

## Chapter 5

# Riding the crest of the wave:

# Sawn softwood markets in 2003-2004<sup>24</sup>

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### Highlights

- Globalization of the sawn softwood sector continues as we ride the crest of the wave, characterized by generally positive markets worldwide.
- In North America, market conditions for sawn softwood are booming, fuelled by a robust housing sector; however, the ongoing trade dispute between the United States and Canada is dampening this generally positive outlook.
- The mountain pine beetle epidemic that rages in British Columbia, Canada continues, with approximately 4.8 million hectares of forestland currently infested and government policies regarding harvesting approaches being enacted as rapidly as possible.
- Demand for sawn softwood in the increasingly important Chinese market continues to grow, providing market opportunities for exporters of both sawnwood products and logs.
- Japanese sawn softwood consumption increased in 2003 for the first time since 1995 because of short-term increases in housing starts: European sawnwood exports to Japan reached record levels in 2003.
- Markets for sawn softwood in Europe remain strong and Nordic producers fared well in 2003, particularly Sweden, whose sawnwood output neared record levels of 17 million m<sup>3</sup>, in spite of increased competition from Russia and the Baltic countries and due largely to increased marketing efforts in the United Kingdom.
- The eastern European countries and Russia continue to re-define the global marketplace for sawn softwood, as foreign investments in these regions all along the forestry supply chain ramp up their ability to compete worldwide.
- A United States government ban on CCA-treated sawnwood in residential applications goes into effect in 2004, leaving wood preservers to seek alternative wood preserving solutions.
- The outlook for sawn softwood markets in 2004 is being impacted by the interplay of lower housing demand, increased roundwood supplies and a weaker US dollar.
- Based on historical trends, it is possible that higher North American prices for sawn softwood could still prevail through the first quarter of 2005, followed by a return to more normal pricing.

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<sup>24</sup> By Mr. Henry Spelter, Dr. Robert Kozak and Dr. Nikolai Burdin.

## Secretariat introduction

We thank Mr. Henry Spelter,<sup>25</sup> Economist, USDA Forest Service, Dr. Robert Kozak,<sup>26</sup> Associate Professor, University of British Columbia and Dr. Nikolai Burdin, Director,<sup>27</sup> OAO NIPIELlesprom, Russia, for another thorough analysis of the sawn softwood markets in the UNECE region. They contributed to last year's UNECE/FAO *Forest Products Annual Market Analysis, 2002-2004*, as well as to previous *Reviews*.

### 5.1 Introduction

In 2003, this chapter focused on how globalization had impacted the production, consumption, and trade of sawn softwood. This incontrovertible trend towards an increasingly complex web of international players continues unabated in 2003 and 2004, as oversupply, fierce competitive pressures, and global currency rates remain the formative themes in shaping the import and export patterns of sawn softwood products.

We characterize the global sawn softwood marketplace in 2003 and 2004 as one that is 'riding the crest of the wave'. Markets were generally positive in 2003, and growing demand for wood products resulting from robust housing activity in various parts of the world, e.g. North America and Japan, kept prices relatively buoyant in those markets. Some interesting trends, which have and undoubtedly will continue to influence the dynamics of the global sawn softwood marketplace, are outlined below.

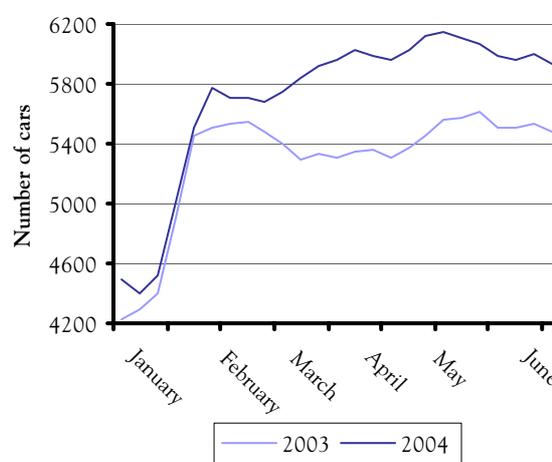
In general, sawn softwood prices increased, especially in North American markets, as rising demand, coupled with a weakening US dollar, began to exhaust available capacity.

