

Microeconomics and starbucks

[Economics](#), [Microeconomics](#)



My hunch is that Starbucks will lose sales during the recession as people are not able to justify spending \$4 for a daily latte. However, their experiential reputation will eventually win in the end. Introduction Starbucks Coffee Company revolutionized the coffee-drinking habits of millions of Americans. Starbucks, whose bright green-and-white logo is almost as familiar as the golden arches of McDonald's, began in Seattle in 1971 when it opened its first location in Seattle's Pike Place Market. It operated as the sole Starbucks coffee shop until 1984 and quickly became the world's leading retailer, roaster and brand of specialty coffee.

In 2007, Americans were willingly paying \$3 or more for a cappuccino or a latte, and Starbucks had grown to become an international chain, with over 16,000 stores around the world. The change in American consumers' taste for coffee and the profits raked in by Starbucks lured other companies to get into the game. Retailers such as Seattle's Best Coffee and Caribou Coffee entered the market, and today there are thousands of coffee bars, carts, drive-thrus, and kiosks in downtowns, malls, and airports all around the country. Even McDonald's began selling specialty coffees (A Modest Construct).

But over the last decade the price of coffee beans has been quite volatile. Just as consumers were growing accustomed to their cappuccinos and lattes, in 1997, the price of coffee beans shot up. Excessive rain and labor strikes in coffee-growing areas of South America had reduced the supply of coffee, leading to a rise in its price. In the early 2000s, Vietnam flooded the market with coffee, and the price of coffee beans plummeted. More recently,

weather conditions in various coffee-growing countries reduced supply, and the price of coffee beans went back up (Waves).

Further adding to the troubles facing Starbucks is the current economic recession our country is in. With unemployment in the double digits and the amount of foreclosed homes hitting record highs, the days of \$3 and \$4 lattes may be over. This paper will examine the rise and fall of Starbucks in terms of supply and demand, elasticity and substitutes and then give a forecast for the future of this coffee giant. Supply and Demand Markets, the institutions that bring together buyers and sellers, are always responding to events, such as bad harvests and changing consumer tastes that affect the prices and quantities of particular goods.

The demand for some goods increases, while the demand for others decreases. The supply of some goods rises, while the supply of others falls. As such events unfold, prices adjust to keep markets in balance (Miller, 51, 62). While different variables play different roles in influencing the demands for different goods and services, economists pay special attention to one: the price of the good or service. Given the values of all the other variables that affect demand, a higher price tends to reduce the quantity people demand, and a lower price tends to increase it.

Of course, price alone does not determine the quantity of a good or service that people consume. Coffee consumption, for example, will be affected by such variables and income and preferences, as we will see later. For now, let's look at how the number of Starbucks (supply) impacted the demand for this product. Supply and demand have an inverse relationship. This means

that as supply increases, demand decreases and vice versa. Starbucks presents an interesting example at how this concept works (Miller, 69). When Starbucks first became a Public Traded Company in 1992, there were only 165 stores open at that time.

The company set a goal for growing 125 stores per year and rapidly expanded until reaching 11, 000 U. S. stores in 2008 (Starbucks website). When Starbucks first opened, it focused on the experiential. At its best, the coffee giant truly represented the “third place” between home and work where a customer can chat with the barista, order a drink to his specification, then settle in for conversation, socializing, and relaxation (Wikipedia). People were not paying \$3 per latte because it tasted that much better than Starbucks’ competitors.

They were paying it because they could go into a Starbucks and get that European cafe feeling and then take the experience home with them by purchasing a CD or maybe a Starbucks coffee mug. People obviously enjoyed this experience because from 1992 through 2006, Starbucks saw increasing revenues and its stock reached a high of just under \$40 (“SBUX”). However, fast growth led to what CEO Howard Schultz termed the “watering down” of the Starbucks experience (Creuder). What started as a 4-store company when it went public in 1992, now had some neighborhoods with a Starbucks on every block or two.

The chart below shows the relationship of supply and demand for Starbucks coffee. That is in the three year period from 2006 – 2008, as the number of stores (supply) increased, the demand (evidenced by percent growth)

decreased. [pic] Source: Table 1 data Price Elasticity The price elasticity of demand measures the responsiveness of the quantity demanded of a commodity to changes in its price (Miller, 528). Some goods have a negative relationship between changes in price and changes in total revenues (elastic). Some goods do not experience any change in total revenues if there is a change in price (unit elastic).

Others have a positive relationship between changes in price and changes in total revenue (inelastic). For years Starbucks appeared to be price inelastic. The company had price increases in 2000, 2004, 2006 and 2007 but continued to see revenues climb (Kirchoff and Petrecca). In fact, the company was used as an example by many economics professors to illustrate this principle. In 2008, it appeared that \$4 was the price at which demand became elastic. In July of this year Starbucks announced it was closing 600 of its U. S. stores, 70% of them which opened in 2005 or later (The Economist). pic] Source: Table 1 data and Kirchoff and Petrecca.

Starbucks had other issues affecting its price elasticity. Costs of production increased, consumers' incomes decreased, and the number of substitutes continued to grow. The US dollar value dropped and people are less willing to purchase goods/services at higher prices and are looking for cheaper alternatives (Welker). Income Elasticity As incomes rise, people increase their consumption of many goods and services, and as incomes fall, their consumption of these goods and services falls.

