

Points of VIEW



TRADE IN CHINA or MADE IN CHINA? How will China's future development affect the Canadian forest sector over the next decade?

China's impressive economic growth has helped fan the flames of foreign investment in China. Over the past 20 years, China's economy has grown almost 10 percent annually, according to official Chinese statistics. While many experts express doubts about the accuracy of these figures, few question that China's growth will continue.

Many expect a short-term lag in growth and subsequent job losses, as a result of the potential adjustment of the yuan to international pressures and the need to privatize inefficient state-owned enterprises and banks. Still, several experts feel that China will be able to generate a soft landing for its economy and eventually rebound. The thinking is that China will resume its growth with better fundamentals to play in global markets and a more robust domestic market for its products.

China is Canada's second largest trading partner (after the United States) and both countries endorse the goal of doubling their bilateral trade and investment relationship between 2004 and 2010. This is a significant increase considering that, in 2004, alone two-way trade between the countries was valued at close to \$31 billion.

While current trade between Canada and China is very active, questions remain. Will China's expansion result in lowered imports from, and increased exports to, Canada? Will the real opportunity be in selling goods to China's expanding population or in partnering with China to sell goods to the world, taking advantage of the low cost of labour in that country to become more competitive?

In particular, Canada is interested in whether China's development provides opportunities, or poses a threat, for the Canadian forest sector over the next decade. While China's per capita consumption of wood and paper is still low compared to North American consumption,

it is expected to grow quickly with the country's rapid economic growth and the development of a middle class. Will the Canadian industry be able to benefit from this increasing demand for wood and paper products? Or will the rapidly growing Chinese forest industry meet all of this new demand, or even become a real competitive threat in Canada's traditional forest products export markets?

On the following pages, four Canadian experts on forest products and global markets tackle these questions and present their views. They generally agree that China will continue to require increasing amounts of fibre in the near future to feed its growing forest products sector. Some high-value Canadian wood products may also hold promise, although opportunities are limited. It is clear, however, that China's demand and industrial growth will continue to have a dominating influence on forest products markets over the next 10 years.

Russell E. Taylor

Russell E. Taylor is President of International WOOD Markets Group Inc. He has provided forest industry expertise in the solid wood field to clients in Canada, the United States, New Zealand, Australia, Chile, Brazil, Japan and other countries. He offers strategic advice in areas such as solid wood market investigation, market and business strategy, sawmill and remanufacturing, and engineered wood/panelboard market strategy.



TRADING WITH CHINA LIKELY TO GENERATE LONGER-TERM GAINS FOR CANADA

Mr. Taylor says that, in the short term, China is a limited market for Canadian wood products. "China is much more of a market for Canadian raw materials, such as pulp, industrial lumber and some panels, and even that could change in the near future as China tends to buy mainly on price." In the longer term, Canada is likely to export products that are not currently being sold to China in significant volumes.

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China will continue to require large amounts of fibre to feed its growing wood sector. Mr. Taylor notes that some observers see this as a huge opportunity for Canada. It is unlikely that China's own plantations will meet the demand in the short- and mid-term. Also, China's current imports typically come from countries where illegal logging is rampant. "If international pressures force China to manufacture export products from certified wood, then Canada could offer its certified wood. Still, a very large source of wood—some of it very similar to Canadian wood—can be found much closer to China, in Russia." However, the delivered log and lumber cost from Russia to China is currently very high.

“Chinese middlemen maintain the wood price that comes from these regions at artificially high levels by siphoning off significant mark-ups on Russian log sales,” says Mr. Taylor. However, the Russian and Chinese governments are trying to resolve these issues. So, unless certified wood becomes an absolute necessity for China, Russian logs could help meet much of China’s fibre needs over the next five to 10 years. Considering that China has also been buying plantations around the world, it is clear that Canada will eventually find it more difficult to export fibre to China.