Sawn softwood markets in North America were strong in the first half of 2004, driven largely by a boom in home construction. Almost three years of low (and in real terms, negative) interest rates for short-term funds and, consequently, low cost mortgages, spurred activity in US single-family home construction, as well as in home repair and remodelling. On the supply side, 2004

shipments were hindered by the inability of railroads to provide enough cars to meet demand. Even with railcar loadings up 8% in the US (graph 5.1.1) and 6% in Canada, the available transport capacity was below needs. This delayed shipments and discouraged some production in both the US and Canada and raised shipping costs. Consequently, US imports of sawn softwood products (especially from European producers) reached an all time high in the first quarter of 2004, up 35% over the same period in 2003.<sup>28</sup>

GRAPH 5.1.1

Weekly railcar loadings of wood products by US railroads, 2003 and 2004



**Note:** Four-week moving average.

**Source:** American Association of Railroads, 2004.

Whilst non-tariff barriers of wood products exported from North America to Europe continue in the form of phytosanitary restrictions, it is the ongoing dispute over Canadian sawnwood exports into the US that has most affected international trade in sawn softwood. Despite various rulings by the World Trade Organization (WTO) and the North American Free Trade Association (NAFTA), stiff tariffs and other barriers are still in place. Further, the weakness of the US dollar, which fell from a high of CDN \$1.60 in 2002 to as low as CDN \$1.30 in early 2004, reduced returns for Canadian suppliers and dampened their incentive to sell to US markets. Initially, Canadian market share fell in the early months of 2003 until significantly higher prices restored their incentives (graph 5.1.2). By May 2004, prices for commodity sawnwood spruce-pine-fir from Canada, pine from the US south, and Douglas fir-hemlock from the US west neared historical highs, which spurred imports.

<sup>25</sup> Mr. Henry Spelter, Economist, Forest Products Laboratory, U S Department of Agriculture – Forest Service, One Gifford Pinchot Drive, Madison, Wisconsin, 53705-2898, U S, telephone +1 608 231 9380, fax +1 608 231 9592, e-mail: hspelter@fs.fed.us.

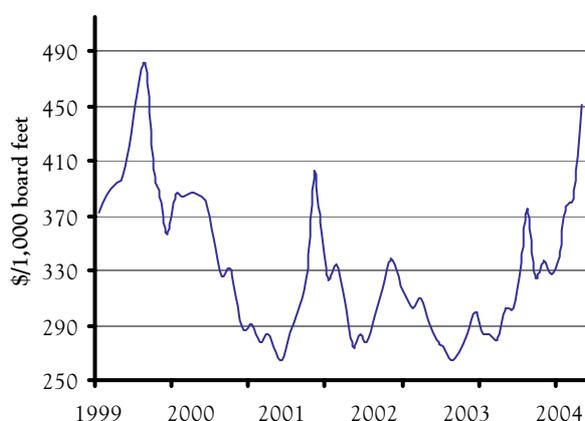
<sup>26</sup> Dr. Robert Kozak, Associate Professor, Faculty of Forestry, University of British Columbia, 4<sup>th</sup> floor, Forest Sciences Centre, 4041-2424 Main Mall, Vancouver, British Columbia, Canada, V6T 1Z4, telephone +1 604 822 2402, fax +1 604 822 9104, e-mail: rob.kozak@ubc.ca.

<sup>27</sup> Dr. Nikolai Burdin, Director, OAO NIPIELlesprom, Klinskaya ul. 8, RU-125889 Moscow, Russian Federation, telephone +7 095-456 1303, fax +7 095-456 5390, email: nipi@dialup.ptt.ru.

<sup>28</sup> US Offshore Lumber Imports Set Record in First Quarter. *Random Lengths International*, 37(12), 9 June 2004.

GRAPH 5.1.2

Weekly price index of structural lumber, 1999-2004



Source: Random Lengths Inc., 2004.

Lastly, it is worth noting trends in two key markets that, while not part of the UNECE region, continue to have significant impacts on production, consumption and exports of sawn softwood products – China and Japan. Unlike other importing regions of the world, China’s demand for commodity sawn softwood products keeps rising rapidly (and is expected to continue), although consumption is still currently dominated by hardwoods. This provides increasing market opportunities for exporters of both sawn softwood products and raw logs to feed domestic production. In Japan, 2003 saw increases in the demand for sawn softwood for the first time since that country’s economic bubble burst some 10 years ago. While the 2003 levels of almost 24 million m<sup>3</sup> of consumption are not anywhere near the levels of 36 million m<sup>3</sup> seen in 1995, they do represent a marked improvement over 2002. That said, this increase – attributed largely to higher rates of housing activity – are expected to slow down modestly in 2004.<sup>29</sup> Interestingly, this is not expected to have a significant impact on European exports of sawn softwood to Japan, which reached record levels of over 2.7 million m<sup>3</sup> in 2003.<sup>30</sup>

