

# **THE FALL OF COMMUNISM AND THE RISE OF STARBUCKS: The Making of the Specialty Coffee Revolution<sup>1</sup>**

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## **Abstract**

For generations U.S. coffee consumers have focused on price point, to the extent of placing tremendous pressure on Congress to take action to prevent the price of a cup of diner coffee from rising above 5 cents. Why then, in the late 1980's and 1990's, do we witness the amazing triumph of the coffee house and its expensive selection of gourmet specialty coffees? Suddenly, the US consumer feels the need to wait in line to spend nearly \$4 for a double shot, skinny caramel macchiato. While prosperity certainly plays a role in the increased demand for luxury coffee, global circumstances also help to explain why the specialty coffee revolution was perfectly positioned to explode during this particular time. The end of the cold war and the worldwide decline of communism led to the dissolution of the coffee cartel which dictated sales based on quantity rather than on quality.

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*"The voodoo priest and all his powders were as nothing compared to espresso, cappuccino, and mocha, which are stronger than all the religions of the world combined, and perhaps stronger than the human soul itself." (Helprin, 1996)*

## **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 market. Approximately 54% of the U.S. population, or approximately 161 million people, consume at least one daily cup of coffee. Eighteen percent of those, or about 29 million, drink specialty or gourmet coffee daily. This popularity is 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 1570's, 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 quite 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 which 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 run screaming to their political representatives asking for emergency measures. 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 1980's, things changed. Suddenly gourmet coffee houses selling expensive coffee concoctions began to spring up everywhere. In 1988, there were 33 Starbucks coffee houses. With the exception of two (in Chicago and Vancouver), all were located in the Seattle area. Today, there are 9,671 Starbucks operating in 35 countries around the globe. Of course, while Starbucks is the market leader, several other chain and individual specialty coffee houses have sprung up, including Caribou Coffee, Peet's Coffee and Teas, and Seattle's Best, to name just a few. Have consumer preferences shifted so much? Doubtful. So why then do we have such a sudden and drastic change? And what happened in the late 1980's that made this change possible? We believe standard public choice models shed light on this mystery.

While changes in income, the price of reasonable substitutes, etc may account for some of the change in consumer consumption patterns, we believe that much of the change is due to supply. After World War II, a cartel formed between the coffee producing countries of Latin America and Africa and the United States of America, the largest coffee consuming country, which was intended to stabilize prices and provide at least some type of foreign aid to the coffee producing countries. The cartel agreement was constructed based on a production quota system which specified the quantities of coffee producing countries could export. With the focus of the agreement emphasizing quantity production, many countries found it unprofitable to produce with an eye towards quality. With the collapse of the agreement in 1989, small higher-cost producers found they could no longer compete based on quantity production and turned to quality production. This shift in production goals, initiated by the failure of the cartel, resulted in an increasing variety of high-quality beans at a lower cost, paving the way for the expansion of the specialty coffee industry.

This paper seeks to examine this theory in more detail, and attempts to answer more fully the "why now" question. The next section provides an historical overview of the coffee market as the background of our discussion, including the peculiarities of the U.S. market. The following section explores the essence of the International Coffee Agreement of 1963 ("ICA"), paying particular attention to the effects of the quota system, and the reasons for U.S. involvement in the cartel. Section three explains 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 sums up our conclusions.

## **Historical Perspective**

### **The Market for Coffee**

The market for coffee is extremely volatile and is characterized by natural cycles. Coffee plants on average take from three to five years to reach maturity and full production capability. The plants are very particular about their growing environment, with a strong preference for temperate mountain air and volcanic soil. Robusta plants are less particular, mature more quickly, and produce high yields of very low quality coffee; arabica plants, on the other hand, are finicky, take longer to mature, and produce lower yields of high 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 mere 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 others to enter the coffee business. Furthermore, a cartel system based on quotas produces a strong incentive for coffee farmers to replant former fields of high-quality/low yield plants with low quality/high yield plants. 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 translated 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. General Foods in the U.S. and Nestle in Switzerland are the major players in the coffee processing and sales end of the business. (Bates, 1997)

### **Demand and Supply of Coffee**

Demand for coffee grows quite slowly and remains relatively stable over time. (Bilder, 1963a; 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 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, 1963a) Arabica trees grow best at higher altitudes, in volcanic soil, and in partial shade. As such, the land suitable for this type of farming, found on slopes interspersed with taller foliage, is most difficult to clear and farm. Due to these conditions -- high fixed costs, very low marginal costs -- 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.

Growing conditions in coffee producing countries vary somewhat. 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 coffee grown in Brazil is mostly of the latter type. Because the terrain is less demanding, Brazilian production is more amenable to mass cultivation and harvesting techniques. Such techniques position Brazil as the low-average cost, large scale producer. The Central American producing countries, in contrast, offer ideal growing conditions for the finest grades of coffee, but they have higher average costs.

