

**IMPACT OF COFFEE RETENTION QUOTAS
ON COSTA RICAN COFFEE MARKETING:
PROSPECTS FOR THE FUTURE**

**Michael Maxey
MBA – Marketing 101
University of Costa Rica**

**San Jose, Costa Rica
January 22, 1996**

OUTLINE

Thesis: The quota system established under the current coffee retention plan of the Association of Coffee Producing Countries limits the availability of specialty coffee for export weakens Costa Rica's competitive advantage in the world coffee market, and could impede efforts to penetrate new markets in the United States, Japan, and Europe.

Introduction: Costa Rica produces high-value specialty coffee in large quantities but continues to link its marketing efforts to world coffee exports of lower quality. The primary vehicle for this linkage is the coffee retention plan currently operated by the Association of Coffee Producing Countries.

1. Costa Rican Coffee Quality

- a) Coffee History
- b) Coffee Types
- c) Coffee Quality
- d) Costa Rica's Place in the World Coffee Market

2. Impact of Coffee Retention Systems on Availability of Costa Rican Coffee

- a) Coffee Quota System History
- b) Costa Rica and the Coffee Quota System

3. Costa Rican Coffee Marketing Potential for the Future

- a) Picking the Right Market
- b) Impact of Coffee Quota System on Costa Rica
- c) Marketing Strategies

Conclusion: Costa Rica's future in the international coffee trade depends on the development of a strategic partnership between private and public interests to 1) produce a high-quality coffee, 2) promote Costa Rica coffee as a specialty coffee identified by region and cupping characteristics, and 3) support the development of innovative marketing channels. Continued participation in coffee retention plans could slow movement toward these objectives.

TABLE OF CONTENTS

1. Costa Rican Coffee Quality	
a) Coffee History	4
b) Coffee Types and Quality	6
c) Costa Rica's Place in the World Coffee Market	
2. Impact of Coffee Retention Systems on Availability of Costa Rican Coffee	
a) Coffee Quota System History	8
b) Costa Rica and the Coffee Quota System	11
3. Costa Rican Coffee Marketing for the 21st Century	
a) Picking the Right Market	13
b) Impact of Coffee Quota System on Costa Rica	15
c) Marketing Strategies for the Future	16

1. Costa Rican Coffee Quality

Coffee History

Coffee is a beverage prepared from roasted beans of the Rubiaciaceae Coffea tree. It has been used in the West for the last 300 years. Coffee came from Arabia and was originally called "qahwah" (a poetic name for wine in Arabic). The Turkish form of this name, "kahve," became "café" in French, "koffie" in Dutch, and coffee in English. Arabica and robusta are the two major commercial species of coffee. Arabica produces the best coffee, and its cultivation may have begun as early as A.D. 575 in Ethiopia. Coffee berries were eaten whole at first or with little processing; roasting the beans and concocting a beverage was started around the 13th century. Its popularity spread throughout the Islamic world, aided by Muslim pilgrims returning from Mecca. By the end of the 15th century, roasted coffee was traded from Persia to North Africa.¹

In the early 1600s, coffee trading in Europe began in earnest. The economic importance of this trade prompted the Europeans to seek ways to produce coffee for their domestic consumption. This was a difficult task, given that Arabia controlled all coffee production and forbade the export of viable coffee seeds capable of germinating and producing coffee cherries. However, in 1616, Dutch traders obtained a coffee plant in India (an Indian Muslim on a pilgrimage to Mecca was said to have been the first to smuggle out viable coffee seeds) and took it to Europe.

The Dutch, followed by the French, Spanish, and English, began plantations of coffee in their colonies, and coffee became dominated by major trading companies. The Dutch had significant coffee plantations in the Dutch colonies of Ceylon, Java, Sumatra, Celebes, Timor, and Bali. The French followed the Dutch example and started coffee plantations in the French colonies of the Americas. It was from these plantations that coffee spread through the hemisphere to the Spanish colonies, to Brazil and to the English colony in Jamaica. Coffee production and consumption increased and became an important world commodity.²

Coffee was an important trading commodity in the 17th and 18th centuries. Still, it was the advent of the Industrial Revolution and the destruction of the trade monopolies that opened markets, lowered prices, and increased consumption of goods traded between the tropical and temperate zones. This new trade helped create a viable consumer class and increased demand for staples such as coffee. In the United States, coffee consumption increased from 9 million pounds of imported coffee in 1800 to 180 million pounds in 1864. Per capita, consumption was increasing rapidly as well, with a 400% increase during the

period 1833 to 1900 (per capita consumption increased from 3 pounds to 11 pounds per year). Production expanded around the globe to meet this new demand.

Central American coffee production started in the 1830s in Costa Rica. A German merchant George Stiepel demonstrated the commercial viability of coffee in 1832 with the first commercial shipment of coffee to Chile that year, followed by a shipment to England the next year. Buenaventura Espinach, a Catalonian merchant also played an important role in early coffee production in Costa Rica. By 1840, he had 170 hectares of coffee in production in Heredia and operated the largest coffee processing facility in the country. The success of coffee encouraged others to invest, and by the mid-1840s thirty-five coffee exporting companies had been established. It should be noted that a technological change, the invention and commercial use of the steamship, played a pivotal role in expanding coffee production in Central America because, for the first time, it allowed for low-cost, reliable transport between the isthmus and all market destinations.

