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The world economic crisis and the coffee sector

The Executive Director presents his compliments and attaches a preliminary evaluation of the effects of the world economic crisis on the coffee sector.

THE WORLD ECONOMIC CRISIS AND THE COFFEE SECTOR

The world economic crisis and the coffee sector: a preliminary evaluation

1. The current economic crisis represents a major shake-up in the way global business is conducted. No sector has been spared from the turmoil, which has already caused a substantial slowdown in most industrialized countries. Governments around the world are trying to contain the crisis and its effects. Stock markets are down more than 40% from their recent highs. Investment banks have collapsed, rescue packages have been drawn up involving more than a trillion US dollars, and interest rates have been cut around the world. Leading indicators of global economic activity, such as shipping rates, are declining. The International Monetary Fund has recently projected world growth to fall to just 0.5% in 2009, its lowest rate in 60 years.

2. Meanwhile, coffee prices have shown signs of recovery after falling below US$1 per lb in early December, with the ICO composite indicator price standing at 112.02 US cents per lb on 30 January 2009, compared to an average of 126.69 US cents per lb in September 2008. The purpose of this document is to provide a preliminary analysis of the effects of the macroeconomic downturn on the world coffee economy.

Effects of the economic crisis on world coffee consumption

3. Early reports show that food sales are holding up better than those of non-food products. It seems that big chains are competing by cutting prices rather than losing market share or seeing the volume of sales decrease, even at the expense of profits. In the developed country markets of North America, Europe and Japan, which account for approximately 58% of world consumption, coffee is a staple good that represents only a small fraction of consumer spending. The information available suggests that coffee consumption in these markets is holding up well. Instead of limiting overall intake, consumers are more likely to 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 and by reduced earnings in the speciality coffee sector in the last quarter of 2008.

4. In coffee producing countries, which account for over 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. In Brazil, the largest coffee market among producing countries, the devaluation of the real has maintained prices of green coffee at pre-crisis levels. As a whole, consumption in these markets is not expected to suffer any major negative impact.

5. The remaining major area 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 cases of widespread unemployment and economic instability. Reports from the Russian Federation, the largest emerging coffee market, indicate substantial short-term disruption of credit facilities, with particular impact on the food distribution sector. More recent information suggests that the situation in coffee appears to be returning to normality, but the overall outlook is still uncertain and especially vulnerable to a possible devaluation of the rouble. Meanwhile, China is still a relatively small coffee consuming market and developments there are not expected to influence the trade to any significant extent.

Impact of the economic crisis on coffee production

6. Over the past two decades, world coffee production has been marked by considerable gains in productivity. However, recent years have been characterized by large increases in production costs, mainly due to rising prices of fertilizers, freight and labour. Even at the prices prevailing before the onset of the crisis in September, growers, 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 existing demand, but not the expected rise in consumption if the annual growth rate of 2.5% registered in the recent past is maintained. This means that major financial investments are required and these will become less viable given the current economic crisis. Of special concern is the development and implementation of financial mechanisms to help smallholders cope with increased risk and volatility in the context of a contraction of credit in producing countries, particularly during the harvesting season. That is precisely one of the major objectives of the ICO Consultative Forum on Coffee Sector Finance, which will be introduced under the 2007 Agreement.

7. In some instances, the upward pressure on costs may ease. Prices of oil and fertilizers have declined sharply in recent months. The beneficial impact of such price decreases on production costs is likely to be subject to a delay, 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 incentive to work on coffee farms, past pay increases are often enshrined in national minimum wage agreements and will remain unchanged. It is still premature to assess the effects, if any, of the crisis on other important determinants of agricultural productivity, such as investments in research and infrastructure.

8. A key component in the response of individual producing countries will be exchange rate policy. In previous ICO monthly market reports, attention has been drawn to the fact that devaluation of the US dollar in recent years had a major impact on the profitability of coffee production in major producing countries such as Brazil and Colombia. This trend has prevented growers in these countries from reaping the full benefits of the recovery in coffee

prices since 2004. On the other hand, growers in countries with currencies linked to the US dollar, such as Vietnam and some Latin American countries of origin, were able to take advantage of higher prices on the international market. The situation is now likely to be reversed. In those countries with flexible exchange rates, price falls in the international market have been (at least partially) compensated by exchange rate movements, and prices of coffee in local currency have not declined in the same proportion. Meanwhile, in countries whose currencies are more directly linked to the US dollar, the impact of recent price reductions on the terminal markets is directly transmitted to growers. Indeed, currency movements have become a driving force in the price behaviour of futures markets for many commodities, and coffee is no exception.

Trade

9. In recent years, export revenues from coffee have recovered from the lows experienced from 2000 to 2004. Foreign exchange income in coffee year 2007/08 is preliminarily estimated to exceed US$15 billion, a record figure in nominal terms. While most producing nations have diversified their economies and reduced their dependence on coffee as a generator of foreign exchange over the past decades, many remain vulnerable to fluctuations in prices. Some countries where coffee still represents a significant share of export earnings are Burundi (52%), Ethiopia (31%), Honduras (23%), Uganda (17%), Nicaragua (17%) and Guatemala (12%). Even producing countries that are less dependent on coffee will suffer, since many rely on other commodities, both agricultural and mineral, for export revenues, and the prices of these products are in decline. On the other hand, countries which depend heavily on imports of oil may see an overall improvement in their balance of payments.

10. In addition to the reduction in export revenues as a result of falling commodity prices, inflows of remittances and direct foreign investment will also be adversely affected. At the same time, there is as yet no evidence that the crisis will automatically translate into reductions in budgets for aid and social lending by developed countries. The economic crisis will certainly have an impact on developing countries, but this will vary widely and will depend on the ability of governments to adapt their economic policies to this new environment.

11. It should be noted that most developing economies are not burdened by deep structural problems, such as an overhang of debt, which could curtail growth for several years. Although 2009 will be a painful year for developing countries, those with high savings and modest debt could recover fairly quickly. Indeed, on many measures, such as fiscal and external balances, these economies look sounder than those in the developed world.

12. In the international coffee trade, new constraints due to the changed economic climate have arisen, with economic agents becoming more cautious and credit tighter. At the same

time, hedging has become more expensive. Whereas governments are putting into place financial rescue packages to bring the situation back to normality, success is by no means guaranteed over the short term and it may take some time before we return to previous levels of liquidity.

Conclusions

13. This analysis of the impact of the economic crisis since September 2008 is preliminary and should be treated with caution. The world economic outlook is still uncertain and subject to instability. Nevertheless, early evidence suggests that the current situation should not have a significant impact on coffee consumption. With regard to production, effects are likely to differ considerably among countries. This will, no doubt, be an atypical year, one where the fundamentals of the world's economy give little reason for encouragement, but also one where those for the coffee economy point towards stable demand and relative scarcity on the supply side. Whatever the outcome, it is essential for the future stability of the world coffee market that prices attain levels that are compatible with much-needed investments in future production.