of payments. A further characteristic is that coffee is produced almost exclusively in developing countries, including 18 least developed countries (LDCs) (see list of ICO exporting Members in the Annex). Coffee is an important agent of development, generating cash returns in subsistence economies and, since coffee production and harvesting are labour-intensive, providing an important source of rural employment, for both men and women.

In terms of international trade, coffee is the most valuable tropical agricultural product. World coffee consumption has been growing steadily at a rate of around 2.5% p.a. and is estimated at approximately 128 million 60-kg bags in 2008. Consumption is concentrated in the mature markets of Western Europe and North America, but is now growing faster in emerging markets, such as those in Eastern Europe and Asia, and in the coffee producing countries themselves.

The International Coffee Organization (ICO) is the main intergovernmental organization for coffee, bringing together producing and consuming countries to tackle the challenges facing the world coffee sector through international cooperation. It administers the International Coffee Agreement (ICA), the latest of which is the 2007 Agreement, which was concluded in London in September 2007. The 77 Members of the ICO account for approximately 97% of world coffee production and 84% of world coffee consumption.

II. TRENDS AND OUTLOOK

Historically, the long-term behaviour of coffee prices has been highly cyclical in nature. These cycles are primarily caused by fluctuations in supply, rather than changes in demand, which is relatively stable. A typical price cycle begins with a situation of approximate balance between supply and demand that is disrupted by a major climatic event (for example, a frost or drought). The consequent reduction in supply leads to a sharp rise in prices, stimulating producers to make new plantings. However, the new trees take three or more years to come into full production, prolonging the period of high prices and continuing to encourage plantings. When the new sources of production come on-stream simultaneously, prices crash because of oversupply. Prices then continue at depressed levels until sufficient marginal land is taken out of production, a process that usually takes some time since coffee is a perennial tree and not an annual crop.

From 1963 to 1989, the amplitude and duration of these price cycles were constrained by market regulatory mechanisms (export quotas and other measures) administered by the ICO. From 1989 onwards, the coffee market, like many other primary commodities, has been free from regulation.

The period of uncontrolled markets has been characterized by greater medium-term price volatility than under the regulated market. As a result of a severe frost in Brazil in 1994, prices rose by some 118% between 1993 and 1994. It is interesting to note that, with replanting, production by 1999 had risen by 35% relative to 1994 and prices had dropped by 38%.

The ensuing coffee price crisis began in 2000 and continued until the end of 2004. During these five years many coffee producers were unable to cover their production costs and only continued to produce coffee because of the lack of alternatives or because they still cultivated subsistence food crops. The effects on farmers included 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. With respect to the balance of payments, earnings by coffee producing countries slumped by more than 50% implying losses in earnings in excess of US$30 billion. On the other hand, it is worth noting that the coffee market in industrialized countries continued to be relatively healthy with steadily rising retail sales, particularly in terms of value.

Since 2004, coffee prices have recovered considerably and reached levels last seen in 1998, with export revenue of producing countries in coffee year 2007/08 estimated at US$15.2 billion. However, this strong performance is unlikely to continue in the near future as a result of the impact of the global economic crisis that began in September 2008. No sector has been spared from the current financial turmoil, which has already caused a substantial slowdown in most industrialized countries. Governments around the world are trying to contain the crisis, but many analysts suggest the worst is not yet over. Coffee prices have been badly affected, having fallen by almost 20% between the end of August and the time of writing.

Effects of the financial crisis on coffee consumption

Early reports show that food sales are behaving better than those of non-food products. In markets in North America, Europe and Japan, which are responsible for approximately 58% of world consumption, coffee is a staple good that accounts for only a small fraction of consumer spending. The available information suggests that coffee consumption is holding up well in these markets. Instead of reducing overall intake, the response of consumers is more likely to consist of a shift from out-of-home to in-home consumption and from higher cost products to cheaper brands. This trend to less expensive products is corroborated by the strong results reported by discount food retailers in late 2008.

In coffee producing nations, which make up more than 26% of world consumption, the situation is more diverse. In some countries, prices of coffee have fallen in local currency and consumption may therefore be stimulated. Meanwhile, in Brazil, the largest coffee drinking market among producing countries, the devaluation of the exchange rate has maintained prices of green coffee at pre-crisis levels. As a whole, consumption in these countries is not expected to suffer any major negative impact.

