



Annual Economic Review and Outlook for the Canadian Forest Sector: 2005-2006

Policy, Economics, and Industry Branch
Canadian Forest Service
Natural Resources Canada

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Forward

The Canadian Forest Service is pleased to present the second Annual Economic Review and Outlook for the Canadian Forest Sector. This report provides an overview of recent developments in Canada's forest products industry and major markets for our forest products. In addition, we provide a qualitative assessment of the outlook for the industry for the remainder of 2005 and into 2006.

This report was prepared using information available as of March 2005. It was prepared by Brice MacGregor, Debasish Datta, Jim Delaney, Saleem Rahman, and Romain Jacques of the Policy, Economics, and Industry Branch of the Canadian Forest Service under the supervision of Darcie Booth, Director of the Economic Analysis Division. Note that this report only represents the opinions of the authors, and does not represent the opinions of the Government of Canada.

We welcome your feedback and suggestions. If you have any comments, or would like to make suggestions, please contact us by e-mail at: forestecon@nrcan.gc.ca.

Executive Summary

Introduction

This report provides an overview of recent developments in Canada's major markets for forest products and the state of Canada's forest industry. We also describe some of the major factors that will affect the state of the forest industry going forward and provide a qualitative assessment of the outlook for the industry's performance over the remainder of 2005 and into 2006. The remainder of this section provides a brief synopsis of the major conclusions of our report.

Economic Outlook for Major Markets

North America

The United States economy accelerated in 2004, showing even stronger growth than it did in 2003 when it began to recover from recession. The Canadian economy also picked up steam after a weak performance the previous year. While the US Federal Reserve began a series of interest rate increases in mid-2004 with the Bank of Canada following suit later in the year, interest rates in both countries remain at historically low levels in both countries. The low cost of borrowing combined with rising income levels has resulted in a North American housing boom. Investment in new and existing housing increased, reflected by near-record housing starts in 2004 along with rising repair and renovation expenditures.

Strong overall economic conditions in North America contributed to a continued rise in demand for pulp and paper products, pushing prices for many products higher in 2004. The hot housing market also contributed to further increases in demand for wood products, pushing prices to near-record levels by mid-year. However, the continued appreciation of the Canadian dollar versus the US dollar offset some of the gains to Canadian producers of higher prices in US markets. In 2004, the Canadian dollar averaged 77 cents US, up a further 7.5 percent from 2003 levels. Furthermore, the Canadian dollar continued to rise in value as the year progressed breaking the 80-cent mark late in October.

Economic growth is expected to continue in 2005 and 2006, though the pace of growth is expected to slow as economies approach full capacity and monetary authorities raise interest rates to curb any inflationary pressures that arise. This should aid further increases in prices for pulp and paper products. However, rising interest rates will cool housing markets leading to declining wood prices from the extremely high levels seen in 2004. The Canadian dollar also looks to remain strong in the near-term given the likely persistence of the US current account deficit and strong commodity prices.

Japan

Japan, which is Canada's most important offshore export market for forest products, experienced an economic recovery in 2004. This was accompanied by a moderate increase in housing starts in the country, raising demand for both wood products and pulp and paper. However, the long-term prospects for demand growth in forest products are poor due to a number of structural factors. Most important of these are the large and growing public debt and a rapidly aging population. These will hamper Japan's macroeconomic performance and reduce housing construction activity over the next decade and beyond.

China

China's economy continued its rapid expansion in 2004 fuelled by strong investment and, to a lesser extent, growth in consumer demand. The country has increased in importance as a market for Canadian pulp, and now ranks third behind the US and Japan in terms of its total imports of forest products from Canada. This trend is expected to continue, as the economy continues to industrialize, though there are concerns that the economy could be overheating. The Chinese government has implemented a macroeconomic control strategy to curb investment growth to engineer a soft landing for the economy.

Western Europe

The major economies of Western Europe have traditionally been large export markets for Canadian forest products. In 2004, the economic picture in the region was mixed, with some countries performing well, notably the United Kingdom, while others continue to do poorly, such as Germany and France, which are the region's two largest economies. Economic growth will continue to be slow in the near-term due to weak consumer demand in Germany and France, along with a strong Euro and British pound, which will put a drag on growth in the export sector.

Developments in Forest Product Markets

Softwood lumber

US consumption of softwood lumber continued to grow rapidly in 2004, breaking record consumption levels seen in 2003 by a considerable margin. Strong demand was fuelled by the current boom in North American housing markets, which has been supported by low interest rates and rising income levels. As a result of this demand, lumber prices reached near-record levels in mid-2004 before moderating late in the year. Both Canadian and US increased production in response to high prices, though they did not keep pace with the demand levels resulting in a large increase in offshore imports to the US market. As a result, offshore producers increased their market share to 5.2% in 2004, compared to only 3.2% in 2003, while Canada's share declined slightly to 33.5%, down from 34.2%. Despite the small loss in market share, Canadian producers benefited

greatly from high prices and increased volumes, which drove exports C\$3.4 billion (40%) higher for the year.

Wood-based Panels

As with lumber, North American structural panel markets have also benefited from strong demand created by the housing boom. North American consumption of both oriented strandboard (OSB) and plywood increased in 2004, driving up prices by 21% over already high 2003 levels. OSB producers in both countries and plywood producers in Canada increased their production to meet strong demand, though offshore imports also surged led by softwood plywood from Brazil. In 2004, offshore producers made up 38% of total US panel imports (all types), up from 31% in 2003. Despite this increase in competition, Canadian producers continued to increase the value of panel exports, which rose by close to 30% from 2003 levels due to a moderate increase in volume (+6.7%) and the large increase in prices.

Wood Pulp

Demand and prices for wood pulp continued to rebound in 2004, with the price of Northern Bleached Softwood Kraft (NBSK), Canada's most important grade of market pulp, rising by 16.8% from 2003 levels. However, despite increased demand, the volume of Canadian pulp exports was virtually unchanged in 2004, as declines in exports to the US and European Union offset gains in volumes to China. The value of Canadian exports increased by 5.1% in 2004 as a result of higher prices, which more than offset the negative impact of the continued appreciation of the Canadian dollar.

Newsprint

Despite strong economic conditions in the US, newsprint consumption fell in 2004, continuing a long-term secular decline. North American production also fell, with most of the decrease occurring among Canadian producers. Despite falling consumption levels, newsprint prices increased in 2004, rising by 8.8% from 2003 levels. The volume of Canadian newsprint exports fell, due to a large drop in shipments to the US, which more than offset modest gains to other markets. The value of Canadian exports also dropped, as newsprint price gains were not sufficient to offset the declining volume of exports and the higher Canadian dollar.

Graphic Paper

Prices for many grades of graphic paper rose modestly in 2004, though remain well below cyclical peaks seen in 2000 and 2001. The volume of Canadian exports of graphic papers expanded substantially in 2004 (+16%), though the value of exports rose more modestly (11%), as exchange rate movements offset some of the impact of rising volumes and prices.

Forest Sector Employment

In this year's edition of the Annual Economic Review and Outlook, we examined employment developments in a few specific sectors of the forest industry: (1) sawmills and wood preservation, (2) panel and engineered wood product manufacturing, and (3) pulp and paper mills. In 2004, employment in the sawmill industry increased modestly from 2003 levels, with increases in BC and Quebec, but a fall in employment in Ontario. This was a reversal of the last few years which has seen a decline in employment in this industry, with the largest declines (relative to employment) occurring in BC and Ontario. Employment in the production of panels and engineered wood products increased strongly in 2004, with increases concentrated in Quebec and Ontario. This is the continuation of a longer-term trend of increasing employment in this industry, which has grown by 3.7% per year since 1991. In contrast, employment in pulp and paper mills has been declining in Canada over the long-term (-3.2%/year since 1991), though average employment was down only modestly in 2004 compared to 2003. However, when compared to 2001, average employment has fallen substantially (13.4%) with substantial losses in all regions.

Financial Performance

Operating profits for Canada's forest industry rebounded strongly in 2004 following three consecutive years of decline. The return on capital employed (ROCE) also increased in 2004 to 7.6%, though it still remains below the 10% target used as a benchmark by many industry observers. Both increased revenues and lower expenses contributed to improved financial performance. Rising wood product and paper prices contributed to improvements in revenues, though these were partially offset by the continued appreciation of the Canadian dollar vis-à-vis the US dollar. Rationalization in the industry and consolidation brought about through mergers and acquisitions in the last couple of years is cited as a possible factor reducing overall industry expenses although rising wood fibre and energy prices have impacted the industry bottom line on the cost side. In the near-term, wood product prices are expected to decline; pulp and paper prices will continue a gradual rise, while the Canadian dollar will remain strong. Overall, this is expected to have a negative impact on financial performance.

1. Economic Outlook

1.1. Outlook for North America

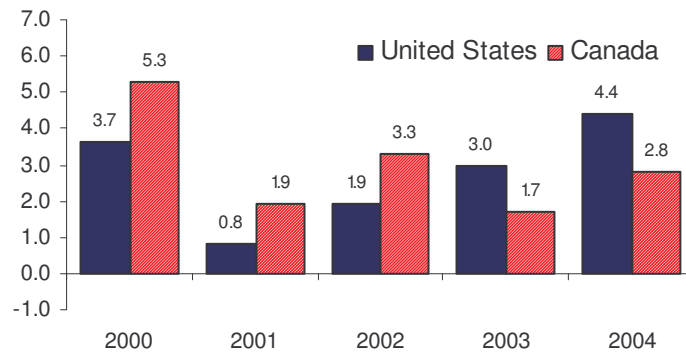
Robust growth spurs the US economy while the Canadian economy shows signs of strengthening...

The US economy moved from recovery in 2003 to expansion in 2004, as real GDP grew by 4.4% (Figure 1.1). This expansion can be partially accredited to favourable borrowing conditions resulting from

low interest rates, driving residential investment and business investment, and from record levels of US federal spending, which grew at an annual rate of 7.3% from 2002-2004 (far exceeding the inflation rate for those years).¹ Improvements in consumer spending also helped foster growth in the economy.^{2,3} An increase in exports, stimulated by a depreciation in the value of the US dollar, was more than offset by an increase in imports due to strong domestic demand for foreign goods, in particular, oil.⁴ However, employment levels continued to rebound due to increased production requirements for the booming economy.^{5,6}

In 2004, the Canadian economy enjoyed a rebound year. Key factors for Canada's economic performance included solid domestic demand, strengthened business investment, and strong export growth in the first half of the year.⁷ High employment and disposable income, as well as favourable credit conditions boosted consumer confidence and thus consumer spending remained strong.⁸ Rising exports due, in part, to China's thirst for resources led the drive in Canada's economic growth in 2004.⁹ Although a sharp rise in the value of the Canadian dollar relative to the US dollar hindered Canadian exports in the second half of the year,¹⁰ overall, Canada's GDP growth reached 2.8%, a significant improvement over the 1.7% growth realized in 2003.

Figure 1.1 Percent Change in Real GDP



Source: Statistics Canada and US Bureau of Economic Analysis

¹ The Heritage Foundation,

² Conference Board of Canada, Canadian Outlook Winter 2005, U.S. Outlook, Page 1

³ Economic Report of the President, Page 18

⁴ Economic Report of the President, Page 36

⁵ Conference Board of Canada, Speed Limit 80 cents, Page 1

⁶ According to the US Department of Labor, Bureau of Labor Statistics, total employment in the US rose by over 2 million in 2004.

⁷ Budget 2005, Page 38, 44 and 45

⁸ Canadian Outlook, Winter 2005, Conference board of Canada, Consumer Expenditures, page 5

⁹ Statistics Canada, The Daily, Study: Canada's economic growth in review, page 1

¹⁰ Budget 2005, Page 45

Low interest rates stimulate economic growth by increasing investment and spending levels...

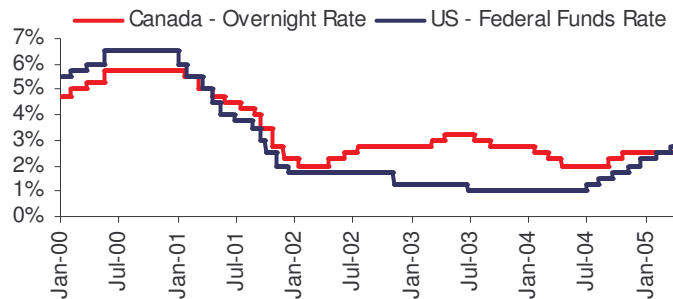
Both the Bank of Canada and the U.S. Federal Reserve raised interest rates in the second half of 2004 (Figure 1.2). The Federal Funds Rate

(FFR), the key indicator of monetary policy in the US, began a gradual upward trend in the second half of 2004 rising from 1.25% to 2.75% realized in March 2005. This reduction in monetary stimulus began in order to keep inflation in check as the US economy was in the midst of expansion.¹¹ Canada began 2004 by lowering its Overnight Rate (OR), the key interest rate in Canadian monetary policy, as the rapid appreciation of the Canadian dollar negatively impacted aggregate demand for Canadian goods.¹² In the second half of 2004, the Bank of Canada began raising its OR as a reduced monetary stimulus was set to curb anticipated inflationary pressures created from stronger than expected aggregate demand in the first half of 2004.¹³ Since October the OR has remained stable as Canada's core inflation remains near its 2% target.