## 5.2 EU/EFTA subregion

In 2003, as in the past, much of the sawn softwood trade in Europe occurred within the continent. However, while trade in the EU/EFTA subregion is generally best described as being fairly dynamic, 2003 was characterized by a remarkable consistency, e.g. of trade flows (graph

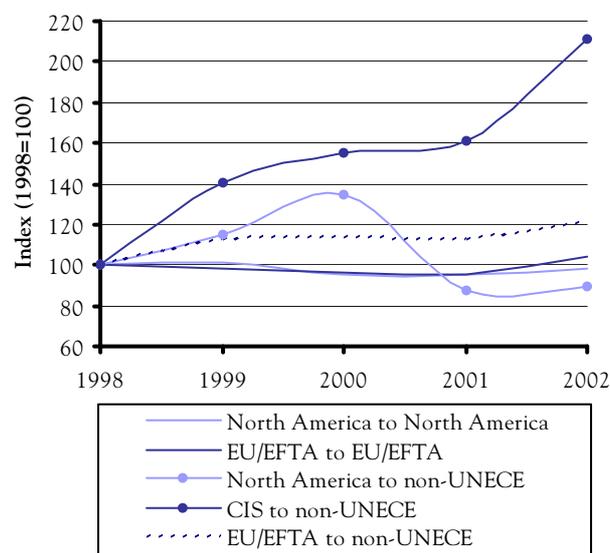
<sup>29</sup> Global Lumber Outlook, 2004. Wood Markets Monthly, November 2003.

<sup>30</sup> Growing European Softwood Lumber in Japan. Japan Lumber Journal, 45(6), 31 March 2004.

5.2.1), as well as some optimism<sup>31</sup> despite fluctuations in sawn softwood prices (graph 5.2.2), global exchange rates and inventories.

GRAPH 5.2.1

Sawn softwood trade flows in the UNECE region, 1998-2002

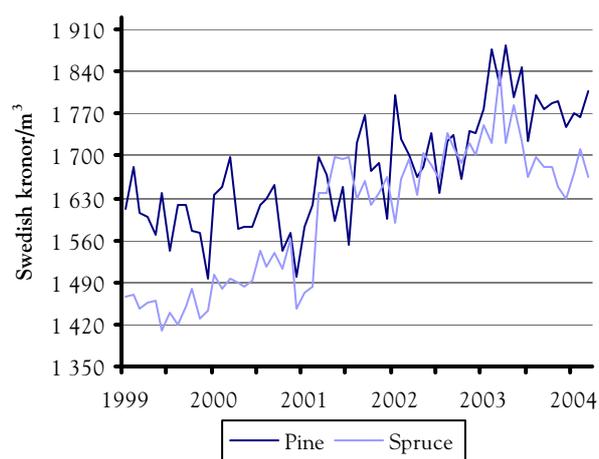


Note: Full trade flow table in the electronic annex.

Source: UN COMTRADE/EFI, 2004.

GRAPH 5.2.2

Sawn softwood export prices from Sweden, 1999-2004



Source: Swedish Wood Association, 2004.

<sup>31</sup> Upbeat Softwood Traders Look Back on Buoyant Year. TTJ, 20 December 2003.

In the EU/EFTA subregion, sawn softwood production increased by 2.2% in 2003 over 2002 and was more than matched by a 4.8% growth in apparent consumption rates (table 5.2.1 and graph 5.2.3). In addition, the value of exports gained nearly 18% over the same period, while export volumes remained steady in 2003. Western European companies are quickly beginning to realize that they must compete against lower cost commodity producers in the Baltic countries and other countries in central and eastern Europe by adopting value-added and niche marketing strategies, increasing capital expenditures to improve mill efficiencies, and exploring new, untapped market opportunities.<sup>32</sup>

