



## Summary

*The demand for Finnish forest industry products in 2008 has been adversely affected by the slowdown in euro area GDP growth, the drop in housing construction, the high level of interest rates and the uncertainties on the financial markets. Sawnwood production and sawnwood export volumes and prices are down in 2008 by about one fifth on the figures for 2007, which was a boom year in the sawmilling industry. Production and exports in the paper industry are also down in 2008. Despite capacity closures, Europe's paper market is still experiencing oversupply, which is evident in the weak price trend for end products and in poor profitability. With the drop in production volumes, the Finnish forest industry's roundwood consumption in 2008 is down on the previous year's total, which is also the case for the volume of domestic commercial fellings, the level of stumpage earnings and forest industry employment. Nominal stumpage prices of softwood sawlogs will also be lower than the record levels of 2007. Pine pulpwood stumpage prices have risen due to growth in demand as declining volumes of sawmill chips are partially replaced with pulpwood. Roundwood imports remain high in 2008, and preparations are being made for Russia's roundwood export duty increases at the start of 2009. The Finnish government's decision to reduce the roundwood sales tax will boost the domestic supply of roundwood.*

*Forest industry production and exports in 2009 will be down further as GDP growth declines on the main export markets. Sawnwood prices are nevertheless expected to be up slightly in the latter half of the year as Russia's export duties adversely affect the global availability of sawlogs. Paper prices are forecast to remain at their 2008 levels due to the capacity cuts,*

*despite any decrease in demand in Europe. The industry's consumption of roundwood will fall further as production decreases, but domestic commercial fellings will be up as roundwood imports shrink to almost half of their 2008 levels. If the economy was booming, such a reduction in imports would push up the price of domestic roundwood. However, with the forest industry's market faltering, the nominal stumpage prices of softwood sawlogs will be down again slightly in 2009, and pine and birch pulpwood stumpage prices will be close to the 2008 average.*

*The principal uncertainty in the forecasts for the Finnish forest sector is the possibility that the state of the economy on export markets and domestically could deteriorate, which would reduce the demand for forest industry products and their prices and would also weaken the profitability of production.*

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### Considerable Slowdown in GDP Growth on the Finnish Forest Industry's Export Markets

Real growth in the world economy weighted according to the distribution of Finnish forest industry exports will slow to 2.6% for the full year 2008, and will slow further in 2009. GDP growth in Germany, the United Kingdom and Japan, which are the main export markets for the Finnish forest industry, is down considerably on the 2007 figures. Growth in the economies of Sweden and Canada – both forest industry competitors for Finland – has also fallen. Rising costs, higher interest rates, fading demand in export markets and the uncertainties in the

housing and financial markets have all served to slow GDP growth in the euro area to about 1.5% during 2008, and will slow growth in 2009 to even less than 0.5%. German GDP growth will be up by about 1.5% in 2008, but in 2009 the German economy could experience zero growth. In the UK economy, the growth figure for 2008 will be about 1% and could even be negative in 2009. GDP growth in Russia and China will slow a little on the 2007 figures, but will nevertheless continue to be significantly higher than elsewhere in the world in both 2008 and 2009. In the United States, the economy has slowed in 2008 and growth may even come to a standstill in 2009. By contrast, GDP growth in North Africa and the Middle East is forecast to continue. The forecasts for the Finnish economy indicate that GDP growth will remain above the euro-area average, but slower export growth in 2008 will mean a drop in GDP growth to 2.5% for the year, and to about 1.5% in 2009.

#### Weak Outlook for Sawnwood Market

The slump in the US housing market and the uncertainty on financial markets were already being felt in Europe in the first half of 2008, with a considerable weakening in sawnwood demand and prices as housing construction declined. Sawnwood demand on the Finnish market has also been affected by the fall in housing construction. Production limits are nevertheless expected to reduce producers' sawnwood stocks in Europe in the second half of 2008, which will curtail the fall in prices. The nominal average export price of Finnish sawnwood for the full year 2008 is expected to be down by about one fifth, and both production and exports are expected to be down by a similar extent.

Sawnwood consumption in the euro area in 2009 is expected to be decrease further as housing construction declines, and so Finnish sawnwood production and exports will again be down slightly. Production costs will remain high, and this is likely to continue to limit sawnwood production in Europe, thus reducing oversupply on the European market. The absence of Russian roundwood on the world market could also reduce the oversupply,

leading to an upsurge in sawnwood prices in Europe in the latter half of 2009. China and Japan, both major importers of Russian roundwood, may meet some of their roundwood needs by importing more processed and converted products, such as sawnwood. However, no significant rise in sawnwood prices can be expected before a revival in Europe's construction sector. The average export price of Finnish sawnwood in 2009 is expected to be below the average for 2008. The cyclical trend on the plywood market has been less dramatic than on the sawnwood market. The average unit price of plywood exports will be up in 2008 by about 6% on the 2007 figure, due principally to the upward price trend for birch plywood. The volume of Finnish plywood exports will be down in 2008 in comparison with the previous year, because of the curtailed growth in plywood consumption on the Western European market as a result of the trend in the construction sector. In 2009, plywood consumption in Western Europe is expected to decline further, which will in turn reduce the volume and price of softwood plywood exports.