Residential construction at or close to all time highs ...

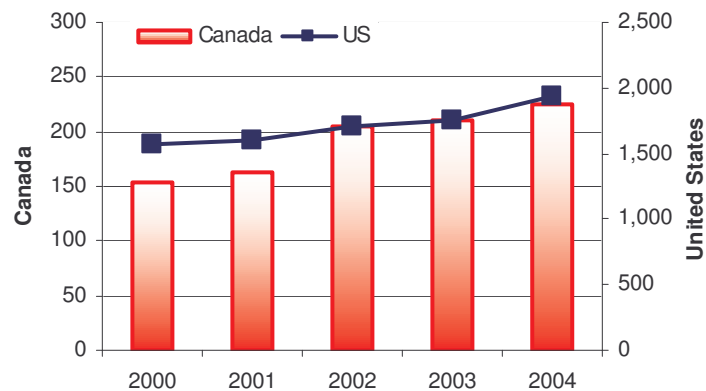
Favourable interest rates in both Canada and the US continue to have a positive impact on housing investment, spurring housing starts to their highest levels since 1987 (for Canada) and 1986 (for the US). Strong employment conditions and high consumer confidence have also boosted demand in the housing market. Figure 1.3 displays the number of housing starts in both Canada and the United States since 2000. This surge in housing starts has strong implications for the forest industry, as residential construction is the most important end use for lumber and wood panels in North America.

Figure 1.2 Key Interest Rates



Source: Bank of Canada and US Federal Reserve

Figure 1.3 Housing Starts (000's units)



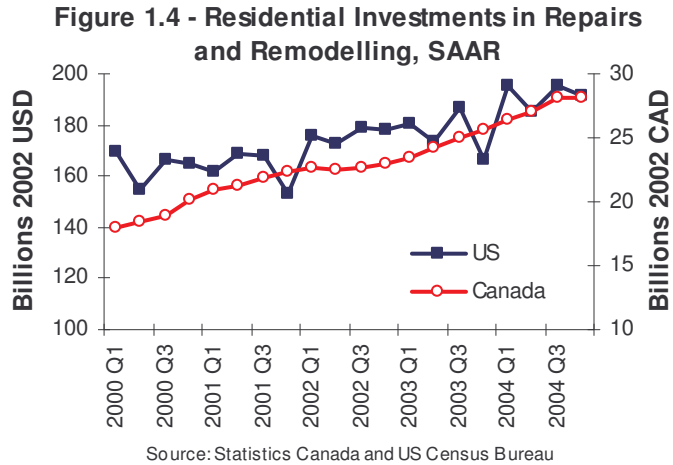
Source: Canada Mortgage & Housing Corporation; US Census Bureau

¹¹ The Federal reserve Board, Monetary Policy report To Congress, section 1, page 1

¹² Bank of Canada, Press Release, January 20, 2004

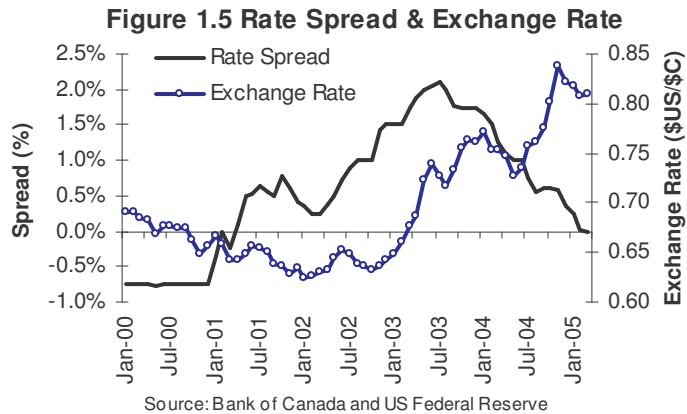
¹³ Bank of Canada, Press Release, September 8, 2004

Historical highs in housing starts were accompanied with a boom in residential investment in repairs and remodelling, which is also an important end use for lumber and wood panels. Quarterly repair and remodelling expenditures in Canada, expressed as a seasonally adjusted annual rate (SAAR), is displayed in Figure 1.4. Residential investment in the US



realized a substantial increase over the previous year having grown by 7.9% in 2004 relative to 2003. Meanwhile, Canada continued with its strong repairs and remodelling expenditure growth realizing an increase of 3.0% in 2004 - part of this increase has been the result of consumers altering their new homes to suit their tastes.

The Canadian dollar continued its dramatic rise in 2004 (Figure 1.5). After decreasing slightly in the early part of the year, the Canadian dollar resumed its appreciation against the US dollar, held up by strong commodity prices.¹⁴ The Canadian dollar averaged 77 cents US in 2004, representing a 7.5 percent



increase over 2003. This followed a 12.4 percent increase from the previous year. These two consecutive increases represent the largest back-to-back gains in the Canada-US exchange rate.¹⁵ The Canada-US exchange rate plays a key role in the financial success of export-oriented industries such as the forest industry. A higher valued Canadian dollar cuts into profits and therefore reduces the competitive advantage.¹⁶ Factors influencing the appreciation of the Canadian dollar include: the US current account deficit, a strong business climate in Canada due to such factors as low interest rates, low and stable inflation, fiscal and current account surpluses, and high commodity prices¹⁷, and the interest rate spread between Canada and the US. Appreciation of the Canadian dollar

¹⁴ Conference board of Canada, Speed Limit 80 cents, Page1

¹⁵ Statistics Canada, The Daily, Study: Canada's Economic Growth in Review, page 1

¹⁶ CIBC World Markets April 22 & Conference Board of Canada, Exports, Inventories Stall Economy, Page1

¹⁷ Conference Board of Canada, Speed Limit: 80 Cents US, Page1

initially reduces the profits realized by exporting firms¹⁸ as sales in US currency generated lower revenue when converted to Canadian dollars. Meanwhile, some exporters are taking advantage of the lower US dollar and have increased their business investment spending, so as to improve their productivity and thus dampen the impact of the higher value of the Canadian dollar.

Currency changes aid Canada's competitive position versus Europe and New Zealand while hurting it against South American producers...

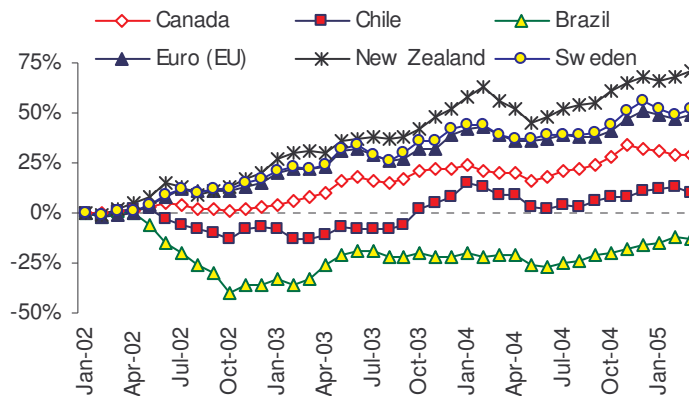
Figure 1.6 displays changes since 2002 in the value of the currencies of Canada's key competitors in US forest product markets. It illustrates that all currencies, excluding Brazil's, have realized an appreciation relative to the US dollar since 2002. New Zealand, Sweden, and EU countries (including major forest producers such as Finland, Germany and Austria) have

witnessed more significant gains in their currency relative to the US dollar (as compared to Canada). This favours Canada's competitive position in the forest industry relative to these countries. However, Brazil has realized a decrease in their currency and Chile has experienced lesser gains in the value of their currency against the US dollar as compared to Canada. As a result, these South American producers benefited from more favourable competitive positions created by the currency changes. The changes are of added meaning to Canada's forest industry (compared to competing nations) as they can affect the large volume of trade that Canada has with the US involving Canadian forest products.¹⁹

Unpredictable oil prices will play a key role in shaping North America's future economic growth...

Economic growth in the United States is expected to decline, but remain strong, in 2005 and again in 2006. US real GDP growth is projected to range between 3.5%-3.8% in 2005, driven by gains in consumer spending, investment growth and an increase in exports.²⁰ Strong growth will continue into 2006 with real GDP expected to be between

Figure 1.6 Percent Change in Currency Value since January 2002



Source: Bank of Canada and OANDA.com

¹⁸ Canada exports approximately 60% of its forest products. In 2004, 79.6% of these exports went to the US.

¹⁹ Budget 2005, page 48

²⁰ Economic Report of the President, February 2005, Page 18

3.2%-3.5%.²¹ Oil prices are expected to play a key role in US economic growth in the upcoming year. A continuation of current high oil prices could restrain growth in the US, while low but increasing interest rates will continue to encourage investment in the near-term. Canada's economic growth is expected to remain steady in 2005 and increase in 2006, supported by strengthened domestic demand, improved business investment and low interest rates.²² A stronger Canadian dollar will continue to have a negative impact on net exports while oil prices will have a modestly negative impact on the Canadian economy as oil rich provinces benefit while the Ontario manufacturing industry suffers.²³ Canadian real GDP is expected to range between 2.5%-2.9% in 2005. In 2006, real GDP is expected to increase between 2.7%-3.4% as the economy adjusts to the stronger dollar.

Canadian economy continues to adjust to the effects of a robust Canadian dollar...

Throughout the first quarter of 2005 the Canadian dollar averaged slightly above 80 cents US. Many analysts predict the Canadian dollar will continue to hover around the 80-cent mark and adjustment to the stronger currency will persist throughout 2005 and into 2006. It is possible that a further appreciation of the Canadian dollar, and other currencies, could be realized in the near future given the large US current account deficit.²⁴ The expected cooling of commodity prices would amplify the impact that further appreciation would have on Canada's real GDP. The expected strength of the Canadian dollar relative to the US will likely have a negative impact on the real trade balance as Canadian exporters continue to feel the squeeze of a high dollar, while importers take advantage and purchase more US products.²⁵

Interest rate outlook – gradual increase expected over 2005-2006...

Inflation is not expected to be a major concern in 2005-2006, as the US Federal Reserve is expected to continue with its gradual rise in the FFR.²⁶ In 2005, the FFR is expected to be between 2.75-3.75%, while the rate is not expected to exceed 4.0% in 2006. The Canadian OR is not expected to rise from current levels until mid-to-late 2005, as inflation remains in check. The interest rate is expected to rise to 2.75%-3.0% in the second half of 2005. The Bank of Canada is expected to continue a gradual rise in the OR in 2006. Analysts predict rates will be similar to those realized in the US as they reach a level between 3.5%-4.0% in 2006. Although rates are predicted to rise in both Canada and the United States, they will remain relatively low, and therefore both personal and business investment should remain strong.

²¹ BMO, North American Outlook, TD Quarterly Economic Forecast, CIBC World Markets Forecast

²² The Conference Board of Canada, Exports, Inventories Stall Economy, page 1

²³ BMO, North American Outlook, April 2005, Page 1 & 8

²⁴ BMO, North American Outlook, Page 9

²⁵ TD Economics, TD Quarterly Economic Forecast, Page 12

²⁶ BMO, North American Outlook

Housing market outlook – slowdown of housing starts anticipated

With both US and Canadian interest rates expected to move forward in 2005 and 2006, and house prices expected to continue to rise, housing starts are expected to fall from the highs realized in 2004. According to the Canada Mortgage and Housing Corporation (CMHC) Canadian housing starts will fall from 233,431 in 2004 to 216,400 starts in 2005, a decrease of 7.3%. In 2006, housing starts will decrease by another 7.5% in 2006 (to a level of 200,200).²⁷ Low interest rates and solid income growth in 2005 will continue to support housing affordability in the near-term and therefore housing starts in the first half of 2005. As 2005 progresses interest rates and slowing income growth will take effect, leading to a decline in housing affordability by mid 2005 – that will continue into 2006. This will push housing starts lower. In the US, RISI forecasts that housing starts will realize an annual decline of 4.4% in 2005, followed by another decline of 12.1% in 2006.²⁸

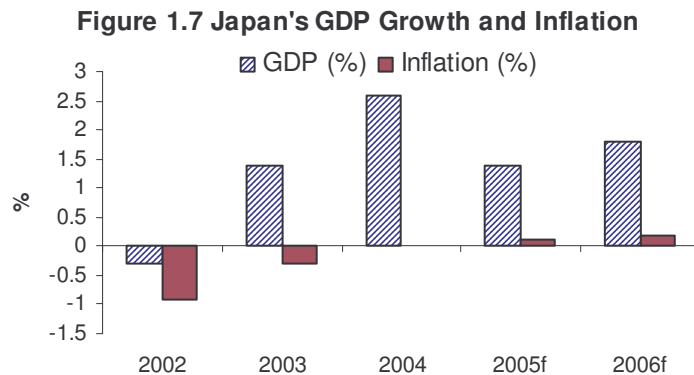
1.2. Outlook For Japan

Japan's economy continues to rebound based on export led growth and some improvement in fundamentals ...

