



## Summary

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*The market outlook for the Finnish forest industry is brighter than it was a year ago. This is due to the revival in GDP growth in the euro area, which is important for Finnish exports. Weighted according to the distribution of Finnish forest industry exports, real GDP growth in the world economy in 2004 is expected to be about 3%, which is more than one percentage point above the 2003 level. The revival in GDP growth has increased the demand for forest industry products, boosting Finnish paper production in 2004 to a new record level. However, export prices have been adversely affected by the oversupply prevailing in Europe's export markets and by the strong euro. Although prices are expected to rise in the last quarter of the year, the average 2004 export price of Finnish paper will be 4–5% below the 2003 figure. The 2004 export price of sawnwood will also be down slightly, due to oversupply in Europe. In the roundwood market, pulpwood removal will be up in 2004 on account of the increased production in the paper industry; some of the industry's growing roundwood needs have also been met by imports and by using stocks of harvested roundwood. Average stumpage prices will be 4% lower than in 2003, mainly because of the fall in pulpwood prices.*

*Euro area GDP growth will continue at about the same rate in 2005, whereas growth elsewhere in the world will already be slowing down. As Europe's demand for paper increases, this is expected to boost Finnish production and export prices in 2005. Growth in sawnwood demand in Europe will largely rely on the housing renovation market, and Finnish sawnwood export prices are expected to fall slightly, due to tougher competition. Demand for wood raw*

*material will increase in the paper industry, raising the level of pulpwood removal and imports. Sawnwood production and sawlog demand are expected to remain close to the high level of 2004. With no major changes anticipated in sawnwood demand and supply, sawlog prices will be at about the 2004 level. Higher production in the paper industry will increase the demand for pulpwood and thus raise pulpwood prices somewhat.*

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### **Economic Operating Environment**

The economic outlook for the Finnish forest industry is more encouraging than it was a year ago. This is because GDP growth in the euro area – important for Finnish exports – is now picking up too, driven by the growth in the United States and Asia. Euro area GDP growth for 2004 will rise to about 2%, not least because exports have begun to increase in response to the clear recovery in world trade, despite the continued strength of the euro. Indeed, the indicators show that business confidence is fairly good, and is in fact higher than consumer confidence. Among the Finnish forest industry's key export markets, even Germany's GDP growth is forecast to be up in 2004, following zero growth in 2003.

In 2005, euro area GDP growth will be at about the 2004 level, whereas growth elsewhere in the world will be down slightly as a result of tighter monetary policies. The euro area growth forecast assumes an increase in private consumption. Although interest rates are also expected to rise in

the euro area, they will still be relatively low, and so economic growth should be aided by an increase in investment. The economic forecasts for 2005 are, however, subject to various uncertainties, the outcome of which could affect the situation considerably. In the United States, household indebtedness could lead to a drop in consumer demand, and the high level of net foreign debt could further weaken the US dollar. If the price of crude oil rises or stays at a higher level than anticipated, this could decelerate growth in export markets.

## **Forest Industry Product Markets**

The consumption of printing and writing papers has begun to increase in Europe too, as a result of GDP growth and a recovery in the advertising sector. Production and exports of Finnish paper in 2004 will be up by about 8% on the previous year's figures, to yet another new production record. By contrast, prices have, in many cases, continued to fall, because of the price competition caused by overcapacity on the export markets, and due to the strong euro. Although the prices of many products are expected to rise in the last quarter of 2004, the average export prices of Finnish paper and paperboard will be about 4–5% below the level of the previous year. The price of softwood pulp has risen in 2004, whereas the price of hardwood pulp has been adversely affected by factors such as the increased supply of low-cost eucalyptus pulp. The average 2004 export price of Finnish pulp is likely to settle at a slightly higher level than the previous year, and both production and exports will increase.

In 2005, paper consumption on the main export markets in Western Europe is expected to rise further, due to the GDP growth. This will mean an increase of about 4% in Finnish paper production and exports. Although some overcapacity will still exist in paper grades of importance to Finnish exports, the consumption growth will allow scope for price increases. The average export price of paper and paperboard is likely to exceed the 2004 level

by a small amount. The demand for softwood pulp will continue to be strong because of the increased demand for paper, which will help to raise Finnish pulp production in 2005 by about 4%, almost to the level of full capacity utilisation.

Demand for sawnwood and plywood in the United States and Japan has been maintained by the high growth in GDP and construction. The demand for sawnwood and plywood in Europe – Finland's main export market – has also grown in 2004. However, the European market is still troubled by oversupply, which has led to a fall in sawnwood prices. The average export price of Finnish sawnwood in 2004 is expected to be about 2% below the previous year's level, but export volumes will be more or less unchanged. The trend in plywood export prices has also been weak on account of the tough competition, although there have been signs of a strengthening in plywood prices in Europe during the autumn. Finnish plywood exports in 2004 are expected to be up by about 4%.

Forecasts suggest that the revival in residential construction in Western Europe will be short-lived, and so the export growth prospects for sawnwood and softwood plywood in 2005 will largely depend on the housing renovation market. As sawnwood supply increases from Eastern European countries, with their lower production costs, the oversupply situation in the sawnwood market will continue. Consequently, the average export price of Finnish sawnwood in 2005 is forecast to drop slightly. Production volume in the sawmilling industry is nevertheless likely to remain close to the record production levels of 2003–2004, due to the buoyancy of residential construction on the domestic market. On the birch plywood market, the continuing tough competition and the closure of some Finnish production units will probably result in a small decrease in exports. By contrast, the average export price for all Finnish plywood will be up slightly.

