

CHAPTER 2

ECONOMIC FACTORS AFFECTING FOREST PRODUCTS MARKETS

Highlights

- 1997 saw strong economic growth in Europe and North America. Good growth conditions are expected to continue in 1998.
- Perhaps 1997 was the year when the Russian economy stopped contracting and started to expand.
- Growth was satisfactory for many countries in transition, but negative or weak for others, notably in south-east Europe and central Asia.
- A major economic, financial and currency crisis affected Asia, with Japan in deep recession in mid 1998.
- New residential construction continues to stagnate in many European countries, but renovation is still growing strongly. United States housing starts remain at a rather high level. The Japanese construction sector plunged into recession in April 1997 and has not yet recovered.
- European furniture production fell slightly in 1997, but a small increase is forecast for 1998.

The analysis below is taken from the *Economic Survey for Europe*, number 1 and number 2 of 1998, prepared by the Economic Analysis Division of the secretariat of the Economic Commission for Europe.

2.1. General economic developments

(i) Economic developments in 1997

The economic situation improved significantly in much of the ECE region in 1997. In the western market economies (western Europe and North America) it was the best year for GDP growth – an average 3.3% – since 1989. In the transition economies of eastern Europe, the Baltics and the CIS, it was the first time since 1989 that their average growth rate was positive (just under 2%), a reflection of continued steady growth in eastern Europe and, finally, the apparent end to seven consecutive years of falling GDP in Russia.

The relatively high growth rate of the western economies was heavily influenced by the unexpected strength of the *United States* economy where buoyant domestic demand was responsible for an increase in GDP of 3.8%, the largest rise since 1988. Household

expenditures increased strongly (3.3%), but so did fixed investment, which rose nearly 6.5%.

In *western Europe*, the growth of GDP averaged 2.7% in 1997, a clear improvement on the 2% increase in 1996. There was a steady, but by no means dramatic, improvement in domestic demand during the year and, because of their very close trading links, this tends to have a multiplier effect through the European economies. Nevertheless, west European growth was still largely driven by exports and especially by the import demands of North America, the transition economies of eastern Europe and the CIS, and developing countries outside East Asia. Fixed investment picked up a little in 1997 but it was very weak in France, Germany and Italy, and even in the United Kingdom, where growth has been relatively strong for the last four years and profits relatively high, the increases have not been very large. The investment that has taken place has tended to be in machinery and equipment rather than new buildings, and focused on the rationalization of production rather than the expansion of new capacities which would lead to higher employment.

TABLE 2.1.1

Real GDP in the ECE market economies, 1995 to 1998
(Percentage change over previous year)

	1995	1996	1997	1998 ^a
Western Europe	2.7	2.0	2.7	2.8
European Union	2.5	1.7	2.6	2.8
4 major countries	2.3	1.4	2.3	2.5
France	2.1	1.6	2.3	3.0
Germany	1.8	1.4	2.2	2.6
Italy	2.9	0.7	1.5	2.5
United Kingdom	2.7	2.2	3.3	1.9
17 smaller countries	3.3	3.0	3.6	3.5
Austria	2.1	1.6	2.5	2.7
Belgium	2.1	1.5	2.9	2.5
Cyprus	5.5	1.9	2.4	4.0
Denmark	3.1	3.5	3.4	2.5
Finland	5.1	3.6	5.9	4.0
Greece	2.1	2.7	3.5	3.0
Iceland	1.1	5.5	5.0	4.6
Ireland	10.4	7.7	10.5	7.5
Israel	6.4	4.5	1.9	2.5
Luxembourg	3.8	3.0	3.7	3.4
Malta	7.3	4.2	2.8	..
Netherlands	2.3	3.3	3.4	3.8
Norway	4.1	5.5	3.4	4.6
Portugal	1.9	3.0	3.5	3.8
Spain	2.7	2.3	3.4	3.5
Sweden	3.9	1.3	1.8	2.9
Switzerland	0.8	-0.2	1.1	2.0
Turkey	7.2	7.0	6.3	4.5
North America	2.0	2.6	3.8	2.7
Canada	2.2	1.2	3.7	3.0
United States	2.0	2.8	3.8	2.7
Total above	2.3	2.3	3.3	2.8
<i>Memorandum item:</i>				
Japan	1.5	3.9	0.9	-0.5
Total above, including Japan	2.2	2.6	2.9	2.3

Source: National statistics; *OECD National Accounts* (Paris), various issues.

Note: All aggregates exclude Israel. Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from 1991 GDP data converted from national currency units into dollars using purchasing power parities.

^a Forecasts.

A general feature of developments in the western market economies in 1997 was the persistence of very low rates of inflation and the absence of any serious incipient labour or other cost pressures. In western Europe the increase in consumer prices averaged less than 2% in 1997, and despite a long period of sustained output growth it was also under 2% in the United States towards the end of the year.

In the labour markets, the favourable changes in production led to a small decline in the average unemployment rate in western Europe to 9.8% in the first quarter of 1998, down from 10% in the same quarter of 1997.

In eastern Europe and the Baltic states, 1997 was generally a year of relatively high rates of growth. The average rate for central and eastern Europe (2.8%) was actually much lower than in 1996 (4.1%), but this was largely due to the large falls in GDP in Albania, Bulgaria and Romania, and a sharp deceleration of growth in the Czech Republic. In these countries policy makers have been grappling with the consequences of severe financial crises in 1996 and 1997, which in turn were the result of poor macroeconomic fundamentals, and weak reform programmes, especially as regards the banking and enterprise sectors. At the root of most of these setbacks is the lack of a political and social consensus on a radical transformation programme. Considerable progress has been made towards establishing macroeconomic stability in Bulgaria, especially since the creation of a currency board in July 1997, but a long process of structural adjustment still lies ahead. Together with Bosnia and Herzegovina and Yugoslavia, the increasing divergence between economic reform and development in these south-east European countries and those in central Europe and the Baltics is a matter of growing concern: not only because of the heavy costs to the peoples of south-east Europe but also because of the risks to economic and political stability in the region as a whole.

A major feature of the recovery in central Europe is the rapid growth of the industrial sector. Industrial output in Hungary and Poland grew more than 11% in 1997 and by some 7% in Croatia; in Latvia it was more than 6% and over 13% in Estonia. Thus, far from developing a post-industrial economy dominated by services, most of the east European transition economies seem to be embarking on a process of reindustrialization with a strong export orientation.