Canada could help Chinese companies on quality control and value-chain management. Still, Mr. Taylor cautions, this opportunity is slowly fading away. World-class Chinese plants, such as the world’s largest door plant, already produce high-quality export products. “Many offshore importers, agents or traders are already working with Chinese companies on quality control through technology transfer. Few Canadian wood importing companies are active in sourcing Chinese products as compared to dozens of American ones.”

Mr. Taylor says that rationalization in the Chinese wood sector could happen in some sub-sectors, such as furniture and flooring, but that its effect may be limited. Any rationalization will likely remove smaller, higher-cost producers, thus having little impact on overall Chinese exports.

He notes that sawmilling in Canada faces no particular threats or opportunities from China’s development, as Canada already has some of the lowest-cost delivered logs and sawmills in the world. “Canada could certainly make some interesting inroads in niche products such as wood roof trusses that are already being used in China. But until China builds houses out of wood, Canada is more likely to export mostly raw materials to China for reprocessing than for end products.”

Mr. Taylor says that China’s incredible growth may result only in small net gains in Canadian commodity product exports. For instance, China could use Canadian logs or lumber



to produce goods that could, in turn, replace similar Canadian products in key markets such as Japan. According to Mr. Taylor, “some products, such as structural lumber, particleboard and OSB [oriented strandboard], could be export growth opportunities for Canadian firms in China. Still, even if China’s industry only meets its own growing needs, it will significantly reduce Canada’s markets in China for these goods.”

For now, says Mr. Taylor, the Chinese finished product exports are likely to have more of an impact in eastern Canada, where more high-value hardwood furniture, flooring and other goods are produced. “Other Canadian commodity sectors, such as softwood and hardwood plywood and even MDF [medium density fibreboard], could also likely feel the impact of planned increased Chinese exports.” In the long term, Mr. Taylor concludes, Canadian firms should consider purchasing strategies centred on a variety of Chinese-manufactured products that fit into their existing product mix and customers in North America.

Ian de la Roche

Ian de la Roche became President and Chief Executive Officer of Forintek Canada Corp. in January 1992. Forintek is Canada’s national wood products research institute. Its mission is to develop scientific and technical knowledge, applications and solutions that will enhance the competitiveness of its members and the Canadian wood products sector. Dr. de la Roche has more than 30 years of experience in research, strategic planning, new technology commercialization and the development of joint research and development ventures with industry, government and universities.



CREATING A MARKET FOR WOOD HOUSING IN CHINA

Dr. de la Roche says that Canada’s brand should stand for certified wood and the knowledge to help other countries build high-quality platform-frame structures. “Finland has been branding for years and there’s no reason to think that Canada cannot do the same.” In fact, Canada has been working hard to create a market for its structural lumber in housing and to sell higher-value products in China instead of simple raw fibre.

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Timber-frame construction in China spans several centuries. However, concrete and mortar have evolved to become the building materials of choice. “Wood has typically been associated with inexpensive housing in China’s rural areas, but as the Chinese have moved around the world they have seen luxurious wood houses. Now, as expatriates return to China, they bring with them this new view of things, which creates a potential market for Canadian structural wood,” says Dr. de la Roche.

Canada identified China as a potential market for platform-frame construction in the early 1990s. In 1996, it established formal relationships and exchange programs with several



Chinese academic and research organizations. “Through these relationships, Canadians joined a working group that was looking to establish Western-style wood building codes in China. This group’s work has paid off as new building and fire codes are now in place.”

Dr. de la Roche adds that once the codes were in place, the next step was to create a demand for wood houses. To do so, he says, “the British Columbia government established a demonstration project in Shanghai called Dream Home Canada, featuring houses built on traditional Western platform-frame construction.” Furthermore, Canada has produced information to help Chinese specifiers gain a better understanding of wood’s environmental benefits, fire retardancy and termite and seismic resistance.

