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Trust and value through long-term market relationships: better than a short-term focus on price

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'Long-term relationships in supply chains can generate significant gains for business, development and the environment, by facilitating investment in the supply chain and increasing its sustainability through reducing volatility'

In January 2010, Walmart, the world's biggest retailer, announced its intention to roll out a system of 'direct' purchase (replacing its previous system based on long-term relationships with suppliers) to its global supply chains. This followed what it deemed to be a successful experiment with apple farmers in Washington State. Walmart's plans to increase the proportion of goods that it buys directly from producers, moving from relationship-based supply chains and cutting out intermediate supplier functions to 'create efficiencies', may sound potentially promising for growers and consumers. However, the model for the US pilot was a form of auction that initiates intense bidding among suppliers. The kind of extreme downward pressure on prices created by this trial could have negative implications for suppliers, consumers, retailers and global citizens at large.

Such bidding systems are highly effective price mechanisms on any one day. Over time, however, they can produce high price volatility, exaggerating price depressions during surpluses and inflating prices during scarcities, in contrast to purchasing relationships based on long term relationships between buyers and sellers. Although retailers in long term relationships with suppliers will still increase prices to some extent when there are scarcities, they will avoid the extreme price rises that are generated by auctions during scarcity, so that they do not pass them on to customers. Similarly, firms anxious to keep their suppliers in business (in order to secure their sources of supply for the long term) will be hesitant to drop the prices they pay to the low levels that auctions can generate.

Volatility benefits those whose advantage lies not in stability but in their ability to capitalise on change, tending to extract high profits while adding little value. For everyone else it is potentially damaging – consumers (who include highly vulnerable groups) are hit by price spikes, retailers cannot forecast their costs, producers cannot predict their incomes and forward contracting becomes impossible.

Such a situation presents a disincentive for investment and improvement as well as leading to unsustainable supply chains because producers, who carry the losses when markets are low, can be forced out of business. Retailers with the keenest business sense realise that they can only guarantee a steady and reliable supply of the goods they sell as long as their suppliers remain in business.

When income is relatively stable and the market is more reliable, producers are more likely to be able to invest to increase productivity or improve product quality and sustainability. In contrast, incentives to buy or sell for the cheapest price, whatever the consequences, encourage short-term thinking and perpetuate environmentally and socially damaging practices. Parties who share trust and objectives 'cut each other some slack'; they 'go the extra mile'. However, tolerance and understanding do not feature in transactions where the only objective is squeezing (from the buyer's point of view) or inflating (from the supplier's point of view) the price. A focus on prices alone may deliver short-term gains but altogether ignores the potential benefits for both business and development of closer, longer-term relationships (Box 1, overleaf).

Ethiopia's commodity exchange (ECX) is at the other extreme of the potentially adverse effects of the auction form of spot market to that of the Walmart example. This system offers consignments of premium quality certified and traceable coffee to international buyers at regional monthly bidding sessions. Its first 'direct speciality trade' (DST) coffee auctions in February and April 2010 returned high prices for the minority of sellers whose coffee was bought. However, the majority (66% and 85%, respectively) of the lots offered went unsold. This generates great uncertainty for

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Box 1: Business and development cases for trust-based longer-term relationships in supply chains

- Longer-term relationships can act as a mechanism for shifting the chain's strategic focus from price to value and prioritise long-term benefits over short-term gains.
- More stable relationships make producer supply and buyer demand more reliable, thereby reducing risk aversion in producer communities, leading to investment in upgrading their processes and products. This can include improved environmental and social performance, and in turn increasing assets and diversification, for example through the capitalisation of new business activities.
- Preferred buyer status enables firms to leverage better quality products and lower prices, particularly during scarcities.
- Actors in strategic alliances share market intelligence, technology and resources and collaborate on continuous improvement, for example through product and process upgrading. In addition, increased efficiency benefits consumers by reducing prices. Investment down the supply chain contributes to technology transfer, safeguards supply, and avoids damaging price rises and quality issues.
- Buyers' provision of services within longer-term relationships, such as financing and technical support, are particularly important to the most marginalised producers, who tend to be excluded from the institutions (such as trade organisations) that provide these services. Such provisions are not possible in one-off spot transactions.

producers about the return they may get for investments aimed at producing premium quality coffee, thereby reducing incentives for investment. Moreover, the auction system limits participation to commercial producers or smallholders in well-functioning groups because the ECX minimum lot size is far greater than the processed output of many smallholdings. In addition, only the best quality coffee is sold in this way. The remainder is sold as commodity coffee and price-indexed to the New York Stock Exchange.

The benefits of longer-term relationships are, therefore, restricted to a small minority of producers. Evidence from Fairtrade coffee schemes in Latin America shows how producers respond to stabilised, reliable income by investing in assets and productive activities. Indeed it suggests that the long-term nature of the relationship achieved through Fairtrade schemes is more important in this than other benefits delivered by the scheme, such as premium prices.

In an approach that is diametrically opposed to that of Walmart's, a major UK supermarket chain, J. Sainsbury, exemplifies the strong business case for heavy investment in supplier relationships. For example, it has extended the benefits associated with its UK Dairy Development Group (through which farmers gain a premium for good agricultural practice) to producers of pork, beef, lamb and eggs, and has introduced a Crop Sustainability Group to share technical knowledge and best practices among producer networks. In addition to securing sustainability of supply the firm enjoys marketing gains and costs savings from working with producers to increase their efficiency. Its product development also benefits from its preferred buyer status, being the first recipient of new supplier innovations. Thus, it seems that investment in relationships is more likely to deliver sustainability in all senses.

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