Despite high rates of economic growth, there was only a marginal rise in the total level of employment in eastern Europe in 1997, and this was largely due to Poland where output has been growing strongly for five years. Unemployment rates remain high. In spite of serious setbacks in some of the south-east European economies, inflation rates have fallen markedly in most of the transition economies in the last few years, although progress was less marked in eastern Europe in 1997. The rate of increase in wages has continued to fall and widespread improvements in productivity, largely associated with increased output, have considerably lowered the growth in unit labour costs.

In the CIS the most significant macroeconomic development in 1997 was the apparent end of seven years of falling output in Russia. The increase in GDP was marginal and the prospects for continued recovery are uncertain, but there are nevertheless signs of

improvement in various parts of the economy. The main source of growth was in manufacturing industry with a recovery taking place in a number of sectors.

TABLE 2.1.2

Basic economic indicators for the ECE transition economies, 1995 to 1998
(Rates of change and shares, per cent)

	GDP (growth rates)					Industrial output (growth rates)			Inflation (per cent change, Dec./Dec.)			Unemployment rate (end of period, per cent)		
	1995	1996	1997		1998	1995	1996	1997	1995	1996	1997	1995	1996	1997
			Ex-ante forecast	Actual outcome										
Eastern Europe	6.1	4.1	3.5	2.9	4¼	7.7	6.5	5.6	..	..	..	12.5	11.8	11.7
Albania	13.3	9.1	..	-7	10	-7.2	13.6	-5.6	6.0	17.4	42.0	13.1	12.1	14.9
Bosnia and Herzegovina ^a .....	..	..	..	..	..	60.8	87.3	35.1	-34.2	3.2	12.2	..	..	..
Bulgaria	2.9	-10.1	-(2-4)	-6.9	3	4.5	3.8 ^b	-7.0	33.0	311.1	578.7	11.1	12.5	13.7
Croatia	6.8	6.0	5.5	6.5	7.5	0.3	3.1	6.8	3.7	3.5	4.0	17.6	15.9	17.6
Czech Republic	6.4	3.9	4-5	1.0	1.4-2.6	8.7	2.0	4.5	7.9	8.7	9.9	2.9	3.5	5.2
Hungary	1.5	1.3	2	4.4	4	4.5	3.4	11.1	28.5	20.0	18.4	10.4	10.5	10.4
Poland	7.0	6.1	5-6	6.9	5.6-5.8	9.7	8.3	10.8	22.0	18.7	13.2	14.9	13.2	10.5
Romania	7.1	3.9	-2	-6.6	-	9.4	9.9	-5.9	27.7	56.8	151.7	9.5	6.6	8.8
Slovakia	6.9	6.6	6	6.5	5	8.3	2.4	2.7	7.4	5.5	6.5	13.1	12.8	12.5
Slovenia	4.1	3.1	4	3.8	3.5-4	2.0	1.0	1.0	9.0	9.0	8.8	14.5	14.4	14.8
The former Yugoslav														
Republic of Macedonia	-1.2	0.7	..	1.0	5	-10.7	3.1	1.6	11.2	0.3	4.5	37.2	39.8	42.5
Yugoslavia ^c	6.1	5.9	13	7.4	10	3.8	7.5	9.5	110.7	59.9	10.3	24.7	26.1	25.6
Baltic states	2.3	4.1	4.5	7.4	6½	1.3	4.8	5.6	..	..	..	6.5	6.4	6.3
Estonia	4.3	4.0	4-5	11.4	5.5-6	1.9	3.4	13.4	28.8	15.0	12.3	5.0	5.6	4.6
Latvia	-0.8	3.3	3.5	6.5	5-6	-3.7	5.5	6.1	23.3	13.2	7.0	6.6	7.2	6.7
Lithuania	3.3	4.7	5	5.7	7	5.3	5.1	0.3	35.5	13.1	8.5	7.3	6.2	6.7
CIS	-5.5	-3.4	..	1.0	1¼	-5.9	-2.8	2.3	..	..	..	5.8	6.2	6.2
Armenia	6.9	5.8	..	3.1	5-6	1.5	1.2	0.9	32.0	5.6	21.8	8.1	9.7	11.0
Azerbaijan	-11.8	1.3	..	5.8	..	-17.2	-6.7	0.3	84.5	6.8	0.3	1.1	1.1	1.3
Belarus	-10.4	2.8	5	10.4	7-8	-11.7	3.5	17.6	244.2	39.1	63.4	2.7	4.0	2.8
Georgia	2.6	8.6	..	11.3	11-13	-9.8	7.7	8.1	57.4	13.6	7.3	3.4	3.2	2.6
Kazakhstan	-8.2	0.5	2	2.0	3.5	-8.2	0.3	4.0	60.4	28.6	11.3	2.1	4.1	3.9
Kyrgyzstan	-5.4	7.1	..	10.4	3.6	-17.8	8.8	46.8	31.9	35.0	14.7	3.0	4.5	3.1
Republic of Moldova ^d	-1.9	-7.8	5-7	1.3	3-3.5	-3.9	-6.5	-2.3	23.8	15.1	11.1	1.4	1.5	1.7
Russian Federation	-4.1	-3.5	0-2	0.8	0-0.5	-3.3	-4.0	1.9	131.4	21.8	11.0	8.9	9.3	9.0
Tajikistan	-12.4	-16.7	..	1.7	..	-13.6	-23.9	-2.5	2 382.2	40.6	159.9	1.8	2.4	2.8
Turkmenistan	-7.7	0.1	..	-20*	..	-6.4	17.9	-35*	..	..	..	..	..	..
Ukraine	-12.2	-10.0	..	-3.0	0.5	-12.0	-5.1	-1.8	181.7	39.7	10.1	0.6	1.5	2.8
Uzbekistan	-0.9	1.7	..	5.2	6	0.1	6.0	6.5	..	..	..	0.3	0.3	0.3
Total above	-1.3	-0.4	..	1.9	2½	-1.7	0.4	3.5	..	..	..	7.5	7.8	7.8
<i>Memorandum items:</i>														
CETE-5	6.0	5.0	4.5	5.5	4.7	8.5	6.1	8.9	..	..	..	12.0	11.3	9.9
SETE-7	6.2	2.1	..	-2.9	3.3	5.8	7.6	-2.6	..	..	..	13.7	12.8	14.2
<i>Ex-GDR Länder</i>	5.2	1.9	1.0	1.6	..	5.8	4.3	5.0	..	..	..	..	..	..

