



Is Fairtrade a subsidy that encourages farmers to grow more coffee and therefore contribute to global oversupply and low prices?

Subsidies

A subsidy is a grant given by a government which lowers the price of a good with the intention of encouraging production and/or consumption of that good or to make a domestically produced good more competitive than an imported good. The cost of these subsidies is imposed on taxpayers or consumers.

Fairtrade, on the other hand, is a voluntary model of trade that brings consumers and companies together to offer smallholder farmers a price for coffee that covers their cost of production and provides a sustainable livelihood. As a result they are able to send their kids to school, improve their business and marketing skills, and diversify if they choose. Whilst it may not be the only solution to the coffee crisis, this is surely more effective than relying on rock-bottom and ever declining world market prices that currently lock farmers into growing more and cheaper coffee each year simply to stand still.

Conventional market

The multinational coffee companies say that it is impossible to help all coffee producers and use that as an excuse for not helping anybody. They are happy to pay rock-bottom market prices for the bulk of their coffee requirements and only pay a higher price when necessary to source a particular quality or origin.

The reality is that the high-volume, low-cost producers can only supply 30% of the quantity needed by the industry. The market therefore relies on around 15 million smallholders who supply 70% of the total market, including a wide range of different qualities, origins and speciality coffees. Inevitably, their production costs are considerably higher than Vietnam's low-wage industry, boosted by government policies to expand agricultural exports, and the large-scale, low-cost Brazilian plantations that have invested in mechanisation and innovative and intensive production techniques.

While the major companies expect smallholders to continue to make available the quantities of coffee they need for their businesses, they aren't prepared even to cover the growers' production costs. This amounts to using smallholders as casual labour to be called on when required and dismissed when surplus to requirements. In the light of this, it is disingenuous for the big players to dismiss Fairtrade as insignificant on the one hand and as distorting the market on the other.

Fairtrade approach

Fairtrade aims to address this situation with particular regard to the most marginalised and disadvantaged producers. Fairtrade works in partnership with traditional coffee growing communities - not recent entrants to the market - and is about promoting production that is both commercially and environmentally sustainable. With the resources to finance cupping laboratories, for example, growers can improve the quality of their coffee which will help them penetrate new markets.

Oversupply and diversification

Most Fairtrade certified coffee co-operatives currently sell only a small part of their crop to the Fairtrade market; therefore their main incentive is to increase sales to the Fairtrade market rather than expand overall production. Like any grower, many may understandably want to increase production to try to recapture from conventional sales some of the income lost as a result of the all-time low prices of the past five or six years. But the reality for most farmers is that they simply don't have the finances to increase planting or purchase additional land to up their production.

Working with Fairtrade can provide opportunities for diversification: in Guatemala, Fairtrade coffee farmers are intercropping with citrus fruits and bananas to increase their incomes and

reduce dependency on coffee. And Fairtrade sales have provided the finances for their co-operative to buy a plot of land to build processing facilities which will increase their share of the export price. Others are growing macadamia nuts and setting up tourism projects. Banana farmers in the Windward Islands now also grow passion fruit and mangoes; tea farmers in Sri Lanka are cultivating spices, while tea estate workers there are accessing low interest loans to set up small enterprises such as vegetable growing, chicken rearing and milk production.

With a global market share of less than 0.5%, Fairtrade is not trying to apply this model across the board, but there is no reason why it can't be applied further into the market to benefit higher cost small-scale producers. We agree with many others, from Oxfam to neo-conservatives, that small-scale coffee farmers would benefit from access to market information, technical support, investment in diversification, a co-ordinated strategy to promote consumption, the reduction or scrapping of tariff escalators on processed agricultural products, and the scrapping of rich nations' agricultural subsidies. Until that day arrives, Fairtrade will continue to engage with producers, consumers and commercial organisations in the development of an equitable coffee market.

The Economic Arguments

Fairtrade coffee is achieving rapid growth but, as mentioned above, remains a very small part of the global market – less than 0.5%. The extent to which the Fairtrade model can be adopted by the world market is debatable, but there are a number of lessons that can be taken from the Fairtrade system in developing a more equitable market for all coffee:

1. The need for new thinking on markets.
2. A more cohesive approach to sustainability.
3. The importance of demand factors and the need to engage with consumers.

