RE:CO Talk 2019 – Janina Grabs

Good morning everybody, and thank you so much for having me.

I would like to start with a parable – that is, a story that tells us something about the world.

My parable is called the fallacy of the single exit. Imagine you are in a crowded theatre with thousands of seats, and a fire breaks out. Everybody looks around, panicked, trying to find a way out. The good news is that there is an emergency exit. The bad news is that there is only one. As everybody scramble to reach it, the person closest to the exit gets out, unscathed, as does the second and third. But how about the 100th? How about the person at the very opposite side of the hall? The more people storm the same exit, the more clogged it becomes; and the less useful it ends up being for latecomers.

In commodity markets, we know the parable of the single exit very well. It is the elusive goal of differentiating oneself from the mainstream, of being unique in a marketplace of interchangeable goods. Yet, more often than not, this quest for differentiation by following short-term trends leads us to look all the more alike – not unlike the quintessential hipster.

This is bad enough for brands, which continuously need to innovate. It is worse for producers who work hard to fulfill the novel demands the supply chain passes down to them. Fulfilling such demands frequently creates high costs, often upfront, as farmers change the way they grow and process their coffee. They do this in the expectation of future benefits such as higher prices and privileged market access. Yet, the more farmers follow the same exit out of commodity markets, the less value this strategy brings for each of them. The formerly differentiated product becomes mainstream – and the cycle begins anew. Instead of climbing up to a higher level of value aggregation, producers are back where they started – as if they had tried to walk up a descending escalator.

Understanding this dynamic creates a special responsibility for buyers, development experts, and researchers such as myself, to consider the long-term benefits and challenges of differentiation strategies, and question at which point we need to think about more systemic solutions to our sustainability problems. By drawing on my research on voluntary sustainability standards, and drawing parallels to the current wave of quality differentiation, I want to encourage us to reflect on three key points when considering new ways of helping farmers to differentiate themselves.

1. Given that there is a first-mover advantage to differentiation – that is, the first person benefits more than the last – whom are we targeting and helping first? Can we make those decisions in a more strategic, and equitable, manner?
2. Given that differentiation tends to create upfront costs for producers, how can we make market signals of future demand more clear, honest, and long-term?

3. Given that upscaling risks diluting the benefits for all, how many farmers can we help before our solutions stop working as intended? And are there better ways to create sectoral change toward sustainability?

To characterize our broad challenge, I want to show you two graphs. In our parable, we could call these the burning theatre. I am sure you are familiar with this one – the long-run price development of ICO indicator prices. We can clearly see the volatility, and more importantly, the short peaks and long valleys of price development. This is typical for perennial crops such as coffee or cocoa, which as tree crops are grown over several years. Planting decisions in one year lock farmers into producing 10 to 15 years of output on the same production surface – unless they want to rip out their trees before those reach their maximum productivity. Hence, if producers react to peak price signals in one year by planting more coffee, this leads to long-run overproduction and price valleys until supply and demand align again.

In this second graph, I used the same price data, but adjusted it to inflation. Consumer prices have been rising at a steady rate for the vast majority of goods – indeed, in the United States consumer prices for coffee have increased sevenfold from the 1960s to today. Inflation is also a concern for the cost of consumer goods in producing countries, as well as inputs and labor costs. According to ICO estimates, production costs at origin increase by 3 to 8% every year.[1] Yet, green coffee prices do not follow the same trend. Adjusting them to inflation, we see a steady downward trend in real prices over the years. [This chart also explains why, during my fieldwork, I kept seeing the same model of car in the coffee fields of Costa Rica – a 1970s jeep. As explained to me by an extension agent, this is because the 1970s, the period circled above, was the only time in recent history that an average coffee farmer could actually afford a car at current prices. *ED: I didn't end up saying this due to time constraints but it's true!*] Hence, in addition to solving the volatility question, we need to think about lifting prices long-term to sustainable levels.

This is especially important if we also care about the social and environmental sustainability of coffee production. Indeed, improving sustainable practices on the farm level has been the main focus of my research for the last three years. It gave me and my research group at the University of Münster the chance to survey over 1,900 coffee farmers in Honduras, Colombia and Costa Rica. We did this to understand the complex decisions a single coffee farmer needs to make day by day in order to be sustainable. Through it, I learned that environmental protection and social welfare measures will only be implemented if the farmer can afford to do so. And in fact, many best practices create higher costs for the farmer – ranging from shade production, to paying fair wages that are higher than the regional average, to acquiring personal protection equipment and protecting on-farm ecosystems.

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[1] http://www.ico.org/documents/cy2015-16/icc-117-6e-economic-sustainability.pdf

This is why I became interested in the possibility of increasing the value added at farm level through the use of voluntary sustainability standards. Such labels emerged as niche initiatives targeting a very narrow segment of conscientious consumers. However, it was soon recognized that *widespread* sustainable change will only happen if *many* farmers can afford to take measures that protect forests and streams, that protect their workers, and that provide their children with safe housing and a good education. Hence, standards have aimed to upscale, and enter the mainstream. This is where the parable of the single exit becomes particularly relevant.

Farmers that participate in private sustainability schemes are promised higher prices and improved market access. Certification schemes do this in two ways: the first option is to regulate price floors and premiums directly – as done in the Fairtrade system. The second option – followed by all other certification schemes – is to use market-based premiums. This means that premiums are negotiated for each contract separately, based on prevailing market power and the demand and supply of certified products. What neither system did was to try to manage supply to match demand, for instance by limiting the entry of new producers. Instead, as often the case in our field, there were optimistic forecasts of future demand, based on projections and the promise of creating consumer demand at the same time as expanding output.

