Of Coffee, Cartels and Communism

Colleen E. Haight[1]
San Jose State University

U.S. concerns regarding the spread of Communism in the Americas in the 1950s and 1960s led to Congressional support of a coffee cartel whereby participating producer countries in the Americas voluntarily restricted coffee exports with the goal of increasing price levels. The intent by coffee producing countries was to stabilize the wide natural swings in the coffee market in order to mitigate the pronounced business cycles inherent in the coffee industry. For the U.S., the main concern was to promote economic stability, reducing the potential for the spread of Communism. The method employed, a voluntary export restraint, ordinarily has the effect of increasing the quality of an exported product. However, in this case, it had the effect of artificially suppressing quality levels of the imported coffee, leading to very low supplies of high quality beans. As fears of Communism disappeared and the cartel dissolved, the increased supply of quality coffee allowed for the tremendous expansion of the specialty coffee industry in the 1990s. This paper seeks to examine the transition in the coffee industry, and attempts to answer more fully why there has been a sudden and dramatic expansion of the specialty coffee market segment, which is so much in evidence today.

Key Words: Commodity Agreements, Coffee cartel, Communism, International Trade History, Latin America

Introduction

Coffee, the world's most widely taken psychoactive drug (Pendergrast 1999), is also the second most traded commodity in the world, petroleum being the first. According to the Coffee Research Institute, in 1999 U.S. coffee consumers spent over $9 billion in the retail coffee market, and an additional $8+ billion on coffee in the food service

[1] Department of Economics, San Jose State University, San Jose, California, 95192. Email: Colleen.Haight@sjsu.edu. The author wishes to thank the Mercatus Center at George Mason University for generous field work support and T. Clark Durant for his creative input and field research assistance. The standard disclaimer applies.

market. In the year 2000, approximately 54% of the U.S. population, or approximately 161 million people, consumed at least one daily cup of coffee.[2] Sixteen percent of those, or about 26 million, drank specialty or gourmet coffee daily.[3] As we will see, the growth of the specialty coffee market has continued.

This popularity has been rather remarkable for a beverage with such a checkered past. At times embraced by religious leaders as a mechanism to promote greater stamina for prayer, coffee has also been viewed with suspicion over the ages. Coffee consumption was outlawed in Mecca in 1511 AD and in Cairo in 1532 AD. In the 1570s, religious leaders in Constantinople ordered the closing of coffee houses. Yet during this same period, Turkish law made it grounds for divorce if a husband should refuse coffee to his wife. (Dicum and Luttinger 1999) Indeed, once coffee has been embraced by people, they are loath to give it up, even when the quality of the brewed beverage is quite poor.

For most of the 20th century, quality coffee roasting and brewing was an unrecognized art form that languished on the periphery of the American consumer's consciousness. Instead, the icon of the 5-cent cup-o'-joe took center stage. Whenever the price of coffee threatened to rise above this magical price, consumers would vigorously protest to their political representatives, asking for relief in the form of price controls. These price fluctuations generally were not due to any illicit scheme, but rather were natural fluctuations due to the cyclical nature of the business of coffee growing.

In late 1980s, things changed. Suddenly gourmet coffee houses selling expensive coffee concoctions began to spring up everywhere. In 1988, there were only 33 Starbucks coffee houses. With the exception of two (in Chicago and Vancouver), all were located in the Seattle area, the corporate home of Starbucks. Today, there are approximately 24,000 Starbucks-owned and licensed enterprises operating in 70 countries around the globe, with 2016 net revenues in excess of $21 billion.[4] Of course, while Starbucks is the market leader, several other chain and individual specialty coffee houses are also thriving, including Caribou Coffee, Peet's Coffee and Teas, and Philz Coffee, to name just a few. A

[2] Statistics available at the Coffee Research Institute's web site: http://www.coffeeresearch.org

[3] According to the Specialty Coffee Association of America, http://www.scaa.org/

[4] Starbucks web site accessed July 17, 2017, https://www.starbucks.com/business/international-stores

mere shift in consumer preferences cannot explain this sudden growth, nor the creation of an entirely new coffee market. What happened in the late 1980's that made this change possible?

While changes in income, the price of reasonable substitutes, etc., may account for some of the change in consumer consumption patterns, the sudden and dramatic spike in retail gourmet coffee outlets can be best attributed to supply changes. After World War II, a cartel formed between the coffee producing countries of Latin America and the United States of America, the largest coffee consuming country. The arrangement was intended to stabilize prices and provide at least some type of foreign aid to coffee producing countries whose economies were largely dependent on this export. The cartel agreement was constructed along the lines of a voluntary export restriction (VER) that specified the quantities of coffee each producing country could export.

