

## **Mounting economic problems**

A report in the Economist suggests that European economic prospects are deteriorating. It notes that "Europe is struggling to stay above water. Figures released on August 14<sup>th</sup> showed that the euro-area economy shrank at an annualised rate of 0.8% in the second quarter, the first such reverse since 2001. Nor are things likely to improve soon. A closely watched survey of purchasing managers in manufacturing and services slumped in July to its lowest level since 2001. Business confidence has turned down sharply in all of the three biggest economies in the euro area: Germany, France and Italy. Indeed, in the second quarter GDP fell in all three countries, paring their annual growth rates...Meanwhile Spain's GDP has predictably stuttered as it endures a painful shock from its burst housing bubble...Ireland's GDP which grew by 6% in 2007 is likely to shrink this year... Britain is on the brink of recession."

The Economist reports that even the Eastern European economy, which has been a source of significant growth following the EU's recent expansion to absorb 10 eastern neighbours, is now experiencing a slowdown. In this region in recent years, economic and political stability has boosted investor's confidence and cut borrowing costs. A big pool of cheap and diligent workers along with the unleashing of entrepreneurial talents has produced thriving new private businesses. This produced stellar growth rates across the region until 2007. But now wage costs are creeping up, labour shortages are biting, out-dated infra-structure is clogging trade, export markets are looking tougher, and some countries are struggling under the weight of large current account deficits built up during the period of rapid growth. The bubble has already popped in the Baltic States and the Hungarian economy also looks very wobbly due a near disastrous government spending and borrowing splurge in the early years of this decade.

One source of comfort is that Poland, Easter Europe's biggest economy and an important market for hardwoods due to its large export-oriented furniture and flooring sectors, looks more stable. Polish GDP growth in the first quarter was a healthy 6.1% and unemployment which was 20% in 2003 has all but vanished. But Poland's growth is now likely to slow as rising interest rates and slowing export markets begin to bite.

## **Plywood**

A recent report in the UK's TTJ notes that while a few UK plywood importers were buying in decent volumes at the start of the third quarter, many others had reined in purchases in a bid to control costs and cash flow and due to uncertainty over market prospects in the second half of the year. As a result some plywood suppliers believe that shortages could arise if demand were to increase unexpectedly. TTJ suggests that without a significant increase in forward buying, shortages of Malaysian and Brazilian hardwood plywood, as well as good quality Chinese ply could emerge in September after the summer holiday lull. TTJ notes that supply problems may be particularly pronounced for Chinese plywood where many manufacturers have closed in recent months in response to rising costs and where some manufacturers are now focusing more on supplying the domestic furniture industry. TTJ also suggests that many UK buyers that switched to Malaysian product at the turn of the year due to uncertainty created by the European Commission's anti-dumping investigation have not returned to Chinese product despite the Commission's decision not to impose duties on tropical hardwood faced plywood from China. TTJ also notes that while Indonesian mills are keen to supply the UK market, their asking prices are currently

well above those of their Malaysian counter-parts. Meanwhile UK importers report that supply of hardwood plywood out of Brazil is still extremely difficult.

### **Hardwood lumber**

TTJ's latest hardwood sawn lumber market report suggests that "while no-one in the UK hardwood trade is pretending that business is anything other than difficult, demand seems to be proving more durable than in other sectors of the timber industry". Some TTJ contacts in the hardwood importing industry suggest that sales volumes in 2008 have been comparable to last year, although rising costs and intense competition have meant that profit margins have been down. Most importers and agents are also reporting a nervousness among purchasers which is manifesting itself in a reluctance to buy forward and in large volumes. TTJ quotes one UK hardwood trader: "If people can get away with buying little and often, they are doing that in preference to buying big box loads." TTJ suggests that a number of leading hardwood importers "confessed to surprise at how sales had held up, but also to concern about the robustness of demand going forward."