With regard to market operations and the crucial mechanism of price, the most frequent criticism of the Fairtrade model is that the adoption of a minimum price for all coffee would encourage further over-production. This has tended to polarise the discussion rather than looking at how Fairtrade principles could be applied more widely. It is clear that a sustained period of low prices has not had the corresponding effect in reducing production that the classic free market model envisages. There are two reasons for this:

- (a) The fact that many small growers are almost totally dependent on coffee production for their livelihoods. Not only do they not have the means of investing in alternative production (whether skills, information or capital) but their market opportunities are limited, often by the trade barriers of developed countries. In fact, as the International Coffee Organisation (ICO) and others have pointed out, their dependence on coffee means that many small farmers will increase output at the expense of quality in an attempt to compensate for lower prices. We should not forget the caveat that is applied to most economic rules such as output responding to price - "*ceteris paribus*" (other things being equal). Clearly in world trade things are not equal and this is why Fairtrade sees part of its role as the mobilisation of consumers in the campaign for trade justice and the honouring of the pledge for the current round of World Trade Organisation (WTO) negotiations to be the "development round".
- (b) The other problem with the classic market model applied to coffee is that the bulk of consumption is in well-developed and mature markets, which limits the potential for low prices to stimulate demand. This underlines the importance of developing coffee markets in emerging economies and producing countries.

Conversely, our experience in Fairtrade suggests that price support need not increase production if it is matched to market requirements and linked to other sustainability measures such as diversification and quality improvements. The minimum Fairtrade price is not something that is just given by purchasers; it is part of the trading relationship and places obligations on producers in respect of complying with Fairtrade standards and improving quality and sustainability.

The final factor in the price discussion has to be the distinctive structure of the coffee market, which touches the lives of millions of people at both the production and consumption end but is

heavily consolidated in the centre through commodity trading, roasting and retailing. Again we see a model that does not conform to the classic free market model of a large number of independent buyers and sellers operating with equal information and power and with no barriers to new entrants. This is not to open an argument about whether or not companies are exploiting their position – merely to suggest that we need new thinking of how markets can best work with the structure that has developed in order to best serve the needs of all participants in the chain.

The second point is that sustainability initiatives need to be considered in their broad social and economic context. Clearly diversification and reduced reliance on coffee by growers is important in helping to make production more responsive to market conditions, but this can only become a reality if producers have markets for alternative crops. Sustainability also focuses on quality improvements but there is a real challenge in making the knowledge and skills necessary for improved quality accessible to weaker producers who are the ones most likely to be producing low-grade coffee. Our experience in Fairtrade strongly suggests that the co-operative model can provide a good opportunity to encourage best practice among small farmers, and that they can also get involved further along the supply chain to improve information exchange and cost-efficiency. However, all these measures, especially developing the capacity of co-operatives to work effectively, require investment which is a real problem for producers who are not recovering their cost of production in the current market. People cannot think about investment for future years when they are struggling to put food on the table tomorrow, and this is something that the Fairtrade price addresses.

Finally, Fairtrade has a very important role in engaging with consumers - the development of an equitable coffee market must consider demand factors as well as supply ones. Fairtrade has always envisaged part of its role to be a way of reconnecting producers and consumers in the belief that this can add to the perceived value of the product by making it less of a commodity. Fairtrade has demonstrated that many consumers are prepared to pay more for products like coffee if they are given a good reason to do so. And in this respect, education about quality is also vital in the consumer market so that the range of different coffees can be more differentiated, and so that consumers can be encouraged to trade-up to higher value products. However, this has to be more than just marketing hype – it needs to be reflected in the business practice of companies in order to have credibility. In the UK, the Fairtrade Foundation has spent 10 years in establishing the credibility of the FAIRTRADE Mark, so that it can support the work of our licensees in promoting their products. A MORI Poll conducted in March 2004 shows that awareness of the FAIRTRADE Mark among the UK population has increased from 25% to 39% over the past 12 months, making it one of the most widely recognised labels in the consumer market.

Brief background to price volatility and market deregulation

Poor countries are under ongoing pressure to increase exports of cash crops like coffee to pay debts and finance development and to open up domestic markets to international competition in order to meet economic conditions set by institutional lenders such as the World Bank. The collapse in coffee prices has had a disastrous effect on producing country economies and thrown millions of small-scale producers into crisis. The complex reasons behind supply and price volatility in commodities, particularly coffee, have been the subject of various studies and reports funded by institutions such as the World Bank, UNCTAD, and the ICO, as well as TechnoServe and Oxfam¹. Along with quality improvement, improved knowledge of the market, diversification into other crops, and promoting consumption, many of these studies recognise the development of a sustainable coffee market, including Fairtrade, organic, shade grown and speciality coffee, as a means of bringing relief to struggling coffee farmers.