While studies have shown that VERs tend to increase the quality of the exported product (Falvey 1979, Rodriguez 1979, Feenstra 1985 and 1988, Santoni and Van Cott 1980, de Melo and Messerlin 1988, among others), the coffee cartel agreement had the opposite effect. With the focus of the agreement emphasizing quantity production, many countries found it unprofitable to produce with an eye towards quality. Furthermore, coffee was sold as a commodity on exchanges in London and New York. Individuals or countries that independently attempted to upgrade quality production would be unable to capture increased rents because their coffee would be combined for sale with that of others. As such, the coffee market was characterized by its utter lack of differentiability. With the collapse of the agreement in 1989, the small higher-cost producers in Central America found they could no longer compete with Brazil's lower-cost production and turned to compete based on quality. This shift in production goals, initiated by the failure of the cartel, resulted in an increasing variety of high-quality beans offered at a variety of price-points. These beans could not be co-mingled with the lower-quality beans available through the exchanges, and instead were sold via individual contracts. Because these higher-quality producers were able to extract higher sales prices, supplies of high quality beans increased, paving the way for the expansion of the specialty coffee industry.

This paper seeks to examine this transition in the coffee industry, and attempts to answer more fully the "why now" question inherent in the sudden and dramatic expansion of the specialty coffee market segment. The next section provides a broad overview of the literature on voluntary export restraints and the mechanisms through which they affect quality. The following section provides an historical overview of the U.S. coffee market as the background of our discussion, and explores the essence of the International Coffee Agreement of 1963 ("ICA"). Section four synthesizes the particular case of coffee with regard to the existing VER literature, explaining how the collapse of Communism and the subsequent collapse of the ICA converged to provide the perfect environment for growth in the specialty coffee market. The last section concludes and offers extensions for further research.

A Brief Overview of Voluntary Export Restraints

Voluntary Export Restraints are trade barriers that restrict the quantity of a good exported by that country. Because they are self-imposed, they are allowable under World Trade Organization guidelines, making them a desirable form of protectionism for many countries. VERs have an additional benefit for the exporting country in that they allow the exporting country to capture the rents associated with the trade barrier. Contrast this with the typical tariff, which channels the rents to the importing country.

The impact of VERs on prices in the importing country is well documented. Because of the decrease in the quantity supplied to the importing country (relative to a free market quantity supplied), prices are subject to upward pressure. This increase in prices is referred to as the scarcity premium. (Hamilton, et al. 1992) Furthermore, that premium tends to rise proportionally with the price of the good. Because the higher cost of production of higher quality goods is reflected in the higher sales price, higher quality goods will generally receive a higher scarcity premium. Consequently, a profit-maximizing firm will export a higher quality good in order to reap the larger scarcity premium. (Rodriguez 1979) This shift to higher quality is often observed when countries respond to a VER by altering the restricted export product mix. (Falvey 1979, Rodriguez 1979, Santoni and Van Cott 1980, Feenstra 1985 and 1988, de Melo and Messerlin 1988, among others).

Most of the relevant research on voluntary export restraints and quality improvement focus on the automobile industry, and in particular on the Japan's 1981 VER on passenger automobiles, limiting exports to 1.6 million(Aw and Hwang 1991, Berry, et al. 1999, Feenstra 1988, Rodriguez 1979, Santoni and Van Cott 1980). By upgrading quality, the firm is able to minimize or even offset the added cost of the upgrade due to the increase in price of the final product. Other research generally supports the conclusion that VERs generally result in an increase in quality (Das and Donnenfeld 1987, Falvey 1979, Rodriguez 1979).

This link between VERs and quality upgrading, however, is by no means a foregone conclusion. Research by John Ries provides a dissenting opinion when he concludes that VERs would not cause Japanese automakers to upgrade to higher quality models if the non-Japanese unconstrained firms produced higher quality in the pre-VER era. Output constraints induce the constrained firms to produce a higher quality product mix in order to compete with the unconstrained firms. (Ries 1993) Similarly, Berry, Levinsohn, and Pakes, found that VERs did not have a significant impact on the increase in prices of the auto industry in the 1980's (Berry et al., 1999). They argue that one can overstate the increase in price if he doesn't take the quality change into full account. Another study found changes in the product mix due to multilateral quantity restrictions were associated with less quality compared to the pre-VER era (de Melo and Winters 1990). Hamilton gives possible reasons for such a phenomenon. (Hamilton, et al. 1992) First, if the constrained firm was more interested in earning foreign exchange than maximizing profit, then foreign exchange losses will be minimized if marginal revenue was equal among the different product categories within the product mix; therefore, the firm will focus on those products with higher marginal revenue even if this leads to lower quality. Second, the cost of quality upgrading might be too high for what was considered to be a temporary distortion. Other studies show quality may decline depending on the particular market structures and diseconomies of scale (Krishna 1987, Das and Donnenfeld 1989, Herguera et al. 2000, Aw and Huang 1991, de Melo and Winters 1993, Lutz 2005).