Costa Rica's coffee exports grew rapidly, rising from 2.5 million pounds in 1843 to almost 7 million pounds in 1853. The majority of Costa Rica's coffee exports went to Great Britain and Germany at premium prices over the next forty years (25% or so of total exports during this period went to the United States) During the period 1840 to 1890, coffee was virtually the only export product of Costa Rica. Guatemala entered coffee production in the 1850s, followed by El Salvador, Nicaragua in the 1860s, and Honduras in the 1880s. From the beginning, the Central American coffee producers were "price takers," given their small size in the world market. However, from the beginning, their product brought a premium price (5 - 10 percent over the Brazil Santos variety).³

In the 1850s, coffee rust, *Hemileia vastatrix* struck Asia and, within a few years, destroyed large coffee production in India, Ceylon, Java, Sumatra, and Malaya, which led to an ideal situation for increasing large-scale coffee cultivation in Brazil. By 1900, Brazil was the largest coffee producer in the world (a position it still holds). It was this large-scale production that made coffee the beverage of the common man and spurred a massive increase in demand. This demand led to the development of a coffee-growing belt spread worldwide between the Tropic of Cancer and the Tropic of Capricorn through the Americas, the Caribbean islands, Africa, and Asia. Grown in more than 60 countries, coffee provides a living for 25 million people and makes it one of the most essential commodities traded in the world.⁴

Today's coffee market consists of 30 major producing countries, totaling 5,385 million kgs in 1995. This production has been distributed by continent over the last five years in the following manner: America provided 67%, Africa 17%, and Asia-Oceania 16%. Brazil and Colombia are the world's largest producers, providing 42% of the world's coffee supply during this period. In Asia, the strongest producers were

Indonesia and India with Vietnam continuing to increase its coffee exports (these three countries produced 13% world of world supplies). Ivory Coast, Uganda, and Ethiopia were the largest producers in Africa, providing 8.8% of world production. Costa Rica's share of coffee production was 2.9% in 1994-1995, putting it 12th place in total production.⁵

Coffee Types

Coffee is identified as a plant in the family Rubiaceae, genus *Coffea*, species *Coffea arabica* or *Coffea canephora* (known commonly as robusta). These two species, arabica and robusta, supply almost all of the world's consumption. Robusta is more disease-resistant than arabica, yields more fruit, and adapts to warm, humid climates, but it produces a harsh-flavored bean and is considered lower quality. Arabica is cultivated primarily in Latin America, accounts for over 75% of the world's coffee supply, and has a higher value.⁶

In Costa Rica, coffee is further identified by the region. This classification the system was established by the Coffee Office (now known as ICAFE - The Costa Rican Coffee Institute) in 1964 to provide a nomenclature system for the coffee industry to use in distinguishing the various bean types produced in the country. Coffee bean types were identified based on the altitude, rainfall patterns and maturation timing in the production area: Strictly Hard Bean - grown at 1,200 - 1,700 meters above sea level in the higher regions of Heredia, Alajuela and San Jose with a high acid content, excellent body and aroma; Good Hard Bean - produced at the 1,000 - 1,200-meter level in the Atenas, San Ramon, and Palmares areas, it has good body and excellent aroma; Hard Bean - from the 800 - 1,200 elevation areas in Heredia, Alajuela, San Jose, Sarchi and Grecia, it has medium acidity and good body and aroma; Medium Hard Bean - is produced in the southern, humid Pacific part of Costa Rica at elevations of 400 - 1,200 meters in Coto Brus and Perez Zeledon areas and has medium acidity. In addition to these four types there are also four Atlantic types: High Grown Atlantic, Medium Grown Atlantic, Low Grown Atlantic and Pacific. The coffee types having the highest quality are the Strictly Hard Bean, Good Hard Bean and Hard Bean types.⁷

Coffee Quality

Where coffee is produced, what husbandry techniques are used, and how the fruit and beans are processed, all contribute to the coffee's final quality. Mild coffees are exclusively high-quality varieties of arabica, principally from Central and South America. Brazilian coffees are also varieties of arabica but are characterized by less refined flavor and aroma than those of the mild group.

Coffee of the robusta species is more neutral in taste and less aromatic than the arabica varieties and has higher caffeine content, 1.6% to 2.5%, compared to 0.8% to 1.5%.⁸

Coffee cherries are processed by removing the coffee seeds from their coverings and pulp then drying them from an original moisture content of 65-70% water by weight to 12-13%. Two different techniques are used: a wet process primarily used for the mild arabica coffees and a dry process used for some arabicas (Brazilian and Honduran types) and robustas. The coffee processed using the wet method produces a green coffee bean called "washed." The wet method relies on a gravity feed system with water running through a series of machines to physically remove the pulp, which is lighter and floats away from the coffee beans. Once the pulp is removed, the beans are allowed to settle in holding tanks for up to 24 hours to allow fermentation to break down the mucilage coating after the pulp is removed. This fermenting process adds "acidity" to the coffee and increases its flavor and sharpness when brewed. The "unwashed" process involves drying the cherries on concrete patios and separating the beans from the dried pulp. The washing and fermentation stages are not used in this process, and this tends to mute the coffee's acidity, producing a blander flavor.⁹

The International Coffee Organization (ICO) established four classifications for world coffee trade based on species, origin, and processing methods. The following is a summary of those types with an explanation of their relative importance in the world coffee market.

1) **Columbian Milds**, which include coffee produced in Columbia, Kenya, and Tanzania is processed under the wet method and is identified as a "washed" arabica. Columbia promoted its coffee as superior to others and obtained a separate classification. Columbian Milds are classified as a higher quality arabica coffee than production from Brazil. Coffee production from Kenya and Tanzania that are washed arabicas are also classified as Columbia Milds. Washed arabicas outside of these countries are classified as "Other Milds." The value of Columbia Milds in the world coffee trade in 1993 -1994 was US\$2,063 million or 25% of the total value of world coffee production during that period, with 87% of that value attributed to Columbia's exports. Total exports during this period were 14,822,000 bags at 60 kg. each (889,320,000 kgs.). This translated to an export price of approximately \$1.05 per pound.

2) **Other Milds** are of the same quality standards as the Columbia Milds (some say Costa Rican and Guatemalan coffee, both classified as Milds, have more body and a richer flavor than the Columbian Milds). This coffee is washed arabica grows at higher elevations. The countries involved in its production are

Burundi, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, India, Mexico, Nicaragua, Papua New Guinea, Peru and Rwanda produced 31% of the total value of world coffee exports in 1993 - 1994. The total amount exported was 21,387,000 bags (1,283,220,000 kgs.) with a value of US\$2,516 million for a per pound value of \$0.89.

