Section B: Short Case Study (35 mins)

THE INTERNATIONAL COFFEE CRISIS

Although depressed prices have been common to most commodities, much attention has focused on coffee. Price; falls for coffee have been particularly dramatic: by 2001 real coffee prices had fallen to levels than ever recorded.

According to FAO (Food and Agriculture Organisation), supplies of coffee on the world market have, typically run ahead of the growth in demand. Since domestic consumption in coffee-producing countries did not expand sufficiently to absorb growing supplies, coffee exports/increased Blit as developed country markets became increasingly saturated, growth in export earnings for the coffee, producing countries have been declining too. Other developments in the world, coffee market that have added to the problems include the new plantings in Vietnam increase in Brazilian exports following expansion of plantings into frost-free areas and productivity improvements.

However, falling prices do not necessarily prompt the expected supply response. The perennial nature of the crop means that adjustment made to coffee production is slow: fn the short run the price elasticity of supply appears to be very small, around 0.25.

Some solutions notably demand promotion and supply control, have been implemented by the industiy to remedy the situation.

To control supply, the Association of Coffee Producing Countries (ACPC) promoted a scheme to retain 20 percent of exports to maintain prices above 95 cents/pound and release supplies onto the market when prices exceeded 105 cents/pound. While 19 countries joined, including non-members of ACPC such as Vietnam, few actually retained any coffee at all: only Brazil, Colombia, Costa Rica and, temporarily, Vietnam cooperated. However, exports and stocks continued to rise.

Difficulties in coordinating international action on the supply side have led to interest (n demand side measures. There appears to be more scope for the promotion of demand in producing countries: Brazil successfully raised coffee consumption during the 1990s. However, not all market, segments offer the same prospects. [Increasing consumption among younger age groups in, particular poses a particular challenge and heavily advertised soft drinks are the main competitive challenge. Market growth possibilities in the high income developed countries where most coffee has traditionally been consumed are relatively limited; only the specialist coffee markets have seen significant growth recently, again indicating product differentiation as a. potentially successful marketing strategy.

Questions

a) With reference to the article, explain one factor affecting the
i. Demand for coffee. (2)
ii. Supply of coffee. (2)

b) i. Explain why the price elasticity of supply for coffee is very small. (2)
ii. Explain whether you expect coffee to have a high or low-price elasticity of demand. (2)
iii. With the aid of a diagram, explain why the fall in coffee prices has been 'particularly dramatic'. (4)

c) Describe and comment for the effectiveness of the following measures to curb the fall in coffee prices:
i. Supply Control (2)
ii. Demand promotion (2)

Students who are interested to learn more, you can join our GCE A level preparation class. Please call Simon Ng @ 96890510 for more consultation.

a. With reference to the article, explain one factor affecting the

i. Demand for coffee. (2)

ii. Supply of coffee. (2)

A i. One factor affecting the demand for coffee would be the consumer's taste and preference, which is greatly affected by the advertising and promotional effort. Extensive promotion and marketing would influence the consumers' preference for the choice of beverages. The advertising would cultivate the consumers' consumption behaviour as seen in the promotion of specialist coffee market whereby 'significant growth' is seen as a result of 'a potentially successful marketing strategy'.

Another factor affecting the demand for coffee is the price of substitutes like carbonated drinks. When the price of carbonated drinks decreases, the demand for coffee will decrease as carbonated drink is a cheaper alternative beverage for consumers, especially the younger consumers.

a ii. One factor that affects the supply of coffee would be the capacity of production. As more land are being used for the planting of coffee or improvement in production techniques, the supply of coffee would increase as seen the increase in Brazilian exports.

Determinants of demand

1) Price of coffee itself – price factor – change in quantity demanded (movement along the demand curve)
2) taste and preference – affected by cultures, education, advertising
3) disposable income of consumers – types of goods (inferior, normal, luxury) – proportion of income spent on it
4) expected future prices
5) government policy – ERP meter, seat belts
6) Price of substitutes

Determinants of Supply

1) Price of coffee – caused by change in demand – will lead to change in quantity supplied.
2) capacity of production – refers to availability of resources – natural endowment/production techniques
3) government taxes and subsidies
4) no of producers – more producers – easier to increase the supply
5) technological advancement – increase productivity – reduce COP – increase the supply

b. i Explain why the price elasticity of supply for coffee is very small. (2)