Having experienced four major recessions since 1991, Japan's economy has been mired in stagnation until recently. In 2003, Japan's GDP grew by 1.4% while a year later GDP growth was 2.6%. This was partially attributable to an improvement in certain fundamentals of the economy including output growth of 2% per annum since 2002.²⁹

However, the primary thrust of Japan's economic recovery can be ascribed to export led growth, based on external demand from its two largest trading partners, China³⁰ and the U.S. In fact, Japan's first quarter performance in 2004 was Japan's best since the mid-1990s and it led to expectations of a strong economic recovery for 2004. However,

Japan's economy contracted in the second and third quarters while remaining flat in the



Source: The Economic Intelligence Unit, February 24, 2005; The Economist, March 21, 2005; f = Forecast.

²⁷ Housing Market Outlook, 2nd Quarter, 2005, Canada Mortgage and Housing Corporation (CMHC)

²⁸ Lumber Commentary, January, 2005, Resource Information Systems Inc. (RISI)

²⁹ Output growth has averaged more than 2% per year, since 2002, according to the OECD Observer, 2005. Policy Brief. *Economic Survey of Japan*, 2005.

³⁰ China now leads the U.S. as the major trading partner of Japan and accounted for a third of the increase in Japanese exports in the past two years.

fourth quarter (showing just 0.1% growth). This occurred because while Japan's economy has been strongly reliant on external demand, the household sector has remained mostly on the sidelines. During this period China tried to cap off its overheated economy and the Japanese yen appreciated against the U.S. dollar, resulting in a slowdown of Japanese exports. Japan's economic performance sagged, demonstrating that as long as Japan's economic revival is not adequately grounded in domestic strengths, the country's economic fortunes are likely to continue to ebb and flow according to the trade patterns of the export sector.

Slowdowns in China and US will induce a slowdown in Japan as well...

Due to the downside risks of an appreciation of the yen against the U.S. dollar and relatively slower economic growth anticipated in both China and the U.S. in 2005, the Japanese economy is likely to experience a significant slowdown in its export growth, and its real GDP is expected to grow by only 1.5% in 2005³¹ (Figure 1.6).

Japan faces numerous challenges to further economic prosperity including addressing persistent deflation, budget deficits and structural issues in the banking sector

Despite being in the best form in a decade, the Japanese economy continues to face a number of challenges that could undermine a sustained economic recovery. Deflation has persisted in Japan since 1998. As a result, poor returns on investment caused corporations to invest less over time and declining asset prices caused banks to curtail lending. Despite progress in reducing the volume of non-performing loans³², bank lending continues to register a decline.

The Bank of Japan plans to continue a policy of easing its monetary stimulus until a target rate of inflation is reached, which is high enough to preclude the risk of sliding back into deflation. However, the threat of further appreciating movements of the Japanese yen against the US dollar would place additional downward pressure on prices and leave any prospective economic recovery vulnerable to another deflationary downturn.

Japan's government is currently running a large budget deficit, which has led to a growing gross public debt, which currently stands at 160% of its GDP—the highest³³ within OECD countries. However, concerns of continued deflation have prevented the government from reining in spending in the near-term while the aging of Japan's population will contribute to putting pressure on public finances over the long-term.

³¹ Some researchers forecast real GDP to grow at 1.1% in 2005. Mitsubishi Research Institute, Inc., Japan's Economic Outlook 2004-2005. February 2005. A group of forecasters polled by *The Economist* forecast GDP to grow by 1.4% (2005) and 1.8% in 2006. *The Economist*, 21 March 2005. Government of Japan projects the real GDP growth rate to be 1.6% in 2005. Cabinet Office, government of Japan. January 21, 2005. "Economic Outlook for FY2005 and Basic Economic and Fiscal Management Measures."

³² NPLs were reduced from 8.4% of their total lending in March 2002, to 4.7% in September 2004.

³³ Economic Survey of Japan, 2005, p. 2. OECD Observer, 2005.

Another potential issue is that with the eventual realization of a positive inflation rate, the government's interest payments as a share of GDP on public debt (that are presently quite low due to very low interest rates) will also increase. This could put further strains on public finances.

Some fundamentals in the Japanese economy have improved gradually, which has ameliorated the outlook for the short to medium-term. For instance, the corporate sector is relatively stronger due to improved profitability. In 2004, the current profits-to-sales ratio was 3.5% — the highest since the 1980s. Corporate bankruptcies have declined to their lowest level in a decade while major Japanese banks have reduced their share of non-performing loans (NPL). The government of Japan expects the share of NPLs to decline to about 4% by mid-2005, thereby improving bank lending over the short-term.

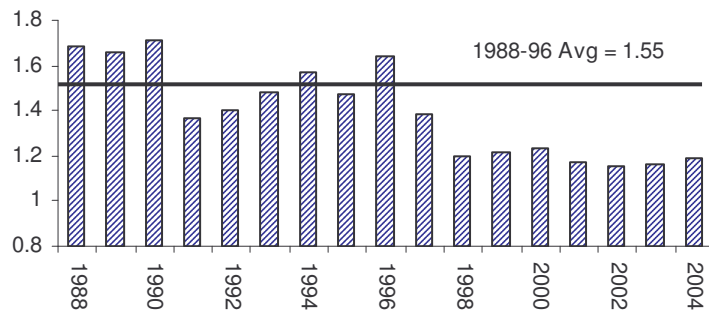
Expected downturns in Japanese residential construction will filter into reduced demand for Canadian wood products...

Unfavourable demographic trends, sluggish economic performance and persistently entrenched deflation create a pessimistic outlook for residential construction in Japan.

In fact, compared to the levels achieved prior to the Asian financial crisis in 1997, the Japanese housing market still remains depressed (see Figure 1.8). Housing starts registered moderate growth in the past two years, but are projected to decline in 2005 (see Figure 1.9).³⁴

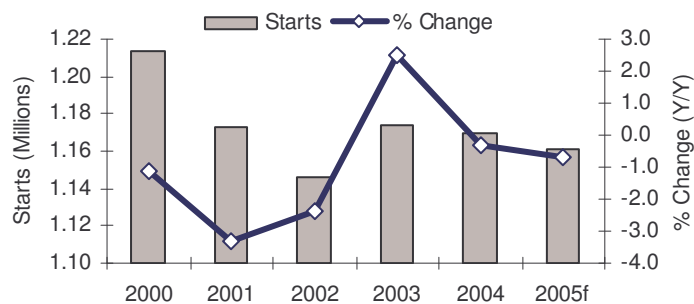
Japan has been a key importer of Canadian wood products, for use in the construction of wood-framed residential housing units. According to the short-term³⁵ as well as mid- to long-term³⁶ forecast by the Research Institute of Construction and Economy (RICE), "... the most recent trends in the number of households and housing establishments suggest that the number of housing starts will continue to decline."³⁷ (Figure 1.10)

Figure 1.8 Japanese Housing Starts (Millions)



Source: Ministry of Land, Infrastructure and Transport (Japan)

Figure 1.9 Japanese Housing Starts and Year-over-Year Change



Source: Research Institute of Construction and Economy

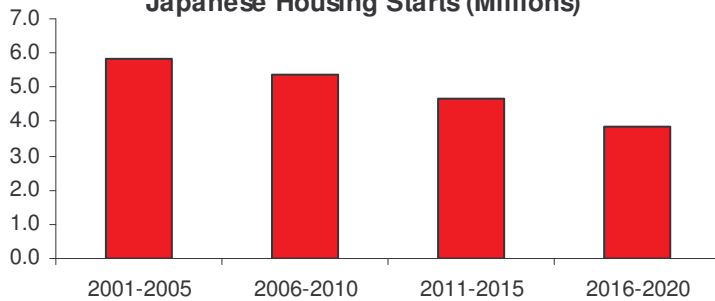
³⁴ Conference Board of Canada. Canadian Industrial Outlook, Spring 2005.

³⁵ RICE, Japan. *Quarterly Outlook of Construction and Macro Economy*, Table 5. January 2005.

³⁶ RICE, Japan. *Construction Economy Report No. 44*, Chapter 4.

³⁷ Preliminary Report of Housing and Land Survey of Japan, 2003; quoted in RICE, Report No. 44, *ibid*.

Figure 1.10 Long-term Forecast for Japanese Housing Starts (Millions)



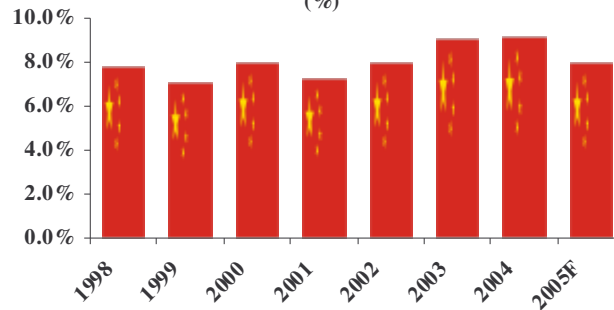
Source: Research Institute of Construction and Economy

1.3. Outlook For China

China rapid economic expansion continues although concerns of an overheating economy exist ...

China is currently the world's second largest economy³⁸ behind the United States. In 2004, the Chinese economy grew by an overall rate of 9.2%, marked by slow growth in the first half of the year and rapid growth in the second half.³⁹

Figure 1.11 China GDP - Annual Growth Rate (%)



Source: Asian Development Bank; Forecasts: Conference Board of Canada

The rapid growth of the Chinese economy has been fuelled largely by strong investment, though other factors such as consumer demand are beginning to make contributions. However, the blistering pace of investment growth and concerns regarding the ability of China's domestic financial system to efficiently allocate capital have led to worries that the economy may be overheating and that over-investment could lead to large excess capacity in many industries. This has prompted the Chinese government to implement a macroeconomic control strategy for 2005-2006 to curb investment growth and provide a soft landing for the fast growing economy.⁴⁰

³⁸ Based on Purchasing Power Parity GDP rankings, World Bank Development Indicators database

³⁹ OECD Economic Outlook No. 76: Developments in Selected Non-Member Economies.

⁴⁰ Asian Development Bank. April 2005. *Asian Development Outlook, 2005*.

Continued strong economic growth expected in the future...

Despite these macroeconomic controls, China's GDP is still expected to grow rapidly (between 8% and 9% annually from 2005-2007), while inflation is anticipated to decrease (from 3.9% in 2004 to just above 3% in 2007).⁴¹ With respect to other aspects of the economy, investment in fixed assets is expected to grow by 18% in 2005, down from 25.8% in 2004 while exports are forecast to decline to the 12-20% range in 2005, down from more than 30% in 2004. The slowdown in exports would be primarily due to (1) the anticipated slowdown in economic growth in major industrial nations, (2) the potential increase in production costs due to rising oil prices, and, (3) higher export costs due to protectionist measures against Chinese exporters.

1.4. Outlook For Western Europe

Strong euro and weak consumer spending in several economies to crimp Western Europe's growth prospects...

Export growth was the main driver of the Western European economy in the first half of 2004. However, the ongoing appreciation of the euro against the U.S. currency undercut this growth and contributed to a weak economy in the region overall. With this underlying trend expected to continue into 2005 Western Europe as a whole is forecast to grow by only 2.25% in 2005.⁴² In terms of the major economies, the United Kingdom, France and Germany are expected to grow by 2.8%, 2.0% and 0.8%, respectively.⁴³

In view of the strength of the euro an increase in labour layoffs are likely as a cost-reduction measure by exporters. This will adversely affect wage growth and, as a result, depress household spending. These developments combined with an expected slowdown in global demand conditions⁴⁴ will likely create weak growth for both 2005 and 2006.⁴⁵

⁴¹ Ibid. p.70, and National Bureau of Statistics of China, March, 2005, available from: www.stats.gov.cn/english/index.htm. Forecast by Conference Board of Canada's, *Ibid.* for 2005 is: real GDP growth by 8% and inflation by about 3.5%.

⁴² United Nations Economic Commission for Europe (UNECE) press release, 22 February 2005.

⁴³ Eurostat.

⁴⁴ *Ibid.* The global economy is forecast to grow by 4.24%, in 2005, down from about 5% growth in 2004 — the fastest in three decades.

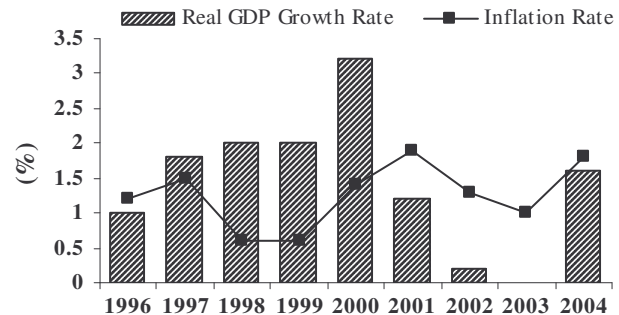
⁴⁵ International Monetary Fund. *World Economic Outlook*, April 2005, forecasts a growth rate of 1.6% for Western Europe. Pricewaterhouse Coopers, *European Economic Outlook*, February 2005 issue, forecasts euro area growth of about 1.7%, in 2005, and about 2% in 2006.