3) **Brazilians and Other Arabicas** are dry-processed arabicas produced in Brazil and Ethiopia. Although an arabica type, this coffee is generally considered inferior in quality to the Milds. It is used mainly for blends or instant coffee. The Brazilians and Other Arabicas represented 25% of the total value of world coffee exports during the period. Total 1993 - 1994 production was 18,513,000 bags (1,110,780,000 kgs.) with a value of US\$2,073 million for a per-pound value of \$0.85.

4) **Robusta** is a different coffee species and a separate category. Robusta is characterized as a strong, harsh coffee with high caffeine content, making it especially useful in blends and instant coffee. Given its lower quality, it is generally cheaper than the arabica types. It is produced in Indonesia, Cameroon, Ivory Coast, Madagascar, Thailand, Uganda, Vietnam and Zaire. Robusta's share of total value of world coffee exports in 1993 - 1994 was 19%. Total production for export was 16,796,000 bags (1,007,760,000 kgs.) at a value of US\$1,537 million for a per pound value of \$0.69.

In summary, there is a price differential for the different types of ICO-classified coffee with Columbian Milds being at the high end of the market, followed by Other Milds, Brazilians and Other Arabicas, and Robusta.¹⁰

Costa Rica's Place in the World Coffee Market

Costa Rica has maintained steady world market share over the last twenty years averaging a production level that is 2.5% - 2.8% of total production for all coffee types. This statistic does not indicate, however, the type of coffee produced and the potential it has for the marketplace, especially the upscale specialty coffee market in the United States, Europe, and Japan.

Costa Rican coffee is recognized as an outstanding coffee. Kenneth Davids, in his book, "Coffee: A Guide to Buying, Brewing and Enjoying," states on page 55 that "Costa Rican (coffee) is a classically complete coffee; it has everything and lacks nothing." Another well-known coffee writer, Timothy Castle, states in his book, "The Perfect Cup," that Costa Rica produces washed arabica coffee with excellent acidity and good body -- "Costa Rica coffee is very good." Castle goes on to state that some of the "estate" coffee (coffee grown and processed on the same farm) is "the most carefully processed coffee in the world and offers a taste that is focused as a laser." Claudia Roden a distinguished

the gourmet writer stated in her book "Coffee" that "the high-altitude Costa Ricans (coffee) are among the world's finest: rich in body, of fine mild flavor, sharply acid and fragrant." An informal survey of coffee stores advertising their products online indicated that 75% of the micro-roaster retail outlets reviewed offered some form of "Costa Rican" coffee, often identified by regions where it was grown (e.g., Tarrazu, Tres Rios, etc.). These coffees are firmly identified as "specialty coffees," a term for gourmet or high-quality coffee that brings a premium price. A recent economic report indicated that Costa Rica is one of three countries with the highest production areas for specialty coffee (the countries identified were Guatemala, Kenya, and Costa Rica). So, while the amount of Costa Rican coffee produced is small in terms of world trade, the type of coffee produced is known as one of the better coffees on the market. Essentially, Costa Rica is producing a product that could and is being differentiated from commercial-grade coffee and sold in the higher-priced specialty coffee segment of the United States market.¹¹

To understand Costa Rica's position in the coffee world, it is important to know the meaning of "specialty coffee."

What is specialty coffee?

A local "estate coffee" producer indicated that specialty coffee is that type of coffee which has high acidity, good body and fine aroma. These characteristics come from producing arabica varieties at higher elevations, wet processing the cherries and then sizing the dried beans to produce a "16" size (this refers to machine sizing of dried coffee beans to separate them by relative size -- a "16" would be a bean that could pass through a screen that is 16/64 inches in diameter or 6.7 mm).¹² There are draft proposals for international standards identifying three classes of coffee based on four characteristics: 1) Full Defects - a scale identifying bean quality and trash contamination; 2) Screen Size - identifies the size of the beans; 3) Cupping - refers to the acidity (a pleasant sharpness adding life and accenting flavor), flavor (perception of the aromatic elements once the coffee is in the mouth), and body (impression and texture that the coffee leaves in the mouth); and 4) Roast - the number of "quakers" (deformed or discolored beans).

Based on these categories, the draft quality classifications call for 3 general grades: 1) Specialty Grade No. 1, 2) Premium Grade No. 2, and 3) Exchange Grade No. 3. In each of these grades, the respective characteristics Full Defects -- 0 - 5 for the No. 1 grade, 0 - 5 for the No.2 grade, and 9 - 23 for the Exchange grade; Screen Size-- as agreed by the seller and buyer for grades 1 and 2, and for the Exchange grade 50% or #15 but no more than 5% or #14; Cupping -- all grades must be free of cup faults; and Roast -- zero quakers for the No. 1 grade, 3 quakers for No. 2, and 5 quakers for the Exchange grade. These categories are under review by the different trade organizations concerned with coffee quality. In the final analysis, the proof of a

coffee's quality is in the cup. Aside from meeting the physical characteristics of these quality standards, Costa Rican coffee is recognized as a reliable source of high-quality cupping coffee.¹³

It is difficult to estimate the amount of coffee produced in Costa Rica that would rank as specialty coffee. Arturo Villalobos, in his publication, "Comercializacion de Productos Agropecuarios", indicated that three classifications of Costa Rican production are high quality -- Strictly Hard Bean, Good Hard Bean and Hard Bean. These three types represent more than 67% of national output in 1993 - 1994 with production amounts of 55,715,499 kgs. for Strictly Hard Bean, 18,811,001 kgs. for Good Hard Bean, and 25,192,969 kgs. for Hard Bean. If only 30% of these coffee amounts resulted in a final quality the product that could be differentiated and graded as Specialty Grade No.1 it would provide the product base for a marketing strategy aimed at reaching specialty coffee customers at both the wholesale and retail levels. But it would mean breaking links that have impeded this type of market segmentation, links that have, in fact, held Costa Rica's coffee dependent on the market prices of much lower-quality coffee. It would mean re-evaluating Costa Rica's continued participation in the Coffee Retention System of the Association of Coffee Producing Countries, or at least finding some mechanism for allowing Specialty Grade coffee to be exempt from the retention scheme.