The third major component of coffee consumption comprises emerging markets, mainly in Eastern Europe and Asia. The position here is less clear. Purchasing power is more limited than in developed countries, and coffee consumption is not as strongly entrenched. Cutbacks in coffee purchases may occur in case of widespread unemployment and economic instability.

Impact of the economic crisis on coffee production

Over the past two decades, coffee production has been marked by considerable gains in productivity. However, we have also witnessed large increases in production costs, mainly due to rising prices of key inputs, such as fertilizers, transportation and labour. Even at the higher prices prevailing before the onset of the crisis in September 2008, producers, especially those of Arabica coffee, were hard put to cover their costs and had little incentive to invest in new plantings. Current levels of production are sufficient to meet demand but not the rise in consumption forecast for the future.

In some instances, pressure on costs is likely to ease. Significant declines in prices of oil and fertilizers have taken place in recent months. The impact of these price decreases on production costs is likely to be subject to a lag, since many of these inputs are purchased well in advance. However, it is not expected that labour costs will fall to the same extent. Even if unemployment rises, thereby increasing the incentives to work on coffee farms, past pay increases are often enshrined in national minimum wage agreements and will remain unchanged.

A key component in the response of individual countries will be exchange rate policy. The devaluation of the US dollar in recent years had a major impact on profitability in key coffee producing countries, such as Brazil and Colombia. This trend prevented growers in these countries from reaping the full benefits of the recovery in coffee prices since 2004. On the other hand, producers in countries with currencies linked to the US dollar, such as Vietnam, were able to take advantage of higher prices on the international market. The situation is now likely to be inverted. In countries with flexible exchange rates, price falls in the international market have been (at least partially) compensated by exchange rate movements and the price of coffee in local currency has not changed significantly. In countries whose currency is more directly linked to the US dollar, the impact of recent price reductions on the terminal markets are directly transmitted to growers. In fact, currency movements have become a driving force in the price behaviour of futures markets for many commodities, and coffee is no exception.

World trade

On a macroeconomic level, export revenues from coffee are expected to fall. Over past decades, most producing nations have diversified their economies and reduced their dependence on coffee as a generator of foreign exchange. Even so, the crisis will affect more strongly some countries where coffee still represents a significant share of export earnings, notably Burundi (52%), Ethiopia (31%), Honduras (23%), Uganda (17%), Nicaragua (17%) and Guatemala (12%).

In the international coffee trade, new constraints due to the new economic climate have arisen: retailers have become more cautious; consolidation is taking place; economic agents are seeking to diversify even more their client base; and hedging has become more expensive. Some disruption to normal trade patterns was reported at the beginning of the crisis, but the situation appears to be returning to normality.

Meanwhile, the persistence of barriers to trade in some importing markets, particularly in the form of tariff escalation affecting processed coffee, continues to impede full access to markets by a number of coffee producing nations.

In summary, early evidence suggests that the current financial crisis will have a significant impact on coffee consumption. With regard to production, effects are likely to differ considerably among countries. However, whatever the response, there appears to be no change in the underlying reality of the world coffee market: prices remain at levels that do not reward much-needed investments in future production. At the same time, in the current context of a fine balance between supply and demand, any disruption to production is likely to trigger a new cycle of high prices and overproduction.

III. STRATEGIC DEVELOPMENT ISSUES

The recent coffee crisis from 2000 to 2004 took a heavy toll on producing countries as noted above. While prices have recovered, the long-term downward trend of coffee prices in inflation-adjusted terms and the cyclical nature of the coffee market point to the continuing need to address this issue. This situation makes measures capable of restoring greater balance between supply and demand to improve prices a matter of priority, given the difficulties of successfully pursuing alternative economic activities in many coffee regions.