## **Costs and Profitability in the Finnish Forest Industry**

Cost trends in the Finnish forest industry in 2004 have been rather mixed. In comparison with 2003, labour, energy and transportation costs have risen, whereas the mill prices of roundwood, and especially pulpwood, have fallen. In the paper industry, the capacity utilisation rate has risen in 2004, but the drop in export prices will again reduce the industry's profitability. In the sawmilling industry, the capacity utilisation rate remains high, although the industry's profitability continues to be poor on account of the lower export prices.

In 2005, export prices in the paper industry will rise, as will the capacity utilisation rate. This will improve profitability, because production costs are expected to remain almost unchanged. In the sawmilling industry, the market will continue to be tough in 2005. Although costs are not expected to rise, profitability will again be weak on account of the low export prices.

## **Roundwood Markets**

With paper production increasing and sawnwood production remaining at a high level, the Finnish forest industry's roundwood consumption will be up in 2004, increasing the volume of commercial fellings by 2%, to 55.9 mill. m<sup>3</sup>. Part of the industry's roundwood need is being met through increased imports and by using stocks of harvested roundwood. Stocks have had to be used since the early part of the year, because roundwood sales have been down on the previous year's level. Roundwood sales will have to pick up in autumn 2004 if the industry's purchase targets are to be met.

The stumpage price level presents a challenge for domestic roundwood sales, as stumpage prices in 2004 are expected to be about 3–4% down on the 2003 level, due especially to the fall in pulpwood prices. Roundwood imports are expected to be up by about 5% and to have a growing emphasis on wood chips rather than roundwood.

In 2005, the increasing wood raw material needs of the paper industry will lead to a rise in commercial fellings, to a total of 58.2 mill. m<sup>3</sup>, as well as an increase in imports. Some of this increase in commercial fellings will be used to replenish depleted stocks. A small rise in pulpwood stumpage prices in response to the increase in paper and pulp prices will help raise the price of roundwood a little in 2005. Sawnwood production will drop slightly but will nevertheless remain high and therefore maintain the good level of demand for softwood sawlogs, ensuring that the stumpage price remains close to the 2004 level.

## **Investment and Profitability in Non-Industrial Private Forestry**

Total investment in timber production in Finnish non-industrial private forestry in 2004 will be almost EUR 170 mill. In 2005, investment will be somewhat higher in real terms, due to the slight increase in the level of state funds allocated for timber production. Overall, however, investment in timber production has fallen considerably since the early years of the decade. By contrast, state funds for management of the forest environment in non-industrial private forests (under the legislation on funding for sustainable forestry) have tripled in less than ten years. In 2005, state funding for these purposes will amount to nearly EUR 6 mill.

Gross stumpage earnings of non-industrial private forest owners in 2004 are expected to total almost EUR 1.5 billion, which is below the previous year's level. In 2005, the increase in fellings and stumpage prices will raise gross stumpage earnings by 3–4%.

Net stumpage earnings in 2004 will be down by EUR 4/ha on the previous year's figure, to EUR 97/ha, but will rise in 2005 to EUR 101/ha. Profitability, calculated as the investment return on forest ownership, has weakened during 2004 as a result of the fall in stumpage prices, and the return in real terms will be negative, at –1%. In 2005, the return is expected to increase to 4–5%, which represents the average for the period 1993–2003.

## Assumptions and Uncertainties in Forecasting

The aim of this *Economic Outlook* is to present clear and consistent information on the current state of the Finnish forest sector and the outlook for the near future. The forecasts for the forest sector are based on publicly available statistics, world economic forecasts, market information and other forest sector data, and research conducted by the Finnish Forest Research Institute. The views of GDP growth in the world economy and in export markets have been formulated on the basis of forecasts made by a number of different organisations, among them the Organisation for Economic Cooperation and Development, the International Monetary Fund and the Research Institute of the Finnish Economy. The forecasts given in this publication are for the years 2004 and 2005 and are based mainly on information available in late September and early October 2004.

The forest sector forecasts presented here are the views of researchers about the most likely course of events. They are point forecasts and are based on export market GDP forecasts and other background assumptions about the markets. One of the greatest uncertainties in the forecasts is whether or not GDP growth will be lower than expected. The uncertainties in the US economy could affect currency markets and jeopardise the level of world

GDP growth and therefore also the growth in the euro area. Another key uncertainty is the future price of crude oil. According to the IMF forecast, a permanent USD 5/barrel increase in the price of crude oil would reduce world GDP growth by an average of 0.3 percentage points, after a lag of about 12 months. A further uncertainty in forecasting the level of world GDP growth is the future course of the Chinese economy.

If GDP growth in the main export markets in Europe turns out to be weaker than expected, the demand for forest industry products will be lower than forecast. This would further exacerbate the already intense price competition and oversupply, forcing down prices. Competition in Europe will also be intensified if the US dollar weakens further against the euro, as this would hamper European export prospects and add pressure to obtain supplies from countries outside Europe. If the growth in export markets is below the forecasts given here, this will affect export prices, production and profitability in the Finnish forest industry. With falling demand for wood, the adverse impact would spread from the forest industry to roundwood markets, forestry employment and the profitability of non-industrial private forestry. Growth in the Finnish forest sector would then fall short of the forecasts presented here.