TABLE 5.2.1

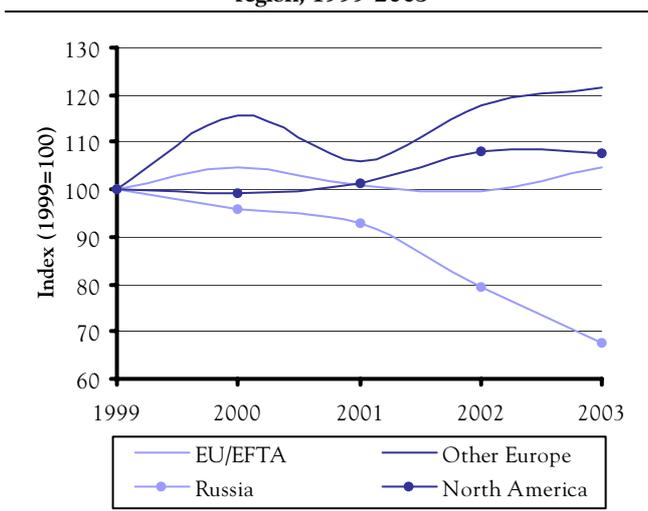
Sawn softwood balance in EU/EFTA, 2002-2003  
(1,000 m<sup>3</sup>)

	2002	2003	Change %
Production	75 480	77 167	2.2
Imports	33 482	35 374	5.7
Exports	34 085	33 941	-0.4
Net trade	603	-1 434	...
Apparent consumption	74 877	78 601	5.0

Source: UNECE/FAO TIMBER database, 2004

GRAPH 5.2.3

Apparent consumption of sawn softwood in the UNECE region, 1999-2003



Source: UNECE/FAO TIMBER database, 2004

In particular, Nordic producers have witnessed a banner year. Production of sawn softwood in Sweden was up 3.9% in 2003, nearing record levels of 17 million m<sup>3</sup>, with profitability of Swedish sawmills estimated to have increased by between 3% and 4% for the second year.<sup>33</sup> This was in spite of intense competition from Russian and Baltic producers in traditional markets like the United Kingdom, Germany and the Netherlands, and significant erosion of market share in other regions of the world such as North Africa. For the time being, Swedish wood producers are concentrating their efforts on the UK, largely as a result of the Sterling's strengthening relative to the Swedish krona.<sup>34,35</sup> Finland also made impressive production gains of 2.7% in 2003. However, while production continues to grow, forest industry profitability is on the decline, owing largely to a sector-wide 7% average drop in prices. Market forecasters should also take note of Finland's investments abroad – totaling 1.5 billion euros – directed for the most part at building new, large-scale sawmills in neighbouring Russia. In addition, a new railway line between Russia and Finland will likely have a significant impact on the wood supply situation, as Russian forests become even more accessible.<sup>36</sup>

### 5.3 Other Europe subregion

Consumption of sawn softwood products in the Other Europe subregion continues to move upwards, hitting a record high of almost 14.5 million m<sup>3</sup> in 2003 (+3.1% over 2002) (table 5.3.1). Production of sawn softwood in 2003 increased by 4.8% overall in spite of negative to marginal growth by the top three producers, the Czech Republic, Latvia and Turkey (in order of decreasing production). Interestingly, the fourth largest producer in this subregion, Poland, has gone from production decreases of 6.0% in 2002 to production increases of 4.9% in 2003, although they are still well below their pre-2001 levels. Export levels of sawn softwood from the central and eastern European countries, which have been relatively consistent over the past five years, grew substantially by 8.9% in 2003 (mostly trade to the EU15). The most impressive gains were seen in the two largest exporting nations, Latvia (+13.9%) and Romania (+26.3%), in part benefiting from government policies to liberalize foreign investment.

<sup>33</sup> Production Hits New Record. TTJ, 17 January 2004.

<sup>34</sup> Eastern European Exports Impact on Sweden's Markets. TTJ, 10 April 2004.

<sup>35</sup> Swedish Shippers Increase Focus on UK Market. TTJ, 13 March 2004.

<sup>36</sup> Production Rises but Prices and Profitability Stumble. TTJ, 22 May 2004.

<sup>32</sup> Global Lumber Outlook, 2004. Wood Markets Monthly, November 2003.

TABLE 5.3.1  
Sawn softwood balance in Other Europe, 2002-2003  
(1,000 m<sup>3</sup>)

	2002	2003	Change %
Production	19 335	20 264	4.8
Imports	3 813	4 120	8.1
Exports	9 087	9 895	8.9
Net trade	5 275	5 775	9.5
Apparent consumption	14 060	14 489	3.1

Source: UNECE/FAO TIMBER database, 2004

In general, industry performance in the central and eastern European subregion is buoyant, thanks largely to decent infrastructures, plentiful timber supplies being harvested in increasing volumes, proximity to markets (with most of the exports being sold into the EU), and relatively stable political and economic climates. In the Baltics, production continues to be more concentrated and consolidated as a result of increased foreign investment, expanded capacities and modernized mills, especially in Estonia and Latvia. Fuelled by this positive climate, sawnwood capacities in the Baltics now sit at an all time high of approximately 7 million m<sup>3</sup>.<sup>37,38</sup>