On specific species, TTJ reports that prices for UK and continental landed stocks of sapele have continued to weaken in the face of subdued consumption and ample availability. Prices for utile/sipo vary widely and available volumes are proving to be readily saleable. Framire prices are soft as supply is relatively abundant and replacement costs are not being met. Wawa purchasing levels in the UK are below the same period last year, although this is at least partly due to the very difficult supply situation in Ghana. According to TTJ, UK forward buying of dark red meranti "has been no better than steady" while "consumption of keruing has been quite low although prices have remained firm on the back of rising freight costs". Trade in hardwoods between Brazil and the UK remains difficult as recent delays in the issue of transport permits by the Brazilian authorities has led many UK buyers to conclude that Brazil is an unreliable supplier.

### **Hardwood flooring**

A recent Asian Timbers article on the international wood flooring market provides some interesting insights into the European flooring sector. The article is by Michael Buckley, a former European Director of the American Hardwood Export Council and now an independent industry consultant. Buckley comments that as a "finishing trade" the European flooring sector has been slower to respond than other timber industry sectors to the recent dramatic downturn in European residential markets. He also notes that the sector may be partially insulated from this downturn because there is often an increase in renovation and restoration by people who cannot afford to move home or are unable to sell the one they have. He suggests that "hopefully, when the backlog of current new housing completions are worked through, then the inevitable downturn for hardwood flooring will be a softer landing than it has been for bricks, cement, concrete and roof tiles." In support of this argument he quotes a Spanish kitchen manufacturer at Interzum Guangzhou who said that the first quarter of 2008 in Spain, where the housing bubble has really burst, was the best the company had enjoyed. But this manufacturer added that they were bracing themselves for the downturn to come based on the new housing starts data emerging in Spain.

Buckley goes on to note that the key to future market success in the European and North American hardwood flooring markets will be specialisation. "No longer will it be possible to make money by just offering basic hardwood flooring. A perceptive

understanding of species, colours, finishes and trends will be all the more important for individual manufacturers – for one reason only. That is the word ‘choice’. Distributors and consumers in most markets enjoy an enormous availability of choice with imported and domestic flooring, solid and engineered, offered in a mind blowing range of designs, species and finishes...to sell well there needs to be something that differentiates any particular brand from others...finally there is the whole issue of sustainable and legal sourcing which is increasingly on the agenda.”

Buckley comments that Europe is much more into engineered flooring than North America which tends to much prefer solid wood. Oak is by far the dominant species in both regions accounting for 50% in Europe and perhaps two thirds of production in the USA and Canada. He notes that “both continents have huge flooring manufacturing capacity but also growing demand for imports, especially at the cheaper end of the market”. He suggests that there is potential for further growth in European consumption, despite the economic downturn. Cheap imports from China may, in fact, have helped to stimulate demand. Buckley is optimistic about longer term prospects, quoting the National Wood Flooring Association of America: “the facts are clear, wood flooring is the only flooring option that is completely sustainable, and with new guidelines promoting responsible management, it has become the flooring option of choice among many eco-friendly builders, architects, specifiers, designers and consumers.”

### **Sliced veneer**

The German trade journal EUWID reports that the central European veneer sector is undergoing a second phase of consolidation and restructuring. The first phase occurred in 2002 when a significant number of slicing machines were shifted from Western Europe (mainly Germany) into Eastern Europe as a cost cutting measure. The second phase now underway is due to a combination of factors. These include: weakening domestic demand in the current economic climate; a slowdown in export sales due to the strength of the euro; continuing substitution of real wood veneer by artificial surfaces; and intensifying competition in international markets from Chinese and North American producers.

EUWID reports that at least 6 slicing machines and 2 Staylog machines have been shut down in the central European veneer industry in the last 18 months, reducing the number of plants operating in the region by 20%. When combined with the 20 slicing and Staylog machines closed in 2002, this means that total veneer capacity in central Europe has fallen by almost 50% in only 6 years.

EUWID notes that the decline in demand and capacity has been particularly pronounced for veneer products manufactured in bulk. Demand for these products from the door and furniture industries has weakened dramatically in recent months, notably in Germany, Spain, Portugal, Italy and the UK. However demand from flooring manufacturers in Scandinavia and Eastern Europe has been more robust in the face of the downturn. Veneer consumption in oil-exporting economies of the Middle East and Russia has also remained brisk, but the strong euro rate has meant that European exporters are losing out to US and Chinese competitors in these markets.