### **Coffee in the US:**

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.

But while coffee warmed the heart and soul of the troops, Americans still had not perfected preparation of the beverage. By the mid-nineteenth century, most Americans bought green coffee beans from a bulk bin at their general store. They roasted these beans in a frying pan, ground them with mortar and pestle, and boiled them in water, letting the grounds settle to the bottom. "It was a bitter brew badly in need of milk and sugar to make it palatable." (Pendergrast, 1999)

Though more advanced brewing systems were widely available in Europe, they didn't catch on in the United States. In spite of the primitive preparation, coffee continued to grow in popularity. By the turn of the century, many entrepreneurs were attempting to drive down their costs by introducing other less expensive substances such as rye flour, chicory, baked horse liver, even dirt and wood chips into the coffee they sold. Still Americans continued to consume approximately six times as much coffee as Europeans per capita.

As a perishable good, coffee presents certain challenges. Once roasted, coffee stales very quickly, discouraging early efforts at national distribution. The invention of the vacuum sealed can represented a vast improvement which allowed companies to sell pre-roasted, pre-ground coffee to the masses nationwide. Coffee could be roasted in a professional oven, resulting in an even, more pleasant tasting product. Unfortunately, this coffee would quickly degrade

upon the opening of the large can, and was then boiled on the stove to produce a strong, bitter beverage. By 1915, approximately 86% of Americans purchased their coffee pre-roasted, pre-ground, and pre-packaged. (Pendergrast, 1999)

Though delivery of the product to the customer had improved, the product itself had other challenges. German coffee growers and exporters dominated Latin American production in the early twentieth century. As such, German importers often had a distinct advantage in procuring the top quality coffee. Additionally, Europeans were willing to pay more for coffee than Americans. These factors ensured that Americans procured the lower grade beans. The U.S. Army encouraged the taste for mediocrity by supplying low grade beans as part of the Army rations for U.S. Soldiers during WWI. In addition, army regulation specified that only five ounces of coffee was to be used for every gallon of water. In order to improve the strength of the coffee, soldiers often left the grounds in the pot for several brewings as additional coffee and water was added. The years following the war were characterized by coffee roasters' various attempts to maintain market share in the face of rising green coffee prices. The major roasters began adding higher and higher quantities of lower and lower quality coffee to their coffee blends in an attempt to keep the price of a cup of coffee low. To stay in business, companies had to cut prices, which meant narrower profit margins. To maintain profitability, they had to lower quality. At the same time, the rising popularity of Coca-Cola eroded coffee's market share as consumers discovered

a substitute in this caffeinated beverage.<sup>2</sup> The threat from Coca-Cola became more troublesome during World War II as the soda company began bottling its beverage overseas in order to provide troops with refreshment and a taste of home. After the war, the popularity of soda fountains inspired one coffee man to lament, "These boys and girls get together to talk, listen to music, and maybe to dance," noting that most also buy something to drink. "How often is that sale coffee? You know perfectly well – hardly ever." (Pendergrast, 1999)

*"I believe that the American coffee industry is doing itself irreparable harm by mass marketing mediocre coffee at a low price. I think that what is happening today in the coffee business is just a foreshadowing of the eventual indifference of the total American public to the world of coffee drinking."  
(Edward Bransten, 1969)*

### **U.S. Commitment to Low Prices**

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

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<sup>2</sup> Indeed in 1936, Business Week reported that "the competition most feared by coffee [is] Coca-Cola." Pendergrast, Mark, 1999, Uncommon Grounds : The History of Coffee and How It Transformed Our World. Basic Books, New York, NY.

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 which would negatively impact the coffee-consuming voter. 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."(1963b) 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 war time, 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 late 1950's, down cycles threatened Latin American economies once again. By 1962, wholesale coffee prices were less than half that in 1954. (Bilder, 1963b)

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, 1963a) Brazil's valorization programs prior to WWII had failed to achieve the stability which 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, 1963a) 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 quotas imposed by the ICA's 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 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 countries 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 which 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, 1963a) 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<sup>3</sup>

During the initial negotiation period, U.S. involvement in the International Coffee Agreement was far from certain. 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". (1963b) 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. (1963c) The main reason for

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<sup>3</sup> The President's Special News Conference with Business Editors and Publishers, September 26, 1962.

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. (1963b; Farmer, 1994; Kravis, 1968) 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 US interests in his country. This move fueled concerns in the U.S. over the possible spread of communism in other Latin American countries. The communist threat to the U.S. reached its peak in the early 1960's with the Cuban Missile crisis. 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 the 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.<sup>4</sup> (Bates, 1997)

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<sup>4</sup> 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." 1963c, Proceedings and Debates of the 88th Congress, First Session, Congressional Record. Senate. United States Government Printing Office, Washington.