This is an appropriate point to discuss precisely how the Association of Coffee Producing Countries Coffee Retention Program works and what has been its impact on the availability of Costa Rican coffee.

2. Impact of Coffee Retention Systems on Availability of Costa Rican Coffee

Coffee Quota System History

The demand for coffee from the mid-1800s through the end of the century was phenomenal, with a 260% increase in per capita consumption. Production, in large part from Brazil, rose to meet this demand. However, during the period From 1896 through 1908, the industry suffered its first round of low prices due to economic recession in the largest consuming nations and increased production from producers worldwide. This started a series of cycles of under and over-production and wide shifts in the world price of coffee. Both the consuming and producing nations recognized the problem this boom or bust production and pricing scheme caused in their economies and sought a common solution.¹⁴

Negotiations between Latin American producers and the United States, the primary consumer nation in the world earlier in this century (in 1920, over 50% of world consumption of coffee was in the United States), resulted in an agreement in 1939 to allocate coffee imports from Latin America countries to the U.S. market. This agreement was made to provide economic support to those countries which had lost their European market due to the outbreak of World War II. It was extended through 1947 and was not renewed due to increased demand from Europe after the end of the war and a drop in production caused by a drought in Brazil. But in the early 1950s, increased prices caused by the Korean War and a freeze in Brazil resulted in market instability that provoked a meeting between the United States and some Latin American countries in 1954 to study how best to stabilize coffee prices on the world market. The result of these meetings was the signing of the first International Coffee Agreement in 1962 and the establishment of the

International Coffee Organization (ICO) to monitor the implementation of the terms of the Agreement.

A major function of the ICO was to assist in implementing a quota system to stabilize the world price of coffee. A price band was set in common agreement among the member consuming countries and producing countries as a target range for coffee prices for a given period (usually set as annual targets). When coffee prices exceeded the target price a retention scheme would activate to decrease supply sufficiently to raise prices back to the target level. The sharper the initial decrease in coffee prices, the larger the percentage of coffee stock retained. Producing countries were allowed to sell overstocked coffee to non-member consuming countries under an arrangement that ensured that the highest quality coffee was sold to member countries.

A second agreement was negotiated in 1968 for another five years, and the system continued to control export quotas and stabilize world prices. However, in 1972 conflicts of interest arose, and growing dissension on quotas, selectivity, and readjustment systems and criticism that prices were kept down for the consuming countries, the International Coffee Agreement lapsed in 1973. After the dissolution of the quota system, the ICO continued as a statistics-gathering organization. However, a price drop during 1973 and 1974 provided an incentive for producing countries to enter some type of market stabilizing arrangement again, while the 1976 "black freeze" in Brazil caused a dramatic increase in coffee prices (coffee prices went from US\$0.50 to US\$3.36 per pound) and encouraged consuming countries to again enter in a trading agreement. The result was the signing of a new agreement in 1976 for a period of six years. In 1983, the agreement was extended through 1991, but in 1989, the agreement's quota system lapsed."¹⁵

The collapse of the agreement in 1989 has been attributed to various causes. The importing countries were dissatisfied with 1) frequent under-shipments whereby exporting countries failed to fulfill their monthly quota amounts, 2) delays in declaring shortfalls so they could be made up by other exporting countries, and 3) large discounts given to non-member countries that resulted in a re-exporting black market scheme whereby discounted coffee was traded for a second time on the world market. On the exporter side, many of the exporters were unhappy with what they thought were unrealistically low export quota levels. The International Coffee Agreement was experiencing the classic problem of cartels: each member had an incentive to cheat on the organization by producing more than its quota and by offering secret price concessions to buyers. A Panorama Internacional article on September 16, 1991, "Difícil Acuerdo Cafetero" cited the primary reason for the failure to finalize a new agreement was Brazil's intransigence in changing the quota system to lower its quota to reflect the decrease in its coffee sales. In 1993, Mario Samper stated the following reasons for the breakdown in his book "Cafe: Crisis e Historia," page 25 (translated).

"... the process of liberalizing the international flow of goods and services culminating in the Uruguay Round of the GATT negotiations changed the rules of the game. ...the viability is questionable of any agreement to re-establish any type of quota system in the international coffee market. This opposition to the agreement is the position of U.S. commercial representatives - with the National Coffee Association -- their position is that the interests of consumers and the coffee industry in the United States is best served by a commerce of coffee that

Whatever the reasons for the collapse of the quota system in 1989, coffee prices fell to record lows from 1989 to 1993. It was calculated that the prices Brazil received for its coffee during this period were the lowest in real terms since the year 1820. After 1989, the price of coffee went down from over US \$1.00 per pound to US\$ 0.48 per pound.¹⁶

Low prices affected the other producing nations as well, but renewed attempts during 1993 to negotiate a new International Coffee Agreement under the designation of the ICO failed because of the inability to agree on the allocation of export quotas and differences between consuming and producing countries over how much higher quality coffees would be available under the quotas. The treatment of sales to non-ICO members was also an issue.

In July 1993, coffee-producing countries began to band together to raise coffee prices, and in September of that year, 28 countries representing nearly 90% of global coffee exports announced the formation of the Association of Coffee Producing Countries, with headquarters in Brazil. It included all major

coffee-producing countries except Mexico, Guatemala, India, and Vietnam. The association agreed to hold back exportable production on a scale beginning at twenty percent when the 20-day moving-average ICO composite price for "Other Milds and Robustas" was below US\$ 0.75 per pound.

