



## **Annual Economic Review & Outlook for the Canadian Forest Sector: 2004-2005**

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

August 11, 2004



Natural Resources  
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ISBN 0-662-38523-3  
Cat. No. Fo51-2/2004E-PDF

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## **Forward**

The Canadian Forest Service is pleased to present the first 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 2004 and into 2005.

This report was prepared using information available as of July 2004. Note that this report only represents the opinions of the authors, and does not represent the opinions of the Government of Canada. If you have any questions or comments regarding the report or would like more information, please contact the authors listed below.

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## **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 2004 and into 2005. The remainder of this section provides a brief synopsis of the major conclusions of our report.

### **Economic Outlook for Major Markets**

#### *North America*

In 2003, strong demand for wood products fuelled by a boom in house construction has driven prices for lumber and wood-based panels to extremely high levels. This housing boom has been driven by low interest rates in both Canada and the US that have pushed mortgage rates to their lowest levels in more than 40 years. Demand from the construction is expected to remain strong through the remainder of 2004, but could begin to tail off late in the year and into 2005 as the Bank of Canada and US Federal Reserve are expected to increase interest rates.

North American demand for pulp and paper has been subdued since 2001 with the onset of a recession in the United States, though prices have been creeping upward since the start of 2003 as the US economy has rebounded. Price and demand levels have not yet rebounded to pre-recession levels, but are expected to continue increasing as the US economy continues to gather steam, which could buoy Canadian exports.

Another significant event for Canada's forest sector was the rapid appreciation of the Canadian dollar in 2003. This has partially offset price gains in forest product markets by reducing what Canadian producers receive for their products in Canadian funds. In January 2003, the Canadian dollar traded at an average of 64.8 cents US, but this increased to 77.2 cents US by January 2004, equivalent to a 19 percent increase. Since then, the Canadian dollar has fluctuated up and down, but most economists expect that the appreciation will continue in the remainder of 2004 and into 2005. However, the degree of change is not expected to be as large as the appreciation that occurred in 2003.

#### *Other markets – Japan, Western Europe, and China*

Demand for Canadian exports from Japan and Western Europe, which have traditionally been important markets for Canada's forest industry, has been weak in recent years. This has been due in part to poor economic conditions in those regions. While growth is projected to increase in 2004-2005 and signs of economic recovery are evident, especially in Japan, domestic demand continues to be weak in both regions. This could prevent demand for Canadian products from growing appreciably in the short-term. In

addition, the recent enlargement of the European Union could have a negative impact on Canada's exports to Europe as many of the new entrants have significant forest resources and fast developing industries that could serve to increase competition.

China's demand for Canadian forest products, especially wood pulp, has grown quickly over the past 10 years owing to that country's rapid economic growth. It is now Canada's third most important market with exports reaching \$950 million in 2003. China's growth is expected to continue, which will continue to provide opportunities for further expansion into that market. However, many economists are concerned that China's economy could be overheated and may be headed for a sharp correction. If and when this might happen is highly uncertain and dependent on the success of efforts by Chinese officials to manage macroeconomic and financial conditions in the country.

## **Developments in Forest Product Markets**

### *Softwood lumber*

US consumption of softwood lumber reached a record level in 2003 spurred by strong demand in the second half of the year. Lumber prices began a rally in August of 2003 in response to this strong demand and have reached near-record levels in 2004. This follows a prolonged period of low prices that began in 2001. The volume of Canadian softwood lumber exports increased slightly in 2003, though the value fell by \$2 billion (18.5%) as higher lumber prices late in the year were not enough to offset the impact of the appreciating Canadian dollar on export earnings. However, further price increases and a halt of the Canadian dollar's ascent have increased exports values in the first quarter of 2004 by 9.3%. Canada's share of the US softwood lumber market was stable in 2003 increasing slightly to 34.2% compared to 33.8% in 2002. However, that share dropped in the first quarter of 2004 owing to higher US production and increased US imports from a few offshore competitors, most notably Brazil, Chile, and Germany.

### *Wood-based Panels*

As with lumber, North American panel markets have also benefited from strong demand created by the housing construction boom. North American consumption of oriented strandboard (OSB) increased while plywood consumption was virtually unchanged in 2003. However, sharp increases in consumption of both products were seen in the first quarter of 2004. Strong demand led to dramatic price increases beginning in July 2003, which have lasted thus far into 2004. Structural panel prices through the first half of 2004 were 95% higher than the same period in 2003. Canadian firms responded to prices by increasing OSB production significantly in 2003 and in the first quarter of 2004. US production also increased but not as dramatically. Canadian plywood producers have also increased their output in response to prices, but only modestly. Both the volume and value of Canadian panel exports to the US increased in 2003 and through early 2004 with high prices more than offsetting exchange rate effects on the revenues for Canadian exporters to US markets.



### *Wood pulp*

North American demand for chemical pulp remained weak in 2003 with total consumption falling by 4.1% compared to 2002. Canadian chemical pulp production increased in 2003, responding to rising pulp prices, especially for Northern Bleached Softwood Kraft. Canada's pulp exports declined in both volume and value terms in 2003, due to weak exports to the US, European Union, and Japan. However, exports to China continued to grow at a rapid pace in 2003, exceeding 2002 levels by 21% on a volume-basis, offsetting some of the losses in other markets.

### *Newsprint*

US consumption of newsprint remained weak in 2003 decreasing slightly from already depressed 2002 levels, while Canadian production of newsprint remained virtually unchanged. Despite weak demand growth, newsprint prices edged upwards over the course of the year and into 2004, though they remain well short of levels preceding the US recession. However, the moderate price increases were not sufficient to offset the impact of exchange rate movements on Canadian exporters, who rely heavily on the US market, resulting in a 10% decline in the value of Canadian newsprint exports despite a slight increase volume.

## **Forest Sector Employment**

Employment in forest-related industries was 285,000<sup>1</sup> in 2003, which was down by 5,700 (equivalent to 2.0%) from 2002 levels. Regionally, employment showed the largest fall in British Columbia, where total employment was down by nearly 4,400 or 7.1 percent, followed by Ontario, which experienced a 2,300 (3.2%) decline in employment. Conversely, employment in Quebec increased by 1,700 (2.0%), while other provinces saw employment remain virtually unchanged. On a sector basis, job losses were concentrated in forestry and logging with more than 6,000 fewer people employed nationally, while employment in wood product manufacturing was little changed and employment in paper manufacturing increased slightly.

Despite the overall decline in employment in Canada's forest industry in 2003, the job losses witnessed in that year were much smaller than those seen in previous years. Between 2000 and 2002, total employment declined by 40,000, an average of 20,000 per year. Most of the job losses since 2000 have been concentrated in BC with the forestry and logging industry being hit the hardest. Nationally, 50% of the decline in employment over this time period has been in forestry and logging with the rest split evenly between the wood and paper manufacturing industries.

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<sup>1</sup> This figure is based on the Survey of Earnings, Payroll and Hours (SEPH) which does not include unpaid family workers, the self-employed, unpaid absentees (such as workers on strike), incorporated businesses, and working partners without employees. These other employment categories are included in statistics reported by the Labour Force Survey (LFS), which reported 376,300 employed in all forest-related industries in 2003. Both surveys are administered by Statistics Canada.

**Financial Performance**

The financial performance of Canada's major forest companies has declined over the past four years with their return on capital employed (ROCE) falling from 6.6 percent in 2000 to 3.9 percent in 2003. This decline has been due in large part to declining forest product prices since 2000 and, in 2003, the appreciation of the Canadian dollar. Recent price gains in wood product markets have helped boost revenues for Canada's forest industry, but pulp and paper prices have not yet rebounded to pre-recession levels. While pulp and paper prices are expected to continue increasing, wood product prices could begin to decline in the next year and the Canadian dollar could further appreciate. Thus, it is difficult to predict whether and to what extent the industry's performance could improve in 2004 and 2005.

## 1. Economic Outlook

### 1.1. North American Outlook

*Broad-based recovery underway in US while Canadian economy shows signs of rebounding...*

The US economy began to recover in late 2003 after entering a recession in 2001. Strong growth has continued in 2004 with real GDP<sup>2</sup> increasing by 3.9 percent in the first quarter (Figure 1.1).

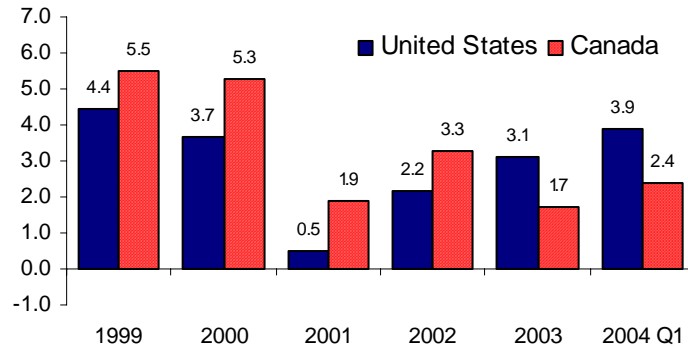
Consumer spending and residential investment, which have been the few bright spots in the economy over the past few years, have remained strong due in part to low interest rates set by the US Federal Reserve (Figure 1.2). Other sectors have accelerated as the recovery has become more broad-based. In particular, capital spending has increased as business confidence has improved and exports have grown with the depreciation of the US dollar. Employment levels have also rebounded following a long period of job losses with total employment rising by 1 million through the first half of 2004.<sup>3</sup>

In contrast, the Canadian economy performed poorly in 2003, which is a striking turnaround from 1999-2002 when Canada's growth exceeded that of the US. Economic setbacks were in part due to unexpected shocks such as SARS, BSE (Mad Cow Disease), the Ontario Blackout, forest fires in BC, and Hurricane Juan on the east coast. However, the sharp rise in the value of the Canadian dollar relative to the US dollar also hurt export-dependent sectors such as manufacturing. As a result, Canada's GDP growth in 2003 reached only 1.7 percent. GDP growth was also slow in the first quarter of 2004 at 2.4 percent, but picked up later in the quarter with a strong showing in March following two months of stagnation to start the year.

*Low interest rates have fuelled strong investment in the housing sector...*

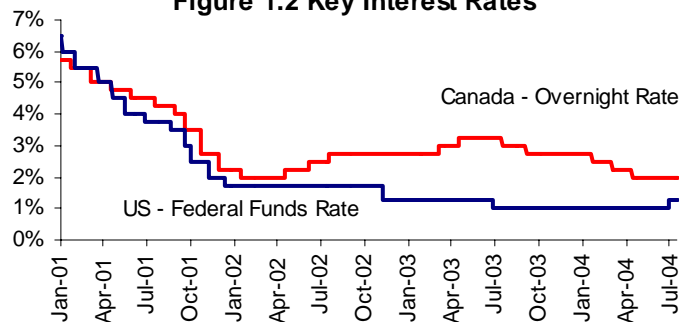
Following the onset of the US recession in 2001, the US Federal Reserve and the Bank

**Figure 1.1 Percent Change in Real GDP**



Source: Statistics Canada and US Bureau of Economic Analysis

**Figure 1.2 Key Interest Rates**



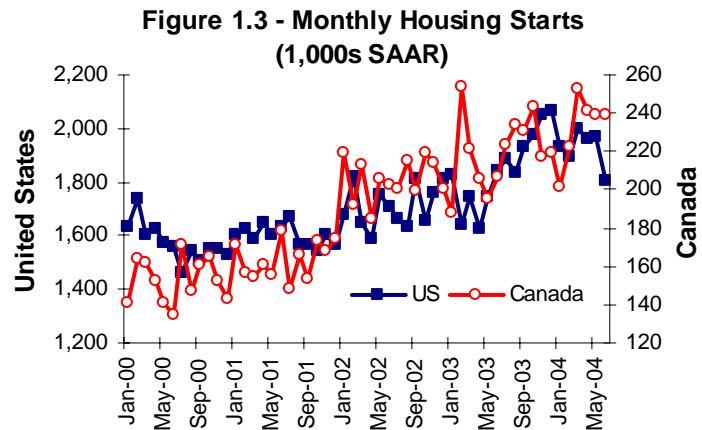
Source: Bank of Canada and US Federal Reserve

<sup>2</sup> The growth rate for 2004 Q1 represents the annualized percent increase in the seasonally adjusted real GDP value from the previous quarter.