Source: National statistics, CIS Statistical Committee and direct communications from national statistical offices to UN/ECE secretariat (IMF and World Bank data for Albania).

Note: Aggregates are UN/ECE secretariat computations, based on previous period weights at 1992 prices. Output measures are in real terms (constant prices). Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Industrial output refers to gross output, not the contribution of industry to GDP. Inflation refers to changes in the consumer price index. Unemployment generally refers to registered unemployment at the end of the period (with the exception of the Russian Federation where it is the Goskomstat estimate according to ILO definition and Estonia where it refers to job seekers). Aggregates shown are: *Eastern Europe* (the 12 countries below that line), with sub-aggregates *CETE-5* (central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and *SETE-7* (south European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, The former Yugoslav Republic of Macedonia and Yugoslavia); *Baltic states* (Estonia, Latvia, Lithuania); *CIS* (12 member countries of the Commonwealth of Independent States); and *total transition countries*.

^a Data reported by the Statistical Office of the Federation; these exclude the area of Republika Srpska.

^b Bulgarian industrial output indices were recently recalculated according to a new methodology and old series reportedly have been revised back to 1991. Here and in appendix table B.4 the industrial output indices now cover gross output of all activities of industrial enterprises (and not gross output of "pure" industry, as previously published). The figure for industrial output growth in 1996 according to the new methodology (3.8 per cent) differs significantly from the figure for the rate of change of gross industrial output (-9.1 per cent) reported in the national accounts for the same year.

^c Gross material product instead of GDP.

^d Excluding Transnistria.

There was also a revival of consumer demand for the first time since 1990 and Russian manufacturers appear to be starting to regain shares in their domestic market. One of the major achievements in the Russian economy has been the reduction in the inflation rate from an annualized quarterly rate of 400% in early 1995 to 2.8% in the last quarter of 1997.

Output was also growing in all the other CIS countries in 1997 except Turkmenistan and Ukraine, and there was also a significant fall in inflation rates in most of them. Tight monetary policies and stable exchange rates were largely responsible for the latter, although higher productivity, and increased price stability in Russia, the principal trading partner of the other CIS countries, also had an influence.

(ii) Diverging performance and increasing instability: the global context in summer 1998

Developments in the first half of 1998 were marked by the contrast between a deepening economic crisis in East Asia and a continuing economic upswing in the western market economies and the transition economies. In East Asia, the economic and social costs of adjustment to be faced after the turbulence in the financial markets have become more visible in 1998. A significant deterioration of the economic situation in Japan, which moved into deep recession, and the associated sharp depreciation of the yen have seriously dampened prospects for recovery in the region, however.

In North America, the economic expansion has continued at a high rate. In western Europe, the cyclical recovery has continued at a moderate pace. Rough estimates suggest that real GDP in western Europe rose by some $\frac{1}{2}$ to $\frac{3}{4}$ of a percentage point in the first quarter of 1998 compared with the preceding quarter, when there was an increase by 0.5%. This would imply an average year-on-year increase of some 3%.

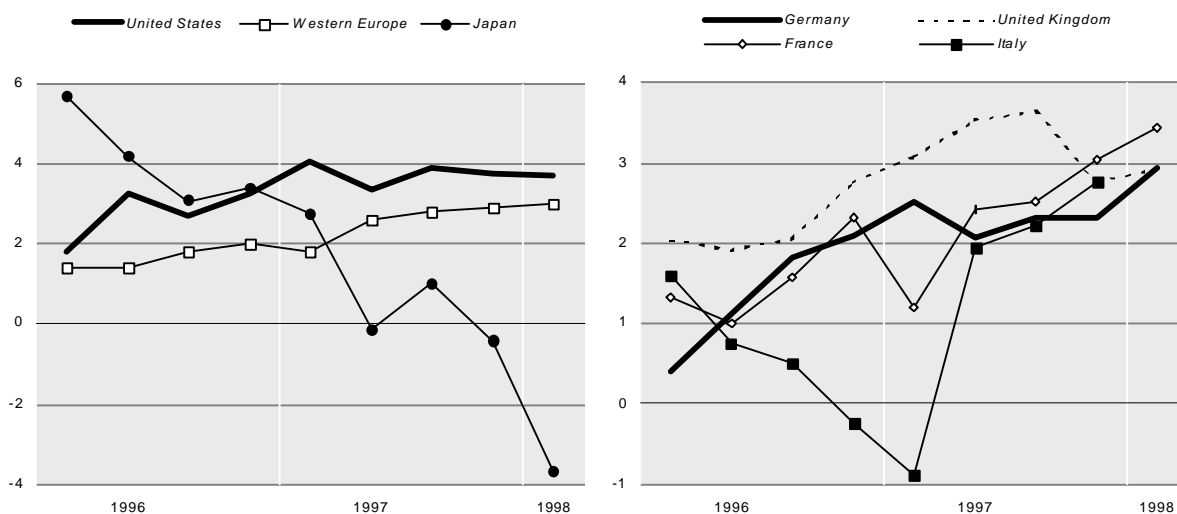
Economic developments have also, in general, been favourable in the transition economies, but they are still vulnerable to financial instability as a result of large domestic or external imbalances, real currency appreciation, weak banking systems, and relatively high exposure to short-term capital inflows. The recent financial turmoil in Russia, which erupted in May 1998, is an illustration of these risks.

In the foreign exchange markets the progressive appreciation of the dollar against the yen, underway since April 1995, has continued. Against the background of a marked weakening of economic activity in Japan, concerns over the problems in its banking sector and sizeable interest differentials in favour of dollar denominated financial assets, the selling pressure on the yen mounted considerably.

The collapse of the yen exchange rate constitutes a major change in the economic environment facing the east Asian emerging economies, because it has progressively eroded, in combination with a sizeable inflation differential vis-à-vis Japan, the price

GRAPH 2.1.1

Quarterly changes in real GDP, 1996 Q1 to 1998 Q1 (Percentage change over same period of preceding year)



Source: National statistics.

Note: Western Europe: Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom.

competitiveness which they had gained from the depreciations of their currencies in the second half of 1997 and in early 1998.