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 which 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, 1963b)

### **Formalizing the Brew:**

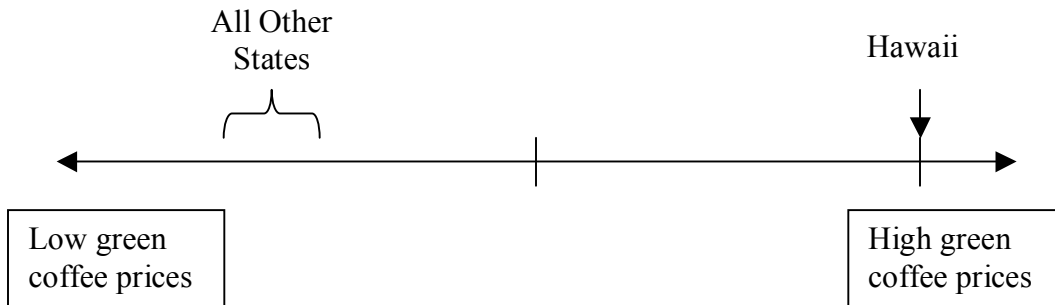
At first glance, the price of coffee appears unrelated to the spread of communism in Latin America. If true, the spatial mapping of the issues could rightly be executed in separate dimensions. For example, preferences over coffee prices could be mapped as below (Figure 1) with Hawaii preferring the price 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.<sup>5</sup> 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

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<sup>5</sup> Of course, logrolling is a potential issue which 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.

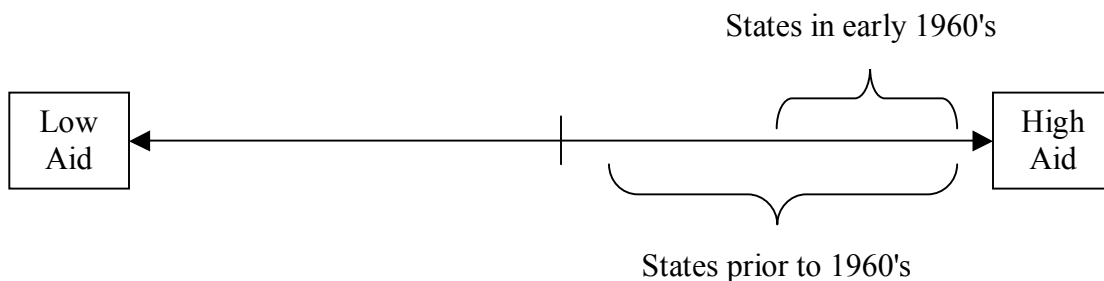
sensitivity of the consumer to price fluctuations. For consumers and producers in the U.S., these preferences remain stable over time. Generally speaking, consumers prefer low prices and producers prefer high prices.

Figure 1: Preferences over Imported Green Coffee Prices



Likewise, preferences regarding efforts to stem the flow of communism can be mapped as below (Figure 2) 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.

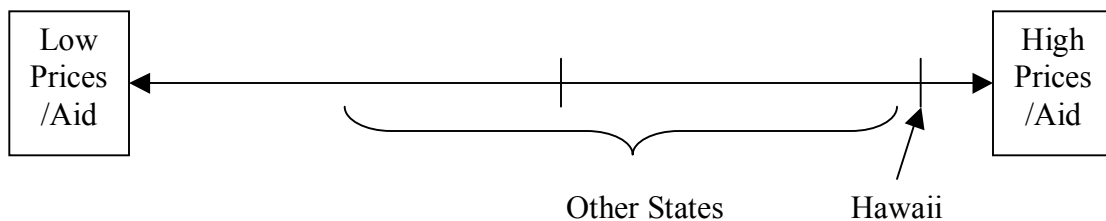
Figure 2: Preferences over Level of Aid to Reduce the Spread of Communism



As the threat of communism became more real to the constituents, the median position of Congress 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 aid and coffee prices, these two seemingly separate issues can be mapped along a single dimension. (Figure 3) In essence, high coffee prices were the delivery method of the foreign aid. When packaged together, the desire for lower coffee prices shifts foreign aid preferences left, while foreign aid preferences shift coffee price preferences right. The more dominant preference will prevail.

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



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.

## The Grand Convergence

The efficacy of the ICA as a vehicle for delivering foreign aid is debatable. However, its affect on coffee prices is apparent: the ICA did raise coffee prices. 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 as well. Because of the quotas, it became more difficult for roasters to buy types of coffee preferred for their blends. (1965a; 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. (1963a; 1965b) The NCA's statement also acknowledged the threat to the 'American Way of Life' posed by the instability in coffee producing countries. (1963a) 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. (1963a) However, even as early as 1968, this support was beginning to erode. Even while voicing support for the ICA, the National Coffee Association admitted to Congress that "any International Coffee Agreement is probably not in the best interests of the U.S. Coffee Trade." (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 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. (1983) The U.S. Coffee industry was growing weary of the binding ties of the ICA.