<sup>3</sup> U.S. Department of Labor, Bureau of Labor Statistics

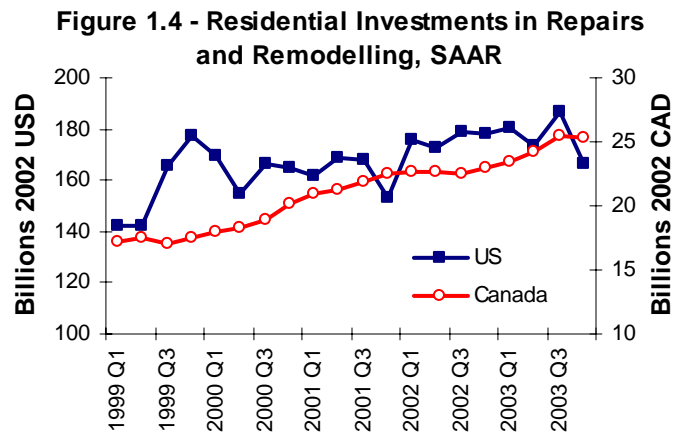
of Canada reduced interest rates significantly in order to stimulate their respective economies (Figure 1.2). In June 2003, the target for the Federal Funds Rate, the key indicator of monetary policy in the US, was reduced to 1 percent bringing it to its lowest level in 45 years. The Federal Reserve increased rates slightly to 1.25 percent in June 2004 responding to inflationary pressures created by high oil prices. From mid-2002 to early 2003, the Bank of Canada increased the target Overnight Rate, the key interest rate in Canadian monetary policy, due to concerns over inflation. However, the poor performance of the economy and a rapid appreciation of the Canadian dollar in 2003 led to a series of rate decreases with the target Overnight rate falling back to 2 percent in April 2004, equivalent to the low levels seen in early 2002. Rates have remained at that level since.

Monetary conditions over the past two years have led to extremely low mortgage rates in both Canada and the US, spurring a boom in housing markets. This has had important implications for the forest industry, because residential construction is the most important end-use for lumber and wood panels in North America. Figure 1.3 shows monthly housing starts expressed on a seasonally adjusted annual average rate (SAAR) since January 2000. In 2003, housing starts in the US and Canada reached their highest levels since 1986 and 1989, respectively. Housing starts have been even stronger in 2004 with total starts through the first half of the year up by 11.2 percent in the US and 11.6 percent in Canada compared to the same period in 2003.



Source: Canadian Housing and Mortgage Corporation and US Census Bureau

The boom in residential construction has been accompanied by impressive growth in investment in existing housing, which also accounts for a significant portion of demand for lumber and wood panels. Figure 1.4 shows real quarterly repair and remodelling expenditures in Canada and the US over the last 5 years expressed as a seasonally adjusted annual rate (SAAR). Growth in Canada has been especially strong with expenditures in 2003 up by 8.5 percent compared to 2002 and 42



Source: Statistics Canada and US Census Bureau

percent compared to 1999. Expenditures in the U.S. have also grown, but more modestly with real expenditures in 2003 being unchanged from the previous year and 12 percent higher than in 1999.

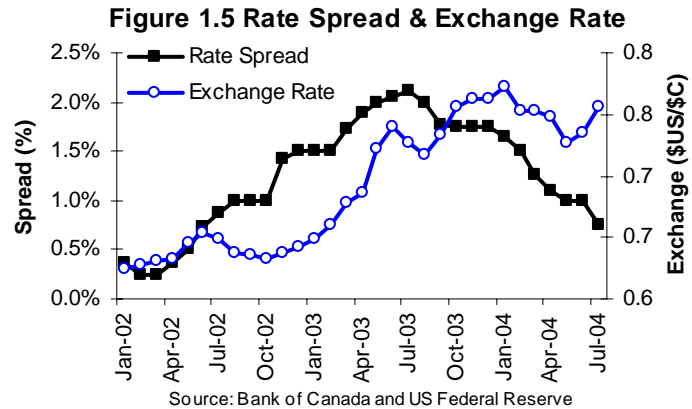
*Canadian dollar surges in 2003, raising competitiveness concerns for the forest industry...*

Owing to the export-oriented nature of the Canadian forest industry and Canada's reliance on US markets<sup>4</sup>, the Canada-US exchange rate has a strong bearing on the fortunes of the industry.

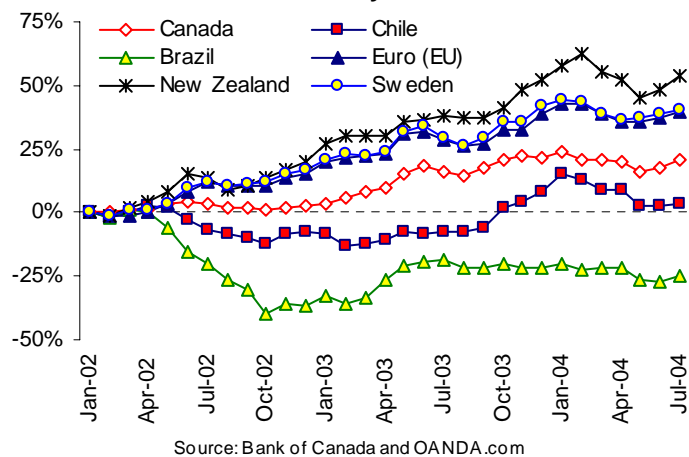
All things being equal, a stronger Canadian dollar increases costs more than revenues as costs are paid in Canadian dollars (e.g., wages, energy, materials) while revenues are based primarily on sales in the US market at US dollar prices. Thus an appreciation of the Canadian dollar hurts the competitiveness of Canadian firms vis-à-vis their US counterparts. In 2003, the value of the Canadian dollar increased dramatically (Figure 1.5). In January 2004, the Canadian dollar averaged 77.2 cents US compared to 64.8 cents in January 2003 for an increase of 19 percent. One factor contributing to this appreciation was the large spread in interest rates that emerged in 2002-2003 as the Bank of Canada increased interest rates to combat inflationary pressures while the Federal Reserve continued to lower rates due to weak US economic conditions.<sup>5</sup> Since, the rate spread has decreased and the Canadian dollar has fluctuated in value first falling to 72.6 cents in May but rising again to 75.6 cents through the first half of July.

*Currency changes have hurt producers in Europe and New Zealand while favouring South American producers...*

Figure 1.6 shows changes since 2002 in the value of the currencies of Canada's most important competitors in US forest product markets. While the Canadian dollar has appreciated greatly during this



**1.6 Percent Change in Currency Value since January 2002**



<sup>4</sup> Canada exports approximately 60 percent of its forest products. In 2003, 78.3% of these exports went to the US. Other major markets included: Japan (5.5%), China (2.4%), Italy, United Kingdom, S. Korea (1.4%), and Germany (1.3%).

<sup>5</sup> A large interest rate spread (i.e., Canadian rates much higher than US rates) increases demand for Canadian currency as rates of return on Canadian-dollar interest-paying assets are higher, thus leading to an appreciation of the Canadian dollar in the short-term.

period, major developed country competitors such as Sweden, New Zealand, and members of the EU (includes major forest product producers such as Finland, Germany, and Austria) have seen their currencies appreciate earlier and to an even greater degree than Canada. This has favoured Canada's competitive position relative to these countries. Conversely, Brazil and Chile, which are the two largest exporters of forest products to the US behind Canada, have not experienced appreciations of their currencies. The Chilean peso made some gains against the US dollar in 2003 but has since dropped back to early 2002 levels. The Brazilian real underwent a significant devaluation in 2002 and has since rebounded, but has stabilized at lower levels. On net, recent currency fluctuations have hurt Canada's competitive position relative to major South American producers and the US domestic industry, while benefiting Canada's position relative to producers from Western Europe, Scandinavia, and New Zealand.

*Strong economic growth is expected to reduce excess capacity in both the US and Canada through 2004-2005 leading to gradual increases in interest rates...*

Strong economic growth in the US is expected to continue with real GDP growth for expected to reach nearly 5 percent for 2004, up from 3.1 percent in 2003.<sup>6</sup> Economic indicators show that this growth is expected to be broad-based with continued strength in consumer spending and an acceleration of business investment owing to high corporate profits. Growth is expected to slow somewhat in 2005, as the excess capacity in the US economy dissipates, but is still expected to reach a healthy 4 percent. Economic growth in Canada is expected to pick up in the second half of 2004 with real GDP growth for the year projected to reach between 2.75-3.2 percent for the year. The situation is expected to improve in 2005 with growth projections centred on 3.5 percent. Continued strength in export markets will foster Canada's improved performance along with an expected increase in business investment owing to strong profits.

As economic conditions improve, the Federal Reserve and Bank of Canada are expected to increase interest rates to ensure that inflation remains in check. The Federal Reserve increased rates in June 2004 from 1 percent to 1.25 percent, which was the first rate since the onset of the US recession. The Federal Reserve announced that its intention is to raise interest rates at a "measured" pace<sup>7</sup> as the economy approaches full capacity. It is expected that rates could return to a more "neutral" level of 4-5 percent by the end of 2005. Thus, while rates are expected to increase, they will likely remain low by historical standards in the near term. Gradual rate increases are also projected for Canada most likely beginning in September 2004. However, given the slower pace of growth and already higher interest rates in Canada, interest rates are expected to rise later and more slowly than in the US.

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<sup>6</sup> The economic outlook for Canada and the US is based on a review of forecasts by TD Bank Financial Group (Quarterly Economic Forecast – June 24, 2004, Monetary Policy Monitor - July 16, 2004), BMO Financial Group (North American Outlook - June 2004), and RBC Financial Group (Economic and Financial Market Outlook - July 2004).

<sup>7</sup> From June 30, 2004 rate announcement by the Federal Open Market Committee (US Federal Reserve).

*Housing markets will remain strong through 2004 but begin to wane in 2005...*

In their second quarter National Housing Outlook<sup>8</sup>, the Canadian Housing and Mortgage Corporation (CMHC) forecast that housing starts in Canada would remain high in 2004, but fall slightly (-4.5%) from their record-setting 2003-levels. They also forecast that starts would decline by another 7.8% in 2005. However, the most recent data (above) show that the projected 2004 decline has not yet materialized with starts through the first half of the year significantly exceeding levels in 2003. The continued high pace of residential construction is attributed to still-low mortgage rates combined with improving employment and consumer confidence.<sup>9</sup> However, the market will eventually turn downward as the Bank of Canada raises interest rates later this year. The data from the US market paint a similar picture with starts through the first half of 2004 exceeding 2003 levels. However, Resource Information Systems Inc. (RISI), a leading consulting firm on the economics of the forest sector, has forecast that US starts will begin to fall significantly beginning in the fourth quarter of 2004 (-14.0% vs. 2003 Q4 levels), though total starts for the year are expected to exceed 2003 by 1.6%.<sup>10</sup> The decline is expected to accelerate in 2005 as interest rates rise to more neutral levels, with a projected decline of 13.9% for that year.

