The Trade Monster

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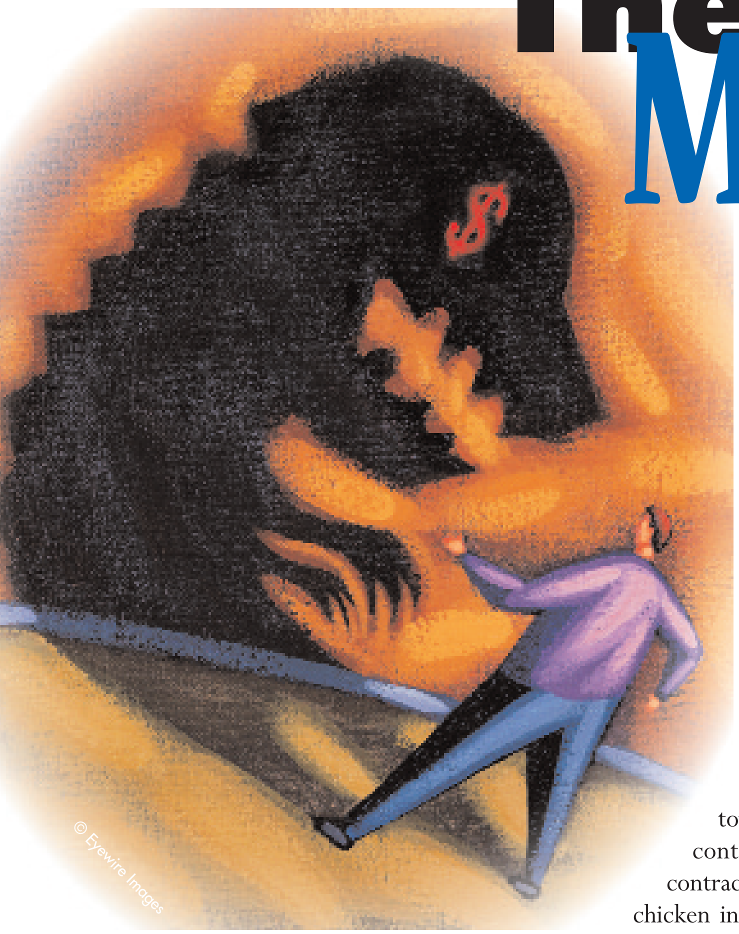
by Paul Aho



The U.S. chicken industry is facing a period of severe financial stress in the next 18 to 24 months due to a sudden restriction in the ability to export product to key markets. The most significant restriction has been in the largest market, Russia. However, other barriers have been erected in a number of countries including Mexico, China and Japan. Some of the restrictions are related to the avian influenza (AI) outbreak. Although AI has played a role in the most recent trade barriers, there has been a worrisome trend toward increased trade barriers of all types against U.S. chicken in many countries. The cumulative effect of mounting trade barriers will cause significant damage to the domestic chicken industry unless political and diplomatic action is taken on a government-to-government basis to reopen markets. This is not a problem that the chicken industry can solve by itself.

If the current trend toward trade restrictions continues, there will be contraction in the size of the chicken industry in the next two years. Some poultry companies may close their doors. As a result, hundreds or thousands of family farmers and processing plant workers could lose their livelihood and billions of dollars could be lost by lenders to the industry as well as equity stakeholders. The ripple effects would be felt across the entire agricultural economy most notably grain and meat producers of all types.

How did we get to this point? The total number of chickens slaughtered last year in the United States was about the same as the year before, 8 billion. On the surface of the U.S. broiler industry everything appears to be calm. However, under the surface there is turmoil. The U.S. industry is in the process of shifting from an industry oriented to the production of bone-in whole and cut-up product to an industry oriented to the production of value-added products made primarily from deboned breast meat. As can be seen in the chart, the number of large chickens (those most likely to be deboned) is increasing rapidly at the same time as the rate of increase in total chickens is slowing. In 1980, large chickens represented just 10 percent of all production. Large chickens now represent half of all production. The table also shows the shrinkage in the U.S. industry possible in 2003 because of the current trade problems.