Germany

Weak domestic demand offsets strong export driven German growth...

The German economy grew by 1.6% in 2004 (see Figure 1.12), which marked an improvement over 2003, but was still quite weak. Germany's growth performance was largely led by exports⁴⁶, but these were constrained by a continued rise of the euro against the US dollar. Consumer spending remains subdued and has acted as an additional drag on growth. Both of these factors are expected to remain issues in the near-term. As a result, real GDP is expected to grow at an even weaker rate of 0.8% in 2005.

Figure 1.12 Germany's Real GDP Growth Rate and Inflation Rate



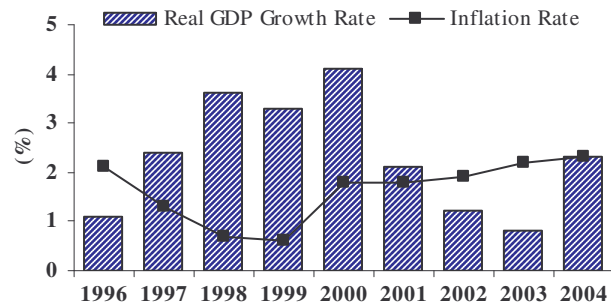
Source: Eurostat

France

Appreciating euro, weak domestic spending dampen France's economic recovery prospects ...

France's economy experienced a mild recovery in 2004. However, as is the case with Germany, unemployment rates remain high (over 9%), which has helped keep consumer spending low. This, in addition to the strong euro, are projected to lead to slightly slower growth in 2005 of 2%, compared to 2.3% for 2004.

Figure 1.13 France's Real GDP Growth Rate and Inflation Rate



Source: Eurostat

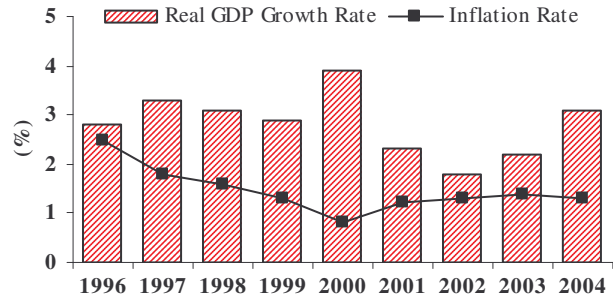
⁴⁶ Eurostat.

United Kingdom

Strong domestic demand spurs economy, though tightening monetary policy, a strong pound and lacklustre demand for exports could dampen future growth...

The U.K. economy performed well in 2004 with real GDP growth reaching 3.1% in 2004. A key driver of growth continues to domestic demand, supported by the ongoing strength of wage growth as well as corporate profits. However, the economy is operating close to full employment, which has prompted the Bank of England to tighten monetary policy to keep inflationary pressures at bay. The British pound has also appreciated in value in recent years, reaching its highest value against the US dollar since 1992, which is expected to weaken demand for exports. Weak economic performance of many European trading partners will also continue to contribute to export weakness. As a result of these factors, growth is projected to slow moderately in 2005-2006.⁴⁷

Figure 1.14 United Kingdom's Real GDP Growth Rate and Inflation Rate



Source: Eurostat

⁴⁷ Eurostat.

2. Forest Product Markets

2.1. Softwood Lumber

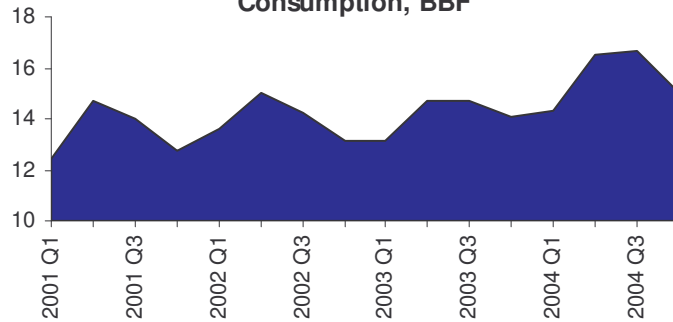
US consumption increased significantly in 2004, breaking the 2003 record ...

US softwood lumber consumption increased by 6.0 billion board feet (BBF)⁴⁸ or 10.5% in 2004 compared to 2003. Reflective of the strength in US residential construction, US softwood lumber consumption in 2004 easily broke last year's record breaking level. Consumption stayed strong throughout the year with little variability in the year-over-year growth for any quarter. While the weakest year-over-year growth was achieved in first quarter (9.2%), the strongest growth was achieved in the third quarter (11.7%).

Softwood lumber production was strong in both Canada and the US ...

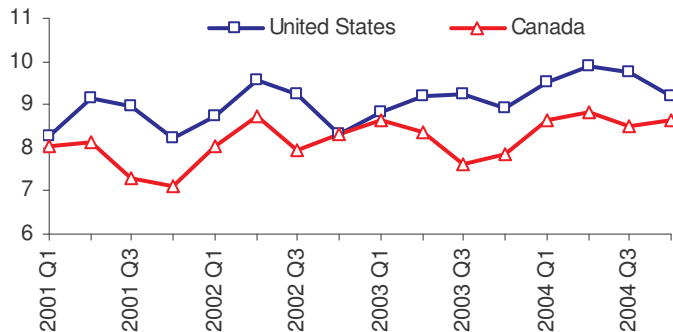
Overall, North American production increased by 6.3% in 2004 compared to 2003. Production growth was strong in both Canada and the US, with Canadian production increasing by 2.2 BBF (6.8%) while US production also increased by 2.2 BBF (6.0%), compared to 2003. While year-over-year production growth in the US started off strong in the first quarter (7.8%) and became weaker with each successive quarter, ending at 3.2% in the fourth quarter, in Canada the opposite was true. Canadian production was largely flat in the first quarter, increasing slightly, by 0.3% in 2004 compared to the same period in 2003. However, Canadian production growth improved over the year, with output increasing by 10.3% in the fourth quarter compared to the same quarter in 2003.

Figure 2.1 U.S. Softwood Lumber Consumption, BBF



Source: American Forest and Paper Association

Figure 2.2 North American Softwood Lumber Production, BBF



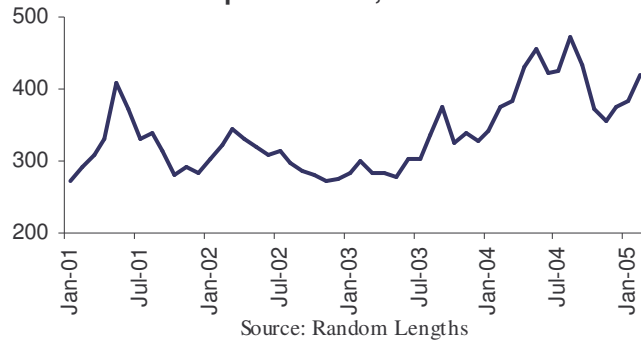
Source: Statistics Canada; American Forest and Paper Association

⁴⁸ Board feet are used to express volume measurements of lumber in this section where 1 board feet equals 0.00235974 cubic metres.

Softwood lumber prices hit a 5 year peak before weakening towards the end of 2004 ...

From late 2001 to mid-2003 lumber prices hovered around cyclically low levels. However, in late 2003, lumber prices embarked on a sustained increase that carried them to a five-year peak in August 2004, at US\$ 473 per thousand boardfeet (MBF), largely as a result of hot North American housing markets. However, prices sagged in the fall when weather related factors dampened demand and an influx of overseas imports contributed to an increase in supply. However, prices rebounded in early 2005 as residential construction markets remained robust.

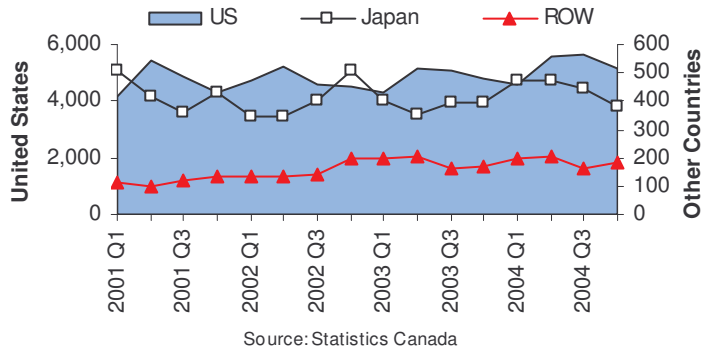
Figure 2.3 Random Lengths Framing Lumber Composite Price, USD/MBF



Volume of Canadian exports surges in latter half of 2004 ...

Exports in 2004 were up 1.8 BBF (8.5%) compared to 2003. This was primarily the result of a 1.6 BBF (8.2%) surge in exports to the US. Exports to Japan also increased sharply in 2004, rising by 230 MMBF (14.9%) compared to 2003 levels. However, exports to the rest of the world only experienced a modest change, rising by 20 MMBF (2.8%).

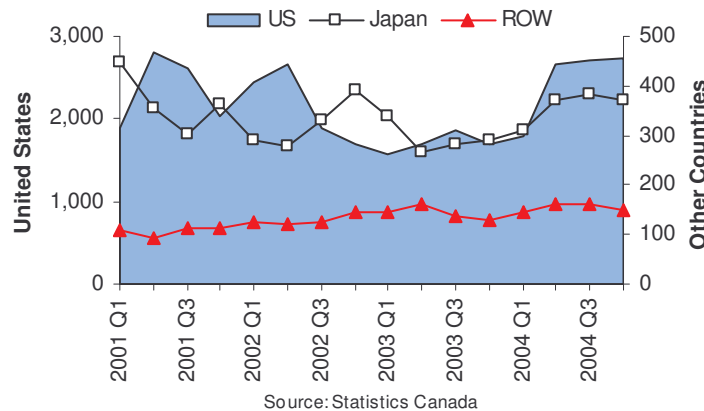
Figure 2.4 Canadian Softwood Lumber Exports, MMBF



Rising volumes and prices lead to huge jump in value of softwood exports in 2004...

The value of Canada's softwood lumber exports rose dramatically in 2004 compared to 2003 due to the combined effect of rising export volumes and prices.⁴⁹

Figure 2.5 Canadian Softwood Lumber Exports, Millions \$C



In total the value of exports increased by C\$3.4 billion (40%), with exports to the U.S.

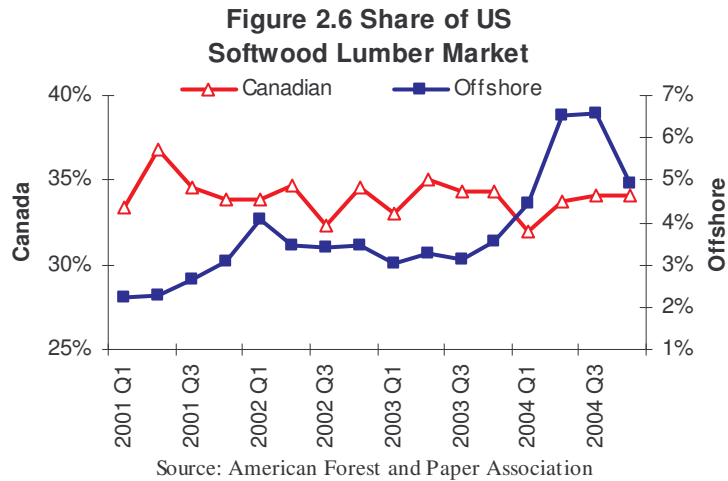
⁴⁹ The Random Lengths composite price for framing lumber rose by 29.7% in 2004 as compared to 2003.

accounting for C\$3.1 billion of that increase, while Japan accounted for most of the remaining C\$300 million.

Offshore producers see US market share surge, as imports from Canada and US production lag behind demand growth...

Since the mid-1990s US offshore imports have been steadily increasing, led by a number of European (Germany, Austria, Sweden) and Southern Hemisphere (New Zealand, Chile, Brazil) producers. In 2004, offshore

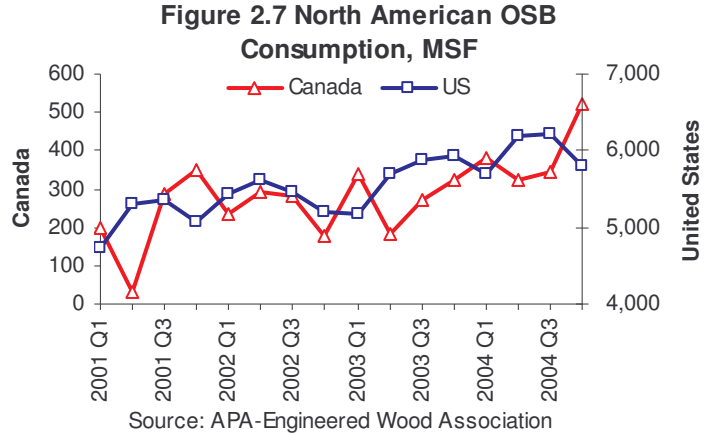
imports into the US market surged, as did their share of the market, which increased to 5.7% of U.S. consumption for the year. This was a reversal from 2003, in which offshore producers saw their market share slip to 3.2%, down from 3.6% in 2002. Meanwhile, Canada's share of the US market fell to 33.5% in 2004, down from 34.2% in 2003, while US producers saw their share decline to 60.8% from 62.5%. It should be noted that shipments to the US market from all three of these sources (i.e., Canadian, US and offshore producers) increased in 2004 as consumption surged to record highs, thus offshore imports were not displacing either US or Canadian lumber. Rather, US domestic production and imports from Canada did not keep pace with US consumption growth, which resulted in a disproportionate share of new demand being served by offshore producers.