#### Paper Exports Down

Paper industry capacity has been closed in Finland and elsewhere in Europe as a result of the protracted period of oversupply and the weak trend in prices. Despite this, new mills have come on stream in Europe and the sector is still affected by oversupply. The significant reduction in GDP growth and the attendant weakening in the demand for paper have led Finnish forest industry corporations to announce further closures of production facilities and machines during autumn 2008, to take effect at the end of 2008 and in 2009. With substantial cuts in production capacity, Finland's production and exports of paper are expected to be down by about 6% for the full year 2008, and production and exports of paperboard by about 2%, compared with the previous year's figures. Although export prices of paper and paperboard in the first half of 2008 have risen a little, the average nominal price for the whole of 2008 will be about the same as in 2007 because of the weaker demand.

The declining GDP growth in export markets will reduce the demand for paper in 2009. With the forest industry making further cuts in its production capacity in Finland, production and exports of paper and paperboard will be down in 2009. Production and exports of paper are forecast to be down by about 4%, and paperboard by about 3%. Although considerable cuts are being made in the capacity of Europe's paper industry, it may be difficult to raise prices because of the lower demand. Nominal average export prices of Finnish paper and paperboard in 2009 are forecast to remain at around their 2008 levels.

### Decrease in Industry's Roundwood Consumption and Fall in Stumpage Prices

In 2005–2007, the Finnish forest industry used an average of 73 mill. m<sup>3</sup> of roundwood annually, of which about 55 mill. m<sup>3</sup> was domestic roundwood. The industry's roundwood use will be down in both 2008 and 2009. Total commercial fellings in 2008 will be down to 51 mill. m<sup>3</sup> as a result of the reduction in sawnwood and paper production. Commercial fellings in non-industrial private forests will be down by 13%, whereas fellings in company-owned forests and in forests owned by the state enterprise Metsähallitus will be down by about 5%. Imports of roundwood are expected to be up on the 2007 total, to just over 18 mill. m<sup>3</sup>. Despite the reduction in fellings, stocks of harvested wood are up considerably.

The rapid drop in the demand for sawnwood already had a downward effect on the stumpage prices of softwood sawlogs in 2007. The drop in sawnwood production will also mean a reduction in softwood sawlog demand for the full year 2008, and the nominal stumpage prices of softwood sawlogs are expected to be some 12–15% below the average for 2007. By contrast, the stumpage price of birch sawlogs will be up by several per cent due to the favourable state of the market for birch plywood and the scarcity of birch sawlogs. The stumpage prices of pine and birch pulpwood are rising slightly, and delivery sale prices significantly, because pulp demand and export prices were up in the

first half of 2008 on the previous year's level. Pulpwood prices will also be affected by the drop in sawmilling production, as this means that the reduced volume of sawmill chips will be partially replaced by pulpwood removals.

Total commercial fellings in 2009 will be up a little, even though the forest industry's production will be lower than in 2008. The need for Finnish roundwood will nevertheless remain high, because the increase in Russia's roundwood export duties will bring an end to Finnish imports of Russian roundwood, with the exception of birch pulpwood and wood chips. The Finnish government's decision to introduce tax relief on roundwood sales revenue is expected to boost the supply of domestic roundwood. As sawnwood production decreases, the nominal stumpage prices of softwood sawlogs are likely to continue to decline a little, whereas the stumpage price of birch sawlogs is expected to remain at the 2008 level. Although birch plywood production is expected to decrease, the demand for domestic birch sawlogs will be up because of the almost complete cessation of imports. Stumpage prices of softwood pulpwood will remain at close to their 2008 levels, as the reduced volumes of Finnish sawmill chips will be replaced in the paper industry with domestic pulpwood. The stumpage price of birch pulpwood is expected to be up by about 5%. The total volume of roundwood imported from all sources is forecast to be down in 2009 by at least 40%, to about 11 mill. m<sup>3</sup>.

### Forest Industry's Profitability Declining

The profitability trend in the Finnish forest industry has turned onto a downward track during 2008. Among the various subsectors, the greatest deterioration in profitability is in the wood products industry. This is especially due to the disparity between the price trends for sawnwood and wood raw material. With the continuing fall in sawnwood prices, the decrease in domestic sawlog prices has levelled off and imported sawlogs have risen significantly in price. No real relief is expected for the profitability trend in the wood products industry until at least 2010, when construction activity is likely

to pick up on both the Finnish market and export markets.

