



Summary

Strong GDP growth in Europe during 2007 has boosted housing construction and thus the demand for sawnwood, and has also increased the consumption of certain paper grades. The unusually large increase in the export price of sawn softwood has also pushed up stumpage prices for softwood sawlogs by a considerable amount. By contrast, pulpwood prices have risen more modestly, and the trend in paper export prices on the European market has remained weak on account of oversupply. Improved profitability in the Finnish sawmilling industry has led to higher production volumes in the first half of the year, whereas in the paper industry, production increases have been kept in check by the rise in production costs and the weak trend in export prices. Commercial fellings for the full year will rise to a new record level as a result of increased production in the forest industry and a reduction in roundwood imports from Russia. The operating profit on timber production in non-industrial private forestry will also reach a record high.

In 2008, GDP growth on the forest industry's export markets will slow down a little, and housing production in the euro area will decrease on account of higher interest rates. Tougher competition will already be evident on the sawnwood market before the end of 2007, and oversupply will curtail the rise in sawnwood prices in Europe. High roundwood costs and falling export prices for sawnwood will contribute to poorer profitability in Finland's sawnwood production, which will lead to lower production levels. In the paper industry, the rise in roundwood and other costs is expected to finally

push up paper export prices. The drop in sawnwood production and prices will mean that stumpage prices for softwood sawlogs will start to fall, but only gently because domestic sawlog demand will remain high as a result of the poorer import opportunities. With a slight increase in paper production and a strengthening of export prices, pulpwood harvesting will be up and prices will rise.

The two main uncertainties surrounding the forecasts are, firstly, the possibility that the financial crisis which began in the US housing market will affect the rest of the economy and spread around the world, and, secondly, the extent to which the euro may strengthen. A further uncertainty in the euro area concerns the interest rate policy to be followed by the European Central Bank in the next few months, and specifically its affect on housing production. In Finland, there is also uncertainty in regard to the outcome of the forest sector's collective agreement negotiations.

Export Market GDP Growth Slowing Down Slightly

Although GDP growth in the world economy for the full year 2007 will be slightly lower than in 2006, it is nevertheless exceptionally high. The current upswing has been in progress for some time, and the focus on the emerging economies of Asia and Eastern Europe has become stronger during 2007.

Real GDP growth in the world economy weighted according to the distribution of Finnish forest industry exports will be 3.6% in 2007 and 3.4% in 2008. Euro area GDP growth has slowed and this will continue in 2008, but nevertheless remaining above the long-term growth trend. The growth is derived particularly from an increase in private consumer demand and investment, because export competitiveness is being weakened by the strong euro and rising costs. Germany, which is driving the euro area economy, is on a slightly faster growth track than the euro area average, as is the case for the United Kingdom economy.

The rise in interest rates has begun to retard housing construction in the euro area, and uncertainty regarding monetary policy actions in relation to GDP growth has also increased elsewhere in the world. In the United States, interest rates have already been cut with the aim of reviving the economy following a downturn in the housing market, and further interest rate cuts are possible before the end of 2007 and in 2008. Although expectations regarding world GDP growth are still positive, the uncertainty surrounding this has increased during 2007. There is considerable uncertainty, for instance, concerning the price trend in crude oil and other raw materials. It is possible, too, that the financial crisis which began on the US housing market could affect the rest of the economy and spread to other parts of the world. This is the principal uncertainty surrounding current economic forecasts. In the euro area, an additional uncertainty is the interest rate policy to be pursued by the European Central Bank over the next few months.

Upturn in Sawnwood Prices Tailing Off

The strong demand for sawnwood and the periodic scarcity of sawnwood due to fluctuations in supply have together led to an unusually large increase in sawnwood prices in Europe. In the first half of 2007, the unit value of Finnish sawnwood exports rose to its highest level in real terms since 1997. The second half of the year will, however, see a downward pressure on the market price of sawnwood because of its

plentiful supply. A major factor in this oversupply will be the slackening growth in housing production that is forecast for Western Europe, and this will keep rising prices in check. The unit price of Finnish sawnwood exports for the full year 2007 will nevertheless be about 20% higher than in 2006. Sawnwood production is expected to be up in 2007 by almost 6%, particularly as a result of strong domestic demand, although export volumes will be close to the 2006 level.