2.2. Wood-based Panels

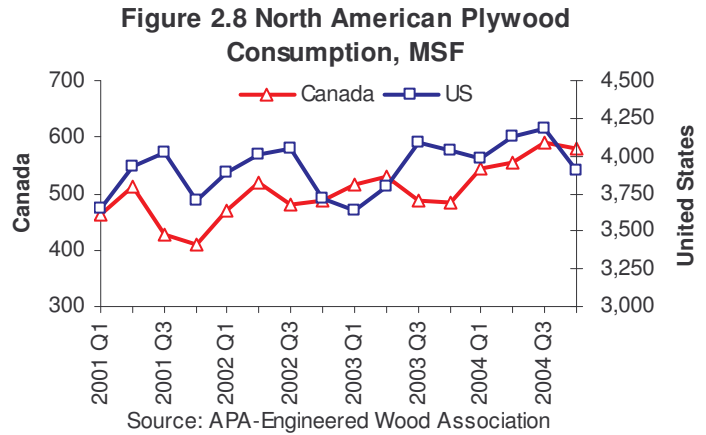
Residential construction continues to drive up North American OSB consumption in 2004...

North American consumption of oriented strand board (OSB) increased by 7.3% in 2004 compared to 2003. Strong consumption increases in Canada (41.3%) and the United States (5.6%) were observed, as residential construction and repair/remodelling activities drove demand in both countries.



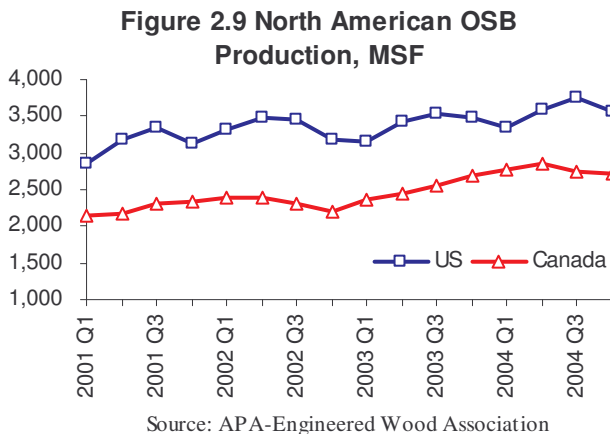
Favourable prices help plywood consumption rebound in 2004...

Supported by favourable prices, North American consumption of plywood increased in 2004 compared to 2003 (up 5.1% overall; 12.4% in Canada and 4.2% in the US). This was a change from the previous year, in which plywood consumption remained stagnant despite rising demand for structural panels overall. However, growth in plywood consumption still lagged that of OSB in 2004 resulting in further loss of market share. Since the late 1980s, plywood has steadily lost market share to OSB due to OSB's lower costs of production and changing preferences of builders.



OSB production in North America continues to grow...

Responding to increased housing-based OSB demand and high OSB prices, North American production rose 7.3% in 2004 compared to 2003. After a slow year in 2003, US output regained the pace that was witnessed in the previous

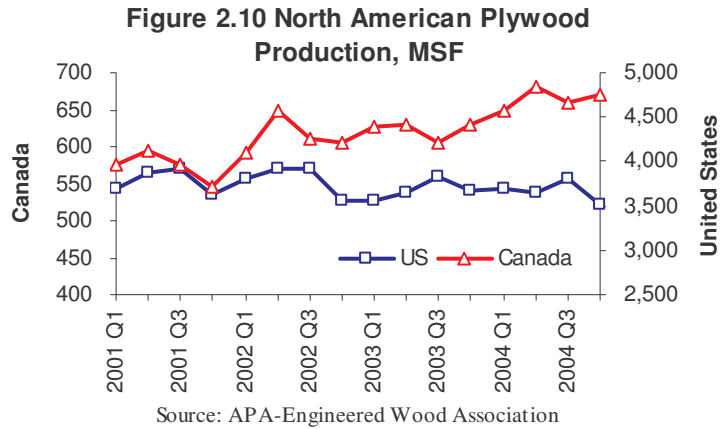


few years (5.3% in 2001 and 7.1% in 2002), growing by 4.8% in 2004 compared to 2003. Canadian production increased at a faster rate, up by 10.6% compared to 2003, the highest production growth rate for the country since 1999. Although US production growth was steady throughout the year, Canadian growth primarily occurred in the first half of 2004, increasing by 17.1% compared to the same period in 2003.

Plywood production increases slightly in 2004 ...

While North American consumption of plywood grew steadily in 2004, North American plywood production grew only slightly, up 0.7% in 2004 compared to 2003, largely piggybacking off a 6.6% increase in Canadian production while US production stayed

relatively flat, down 0.3%. While US production was stagnant in 2004, it was actually a relatively good year for the industry, which has seen its production fall for by an average of 2.9% per year over the last 10 years. Residential construction fuelled high plywood prices have helped Canadian output grow while slowing the slide in US production.

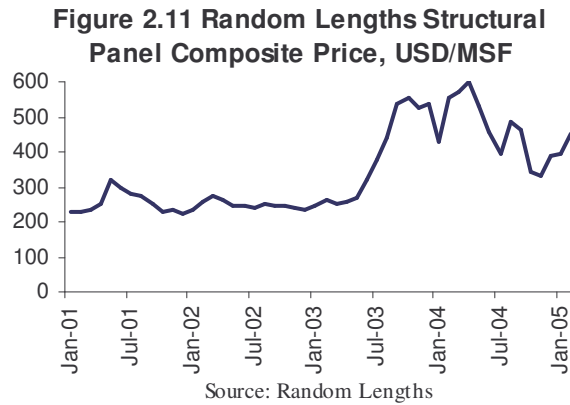


Source: APA-Engineered Wood Association

Structural panel prices soar due to short supplies and strong demand ...

While North American production of structural panels increased in 2004, strong demand growth outstripped the increased supply leading to higher prices in 2004. For the year, the Random Lengths Structural Panel composite price⁵⁰ was 21.1% higher in 2004 than 2003. The main thrust of this increase occurred in the first half of

2004, which saw prices rise by 95.5% compared to the same period in the 2003. However, prices began to cool in the second half of the year, responding in part to increased imports from offshore producers.



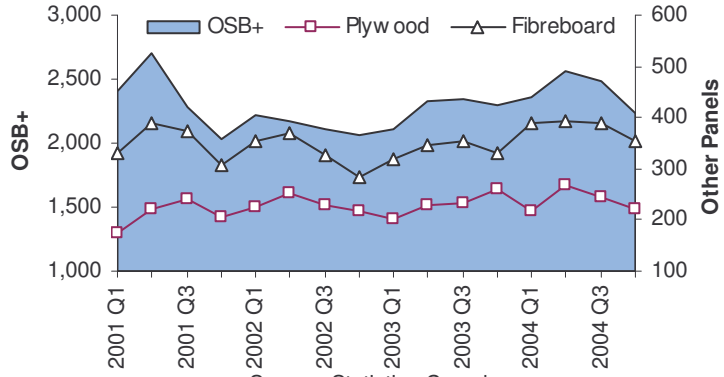
Source: Random Lengths

⁵⁰ The Random Lengths Composite Price is a broad measure of price movements in structural panel markets in North America.

Volume of Canadian panel exports increases led by OSB ...

Canada’s main panel market is the United States, with over 90% of Canada’s panel exports heading south of the border. In 2004, Canada’s wood panel exports to the US increased by 6.7% relative to 2003 on the strength of a 6.0% increase in OSB and particleboard (OSB+) exports.⁵¹ Fibreboard exports increased even faster, rising by 13.4%, while plywood exports grew moderately (3.2%). For all panel products, exports were strong in the first half of the year, weakening as the year went along. While OSB+ and plywood exports increased by 11.0% and 17.6% in the first half of the year, in the fourth quarter exports for these products actually declined by 3.2% and 13.9% respectively compared to the same period in 2003, likely due to a decline in US prices which were near record highs in late 2003.

Figure 2.12 Wood Panel Exports to US, Thousands m³

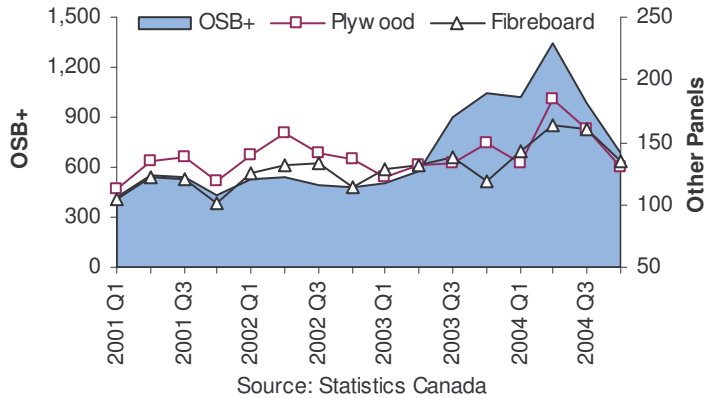


Source: Statistics Canada

The value of wood-panel exports increased even faster due to price increases...

In 2004, the value of wood panel exports to the US increased by 28.7% compared to 2003. This was due to a 33.5% increase in value of OSB+ exports to the US although the value of exports for fibreboard (+16.5%) and plywood (+13.5%) also increased. Most notable during the year was the value of OSB+ exports increasing by 120.2% over the first half of 2004 compared to the same period in 2003. While the increasing volume of exports contributed to this, strong growth in panel prices was the main driver.

Figure 2.13 Wood Panel Exports to US, Millions \$C



Source: Statistics Canada

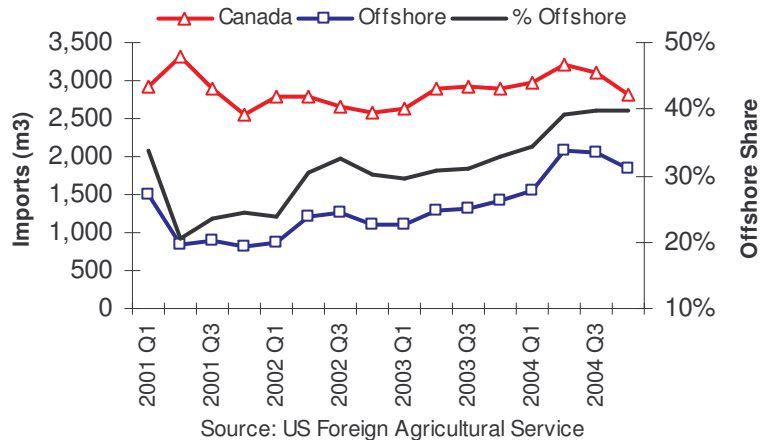
⁵¹ Prior to 2002, Statistics Canada trade data did not distinguish between OSB and particleboard despite differing end-uses for these products, which is why they are grouped together here. However, we note that in 2002, OSB accounted for 85% of the total value of Canada’s exports in this category.

Offshore share of US panel imports continued to rise in 2004...

Following a sharp fall in 2001, offshore panel imports into the US have risen steadily both in absolute terms and as a percentage of total panel imports. The offshore share of imports reached 38% in 2004, up from 31% in 2003. The current degree of offshore market penetration greatly

exceeds the previous high observed in 2000, when offshore producers supplied 32% of US imports. Brazilian softwood plywood and OSB have led this surge into the US market. Brazil now ranks second behind Canada in shipments of OSB to the US, which marks a dramatic change given that they were shipping nothing in 2002.⁵² With regards to softwood plywood, Brazil has been the US's number one supplier of structural softwood plywood having passed Canada in 2003.

Figure 2.14 US Panel Imports (1,000s m3) and Offshore Share of Imports



⁵² Wood Markets Monthly, April, 2005.

2.3. Wood Pulp

Softwood pulp prices continue to rebound in 2004...