VERs usually address an entire category of goods with multiple price points (Hamilton, et al. 1992). The coffee market during the 1960's, 70's and 80's does not fit this description. Instead of many types of coffee with a variety of characteristics and price points, the coffee market during this period consisted almost entirely of exchange grade coffee, a standardized product with a single price-point defined by the commodity market. The commodity was then sold on an exchange, where no product differentiation can occur. In studies showing quality improvement, the improvement is measured over a product mix, where fewer lower-quality products are exported in favor of exporting more higher quality products. In such a market with a variety of price points, exporters will have an incentive to export higher quality goods to attract the higher returns.

In the coffee market, there was no product mix within which to shift allocations. Another important factor was the sheer dominance of Brazil in the coffee market. Brazilian growing conditions favored the lower quality producing coffee plants. Because Brazil produced a huge volume of coffee relative to the other participating countries in the ICA, any improvement in quality attempted by another country would be lost when mixed with the Brazilian beans for sale on the exchange.

The U.S. Coffee Market and the ICA

The Market for Coffee

The market for coffee is extremely volatile and is characterized by natural cycles. The two most popular varietals of coffee plants, Arabica and Robusta, take, on average, three to five years to reach maturity and full production capability. Arabica plants are very particular about their growing environment, with a strong preference for temperate mountain air and volcanic soil, take longer to mature, and produce lower yields of high quality coffee. Robusta plants are less particular, mature more quickly, and produce high yields of very low quality coffee. A frost can easily destroy the year's harvest of either, and may even kill the plants themselves. When such a frost occurs, killing off much of a country's production, supply declines and, predictably, prices rise. Indeed, even rumors of a Brazilian frost are enough to substantially impact the price. (Pendergrast 1999) The unusually high prices created by the contraction in supply, and the resulting high profit margins, produce an almost irresistible incentive for entry into the coffee farming business. This heavy planting of new coffee plants results in a predictable surplus of coffee about five years hence. The huge surpluses cause great economic hardship to all those involved in the coffee industry as prices are driven down. One estimate provides that a one-cent drop in coffee prices translates into a loss of $50 million for Latin American coffee producers (Kennedy 1962). Brazil, and to a lesser extent Columbia, dominate the coffee production end of business.

Demand and Supply of Coffee

Demand for coffee grows quite slowly and remains relatively stable over time. (Bilder 1963, Farmer 1994) Historically, coffee consumption has grown at the rate of the population plus real per capita income. This implies a steady, gradual growth in demand. However, in recent years demand has risen even more slowly due to the popularity of caffeinated beverages, such as Coca-Cola (Bates 1997, Farmer 1994).

Whereas the demand for coffee has some small amount of elasticity, a central characterization of the coffee market is the relative inelasticity of supply. Coffee farming requires significant investments of capital and long-term capital commitments which cannot be easily reallocated to other types of farming or production in down cycles. The principal cost to the farmer is the cost of purchasing and clearing land suitable for coffee farming, and then planting the trees (Bilder 1963). Because Arabica trees grow best at higher altitudes, in volcanic soil, and in partial shade, the land suitable for this type of farming, found on slopes interspersed with taller foliage, is most difficult to clear and farm. Due to the high fixed costs of these conditions, production is relatively inelastic to short run changes in price. Farmers will continue to bring their stock to market so long as they are covering their marginal costs, which may only be their labor and that of their families. While there is some low intensity volatility that is generated by every other year's yield of a Brazilian bumper crop, the real uncertainty in the coffee market arises in the form of negative weather shocks.

While the finest grades of coffee are grown in the tropical shade of volcanic slopes at higher altitudes, average and lower grades can be grown on flat, sunny expanses. The Central American producing countries offer ideal growing conditions for the former, but they have higher average costs. The coffee grown in Brazil is mostly of this latter type. Because the terrain is less demanding, Brazilian production is more amenable to mass cultivation and harvesting techniques, and economies of scale. Such techniques position Brazil as the low-average cost, large-scale producer.

Coffee in the U.S.

The history of coffee consumption in the U.S. is inextricably intertwined with our politics. During the revolutionary period, consumption of tea fell out of favor, as tea came to symbolize oppressive taxation. Coffee houses in New York and Boston served as sites for the planning of the boycotts of English goods (Dicum and Luttinger 1999) . Drinking coffee was viewed as a patriotic act, while drinking tea was considered 'un-American'. During the Civil War, a Union soldier's rations contained one tenth of a pound of green coffee beans. Translating this into annual consumption reveals an intake of 36 pounds per capita.[5]

[5] Thirty-six pounds would equal approximately 7 cups of coffee per day, using an average of 72 cups of coffee per pound of beans.