### **The Fall of Communism:**

The political condition which instigated the U.S. support of the ICA collapsed in 1989. With reform-minded Gorbachev at the helm of the Soviet Union, the Sandinistas on their way out in Nicaragua, and the Cuban threat reduced to insignificance, the U.S. no longer had a compelling reason to participate in the ICA. Additionally, lacking the support of 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 again became two separable issues. 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 85 cents a pound.

### **The Rise of Starbucks:**

In a world without the ICA, coffee producing countries could produce as much as they thought prudent. For Brazil and Columbia, increased production could only lower sales prices, and ultimately, revenues. 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 in a quantity-production world.

Recognizing these essential differences, the Central American countries 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. High quality beans are not traded at the New York Exchange, as are the majority of the Brazilian harvest. The beans which are exchange traded are lower quality beans, traded as commodities. In other words, these 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 beans to

purchase, and in which 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.<sup>6</sup> 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.

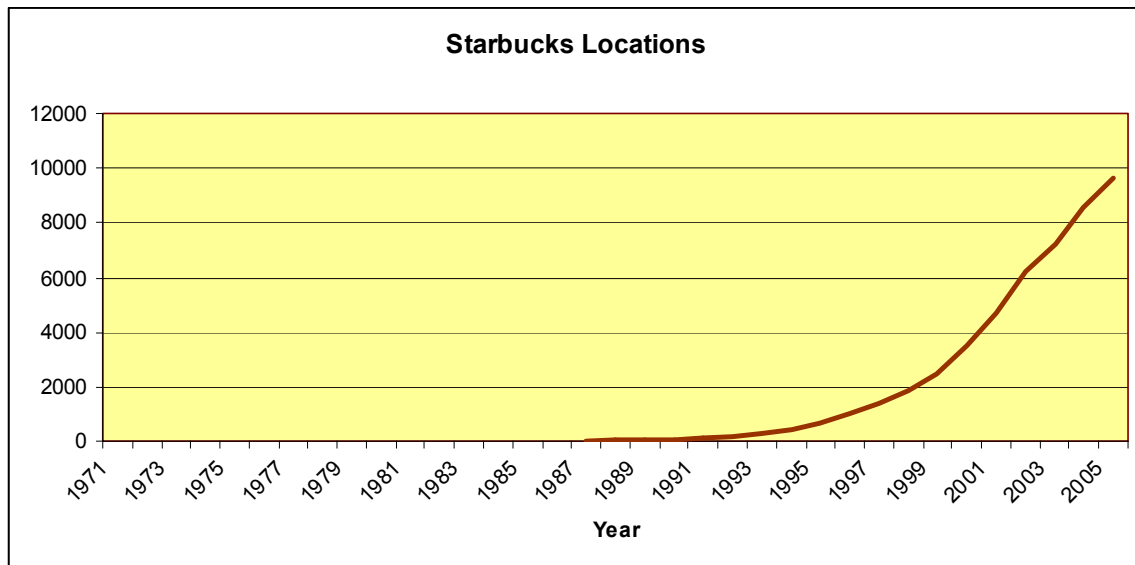
Jerry Baldwin, Gordon Bowke and Zev Siegl opened their first Starbucks store in Seattle on March 30, 1971. When they discussed opening another store the following year, Alfred Peet, veteran roaster and founder of Peet's Coffee and Teas in Berkeley, California, advised them they were getting "too big". 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. 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 cappucino" 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. By 1987, the U.S. was

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<sup>6</sup> Because the transactions occur between private parties, sales prices of gourmet beans are tremendously difficult to track. Available price data is limited to exchange traded beans.

pushing for a quota reallocation which would favor high-quality Arabica coffee beans.

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.<sup>7</sup> 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

<sup>7</sup> It is difficult to compare Starbucks to its competitors, as Starbucks has owned (i.e. Peet's Coffee and Teas), or still owns (i.e.: Seattle's Best) several. Others have only existed for such short period of time that no historical public data exists for the period we are most interested in (such as Caribou Coffee and Green Mountain Coffee Roasters).

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 among its neighbors. The slightly higher prices for coffee imposed upon the consumer in the 1960's were not welcomed, but were viewed instead as a necessary sacrifice to prevent a political disaster. The International Coffee Agreement had the effect of encouraging quantity production, as opposed to quality production. It 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, 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, a product which 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. Indeed, it was the supply side changes which made the specialty coffee market possible, providing an interesting link between the fall of communism and the specialty coffee revolution.

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