The shift to large broilers started in earnest in the early 1980s when the first plant dedicated to deboning breast meat was opened. The number of chickens grown to be deboned (primarily for breast meat) increased from 400 million in 1980 to 4 billion in 2002. Since each large chicken yields about a pound of deboned breast meat and two pounds of large bone-in leg quarters, the tonnage of

***Table 1.* U.S. Chicken Production In Billions**

Year	Total Chickens	Larger Chickens > 5.25 Lbs. Live	Percent Large
1980	3.9	0.4	10
1990	5.8	1.6	28
2000	8.0	3.2	40
2001	8.0	3.6	45
2002	8.1	4.0	49
2003	7.9	4.2	53
2004	8.0	4.4	55

***Table 2.* Billions Of Pounds Of Deboned Breast Meat And Bone-In Leg Quarters**

Year	Deboned Breast Meat	Bone-In Leg Quarters
1980	0.4	0.8
1990	1.6	3.2
2000	3.2	6.4
2001	3.6	7.2
2002	4.0	8.0
2003	4.2	8.4
2004	4.4	8.8

Table 3. Use Of Leg Quarters, Billions Of Pounds

Year	Domestic Consumption	Exports
1980	0.6	0.2
1990	2.3	0.9
2000	2.2	4.2
2001	2.5	4.7
2002	4.0	4.0
2003	4.2	4.2
2004	4.4	4.4

leg quarters is growing twice as fast as the tonnage of deboned breast meat.

Even without the latest restrictions on the U.S. export of leg quarters, the current production of 8 billion pounds of leg quarters would have been cause for alarm. The few open markets around the world were saturated with U.S. leg quarters. With the current increased restrictions on leg quarter exports, the problem has become a full-blown crisis.

As can be seen in the table, the consumption of leg quarters in the U.S. will increase dramatically in 2002 compared to 2001 due to the export problems. The price will fall far enough to induce Americans to eat 1.5 billion more pounds of large leg quarters. As a result, the price of leg quarters will drop about a dime in one year. The continuing heavy loading of the domestic market with leg quarters will force shrinkage in the size of the industry in 2003 if exports do not improve.

Trade Problems Triggered Current Crisis

It was not inevitable that the rapid increase in the production of bone-in leg quarters would lead to the current collapse in the price of leg quarters. Exporting leg quarters is a natural fit for the U.S. poultry industry. There are many countries where consumers prefer dark meat. In the absence of trade barriers, the excess leg quarters would be spread out among a large number of countries. However, trade barriers around the world have helped create a monster. Since U.S. leg quarters are blocked at almost every turn their price has dropped to levels that motivate countries to take import-restricting actions which, of course, lowers the price even further. Leg quarters have fallen into the dreaded vicious circle of falling prices.

The U.S. Poultry and Egg Export Council has worked patiently to try to reverse this vicious circle and convert it into a virtuous circle. If more countries were to open their market to leg quarters, the price would rise which in turn would encourage more countries to open their market, which in turn would increase the price. Losing a large chuck of the Russian market this year was a massive setback to that effort.

To understand how U.S. leg quarter prices became so contentious, a little history is instructive. In the early 1980s, the first large processing plant in the United States dedicated to the deboning of chicken meat started operations. As the supply of products made from deboned breast meat began to flow into the market, the supply of bone-in leg quarters simultaneously started to flow into the market. The leg quarters were the inevitable product of the production of deboned breast meat. At the beginning of this process, leg quarters were worth about 35 cents per pound.

As the production of deboned breast meat accelerated during the 1980s and early 1990s, the price of leg quarters dropped steadily. An increasing supply of leg quarters was forced onto a U.S. market reluctant to purchase leg quarters or dark meat of any kind. Since there were few exports of leg quarters, the price fell steadily from the middle 30's down to the lower 20's.

In the middle 1990s, the Russians came to the rescue. Exports to Russia suddenly rose in the middle 1990s. Leg quarter prices responded by rising from the low 20's to the low 40's. Since then, U.S. leg quarter prices have been on a roller coaster determined by Russian policy makers. Since Russia is the largest market for leg quarters, prices rise and fall depending on the political mood in Moscow.

Without international markets and in particular without the Russian market, the U.S. broiler industry faces a grave financial crisis. Without a reliable export market, the current system of organizing the U.S. broiler industry will have to change.