In addition to the Baltics, increased investments are also prevalent in other central and eastern European countries,<sup>39</sup> which also continue to benefit from lower labour rates, liberal trade restrictions and accession to the EU. In short, countries in the Other Europe subregion are fast becoming formidable competitors in the sawn softwood arena. In particular, Sweden and Finland are feeling competitive pressures from producers in these regions, as some of their traditional export markets begin to source more and more wood products from eastern Europe.<sup>40</sup>

## 5.4 CIS subregion

In 2003, the total output of sawn softwood produced in the CIS region was up by 5.2% over the previous year, totalling over 20 million m<sup>3</sup> for the first time since 2000. Of this total volume, Russia accounted for over 17 million m<sup>3</sup> (table 5.4.1). This impressive production continues unabated due to the relative value of the rouble compared to other world currencies, stable demand from key importers, and increased foreign investments in

forestry and sawmilling infrastructures. While comparatively small, volume outputs from Belarus and Ukraine are also on the rise, both with impressive double-digit gains in exports (+34.0% and +19.2%, respectively).

Russian exports continued to rise strongly in 2003, by over 18%, reaching more than 10 million m<sup>3</sup>. This increase comes at the expense of an 11-year downward slide in apparent domestic consumption. Russian consumption fell by 14.6% in 2003 over 2002, and has plummeted by 81% since the maximum in 1992 of 37.8 million m<sup>3</sup>. The remarkable fall is evident in the apparent consumption graph (graph 5.2.3). However, it should be noted that Russian apparent consumption figures may be understated, as the domestic consumption of sawn softwood produced by small sawmills for local markets' consumption is difficult to track. There is also the possibility of some volumes of sawnwood not being reported because of the questionable legality of the raw material source. However, this downward trend is in contradiction to the general rise in standard of living in Russia; there is a need to more closely investigate the data quality question.

TABLE 5.4.1  
Sawn softwood balance in the Russian Federation, 2002-2003  
(1,000 m<sup>3</sup>)

	2002	2003	Change %
Production	16 931	17 282	2.1
Imports	10	5	-50.0
Exports	8 600	10 160	18.1
Net trade	8 590	10 155	18.2
Apparent consumption	8 341	7 127	-14.6

Source: UNECE/FAO TIMBER database, 2004

As in the past, Russia continues to play a dominant and growing role in the world trade of sawn softwood. In 2003, the major importers of sawn softwood from Russia were: Egypt (12.0%), Japan (8.0%), UK (7.2%), Germany (5.2%), China (4.8%) and Italy (4.4%). Among all of the sawnwood trade flows in the UNECE region, exports from CIS countries to non-UNECE region destinations, for example the mideast, Japan and China, have seen the most rapid changes, as shown in the sawn softwood trade flows (graph 5.2.1). According to preliminary forecasts, this surge in production and exports is expected to continue into 2004.

<sup>37</sup> Global Lumber Outlook, 2004. Wood Markets Monthly, November 2003.

<sup>38</sup> On Into Europe. TTJ, 29 May and 5 June 2004.

<sup>39</sup> Global Lumber Outlook, 2004. Wood Markets Monthly, November 2003.

<sup>40</sup> Eastern European Exports Impact on Sweden's Markets. TTJ, 10 April 2004.

## 5.5 North America subregion

Overall, both production and consumption of sawn softwood in North America decreased marginally in 2003 (-0.5% and -0.6%, respectively) (table 5.5.1). Modest increases in production were observed in the US (+0.5%), while Canada saw a net reduction (-1.5%). That said, the volume of sawn softwood exports from the US decreased by 1.0% over 2002, while Canadian exports continue to grow (+1.7% in 2003). This implies that it was mainly production from North American manufacturers that met the increased demand in the US in 2003. Other offshore imports fell by 3%, reflecting the weakness of the US dollar. A strong Canadian dollar also hampered Canadian exports in the first quarter of 2003, but these strengthened as prices rose in the latter part of the year.

Looking ahead, the US economy is in the upward phase of a business cycle. With the current revival of previously lagging sectors (e.g. non-residential construction and manufacturing), inflation pressures are also increasing. Currently, the extraordinarily low interest rate environment is ending, as the US Federal Reserve began to raise lending rates in June 2004. Accordingly, the prospects for home construction are also beginning to change.