*Canadian dollar could lose ground in the short-term, but further appreciation is still expected...*

With faster economic growth and higher inflationary pressures<sup>11</sup> in the US, it is expected that the Federal Reserve will increase interest rates faster than the Bank of Canada. This will further decrease the interest rate spread between the two countries and take upward pressure off the Canadian dollar in the short-run. However, many economists see the broad devaluation of the US dollar against major world currencies that occurred in 2003 as a long-term correction in exchange markets pointing to large and growing US current account deficit. In 2003, the US current account deficit reached a record 4.9% of GDP and has not been balanced since 1991, which has led to a significant increase in the net indebtedness of the US to foreigners. In addition, the US budget deficit reached 4.2% of GDP in 2003, its largest value since 1992, and deficits are projected to continue for the foreseeable future. These large “twin deficits” have led to concerns in global financial markets about a shortfall in national savings contributing to the devaluation of the US dollar.<sup>12</sup> Based on these factors, the Canadian dollar is expected to appreciate modestly against the US dollar over the next year and a half. Many analysts expect that the Canadian dollar will be trading between 76 and 80 cents US in 2005, up from 71.6 cents in 2003 and 74.8 cents through the first half of 2004.<sup>13</sup>

<sup>8</sup> CMHC National Housing Outlook – Second quarter 2004 released May 4, 2004.

<sup>9</sup> “Housing Starts Remain High in June”, CMHC Press Release, July 9, 2004.

<sup>10</sup> RISI Lumber Commentary – June 2004.

<sup>11</sup> The consumer price index (CPI) rose by 3.3% in the US and 2.5% in Canada in June 2004 compared to June 2003. The CPI excluding food and energy, two of the most volatile components, rose by 1.9% in the US and 1.5% in Canada over the same period.

<sup>12</sup> “The Dollar: Keep an Eye on it”, The Economist, July 10, 2004.

<sup>13</sup> TD Bank Financial Group – Quarterly Economic Forecast – June 2004, BMO Financial Group – July 2004 Outlook Update, RBC Financial Group – July 2004 Economic and Financial Market Outlook.

*Currently high demand for wood products is expected to wane in late 2004 and continue to fall in 2005 while recent growth in demand for pulp and paper should continue as global economic conditions improve...*

With the currently high demand in residential construction and home repairs and remodelling set to decline, demand for wood products will decline given that these end-uses account for approximately three-quarters of North American lumber and panel consumption.<sup>14</sup> North American demand for pulp and paper remained weak in 2003 despite improvements in general economic conditions. However, demand is projected to improve through 2004-2005, though competition from electronic media with graphic papers (e.g., newsprint and other papers) is becoming increasingly important issue for the industry.<sup>15</sup>

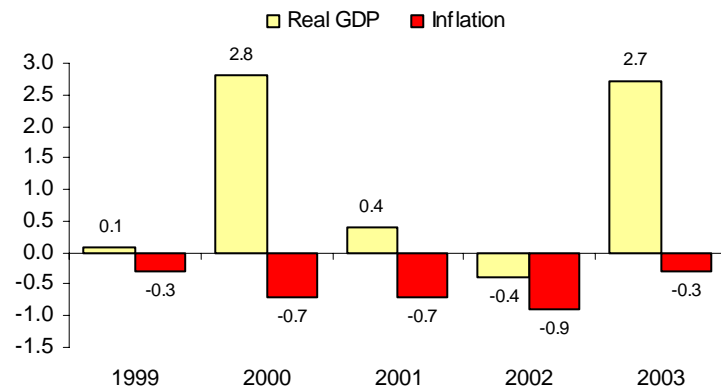
## 1.2. Japanese Outlook

*Japanese economy rebounds though concerns persist on whether the recovery can be sustained...*

Japan, which is the second most important consumer of Canadian forest products<sup>16</sup>, enjoyed an economic resurgence in 2003 after several years of stagnation following the Asian financial crisis in 1997 (Figure 1.7). From 1997 to 2002, real GDP growth averaged only 0.7 percent in contrast to 2.7 in 2003. Growth has been exceptionally strong in the last two quarters reaching 7.3 percent in the fourth quarter of 2003 and 6.1 percent in the first quarter of 2004. The recovery has been led by the export sector, which has benefited from strong demand for Japanese products from other Asian countries, most notably China. Business investment has also been strong with the improvement of profits in the corporate sector in 2003.

However, a persistent concern regarding Japan's economic performance is deflation. Despite Japan's impressive growth in 2003, price levels in the country continued to fall as they have since 1999. In 2003, the consumer price index fell by 0.3 percent. While, this is an improvement over previous years, it shows that deflationary expectations have not been eliminated. Such expectations inhibit economic growth by providing an

**Figure 1.7 Japanese Real GDP and Inflation**



Source: Economic and Social Research Institute (ESRI), Japanese Cabinet Office

<sup>14</sup> RISI North American Lumber Forecast – July 2003 and RISI North American Panels Forecast 2003.

<sup>15</sup> RISI North American Graphic Paper Forecast – August 2003.

<sup>16</sup> In 2003, Japan accounted for \$2.2 billion or 5.5 percent of Canadian exports of wood, pulp, and paper products ranking second behind the United States (\$30.9 billion or 78.3 percent) and ahead of China (\$956 million or 2.4 percent).

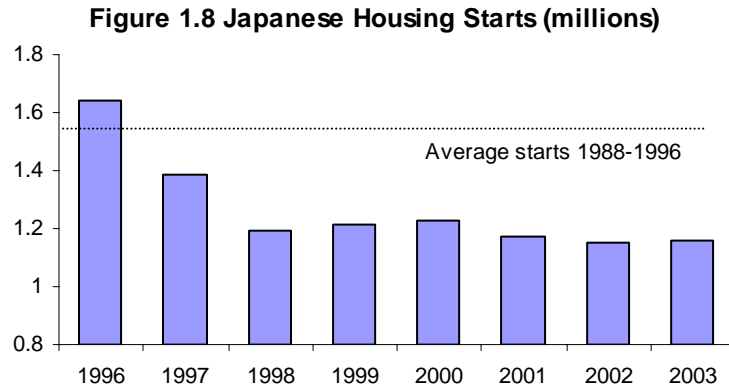


incentive for consumers to put off large expenditures, thus depressing demand in the economy.

*Japan's housing market remains depressed due to deflation...*

Japan's housing market, which is the world's second largest behind the US, remains depressed despite an upturn in other sectors. Total starts for 2003 were still at very low levels and nowhere near

levels seen prior to the Asian Financial Crisis in 1997 (Figure 1.8). Average starts per year from 1988 to 1996 were 1.55 million compared to 1.16 million last year. This weakness has persisted despite a zero interest rate policy put in place by the Bank of Japan. Falling housing prices, which are one component of the general decline of prices in the economy, are partially responsible for the weak market. Price declines, particularly in housing, give consumers the incentive to postpone their investments thus reducing demand and leading to further price declines. Average housing prices in 2002 fell to 37.2 million yen from 42.3 million yen in 1997. This represents a cumulative decline of 14% or 2.5% per year.



Source: Japanese Ministry of Land, Infrastructure and Transport

*Continued growth is projected, though structural problems remain a concern ...*

While most analysts are projecting continued strong growth for Japan in 2004, the economy still faces a number of challenges created by structural problems. One area for concern is Japan's banking sector, which has suffered financial difficulties due to the preponderance of non-performing loans (NPLs). Progress was made in reducing the amount of NPLs in 2003 as strong export growth helped many debtors in the export-sector service loans, but many experts believe that structural reforms are required to fully address the issue.<sup>17</sup> The growth of Japan's fiscal deficit is another concern, as the debt-to-GDP ratio reached 161% in 2003, which is the largest of any industrialized country. However, officials are reluctant to cut spending fearing that it will contribute to deflation. In addition, the rapid ageing of Japan's population will continue to put pressure on government finances in the long-term. However, despite these concerns, Japan's Cabinet Office forecast that real GDP growth for the year ending March 2005 will reach 3.5 percent, which would be the fastest pace of economic growth in Japan in 8 years.<sup>18</sup>

<sup>17</sup> International Monetary Fund. 2004. World Economic Outlook: Advancing Structural Reforms, April 2004.

<sup>18</sup> Japanese Cabinet Office - A Forecast of Economic Situation for FY 2004 – July 21, 2004.

*Demands for both pulp and paper products and wood products are expected to rise, though wood product demand will not likely reach pre-1997 levels ...*

Japanese demand for pulp and paper products is expected to increase with continued economic growth. Share prices of many Asian forest-product companies have been rising in 2004 in anticipation of increased sales in the Japanese and Chinese markets.<sup>19</sup> Demand for wood products is also expected to rise with improving economic conditions. However, deflationary expectations could continue to depress demand for housing, which will likely prevent demand for wood products from returning to levels seen prior to the 1997 Asian Financial Crisis.

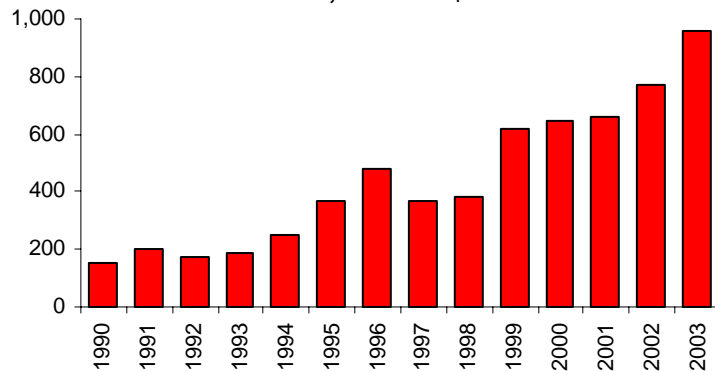
### 1.3. Outlook for Other Markets

*China's rapid growth will provide further opportunities for expansion of Canadian exports of forest products...*

China has been the fastest growing market for Canada's forest industry, with total exports of wood, pulp, and paper products to China rising from \$154 million in 1990 to \$955 million in 2003, equivalent to a 15 percent increase per year. It is now

Canada's third largest market behind the US and Japan. China's economy is expected to continue its rapid expansion with GDP growth rates projected to reach 8 percent in 2004-2005. Much of this growth is being driven by investment, which has been fostered by an expansion of bank lending, a continuation of large inflows of foreign direct investment, and a property market boom. This will lead to a continued increase in opportunities for expansion of exports to the Chinese market. However, there are some downside risks in China's economic outlook. First, there are concerns that the economy could be overheating due to excess investment. Second, concerns persist regarding the health of China's four state-owned banks due to the large amount of non-performing loans. To address these concerns, the Chinese government has taken actions to avert a crisis in the financial sector, by recapitalizing state-owned banks, increasing reserve requirements for banks, and introducing regulatory reforms to ensure better management of credit risks.<sup>20</sup>

**Figure 1.9 Canadian Forest Product Exports to China, Millions \$C**



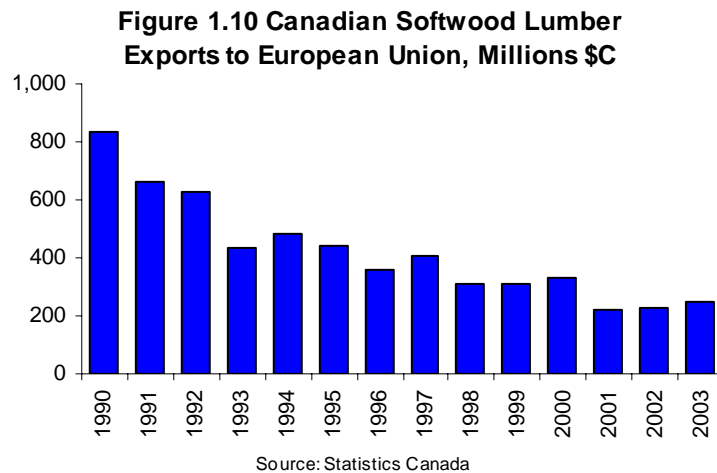
Source: Statistics Canada

<sup>19</sup> "Daio Paper, Carter Holt, Asian Forest-Products Shares May Rise", Bloomberg.com, July 26, 2004.