Members exporting less than 400,000 bags annually would be exempt from retention, and no decision was made on whether to include instant coffee in the scheme. The indicator price, after averaging nearly US\$0.54 for 1992, had risen, with the implementation of the scheme, to over US\$0.71 in mid-December 1993. Coffee prices shot upward in 1994 because of an announcement by members of the Association of Coffee Producing Countries that they would continue withholding coffee from the market. Also, a freeze occurred in Brazil, reducing the estimates for its crop.

The retention operation was barely underway when it was suspended after prices moved above US\$ 0.85 per pound. Prices took off when a survey estimated that the freeze, followed uncharacteristically by drought, would cut the 1995-96 Brazilian crop short by 9 million to 13 million bags from its 29 million-bag potential (this represented a 12% to 15% reduction in world supply). Prices of green coffee, which had averaged about US\$ 0.62 per pound in 1993, went as high as US\$ 2.75 on the futures market in September in 1994 but fell as low as US\$ 1.45 in early December. Retail prices of roasted coffee, which in the U.S. averaged US \$2.47 per pound in 1993, reaching a plateau of a little under US\$ 4.50 in August-November 1994. In 1995, increased production by non-members of the Association of Coffee Producing Countries and reported cheating by some member nations resulted in a decrease in coffee prices to below the US\$ 0.85 floor price established in 1994¹⁷

In response to this drop in prices, Brazil, Colombia, Costa Rica, El Salvador, Honduras and Nicaragua signed an agreement on July 10, 1995, to institute a coffee retention plan again. The Santa Fe de Bogota Agreement called for limiting world coffee exports to 15 million bags in each of the following quarters (July/September 1995 through April/June 1996). This represented a 30% contraction in world production and was slated to be achieved by a quota system imposed on each signatory limiting exports.

The agreement also provided that the retention of coffee required to meet these levels would be subject to audit verification and that efforts would be made to include other members of the Association of Coffee Producing Countries in the retention plan to ensure that the 15 million per quarter limit on exports worldwide was met. Brazil reconfirmed its commitment to abide by the required retention levels. Brazil also committed itself to effectively managing coffee stocks under government control under the retention scheme.¹⁸

Costa Rica and the Coffee Quota System

Between 1988 - 1989 and 1992 - 1993, the foreign exchange earned by Costa Rican coffee exports decreased by 33% (US\$ 317 million in 1989 down to US\$ 215 million in 1993), while the amount of coffee exported increased during the same period from 96,600,000 kgs in 1989 to 119,600,000 kgs in 1993. Costa Rican producers decreased from 132,609 to 88,708 during this period, a one-third drop. The Costa Rica coffee sector was clearly in a crisis, and the government responded with a lifting of the export coffee tax and a 50% reduction in the production tax. The government also responded by supporting the formation of the Association of Coffee Producing Countries and its coffee retention program. Under the program, each member country was required to report weekly sales, exports, and retentions and present certifications of the amount of coffee retained and where it was held. Costa Rica's participation in this program resulted in the retention of 1,590,909 kgs in 90 coffee beneficios. The value of the retained coffee was US\$ 31.5 million in April 1994.¹⁹

Over the years, Costa Rica's implementation of the International Coffee Agreement resulted in the establishment of procedures to effectively enforce the terms of the Agreement's retention plan. A review of ICAFE documents and personal interviews with the coffee industry people indicated that Costa Rica's system for retaining coffee under the retention program is very effective." The program is managed and monitored by ICAFE, with each coffee beneficiary held responsible for certifying in their sales agreements that the required quota the amount has been retained (ICAFE assigns an amount that each of the 90 beneficios in Costa Rica must be retained for the country to comply with Bogota Agreement).

Essentially, the system works at the expense of the beneficio owner in that he must hold and absorb the cost of storing retained coffee until it can be released on a rolling stock basis (when new coffee comes in the "held-over" coffee is liquidated, and accounts are settled with the producer- up until this time, the producer has been advanced a portion of the estimated value of his crop). The system does also not discriminate based on the quality of the coffee retained. The limits are placed across the board on all beneficios based on their previous production history. Ironically, one of the complaints heard is that Costa Rica may be too effective in retaining its coffee and that other countries are continually "leaking" some of the retained coffee. This may be why the ICAFE press release announcing the Bogota Agreement reiterated that Brazil was taking extra measures to ensure it maintained tight control on its retained stocks.

The retention program has succeeded in keeping prices above the US\$0.85 floor of the previous agreements, but at a cost. A 20% retention on all types of coffee produced in Costa Rica resulted in a significant percentage of the highest quality coffee being retained. This quality coffee is represented by three types - Strictly Hard Bean, Good Hard Bean and Hard Bean -- with production levels in 1993 - 1994 respectively of 55,715,499 kgs., 18,811,001 kgs., and 25,192,969 kgs. A 20% cut in the availability of these coffee types limits Costa Rica's ability to differentiate its market by reducing the availability of this high-quality product by an estimated 20,000,000 kgs. An informal telephone interview indicated that the quota system had impacted the supply of the very best Costa Rican coffee, the Strictly Hard Bean type, and impeded the ability of the market to supply the product.²¹