For much of the twentieth century, U.S. consumers demanded and received price controls. This downward pressure on prices, coming from the world's largest purchaser of coffee, had dramatic consequences in the coffee producing countries. In spite of diplomatic pressure from Brazil and Columbia, the U.S. remained committed to the five cent cup of coffee. (Bates 1997) As a result, some countries stopped exporting coffee to the U.S., as it was no longer profitable. Even so, in the late 1940's restaurants raised the price of a cup of coffee to seven cents, prompting outraged patrons to break mugs and dump cream and sugar on tables and counters in protest (Pendergrast 1999). Due to rising coffee prices, U. S. consumers demanded Congressional investigations in 1950 and 1954 (Krasner 1973). Senator Guy Gillette of Iowa led the Agricultural Subcommittee to explore the reasons behind the high coffee prices, resulting in an inflammatory report accusing the Brazilian government of withholding huge stocks. In an effort to demonstrate good will, the Brazilian government flew U.S. housewives down to the fields in Parana in 1954 to allow them to see for themselves the devastation brought on by a heavy frost (Pendergrast 1999).

Due to this history of extreme price sensitivity, Congress was hesitant to involve itself in any type of agreement that would negatively impact the coffee-consuming voter. In the early 1960's, Congressional support of an International Coffee Agreement was quite mixed. Some objected, saying "it seems ridiculous for Congress to sanction agreements which could victimize the American household"('Proceedings and Debates of the 88th Congress, First Session' 1963). Others saw the utility of a commodity agreement as a type of foreign aid.

Historical Background of the International Coffee Agreement of 1963

The Essence of the International Coffee Agreement

The International Commodity Agreement (ICA) evolved as a means to stabilize the chronic price cycles and endemic instability of the coffee industry. The first of these agreements involving the U.S. arose in the 1940's as a way to provide stability during wartime, since the European markets were unavailable to Latin American producers. After the war, a coffee boom made renewal of the agreement unnecessary. However, during the late1950's, down cycles threatened Latin American economies once again. By 1962, wholesale coffee prices were less than half that in 1954. (Bilder 1963)

Almost all coffee producing countries are underdeveloped, monocultural economies. As such, they rely heavily upon coffee exports as the primary source of income. Latin American countries derive nearly twenty five percent of their export revenue from coffee (Bilder 1963). Brazil's valorization programs prior to WWII had failed to achieve the stability that was sought, and the war time arrangements had expired. Brazil accordingly proposed a commodity export agreement in which all of the coffee producing countries in Latin America would agree to export quotas. Such quotas would ensure that during the boom years, prices would not decline to the extent that they had in the past. While the ICA included all of the coffee producing countries in Latin America, the largest producer by far was Brazil. By the 1950's, coffee accounted for over 50% of Brazil's total exports (Bates 1997). As of the 1960's, Brazil was fully responsible for about half of the world's coffee production. Columbia, the next largest producer, was responsible for about 11% of the world's production (Bilder 1963). As the largest coffee producer, Brazil also felt most acutely the sting of a price drop. By orchestrating a producer's alliance, Brazil could increase its export earnings and redistribute income from the advanced industrialized coffee purchasing countries to the poor developing coffee producing countries. (Bates 1997) At its peak, the ICA's producing countries accounted for virtually all of the world's coffee exports and its consuming countries accounted for approximately ninety percent of the world's imports.

The Quota System

The quota system set up by the ICA was based on world exports of 45.6 million bags of coffee, or roughly 90% of a good production year for each member producer (Pendergrast 1999). Interestingly, instead of providing for stable production levels, the ICA's quotas actually tended to increase production by minor member countries over time, while the production of Brazil and Columbia, the two major members, remained stable (Kravis 1968). For example, between 1957 and 1966 exportable production of green coffee rose by 38%. Such increases in production were encouraged by the above- market prices which coffee could garner under the agreement. While the ICA provided for diversification by encouraging movement of production to other crops, the high coffee rents made this movement unattractive. As a result, the ICA unwittingly encouraged persistent excess production of coffee. Instead of punishing countries for over-shipment, countries were often given ad hoc waivers, which in turn strengthened the country's request to have its quota increased (Kravis 1968). While importing countries were relied upon to enforce the export quota system (Kravis 1968), this was tantamount to asking the wolf to guard the sheep. U.S. consumers were still quite price conscious at this time. Roasters were able to get around the export/import controls imposed by the ICA through a loophole in the agreement which allowed member producers to sell to non-member 'new-markets' such as the Soviet Bloc countries. The same coffee was then resold under different labels to the member consumer countries (Kravis 1968). This practice became known as "Triangle Trade"; and the coffee that was traded in this manner became known as "Tourist Coffee".