The boom in housing that low interest rates have helped has led to a dramatic 37% increase in home prices since 1997 (26% when adjusted for inflation), leading some analysts to speculate that a housing-price bubble has been created that is vulnerable to collapse. A review of home prices shows that they are at a 14-year high in relation to wages, but, because of the extraordinarily low mortgage rates, mortgage payments on these prices have actually been quite affordable. The outlook for housing and its vulnerability to a price collapse depends, in large measure, on the upward path of interest rates, but this appears unlikely in the framework of the current cycle. Rather, historic evidence points to interest rates rising gradually, causing housing starts to weaken only modestly (as discussed in chapter 3).

TABLE 5.5.1

### Sawn softwood balance in North America, 2002-2003

(1,000 m<sup>3</sup>)

	2002	2003	Change %
Production	117 663	117 081	-0.5
Imports	36 059	36 497	1.2
Exports	37 607	38 201	1.6
Net trade	1 548	1 704	10.0
Apparent consumption	116 115	115 378	-0.6

Source: UNECE/FAO TIMBER database, 2004

Two other occurrences in the North American sawn softwood marketplace that will have far reaching impacts are worth noting. First, a US ban on chromated copper arsenate preservative (CCA) in sawnwood for residential applications went into effect at the end of 2003. The available alternatives, mainly copper-based solutions, pose new challenges to US wood treaters with respect to meeting the demand for durable wood that does not corrode metal fasteners during the active service lives of the products in place.<sup>41</sup>

Second, in the major Canadian sawn softwood producing province of British Columbia, the mountain pine beetle problem has reached epidemic proportions. Estimates for 2003 put the area of coniferous forests that have been infested at an astounding 4.2 million hectares (from 165,000 hectares in 1999).<sup>42</sup> Unquestionably, this will have a profound impact over time on the economic well-being of forest-dependent communities across British Columbia. On a global level, this epidemic will no doubt impact on the dynamics of sawn softwood production, trade and consumption, as the provincial and federal governments work quickly to develop and enact policies regarding the appropriate harvest levels and companies explore market opportunities for the high volumes of beetle-killed wood coming on stream.

## 5.6 Outlook for 2004 and 2005

The short-term outlook for sawn softwood production, consumption and trade will be affected by three main factors: global exchange rates, sawn softwood prices and the ongoing trade dispute between the US and Canada. The course of exchange rates hinges largely on the US dollar, which has been weak because of the large current account deficits and low interest rates. A weaker US dollar hinders imports, which, in turn, bolsters domestic prices. In the meantime, a strong euro in early 2004 was already expected to slow US imports of whitewood (spruce and fir) from northern Europe, but the ensuing price boom offset its negative effects and European exports to the US in the first four months of 2004 actually recovered by 39% after falling off in 2003.

The second element affecting the outlook of sawn softwood dynamics is the supply response to the highly favourable prices experienced since the second half of 2003. Preliminary surveys indicate that US mills have increased capacity by 4% relative to 2002.<sup>43</sup> Planned

<sup>41</sup> Environmental Issues and Protection. The Forest Products Conservation and Recycling Review, USDA Forest Service, 16(5/6), May/June, 2004.

<sup>42</sup> British Columbia Ministry of Forests (2004). Mountain Pine Beetle Action Plan Update, 2004 ([www.for.gov.bc.ca](http://www.for.gov.bc.ca)).

<sup>43</sup> Timber Processing, July/August 2004 issue. Hatton Brown publishers, Birmingham, Alabama.

capacity additions in Canada and Europe for several new or expanded mills suggest that similar increases are also taking place in those regions.<sup>44</sup> With the eventual rebalancing of railroad capacity in the US, supply flow increases are likely to follow. Based on past experience, they could exceed demand and upend the current upbeat prices. The interplay of possibly lower housing demand and increased supply on the one hand, versus a weaker dollar discouraging imports on the other, will set the stage for market forces in 2004 and 2005. Higher prices could still prevail through the first quarter of 2005, followed thereafter by a return to more normal pricing.

The final unresolved issue clouding sawn softwood markets concerns the US-Canada trade dispute. Although the general flow of decisions has been favouring the Canadian view and a possible ruling later this year could abolish all tariffs, inevitable appeals would delay its implementation until 2005 at the earliest. This means that Canadian companies will have to continue to operate under the uncertainty of the appeals process.

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<sup>44</sup> Madison's Canadian Lumber Reporter, 25 June 2004.

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