In 2004, the price for Northern Bleached Softwood Kraft (NBSK) pulp, Canada's most important market pulp grade⁵³, averaged US\$640/tonne, up from US\$548/tonne in 2003 for a 16.8% increase. This was the second straight year of strong price increases, following a long period of stagnant prices

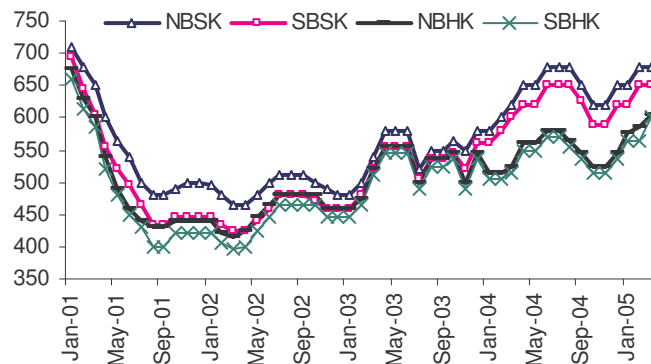
stretching from late 2001 to the beginning of 2003. NBSK prices reached a peak of US\$670/tonne in the third quarter of 2004 before dropping off the fourth quarter. This was \$40 shy of the previous cyclical peak reached of US\$710/tonne in the third and fourth quarters of 2000. Strong economic growth in the United States along with a continued increase in demand for pulp from China helped drive up prices.

Volume of pulp exports remain flat in 2004, but China's share continues to grow as exports to Western Europe fall ...

In 2004, the volume of Canadian pulp exports remained flat with pulp exports to the US and the EU-15⁵⁴ continuing to decline, down 1.6% and 11.3% compared to the previous year. In contrast, the quantity of exports to China continued to rise, up 21.4% in 2004. Exports to Japan (+2.2%) and the rest of world (+1.7%) also grew modestly.

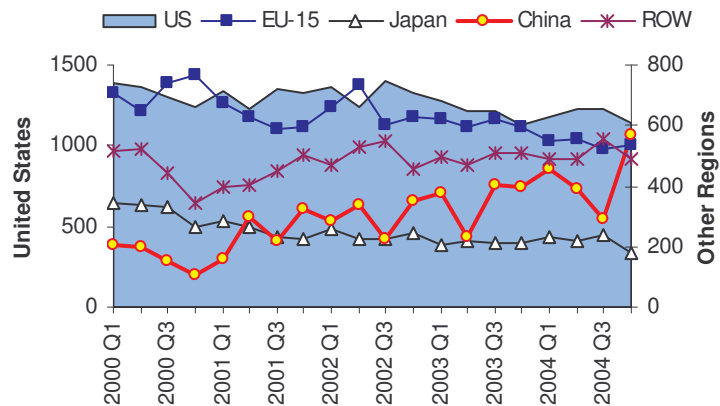
While the volume of Canada's pulp exports has changed little, the composition of those exports continued to change. In 2004, the US, which is Canada's most important export market, received 41.3% of Canada's exports, followed by the EU-15 (18.6%), the rest of the world (17.6%), and China (14.8%). However, the share of Canada's pulp exports going to the US and the EU-15 are now at their lowest proportion within the last decade

Figure 2.17 Chemical Market Pulp Prices, USD/Tonne



Source: Pulp and Paper Week

Figure 2.18 Pulp Exports, 1,000s Tonnes



Source: Statistics Canada

⁵³ NBSK made up 62.4% of Canada's market pulp production in 2004.

⁵⁴ The EU-15 includes the following countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom. It does not include the 10 countries acceding to the EU in 2004.

while Japan's share is at its 2nd lowest over the same period. The US share has experienced periodic fluctuations over the last 10 years and in terms of the volume of Canadian exports shipped to the US, the quantity is only slightly below its 10-year average. The decline in export volumes for Japan and the EU-15 represent a consistent trend, in which exports to these regions have fallen by 25.2% and 42.7%, respectively in 2004, compared to 1995 levels. Declining shipments to the EU-15 can be attributed to new bleached softwood capacity in the region and an increase in competition from US softwood imports and Latin American bleached hardwood pulp shipments. Declining shipments to Japan are due largely to weak demand that has accompanied poor economic conditions.

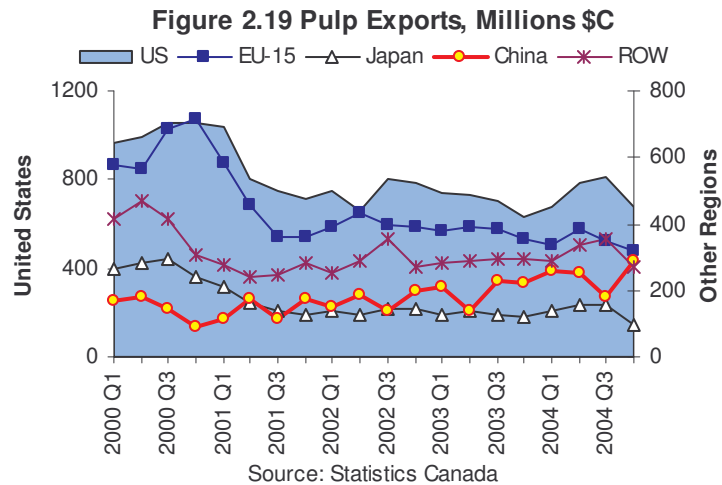
In contrast, Canadian exports of wood pulp to China have grown consistently over the last decade. In 1995, Canadian exports to China accounted for only 2.6% of exports, while their share reached 14.8% in 2004. Pulp shipments to other countries have also increased from 13.6% to 17.6% of total exports over the same period.

Rising prices boost the value of pulp exports...

The value of total Canadian pulp exports increased by 5.1% in 2004 compared to 2003.

Although the value of Canadian exports to the EU-15 (-8.0%) decreased, the increased value of exports to China (+23.0%), the US (+5.6%), Japan (+7.6%) and the rest of the world (+7.8%) ensured an increase in the total value of Canadian

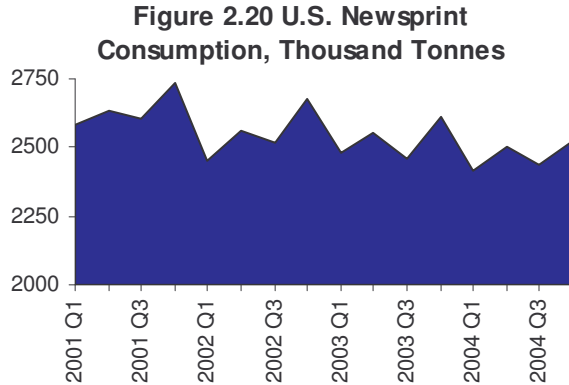
exports for the year. In 2004, the Canadian dollar appreciated relative to the US currency (+7.5%), to the Chinese currency (+7.6%) and to the Japanese yen (+0.4%). However, a substantial increase in softwood pulp prices (US NBSK was up 16.8% in 2004 compared to 2003) more than offset the effect of the appreciating Canadian dollar on export earnings.



2.4. Newsprint

US newsprint consumption continues its steady decline in 2004 ...

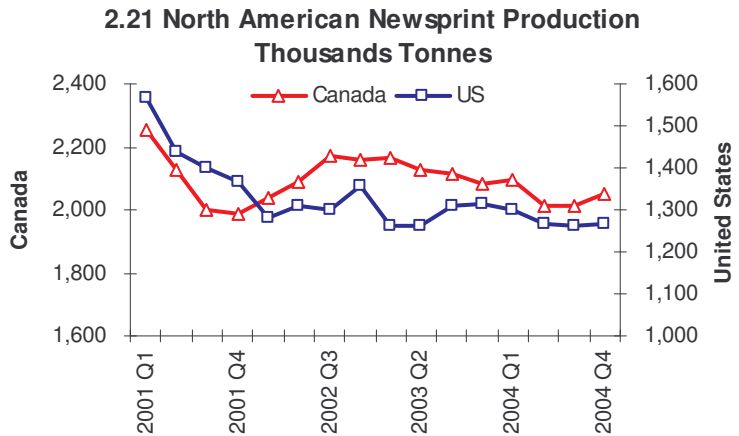
The United States is the primary market for Canadian newsprint producers.⁵⁵ Amid year-to-year fluctuations, US newsprint consumption has been falling since 1987. This decline has become more pronounced since the recession of 2001. Despite the rebounding of the US economy in 2003-2004 and accompanying increases in ad spending, US newsprint consumption continued to decrease. In 2004, US consumption fell by 2.2% compared to 2003. This is the continuation of a long-term trend. A number of factors, including the direct competition from online media, a shift in advertising expenditures away from newspapers, and the emergence of small free daily newspapers, have eroded demand for newsprint over time.



Source: North American Newsprint Statistics Monthly Bulletin

North American newsprint production declines, mirroring falling consumption...

Mirroring declines in consumption, North American newsprint production also declined in 2004, falling by 2.7% compared to 2003. Most of the recent production decline was concentrated in Canada, where production fell by over 300,000 tonnes (3.7%) for the year. US production fell more modestly, declining by 50,000 tonnes (1.0%). This contrasts with the last few years, in which US producers experienced larger declines in production following the onset of a recession in 2001. Canadian production actually increased in late 2002 and early 2003. However, the secular decline in Northern American newsprint demand appears to be catching up with producers on both sides of the border.



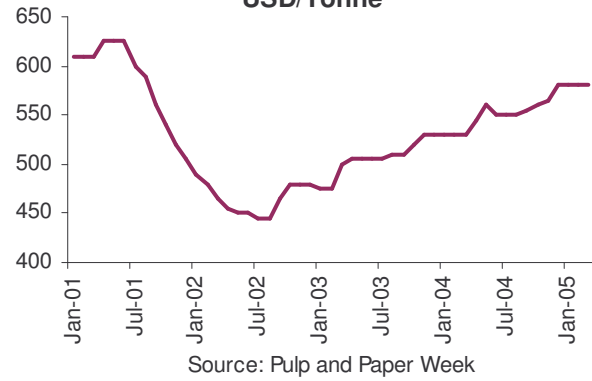
Source: North American Newsprint Statistics Monthly Bulletin

⁵⁵ In 2004, the approximately 70% of Canadian newsprint production was exported to the US.

Prices continue gradual increase despite weak consumption...

In 2004, U.S. East Coast newsprint prices averaged \$550/tonne, up from \$506 in 2003, equivalent to a 8.8% increase. Prices rose gradually throughout the year despite weak demand conditions, reaching \$580/tonne by year-end. Rising costs for newsprint producers and resulting curtailments of supply more than offset weak demand. However, prices are still short of the last cyclical peak in the newsprint market of \$625/tonne (April-June 2001).

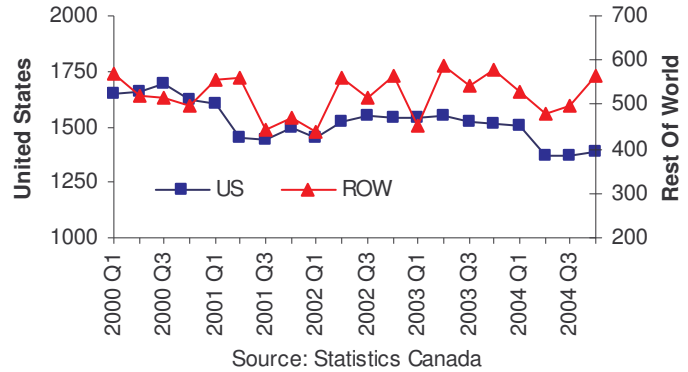
Figure 2.22 Newsprint Prices, USD/Tonne



The volume of Canada's exports decline in 2004, due to weak US demand ...

Total Canadian newsprint exports declined 7.0% in 2004 relative to 2003 with exports to the US decreasing by 8.9% while exports to the rest of the world by 4.2%. Exports to non-US markets started the year quite strong, increasing by 16.4% in the first quarter of 2004 compared to the same period the previous year. However, exports to these regions tailed off during the second and third quarters resulting in only a modest increase for the year. In contrast, exports to the US showed consistent declines throughout the year, with the volume of exports lower in each quarter than the same quarter in 2003.

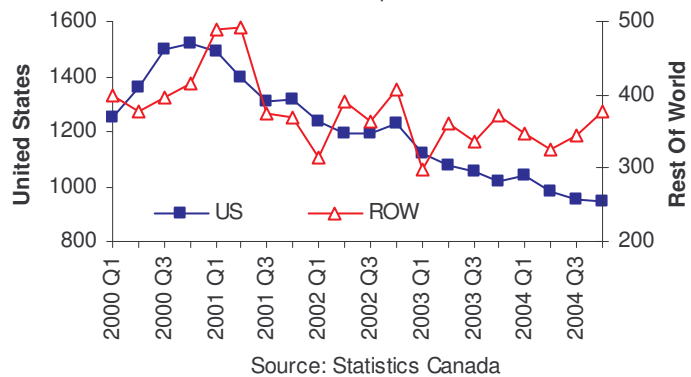
Figure 2.23 Newsprint Exports Thousands Tonnes



Total value of exports to the US decreases but increases elsewhere ...