In the pulp and paper industry, profitability for the full year 2008 will only be down slightly on the 2007 level, despite the trend in product prices being weaker than anticipated. Contributory factors in this are the production cuts and cost-saving measures aimed at raising profitability, the result of which is a gradual reduction in Europe's oversupply of paper grades that have been the subject of capacity cuts. The stronger US dollar has also improved the sector's competitiveness and profitability. The continuing deterioration in the economic outlook and the fall in demand are, however, jeopardising the prospects of successfully raising export prices of paper, which is essential for profitability. Thus no significant improvement is expected in the pulp and paper industry's profitability in 2009.

Russia's decisions on its roundwood export duties will have a significant impact on the operating environment of the Finnish forest industry in 2009. Imposition of the duty increases will lead to considerable changes in the Finnish forest industry's roundwood procurement. Finding alternative raw material sources may prove difficult and so further cuts in production capacity are likely. However, the almost complete cessation of Russian roundwood exports, especially softwood sawlogs, will hamper raw material availability not only in Finland but in many other European countries too, and particularly also in China and Japan. This will reduce the world supply of sawnwood and could raise sawnwood prices on export markets by more than expected. This would have a favourable impact on the profitability of the Finnish wood products industry, which would be felt during 2009. However, for the Finnish-based pulp and paper industry, the effect of Russia's roundwood export duties will be purely negative.

### Stumpage Earnings Down but Investment in Non-Industrial Private Forestry Up

Total investment in timber production in Finnish non-industrial private forestry for the full year 2008 will rise to over EUR 200 mill., which represents more than 13% of stumpage earnings.

As a result of the increase in the surface area for forest regeneration, total investment in 2009 will already reach about EUR 210 million, of which almost one third will be financed using the support available for financing sustainable forestry. By contrast, stumpage earnings in 2008 will be about 25% below the record level of 2007, falling to less than EUR 1.6 billion. In 2009, stumpage earnings will be down slightly on the 2008 figure. The decrease in activity on the sawnwood market is clearly visible in the figure for operating profit in non-industrial private forestry, which will be down on the peak level reached in 2007, to below EUR 100/ha in both 2008 and 2009. Due to the drop in stumpage prices, the real return on assets in timber production will be about minus 10% in 2008.

### Assumptions and Uncertainties in Forecasting

The aim of this *Economic Outlook* is to provide information 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 forecasts presented here are based on the principle of derived demand, according to which fluctuations in GDP growth on the domestic and export markets will, via demand, be reflected in forest industry production and thus the domestic roundwood market. Changes in the forest sector's operating environment, such as Russia's export duties and the Finnish government's economic policy measures, are taken into account in making the forecasts. If GDP growth turns out to be below the level forecast, this would mean that export prices, production and profitability for the Finnish forest industry will be lower than indicated in the forecasts given here. 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.

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 2008 and world economic forecasts for 2008 and 2009. 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 in export markets. At the time of writing there are a number of uncertainties and risks concerning economic growth, the most prominent of which are the possible deepening of the financial crisis that originated in the United States to become a credit crisis, and the prospect that inflation rates may remain high. Such a credit crisis would compound the general economic uncertainty and would ensure that interest rates remain high and that investment financing and private consumption face a difficult period. If

Key forecasting variables, 2007–2009.

| Forecasting variables | 2007                        | 2008 | 2009 |
|-----------------------|-----------------------------|------|------|
|                       | % change from previous year |      |      |
| Sawnwood production   | 2                           | -20  | -1   |
| Sawnwood export       | -8                          | -18  | -3   |
| Sawnwood export price | 23                          | -18  | -3   |
| Paper production      | 1                           | -6   | -4   |
| Paper export          | 1                           | -6   | -4   |
| Paper export price    | -2                          | 1    | 0    |
| Commercial fellings   | 13                          | -12  | 1    |
| Roundwood imports     | -9                          | 4    | -40  |
| Sawlog prices         |                             |      |      |
| Pine                  | 34                          | -12  | -5   |
| Spruce                | 33                          | -15  | -4   |
| Birch                 | 10                          | 3    | 0    |
| Pulpwood prices       |                             |      |      |
| Pine                  | 23                          | 2    | -1   |
| Spruce                | 11                          | -9   | -1   |
| Birch                 | 21                          | 2    | 6    |

Price changes are nominal

inflation were to remain above the target level of about 2% set by the European Central Bank, this would keep central and market interest rates high and would delay the recovery in the euro area's housing market and its economies. The weather and harvesting conditions in winter 2008/09 will also affect the extent to which roundwood procurement can rely on domestic sources to replace Russian imports.

## NOTE

The forecasts used in this Outlook report were made on the assumption that Russia will impose substantial increases in its roundwood export duties as of 1 January 2009 (see p. 34). However, on 12 November 2008 it was announced that the export duty increases will be postponed by 9–12 months. The effects of this postponement are likely to be minimal as

the Finnish forest industry has already introduced measures to procure roundwood from alternative sources and is unlikely to make further significant alterations to these arrangements.

At this point, it can be added that the most recent economic forecasts world wide are gloomier than those available in early October when this report was produced.