Economic Consequences

To understand the economic consequences of trade restrictions, it is important to understand the importance of leg quarters. Half of the weight of the chicken is represented by the leg quarters. Since total RTC chicken production in the U.S. will be 32 billion pounds this year, the back half (leg quarters) represents 16 billion pounds of production. As can be seen in the rough calculation of industry revenues (see Figure), the contri-

Table 4. Chicken Industry Revenue Without Recent Trade Problems

	Percent Of Chicken	Price	Revenue
Leg Quarters	50	$0.25	$4.0 Billion
Breasts	38	$0.70	$8.5 Billion
Wings	12	$0.60	$2.3 Billion
Total Revenue			$14.8 Billion
Cost of Production			$14.4 Billion
Profit			$0.4 Billion

Table 5. Chicken Industry Revenue As Currently Projected

	Percent Of Chicken	Price	Revenue
Leg Quarters	50	$0.15	$2.4 Billion
Breasts	38	$0.70	$8.5 Billion
Wings	12	$0.60	$2.3 Billion
Total Revenue			$ 13.2 billion
Cost of Production			$14.4 billion
Loss			$1.2 Billion

***Table 6.* Approximate Loss In Billions**

	Amount
Short Term—One Year	
Lower Earnings for all Chicken Companies	$1.6 Billion
Long Term—Two to Four Years	
Broiler complexes close, some bankrupt companies lost Contracts for farmers, lost jobs for workers loan losses and lost equity	$2.4 Billion
Approximate Loss before Considering Multiplier Effects	$4.0 Billion

***Table 7.* Economic Demand In The USA For Leg Quarters $550,000,000**

Quantity Supplied (MT)	Price
1,000,000	25
1,250,000	21
1,500,000	17
1,750,000	15
2,000,000	13

bution of leg quarters to total revenue is significant.

As matters now stand, the industry will be faced with a serious financial crisis. The extremely low price of leg quarters will result in losses at current production levels. The losses will continue until production is forced to decline through the closing of complexes or the bankruptcy of poultry firms. If exports decline significantly, the industry will shrink. Although projections at this point are merely speculative, production in 2003 could fall to 7.9 billion chickens or less from 8.1 billion this year.

The economic consequences of the recent trade problems could be severe. Economic losses could total in the billions of dollars over the next few years. In the short term, there is the $1.6 loss in top line sales. In the long term, there are costs associated with the closing of broiler complexes including the loss of contracts for farmers, lost jobs for workers, loan losses and lost equity among other losses. Any estimate of such losses would be speculative but the number is clearly in the billions of dollars.

Economic Demand

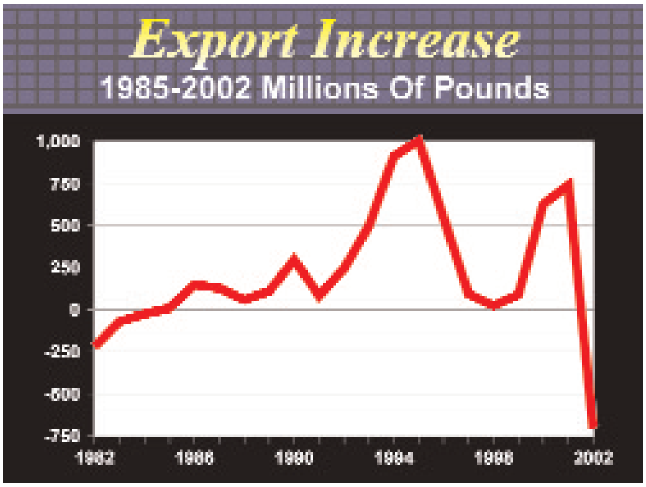
The economic demand in the U.S. (price times quantity) of leg quarters has been remarkable stable at about $550,000,000 in the last several years. As the U.S. market is supplied with more or less leg quarters (due to fluctuating export sales) the price fluctuates but not the demand. In the year 2000, the U.S. market was supplied with about 1 million metric tons of leg quarters, which translated to a price of 25 cents per pound. In 2002, the U.S. market is being supplied with 1.75 million metric tons. With that supply, the price is likely to settle in at about 15 cents per pound.