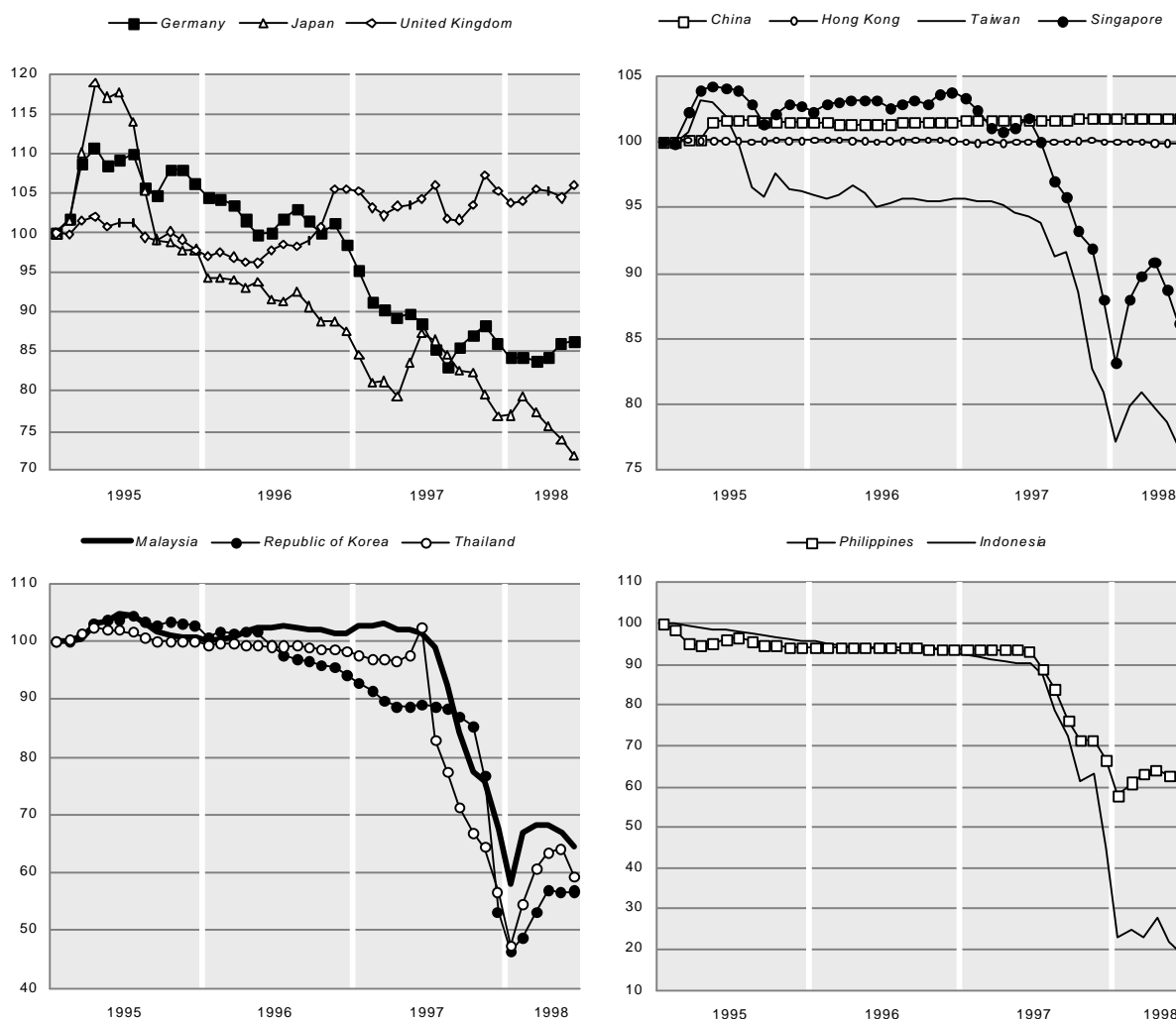
Share price indices in western Europe and the United States rose to record levels in the second quarter of 1998, but there was increasing volatility in May, which was partly related to the political turmoil in Indonesia and to temporary concerns over possible interest rate increases in the United States. This led also to selling pressure on share prices in emerging markets in Latin America and the transition economies. There was renewed volatility in early June against the background of the sharp depreciation of the yen, which was seen as a possible trigger of a new

round of currency depreciations in the region

The decline of international commodity prices accentuated in the first half of 1998. This was partly related to the reduced demand originating in East Asia on account of depressed domestic activity levels, but increasing supplies of some commodities have also played a role. There has been a conspicuous fall in the price of crude oil, the world market price (Brent Crude) falling below \$14 per barrel in May 1998, some 30% lower than in the same month of the previous year. Oil producing countries agreed in March 1998 to cut output until the end of the year to reverse the slide, but the reductions appear to have been outpaced by the decline of demand.

GRAPH 2.1.2

Average monthly nominal exchange rates against the dollar, January 1995 to June 1998
(Indices, January 1995=100)



Source: Federal Reserve Bank of New York; IMF, *International Financial Statistics* (Washington, D.C.); Reuters Business Briefing, online database.

Note: Dollars per national currency unit. Data for June 1998: average of first week.

(iii) Economic crisis in East Asia

In Japan, there has been a further significant deterioration of the economic situation, and the economy is now in deep recession. Real GDP fell by 1.3% in the first quarter of 1998 compared with the last quarter of 1997 when there had already been a fall of 0.4%. Economic activity had started to weaken significantly in the wake of the tightening of fiscal policy in April 1997 which, with hindsight, was premature. To this was added the restraining effects of the Asian financial crisis on regional export performance and the lingering balance sheet adjustment problems in the banking sector, which led to a tightening of lending standards. This last factor has made it difficult for small- and medium-sized enterprises to obtain credit. The collapse of some important financial institutions in late 1997 also depressed consumer and business confidence.

One factor hampering exports is the difficulties encountered in some countries in obtaining trade financing. Companies are having to cope with tight liquidity and high interest rates. It should also be recalled that the potential gains in price competitiveness from the sharp decline of the exchange rates are offset to a more or less large degree by the increased dollar cost of imported inputs.