When the price elasticity of supply is small, it is noted that the price elasticity of supply is price inelastic whereby an increase in the price of coffee would lead to a less than proportionate increase in quantity supplied. This is because of the constraint of production capacity in the short run. The production capacity is constrained by the perennial nature of harvesting for coffee production, contributing to the slow response in supply of coffee to price changes. (implying that the production period for coffee is long)

Determinants of price elasticity of supply

i) capacity of production – nature of production for the type of good (coffee – long production process – difficult to increase the supply in short run – constrained by land yield)

ii) unit cost of resource – high unit cost of resource will make it difficult to increase supply – a larger percentage increase in price is needed to increase greater quantity supplied

iii) ease and cost of storage – high cost of storage and perishable products will make it difficult to increase supply in the short run

ii. Explain whether you expect coffee to have a high or low-price elasticity of demand. (2)

It is likely that the price elasticity of demand of coffee is low as it is price-inelastic as the demand for coffee is quite habitual due to its addictive preference and lifestyle consumption. Under this situation, the degree of necessity for coffee consumption is high which means that an increase in the price of coffee would lead to a less than proportionate decrease in quantity demanded.

Besides this, the proportion of income spent on coffee is small and thus, the consumer is not price sensitive. This implies that the good is an inferior good to most consumers and the demand is likely to be price inelastic for most consumers who are average income earners.

Consumers also take a short time period for the consideration of purchase for beverages and this will mean that the availability of choice is limited. Consequently, the consumer's demand will be price-elastic as there is lesser availability of substitutes.

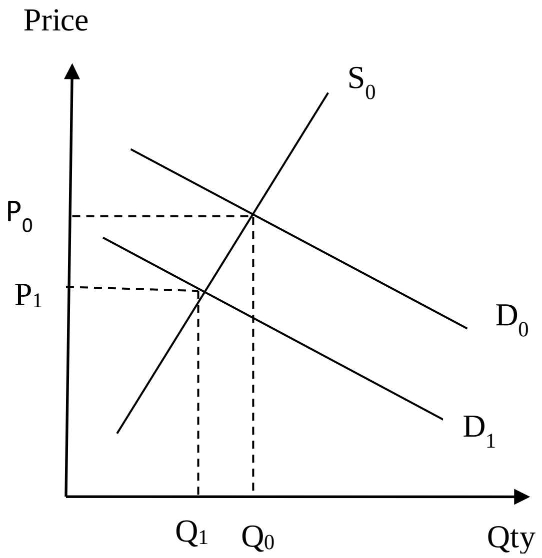
Determinants of PED

1) Degree of necessity of demand – affected by habits (high / low)
2) proportion of income spent on the good (small / large)
3) time period of purchase (short / long)
4) availability of substitutes – market classification (broad/narrow)

Simon Ng @ 96890510 simon@economicfocus.com.sg
Main Centre: Block 283, Bishan St 22, #01-185, S570283
Branch : 1 Brooke Road, Katong Plaza, B1-07, S429979

iii. With the aid of a diagram, explain why the fall in coffee prices has been 'particularly dramatic'. (4)

The fall in coffee prices can only be contributed by a fall in demand for coffee or an increase in the supply of coffee. The fall in price can be dramatic when both demand and supply are both price-elastic.



As seen from the diagram 1, the fall in demand will contribute to more dramatic or greater in price level when the supply is price-elastic as seen in the diagram. When the demand decreases or shifts to the left, the fall in price is lesser for a condition where the supply is price inelastic.

c. Describe and comment for the effectiveness of the following measures to curb the fall in coffee prices:

i. Supply Control
ii. Demand promotion

i To curb the fall in price, the government can control the supply to prevent the increase in supply. In doing so, the price will not fall as there will not be an excess supply condition. However, such control may not be effective as the supply cannot be completely controlled as producers may not corporate to reduce supply as seen from the control made by ACPC. The control in supply can also be quite disruptive to the farmers. As coffee is an agricultural product, it is perishable and difficult to stockpile.

ii. The introduction of demand promotion through advertising and consumer education will shape the preference of the consumers and thus contributes to an increase in demand will lead to a rise in the price level. However, the corresponding demand promotion by producers of substitute goods will undermine the effectiveness of the demand promotion. Besides this, the consumers may have very deeply-rooted consumption behaviours which are difficult to change. Lastly, the cost of consumer education can be quite high to render the demand promotion's profitability not worthy.