The importance of export markets as a whole, and Russia in particular, is overwhelming for the U.S. boiler industry; it directly affects the long-term viability of the industry itself. A low leg quarter price would have the long-term effect of raising the price of breast meat (which would have to carry the weight), which in turn could make the internal U.S. breast meat market attractive to other countries. Other countries, most notably, Mexico and Brazil, could begin providing the breast meat used in this country. To support a 15-cent leg quarter price, the U.S. chicken industry would have to clear $2.00 per pound for deboned breast meat. Brazil could deliver deboned breast meat to the U.S. for less than half that price. A U.S. breast meat price that is two or three times the international price would put the domestic industry in an uncomfortable position.

A Defining Moment

The year 2002 presents a defining moment for the U.S. broiler industry. After years of using export markets as an effective safely value for the sale of leg quarters, the system has broken down. Either the system needs to be repaired or a new system will have to be put in place. An embargo followed by a begrudging acceptance of some leg quarters insures that exports to Russia and exports in general will decline this year for the first time in 17 years.

The USDA is now projecting a decline in total chicken exports from 5.5 billion pounds to 5.4 billion pounds. That estimate is timid. The true decline is likely to be much greater, in the order of 700 million pounds. The swing from an increase of 750 million pounds in 2001 to a decrease of 700 million pounds in 2002 will be extremely difficult to accommodate.



As can be seen on the chart, the U.S. experienced an unprecedented run of rising exports from 1984 to 2001. Sometimes, they increased in a spectacular fashion. In 1995, for example exports increased by one billion pounds. Most exports were leg quarters, and the largest customer by far was Russia. Without immediate political help, this export run by the broiler industry is over, and the industry will face grave danger.

Last year, total exports to Russia climbed by nearly 100 percent thanks in part to a real increase in exports to Russia and in part to an accounting increase in exports to Russia (exports going directly to Russia rather than going through other countries on their way to Russia). This year the comparisons will be very different. It is now certain that exports to Russia will be significantly lower in 2002 compared to 2001. Exports to the rest of the world will also be down thanks to the closing of entire important markets like Japan for periods of time due to avian influenza. As a result, the best that can be expected for exports this year is a decrease of 700 million pounds. Results may be a lot worse. The export decline could reach over one billion pounds.

The dilemma of the leg quarters is evident in chicken prices since September 11th. Leg quarters are stuck at low levels, while boneless breasts are making a weak summer run. Wings, like legs, are just half the price they were in September. The returns to the industry are nowhere near those of last summer and are negative for commodity chicken. Current production and export levels are creating commodity chicken losses.

Much At Stake

The U.S. broiler chicken industry exported 18 percent of its production last year, mostly leg quarters. If export problems reduce that percentage significantly, the industry will be forced to shrink in size. The processes of shrinking will be painful and will be accompanied by the closure of complexes and the potential loss of the livelihood of contract family farms and processing plant workers. The resulting industry will have to price breast meat so high as to make it vulnerable to production in other countries, including most notably, Brazil.

The broiler industry can help itself by bringing to market innovative ways to sell dark meat in the USA. However, the most important immediate help needed by the industry is one that it cannot bring about by itself. It needs political and diplomatic help to open markets overseas. Without that help, the industry will shrink in an untidy process that will cost the agricultural sector billions of dollars. The losses will not be sustained just by the poultry industry. Billions of dollars will be lost by pork, beef and grain producers as well.

During the 1990s, increasing poultry exports led to the rapid increase in the employment of capital, farmers and labor in the industry. Now the industry is confronted with the opposite scenario, declining exports that will lead to the shedding of assets, workers and farmers. The downside scenario would be damaging to thousands of workers and family farmers, but it is not inevitable. Prompt diplomatic action can prevent this economic disaster. The industry can hang on for about six more months without damage to any company (the summer months are always kind to the industry). However, if exports are down by 25 percent or more this fall, entire poultry complexes will surely begin to close over the winter. The economic damage to the agricultural sector would be felt most keenly in 2003 and 2004.

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Table 8. Quotes From USDA, AMS

	9/10	11/10	1/28	3/18	5/21
Northeast Leg Quarters	34	28	25	17	18
Northeast Bnls/Sknls Breast	163	120	120	130	145
Northeast Wings	109	79	86	64	51
Commodity Blend (LQ *.5+BB/2*.38+W*.12)	61.1	46.3	45.6	40.9	42.6