<sup>20</sup> Asian Development Bank. Asian Development Outlook - March 2004.

*Tentative recovery in Western Europe and UK could boost demand for exports, though EU expansion could negatively affect Canadian exporters in the next few years ...*

Western Europe and the United Kingdom have traditionally been important markets for Canada's forest sector, though exports to the region have declined over time. In 1994, Canada exported \$3.2 billion of forest products to the region. By 2003, exports had fallen to \$2.7 billion. However, the region still accounted for close to 7 percent of Canada's forest product exports in 2003. Poor economic conditions, particularly in the Euro region<sup>21</sup>, have been partially to blame for the fall in exports. Market access has also been a factor. In 1990, the EU imposed a ban on the import of untreated green softwood lumber to prevent the inadvertent entry of the pinewood nematode, a wood parasite indigenous to North America. The requirement to kiln-dry or heat-treat lumber, which was put in place in 1993, increased costs for North American companies shipping to the EU and resulted in a drop in exports to the region (Figure 1.10).



Real GDP growth in the Euro region was an anaemic 0.9 percent in 2002 and 0.4 percent in 2003. The region has been hampered by weak domestic demand and high unemployment. Growth is expected to accelerate slightly to 1.75 percent and 2.25 percent in 2004 and 2005, fostered by low interest rates and increased demand for exports due to economic expansion in other regions.<sup>22</sup> However, an improvement of domestic demand conditions will be required to boost Canada's exports to the region.

The United Kingdom has fared better than other nations in the EU during the last few years with low interest rates spurring strong consumer spending and a boom in the housing market. Real GDP growth was 1.7 and 2.3 percent, respectively, in 2002 and 2003. With improvements in world markets and, in particular, the tentative recovery in other EU nations, the economy should pick up more steam and will likely have growth exceed 3 percent for 2004. However, the rapid inflation in UK housing prices has raised concerns that the real estate market is overvalued, which poses a downside risk for the economy and wood product markets that rely on this sector.<sup>23</sup>

<sup>21</sup> "Euro region" refers to the countries in the EU that use the Euro as their currency. These currently include Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

<sup>22</sup> PriceWaterhouseCoopers. European Economic Outlook – February 2004.

<sup>23</sup> UK National Institute of Economic and Social Research. Forecast for the UK economy – July 2004.

Overall, demand for Canadian exports in Western Europe and the UK will increase with accelerated economic activity. However, already strong competition from European producers could become more intense as the process of economic integration with the 10 countries acceding to the EU in 2004 progresses. Many of the acceding nations have significant forest resources and have already benefited from significant investment in their forest industries, particularly from Scandinavian forest companies.<sup>24</sup> This could further accelerate the growth in production and exports of forest products from Eastern Europe that has already been observed over the last 10 years, which could increase competition in markets in Western Europe.<sup>25</sup> However, in the long-term, economic growth in these countries is expected to accelerate with accession, which could provide new market opportunities in the future.

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<sup>24</sup> Poland has the largest forested area of acceding countries. However, a number of smaller nations also have significant forest resources owing to the high percent of their land base that is forested, such as Estonia, Latvia, the Slovak Republic, and Slovenia.

<sup>25</sup> From 1993 to 2002, roundwood production from acceding countries increased by nearly 70 percent. Source: PriceWaterhouseCoopers. 2004. Distinguishing the forest from the trees: The impact of EU enlargement on the forestry, forest products, and paper industries.

## 2. Forest Product Markets

### 2.1. Softwood Lumber

*US consumption increased in late 2003 helping break the 2002 record...*

US softwood lumber consumption increased modestly by 460 MMBF or 0.8% in 2003 compared to 2002. However, this is the highest total on record,

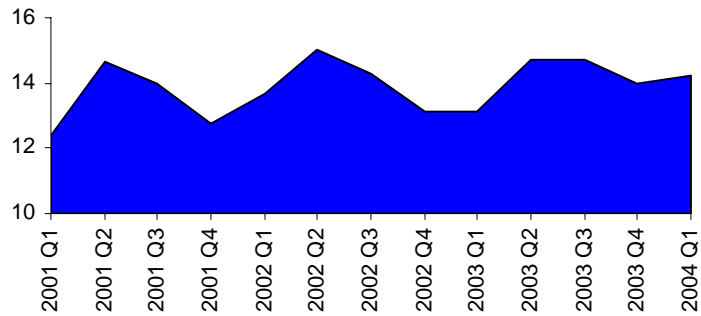
reflective of the strength in US residential construction, particularly in the latter half of 2003. While consumption lagged in the first half of the year, strong consumption in the latter half of the year helped push consumption past the level set in 2002. Consumption in the third and fourth quarters of 2003 was 3.1% and 6.6% higher than 2002, respectively. Consumption continued strongly into the first quarter of 2004, increasing by 8.4% compared to the same period in 2003.

*However, North American production was down slightly in 2003 due to declines in Canada ...*

Overall North American production fell slightly (0.4%) in 2003 compared to 2002. A decrease in Canadian production, of 510 MMBF (1.5%), was partially offset by 220

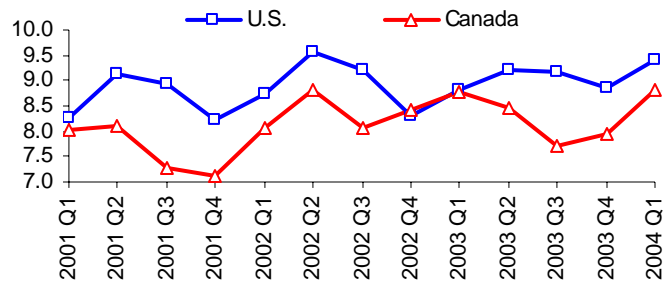
MMBF (0.6%) increase in US production. Trends in fourth quarter production were primarily responsible for the changes in both countries. While fourth quarter production in Canada declined by 5.8% compared to 2002, US production was up by 6.7% in the same period. In the first quarter of 2004, North American production improved by 3.5%, bolstered mainly by strong US production, up 6.5% in that period compared to same time frame 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**

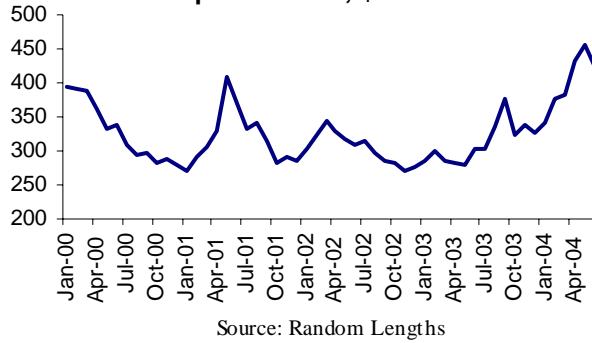


Source: Statistics Canada; American Forest and Paper Association

*Market disruptions and strong residential demand lead to high lumber prices...*

Despite strong housing demand, lumber prices were low from late 2001 to mid 2003. This was due in part to increased production by BC producers in an effort to lower their unit costs to offset duties paid on softwood lumber exports to the US. However, in the summer of 2003, prices rallied in part due to concerns that forest fires in the southern interior of British Columbia would curtail logging. Prices sagged briefly before embarking on a sustained increase towards the end of 2003, fuelled by a record level of construction in the housing industry in both Canada and the United States. Strong lumber prices have continued into 2004. In May 2004, the Random Lengths Composite Price reached US\$456 per thousand boardfeet (MBF), which was its highest level since July 1999.

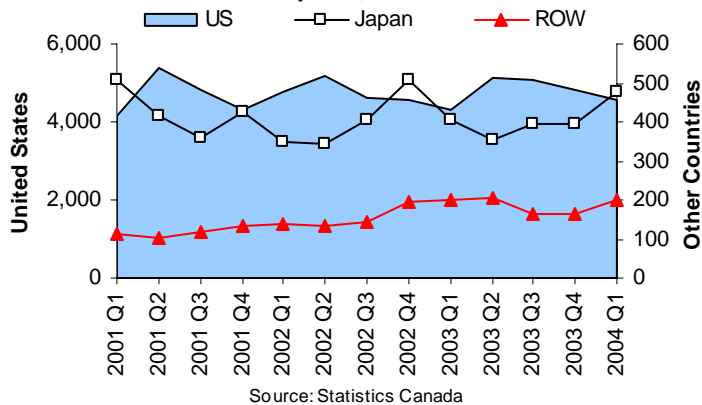
**Figure 2.3 Random Lengths Framing Lumber Composite Price, \$USD/MBF**



*Volume of Canadian exports surges in latter half of 2003 but only up slightly for the year...*

Exports in 2003 were up 338 MMBF (1.6%) compared to 2002. This was primarily the result of an 8.2% surge in exports to the US in the latter half of 2003, compared to the same period in 2002. While exports to Japan declined by 3.8%, exports to the rest of the world (excluding Japan and the US) rose significantly, by 19.2% (116 MMBF) in 2003 compared to 2002. In 2004, the total volume of exports increased by 6.5% in the first quarter, buoyed by increased exports to the US (5.8%) and Japan (17.2%), compared to the same period in 2003.

**Figure 2.4 Canadian Softwood Lumber Exports, MMBF**



However, export earnings fell in 2003 due to an appreciating Canadian dollar and weak prices in first half...

Despite the relatively stable volume, the value of Canada's softwood lumber exports fell in 2003 due to the considerable appreciation of the Canadian dollar relative to the US dollar. The value of exports was \$2.0 billion (18.5%) lower in 2003 than 2002. This was mainly due

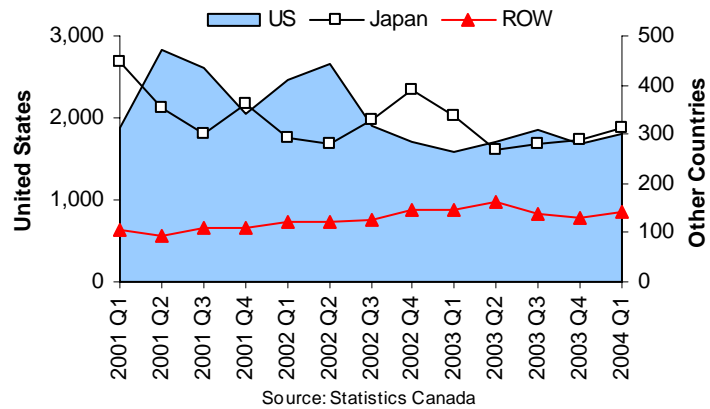
to the decrease in value of exports to the United States through the first half of the year, which declined by 36.0% (\$1.8 billion) compared to the first half of 2002. This decline was offset in the latter half of the year by the rising volume of exports to the US and increasing lumber prices.<sup>26</sup> The value of exports continued to rise into 2004 increasing by 9.3% in the first quarter compared to the same period in 2003. The value of exports to the US rose by 14.1% during this period.

Canada's market share was steady in 2003 while offshore producers lost market share, but they have made gains in early 2004...