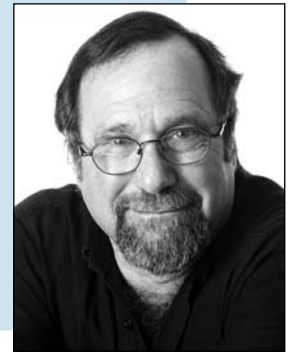
This type of information/demonstration initiative will help position Canada when the demand for housing eventually increases. As the Chinese are saving their money at a much higher rate than Westerners, they will, in time, be in a position to make larger purchases such as houses and cars. Dr. de la Roche comments that “the market will not be for single family dwellings but for less expensive multi family dwellings, made from a combination of materials (wood, steel and concrete). These will provide opportunities for Canadian wood in roof trusses, interior finishing and curtain walls.”

Of course, despite new building codes in China and Korea, it will likely take a few years before wood makes a strong showing in housing starts in those countries. But Dr. de la Roche says that the basic foundation has been put in place to maximize wood’s potential.

Dr. de la Roche points out that another area where Canada could be a leader is in post-disaster housing reconstruction. Over the past few years, major disasters have created a huge need for replacement housing. “An initiative with good potential is the use of houses made of wood and local materials in a prefabricated-type system to speed up reconstruction. In fact, in Indonesia, 11 such houses have been built and there is a potential agreement being considered that would provide another 10 000 units.”

David Cohen

David Cohen is a professor at the University of British Columbia's Faculty of Forestry. He is recognized as a leading researcher in globalization and its impact on the wood sector, with an emphasis on Asia. Since 1989, he has been carrying out research in Japan and China and has provided strategic advice to companies and organizations in Europe, the United States, Canada and New Zealand.



FIBRE, HIGH-END PRODUCTS, STRATEGIC SERVICES ARE CANADA'S BEST OPPORTUNITIES

According to Dr. Cohen, "it's difficult to say whether Canada's forest products sector will benefit or suffer from China's development, as several factors must be weighed. My view is that Canada's best opportunities in China lie in supplying fibre, high-end products and strategic services."

Fibre will definitely continue to be an opportunity for Canada. Dr. Cohen says that it is even possible that China will invest in Canada to acquire that fibre, as it has in other regions of the world. The reason is that most of China's plantations are being used for ecological restoration, not for eventual wood production. "However, 10 to 15 years down the road, China could have extremely efficient plantations of fast-growing species such as genetically modified eucalyptus. Fibre from the Russian Far East will also continue to displace some of the Canadian fibre coming into China."

"Over the next 10 to 15 years, the economy of the world will be determined by how well the Chinese industry is integrated in global markets, so it's important to help them do it right."

With the future in mind, it will be critical for Canadian manufacturers to create a niche for themselves in high-end specialty products, according to Dr. Cohen. China's low labour costs will make that country much more competitive in low-end products. He adds that it remains difficult to sell Canadian structural wood for

houses in China as the population does not currently have the disposable income to make large purchases. Higher-end housing has been built in the recent past and has only led to speculation with no real customer base to support it. "That being said, the Chinese are saving their money at a much higher rate than North Americans. Despite lower salaries, they could, therefore, be in the market for housing down the road, and this could be a future opportunity for Canada."

In Dr. Cohen's view, China's focus on the growth of its Gross Domestic Product has left little consideration for the basic business performance of firms in terms of profitability, shareholder value or competitiveness. "In China, there is a basic assumption that supply exists for all increased production. Such basic lack of strategic planning is leading to a growing but unprofitable production of many manufactured wood products."

He adds that current plans for production expansion rarely consider markets—more specifically, the unintended market consequences, such as protectionism, that China’s unbridled expansion could cause.

Given this scenario, Dr. Cohen suggests that there would be an opportunity for Canadian companies to sell strategic marketing and supply-chain management services to help Chinese companies.