In 2008, the forecast decrease in housing construction in many Western European countries will reduce sawnwood demand and lead to tougher competition on the forest industry's European export markets. As a consequence, a drop in sawnwood prices is anticipated, with the unit price of Finnish sawnwood exports expected to be about 4% below the average price for 2007. The expected drop in prices will nevertheless be moderate in comparison with previous cycles, in which a strong price rise has been quickly followed by a sharp and deep fall. The reason for expecting only a moderate drop in prices is the assumption that an increase in building renovations will partially compensate for the reduced demand for new construction, and that high raw material prices will start to act as a minor restraining factor on sawnwood production in Western Europe. In Finland, sawnwood demand will be down a little in 2008, leading to lower sawnwood production, though the production total will still be higher than in 2006.

Opportunity for Price Rises Still Awaited in the Paper Industry

On account of the strong GDP growth in 2007, total paper consumption in Europe is up slightly, though there has been a drop in the demand for uncoated magazine paper. Despite the fact that paper prices have been rising gently since 2006, the price trend for Finnish paper exports has been very modest due to oversupply on the market. With low paper prices prevailing, the rise in costs in 2007 has reduced profitability in the Finnish paper industry. Export

prices have climbed slightly in recent months, but for 2007 as a whole the average price of all paper exports is expected to be 1% below the previous year's figure.

In 2008, GDP growth in Western Europe is forecast to remain relatively strong and the right conditions for an increase in demand should be in place. This increase in demand, coupled with the fact that raw material costs will be higher, should mean that producers will increase prices. This will be essential for any growth in production and exports. The potential for raising prices may well be reinforced by the fact that raw material costs have risen in other countries, too. In addition, efforts have been made to reduce the oversupply on the European market through a number of production unit closures. In 2008, the average price of paper and paperboard exports is forecast to be on a growth track, pushed up by costs, resulting in average prices 2% higher than in 2007. Factors that could threaten the materialisation of these forecasts are the uncertainty over the level of growth in the world economy and the strength of the euro.

Two-Track Profitability Trend in the Forest Industry

The profitability trend in 2007 differs considerably from one sector of the Finnish forest industry to another. In the wood products industry, for example, strong demand and higher prices for wood products, especially sawnwood, have improved the sector's profitability significantly, even though production costs have also risen. By contrast, profitability in the pulp and paper industry has weakened a little compared with 2006, due to the rise in production costs and the weak price trend in certain paper grades, particularly magazine papers. Efficiency improvement measures are currently being taken in the sector with the aim of improving profitability.

Proportionately the biggest rise in the forest industry's costs in 2007 has been in roundwood costs. These costs have risen because of the strong increase in stumpage prices, though the impact of

stumpage prices on roundwood costs and hence the forest industry's profitability is not immediate but involves a time lag. In addition to the impact of higher roundwood costs, profitability in the wood products industry in the second half of 2007 will be weakened by the slight decline in export prices. Sawlog prices will also remain high in 2008. The increase in roundwood costs will also contribute to poorer profitability in the pulp and paper industry, although the prices of other raw materials, especially crude oil, are more significant in relative terms, both directly and indirectly. The reduction in roundwood imports has boosted the demand for domestic roundwood and focused attention on an issue of key importance for the profitability of the Finnish forest industry, namely the need to ensure a sufficient supply of wood at a competitive price.

Domestic Roundwood Demand Increases as Imports Fall

During 2007, the impact of a strong rise in sawn softwood prices has been felt in the prices of pine and spruce sawlogs, which have increased dramatically. Stumpage prices have reached their highest levels since the 1973 oil crisis. The unusually rapid rise in sawlog prices is attributable in particular to the increased production of sawnwood, the reduction in sawlog imports and the poor winter harvesting weather that restricted the availability of roundwood. The stumpage price of softwood sawlogs for the full year 2007 is expected to exceed the previous year's average by almost 40%. Birch sawlog stumpage prices have risen considerably less quickly than those for softwood sawlogs, due to the more moderate price trend on the plywood market. The rise in pulpwood prices has been kept in check by the very modest price trend on the paper market, though the pulpwood stumpage price is nevertheless expected to be up by 12–25% on the 2006 average. Commercial fellings will rise to a new record level on account of the production growth in the forest industry and the fall in roundwood imports. The increase on the previous year is forecast to be 15%, bringing com-

mercial fellings to an unprecedented 59 mill. m³. Imports of roundwood are forecast to be down by about 10%.