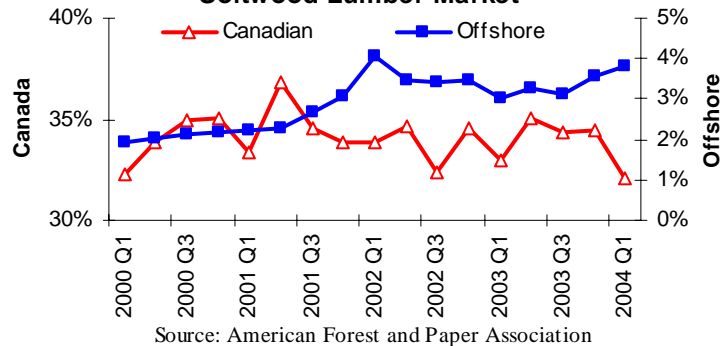
Canada's share of the US softwood lumber market<sup>27</sup> increased slightly in 2003 to 34.2%, up from 33.8% in 2002. During this period, the market share for offshore

producers dropped from 3.6% in 2002 to 3.2% in 2003. This reversed a long-term trend that has been underway for over a decade and that accelerated in the mid-1990s of increasing US imports from offshore producers led by a number of European (Germany, Sweden, Finland) and Southern hemisphere (New Zealand, Chile, Brazil) producers. The currencies of the European countries and New Zealand have appreciated to an even greater degree than the Canadian dollar since 2002, which has made their lumber relatively more expensive, which may explain the reversal of this trend. However, Canada's market share dropped to 32.1% in the first quarter of 2004, while offshore

**Figure 2.5 Canadian Softwood Lumber Exports, Millions \$C**



**Figure 2.6 Share of US Softwood Lumber Market**



<sup>26</sup> The Random Lengths composite price for framing lumber rose by 16.1% in second half of 2003 compared to 2002.

<sup>27</sup> Market share is the volume of US softwood lumber imports from Canada expressed as a percentage of total US softwood lumber consumption.

producers increased their share to 3.8%. This was attributable to large increases in US imports from Germany, Brazil and Chile. The volume of imports from these countries were 75.6%, 103.8% and 33.4% higher, respectively, in the first quarter of 2004 compared to the same quarter in 2003.

**2.2. Wood-based Panels**

*Residential construction raises North American OSB consumption in 2003...*

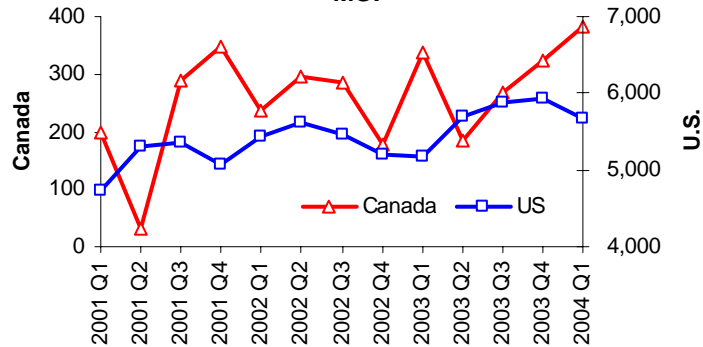
North American consumption of oriented strand board (OSB) increased by 4.7% in 2003 compared to 2002. Strong consumption increases in Canada (12.3%) and the United States

(4.4%) were due to strong residential construction activity throughout the year. This continued into the first quarter of 2004 with North American consumption increasing by 9.5% compared to the same period in 2003. Canadian consumption increased by 16.2% while the US consumption increased by 9.0%.

*Plywood consumption continued to sag in 2003, but was rescued by residential construction in the first quarter of 2004 ...*

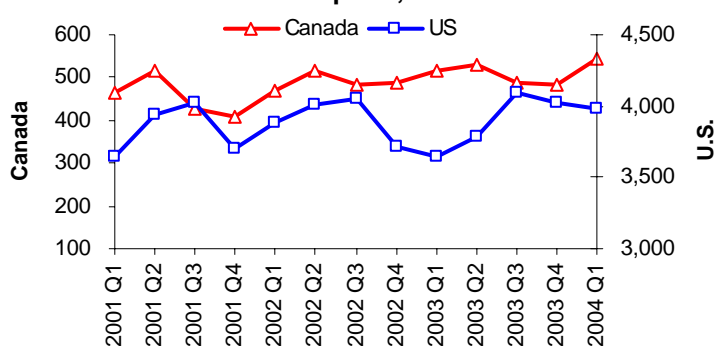
Since the late 1980s, plywood has steadily lost market share to lower cost alternatives such as OSB. While North American consumption of plywood was virtually unchanged (down 0.3% overall; up 3.0% in Canada, but down 0.8% in US), OSB continued to eat into the market as its consumption increased at a much faster rate. However, in the first quarter of 2004, plywood consumption rebounded, bolstered by strong residential construction activity, which led to a 8.8% consumption increase compared to the same period in 2003. US consumption was particularly strong rising by 9.2% while Canadian plywood consumption increased by 5.4% during that quarter.

**Figure 2.7 North American OSB Consumption, MSF**



Source: APA-Engineered Wood Association

**Figure 2.8 North American Plywood Consumption, MSF**



Source: APA-Engineered Wood Association



*OSB production in North America continues to grow...*

Responding to increased housing-based OSB demand and high OSB prices, North American production rose 4.2% in 2003 compared to 2002. Although US output continued to grow (1.4%), the pace that was witnessed in the last few years (5.3% in 2001 and 7.1% in 2002) did not materialize. In contrast,

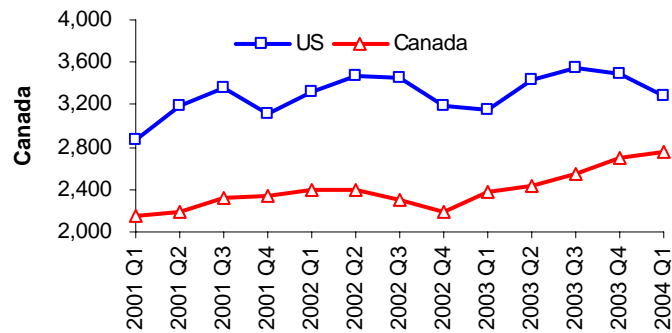
Canadian production increased considerably, up by 8.3% compared to 2002, the highest production growth rate for the country since 1999. Both Canada and the US experienced rapid output growth in the fourth quarter of 2003 that continued into the first quarter of 2004. North American production improved by 9.6% in the first quarter of 2004 (compared to the same period in 2003) as Canadian production surged by 16.5%, benefiting from the opening of a 600 MSF facility in Meadow Lake, Saskatchewan while US OSB output increased by 4.4% for the quarter.

*Plywood production fell in 2003 but high plywood prices sparked a turnaround in the first quarter of 2004 ...*

North American production of plywood fell 2.6% in 2003 compared to 2002, with a 3.3% decline in US production partially offset by a 1.4% increase in Canadian production. However,

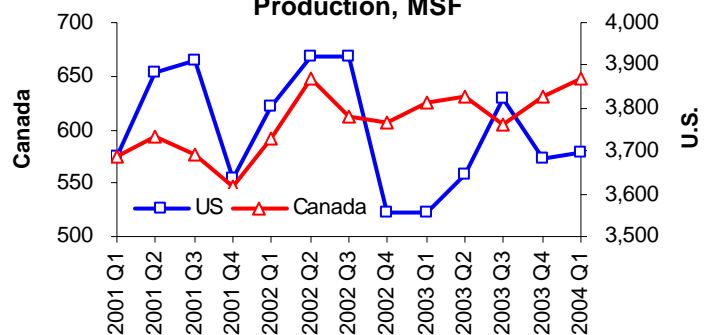
in response to high plywood prices caused by unusually high construction activity in the housing sector, North American plywood production improved by 3.8% in the first quarter of 2004 compared to the same period in 2003. Production in Canada and the US increased by 3.5% and 3.9%, respectively. This first quarter result marks a reversal in fortunes for the US industry, which has seen its production fall by an average of 3.2% per year since 1994. In contrast, Canadian production has grown at a moderate rate of 2.1% per year over the same period.

**Figure 2.9 North American OSB Production, MSF**



Source: APA-Engineered Wood Association

**Figure 2.10 North American Plywood Production, MSF**



Source: APA-Engineered Wood Association

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

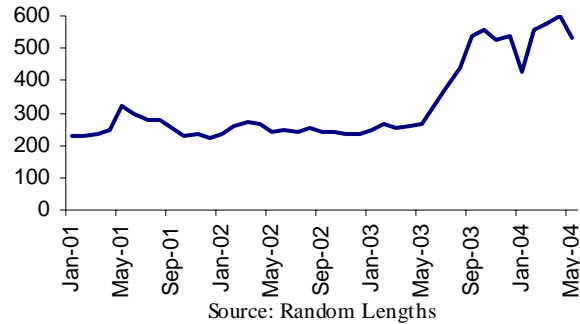
Low production levels in early 2003 and strong demand led to supply shortfalls and significant price increases in structural panel markets.

For the year, the Random Lengths Structural Panel composite price<sup>28</sup> was 53.8% higher in 2003 than 2002.

This increase was led by a rally in prices in the latter half of 2003, which

saw prices rise by 104.4% over 2002-levels. Strong prices were maintained into the first quarter of 2004, as the composite price was 104.2% higher than the first quarter of 2003.

**Figure 2.11 Random Lengths Structural Panel Composite Price, \$US/MSF**



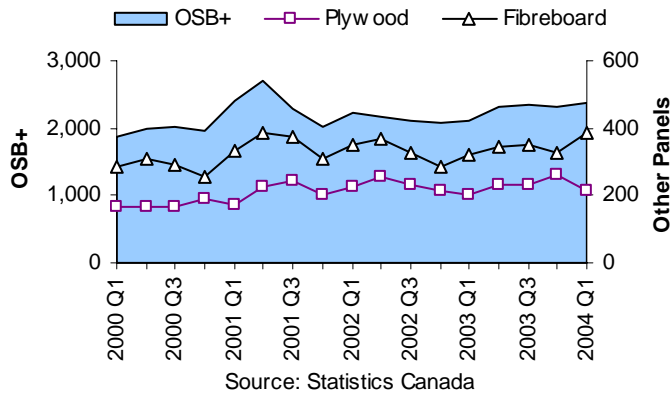
Source: Random Lengths

*Increased exports of OSB led to an overall increase in wood panel exports...*

Canada's main panel market is the United States, with over 90% of Canada's panel exports heading south of the border. In 2003, Canada's wood panel exports to the US increased by 4.9% on the strength of a 6.1% increase in the volume of OSB and particleboard (OSB+)

exports.<sup>29</sup> This increase was led by a second half surge in exports to the US with OSB+ and fibreboard exports increasing by 11.5% each. Strong demand in the US market continued to buoy export volumes in the first quarter of 2004 which were 12.8% higher than the first quarter of 2004, led by 12.0% and 21.3% increases in OSB+ and fibreboard exports, respectively.

**Figure 2.12 Wood Panel Exports to US, Thousands m3**



Source: Statistics Canada

<sup>28</sup> The Random Lengths Composite Price is a broad measure of price movements in structural panel markets in North America.

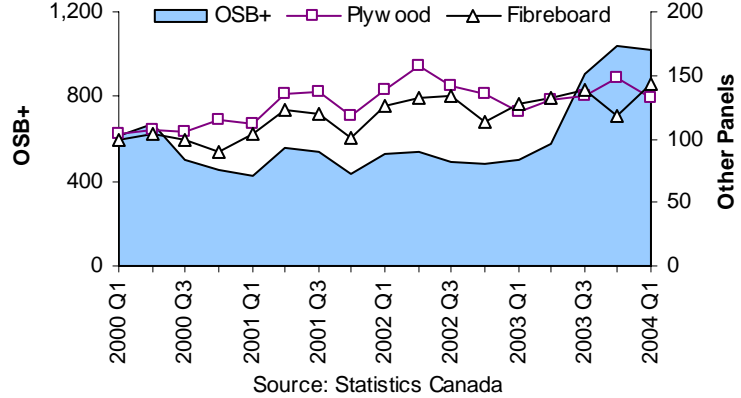
<sup>29</sup> Prior to 2002, Statistics Canada trade data did not distinguish between OSB and particleboard despite differing end-uses for these products, which is why they are grouped together here. However, we note that in 2002, OSB accounted for 85% of the total value of Canada's exports in this category.

