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**Session One**

***"Lessons Emerging from the Crisis: New Paths for the Coffee Sector"***

**Remarks Presented By**

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Excellency, President Luis Inacio Lula da Silva, the Honorable Roberto Rodrigues, Minister of Agriculture of Brazil and Chairperson of the World Coffee Conference, Mr. Nestor Osorio, Executive Director of the International Coffee Organization (ICO), distinguished officials from across the world, honored guests, ladies and gentlemen. It is a great honor to be part of this 2nd World Coffee Conference. I first want to thank Minister Rodrigues for the very warm hospitality extended to us all here in this magnificent city of Salvador/Bahia; and I wish to congratulate Mr. Nestor Osorio, Executive Director of the ICO, for his leadership in the world coffee economy.

This opening session is addressing lessons learned from the crisis. So I would like to begin by raising the question: What is a crisis? When prices go up or go down? Today oil prices are over $60/barrel—in 1999 the same barrel traded internationally was worth less than $12. There are several definitions of a crisis: "stage in a sequence of events in which the trend of all future events, esp. for better of for worse, is determined; turning point; a condition of instability, leading to a decisive change." The reason I raise this issue is for two reasons. First, because I don't believe that we have been in a crisis according to technical definitions. Rather, we have experienced the effects of an adverse commodity cycle which lasted longer and was influenced by more structural change (both in production capacities and technological innovations) than in more recent cycles.

Second, the "crisis" referred to is the substantial drop in prices of coffee on international markets to below 50 cents a pound for most of the last five years. It has particularly adversely impacted individual producers, their families, communities and the revenues of producing countries. It has reduced foreign exchange reserves of coffee producing countries and, in some cases, impaired their ability to improve social and economic services. However, now that prices have rebounded in sympathy with other commodities and due to coffee market fundamentals to a range closer to $1/pound are we out of this "crisis" or is the structure of coffee market cycles a permanent state of insecurity? To this last question, I would definitely answer "yes".

This brings me to the point of my brief remarks today: commodity markets are by their very nature volatile. Commodity markets are insecure—particularly agricultural commodities which are impacted by not only general economic conditions but also, very importantly, weather patterns. I began work in the commodity sector in 1972…just after the world went off the gold standard and at the time soon after when OPEC more than doubled the price of oil and embargoed shipments to western countries. Coffee prices soared in the 1970s with other commodities, driven in part by inflation—both energy and money. So did grain and oilseed price—which doubled in nominal terms-- when the Soviet Union became a big purchaser, when drought cut production substantially in the northern hemisphere and when the El Nino reduced the anchovy harvest in Peru.

Since that time, there have been successive recessions and recoveries. We learned the lesson that commodity agreements—whether for coffee, wheat or tin—do not work to manage prices in a competitive global economy. There is an adage about commodity markets which I have always found to be true: Bull markets start with large supply and low prices; bear markets conversely begin with short supply and high prices. High prices signal producers to expand their production, and consumers to manage their purchases.

Low prices, as the past few years, have reduced producer output in coffee and that is one of the reasons for the increase in prices today—with supply projected to be at 106 million bags for crop year 2005/2006—a decline of 6.28% from the previous season.

Moreover, when we hear officials talk about the need to "stabilize" prices, I always question whether any of these officials has asked a coffee producer if he (or she) want a ceiling on prices per pound! I doubt that very much. The real meaning of what officials call "stable" prices for producers instead means minimum price floors to cover individual production costs—in other words, taking the downside risk out of production.

Therefore, the important context of this panel's consideration must be the second part of the topic: "New Paths for the Coffee Sector". I would like particularly to focus on risk management, because we must better prepare to address the impacts of commodity cycles and structural changes in coffee markets. At the same time, we must look at managing risk in coffee that affects developing countries in a more holistic context, because the coffee economy and producers in the rural areas are impacted as much by government policies, infrastructure and finance as they are by international prices and weather.

The excellent paper prepared by ICO is a very good starting place for assessing what needs to be done in the future. It has specifically targeted a range of initiatives:

- Market development (expanding markets in both producing and consuming countries)
- Improving quality and technological advances along the chain;
- Expanding and deepening niche markets and value added products;
- Dissemination of viable research and information on the health benefits of coffee consumption and technology enhancements;
- Diversification of producers where appropriate to alternative crops and/or other off-farm economic activities.

ICO has provided valuable leadership in all of these areas critical to the functioning of a global market, and they form an excellent base for cooperation within the industry sector, and with both bilateral and international development institutions. In fact, the ICO has moved very successfully to a new role which will be growing in importance over the coming years as the coffee sector and its partners move to implement these critical initiatives.