More specifically, to create a more favourable atmosphere for economic restructuring and to avoid long periods of depressed commodity prices, it is essential to:

- maintain prices at levels that are remunerative to producers while taking into account the interests of consumers;
- stimulate the improvement of quality and productivity;
- promote a favourable image of coffee;
- encourage increased consumption and market development;
- promote the contribution of coffee to poverty alleviation and living conditions of smallholders;
- support the research and development of new technologies;
- explore ways to mitigate the effects of the rising costs of some key inputs in the production process, such as labour and fertilizers;
- ensure the environmental sustainability of coffee cultivation, including adaptation to and mitigation of the effects of climate change;
- improve infrastructure of coffee production and logistics;
- diversify production in exporting countries;
- reduce excessive short-term fluctuations in prices and export earnings;
- improve market access and reliability of supply;
- promote market transparency by the provision of accurate and timely data at an accessible cost;
- improve market structures, including access to financial instruments, such as price-risk management schemes;
- enhance the participation of producing countries in the processing, marketing, transport and distribution of their commodity exports; and
- develop an understanding that action may be needed at all points in the supply chain, which should be understood as reaching from the grower to the final consumer, not just from the grower to the importer.

In order to achieve its strategic objectives, the ICO has developed a close and constructive relationship with the Common Fund for Commodities, by means of development projects in Africa, Asia, Latin America and the Pacific. Up to today, the CFC has provided approximately 54% of the funding for 30 projects with a total value of around US$84 million. The rest of the funding has come from bilateral and multilateral donor institutions in respect of co-financing, and from the beneficiary countries in the form of counterpart contributions. LDCs receive priority in participation in ICO project activities; of the projects sponsored, 95% have at least one LDC as a direct beneficiary.

IV. TRADE ISSUES

Significant progress has been made in importing countries in regard to the reduction or removal of certain tariffs. These efforts have been undertaken both within the multilateral framework created by various rounds of trade negotiations (GATT Agreements, Tokyo, Uruguay and Doha rounds), and within the framework of regional or bilateral arrangements. In addition, the Member countries of the European Union have applied a preferential trade system to African, Caribbean and Pacific States (ACP) since 1975 under the Lomé and Cotonou cooperation agreements. Countries of the Andean Community (Bolivia, Colombia, Ecuador, Peru and Venezuela) also have privileged trade relations with the European Union and the United States (without Venezuela). Some countries do not benefit or benefit only partially from tariff reduction measures applied by the European Union within the framework of these trade cooperation agreements. In the case of these countries, only exports of green coffee are exempt from tariffs, indicating that the creation of added value must take place within the European Union. Moreover, these countries do not benefit from the preferential margin, which is the difference between the customs duties normally levied on entry into the single European market and those, frequently nil, paid by ACP exporters.

The preferences given to ACP States were originally designed to promote and diversify their exports, thereby encouraging their growth and development. The advantages offered also take the form of exemptions from restrictions other than customs duties, such as quotas, which, especially in the case of agricultural products, set upper limits on the volume of imports for a given product or a particular supply country. Tropical products that do not compete with European products (coffee, cocoa) can enter freely into the European Union. Many ACP States have successfully developed their exports of non-traditional products (cut flowers, tropical plants), which benefit from a significant preferential margin. Preferential tariffs are also applied by the United States and Canada within the framework of trade agreements such as the North American Free Exchange Agreement (NAFTA) (Canada, Mexico and United States). Nevertheless, special tariff concessions given by developed countries for imports from selected developing countries have become less and less important. In other words, the difference between normal and preferential rates has lessened with the progress achieved within the framework of liberalization of world trade.

The progressive nature of customs duties is evident in the increased tariffs applicable at each stage of production, from the processing of the raw materials to the finished product. Thus, the lowering of tariffs has been much more pronounced in the case of exports of green coffee than that of manufactured products derived from coffee, particularly ground and soluble coffee. This progressiveness in customs duties can be explained in terms of the desire to protect the roasting industry in some importing countries. Customs duties have, however, been reduced in many coffee-importing countries and European Union countries have a harmonised system.

In coffee exporting countries, tariff and non-tariff measures applicable to imports exist that may constitute an obstacle to the increase in coffee consumption. For example, restrictions on imports of coffee from other origins as a means of protecting local industry limits the possibilities available to domestic roasters for producing blends that can further improve the quality of the beverage and increase domestic consumption.