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

In 2003, the value of wood panel exports to the US increased by 30.4% compared to 2002. Most notable during the year was the value of OSB+ exports increasing by 98.9% over the latter half of 2003 compared to the same period in 2002. The growth continued into 2004 as the

value of wood panel exports increased by 72.7% in the first quarter of 2004 compared to the same period in 2003, buoyed by a 103.6% increase in the value of OSB+ exports. The main reason for the strong growth in the value of exports was the increase in panel prices, which has more than offset the negative impact that recent exchange rate movements have had on revenues of Canadian firms exporting to the US.

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

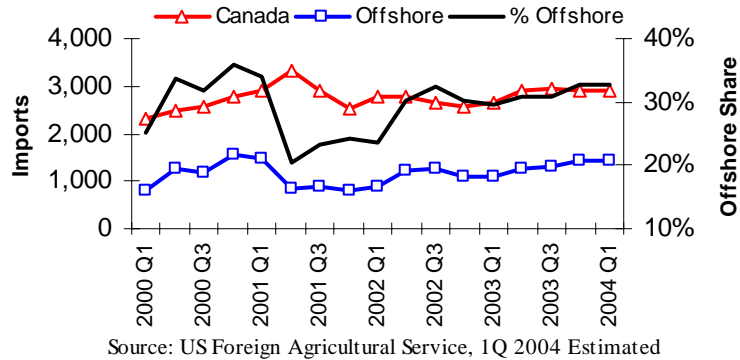


*US imports from both Canada and offshore countries have increased though the share of offshore imports has risen steadily...*

The offshore share of US panel imports has averaged 29.6 % since 2000, peaking at 35.8% in the last quarter of 2000 and falling sharply to 20.4% by the second quarter of 2001. While the

volume of Canadian and offshore imports have both increased since that time, the share of offshore imports has gradually improved, to 34.5% in the first quarter of 2004, its highest level since the fourth quarter of 2000.

**Figure 2.14 US Panel Imports (1,000s m<sup>3</sup>) and Offshore Share of Imports**



### 2.3. Wood Pulp

*North American consumption of chemical market pulp fell in 2003 with poor consumption in the 4th quarter...*

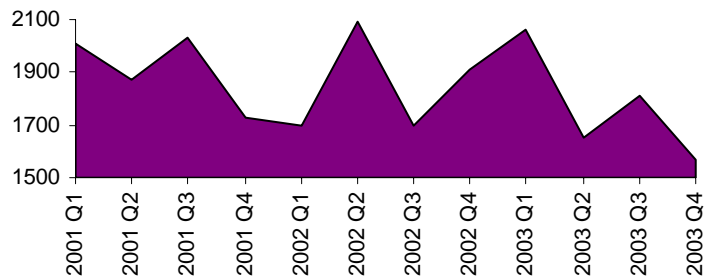
Despite the improvement in the US economy in 2003, North American consumption of chemical market pulp<sup>30</sup> dropped by 4.1% in 2003 compared to 2002. This large decline was due largely to a 17.8% drop in consumption in the fourth quarter of 2003 compared to the same quarter in 2002.

*However, North American production increased in 2003 particularly in the fourth quarter...*

North American production of chemical market pulp increased by 1.3% in 2003 compared to 2002, largely due to strong production in the fourth quarter of 2003.

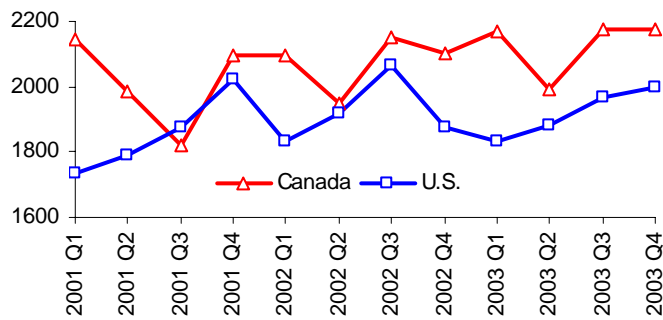
Production, which grew 4.8% in the fourth quarter relative to the same period in 2002, was based on solid growth in both Canada (up 3.8%) and the US (up 6.3%). For the year, Canadian production was 2.6% higher in 2003 than 2002 while US production was down slightly by 0.2%.

**2.15 North American Consumption of Chemical Market Pulp, Thousand Tonnes**



Source: North American Market Pulp Statistics Monthly Bulletin

**Figure 2.16 North American Chemical Market Pulp Production, Thousand Tonnes**



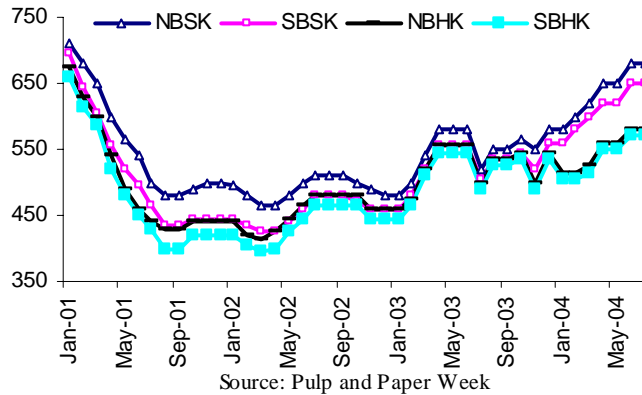
Source: North American Market Pulp Statistics Monthly Bulletin

<sup>30</sup> About 90% of the pulp traded in the North American market place is chemical market pulp. As a result, chemical market pulp will be the focal point of this discussion. However, data presented on Canadian exports include all pulp, not just chemical market pulp.

*Pulp prices rebounded in 2003 led by softwood pulps with the help of surging Chinese demand...*

Historically, Northern Bleached Softwood Kraft (NBSK) has sold at a premium over other grades of pulp with its price closely followed by Southern Bleached Softwood Kraft, Northern Bleached Hardwood

**Figure 2.17 Chemical Market Pulp Prices, \$US/Tonne**

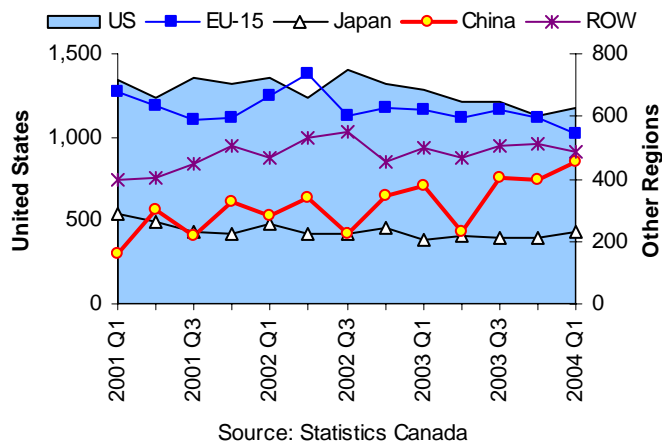


Kraft and Southern Bleached Hardwood Kraft. In 2001, U.S. domestic market pulp prices went into a free fall that stretched from January until August of that year. However, from September of 2001 until January of 2003 prices stayed relatively flat before embarking on a gradual rise, which was largely supported by surging Chinese demand. As of July 2004, NBSK reached its highest price since February 2001, at US \$680/tonne.

*2003 export volume down but shipments to China continue to increase...*

Although the US is Canada's most important export market for wood pulp, receiving 42.0% of Canada's pulp exports in 2003, there are many other significant markets. Of particular note is China, which has seen its share of Canada's pulp exports increase from 2.6% in

**Figure 2.18 Pulp Exports, 1,000s Tonnes**



exports increase from 2.6% in 1995 to 12.2% in 2003. Overall, Canadian pulp exports declined by 5.0% in 2003 compared to 2002, with falling pulp exports to the US (-9.2%), EU-15<sup>31</sup> (-7.6%) and Japan (-10.3%), while exports to China increased by 17.3%. Similar results were observed in the first quarter of 2004, with Canada's total exports declined by 2.9% compared to the same period in 2003. Exports to the US (-8.2%) and the EU-15 (-11.8%) continued to fall. However, exports to Japan rebounded (+11.6%) and exports to China continued to grow rapidly (+21.8%).

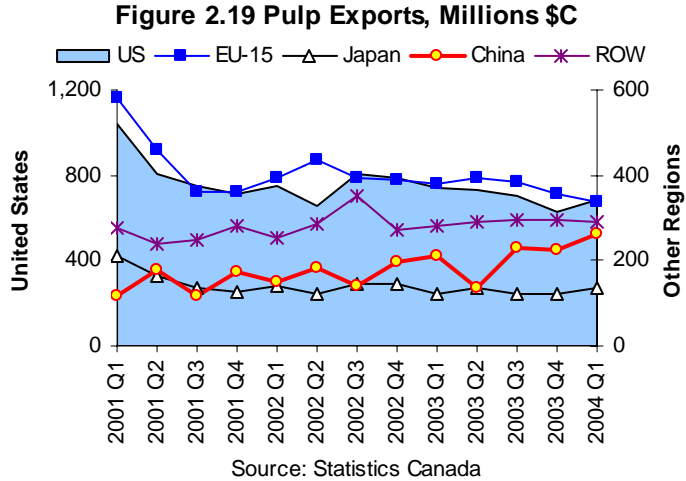
<sup>31</sup> The EU-15 includes the following countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom. It does not include the 10 countries acceding to the EU in 2004.

*Overall value of exports fell in 2003 and in the first quarter of 2004 due to exchange rates...*

The value of total Canadian pulp exports decreased by 2.9% in 2003 compared to 2002.

Although the value of Canadian exports to the US (-6.3%), the EU-15 (-6.1%) and Japan (-8.3%) declined, the surging value of exports to China (+20.2%) for the year minimized the overall descent.

In the first quarter of 2004, the value of Canadian exports fell by 1.9% relative to the same period in 2003. This was reflected in a significant drop in the value of exports to both the US and the EU-15 (declines of 8.4% and 11.0%, respectively), which offset the increase in the value of exports to Japan and China, up 10.3% and 24.2% for the quarter. The decline in the value of total Canadian exports in 2003 and into the first quarter of 2004 was due in large part to the appreciation of the Canadian dollar relative to the US dollar in 2003, which has more than offset increases in pulp prices.

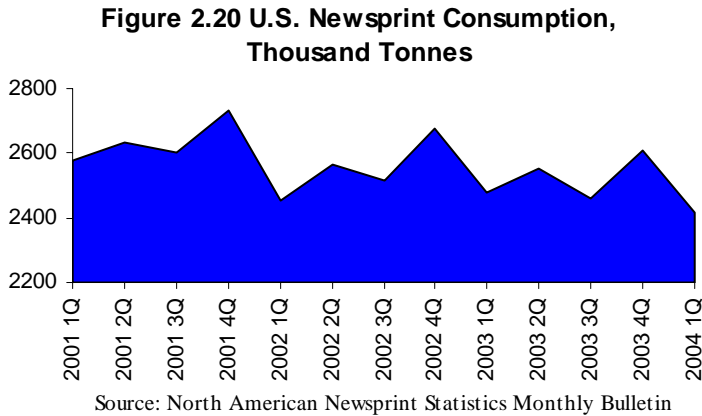


**2.4. Newsprint**

*US newsprint consumption fails to rebound in 2003 despite improving economy...*

The US is the primary newsprint consumer in North America. Although the US economy has begun to rebound from the 2001 recession, newsprint consumption hasn't recovered to pre-recession levels.