All of these components should contribute to the general development of the coffee economy in world markets. As the world economy expands and consumer markets grow, coffee will have increased opportunities in the beverage sector. Market development will have to be targeted at the local culture of a country, as is apparent in China and other major emerging markets. Brazilian roasters have been successful in improving labeling and quality in the domestic market, which has increased demand and allowed Brazil to become the world's second largest consumer. Improving quality from the producer through the chain is critical for the "coffee experience" and marketing quality through such initiatives as the "Cup of Excellence" has proven successful. Niche markets—specialty and gourmet coffees—are a growth sector. Fair trade coffees are starting to proliferate through specialized supply chains from specific locales to consumers.

The World Bank's Development Research Group ("Dealing with the Coffee Crisis in
Central America", Policy Research Working Paper 2993) specifically identified options to increase competitiveness. These include:

- Changing how coffee is produced through technologies to increase productivity and/or quality; as well as improving producer returns through diversified land use including inter-planting with other crops and livestock.
- Changing business relationships in financing and marketing coffee to lower transaction costs and increase produce value added, as well as use of risk management instruments.
- Changing the form of the final coffee product through adopting new and improved post-harvest technologies, including processing, packaging, warehousing and transport that add to the net producer return.
- Increasing alternative uses for coffee through processing technologies and market niches for coffee-based products including confectionary and new products developed using coffee by-products.
- Expanding information technologies in the marketing and production chain through B2B, on line auctions and other direct marketing and market information system (MIS) applications.

These strategies are relevant globally. It is here that diversification strategies to alternative crops and off-farm employment are significant to the welfare of producers, and to the economic potential of rural, coffee-dominant, communities. In some cases, where tourism is a growth industry, "caffeine tourism" may become an income-generating activity. An article in *Newsweek* magazine (July 11, 2005) focused on "caffeine tourism" initiatives in Ethiopia, Mexico, Peru and Costa Rica today—modeled after the success of vineyard tours and other Agro and Eco-tourism. Coffee excursions are linked to a range of special tourism interests such as an ecological focus on sustainable "shade grown" coffee in rain forests, meeting with indigenous women's cooperatives or receiving a guided lecture from a coffee connoisseur at a luxury resort amidst coffee plantations.

I raise these points only briefly, because they are specific to the development of the coffee industry; all of you in this congress are focused every hour of every day on these fundamentals of the sector's performance and development. What I would like to discuss in my remaining time are two components related to the coffee and general economy:

- Innovative risk management mechanisms emerging for coffee and general commodity instability; and
- Investment, business and trade climate

## Innovative Market-Based Risk Management Products

Now that the world's officials have generally agreed that efforts to manage commodity prices and markets cannot succeed in a competitive global economy, attention is turning at last to the potential for innovative market-based financial products to mitigate risk and create safety nets for both producers and for producing countries. Insurance products are being used effectively to deal with natural disasters—like earthquake insurance in Turkey—and other climatic conditions. Coffee specific safety nets for producers have been operating for a number of years. A number of coffee producing countries have set up individual national funds to stabilize coffee revenues for producers such as Costa Rica's National Fund for Coffee Stabilization (FONECAFE), created in 1992 to respond to the crisis following the collapse of the International Coffee Agreement in 1989. Other countries have sought to mitigate crises for producers in times of falling revenues through funds for debt cancellation or other mechanisms to reduce financial burdens. The ICO is currently in charge of a project on coffee price risk management in Eastern and Southern Africa.

While cyclical price volatility during the production season can be managed for producers using price risk management instruments, not all farmers have access to these financial products. The World Bank and other institutions are working on a range of projects to improve access for producers to seasonal price risk management products.
These include attaching price insurance to loan agreements and aggregating quantities for hedging through processors, traders or cooperatives.

In addition, weather-based index insurance based on the occurrence of a certain event that can be measured and verified independently is being used in other industries—like energy—and is an instrument that can be crucial for not only individual producers but for producing countries.

Index insurance products can be developed that provide risk mitigation to producing countries against price, weather and natural disasters for their vulnerable commodity sectors, including coffee. In my view there is great merit in concentrating efforts on developing a global market for index based insurance instruments that provide an **ex ante management** of shocks due to weather disasters or catastrophic declines in prices, rather than the current ex post responses. This type of approach would go a long way to helping countries deal with the variability of commodity cycles; it would improve emergency planning, and the ability to respond with appropriate producer and rural safety nets; and it would strengthen the financial sector's participation in lending to the sector.

## Investment, Business and Trade Climate

No matter how efficient a coffee producer may be on his own farm, his ability to be competitive in international markets depends on the business climate and infrastructure. What is the source and cost of money for producers, cooperatives, traders, processors in a national market? What are the barriers to investment? What is the cost and time frame to open and/or close a business? For example, the World Bank's *Doing Business* 2005 report estimates that Brazil could add one half of a percentage point to its output by reducing the licensing time for new businesses by reducing the licensing time for new businesses from the current 152 days to Chile's level of 27 days. The World Bank is working with Brazil's government under a competitiveness loan to improve the country's performance. You must consider as well issues like whether there a good commercial code in a country and does the judiciary have a transparent and commercially relevant dispute settlement process? Do the government's standard setting institutions provide the necessary efficient regulations, inspection procedures and technologies to meet WTO standards on food products under the SPS Agreement?