Assessing Canada’s opportunities in China is complicated by the difficulty in obtaining strategic business information from China. “Most people working there in positions responsible for the generation of this information basically have sales backgrounds. Canada needs to address that issue,” says Dr. Cohen.

Experts need this information to make strategic decisions, especially since there is little real data about China’s wood industry, such as plantation areas and volumes, as well as imports and exports. Dr. Cohen says, “The words of experts are therefore probably closer to opinions than actual facts.”

Regardless of whether China’s development results in a boom or a bust for Canada, one thing is absolutely clear, says Dr. Cohen: “Over the next 10 to 15 years, the economy of the world will be determined by how well the Chinese industry is integrated in global markets, so it’s important to help them do it right.”



Don Roberts

Don Roberts is Managing Director and Senior Paper and Forest Products Research Analyst with CIBC World Markets Inc. He specializes in international commodity markets, and has collaborated with a number of international forestry organizations to gain a global perspective on the paper and forest products sector. He is consistently ranked by institutional investor surveys as one of the top equity analysts covering the global paper and forest products industry.

PULP IS CANADA’S BEST BET IN CHINA

Mr. Roberts says he has no doubts that China will continue to provide a market for Canadian pulp. “Although Europe remains the largest single consumer of market pulp, Chinese imports have risen by approximately 150 percent over the last five years, with Canada being the largest supplier. There could be an added opportunity for Canada if China decides to invest directly in Canadian mills to upgrade them and produce the fibre it desperately needs.”

According to Mr. Roberts, “Few countries have as strong a mercantile philosophy as China and their forest products sector is no exception. But to maintain this approach, China will require fibre and water, two resources that are not found in sufficient quantity within its

own borders. How China deals with these shortages will ultimately determine how much of an opportunity its development will offer for Canada.”

Currently, China’s main sources of imported virgin fibre are the Russian Far East and Southeast Asia, where illegal logging is widespread. To address the illegal-logging issue, the Chinese government has claimed it supports certified wood, but how this may translate into action remains unclear.

“...if the price of recovered paper rises enough, it could make Canadian virgin fibre even more interesting.” A potential future source of fibre for China lies in its own plantations. However, Mr. Roberts stresses that there is significant uncertainty about China’s plantations as there is a large discrepancy between what is observed on the ground and what government reports is on the ground. “They assert that they will be self-sufficient by 2020 to 2030 but many pundits are skeptical; current plantations are not very successful and growth rates are far below targets.”

China is also a large consumer of recovered paper and will continue to make increasing use of it as a fibre source in the foreseeable future. This rise in consumption will likely cause a global shortage of recovered paper and will eventually drive up the price. According to Mr. Roberts, “if the price of recovered paper rises enough, it could make Canadian virgin fibre even more interesting.”

There is an important link between the issues of water unavailability and fibre scarcity. It has been widely reported that China’s water reserves are low, creating shortages in some parts of the country—not surprising, given that China has eight percent of the world’s freshwater but 22 percent of its population. Mr. Roberts adds that “what people may not realize is that China has many processing plants that consume water very inefficiently, such as non-wood fibre paper mills and older recycled-based mills (85 percent of China’s pulp production is from non-wood fibre). If China decides to close off these water hogs—as much as 25 percent—it could mean a huge need for pulp in the near future.” This would mean that China would need to be a major importer of pulp, which would again offer opportunities for Canada.

Despite fibre and water availability issues, the Chinese have become clear net exporters of paper and allied products. “This is most true in the case of boxboard and the coated grades of paper. However, this may soon be true even for newsprint, due to a 23-percent increase in Chinese capacity in 2006 and a further 17-percent rise next year,” says Mr. Roberts.

Due to the rapid rise in both its consumption and capacity, the Chinese paper and forest products industry will continue to be the fastest growing in the world. Mr. Roberts concludes, “in spite of the inevitable future restructuring of this sector, and the associated reduction in the number of companies, China will continue to dominate the changes in supply and demand in the global paper industry.”