Coffee has historically been subject to supply and price volatility, mostly due to weather shocks. The repeated cyclical nature of the industry is demonstrated by the 1994 frosts and the 1997 drought which damaged the crop in Brazil, by far the world's largest producer. This resulted on both occasions in global supply deficits which many growers responded to by increasing production to capitalise on the consequent, if short-lived, high prices. These booms were followed several years later by low prices when both supply and stocks recovered to create a further period of oversupply.

From the 1960s until 1989, the market was kept in reasonable balance in part due to successive International Coffee Agreements (ICA). The ICA regulated much of global trade through a system of export quotas and buffer stocks which largely maintained stable and remunerative prices to growers. The economic clauses of the ICA were suspended in 1989 because of abuse of the quota system and their incompatibility with prevalent free market economic policies. These same policies also drove the economic restructuring which progressively dismantled state control of the sector and the support provided by national coffee boards or governments in the form of agricultural subsidies and services and investment in infrastructure.

While liberalisation exposed farmers to market price volatility, it also in many cases initially improved their share of market prices, previously controlled by often incompetent or corrupt institutions. This provided an incentive and, importantly, the opportunity to expand production. Following the suspension of the ICA quota and control provisions, prices immediately dropped to around half their previous level and remained at these lower levels for more than four years until the weather intervened as mentioned above. In effect, coffee producers were left to sink or swim in a liberalised market in which private enterprise had largely failed to fill the vacuum created by the withdrawal of institutional support.

The periods of oversupply historically occur as a result of difficult-to-predict bumper Brazilian crops. The situation has been compounded in recent years by huge production increases in Brazil (mainly arabica) and Vietnam (mainly robusta), which along with Colombia (arabica) account for around 60% of global production and 55% of exports. The combined production surges in Brazil and Vietnam increased global supply by around 12% in 2001 and 2002 at the peak of the current price crisis. That's their prerogative; but it effectively created a 400,000 tonne coffee glut rather than a 400,000 tonne shortfall had their production remained at previous levels. Brazil and Vietnam have cost advantages over other producers because of their high efficiency. In the case of Vietnam this can be attributed to very low labour costs, while Brazil's high labour costsⁱⁱ are mitigated by the use of improved mechanical harvesting and a consequent reduced need for labour.

Interestingly, the increased supply in Brazil is a direct result of the deregulation, private investment and technical innovation so approved of by neo-conservatives, while Vietnam's supply surge was made possible by their bêtes noires – government subsidies and institutional funding.

Vietnam's huge growth in coffee production appears to have hit the buffers as even this low-cost, low-wage producer is struggling to survive on current price levels. According to an ICO reportⁱⁱⁱ, 45% of Vietnamese coffee-growing families lack adequate food, 66% have bank debts and many children have been taken out of school. Farmers are now being urged to change to higher value arabica production but many are understandably reluctant to grub out their robusta trees and, instead, are upping output in a desperate attempt to earn enough money to survive. Vicofa, the national coffee industry body, is also considering diversifying over 110,000 ha of low quality plantations (out of a total 500,000 ha under coffee) into other crops such as cocoa, cashew, rubber and peppers.

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ⁱ For example: *The State of Sustainable Coffee: A study of twelve major markets*, Daniele Giovannucci with Freek Jan Koekoek, World Bank 2003

Mugged: poverty in your coffee cup, Oxfam 2002

Coffee Markets: New Paradigms in Global Supply & Demand, Bryan Lewin, Daniele Giovannucci, Panos Varangis, World Bank 2003

Business Solutions to the Coffee Crisis, TechnoServe/McKinsey 2003

International Coffee Crisis – Looking for long-term solutions, High-Level Round Table Report, ICO/World Bank 2003

Coffee: An exporter's guide, International Trade Centre UNCTAD/WTO 2002

ⁱⁱ Labour costs per person per day: Brazil, US\$4.3 – US\$9.5; Guatemala, US\$3.9 – US\$4.8; Vietnam, US\$1.3, *Business Solutions to the Coffee Crisis*, TechnoServe/McKinsey 2003

ⁱⁱⁱ *Impact of the coffee crisis on poverty in producing countries*, ICO 2003