Real GDP fell in several of the east Asian emerging markets in the first quarter of 1998 compared with the same period of the preceding year. Among the five countries most affected, the downturn was particularly pronounced in Indonesia (6.2%) and the Republic of Korea (3.8%), but aggregate output also fell in Malaysia (1.8%) and most probably in Thailand. For the Republic of Korea, this was the first quarterly decline of real GDP in 18 years and for Malaysia, in 13 years. In the Philippines, there was a sharp slowdown in economic growth.

In all these countries official forecasts for GDP growth in 1998 have been – or will be – significantly lowered. This is especially the case for Indonesia, where a fall in real GDP by more than 10% is now expected following earlier forecasts of a fall by 5%. Private forecasters expect also quite a sharp decline in real GDP in the Republic of Korea and Thailand.

In Indonesia, against the background of falling output, soaring inflation (the annual inflation rate was some 50% in May) and a steep rise in unemployment, the government was facing massive protests when it decided to raise administered prices of energy and transport in early May 1998. Although the authorities cancelled this decision, the protests continued and led to the resignation of the President and a change of government. Given the persistent political uncertainty,

the IMF suspended disbursement of the loan arranged in the context of the rescue package agreed in October 1997. The Indonesian rupiah, which had recovered somewhat in April, weakened sharply in May, falling to more than 11,500 rupiah against the dollar in early June. This corresponds to a depreciation of the rupiah by nearly 80% against the dollar since June 1997.

The expected negative effects of the east Asian crisis on net exports of western Europe and North America have only gradually started to appear and so far they have been offset by stronger domestic demand. In general, the western countries have so far mainly experienced the beneficial effects of the Asian crisis: falling inflationary expectations have put downward pressure on interest rates and this has supported domestic demand. Falling interest rates have also contributed to the rise in asset prices and, hence, household wealth, which has also been supporting private consumption expenditures.

TABLE 2.1.3

Annual changes in real GDP in east Asian countries, 1996 to 1998
(Percentage change over preceding year)

	1996	1997	1998 ^a	Memo item: 1998-Q1 ^b
ASEAN-4	7.0	4.0	-7.4	..
Indonesia	8.0	5.0	-12.0	-6.2
Malaysia	8.6	7.8	-2.5	-1.8
Philippines	5.7	5.1	1.0	1.7
Thailand	5.5	-0.4	-8.0	..
NIEs	6.4	6.0	-1.6	0.1
Hong Kong	4.9	5.3	-2.0	-2.0
Republic of Korea	7.1	5.5	-6.0	-3.8
Singapore	6.9	7.8	1.0	5.6
Taiwan Province of China	5.7	6.8	5.0	5.9
China	9.7	8.8	6.0	7.2
Japan	3.9	0.9	-0.5	-3.7
Total above	4.7	3.5	0.7	..

Source: National statistics and UNCTAD.

Note: Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from 1996 GDP data converted from national currency units into dollars using purchasing power parities.

^a Forecasts. Country data supplied by the Division on Globalization and Development Strategies, UNCTAD.

^b Percentage change over same quarter of previous year.

(iv) The short-term outlook for western Europe and North America

Economic forecasts prepared in the spring pointed to a rather favourable development in western Europe and North America in 1998 and 1999. In western Europe, the dominant expectations are still for a steady, albeit moderate, strengthening of cyclical

forces; the current forecasts still point to an average annual growth of GDP in western Europe of 2¾%, but this may now be an upper estimate (see table 2.1.1). In contrast, in the United States the often anticipated cyclical slowdown (“soft landing”) has yet to appear but is still expected to occur eventually; current forecasts for annual growth in the United States economy in 1998 are in general close to 3% but given the likelihood of a stronger than expected slowdown in export growth, the outcome could be nearer 2.7%. It was clear that these benign changes depended to a large degree on how serious the ramifications of the 1997 crisis in Asia would be and on the persistence of low inflationary expectations in the United States.

The economic crisis in East Asia, however, has deepened significantly in the first half of 1998. In the emerging economies of the region, the decline in output or the slowdown in economic growth, which is now forecast for 1998, is much larger than expected earlier. The east Asian crisis has also acquired a much larger dimension with the deep recession in Japan against the background of a persistent crisis in the banking sector. The recession in Japan, if not quickly reversed, will aggravate the economic crisis in the east Asian emerging markets and delay their recovery. In combination, these developments will also affect growth prospects in other parts of the world economy, notably the United States. Import demand in East Asia will be lower than expected as a result of depressed domestic demand, while the pressures to step up exports to other regions of the world economy will be accentuated. The adverse changes in export demand facing the western market economies will be aggravated by the marked weakness of international raw materials prices, notably of crude oil, as witnessed recently. This, in addition to the shortfall of demand from Asia, will depress the export revenues and domestic incomes of commodity exporting countries and, consequently, their demand for products from the rest of the world.

In the United States, the available data suggest that relatively strong growth continued in the second quarter, but the expansion is now only supported by the growth of domestic demand. Changes in real net exports are expected to exert a significant drag on domestic activity levels in the second half of 1998 reflecting the strong dollar and the trade effects of the Asian crisis. In addition, stockbuilding is unlikely to continue to support economic growth. Moreover, the growth of employment, which has been supporting aggregate income growth, cannot possibly continue for much longer without rekindling inflationary pressures, given the already very low unemployment rate. Thus, even without a tightening of monetary policy there is

likely to be a more or less strong slowdown in the pace of economic expansion in the second half of 1998.

A pronounced slowdown in output growth, however, could lead firms to revise downwards their profit expectations and, consequently, their investment expenditures. This will have negative ramifications not only for stock market prices but also for the situation in the labour market and the income prospects of private households. Household debt has risen to very high levels in the current expansion and any deterioration in the financial position of households is therefore likely to have a significant dampening impact on consumption expenditures and the growth of GDP unless offset by increases in government consumption or foreign demand.

In western Europe, the cyclical momentum associated with the strengthening of intraregional trade has so far helped to offset the negative effects of the Asian crisis. Long-term interest rates are close to historic lows, and fiscal policy has shifted to a broadly neutral stance. But net export growth will be affected by the deepening crisis in East Asia and by a slowdown in economic activity in North America and in developing countries outside Asia.

But there are also downside risks originating within western Europe. In the United Kingdom, the recent additional tightening of monetary policy has probably increased the risk of a “hard landing”. A weaker than expected growth of domestic demand in the United Kingdom would then have negative repercussions for the other west European economies as well.