3. Costa Rican Coffee Marketing for the 21st Century

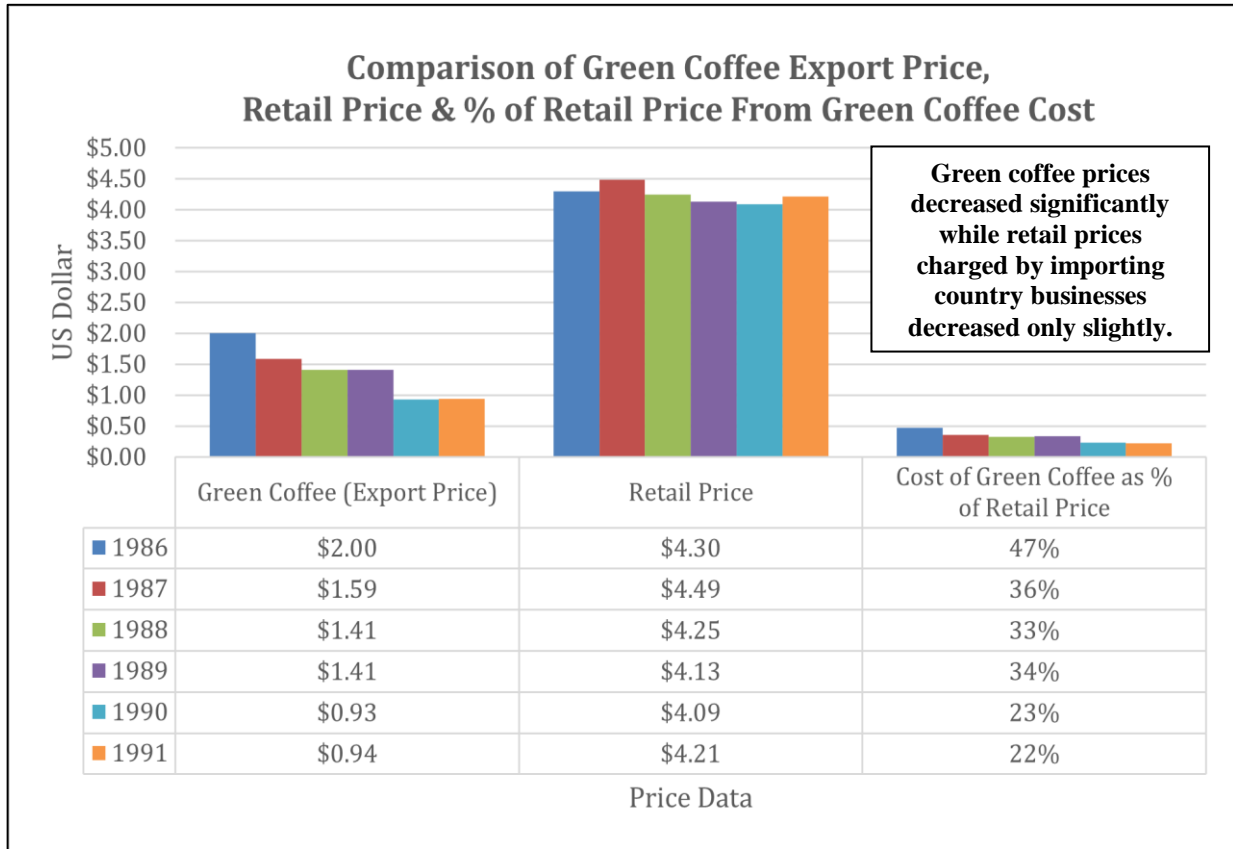
Picking the Right Market

The world coffee market is controlled by 10 coffee roasting companies with a combined annual income of US\$ 3,000 million. The production pyramid for Costa Rican coffee consists of 88,700 producers, 90 beneficios, 27 exporters feeding into the world market. The sector is comprised of small farms (0 to 5 hectares -- 92% of total farms but only 44% of area in production) and larger farms (>20 hectares -- 2% of the total farms but 35% of area in production). A recent *Actualidad Economica* article indicated that Costa Rica should try to enter the market farther up the production pyramid, closer to the retail end of the market, that the turmoil seen in the coffee sector over the last five years is an indication that new solutions are needed.²²

The marketplace in importing countries coffee is divided into three broad categories: 1) commercial (roasted, canned coffee -- low-cost blends for commercial sale generally consisting of 1/3 robusta, 1/3 lower quality arabica and 1/3 higher quality arabica coffees), 2) instant (robusta and lower quality arabica) and 3) "specialty" (roasted or green whole bean or ground, high quality arabica coffee). The market share of these categories in 1989 was the following 7,850,000 bags (60 kg.) for commercial coffee, 1,394,000 bags for production of instant coffee and 2,655,000 bags of specialty coffee, giving a percentage market share of 66%, 12%, and 22%, respectively.

The following is a price comparison of coffee prices in the green bean, wholesale and retail markets (from a February 2, 1992, ICO Market Situation report).

Comparison of Coffee Pricing - 1986 - 1990



This table indicates the cost of green beans as a percentage of the retail price declined significantly from 1986 through 1991, illustrating that there is a resistance to lower retail prices even when there are substantial drops in the export price of green coffee. According to the Specialty Coffee Association of America report ("Avenues for Growth: A Twenty-Five Year Review of the Specialty Coffee Association", 1991, page 47), the price of specialty coffee averaged around US\$5.98 per pound and also did not decrease in response to decreasing green coffee prices. The closer Costa Rica can come to entering the retail market segment of the coffee market (either by wholesaling high-quality green beans directly to small retail outlets or by exporting roasted coffee as both a wholesale and retail product) the more price stability and higher returns it will mean for the Costa Rican coffee farmer.