The total value of Canadian exports dropped by 5.9% in 2004 compared to 2003. Over that time frame, the value of exports to the US decreased by 8.4%, while the value of exports to other countries increased by 1.8%. Besides the significant decline in the volume of exports

Figure 2.24 Newsprint Exports Millions \$C

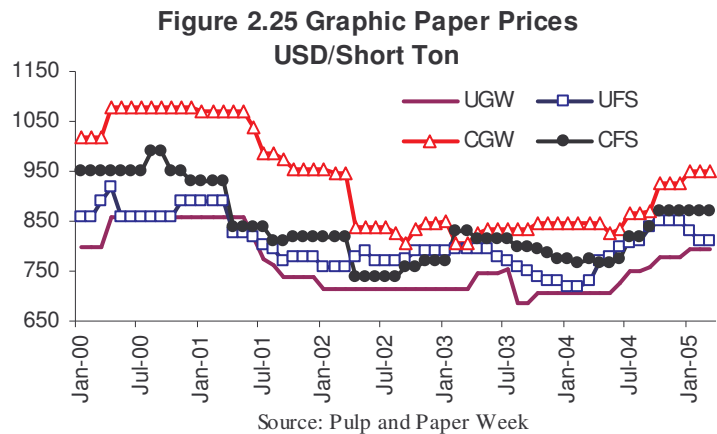


to the US, the appreciation of the Canadian dollar relative to the US currency, increasing by 30% from January 2002 to December 2004, has also contributed to the decline in the value of exports shipped to the US. As noted earlier, the volume of exports to non-US based destinations declined in 2004. However, due to newsprint prices increasing by 8.8% in 2004 (relative to 2003) and to increasing offshore exports for destinations such as Brazil (where the currency has depreciated little relative to the Canadian dollar - by only 2.7%), a slight rise in non-US destined exports for the year resulted.

2.5. Graphic Paper (Printing and Writing Paper)

Prices for major graphic paper grades rise in 2004 following prolonged decline or stagnation...

Figure 2.22 shows prices for a number of important grades of graphic paper.⁵⁶ Graphic papers, along with wood pulp and newsprint, are a key component of Canada's pulp and paper industry.⁵⁷ Graphic paper can be divided into four major types based on two characteristics of the paper, namely whether the pulp used in production is mechanical (groundwood) or chemical (free sheet) and whether the paper is coated or uncoated. Uncoated groundwood (UGW) is the most important type of graphic paper for Canada, accounting for 59% of graphic paper production in 2004, followed by uncoated freesheet (UFS) at 21%, coated groundwood (CGW) at 16%, and coated free sheet (CFS) at 5%.



In 2004, US graphic paper prices rose modestly after several consecutive years of declining or stagnant prices following the 2001 recession. Prices for SC-A, our bellwether UGW grade, were 2.6% higher than 2003 levels. Price increases for other key grades ranged from 0.7% for CFS to 4.0% for CGW. Given the modest size of price increases and their late arrival in relation to the US economic recovery, it is not surprising that prices are still well below cyclical peaks reached in 2000 (UGW is 12.7% lower than 2000; UFS: 9.0%; CGW: 18.5%; UFS: 15.3%).

⁵⁶ The following prices are given for each of the distinct graphic paper product types (all obtained from Pulp & Paper Week):

- (a) Coated Groundwood (CGW) is represented by No. 5, 34 lb, roto, rolls.
- (b) Coated Free-Sheet (CFS) is represented by No. 3, 60 lb, rolls.
- (c) Uncoated Free-Sheet (UFS) is represented by 50 lb offset rolls.
- (d) Uncoated Groundwood (UGW) is represented by 35 lb, supercalendered (SC-A).

⁵⁷ In 2004, graphic paper accounted for 43% of Canada's total paper production and 23% of Canada's total production of pulp, paper, and paperboard products based on tonnage (Pulp and Paper Products Council).

Graphic paper export volumes surge in 2004...

The volume of Canadian exports of all major graphic paper product types increased in 2004, up by 21.4%, 5.0%, 13.5% and 11.0% for UGW, UFS, CFS and CGW respectively, relative to 2003. Total exports (all grades combined) were 16% higher. Strong US demand for super-bright and lightweight grades contributed to an increase in UGW

exports. Exports for coated groundwood papers, mainly used in magazines, also improved during the year, due to an increase in ad spending experienced in the magazine sector. Exports for coated free-sheet paper products also increased, typically used in high-end magazines, catalogues and promotional material.

The value of exports increase overall, but decline for some grades...

The value of Canadian CGW and UGW exports increased significantly in 2004, rising by 7.5% and 19.7%, respectively, compared to 2003. Conversely, the value of CFS and UFS exports declined slightly, falling by 0.8% and 3.3%, respectively, over the same time period. The increasing volume of exports was the primary contributor to increased export values, with increased prices also making a contribution. However, the value of exports increased less than the volume, rising by 10.9% for the year (compared to a 16.0% increase in volume), as currency movements eroded the export earnings of Canadian producers.

**Figure 2.26 Graphic Paper Exports
Thousands of Tonnes**

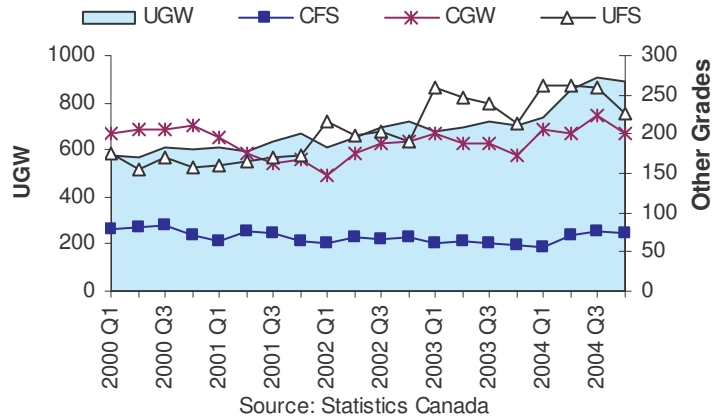
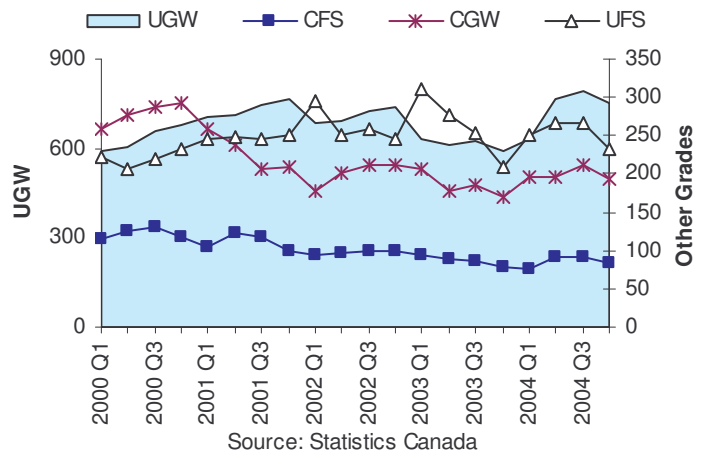


Figure 2.27 Graphic Paper Exports, Millions C\$



3. Forest Sector Employment

In this year's edition of the Annual Review and Outlook, we examine recent developments in employment in three segments of Canada's forest industry: (1) sawmills and wood preservation, (2) panel and engineered wood product manufacturing, and (3) pulp and paper mills. The annual average number of employees for each industry is calculated by averaging monthly employment estimates taken from Statistics Canada's Survey of Employment, Payroll, and Hours (SEPH).⁵⁸

Employment in sawmills rises slightly in 2004, but down from the 2001 levels...

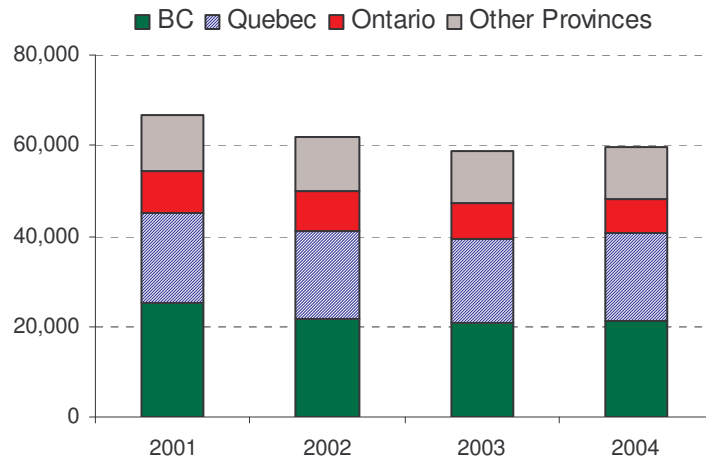
In 2004, employment in sawmills and wood preservation averaged 59.6 thousand for the year, up by 1.7% from 2003.

Employment in British Columbia and Quebec increased by 3.5% and 4.0%, respectively. In contrast, Ontario experienced a decline in employment of 7.7%, while other parts of Canada saw little change in aggregate.

The increase in overall employment accompanied high lumber prices in 2004 following several years of cyclically low prices although wood fibre availability issues in Ontario have in part been responsible for the decline in employment in that province.

Overall employment levels have fallen since 2001, averaging 7,200 fewer people Canada-wide in 2004 (down 10.8%). The largest decline occurred in British Columbia, where average employment was 3,900 less (down 15.4%), while the largest relative decline occurred in Ontario (down 1,800 or 19.5%). Quebec's decline was more modest, with average employment falling by approximately 600 (3.0%), while employment in all other regions fell by close to 1,000 (7.7%). The decline in nation-wide employment levels can in part be explained by a stronger Canadian dollar, which has resulted in lower revenues received from US based markets and upon which the sawmills and wood preservation sector is highly dependent.

3.1 Average Annual Employment in Sawmills and Wood Preservation



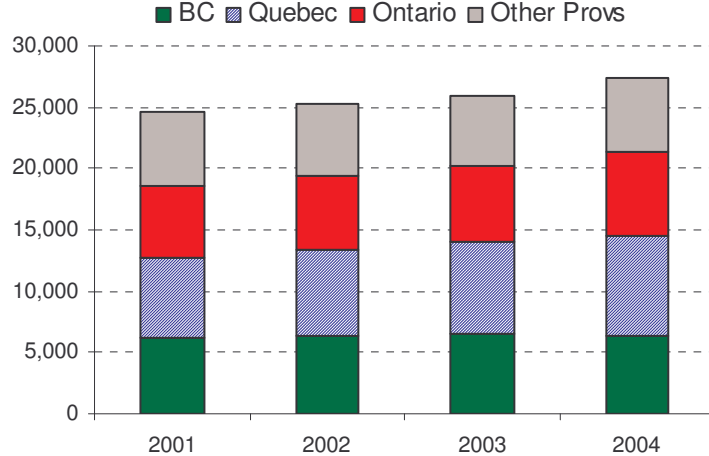
Source: Statistics Canada, Survey of Employment, Payroll, and Hours

⁵⁸ Statistics Canada's SEPH is a monthly survey of enterprises. Note that Statistics Canada also estimates employment by industry using the Labour Force Survey (LFS), which is a monthly survey of households. The two surveys differ in terms of methodology and also coverage (e.g., self-employed may not be captured by SEPH).

Employment in panel and engineered wood production continues strong growth in 2004...

Employment in veneer, plywood and engineered wood products manufacturing⁵⁹ increased in 2004, rising by 1,600 (6.2%) compared to 2003 levels. The largest increases occurred in Quebec and Ontario, where average employment increased by close to 800 (10.4%) and 600 (9.5%), respectively. Employment in British Columbia was down slightly (less 150 or 2.4%), while employment for other regions of Canada was up by close to 400 (6.7%).

3.2 Average Annual Employment in Veneer, Plywood, and Engineered Wood Products



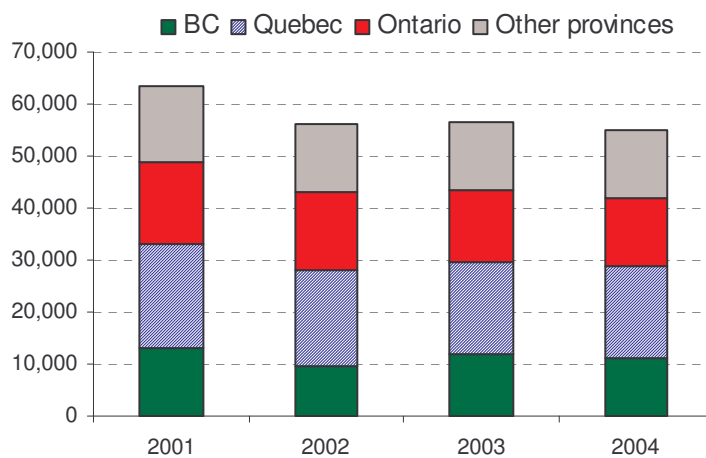
Source: Statistics Canada, Survey of Employment, Payroll, and Hours

The increased employment in this industry is the continuation of a longer-term trend in the Canadian industry. Since 2001, average employment Canada-wide has increased by nearly 3,000 or 11.9%. The increase has been concentrated in Quebec and Ontario, where employment has risen by 1,700 (26.7%) and 1,000 (17.9%), respectively. Employment in other regions has changed little (up 1.0% in BC and 1.2% in the rest of Canada). This is part of a long-term trend of increasing employment in the industry. Since 1991, average nation-wide employment has grown by 3.7% per year. Over the same time period structural panel capacity has increased by 7.5% per year.

