The exceptional growth that occurred in the rest of the world economy outside the euro area in 2004 is now weakening. Real GDP growth in the world economy in 2005, weighted according to the distribution of Finnish forest industry exports, will be about 2.5%, and will rise a little higher in 2006. The demand for forest industry products in Europe has grown slightly but has been too slow to reduce the persistent oversupply. Finnish paper prices have nevertheless risen modestly in 2005, although sawnwood prices have continued to fall. The 2005 figures for Finnish forest industry production and exports and domestic roundwood consumption will be considerably below the previous year’s level, due to the effects of the labour market dispute in the paper industry.

The economic outlook for the euro area, so important for Finnish forest industry exports, will be slightly improved in 2006, which will raise paper industry production and exports to new record levels following the low of 2005. Exports of sawnwood, however, will not reach the 2004 level because of the decrease in domestic production and the weak trend on the European construction market. With continued oversupply in Europe, the average export price of paper will remain at the 2005 level. Oversupply on the sawnwood market will increase as new investments in Central and Eastern Europe come on stream, and so the average price of Finnish exports is forecast to decrease a little further. Pulpwood will feature more prominently in roundwood demand and in total fellings, as production in the sawmilling industry in 2006 will be below its 2004 level. With the demand for sawlogs changing little and imports of roundwood and wood chips increasing further, no dramatic changes are forecast in stumpage prices in 2006.

Only Slight Improvement in Euro Area GDP Growth in 2006

The economic outlook in Western Europe, a key market for the Finnish forest industry, will improve in 2006, but GDP growth for the year will again be slower than elsewhere in the world. Euro area GDP growth in 2006 is forecast to rise to about 2%, following the growth of about 1.5% in 2005. Growth in the German economy will again be below the level of other euro countries, despite the slow recovery, and growth in the United Kingdom economy will slow to just over 2%. Interest rates in Europe will remain low in 2006. The Chinese economy will continue growing at a rate of almost 10%, while Japan’s economy is forecast to grow by almost 2% in both 2005 and 2006. In the United States, GDP growth in 2005 will be 3.5%, and is forecast to remain over 3% in 2006.

The main uncertainties in the 2006 growth forecasts for the world economy are the price of crude oil and the state of the US economy. In the latter case, the uncertainty concerns a possible weakening in consumer confidence and also the massive US budget and current account deficits, which, through exchange rates, share prices and interest rates, could affect the entire world economy. Although the structure of national economies and their ability to with-
stand energy price rises have improved since the 1970s oil crises, a rise in oil prices to over USD 50/barrel would reduce household purchasing power in real terms and encourage general uncertainty about the world economy.

**Slow Growth in Paper Demand Means Sluggish Price Trend**

Total paper consumption on Finland’s main export markets in Western Europe in 2005 will be more or less unchanged from 2004. However, the drop in supply caused by the shutdown of Finnish mills in May–June has meant a reduction in producers’ and customers’ stocks, and the situation also brought the opportunity for price increases. The average prices of Finnish pulp and paperboard exports in 2005 are likely to be close to the 2004 level. On account of the mill shutdowns, Finnish production and exports of paper, paperboard and pulp for 2005 as a whole will be down by about 10% on the previous year’s figures.

In 2006, the growth in private consumption in Western Europe will lead to a slight increase in advertising and thus in the demand for paper. However, there will also be a modest increase in capacity within the paper industry, and so the oversupply on the European market will continue almost unchanged. To reduce oversupply, deliveries to markets outside Europe will probably increase further. The rise in costs will generate pressure on prices and may well prevent them from returning to a downward track. Finnish pulp and paper industry production and exports will be up considerably in 2006 in comparison with the exceptionally low figures for 2005. In comparison with 2004, production and exports of paper and paperboard are forecast to be up by about 3% in 2006, and the percentage increase in pulp exports will be even greater. Prices are forecast to remain at the 2005 level on average, or to rise slightly.

**Drop in Finnish Sawnwood Production, and Oversupply Pushes Prices Down**

The demand for sawnwood in Europe has been less active than in the rest of the world, and producers have felt the effects of the weak price trend caused by oversupply. Finnish exports have decreased to many of the traditional European export markets, and the average export price has fallen, too. The drop in exports has also been due to the decrease in production resulting from the paper industry shutdowns. Exports in 2005 are expected to be about 6% lower than in 2004, and production will be down to about 12.5 mill. m³.

In 2006, any increase in Finnish sawnwood exports to the European market will be linked to growth in Europe’s housing renovation sector. The European market will again be troubled by overcapacity, because sawnwood supply from Russia will increase and capacity expansion plans in Central Europe will come to fruition. A slight decrease is again forecast in Finnish sawnwood export prices. With only minor growth expected in Finland’s domestic sawnwood consumption in 2006, and exports remaining at the 2005 level, there will be only a small increase in production in the sawmilling industry, keeping the total near to the 2005 figure.