The concerted and massive intervention of the United States Federal Reserve and the Bank of Japan in the foreign exchange markets on 17 June 1998 has led to a substantial strengthening of the yen. The spot exchange rate against the dollar fell to about 137 yen, compared with an eight-year high of some 144 yen on the previous day. But the current relative stability in financial markets could well be short-lived if expectations of a significant policy shift in Japan are not being confirmed and strengthened in the near future.

(v) The transition economies: economic pattern in the first half of 1998

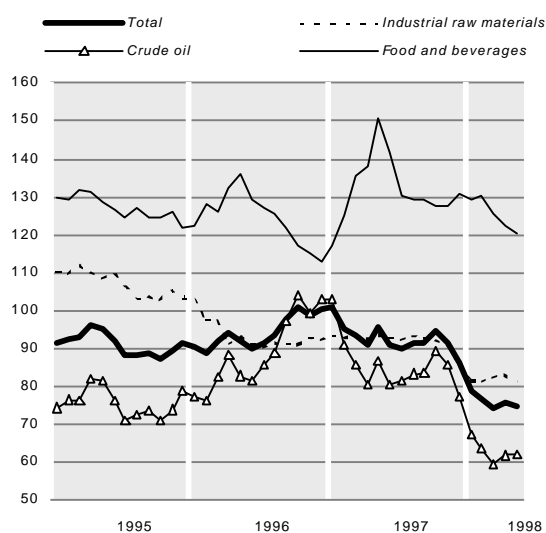
The positive trends which prevailed in most of these countries in the second half of 1997 have been maintained during the early months of 1998. Preliminary data for the first quarter suggest that output continued to rise in the transition countries as a whole and in all the main subregions as well. The performance of individual countries remains quite

heterogeneous, but there appears to be less variation among them in 1998 as compared with previous years.

Favourable demand conditions in western Europe have contributed to the continuing strength of economic performance in eastern Europe and in the Baltic region: total exports from these countries continued to rise strongly in the first quarter of the year. Rates of inflation continued to fall in most transition countries and there has been some improvement (or at least no further deterioration) in the external balances of some east European countries. However, the fall in world commodity prices in 1998 has had a negative impact on the export earnings of Russia and other CIS primary commodity exporters.¹

GRAPH 2.1.3

World commodity prices, January 1995 to May 1998
(Indices, 1990=100)



Source: Hamburg Institute for Economic Research (HWWA).

Note: Indices calculated on the basis of dollar prices.

Although on balance developments have remained positive in the first half of the year, economic performance in some countries has remained bleak and in others has been marked by considerable volatility. The most serious disturbance occurred in Russia which was shaken by financial instability in May-June. The shockwaves of this sudden turbulence were felt on all financial markets in central and eastern Europe and in the Baltic region. Neighbouring Belarus

was also hit by financial turmoil in March-April leading to a sharp drop in the exchange rate of the national currency. Economic performance in most of the south-east European transition countries has remained rather weak.

One of the important policy events in early 1998 was the formal opening by the European Union of the enlargement process towards central Europe. On 31 March, six applicant countries – the Czech Republic, Estonia, Hungary, Poland and Slovenia, together with Cyprus – officially started the process of pre-accession negotiations with the EU. Five other countries with association agreements with the European Union – Bulgaria, Latvia, Lithuania, Romania and Slovakia – are also formally involved in the enlargement process but substantive negotiations with them will only start at a later stage. The target of full EU membership – if pursued consistently – will set a rather rigid policy framework for the applicant countries during the pre-accession period leaving relatively limited degrees of freedom for deviations from this course.

The short-term economic outlook for the transition economies as a whole remains positive and it is likely that economic conditions in general will continue to be favourable in the second half of the year for the majority of these countries. Among the east European and Baltic countries, some further acceleration of growth can be expected in Hungary and possibly in Slovenia while the Estonian economy is likely to perform above official expectations. In contrast, economic decline is likely to continue in Romania and the output performance for the year as a whole may well turn out to be below the official zero growth target. The 10% growth target in Yugoslavia for 1998 is also unlikely to be met. Within the Commonwealth of Independent States, and despite the apparent improvement from previous years, there remain many uncertainties regarding the outlook for all the European CIS countries.

However, the greatest potential risks both for the CIS and for eastern Europe as a whole arise from the considerable uncertainty surrounding the economic situation in Russia. In view of the financial instability observed in the first half of 1998 and the subsequent substantial tightening of monetary and fiscal policy, the short-term growth prospects in Russia have deteriorated considerably. Official forecasts were already being revised downwards in the first quarter, but if instability and policy austerity continue, Russian GDP growth in 1998 may very well fall below these revised targets, and in the second half of the year there could even be a fall in aggregate output.

¹ In April 1998, copper, aluminium, nickel, zinc and lead prices were lower by 21, 11, 22, 17 and 8% respectively compared with their 1997 averages. Also, the oil price was hovering around \$13.5 a barrel in April compared with an average price of \$19.3 in 1997 – a decline of 30%. IMF, *Primary Commodity Prices*

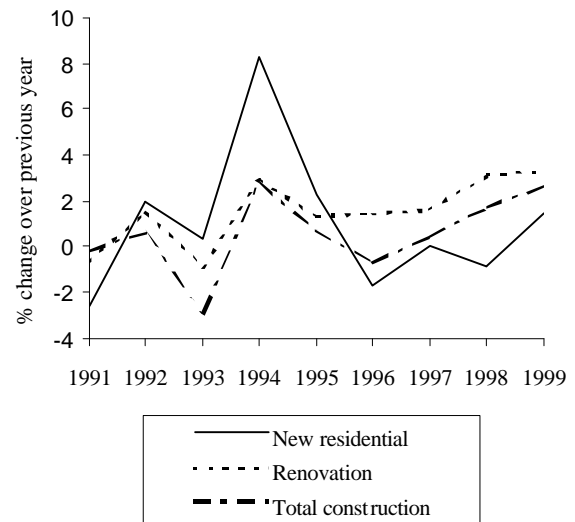
(<http://www.imf.org/external/np/res/commmod/index.htm>).