In general, special tariff concessions given to importing countries for imports from some developing countries are less and less important, since the difference between normal and preferential rates is narrowing. The progressive increase of tariffs on processed coffee (tariff escalation) applied by the European Union and other importing countries seems to be explicable in terms of the desire to protect the national roasting industry in the countries concerned. This is definitely a factor limiting the growth of added value in exporting countries, but does not seem to be a major obstacle to the increase in consumption of coffee.

V. AREAS FOR ACTION

In the case of coffee, seven main strategic areas for action to encourage socio-economic development and a sustainable coffee economy can be identified, based on specific objectives in Article 1 of the International Coffee Agreement 2007.

1. Promotion of a sustainable coffee economy

It is vital that coffee production and processing should take into account the United Nations Agenda 21 criteria to ensure economic, environmental and social sustainability. It is particularly necessary that the economic environment should encourage stability and reasonable living standards for the populations involved with coffee by securing adequate returns to producers, ensuring meanwhile that adequate consideration is given to maintaining quality rather than the amount of coffee produced. Furthermore, the issue of climate change is expected to exert an increasing influence on coffee production in upcoming years, necessitating appropriate adaptation and mitigation strategies. The ICO also recognizes the social importance of established coffee-growing communities and the difficulties of finding alternative sources of income in many coffee areas.

In addition, the ICO seeks to promote the use of environmentally friendly technologies throughout the production and processing chain, integrated biological pest control and improved technology for the washing process. Action against pests and diseases is important not only to protect the economies of producing countries and the livelihood of farming populations but also to protect the quality of the product. Care must be exercised when developing protection programmes to ensure that these are as environmentally friendly as possible. Such programmes could include the conservation of germplasm of wild coffee species threatened by the destruction of native habitats as well as key features such as resistance to pests and diseases, tolerance to adverse growing conditions, yield potential, and cup and technological quality.

2. Increased consumption and market development

To maintain a sustainable coffee economy, it is important to ensure that increases in supply are matched by corresponding growth in demand. This can be done through quality improvement (see below) and through promotional and educational projects. The ICO attaches particular importance to programmes targeting new or emerging markets and the producing countries themselves. These are the areas of greatest potential for future growth in demand. For example, India, Indonesia and Mexico have a combined population of 1.5 billion but currently have an annual consumption of only 5 million bags. Promotion programmes already under way, based on the ICO Step-by-Step Guide to Increasing Coffee Consumption, aim to increase this figure to a range between 7 and 9 million bags/year in a five-year period. Similar opportunities for raising consumption exist in other markets. Increased domestic consumption in producing countries also has other benefits: making producers more aware of consumer demands and quality factors; providing an alternative market to the export market; generating experience in the production and marketing of value-added products; and stimulating small and medium enterprises. Finally it should be noted that new transport technologies are making it more technically feasible to export roast coffee but tariff escalation on processed coffee in many markets remains a problem.

3. Quality enhancement

The maintenance and improvement of quality are crucial to sustain consumption in the long term, add value to the product and ensure compliance with international food safety requirements, thus contributing to a healthier balance between global supply and demand. The bottom line is that consumers will drink more coffee if the quality is good, leading to gains in all sectors of the market. This can be done through: disseminating awareness of marketing and preparation methods appropriate to high quality coffee; improving cultivation, processing, storage and transportation practices; and through protection against pests, diseases and contamination during storage. In order to preserve coffee quality, the ICO discourages the trade of coffee with less than the equivalent of 95 percent of green coffee as the basic raw material. In addition, the ICO Coffee Quality-Improvement Programme encourages Members to ensure that their green coffee shipments fulfil certain basic quality standards.

4. Diversification

As part of its efforts to address the constraints facing coffee producers, the ICO encourages horizontal diversification. Such programmes include projects that aim to generate complementary earnings for growers, such as by the introduction of new crops, without eliminating coffee growing itself. However, vertical diversification to address issues such as the production of speciality coffees has the potential of creating even bigger benefits for the producers. The aim should be to create a balanced enterprise for farmers which need not entail total elimination of coffee growing. A careful analysis of market and ecological conditions is essential in embarking on projects in this area.

