

Starbucks coffee: buy
low sell high



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This paper is a case analysis of coffee market. The purpose of this paper is to study the supply and demand mechanism through the case analysis of Starbucks in coffee market. This paper has three main sections. The first two section states the problems in coffee market and its ramifications. The first main problem is that Starbucks being the price maker in the oligopolistic coffee retail market, Starbucks exerts its market power to set its coffee retail price much higher than other coffee sellers. The second problem facing by the coffee retail market is unsteady supply of coffee beans.

The third section states the proposed solution to the above two problems. Possible solutions for the first problem include introducing more sellers into the market, branding and product differentiation campaign by other coffee sellers and government intervention. Possible solutions for the second problem include backward integration and product diversification. Case Analysis Problem Definition 1 - Oligopolist Exerts Market Power over Prices Starbucks buys coffee beans at low prices but sells the coffee in retail market at relatively higher prices than other coffee retail sellers.

This is what described as “ buy low sell high” (Keat; Young, P. 61). Starbucks is able to buy low because of coffee beans prices goes down as a result of overproduction of coffee beans in 2000-2003. Starbucks is able to sell high because of its market position in coffee retail market as being an oligopolist. Starbucks being an Oligopolist in coffee retail market acts as price maker “ by exercising varying degrees of control over the price of their product” (Keat; Young, P. 61).

Coffee retail market is operated as imperfectly competitive market.

Starbucks is able to exert its market power over retail coffee price by its ability “ to differentiate their product through advertising, brand name, or special features or add-on services” (Keat; Young, P. 61). As a result, they are able to charge a much higher price. The demand of Starbucks coffee is relatively inelastic compare to that of other coffee retail seller.

The problem of the coffee retail market will be discussed and illustrated in greater depth through Starbucks as a case study in the next section. Buy Low at Coffee Bean Market in 2000. In 2000, there is overproduction of coffee beans. The high prices of coffee beans acted as a signal to attract more resources to the coffee bean growing market. As a result, more and more coffee bean farmers and resources were attracted to the market as they expected the price would rise further. This was reflected by a rightward shift of supply curve (from S_0 to S_1).

When there were too many coffee bean farmers, the supply was too much. This was reflected by an overshifting of the supply curve to the right (from S_0 to S_{2000}) where the price was dropped too low (from P_0 to P_{2000}) and the quantity supplied was too much (from Q_0 to Q_{2000}). This was exactly what happened in 2000 when they experienced overproduction. Since the price of coffee bean was too low, the coffee bean farmers “ stopped attending their coffee trees” (Keat; Young, P. 62) in an effort to cut the cost as they were barely profitable to sell their coffee beans while Starbucks were buying their coffee beans at the historically “ lowest prices in more than 30 years” (Keat; Young, P. 2).

Sell High in Coffee Retail Market in 2000. Starbucks and other coffee sellers in retail market were able to buy coffee beans at low prices since 2000. In other words, Starbucks and other coffee retail seller benefited from the doomed wholesale coffee bean market and enjoyed low cost of production. Other things being constant, the retail coffee market price would have then expected to go down. However, Starbucks charged a high price for its coffee (at \$3.

) while most of other coffee sellers in the same market did not dare to raise their prices for at least 4 to 5 years. Starbucks was able to sell its coffee at much higher prices than other coffee sellers in the market because of its successful product differentiation. Starbucks had branding itself as specialty coffee retailer and differentiated its coffee as high quality coffee for unique tastes and preferences. With the successful product differentiation, the demand of Starbucks coffee has become more and more inelastic compare to that of other coffee sellers. In other words, customers preferred more of Starbucks coffee to other coffee seller as they were becoming more addicted to Starbucks coffee and did not see other coffee as substitutes. Under such circumstances, the change in quantity demanded of Starbucks coffee was highly insensitive to a change in price.

Therefore, the quantity demanded of Starbucks coffee remained unchanged when Starbucks coffee price was raised to \$3.5. However, the other coffee sellers were having a more elastic demand curve. A small percentage increase in price would have caused a large percentage decrease in quantity demanded. Therefore, other coffee retail sellers have not raised their coffee prices for a long time. Referring to the diagram below, D2 is the demand

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curve of Starbucks which is more inelastic; while D1 is the demand curve of other coffee retail sellers which is more elastic.

When price increased from P_0 to P_1 , Starbucks would have a very small drop of quantity demanded of Starbucks coffee by an amount of quantity Y; while other coffee retail sellers would have a huge drop of quantity demand by an amount of X. Problem Definition 2 - Unsteady Supply from Factor Market, Coffee Beans In 2004, wholesale coffee prices started to move up due to reduced supply of coffee beans as a result of bad harvest and some coffee tree farmers had left the market. This enabled common coffee retail sellers to justify the raising of their coffee retail prices. Starbucks pointed out an important fact that the "continuity of supply can be as important as the purchase price" (Keat; Young, P.

62). When more and more coffee tree farmers left the market since 2000 as a result of coffee bean prices dropped to a level too low for the farmers to cover their cost, the long run supply will become insecure or even discontinue. When coffee retail sellers cannot get enough of its essential raw material, coffee beans, the line of production will stop in extreme case. Therefore, a steady and a continuous supply of coffee beans is essential to the survival of coffee retail market. This is why Starbucks claimed that they are willing to pay a higher price for their coffee beans in order to keep the coffee tree farmers in the market. It is only when the factor market keeps on operating while the coffee tree farmers keeps on growing and harvesting, the product market can get its supply of coffee beans.

If the factor market does not survive, neither will the product market.

Solution to Problem 1 - Starbucks is Price Maker and Its Demand is Inelastic.

Solutions include introducing more sellers into the market, branding and product differentiation campaign by other coffee sellers and government intervention. Starbucks is the price maker because the coffee retail market is non-perfectly competitive.

If more and more sellers can be introduced into the coffee retail market, and if the existing coffee sellers or the newcomers can launch a branding and product differentiation campaign like what Pacific Coffee, Gloria Jeans, Hudson Coffee have been doing to gain a considerable market share, then customers will no longer see Starbucks as their only option. Coffee from other retail sellers become close substitutes and the demand curve of Starbucks will be less inelastic. Likewise, the retail coffee market will become more and more perfectly competitive, and the price elasticity of other coffee sellers will be more elastic. As a result, everyone in the market has to follow the market mechanism and they are all price takers in the ideal theoretical case. Moreover, government can set a price ceiling for retail coffee.

However, this is a very risky thing to do. Such government intervention usually found in staple food and necessity markets only. Purposed Solution to Problem 2 - Unsteady Supply of Coffee Beans . Possible solutions include backward integration and product diversification. In order to ensure a steady and a continuous supply of coffee beans, coffee retail sellers can consider backward integration. If they purchase a coffee plantation and hire back the coffee tree farmers to grow and harvest for them, the coffee tree farmers

can live on a stable and a relatively high income while the coffee sellers can ensure its supply of coffee beans.

This is a win-win situation and both parties are better off. Moreover, coffee sellers can consider diversifying the risk of relying its income mainly on coffee selling by product diversification. By expanding the food choices available and consider selling tea, close substitutes of coffee can expand the source of income. Conclusion Starbucks being the price maker in the oligopolistic coffee retail market, Starbucks exerts its market power to set its coffee retail price much higher than other coffee sellers.

Possible solutions include introducing more sellers into the market, branding and product differentiation campaign by other coffee sellers and government intervention. The second problem facing by the coffee retail market is unsteady supply of coffee beans. Possible solutions include backward integration and product diversification.