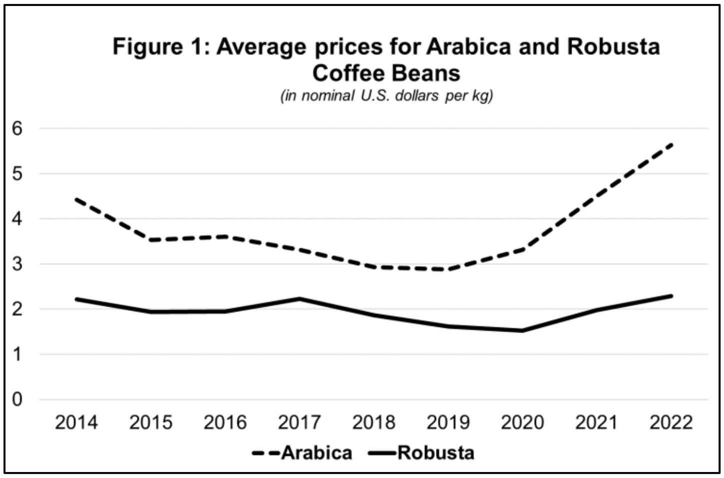
NAME: ____________________________ CLASS: ________________

Raffles Institution
Year 5 H2 Economics 2024
T2W8 – Class Test 2 (Thursday)
Price Mechanism and Firms (Part 1)

	20

You have 45 minutes to complete the case study.

Question: To Starbucks or not to Starbucks



Extract 1: Why does my latte cost so much?

It's not your imagination — coffee prices have gone up. Here's why. Gone are the days of scrounging loose change for your daily caffeine fix: Coffee costs more. People now spend about $6 on average for a beverage at cafes and bakeries. Grocery store bean prices have soared, climbing 22 percent in the last three years.

"Every cup of coffee is a small miracle," said Lauren Crabbe, owner of Andytown, a coffee shop in San Francisco. Coffee crops — commonly grown in Brazil, Vietnam and Colombia, among other countries — are at the mercy of changing weather. Many small farmers are also struggling to make a profit as they deal with rising material costs and labour shortages.

Coffee chains such as Luckin Coffee and Tim Hortons have increased the prices of their beverages, with U.S. giant Starbucks, blaming "multiple factors" such as higher operating costs. Although a nation of tea drinkers, China is one of the world's fastest growing coffee markets, with nearly 110,000 shops in larger cities by April, consultants Deloitte have said, as young people drive consumption.

Source: Washington Post

Extract 2: Climate Change Is Making Your Coffee More Bitter and Expensive

For coffee lovers, the brew of the future is shaping up to be bitter and pricey, as climate change parches the world's key growing regions. Increasingly erratic weather is putting crops at risk globally. Hardier varieties are expected to fare better, and for coffee that means strong, earthy robusta. But in Vietnam, the top producer of these beans, alarm bells are ringing. They have to dig deeper to get water.

Traditionally, sellers like chain Starbucks Corp. favor the milder, more aromatic arabica variety, whereas robusta is used for instant coffee. Starbucks buys coffee beans using a method called hedging. Starbucks locks in a price to buy coffee beans over an agreed-upon future period, "hedging" against risk. The contract acts almost like insurance, protecting Starbucks from paying higher prices if coffee beans spike due to a weather event, shortage, or some other issue. "Over the years we've created a very thoughtful approach to how we source, warehouse, and use hedging techniques to ensure we always have supply of premium Arabica green coffee at an attractive cost basis," Starbucks CEO Kevin Johnson told investors. "In fact, we purchase green coffee 12 to 18 months in advance, and we never stopped buying green coffee through the pandemic."

Nestle, the Swiss maker of Nespresso and Nescafe, is among those grappling with the change. “Estimates show that 30 years from now, basically 50% of coffee lands as we know them today will not be viable for coffee production anymore” if climate change isn’t tackled, Philipp Navratil said during an interview. Nestle is a major consumer of robusta — around the world, consumers drink more than 6,000 cups of Nescafe every second. It spends $700 million each year to buy around a quarter of Vietnam’s coffee production. Last year, it said it would invest over one billion Swiss francs ($1.2 billion) by 2030 to encourage growers supplying its Nescafe brand to use more sustainable farming methods as extreme weather threatens crops, and to adapt. That includes replacing existing trees with varieties that can better cope with climate change.

Source: Bloomberg, December 2023

Extract 3: A tough decade for India’s coffee farmers

A body of coffee growers demanded government intervention and subsidies in the wake of unseasonal rain wreaking havoc on harvest of the crop. Even though coffee is a very important crop for India, it doesn’t come under the purview of the Ministry of Agriculture. And that classification creates its own issues. For instance, coffee growers may not get the same subsidies and benefits that are extended to India’s farmers.

Now even if we were to ignore all these problems, India still wouldn’t be able to ramp up coffee production quickly. Simply because growing coffee is not an overnight affair. It takes 3–5 years for coffee trees to mature and yield bright red coffee cherries.

Sources: Various

Questions

(a) (i) Compare the trend in prices of arabica and robusta coffee beans during the period shown in Figure 1. [2]

(ii) Using a relevant elasticity concept, account for the sharp change in price of arabica beans from 2020 to 2022. [2]

(b) Distinguish, with examples, between the fixed and variable costs incurred by a coffee retailing firm. [4]

(c) Explain a possible cost advantage enjoyed by large coffee retailers such as Starbucks. [2]

(d) Using your own knowledge and case evidence, discuss whether a subsidy or a price floor is likely to be a better measure to support coffee growers. [10]

[Total: 20 Marks]