Hence, in the early 2000s, certification was seen – and sold to many producers – as ***the*** avenue out of the commodity market. Buyers were making promising commitments, the premiums were significant, and the demanded practices, while often very costly, had the potential of improving long-term farm and community resilience as well. And so it was for a couple of years. However, as more farmers joined, making upfront investments and substantive efforts to get certified, the pay-off diminished. Today, only 22% to 42% of certified supply is sold under a label in every category. This has led to a struggle for many producers to gain market access; the erosion of premiums; and a high disenchantment at producer level in maintaining the costly practices. We can see in our graph that 2017 is the first time that total volume has decreased for some schemes compared to previous years. Even before that, turnover rates in many schemes have been quite high, with motivated new farmer groups replacing those that dropped out due to a perception of insufficient benefits. This, of course, affects the idea of continuous improvement as well – as continuous improvement requires farmers to stay multiple years in a program in order to upgrade their practices over time.

So what's next? Today, from what I hear on the ground, focusing on quality improvements is the next secret sauce to allow farmers to delink themselves from the commodity system and access premium markets. Hence, quality today is in a place where certification schemes were in the early 2000s – with validation of consumer interest in the niche, high hopes for its expansion, and an almost singular focus regarding value aggregation at producer level.

I want to argue that lessons from the world of sustainability standards are highly applicable for the future of specialty coffee as well. Let's come back to the three questions I posed at the beginning: Whom are we targeting and helping first? How can we make market signals of future demand more clear, honest, and long-term? And how many farmers can we help before our solutions stop working as intended?

First, we know that the benefits of differentiation are skewed toward the early movers. In many certification schemes, this has meant the comparatively larger farms; those farmers with higher levels of education and professionalization; and those farmer groups and cooperatives that had already made connections and invested in international market access. As stragglers have tried to replicate these strategies, they are in a double bind because the differentiation benefits are decreasing while they have to work even harder to meet buyers' expectations. In specialty coffee, we have a unique opportunity to be selective in sourcing and to build longer-term relationships with comparatively underprivileged farmer groups. Being aware of the long-term repercussions of who we start working with – and making an extra effort early on to become connected to farmers who haven't had access to markets before – can make a huge difference in making specialty coffee more equitable.

Second, we need to think more about how we pass along long-term demand signals in a way that is clear, honest, and fair to producers that invest upfront in fulfilling such demand. In the world of certifications, sourcing commitments have been vague; they have not been geographically specific, allowing companies to move in and out of origin countries and leave certified producers in the lurch; and over time, as we can see here, demand has trended toward those labels that have the lowest premium – and therefore also the lowest cost for buyers, and benefits for producers.

In specialty coffee we are well on our way to delink pricing from the C-market and construct a new price floor based on covering the costs of sustainable production through long-term contracting. I highly applaud and encourage this practice. But we can see even in the Transparent Trade Guide that prices paid for larger lots are much closer to the market level than those for small quantities. The next step, then, needs to be to build medium-level scaling solutions into the model itself. A great example is the use of multi-tiered contracts in direct trade, which expand the quality pyramid of coffees that are directly traded downward by setting fixed prices for several quality tiers sourced from the same cooperative or producer group. Such contracts, especially if they are maintained over multiple years at stable price levels, irrespective of the C-price, can encourage the search for excellence and the next best unicorn while still providing stable support to producers. Most importantly, they provide the consistency in demand signals that allows producers to plan ahead and make investments in their farms with a good idea of the final payoff.

Third, in my eyes it is important to have an honest conversation about the scalability of solutions based on differentiation. The oversupply in certified coffee, I believe, can be traced back to two issues. One, the fact that producers and traders anticipated a higher demand than there turned out to be, and were uncoordinated in their upfront preparations to fulfill this demand. This can be linked to the problem of vague demand signals. The second, however, is that certified producers, once in the system, are often encouraged to increase productivity on their farms, both to make sourcing easier, and to increase on-farm profitability. Yet, there are trade-offs involved. Firstly, this approach again locks in first-comers, and makes it comparatively harder for latecomers to meet the market demand. More importantly, it drives down prices for everybody involved as the product moves from scarce to widely available. Finally, pushing producers toward intensification may have adverse environmental consequences, particularly with regard to the implementation of shade production and agroforestry.

Hence, I believe there is the need to talk about sustainable intensification – both in an environmental sense, as well as an economic one. Let's not forget that one main reason for the current coffee price crisis is oversupply in the market due to Brazil's record yield levels. Even in an emerging alternative market such as specialty coffee, increasing supply too fast – either by adding lots of producers into the system, or by indiscriminately encouraging intensification – may lead to the erosion of prices and premiums, and producer drop-out, not unlike the one observed in sustainable coffee. How do we guard against this?

The first recommendation I have is to be honest in identifying where an effort to scale makes sense, and where it might dilute solutions that have been working well. This means hard conversations about how many people we *can* help, and even harder conversations, as noted, on *who* those people are. Pursuing niche approaches in a long-term fashion that allows for planning certainty in itself is an important component of sustainability – and, in my view, is better than upscaling so fast that promised benefits may not materialize.

Finally, the efforts made within the specialty coffee world – particularly in appreciating the cost of sustainable production at different origins, and endeavoring to cover it – need to spill over into the mainstream coffee market as well. The hard reality is that price levels like this barely work even for the most productive origins such as Brazil or Vietnam, and often leave social and environmental sustainability on the table. Pricing these in again has to be done at scale: we need to tackle the macroeconomic fire through – if we will – a holistic sprinkler system, rather than a single exit. In my eyes, this will require the collaboration of producing and consuming countries in a hitherto unprecedented manner – and I look forward to discussing possible ideas to achieve this over the next two days.

Thank you so much for your attention.