As is the case with many cartel arrangements, the ICA had little monitoring or enforcement power, and was plagued by persistent cheating (Farmer 1994). The sheer size of production in Brazil and Columbia put them at a relative disadvantage. Brazil and Columbia had the lion's share of the production, with a combined output of approximately 61% of total coffee production; the remaining member producers of the ICA each produced less than 5% of world production (Bilder 1963). Should Brazil increase production even by a tiny percentage, this increase would affect the market price and would be relatively unprofitable. However, cheating by the smaller countries could ensure large returns while remaining virtually undetectable (Farmer 1994). Thus, countries such as Nicaragua, Costa Rica, and Honduras had a comparative advantage in this respect. This theory is supported by the data showing the export quantities of the smaller member producers grew over time, whereas the quotas of Brazil and Columbia remained stable (Farmer 1994, Kravis 1968). The ability to cheat, combined with forgiveness for going over quota, access to the triangle trade, and higher-than-market prices provided a strong incentive for Central American coffee producers to focus efforts on increasing the quantity of production, without any concern for the quality of the harvest.

A Prophylactic for Communism

> *We are attempting to get an agreement on coffee because if we don't get an agreement on coffee we're going to find an increasingly dangerous situation in the coffee producing countries, and one which would threaten....the security of the entire hemisphere.*
>
> President John F. Kennedy–1962[6]

[6] The President's Special News Conference with Business Editors and Publishers, September 26, 1962.

Historically, with the voting consumer being highly sensitive to price, the U.S. government had no interest in taking any action that might raise prices, and such was true during the initial negotiation period of the International Coffee Agreement. Except for during World War II, the U.S. had not been a party to prior agreements because of the negative impact on the U.S. consumer. Indeed, during the initial negotiations in Congress, Missouri Congressman Thomas Curtis equated the ICA to "economic violence" ('Proceedings and Debates of the 88th Congress, First Session' 1963). However, as a new world order emerged after World War II, the U.S. came to the conclusion that the ICA was more than a mere economic agreement. "This agreement is so great a contribution to international stability and international peace and to the anti-Communist struggle, that we must wonder why it is opposed," opined New York Senator Jacob Javits ('Proceedings and Debates of the 88th Congress, First Session' 1963). The main reason for U.S. involvement was the idea that the commodity agreement could serve as a type of foreign aid by providing for the transfer of resources from the primarily OECD consuming countries to the lesser developed producer countries (Farmer 1994, Kravis 1968, 'Proceedings and Debates of the 88th Congress, First Session' 1963).

Stabilization of these countries took on great importance in light of the rise of Communism in Cuba and the apparent success of the Soviet Union. In 1959-60, Fidel Castro had taken control of Cuba and aligned himself with the Soviet Union, nationalizing the U.S. interests in his country, and fueling concerns in the U.S. over the possible spread of Communism in other Latin American countries. After the failed Bay of Pigs invasion in 1961, the Soviet Union deployed ballistic missiles in Cuba ostensibly to prevent further coup and assassination attempts in Cuba, leading to the 1962 Cuban Missile Crisis. Should Communism spread in other Latin American countries, the Soviet Union would have increased opportunity to establish missile sites within range of the U.S. President Kennedy reflected, "If the only alternatives for the people of Latin America are the status quo and Communism, they will inevitably choose Communism" (Bates 1997). Even prior to Kennedy, the Eisenhower administration was concerned about the spread of Communism in Latin America, acknowledging that U.S. international economic policy must concern itself with the political challenges of the Left, and not rest simply on market principles. Any resistance to the ICA faded as the U.S. sought to ensure no other countries in Latin America followed Cuba's lead. Hence, in spite of the costs to U.S. consumers, the U.S. chose to engage in the ICA as a solution to the perceived leftist threat, demonstrating a clear trade-off between economic and political interests[7] (Bates 1997).

Price stabilization is an objective commonly sought by lesser-developed countries through commodity agreements (Kravis 1968). Ideally, such an agreement makes transfers possible in an efficient manner with little loss. However, studies have shown commodity agreements that operate based on export restrictions, such as the ICA, may not achieve these goals, due to rent-seeking activity which concentrates the benefits of the transfers on fewer, less needy individuals (Bohman, et al. 1996). Be that as it may, Richard Bilder, a Department of State attorney, wrote in October of 1963, "few matters are as important to the economic and political stability and development of these nations as the maintenance of a healthy and expanding coffee market." (Bilder 1963)

Formalizing the Brew

At first glance, the price of coffee appears unrelated to the spread of Communism in Latin America. If true, the spatial mapping of the issues could rightly be executed in separate dimensions. For example, preferences over coffee prices could be mapped (Figure 1, next page) with Hawaii preferring the price of imported coffee to remain high, reflecting their interest in protecting Hawaiian coffee producers from outside competition. As Hawaii is the only coffee producing state in the union, this preference is not likely to be shared by other Congressmen. [8] Other states might have a greater interest in maintaining low coffee prices for their constituents. As discussed above, the past history of the U.S. reflects the sensitivity of the consumer to price fluctuations. For consumers and producers in the U.S., these preferences remain stable over time. Generally speaking, consumers prefer low prices and producers prefer high prices.