5. Improvement of marketing systems

With the transition in many exporting countries to liberalized marketing systems, care is needed to ensure that the benefits of increased market flexibility are not jeopardized by the elimination of necessary functions previously undertaken by marketing boards and similar regulatory bodies, and that there are sound institutions at the domestic and international levels to develop and implement relevant policies and programmes. In addition, the coffee sector in many exporting countries consists of large number of smallholder farmers who need assistance to: strengthen grass root organizations and build up the capacity of coffee sector institutions; develop their capacity to compete in the market; obtain access to commercial credit and technical information; cope with price volatility and other risks through appropriate financial instruments; and generate benefits to their communities. In the interests of a healthy and competitive trading economy it is important that the coffee trade in producing countries has the necessary degree of commercial expertise, access to credit and appropriate legal framework to function effectively.

There are considerable differences in countries’ ability to assess coffee trade-related issues and subsequently benefit from the results. The ICO is committed to enhancing market transparency by producing statistics, research studies and other information on the world coffee economy, as well as organizing seminars covering a wide array of topics of interest to the world coffee community. In so doing, transaction costs are reduced to the benefit of all components of the coffee supply chain and economic decisions can be taken on the basis of accurate and timely data. The ICO also seeks to evaluate and, if appropriate, propose new instruments of international cooperation designed to monitor particular coffee market trends that might be of interest to Members.

6. Research and development of new technologies

Research and development of technologies to improve conditions for producers can be instrumental in assuring a healthy coffee sector. This should be seen together with the necessary capacity building measures and training to ensure the dissemination of the results of such research. Special attention should be given to environmental issues in view of the positive impact of coffee growing on the global environment. New technologies under development include: ecologically more beneficial post-harvest processing methods; plant breeding; genetically modified plant material; improved soluble coffee manufacturing processes; and Internet trading. It is important that appropriate technological advances be developed, evaluated and disseminated to the benefit of the world coffee community, and that increased exchanges of information amongst producers be promoted.

7. Rehabilitation of production capacity

In cases where producing countries have suffered a large decrease in production for reasons of *force majeure*, it may be appropriate to encourage programmes to help a recovery in production capacity, providing increases are not of a scale to exert an adverse effect on the supply-demand balance. Such action assists in ensuring that characteristic coffees remain available to the market, in safeguarding the exploitation of comparative advantage and, not least, in providing an important source of employment in view of the labour-intensive nature of coffee cultivation. As part of this strategy, emphasis is given to promoting studies/technical assistance on coffee development in countries that have suffered major natural disasters and/or war disruption.

VI. CONCLUSIONS

Coffee is a strategic crop for many developing and least developed countries, especially due to its capacity to generate income and employment in rural areas. In the long-term, the world coffee economy must strive to attain sustainability, in its economic, social and environmental dimensions. International cooperation, under the aegis of the ICO, is a key instrument to achieve this ambitious goal.

ANNEX

Exporting Members of the International Coffee Organization

	Developing Country	LDC
Angola	√	√
Benin	√	√
Bolivia	√	
Brazil	√	
Burundi	√	√
Cameroon	√	
Central African Republic	√	√
Colombia	√	
Congo, Democratic Republic of	√	√
Congo, Republic of	√	
Costa Rica	√	
Côte d'Ivoire	√	
Cuba	√	
Dominican Republic	√	
Ecuador	√	
El Salvador	√	
Ethiopia	√	√
Gabon	√	
Ghana	√	
Guatemala	√	
Guinea	√	√
Haiti	√	√
Honduras	√	
India	√	
Indonesia	√	
Jamaica	√	
Kenya	√	
Liberia	√	√
Madagascar	√	√
Malawi	√	√
Mexico	√	
Nicaragua	√	
Nigeria	√	
Panama	√	
Papua New Guinea	√	
Paraguay	√	
Philippines	√	
Rwanda	√	√
Tanzania	√	√
Thailand	√	
Timor-Leste*	√	√
Togo	√	√
Uganda	√	√
Venezuela	√	
Vietnam	√	
Yemen*	√	√
Zambia	√	√
Zimbabwe	√	

*Signatory of the 2007 International Coffee Agreement.