For example, an increase in income is likely to raise the demand for a bigger house, trips, new cars, and jewelry. There are, however, goods and services

for which consumption falls as income rises—and rises as income falls (Miller, 540). A good for which demand increases when income increases is called a normal good. A good for which demand decreases when income increases is called an inferior good (Miller, 58). An increase in income shifts the demand curve for normal goods to the right; it shifts the demand curve for an inferior good to the left.

Starbucks has always been the coffee of choice for those who are college-educated and will incomes of \$75, 000 or more (Business Week). However, unemployment has reached 8. 9% (Bureau of Labor) and the value of the US dollar is progressively decreasing. This is leading to a diminishing of the income of consumers. As incomes fall, the demand for normal goods will decrease and cause a shift in the demand curve. Starbucks is considered a luxurious good; both of high quality and of high prices. And as consumers' incomes fall, they will need to prioritize on purchases, and the amount of luxurious goods bought will decrease (Welker). pic]Source: Welker (As income increases, demand for Starbucks rises – normal good. With unemployment increasing and household incomes decreasing, demand for Starbucks is decreasing) SUBSTITUTES The coffee industry can be defined as a monopolistic competition. There are many producers and consumers, the goods and services are heterogeneous but the companies are still able to differentiate their products (Miller, 662). However, what happens when all things are equal except for price? Or, what if current economic conditions change consumers' preferences?

As mentioned earlier, other factors might shift the demand curve for Starbucks. A lower price for a similar product would be likely to reduce the demand for Starbucks and shift the demand curve to the left. In general, if a reduction in the price of one good increases the demand for another, the two goods are called complements. If a reduction in the price of one good reduces the demand for another, the two goods are called substitutes (Miller, 59). Over the years, there have been a few competitors to Starbucks that in recent years have started to take share away from the coffee giant.

Tim Hortons Tim Hortons was founded in 1964 in Ontario. The first location only offered donuts and coffee but quickly began offering more choices. In 1995, it merged with Wendy's International, Inc. and started its expansion into the United States. In March 2006 the company completed its initial public offering and was fully spun off as a separate company by late September of the same year (Tim Hortons) The company's famous coffee is made of 100% Arabica beans, as is Starbucks'. Tim Hortons also offers other beverages such as hot chocolate, lattes and cappuccinos.

Over the last few years, the company has experienced increased revenues and has plans to add 30-40 stores in 2009 (Tim Hortons). The price of a tall (medium) cup of coffee at Starbucks retails for \$1.65 while the same size cup at Tim Hortons sells for \$1.22 (THI). Dunkin' Donuts Dunkin' Donuts was founded in 1950 by Bill Rosenberg and began licensing franchises in 1955. It is now the world's largest coffee and baked goods chain (Dunkin' Donuts). In 2007 the company was in the Top 10 of Restaurants, along with competitor Starbucks (Table 2). In 2008 Dunkin Donuts had global sales of \$5. billion

(Dunkin' Donuts). McDonald's Perhaps the biggest competitor to Starbucks has been an equally iconic brand. McDonald's launched its McCafe in select markets in late 2007 and then nationwide in May 2009. It has been taking a chunk out of Starbucks' market share since. Table 3. McDonald's McCafe line probably draws the most similarity to Starbucks' products. The new McCafe line includes: McDonald's Latte – A soothing blend of aromatic espresso and whole or non-fat steamed milk, customizable with flavored syrup, including caramel, hazelnut, vanilla or sugar-free vanilla.

Iced Lattes are also available, served with whole or non-fat milk. McDonald's Cappuccino – A blend of espresso and whole or non-fat steamed milk, topped with a cloud of frothy milk. Add a hint of flavor with one of four syrup options, including caramel, hazelnut, vanilla or sugar-free vanilla McDonald's Mocha – A decadent medley of espresso, whole or non-fat steamed milk and chocolate syrup, topped with a crown of whipped cream and ribbon of chocolate syrup. Iced Mocha blends are also available (Chain leader). In today's economic climate, consumers are forgoing their \$4 lattes in order to save money.

With the price of a McCafe beverage around \$0.30 less than that of a comparable Starbucks beverage, more consumers are going for the McDonald's substitute (Table 5). Their lower than specialty coffee price point with higher than perceived McDonald's quality is perfect for consumers looking for a better value proposition. “ Value is an attribute that has been a fundamental piece of our business since 1955 when we first opened our doors. That today more than ever certainly plays a role in why we believe

many of our customers come to us because we know people still want luxuries, but they want affordable luxuries.

And the coffees that we're making available are in fact that — they're great tasting, and they're at a value that only McDonald's can offer. " McDonald's USA spokeswoman Danya Proud (Hoyland). In fact, shares of Starbucks fell 10 cents to \$14. 14 in afternoon trading on the day of the McCafe launch while shares of McDonald's rose 59 cents to \$53. 36 (MSNBC). Forecast Starbucks has enjoyed a long run as the industry leader in the luxury coffee market. It is known for its high quality coffee and also its experiential focus.

However it is also known for its high price and with other competitors entering the scene providing substitutes with as high of quality but a lower price, Starbucks will have to either cut costs or provide other incentives for consumers to frequent its restaurants. As the economy turns around, I believe more consumers will return to Starbucks. While high quality competitors are out there, they have a more transactional focus. It will probably be a while before a guy takes his date to a McDonald's McCafe for a latte after a movie. Starbucks has been both a high demand and now a low demand product.