Likewise, preferences regarding efforts to stem the flow of Com-

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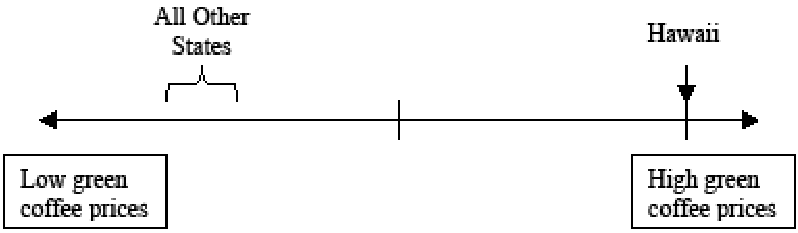
[7] Indeed, Hawaii was enthusiastic in its support of the ICA from the beginning until the very end. "As the price in the world's coffee market goes, so goes the price of Kona coffee." Congressional Record, *Proceedings and Debates of the 88th Congress, First Session*, First Session, May 20 1963.

[8] Of course, logrolling is a potential issue that should not be overlooked. It is quite possible the Hawaiian Congressional representatives were able to work out some cooperative agreements with Congressmen from other states. Although an interesting avenue to explore, it is beyond the scope of this paper.

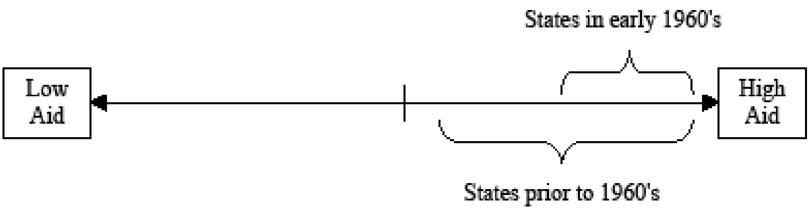
munism can be mapped (Figure 2 below), with all states preferring some degree of effort to keep Communism from spreading in Latin America. Indeed, in the turbulent times surrounding the Cuban Missile crisis, such preferences would have been more concentrated than perhaps at any other time.

Figure 1: Preferences over Imported Green Coffee Prices



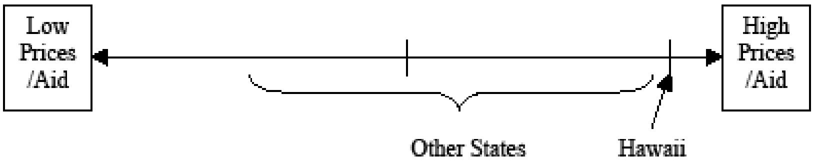
As the threat of Communism became more real to the constituents, the median position of Congress on this issue would have edged to the right.The International Coffee Agreement was a commodity-based opportunity to provide aid to Latin American countries. Because of the tie between economic aid (in the form of propped up coffee prices) and the desire to prevent the spread of Communism, these two seemingly separate issues can be mapped along a single dimension (Figure 3, next page). In essence, high coffee prices were the delivery method of the foreign aid. When considered together, foreign aid preferences shift coffee price preferences right.

Figure 2: Preferences over Level of Aid to Reduce the Spread of Communism



The International Coffee Agreement inextricably linked these two seemingly separate issues, effectively moving the median voter (Congressman) into a position of supporting the ICA, as fears of spreading communism reached a peak.

Figure 3: Combined Preferences over Level of Aid and Coffee Prices



The Grand Convergence

The efficacy of the ICA as a vehicle for delivering foreign aid is debatable. However, its effect on coffee prices is apparent: the ICA did raise coffee prices (Bilder, 1963a). Because demand for coffee is not completely inelastic, sales declined. This decline in sales put extra pressure on the coffee traders, who acted as the primary intermediaries between coffee producing countries and the roasters in the consuming countries. The number of these intermediaries hence declined. Because of the quotas, it became more difficult for roasters to buy types of coffee preferred for their blends ('Executive Hearing before the Committee on Ways and Means' 1965, Krasner 1973). Once the quota for a country's coffee was reached, legal exports from that country came to a halt.