In short, the investment climate must be conducive to both domestic and foreign investment. That is crucial for strategies in the coffee sector to provide the fullest development benefits both directly to improving producers' returns and to raising economic performance generally in producing countries. The *Doing Business 2005* report lays out huge internal barriers to competitive business development from the poorest to the middle income countries, and compares very specific areas with industrial country (OECD) performance. For example, it takes an average of 58 days to start a business in Mexico, compared with 8 days in Singapore. Similarly, it takes 74 days to register property in Mexico, but only 12 in the U.S. Enforcing a contract requires 37 different procedures and takes more than 400 days to move through the legal system. Electricity costs in Mexico are 10% higher than the U.S. and 40% higher than China's. Starting a business in Australia requires 2 procedures and takes 2 days; in Colombia starting a business requires 14 procedures and takes 43 days. In Brazil, 17 procedures and 152 days are required whereas in Vietnam the process takes 11 procedures and 56 days. The cost of starting a business equals 0.6 of income per capita in the U.S., but it is 53.4% in Kenya and 131% in Uganda. In Vietnam starting a business equals around 26% of income per capita, in Ethiopia, the cost equals 77% and in Indonesia 130%.

Is there access to infrastructure, especially reliable infrastructure—power, transportation, communication, water and sanitation? Is the logistics adequate along the supply chain? (I would note here that the cost of shipping a container from Europe to Mombassa, Kenya is one-third of the cost to ship a container to or from Mombassa to Kampala, Uganda).

Opportunities for crop and off-farm diversification normally are more abundant close to urban areas and large farming enterprises linked to export markets. Getting infrastructure into rural areas, including coffee growing regions, must be a priority for improving supply chains and incomes.  The public sector needs to target investment in basic transport infrastructure, along with power, water and sanitation to strengthen rural communities and provide greater off-farm employment gains.  How can coffee producers add value and diversify without cold chains, viable transportation linkages and other basic technologies?

In Latin America and the Caribbean, paved roads account for less than 30% of total roads, in Sub Saharan Africa less than 15%, in Peru only 13% of total roads are paved.
In Nigeria, electricity use per capita is 82 kilowatt hours, in France it is over 6800 and
Brazil is 1074.  There are 38 internet users in Indonesia per 1,000 people, 193 in Costa
Rica, 1 in Ethiopia, 5 in Cote d'Ivoire, 2 in Tanzania, 33 in Guatemala and 16 in India.

These are 2002 statistics compiled by The World Bank but they are representative of the problems facing supply chains and agricultural regions in particular across many coffee producing countries.   My comments here are not meant to be criticisms but rather to highlight the basic infrastructure barriers to investment and trade—to creating improved living standards and delivering essential services to rural populations and to strengthening the coffee supply chain.

And how can developing coffee producing countries improve their competitive positions in global markets with substantial impediments to trade.  Trade facilitation includes the components that move product to market, or constrain competitiveness.  Take, for example, customs clearance for sea cargoes.  In developed countries the average is 2 days to clear customs; East Asian countries average 4 days; Latin America's average is 9 days, and Africa and South Asian customs clearance takes on average more than 10 days. In India, logistics accounts for 33% of shipment costs; in Brazil, administrative costs add 20% to the final cost of all products traded.

**Conclusion**

It is both appropriate and timely to consider the Coffee Sector's future in a more holistic context, including both factors that are sector specific and those that impact the overall business environment. Managing individual producer price and production risk remains a core objective for mitigating the adverse impacts of volatility in commodity cycles, while initiatives to develop markets create the anchor for demand enhancement. At the same time, producing countries, the coffee industry and development institutions would be well advised to consider a range of innovative index insurance products that can provide ex ante options to mitigate against catastrophic shocks in production and price cycles. Ex ante risk mitigation can provide a solid platform to improve national safety nets.

The overarching objective for all parties engaged with the sector is to improve living standards for coffee producers, their families and communities. This will not be accomplished through hoping for a a commodity price bubble, but rather through a dedicated and committed international effort to improve the access of rural communities to improved infrastructure services, to strengthen and modernize supply chains and to give coffee farmers access to diversified economic opportunities and markets.

I believe that the stage is set for unprecedented opportunities in the coffee sector to create new channels for demand, to improve the quality and productivity of growers, to provide basic services and improved living standards to coffee growers and their communities. Most importantly, remember that cycles are not crises. Price shocks are good for markets, because they force us out of complacency, they challenge the status quo and cause us to innovate. The structure of the coffee economy is changing; it has changed many times and during many commodity cycles. In today's globally integrated economy, with unprecedented technological advances, the wealth creation potential for the coffee sector is greater than ever before in the history of mankind.