2.2 Developments in the construction sector

(i) The construction sector in Europe and the CIS

The construction sector in each country is often influenced by national, even local, factors, so that there is a wide variation in rates of change between countries. Nevertheless, it is clear that the European *new residential sector* has not yet emerged from a long period of stagnation or even contraction in some countries (graph 2.2.1). The major exception to this, the strong growth in the European total in 1994/95, was due to the post reunification building boom in Germany, the largest market, and hardly affected most countries. EUROCONSTRUCT² data show no change in the total level of activity for new residential construction in 1997 in the 14 countries covered (most of western Europe), with drops in three of the four major economies (France -2.2%, Germany -3.1%, Italy -7.9%), counterbalanced by strong growth in the United Kingdom (+9.2%, after two successive declines), and very strong increases in Denmark,

GRAPH 2.2.1
Change in construction activity by sector,
1991 to 1998 and 1999



Source: EUROCONSTRUCT, 1998.

TABLE 2.2.1
Developments in the construction sector, 1997 to 1999
(% change over previous year)

	New residential construction			Renovation		
	1997	1998	1999	1997	1998	1999
Austria	3.5	-1.3	-1.9	2.5	3.0	4.6
Belgium	4.9	4.0	4.5	4.1	4.0	4.5
Denmark	24.0	10.0	5.0	0.1	1.9	1.9
Finland	36.0	10.0	10.0	10.1	6.4	4.0
France	-2.2	1.3	2.4	0.5	2.2	1.9
Germany	-3.1	-2.9	1.8	1.1	2.3	2.0
Italy	-7.9	-8.9	-5.8	1.9	3.9	6.0
Netherlands	7.9	0.0	-3.0	2.1	2.3	2.5
Norway	24.2	7.9	4.4	7.3	3.7	-0.3
Portugal	12.0	8.0	6.0	4.1	5.1	4.8
Spain	6.0	3.5	2.0	6.4	6.5	5.0
Sweden	-19.2	8.0	26.0	-3.3	3.0	2.4
Switzerland	-8.0	-3.5	1.0	-2.6	2.1	2.8
United Kingdom	9.2	1.6	2.7	1.3	3.5	3.7
EUROCONSTRUCT area	0.0	-0.9	1.4	1.6	3.1	3.3
Czech Republic	15.4	12.0	18.8	-9.4	-6.4	-5.0
Hungary	0.0	4.0	5.0	5.0	7.0	10.0
Ireland	14.8	8.3	2.8	0.1	2.6	2.5
Poland	10.0	7.5	15.0	-7.2	-8.1	-2.1
Slovakia	17.7	20.5	15.0	5.0	4.8	9.5

Source: EUROCONSTRUCT (<http://www.euroconstruct.com/project.htm>)

² EUROCONSTRUCT is a consortium of research institutes specializing in the construction sector who monitor developments at regular (twice a year) meetings. More information is at <http://www.euroconstruct.com>.

Finland, Norway and Portugal. Three of the four transition countries covered by EUROCONSTRUCT show growth rates in new residential construction of over 10% in 1997 (table 2.2.1).

The picture is similar for 1998, with further contraction expected in Germany and, above all, Italy (-8.9%), with moderate growth in France and the United Kingdom. The Nordic countries expect rather healthy growth around 10% in 1998. The situation is expected to improve further in 1999, with negative growth only in Austria, Italy and the Netherlands, weak recovery in Germany and continued growth in the transition countries.

Through most of the 1990s, *renovation* has shown faster growth rates than any other part of the construction sector, and now accounts for about 34% of total construction expenditure. Furthermore the differences between countries are smaller, as renovation expenditure appears to be less vulnerable to cyclical factors. In 1997, in the 14 EUROCONSTRUCT countries, expenditure on renovation was 1.6% higher than in 1996, with drops only in Sweden and Switzerland. Germany recorded an increase of 1.1%. However, among transition countries, fairly steep drops were recorded by the Czech republic and Poland. Stronger growth was expected in 1998, across all western European countries, for an average rate of increase of 3.1%, with a rather similar forecast for 1999. As forest products, which are relatively light and flexible, have a competitive advantage in many renovation uses, the continued strength of the renovation sector is a major positive factor for consumption of forest products in Europe.

In Russia, the condition of the construction sector in 1998, according to Oxford Analytica³, remains poor, with volumes falling and the financial state of many construction enterprises weak, reflecting the decline in investment generally. Most construction is now undertaken by the private sector (e.g. 87% of new housing completions).

Construction volumes in Russia continue to contract, by 14.5% in 1996 and 6.4% in 1997, although localised construction booms are under way in some places, most notably Moscow. One cause of the decline is the reduction of public funding, but the main influence is the overall decline in investment, and the high interest rates.

Most medium- and large-scale construction enterprises are in difficult financial positions (although the black economy plays an important role in the

Russian construction sector, as in other countries). In the early months of 1998 the proportion of loss making enterprises, roughly unchanged from a year earlier was 43%.

Industrial, road and other non-housing construction is performing better than new residential building, dropping marginally, or even rising in the case of investment in industrial construction, while investment in "non-productive objects" (mainly housing) fell by 11.5%, although the level of output may be underestimated because of the black economy.

New, higher quality construction methods, using steel and reinforced concrete, are replacing the traditional Soviet era, concrete panel construction. The consequences of this for patterns of consumption of forest products are not clear.

(ii) The construction sector in North America

In the United States, housing starts have fluctuated around (or slightly below) the 1.5 million units/year mark since early 1994. This has corresponded with the long period of sustained growth of the United States economy, and contrasts with the early 1990s when for one year housing starts were barely above 1 million units⁴. Satisfactory levels of disposable income, low real interest rates and the feeling of confidence engendered by the long expansion all contributed to maintaining this situation. From autumn 1997, starts rose even higher, to an annual rate in March 1998 of 1.57 million units, although in April, this rate fell slightly, to 1.54 million units. In 1997, 77% of starts were in structures with one unit, the most intensive users of forest products. This proportion has remained roughly constant since the early 1990s. Thus, although an economic "soft landing" is expected some time in 1998, there is as yet, no sign of its coming to the housing market. The continuing strength of United States housing starts has been the backbone of the firm market for sawnwood and panels in North America over the period covered by this review.

1997 was a record year for Canadian housing starts, which, under the influence of low mortgage rates for most of the year reached 147 thousand, nearly 18% more than in 1996. In May 1998 the Canada Mortgage and Housing Corporation forecast further rises for 1998 and 1999, to 156 and 161 thousand units respectively (successive rises of 6.3% and 3.4%). However results for May and June showed a downturn, attributed to technical factors, notably

³ Daily Brief on Eastern Europe, circulated by Internet.