The agreement initially garnered the unanimous support of the members of the National Coffee Association (NCA). The NCA acknowledged the possibility of price increases, but was confident the U.S. had sufficient negotiating power under the agreement to protect the American consumer ('Hearing before the Committee on Finance' 1965, 'Hearing before the Committee on Foreign Relations' 1963). The NCA's statement also acknowledged the threat to the 'American Way of Life' posed by the instability in coffee producing countries ('Hearing before the Committee on Foreign Relations' 1963). Surprisingly, the ICA also had the support of major coffee roasters in the U.S., such as Maxwell House and Hills Brothers Coffee, as evidenced by letters written to Congress in support of the agreement[9] ('Hearing before the Committee on Foreign Relations' 1963). However, even as early as 1968, this support was beginning to erode. Even while voicing support for the ICA, the National Coffee As-

[9] Incumbent companies are better able to absorb higher costs from government action and often benefit to the extent that these higher costs discourage domestic entry.

sociation admitted to Congress that "any International Coffee Agreement is probably not in the best interests of the U.S. Coffee Trade" ('Hearings before the Committee on Foreign Relations' 1968). Although the Association formally remained a supporter of the agreement, the decision was no longer unanimous. Separately, numerous smaller coffee associations wrote to Congress proclaiming their opposition to continued participation in the agreement. Tourist Coffee was also becoming an increasing problem. Growing supplies of coffee were entering the country under false labels. Those in the coffee industry who followed the law found they were paying higher prices than some less scrupulous competitors. Additionally, some law-abiding enterprises were unwittingly running afoul of the law as they were unable to truly distinguish between legitimately labeled coffee and re-labeled coffee. "Coffee importers in the United States have been subject to detentions and seizures of their shipments and assessments of civil penalties up to the value of the shipment" for unknowingly purchasing falsely documented coffee ('Hearing before the Subcommittee on International Trade of the Committee on Finance' 1983). The U.S. Coffee industry was growing weary of the binding ties of the ICA.

The Fall of Communism

The political condition that instigated U.S. support of the ICA collapsed in 1989. Reform-minded Gorbachev ascended to power in the Soviet Union in the mid-1980's; the Soviet-backed Sandinistas were on their way out in Nicaragua; Cuba and Castro had been reduced to insignificance; Communism in China was evolving and making room for capitalism and private enterprise. Simply stated, Communism was on the retreat world-wide as a failed economic system, and the U.S. no longer had a compelling political reason to participate in the ICA.

Additionally, with eroding support from the major U.S. roasters, politicians had little reason to risk angering the coffee-consuming constituent. At this point in time, the issues of coffee prices and foreign aid became two separable issues once again. The fear of spreading Communism was no longer connected to the economic stability of Latin America. As the reason for the foreign aid dissipated, so too did the tie between foreign aid and coffee. With the dissolution of the agreement, coffee prices dropped from $1.20 to $0.85 a pound.

The Rise of Starbucks

In a world without the ICA, coffee-producing countries could produce as much coffee as they thought prudent. For Brazil and Columbia, increased production could only lower sales prices, and ultimately, revenues. However, Central American countries faced a different problem. While they could safely increase production without a substantive effect on price, they could not afford to produce coffee at the lower prices. As previously mentioned, the volcanic slopes of tropical Central America constitute labor-intensive farm land, ill-suited for machine harvesting and other cost-effective methods of farming used by Brazil. It would be impossible for these countries to compete with Brazil on price in a quantity-production world.

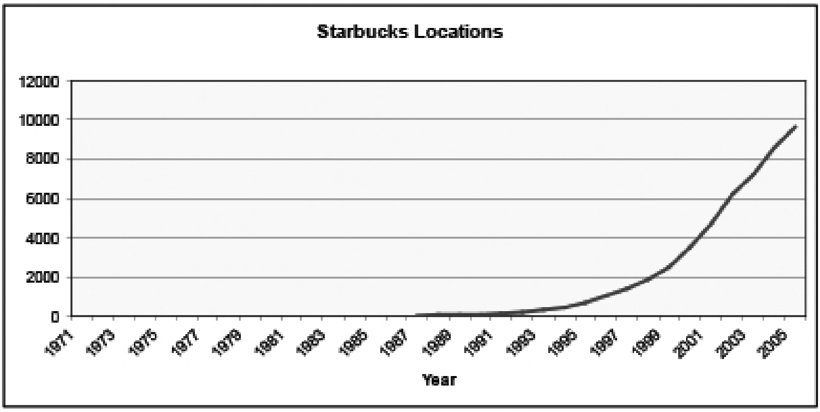
Recognizing these essential differences, the Central American coffee growers turned toward their comparative advantage: the market for high-quality gourmet coffee. As more and more Central American producers focused on quality production, the supply of these gourmet beans gradually began to meet demand. An important note is that high quality beans are not traded on the New York Exchange, as are lower-quality beans. In other words, these lower-quality beans are of standardized qualities and quantities. Gourmet beans, in contrast, are personally evaluated by roasters, who sample a variety of beans before choosing which to purchase, and in what quantities. Often a roaster will forge a personal agreement with individual farms, purchasing the entire harvest. These gourmet sales depend on personal relationships, as opposed to an anonymous exchange setting.[10] Hence, with the collapse of the ICA, roasters, who previously had very limited opportunity to procure these unique beans, finally had access to the world's best coffees.