**Profitability Up in the Paper Industry but Still Weak in Sawmilling in 2006**

Profitability in the Finnish forest industry in 2005 has been affected by higher prices of production inputs, falling sales and a weak price trend. The prices of end products in the pulp and paper industry have remained almost unchanged in annual terms and have fallen slightly in the sawmilling industry.

In 2006, profitability in the pulp and paper industry will improve considerably, as production and exports increase to new records. Profitability will be boosted by higher turnover, even though prices are not forecast to rise very much. In the sawmill-
ing industry, the tough competition on the export markets will also continue in 2006, and production and export volumes will be at approximately their 2005 levels. Profitability in the sawmilling industry will remain weak, as sawnwood prices are expected to fall slightly again.

**Higher Imports Will Keep Domestic Pulpwood Price Rises in Check**

Roundwood consumption in the Finnish forest industry will be down in 2005 on account of the production shutdowns. Despite this, roundwood imports for the year will be higher than expected, and will account for a record one quarter of all roundwood consumption in the forest industry. Commercial fellings in 2005 will be down to 50.9 mill. m³ from the previous year’s 55.1 mill. m³, because of the drop in roundwood consumption and the increase in imports.

Increased production in the paper industry in 2006 will mean an increase in the industry’s roundwood consumption. An estimated two thirds of the additional demand for roundwood will be met from commercial fellings in Finland, which will rise to almost 53 mill. m³, and one third will be from imports of roundwood and wood chips, which will increase to nearly 21 mill. m³. The growth in imports will limit the extent to which domestic roundwood prices can be raised. The price of pulpwood will also be affected by various stand-specific factors, because the emphasis in fellings will shift further towards pulpwood and thinnings. Stumpage prices for pulpwood will rise slightly, but softwood sawlog prices will be at their 2005 level, because sawlog demand in the sawmilling industry will change little.

**Further Decline in State Subsidies for Timber Production**

Overall investment in timber production in non-industrial private forestry in 2005 will be down to less than EUR 175 mill. but will increase somewhat in 2006, partly because of an increase in artificial regeneration. The amount of financing provided by the forest owners themselves will be up in 2005, but state subsidies for timber production in non-industrial private forestry will down for the third successive year; the decrease in 2005 is more than 5%. In 2006, state subsidies of approximately EUR 60 mill. will be allocated for ensuring that timber production in non-industrial private forestry remains sustainable.

Stumpage earnings in non-industrial private forestry will be down to about EUR 1.4 billion for 2005, due to the reduction in fellings, but will rise by 2–3% in 2006. Net stumpage earnings per hectare in 2005 will be down by 8%, to EUR 88/ha, as a result of the reduced fellings. An increase in fellings in 2006 will raise net stumpage earnings to almost EUR 90/ha, although this, too, will be significantly below the peak years of the forest taxation transition period. The investment return on forest ownership will increase to over 4% in 2006, due to a slight rise in stumpage prices.

**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 2005 and 2006 and are based mainly on information available in late September and early October 2005.

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 main uncertainties in the growth forecasts for the world economy are the price of crude oil and the performance of the United States economy. 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. Although the structure of national economies and their ability to withstand energy price increases have improved since the 1970s oil crises, a rise in oil prices to over USD 50/barrel would reduce household purchasing power in real terms and encourage general uncertainty about the world 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 prevailing oversupply, forcing down prices. If there is an unforeseen weakening of the US dollar against the euro, this would hamper European export prospects and add supplies from countries outside Europe. The demand-supply balance on the European market could also change as a result of storm damage occurring in Europe or elsewhere in the world, and the effects would be felt quickly through today’s international trade. However, the overall impact of the storm damage in the Baltic Sea region in the early part of 2005 on the supply situation in the European sawnwood market will probably turn out to be relatively small, as seems to be the case for the demand impact of Hurricane Katrina.

If the GDP 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.

### Key forecasting variables, 2005–2006

<table>
<thead>
<tr>
<th>Forecasting variables</th>
<th>2005*</th>
<th>2006*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% change from previous year</td>
<td></td>
</tr>
<tr>
<td>Sawnwood production</td>
<td>−7</td>
<td>1</td>
</tr>
<tr>
<td>Paper production</td>
<td>−11</td>
<td>16</td>
</tr>
<tr>
<td>Sawnwood export price</td>
<td>−2</td>
<td>−2</td>
</tr>
<tr>
<td>Paper export price</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Commercial fellings</td>
<td>−7</td>
<td>4</td>
</tr>
<tr>
<td>Roundwood imports</td>
<td>11</td>
<td>8</td>
</tr>
<tr>
<td>Sawlog prices</td>
<td>−4</td>
<td>0 - 2</td>
</tr>
<tr>
<td>Pulpwood prices</td>
<td>0 - 1</td>
<td>1 - 2</td>
</tr>
</tbody>
</table>

*estimate based on forecasts