Demand for custom veneers for interior finishing, yacht building, the aircraft and car industries has also been holding up reasonably well, although the recent insolvency of one German firm engaged in this business suggests that the high value sector has not completely escaped the slowing pace of business activity. In any case the high

value sector accounts for a relatively small proportion of overall production and cannot adequately compensate for declining sales in the bulk door and furniture sectors.

EUWID suggests that prospects for the second half of the year do not look promising. Despite recent cut-backs in production, manufacturers report that consumption is so slow that production and stock levels remain well in excess of demand. Veneer prices remain under pressure especially for standard products. Longer term, manufacturers expect veneer's share of the surfaces market to continue to slide.

The decline in veneer capacity in central Europe will of course have a major impact on market demand for veneer quality logs in the region. According to EUWID, less than 100,000 m<sup>3</sup> of logs are expected to be converted into veneer in Germany during 2008, down from 120,000 m<sup>3</sup> last year. To put this into long term perspective, 30 years ago the German veneer industry was processing in excess of 800,000 m<sup>3</sup> of logs into veneer every year.

The German Timber Trade Federation's annual poll of the German veneer trade reveals that in 2007, 56% of total veneer output comprised European hardwoods (down from 60% in 2006), 23% comprised North American hardwood (up from 19% in 2006), 16% comprised tropical hardwood (down from 17% in 2006), while specialities such as burl veneer and flamed maple accounted for 4% (up from 3.5% in 2006). Leading tropical wood species used by the German veneer industry are mahogany, wenge, sipo, sapele, zebrano and makassar.

### **French construction sector shows weakness**

Until recently the French market for hardwoods seemed to be holding up rather better than other western European countries. However prospects for the second half of the year appear gloomy with emerging reports of a sharp downturn in French construction activity during the first half of 2008. According to EUWID, the French authorities have reported that the number of residential planning permits issued during the first 6 months of the year reached only 234,866, 16% lower than the same period in 2007. The number of housing starts during the first 6 months of 2008 reached 171,006, that is 20% down on the same period in 2007. The slowdown is reflected in a decline in trading activity by members of CAPEB, the French builders' merchant association. According to CAPEB, the total value of members sales during the second quarter of 2008 were only 0.5% higher than the same period in 2007. This compares with a 2% increase in sales value in the first quarter of 2008 compared to the same period in 2007. According to CAPEB the slowing rate of sales growth is particularly worrying because it seems to have affected all regions of France. Furthermore, while sales growth to the new build residential sector has slowed particularly dramatically, there has also been a slowdown in the renovation sector.

### **Green issues**

The European Commission recently reported on the status of their deliberations on additional legislation to prevent imports of illegal wood into the EU. The EC Communication on this issue, originally scheduled for April, is now expected in September. The EC's favoured option is now to directly impose a requirement for due diligence on wood trading companies in the EU. Although no final decision has been taken, the process of formal public consultation on the legislation is now ended and all EC DG's are believed to be in broad agreement with the approach proposed.

However signs are they still have much work to do to convince key stakeholders. Environmental groups are looking for much more far-reaching measures putting the onus on the trade to demonstrate that all wood derives from legal sources. At the same time, many EU timber importing associations are against the idea of their members being required to take full responsibility for assessing the legality of their wood imports. They want governments in timber supplying countries to play the lead role, for example by issuing a “declaration of legality” with each consignment of timber.

Following delays, a draft version of the much anticipated EC Communication on Green Public Procurement (GPP) was released in July 2008. The Communication sets out a process with potential to encourage convergence between public sector procurement policies in the EU. It also enshrines various principles that could boost prospects for timber. For example it recommends discrimination in favour of renewable products and emphasises full life cycle impacts. But the Communication and associated documents have certain weaknesses for timber. For example, draft procurement guidelines issued with the Communication propose that verification of legality should require full supply chain traceability. This could create problems for timber from small forest owners and communities and is out of line with green requirements imposed on alternative non-wood products.