Jerry Baldwin, Gordon Bowke and Zev Siegl opened their first Starbucks store in Seattle on March 30, 1971. When they discussed opening another store the following year, Alfred Peet, veteran roaster and founder of Peet's Coffee and Teas in Berkeley, California, advised them they were getting "too big". At this time, gourmet coffee was a niche market relegated to a few big cities on either coast. The average coffee consumer was still buying two-pound cans of pre-ground coffee in the supermarket, and marveling over the invention of the "Mr. Coffee" automatic drip coffee maker. Freshly roasted and ground gourmet coffee was consigned to the purview of the aging beatnik and the bohemian coffee shop, known for its dissension from mainstream politics.

[10] Because the transactions occur between private parties, sales prices of gourmet beans are tremendously difficult to track. Available price data are limited to exchange-traded beans. Industry insiders estimate the average price of gourmet beans to be approximately $0.30 per pound more than the price of exchange-grade coffee,

Gourmet coffee was introduced to the general population in the form of General Foods International coffees, essentially a low-grade soluble coffee flavored with chocolate. A few years later, Kraft added “orange cappuccino” and “amaretto” to its offerings. Flavored coffees were a common way to introduce neophytes to the idea of gourmet coffee, and demand for them continued to grow.

With the fall of the ICA, entrepreneurs in the Gourmet Coffee industry could easily procure high quality beans from all over the world. The market was no longer constrained by the availability of high quality coffee, and the stage was set for a specialty coffee revolution.



This graph shows the growth of Starbucks since its inception in 1971, with its first location.[11] By 1987, over the intervening 16 years, they had only grown to 17 locations. However, growth after the collapse of the ICA in 1989 was exponential. Today it is nearly impossible to walk the length of a city block, or walk from one gate to another in any international airport, without coming across a specialty coffee vendor, usually filled with eager clientele. The explosive growth of Starbucks since the late 1980’s is a testament to the popularity of high end coffee.

Conclusion

The U.S. entered into a cartel relationship with Latin American states in 1963 for the purpose of preventing the spread of Communism

[11] Data gathered from Starbuck Annual Reports for the years in question. It is difficult to compare Starbuck’s to its competitors, as Starbucks has owned (i.e. Peet’s Coffee and Teas), or still owns (i.e.: Seattle’s Best) several. Others (such as Caribou Coffee and Green Mountain Coffee Roasters) have only existed for such a short period of time that no historical public data exists for the period we are most interested in.

among its neighbors. The slightly higher prices for coffee imposed upon the consumer in the 1960's were not welcomed, but were viewed as a necessary sacrifice to prevent a political disaster. The International Coffee Agreement, acting as a VER, had the effect of encouraging quantity production, as opposed to quality production because of the dominance of Brazil, the nature of the product and the mechanism for trading beans as a commodity on exchanges. The agreement elevated prices enough that higher-cost producers could remain in a market where export quantities were stipulated by prior agreement. When the agreement collapsed in 1989, the smaller, high-cost producers found they could not survive in direct competition with Brazil, and were forced to differentiate their coffee product. The growing environment in Central America provided these countries with a comparative advantage in growing high-quality grades of coffee which could be sold at premiums via individually negotiated contracts, relieving them from the intense competition in the lower-quality coffee commodity market.

The 1990's witnessed a tremendous change in the coffee market. While the U.S. consumer had previously been reluctant to pay more than a few cents for a cup of coffee, suddenly he was willing to pay a lot for a higher quality product that did not exist in large quantities a few years before. Demand for coffee in the past had always grown relative to population and income, at a slow and steady pace. There was no explosion of population and income in the 1990's of a magnitude to explain the explosion of the specialty coffee industry. Supply side changes made the specialty coffee market possible, providing an interesting link between the fall of Communism and the specialty coffee revolution.

Today, 43 exporting countries and 7 importing countries (in which the agreement includes all of the European Union as one country), belong to the most current International Coffee Agreement, signed in 2007. The current agreement, unlike its 1962 predecessor, does not include any market-regulatory clauses. Instead, the goal of today's agreement "is to strengthen the global coffee sector and promote its sustainable expansion in a market-based environment for the betterment of all participants in the sector."[12] The price for exchange grade coffees hovered around $1.30 per pound in July 2017, and 2016/17 production was estimated at 153.9 million bags, constituting an all-time record.[13]

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[12] International Coffee Agreement, 2007. http://www.ico.org/Benefits_ICA2007.asp.

[13] The Coffee Market Report, International Coffee Organization, July 2017. http://www.ico.org/documents/cy2016-17/cmr-0717-e.pdf

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