Specialty coffee is clearly an area that Costa Rica should target for the future. As stated, specialty coffee is a high-quality arabica variety grown and processed with techniques to enhance cupping quality. It began as a separate category of retail coffee in the 1960s, with sales around US\$ 45 million in 1970. Sales increased and by 1979 reached \$750 million. A recent Miami Herald article indicated that although overall U.S. coffee consumption has remained steady at 45 million pounds per week over the last decade, specialty sales have more than doubled, with increases of 15% every year for the previous three, reaching sales of over \$1,500 million in 1994.²³

Ted Lingle, the Executive Director of the Specialty Coffee Association, recently indicated that annual sales of specialty coffee will reach the \$3 billion mark in annual sales in the next four years and if combined with the \$1.5 billion in retail food service sales of specialty coffee beverages, the industry will retail for approach a \$5 billion retail business by the turn of the century. This is a “Rising Star” market with exceptional prospects for the future.²³

Impact of Coffee Quota System on Costa Rica

If Costa Rica were a low-quality coffee-producing country unable to differentiate its product and sell in a higher profit segment of the coffee market, then it would be appropriate to remain linked to the giant producers of inferior quality coffee (Brazil and others). Costa Rica is at a crossroads as it approaches the 21st century. One road leads to the same policies followed for the last fifty years of quota agreements and depending on inferior but higher volume coffee types to set the market price for Costa Rican coffee. The alternative leads to a change in production and marketing strategy with a focus on quality and penetration in the upscale wholesale and retail specialty coffee markets in the United States, Europe, and Japan. Staying linked to the quota system has three negative impacts: 1) it keeps Costa Rica moving toward the wrong market (the huge but descending commercial coffee market), 2) it could limit the amount of coffee that could be placed in higher return markets, and 3) it creates a disincentive to produce higher-quality coffee.

Costa Rica's future in the coffee industry should be linked to promoting and selling a differentiated product aimed at the wholesale/retail levels of the specialty coffee segment of the market. A 1990 assessment of Costa Rica's future in the coffee sector by the United States Department of Agriculture concluded that "Costa Rica may be better off over the long run without a quota system." Its advanced technological development should enable it to continue profitably increasing the production of high-quality coffee.²⁴

Costa Rica's continued participation in coffee retention plans may be necessary in the short run. Still, a medium—to long-term strategic plan should focus on only high-quality coffee production and marketing. At a minimum, a separate classification of the ICO coffee types should be made to allow any coffee meeting the minimum standards for "specialty grade" coffee to be exempt from the retention quotas.

It has been estimated by industry experts that only 10% of the world's production would meet these standards. This relatively small amount of this production and the fact that it competes or should compete in a completely different market from robusta, Brazilian dry arabicas, and lower grades of washed arabica should be justified enough to make this change. This change is also necessary to avoid a negative impact on the coffee -- a January 44, 1986 World Bank Information Paper, stated on p.15 that “one of the adverse

effects of a quota market system such as the one for coffee is that producers have less incentive than they would under an open market to maintain the quality of their product. The emphasis should be on producing the highest quality product possible. Staying in the coffee quota system is the wrong direction for Costa Rica over the long term; it's the wrong market. The future market opportunity is specialty coffee.²⁵

Marketing Strategies for the Future

The world is undergoing tremendous change as we enter the 21st century. Information technology makes it possible to reach a world audience at an incredibly low cost. The Internet is the gateway to this communication revolution. It is estimated that of the 34 million with access to the Internet, at any one time, 4 million people are using the system, and anyone can communicate regularly and with minimum costs with countless other people on the system. This technological advance is giving rise to a new form of marketing -- "relationship marketing" -- which is a method of developing a long-term relationship with a discrete group of consumers that includes providing personalized service via the Internet to help them buy products which meet their needs.

Relationship marketing also allows instant feedback on their needs and concerns. This type of marketing would be ideal for the specialty coffee wholesale market (to micro-roasters, there are now 1,500 in the United States using between 250 to 500 pounds of high-quality green beans per week) and retail market (direct links with a set client base that wants a good quality coffee at a reasonable price -- one can begin to close the gap between producer and final market). Retail companies in Costa Rica are already starting to move toward this type of marketing. Café Britt, for example, is developing an online database of customers with whom they will provide regular mailings, sales information, and special offers. A client base of 5,000 specialty coffee consumers could provide annual sales of over \$1.37 million." Costa Rica has the infrastructure and resident expertise (Inter@merica is an example of a local company offering complete internet marketing services locally) to make this marketing strategy a reality for an individual producer, a beneficio, or a corporation.²⁶

The following are suggestions for targeting the specific clients one could include in your client base. The assumption is first to go for the customer who wants a high-quality product and is willing to pay a premium. After the first screening, other characteristics may differentiate coffee profiles that are favorable to Costa Rica for higher value markets.

Marketing recommendations for developing client bases for Costa Rican coffee.

1) Promote Costa Rican coffee as a high value product -- Emphasis should be placed on finding niche markets for high-quality green beans (e.g., estate coffees and coffee certified and sold as organically grown), expanding sales of roasted coffee as a specialty coffee product (90% of current Costa Rican coffee exports are green beans) and promoting varietals (Tarrazu, Heredia, Tres Rios, etc.) of Costa Rican coffee in the principal markets - United States, Germany and Japan. The Costa Rican government should consider an all-out promotion campaign like the type being conducted by Guatemala to raise recognition of their coffee on a regional basis .. as varietals - (this is not unlike the French promotion and control of brandy production so that only brandy from the Cognac region of France can carry that name -- this can only be done effectively as one moves closer to selling a "retail" product, roasted coffee). The objective of the campaign should be to promote Costa Rican coffee but also build a client list of those people to receive regular information about Costa Rica and its coffee products.

2) Promote Costa Rican coffee under the "Just Cup" program starting in Germany and the United States. Small-scale farmers (producers with holding between 0 and 5 hectares) produce 44% of Costa Rica's coffee. These small farmers should be eligible for entry into programs such as TransFair in Germany and the Max Havelaar Foundation in Holland. Similar programs are being discussed in the United States. The Association of Fair Commerce with the Third World (TransFair) which aims to sell 2% of Germany's coffee under a program that guarantees direct trade with small farmers and a higher price than world market prices. TransFair provides a seal for display on roasted coffee purchased under their program. Between April 1993 and May 1994, the program provided additional income to small producers of \$4.3 million dollars on a total of 3,272,727 kgs marketed. The Max Havelaar Foundation is making efforts to buy directly from small producers and sell at a premium price in Holland and the United States. The product would be sold under a seal of the Foundation insured production by small producers. The current margin over world market prices would be a \$0.26, with part of the funds going to a development fund and the remaining portion going directly to the small producers. Again, target clients that are concerned about equity issues and attempt to forge direct links between small producer groups and the final customers.²⁷