In 2008, the anticipated drop in sawnwood production and prices will lead to a gradual decrease in sawlog demand and sawlog prices, as supply from non-industrial private forests will also fall slightly. Despite the declining price trend for softwood sawlogs, the average price for the year is forecast to be only a little below the 2007 figure. With plywood production remaining high, birch sawlog demand and stumpage prices are forecast to be up on the previous year by an average of 3%. The drop in sawnwood production will reduce sawlog harvesting, but pulpwood harvesting will be up because of the small increase in paper production.

Russia's export duties on its roundwood are expected to mean a moderate reduction in Finland's roundwood imports in 2008. The average pulpwood price for the year is forecast to exceed the 2007 figure by 7–10%. With a decrease in sawlog harvesting and an increase in the pulpwood harvest, the total volume of commercial fellings is forecast to be at about the level of 2007.

Non-Industrial Private Forestry: Record Operating Profit but Only a Small Increase in Investment

In both 2007 and 2008, the rise in stumpage prices will push annual stumpage earnings in non-industrial private forestry to a record EUR 2 billion. At the same time, operating profit (previously termed 'net earnings') will climb to almost EUR 140/ha. Despite the huge rise in stumpage earnings, to a level some 50% higher than in 2006, this has not resulted in a major increase in investment in timber production in non-industrial private forestry, although there is a continuous increase in investment nonetheless. Though the current emphasis in public funding is on the tending of young stands and harvesting of energy wood, the goals set out in the revised National Forest Programme include increasing support for silvicultural and forest-improvement works. Through this, the aim is to be able to increase domestic fellings

as roundwood imports decrease, especially in the longer term. Total investment in timber production will be up in 2007 to EUR 190 mill., and in 2008 to about EUR 195 mill.

Assumptions and Uncertainties in Forecasting

The aim of this *Economic Outlook* is to present clear and consistent information and analysis on the current state of the entire Finnish forest sector and the outlook for the sector in the near future. The forest sector forecasts are based on publicly available statistics, world economic forecasts, market information and other forest sector data from different sources, 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 based mainly on forest sector information available in late September and early October 2007 and world economic forecasts for 2007 and 2008.

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. The greatest uncertainty in the forecasts is that unexpected changes in GDP growth may occur. A key uncertainty regarding world GDP growth is once again the performance of the United States economy, and there is also uncertainty in Europe concerning the interest rate policy to be pursued by the European Central Bank and its effect on housing construction and therefore sawnwood demand. Environmental factors and environmental policy are also becoming ever more important considerations in economic growth. In 2007, the potential impact of changes in the weather has been very evident, having seen how quickly this can affect the economy and especially raw material

markets. The price of crude oil, for example, has been affected not only by supply disturbances but also weather conditions. The drop in the world price of crude oil at the start of 2007 was the result of an exceptionally warm early winter in the United States, which considerably reduced the demand for heating oil. In Europe, the exceptionally mild winter increased housing construction but hampered roundwood harvesting, reducing supplies and contributing to the strong rise in sawnwood and sawlog prices. The same could happen in roundwood markets in winter 2007/2008. The spring 2008 expiry of the paper industry's collective agreement is also a cause for uncertainty.

If GDP growth and housing construction in the main export markets in Europe fall below the forecast levels, the demand for forest industry products will also be lower than forecast. This would add to the prevailing oversupply in Europe, which would lead to an unexpectedly strong decline in sawnwood prices and would also depress paper prices. If the US dollar were to weaken significantly more than expected against the euro, this would hamper exports from Europe and add to the pressure to source supplies of forest industry products from countries outside Europe.

If GDP growth were to fall short of the forecasts, this would also 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, 2007–2008.

Forecasting variables	2007*	2008*
	% change from previous year	
Sawnwood production	6	–4
Sawnwood export	0	–4
Sawnwood export price	22	–4
Paper production	2	2
Paper export	2	2
Paper export price	–1	2
Commercial fellings	15	0
Roundwood imports	–11	–1
Softwood sawlog prices	35–36	–1
Birch sawlog prices	10	3
Pulpwood prices	12–25	7–10

**price changes are nominal*