Instead, US newsprint consumption fell by 1.0% in 2003 compared to 2002. Weak demand continued into the first quarter of 2004 with US consumption falling by 2.5% relative to the same period in 2003.

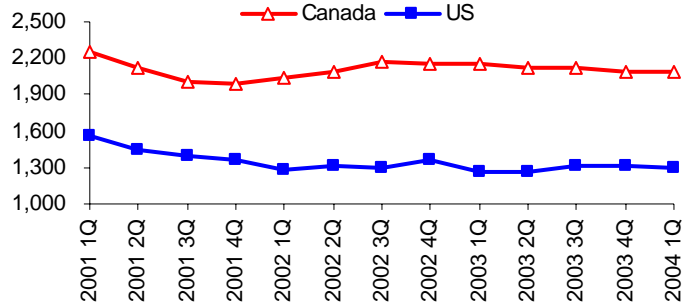


*North American production fell slightly in 2003...*

North American newsprint production fell slightly in 2003 compared to 2002, diminishing by 0.5%. Although Canadian production increased slightly by 0.4% for the period, this was more than offset by a decline in US production, which decreased by 1.9%.

North American production worsened in the first quarter of 2004, declining by 0.9% compared to the first quarter of 2003. During this period, Canadian production declined by 3.2%, which was partially offset by a 3.1% increase in US production.

**Figure 2.21 North American Newsprint Production, Thousand Tonnes**

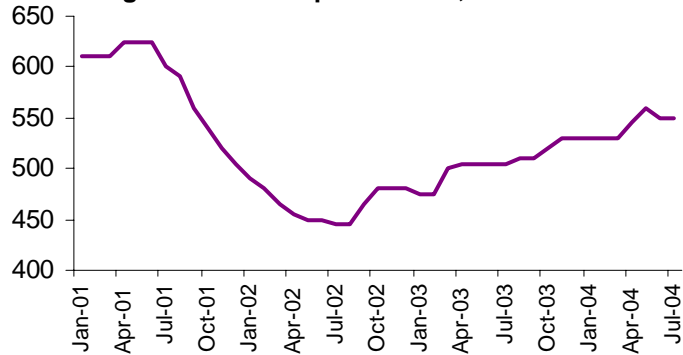


Source: North American Newsprint Statistics Monthly Bulletin

*Prices have gradually rebounded...*

After enduring a dramatic slide from April 2001 to August 2002, a decrease of 28.8%, newsprint prices have made a gradual recovery. Since hitting their low point in 2002, prices have increased by 25.8%. By May 2004, the US east coast price hit US \$560/Tonne, which is its highest level since September 2001.

**Figure 2.22 Newsprint Prices, \$US/Tonne**

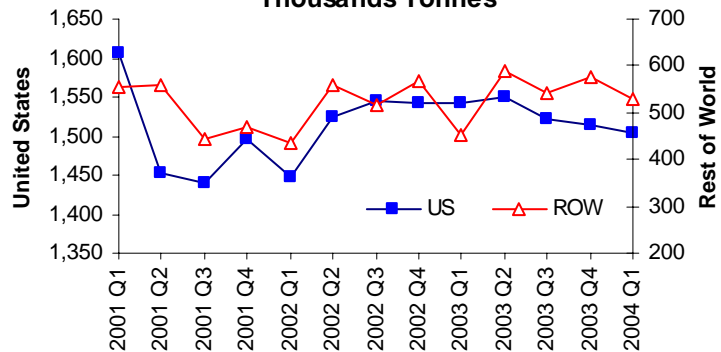


Source: Pulp and Paper Week

*The volume of Canada's exports increased slightly in 2003 due to exports to non-US markets ...*

Total Canadian newsprint exports increased 1.8% in 2003 relative to 2002 on strength of exports to the US increasing by 1.1% while to the rest of the world increasing by 3.9%. In the first quarter of 2004, total Canadian newsprint exports

**Figure 2.23 Newsprint Exports Thousands Tonnes**

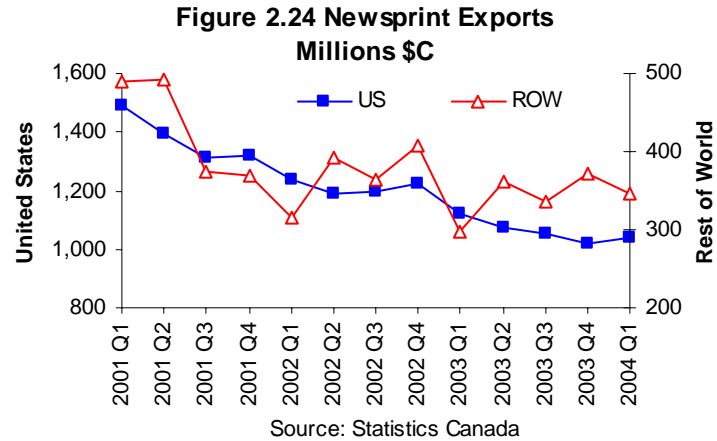


Source: Statistics Canada

improved by 1.8% compared to the same time frame in 2003. This was primarily due to growth in Canadian exports to non-US markets, which increased by 16.4% offsetting a 2.5% decline in exports to the US.

*Total value of exports drops due to exchange rates...*

The total value of Canadian exports dropped by 10.8% in 2003 compared to 2002. Over that time frame, exports to the US decreased by 11.9% while exports to other countries fell by 7.5%. In the first quarter of 2004, the total value of Canadian exports continued to decline, falling by 2.6% compared to the same period in 2003. However, while the value of exports to non-US markets increased (+15.9%), exports to the US continued to fall (-7.6%). This divergence was primarily attributable to the appreciation of the Canadian dollar relative to the US currency, which has increased in value by 14.5% over the first 3 months of 2004 compared to the first quarter of 2003.





### 3. Forest Sector Employment

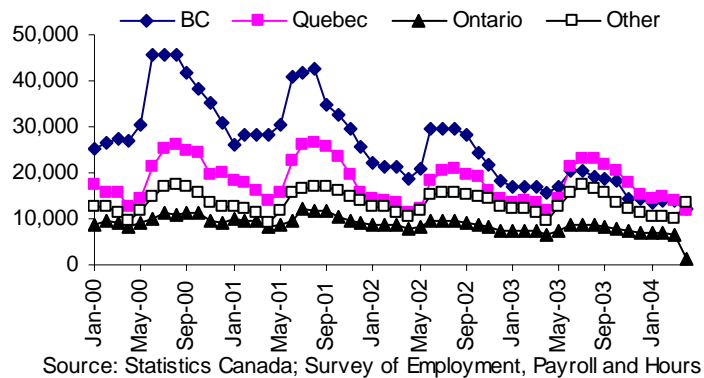
*Employment in logging, forestry and support activities continued to decline in 2003 led by job losses in BC ...*

Total employment<sup>32</sup> in logging, forestry, and support activities in Canada was 56,000 in 2003, for a decline of 6,400 (-10%) compared to 2002. This was equal to BC's decline, which represented a 26.9% drop in employment in the industry for that province. Employment changes in other provinces largely offset each other with Quebec enjoying a 1,300 gain in employment (+7.9%), while Ontario's employment fell by 1,000 (-11.9%), and employment in other provinces declined slightly by 400 (-1.8%). The drop in employment observed in 2003 continues a trend in the industry that accelerated after 2000. From 2000-2003, average employment in the industry fell by 17,500 (50.2%) in British Columbia, 2,200 (22.2%) in Ontario, 2,300 (11.6%) in Quebec, and 400 (3.1%) in other provinces. Employment shows signs of a continued decline so far in 2004, with average employment through the first 4 months of the year falling by 9.6% compared to 2003 levels, led by lower employment in BC and Ontario.

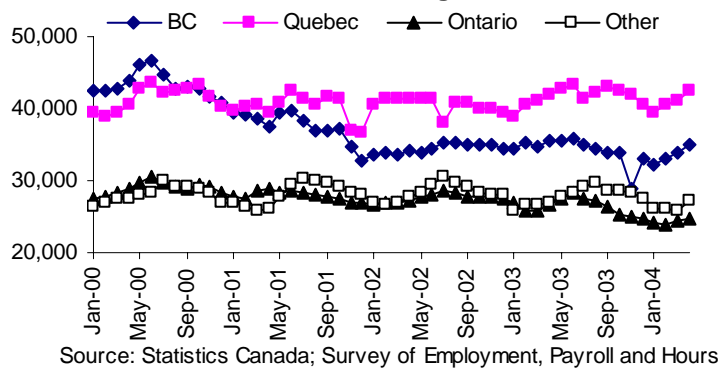
*Wood manufacturing employment was little changed in 2003...*

Employment in wood product manufacturing changed little from 2002 to 2003 with just over 130,000 employed nationwide. This is a change from the previous two years in which significant job losses occurred. Between 2000 and 2003, 11,700 jobs were lost in the industry, equivalent to an 8.2% decline over the period. The majority of these losses occurred in British Columbia (drop of 9,200 or 21.1%) though Ontario also experienced significant losses (2,500 or 8.6%). Through the first four months of 2004, employment in the industry is down slightly from the same period in 2003, with 3,400 fewer people

**Figure 3.1 Employment in Forestry, Logging, and Support Activities**



**Figure 3.2 Employment in Wood Product Manufacturing**



<sup>32</sup> As noted in footnote 1, the Survey of Earnings, Payroll and Hours (SEPH) uses a narrower definition of employment than the Labour Force Survey (LFS). Hence, the numbers reported here may be smaller than those based on the LFS.

employed. Most of this decline has occurred in Ontario, where average employment fell by 2,000 (7.7%) followed by BC (1,400 or 4.0%). Employment in other regions shows little signs of change.

*Employment in paper manufacturing increased slightly in 2003 after losses in the previous two years ...*

Employment in Canada's paper manufacturing industry was 98,700 in 2003, increasing by 1,500 (1.5%) from the previous year. This increase was led by a rebound in employment in British Columbia. This was

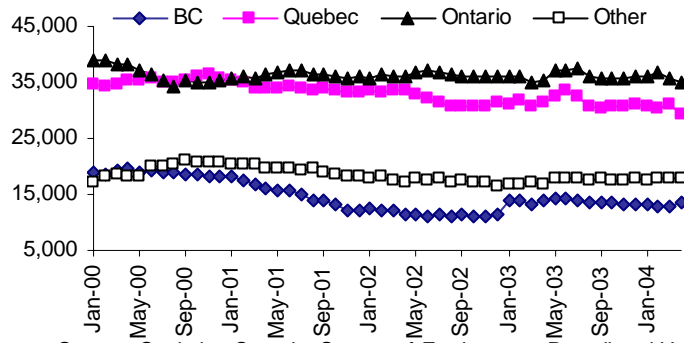
partially offset by a slight decline of employment in Quebec (-600 or 2.0%), while other regions experienced little change. The increase was in sharp contrast to the previous two years in which large job losses occurred in the industry. From 2000 to 2002, employment in the industry fell by close to 13,000 nationally, led by losses in British Columbia and Quebec which experienced declines in employment of 7,400 (39.1%) and 3,300 (9.4%), respectively. Through the first 4 months of 2004, employment in the industry is little changed from 2003 levels.