⁴ To put this in perspective, it should be recalled that United States housing starts briefly went over 2 million units/year in the late 1970s.

labour disruptions. According to the CMHC spokesman in July 1998 “main market indicators point to higher residential activity”, although June starts were at an annual rate of 133 thousand units (table 2.2.2).

TABLE 2.2.2
North American housing starts, 1995 to 1998
(in thousand units)

	1995	1996	1997	1998 (forecast)
Canada	111	125	147	156
United States	1354	1477	1474	1540

Note: For 1998, for Canada, the forecast is by CMHC, and for the United States is the annual rate in April.

Sources: Canada Mortgage and Housing Corporation, and United States Bureau of the Census, 1998.

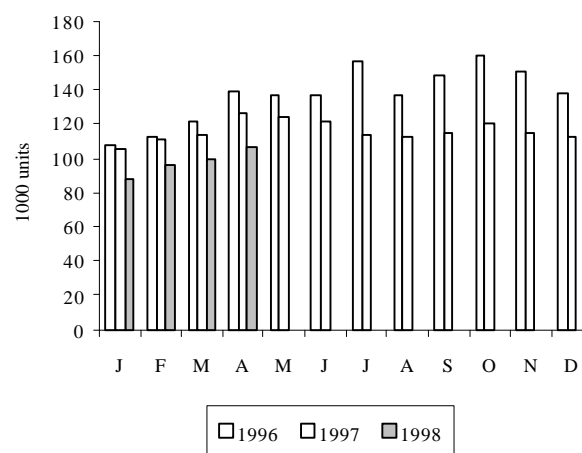
(iii) The construction sector in Japan

The weakness of the Japanese housing market was one of the major features of global forest products markets in 1997. The causes were multiple: domestic demand fell in general, as did fixed investment. Households had brought forward expenditures in anticipation of an announced rise in sales taxes in April 1997. There was therefore a sharp drop in spending in the second quarter of 1997. This coincided with major problems in the banking sector, making banks more restrictive in their lending, and shortly after the currency/banking/political crisis in other Asian countries. Taken together, this represented not only cyclical economic events, but also a major crisis of confidence in the Japanese system, which had brought about sustained growth over a long period. It is for this reason that the decline in housing starts, which in relative terms is much less brutal than recent events elsewhere (for instance in the transition economies) had such a strong influence on market behaviour. Another factor was the length of the crisis in the Japanese housing sector: in April 1998, housing starts were below those of the same month in the previous year for the sixteenth month in a row, something which had not been observed for decades.

Housing starts in 1996 were at the record level of 1.64 million units, fuelled by the rush to start houses before the imposition of the sales tax. The monthly data show quite clearly that it was in March/April that the 1997 results started to diverge from those of a year before (graph 2.2.2). This gap grew steadily over the following months. The 1997 results show 1.39 million units, combining the strong first quarter with a weak

rest of the year. The annualized rate for 1998, on the basis of figures for the first quarter are about 1.3 million, but these must be considered tentative, in view of the major uncertainty about economic trends. An aggravating factor for market confidence was that successive forecasts of imminent recovery in the housing sector proved unjustified. In the circumstances it is hardly surprising that importers of forest products imported cautiously and did everything possible to reduce stocks. The continuing decline in the yen, and the consequent increase in the cost of dollar denominated imports, also reduced the confidence of Japanese importers.

GRAPH 2.2.2
Monthly housing starts in Japan, 1996 to 1998

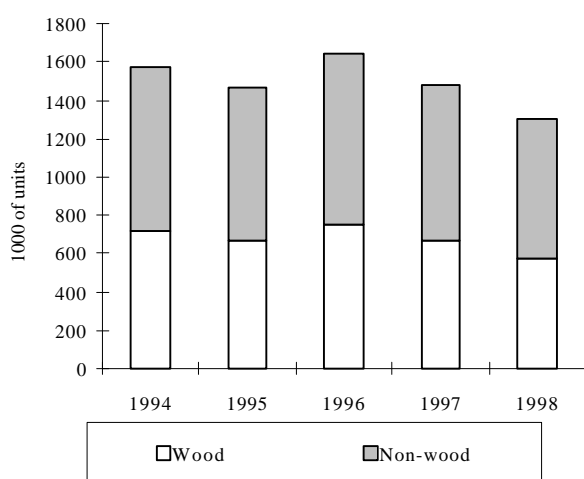


Source: Japan Wood-Products Information and Research Center, 1998.

The share of wooden houses in the total remained roughly constant, around 45% of the total (graph 2.2.3).

GRAPH 2.2.3

Japanese wooden versus non-wooden housing construction, 1994 to 1998



Note: 1998 forecast based on annualised rate from first quarter 1998.

Source: Japanese Ministry of Construction, 1998.

2.3 Developments in the furniture sector

This section is based on a "special topic" prepared by CSIL in the *FESYP Annual Report*.

Furniture production is a major end-use for wood-based panels and sawnwood, so trends in this sector are a component of demand for these products. Furthermore, although there is an obvious link between furniture and construction, the connection is not direct, notably because furniture is traded internationally, and may be replaced quite frequently during a building's life.

From the point of view of consumption of forest products, it is necessary to focus on production (rather than consumption) of furniture.

About 35% of world furniture production is in the western European market economies, 20% in the United States and 10% in Japan. The four largest European furniture producers are Germany (27% of European production), Italy (24%), France (11%) and United Kingdom (10%). Italy is the world's leading furniture exporter. The relative importance of German furniture exports has tended to decrease as German manufacturers have located production facilities in

eastern Europe, where production costs are lower, rather than exporting from Germany itself.

National furniture industries show some specialisation, e.g. Germany for kitchens and Italy for upholstered furniture.

The rather strong European growth in GDP in 1997 was driven by export demand and to a lesser extent by investment in machinery, and so did not convert into increased demand for furniture. For the second successive year, according to CSIL, there was a slight drop (-0.3%) in European furniture production, although an increase of just over 2% is forecast for 1998.

In 1997, furniture production rose modestly in France and Italy, and by over 4% in the United Kingdom, but fell by 3% in the largest producer, Germany, because of a shrinking domestic furniture market. German exports fell and imports rose partly because of the above-mentioned policy of relocating manufacturing facilities in lower cost regions.