Pulp and paper employment continues to fall...

Employment in mills manufacturing pulp, paper, and/or paperboard fell by 1,600 (2.9%) in 2004 compared to 2003. British Columbia experienced the biggest decline with average employment falling by nearly 700 (5.8%), followed by

3.3 Average Annual Employment in Pulp, Paper, and Paperboard Mills



Source: Statistics Canada, Survey of Employment, Payroll, and Hours

⁵⁹ Note that this category also includes employment in mills manufacturing other panels such as OSB, particleboard, and fibreboard.

Ontario with a drop of close to 500 (3.5%). Employment in Quebec was virtually unchanged, while that of all other provinces declined by about 300 (2.4%).

Since 2001, nation-wide employment in the industry has fallen by close to 9,000 (13.8%), with declines spread fairly equally across regions. The largest absolute declines occurred in Ontario (2,500 or 15.7%) and Quebec (2,400 or 11.8%), followed by British Columbia (2,000 or 14.8%). Employment in other regions also fell by about 2,000 (13.4%). While this decline accompanied a cyclical decline in prices for many paper products, the industry has exhibited declining employment levels over the long-term. According to the SEPH, Canadian employment in the industry has fallen by 35% since 1991, equivalent to a 3.2% decrease annually.

The decline in overall employment has been in part attributable to numerous mill closures in the pulp and paper industry, directly accounting for 2,300 lost jobs between 2003 and 2004. The closure of these mills stemmed from a number of factors, including a higher Canadian dollar, rising energy costs, higher fibre prices and the declining consumption of newsprint (Canada's highest volume paper export).

4. Forest Product Prices and Forest Industry's Financial Performance

4.1. Introduction

In this section, trends in forest product prices will be examined and their impacts on the recent financial performance of the Canadian forest industry analyzed. Trends in price indices for (1) wood products, (2) pulp and paper products, and (3) forest products as a whole, will be described to reflect broad movements in prices for each of the groupings of the forest industry indicated.

The price indices are based on forest product prices sold at the factory gate. The prices refer to what the producer receives rather than what a purchaser pays. They exclude all indirect taxes, such as sales taxes and tariffs as this money does not go to the factors of production (i.e. labour, capital, or profit). Generally, they also exclude any transportation service performed beyond the factory gate and any distribution services performed by the retail or wholesale trade industries.

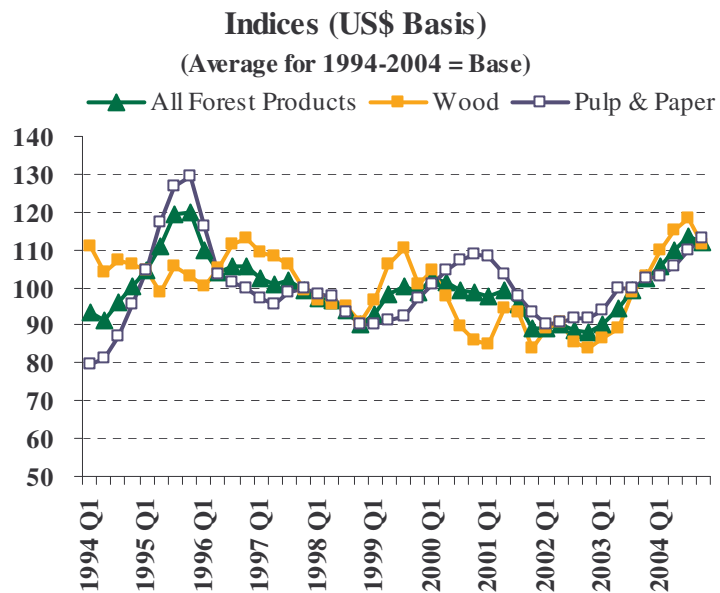
All price indices are denominated in Canadian dollars. However, most Canadian firms sell in US prices. Therefore, in order to understand the effects on prices received by Canadian firms from exchange rate fluctuations, all price indices are converted into US dollar amounts.⁶⁰ Later in the section the Canadian dollar index is compared with the rate of return on capital observed in Canada's forest industry over the past 4 years. These are discussed in relation to the prospects for future price movements and profitability of the industry.

4.2. Forest Product Price Indices

Prices in US markets entered a prolonged decline in 2000, but rebounded in 2003 and 2004 led by a surge in wood products prices...

Figure 4.1 shows the quarterly price indices for wood, pulp and paper, and all forest products expressed in US dollars. The indices express prices relative to average price levels observed from 1994-2004. During the period, the overall price index peaked in the fourth

Figure 4.1 Canadian Forest Industry Price



⁶⁰ Note that these indices do not capture taxes nor shipping costs.

quarter of 1995 before going on a steady decline until the end of 1998. The index rose again in 1999, hitting a local peak (in 2000 Q1) before bottoming out (for the entire period) in the fourth quarter of 2002. Since that time the price index has been rising rapidly, reaching a local high in the third quarter of 2004.

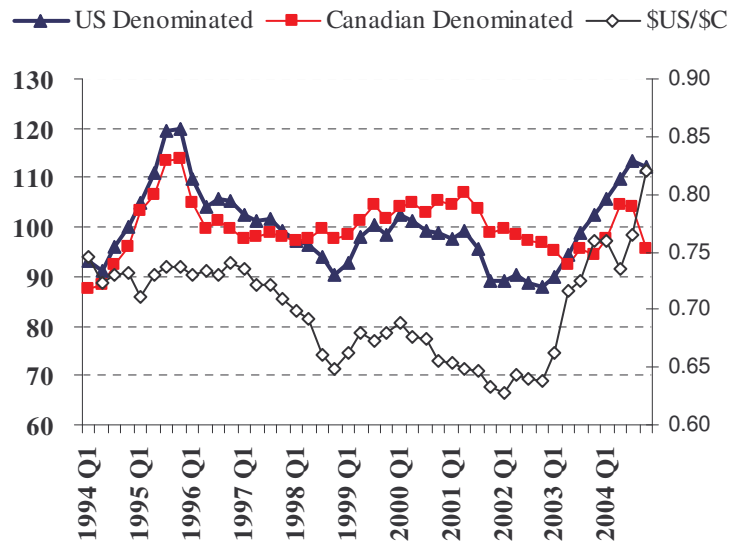
The 1994-2004 period was marked by two key trends. First, from 1994 until the first quarter of 2001, for the most part (although not exclusively), prices for wood products and pulp and paper prices were characterized by movements in opposing directions, thereby resulting in offsetting effects. For example, in late 1999 falling pulp and paper prices (indicated by a decrease in the pulp and paper price index) were offset by rising lumber prices (marked by an increase in the wood products price index). Second, beginning in the second half of 2001 until the latest quarter (Q4 of 2004), the period was marked by a synchronous fall in forest product prices for both the wood and pulp and paper industries, with prices hitting a low point in late 2002. However, the index began to rebound in 2003 and reached its highest level since late 1995 in the third quarter of 2004. This rally has been driven by a run on lumber and panel prices caused by the housing boom in North America as well as a modest increase in pulp and paper prices fostered by the US economy's continued robust performance.

Appreciating Canadian dollar offsets price movements in forest product markets...

Figure 4.2 shows the forest products price index expressed in both a Canadian and US dollar basis along with the exchange rate. While prices in US dollars consistently increased from the beginning of 2003 until the third quarter of 2004, prices expressed in Canadian dollars did not. At the same time as US forest product markets heating up, the Canadian dollar began increasing in value, which had an offsetting effect.

However, exceptionally strong wood prices did manage to pull the Canadian dollar index up in the second and third quarters of 2004, before further currency appreciation and moderating wood prices pulled it back down by the end of the year. The surge in wood prices did increase the Canadian index by 6.3% in 2004 relative to 2003, while the index rose by 14.2% when expressed in US dollar terms.

Figure 4.2 Price Indices in US and Canadian Dollars & the US/Cdn Exchange Rate



Source: Statistics Canada, Bank of Canada

4.3. Financial Performance and Price Indices

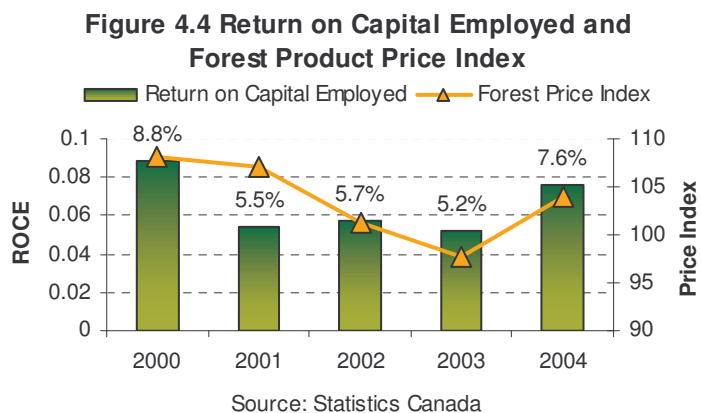
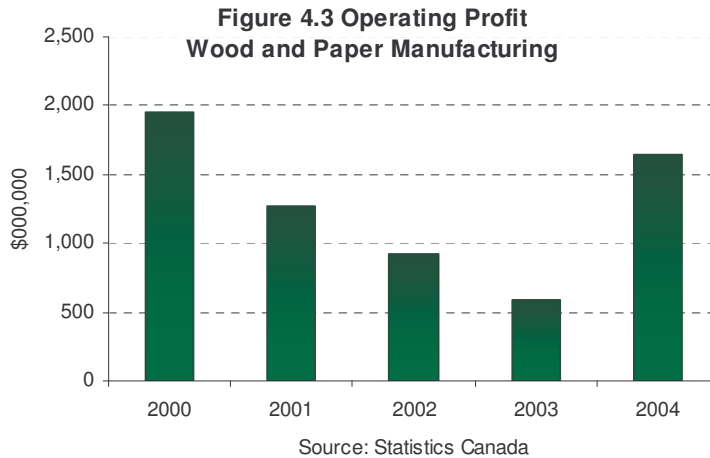
Forest product prices drive operating profit and return on capital employed...

After three consecutive declines, operating profits rose dramatically in 2004. The rise in operating profits was the result of both increased revenues, as well as declining operating costs. The rise in revenues can be partially attributed to high prices for many forest products, which

more than offset exchange rate movements. On the cost side, although rising wood fibre and energy costs have impacted the industry's bottom line, mergers and acquisitions, as well as firms disposing of less productive assets are possible explanations for the overall lower operating expenses realized by the industry. As prices for wood products are expected to decline in 2005, it is likely operating revenues will also decline. Although merger and acquisition activity should continue to reduce costs in Canada's forest industry these activities are not likely to offset the impact that lower end product prices, rising energy prices and increasing wood fibre costs will have on revenues. Therefore it is likely that 2005 will see a decline in operating profits.

Return on capital employed (ROCE) is a key indicator of financial performance in the capital-intensive forest sector. ROCE should exceed the rate at which the industry borrows. With this in mind a common referred to target within the forest industry is 10%. The high operating profits realized in 2004 helped boost ROCE. As

mentioned above prices were a key driver in 2004 operating profits. Figure 4.3 displays a close correspondence between ROCE and the forest product price (FPP) index (expressed in Canadian dollar terms) as can be expected given the impact of prices on firms' revenues. The rise in the forest product index was driven by wood product prices, while



paper prices realized more moderate growth in 2004. It is important to note the FPP does not take into account the cost side of the industry. The figures above show that the financial performance of the industry between 2001-2003 was weak. However, 2004 realized a significant turn around driven in large part by prices for forest products.

Wood product prices expected to decline, while pulp and paper prices will see a modest increase before levelling off. No relief expected from currency appreciation ...

As we move forward into 2005-2006 prices for forest products are not expected to outperform levels realized in 2004. Prices for wood products are expected to decline in 2005 and 2006 as the North American housing market begins to cool from historic highs. Prices for newsprint are expected to experience a slight rise, as the US economy remains strong, therefore increasing demand for advertising. Price increases are projected for graphic papers (uncoated free-sheet and light weight coated).⁶¹ The bulk of this increase will occur in 2005, while price gains will be modest in 2006. Strong demand for pulp from paper products should counteract the impact of high inventories and therefore lead to moderate price increases in the short-term. It is difficult to project long-term prices for pulp, as it is difficult to forecast demand from China.⁶² As discussed in the economic outlook (Section 1.1), the Canadian dollar is expected to remain strong given the large US current account deficit and high commodity prices.

⁶¹ RISI Graphic Paper Forecast 2004

⁶² Conference Board of Canada, Canada's Paper Products Industry