3) Promote Costa Rican Coffee as a Socially Conscious Product - Recently, a coalition of labor activists including the U.S. Guatemala Labor Education Project and the International Labor Rights Education and Research Fund reached an agreement with Starbucks, the largest retailer of specialty coffee in the United States to abide by a code of conduct encouraging good labor and environmental practices by its producers. The agreement commits Starbucks to

affirm that coffee sold by them is procured only from countries where workers have the right to unionize and to earn wages and benefits that provide for the basic needs of their families. The labor groups believe this agreement affirms Starbucks commitment to be publicly accountable for abuses and worker rights violations and provides a framework for individuals and concerned groups to raise issues.²⁸

This type of agreement indicates that the level of awareness is rising in the United States and other consuming countries as to the conditions, sometimes oppressive, under which coffee is produced in some parts of the world.? An organization that was started in the United States to assist the children of coffee workers, Coffee Kids, figures prominently in the advertising of a significant number of specialty coffee retailers where the business is earmarks a percentage of sales for this charity. There seems to be a growing awareness in the United States of the importance of sourcing coffee is produced in a sustainable and equitable manner.²⁹

Costa Rica has a comparative advantage in this area with how its coffee (a world-class quality product) is produced. It is an equitable and open system relatively free from repression and concerned with the rights and well-being of small producers. If there is a growing awareness and concern for how coffee is produced, Costa Rica should exploit that concern with a promotional campaign directly to the retail customers of the consuming countries. Target customers concerned about social issues and the conditions under which coffee is produced should be explained how their purchase can ensure the sustainability of small-scale Costa Rican farmers' coffee production and access to this unique quality that comes from a handcrafted product.

REFERENCES

- 1 Claudia Roden, *Coffee* (London: Penguin, 1981) pp. 19-20.
- 2 Robert Williams, *States and Social Evolution: Coffee and the Rise of National Governments in Central America* (Chapel Hill: Univ. of North Carolina Press, 1994) pp. 15-16.
- 3 Williams, p. 17-26.
- 4 Roden, p. 22.
- 5 Informe Sobre La Actividad Cafetalera de Costa Rica, XXIV (San Jose, Costa Rica: Instituto del Cafe, 1995), pp. 5-8.
- 6 Timothy Castle, *The Perfect Cup: A Coffee Lover's Guide to Buying, Brewing and Tasting* (New York: Addison-Wesley, 1991), pp. 9-15.
- 7 Arturo Villalobos, "Comercialización de Productos Agropecuarios," EUED, 1985, pp. 195-198.
- 8 Timothy Castle, p.169.
- 9 "Coffee," Encyclopaedia Britannica, 1995 ed., Internet:<http://www.eb.com:195/>.
- 10 Informe Sobre La Actividad Cafetalera de Costa Rica, XXIV, pp.19 - 43.
- 11 "Dificil Acuerdo Cafetero," Panorama Internacional, 16 de setiembre de 1991.
- 12 Personal Interview with Fernando Castro, Vice-Presidente, Corporacion Kahle International, Alajuela, Costa Rica, January 12, 1996.
- 13 Based on personal interviews with coffee industry personnel. January 1996.
- 14 Mario Samper Kutschbach, *Café: Crisis e Historia* (San Jose: UCR 1993) pp. 11 - 24.
- 15 Informe Sobre La Actividad Cafetalera de Costa Rica, XIX (San Jose, Costa Rica: Instituto del Cafe, 1990), pp. 17-18.
- 16 Mario Samper Kutschbach, *Café: Crisis e Historia* (San Jose: UCR 1993) p. 25.1
- 17 "Coffee," Encyclopaedia Britannica, 1995 ed., Internet:<http://www.eb.com:195/>.
- 18 Press Release, San Jose, Costa Rican Instituto del Cafe, July 1995.
- 19 "Habia Una Vez Un Pais Cafetalero," Actualidad Economica, Junio 1995, pp. 54-60.
- 20 Various interviews were held with representatives of La Meseta Coffee Company, the operators of three coffee beneficiaries and representatives of the ICAFE Export Office (specifically, a meeting was held with Guillermo Padilla, Chief of the Export Office on January 12, 1996).
- 21 Survey was made of the largest exporters in late December 1995 and found that the largest single exporter, responsible for 40% of the country's green beans, had the best price for Strictly Hard Bean (the New York Coffee, Sugar and Cocoa Exchange (CSCE) price for March delivery coffee plus a \$0.05 per pound margin) but was unable to provide any product until April 1996 because of quota limitations.
- 22 "Habia Una Vez Un Pais Cafetalero," p. 60.
- 23 Miami Herald article is from 1995 but is undated, the title is "Specialty Coffee Craze is Sweeping the U.S., Sales Exceed \$1.5 Billion."

24 Internal USDA Memorandum, January 10, 1990.

25 Margaret Andrews, "Avenues for Growth: A 20-Year Review of the U.S. Specialty Coffee Market," Specialty Coffee Association of America, 1991, p. 6 - 9.

26 Assume consumption of 4 cups of strong brew per day (57 grams) for 365 days times 5,000. That would give you 104,000 kgs or 228,800 pounds. If you average \$6.00 gross a pound, which is the low end price of specialty coffee, you would achieve annual sales of US\$1.37 million.

27 "Habia Una Vez Un Pais Cafetalero," p 60.

28 "Trade Information: Coffee," International Association for Trade Promotion (IATP), Internet:<iatp@igc.apc.org>, December 1995.

29 Informal survey of online specialty coffee retailers on the Internet. January 1996. (examples of support to Coffee Kids can be seen at several specialty coffee outlets such as Thanksgiving Coffee Company, Los Gatos Roasting Company and many others).