*Total forest sector employment decline modestly in 2003, though job losses were not as large as in previous years...*

Canada's total employment in all forest-related industries was approximately 285,000 in 2003, down by 5,700 (2.0%) from 2002 levels. British Columbia experienced the largest decline in employment (4,400 or 6.3%) followed by Ontario (2,300 or

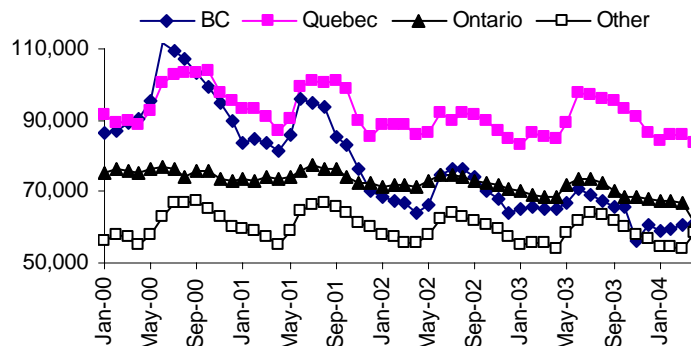
3.2%), while Quebec's employment increased slightly (1,700 or 2.0%). Job losses in Canada's forest industry were much worse in the previous two years with employment in the sector falling by close to 41,000 from 2000 to 2002. Cumulative job losses have been concentrated in British Columbia, which has experienced a 32,000 (32.7%) decline in total forest sector employment since 2000, representing close to 70% of jobs lost nationally. Employment in Quebec and Ontario has fallen by 6,000 (6.2%) and 5,000 (6.7%), respectively, over this period. On a sector basis, 50% of job losses since 2000 have occurred in forestry, logging, and support activities, with the remaining losses split evenly between wood and paper manufacturing industries.

**Figure 3.3 Employment in Paper Product Manufacturing**



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

**Figure 3.4 Total Employment in Forest Related Industries**



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

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

### 4.1. Introduction

In this section, we examine trends in forest product prices and analyze their impacts on the recent financial performance of the Canadian forest industry. We derive price indices to reflect broad movements in prices for (1) wood products, (2) pulp and paper products, and (3) forest products as a whole. The indices are based on forest product prices in US markets and are expressed in both US and Canadian dollars to help distinguish between the effects that changes in market conditions and fluctuations in exchange rates have on prices received by Canadian firms. We weighted individual price series used to construct the indices by their shares of Canada's forest product exports. We also compare the Canadian dollar index with the rate of return on capital observed in Canada's forest industry over the past 4 years and discuss the prospects for future price movements and profitability of the industry. The appendix at the end of this section explains the data and methods used to calculate the price indices.

### 4.2. Forest Product Price Indices

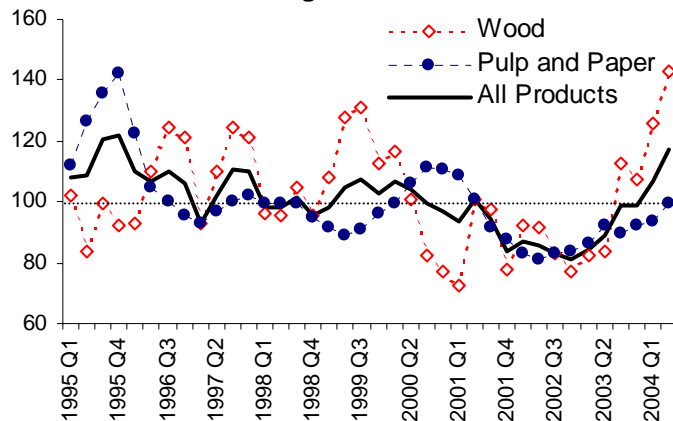
*Prices in US markets entered a prolonged decline in 2001, but have rebounded over the last year led by a surge in wood products...*

Figure 4.1 shows the quarterly price indices for wood, pulp and paper, and all forest products based on prices reported in US markets. The indices express prices relative to average price levels observed from 1995-2003, which is denoted by the

dashed line. Prices were at their highest levels in 1995-1996. After that period, the overall index fluctuated close to the 1995-2003 average until 2001. However, the relative stability of the index masked significant fluctuations in its components as prices for wood products and pulp and paper both changed significantly but generally had offsetting effects. For example, high lumber prices in 1999 were offset by low pulp and paper prices while the opposite occurred in late 2000 and early 2001.

The second half of 2001 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 second quarter of 2004. This rally has been driven by a run on lumber and

**Figure 4.1. Price Indices expressed on \$US  
Basis Avg. 1995-2003 = 100**



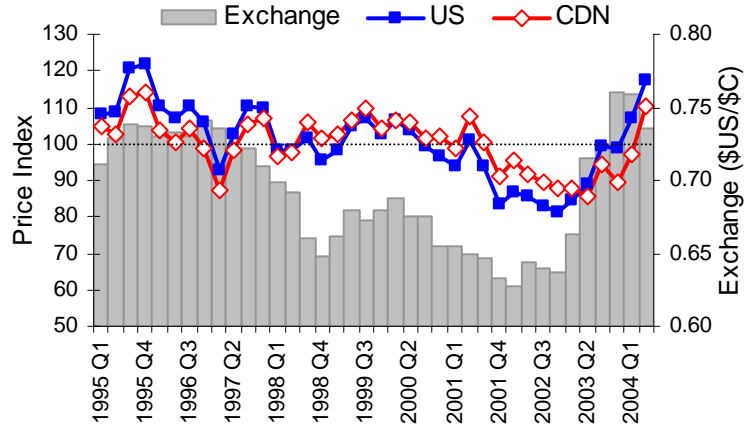
panel prices caused by the housing boom in North America as well as a modest increase in pulp and paper prices fostered by the US economy's recent upturn.

*Changes in the exchange rate have generally dampened effects of price changes for Canadian firms but have also offset recent prices gains...*

Figure 4.2 shows forest product price indices calculated using prices expressed in both US and Canadian dollars along with the Canada-US exchange rate. While the two indices generally tracked each other

well, changes in the Canada-US exchange rate have tended to offset changes in prices. As a result, the Canadian dollar index has been less variable over time, which has mitigated the impacts of commodity price movements on Canadian firms to some extent. For example, falling prices from 1999 to 2001 were partially offset by a depreciation of the Canadian dollar. Thus, while the Canadian dollar index fell over the period, it did not fall as far or as fast as the US dollar index. However, increases in prices over the last year have also been offset by the strong appreciation of the Canadian dollar that occurred in 2003.

**Figure 4.2. Prices Indices in US and Canadian Dollars and Exchange Rate**

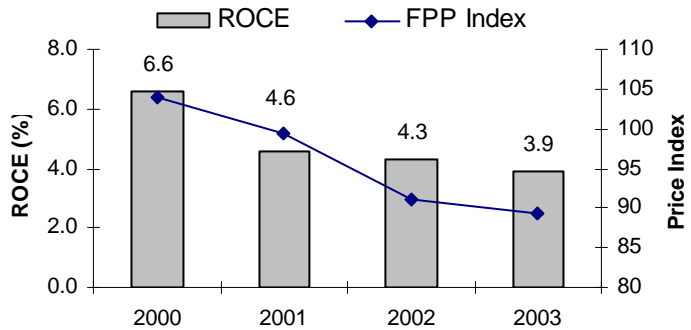


**4.3. Price Indices and Financial Performance**

*The forest industry's return on capital employed (ROCE) has moved in tandem with the price index...*

The return on capital employed (ROCE) is a key measure of profitability in capital-intensive industries such as those in the forest sector. Figure 4.3 shows the Canadian-dollar forest product price (FPP) index and the ROCE in Canada's forest sector from 2000-2003.

**Figure 4.3 Return on Capital Employed and Canadian-Dollar FP Price Index**



product price (FPP) index and the ROCE in Canada's forest sector from 2000-2003.<sup>33</sup> The data show a very close correspondence between the ROCE and the FPP index, as one

<sup>33</sup> ROCE estimates were taken from PriceWaterhouseCoopers press release entitled "Fluctuating Currencies and Fragmentation Stifle Global Forest and Paper Industry Growth in 2003" dated March 31, 2003. These figures represent the ROCE for the major publicly traded forest companies in Canada.

would expect given the impact of prices on the revenues of firms. However, the price index does not account for other factors affecting profitability such as production costs. The data show that the financial performance of the industry has declined over the past few years, at least in part due to weak product prices as the FPP index reached a low point of 89.3 in 2003. Through the first half of 2004, the index averaged 103.7, which is its highest value since 2000 when the index averaged 104.0 for the year and the ROCE for Canada's major forest product companies was 6.6 percent. Based on these data, an improvement in the financial performance of the industry is expected for 2004. However, recent price movements have benefited producers of wood products more than pulp and paper producers. Through the first two quarters of 2004, the wood product index has averaged 124.1, which is significantly above the 1995-2003 average. Conversely, the pulp and paper index averaged only 89.3, which is only a slight increase from the 2003 average of 87.0 and is still well below the average levels seen from 1995-2003.

*Declining wood prices and a continued, though modest, appreciation of the Canadian dollar could offset expected increases in pulp and paper prices...*

Pulp and paper prices are expected to continue to rise with the continued strong growth in the US economy and improving economic conditions globally. However, the prices for wood products are expected to fall from their current high levels with the projected cooling of North American housing markets as interest rates rise from their historic lows. For 2005, pulp prices are expected to increase modestly over 2004 levels, moderate price increases are projected for graphic papers (e.g., newsprint and other writing and printing papers), lumber prices are expected to fall moderately, and a sharp downward correction is expected for panels.<sup>34</sup> Many economists expect that the Canadian dollar will continue to appreciate against the US dollar in 2004-2005 given the large US current account and budget deficits (see section 1.1). However, the projected rise is not expected to occur as quickly as the appreciation of the Canadian dollar in 2003 nor is the dollar expected to rise to the same extent.

#### **4.4. Appendix – Data and Methods for Calculating Price Index**

We constructed three indices to capture broad price movements in forest product markets. These indices are for: (1) wood products, which include lumber and structural panels, (2) pulp and paper products, including wood pulp, newsprint, and other paper, and (3) a composite index combining prices from both the wood and pulp and paper sectors. Each index was constructed as a weighted average of individual price series representing movements in those prices in US markets, our primary export destination for forest products. Specific price series used are summarized in Table 4.1 below.

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<sup>34</sup> CIBC World Markets, Spotlight on the Wood and Paper Stocks – June 28, 2004.

**Table 4.1 Data Series used in Price Indices**

Product	Price Series
<i>Wood Products</i>	
Softwood Lumber	Western Spruce-Pine-Fir Composite Price
Structural Panels	Oriented Strand Board (OSB) 7/16" North Central f.o.b. mill
<i>Pulp and Paper Products</i>	
Wood Pulp	Northern Bleached Softwood Kraft, US Domestic Prices
Newsprint	East Coast, 30 lb., delivered
Uncoated Groundwood	35-lb supercalendered (SC-A)
Uncoated Free Sheet	20-lb repro bond, 83/84 bright (cutsize)
Coated Groundwood	No. 5, 34-lb roto, rolls
Coated Free Sheet	No. 3, 60-lb rolls

Sources: Random Lengths (Wood Products) and Paperloop (Pulp and Paper Prices)

The weights for each price series were based on the average value of Canadian exports for each product category from 1998-2002. The products used, their HS codes, and weights are summarized in Table 4.2 below.

**Table 4.2 Weights in Price Indices**

Product	HS Codes	Weights: Sub-category index	Weights: Index for All Products
<i>Wood Products</i>			
Softwood Lumber	440710, 440910	0.84	0.35
Structural Panels	441011, 441021, 441029, 441219, 441293, 441299	0.16	0.07
Total		1.00	0.41
<i>Pulp and Paper Products</i>			
Wood Pulp	4701 to 4705	0.39	0.23
Newsprint	4801	0.35	0.20
Uncoated Groundwood	4802	0.12	0.07
Uncoated Free Sheet		0.05	0.03
Coated Groundwood	4810	0.06	0.03
Coated Free Sheet		0.03	0.02
Total		1.00	0.59

Note: Uncoated and Coated papers were further subdivided using data on Canadian production of these products found in Paperloop's Pulp and Paper Factbook 2002.