

Financial follies and the pulp industry



Indonesia's pulp and paper industry is a major consumer of natural forests.
Photo: Romain Pirard

“A lack of financial due diligence could lead to a new wave of projects which are risky for investors and potentially disastrous for the environment and forest-dependent communities.”
Machteld Spek

When it comes to devouring natural resources, few things can beat a modern pulp mill. Mills with an annual capacity of 1 million tonnes – these are increasingly common – require the equivalent of 15 per cent of the Brazilian Amazon's annual timber harvest. There is nothing wrong with this if the harvest comes from sustainably managed forests or plantations. However, all too often the wood fibre comes from the clearance of natural forests.

Riau province in Indonesia provides a classic example of the damage the pulp industry can do. In 1982, there were 6.4 million hectares of primary forest in Riau. By 1996, almost half of this had gone, and if current cutting rates continue there will be less than half a million hectares of natural forest left by 2015. In just over 30 years, forest cover will have been reduced from 78 per cent to 6 per cent. It is no coincidence that two of the world's largest pulp mills are sited here.

CIFOR first began investigating the pulp and paper industry in the late 1990s, when it became clear that the industry in Riau was expanding its processing capacity much faster than it was bringing plantations on line. The research showed that companies were investing billions of dollars in mills before they had secured legal and sustainable supplies of fibre. They did this, in part, by convincing investors that they had access to long-term suppliers of very cheap wood.

“Indonesia's pulp and paper industry became a speculative bubble,” explains CIFOR policy scientist Chris Barr. “Banks and fund managers lost sight of the fundamental fact that pulp mills need wood to operate, and financial analysts tended to rely on the company's own wood supply figures, which were often wildly optimistic.” CIFOR's research, and the decision by Asia Pulp and Paper (APP) to default on \$14 billion of debts, sent shockwaves through the financial industry, forcing banks, brokerage houses and export credit agencies to reassess their forestry portfolios.

But have banks and international investors changed their ways? Are they now exercising greater 'due diligence' when assessing the financial and environmental sustainability of pulp-mill operations? CIFOR commissioned Machteld Spek, a chartered financial analyst with long experience in South-East Asia, to find out. Her report, *Financing Pulp Mills*, provides a disturbing portrait of how little the financial industry seems to have learnt from APP's debt *débâcle*.

Spek looked at the ways in which investors and lenders assess the financial risks, and social and environmental impacts, associated with pulp mills. She did this by reviewing 67 projects proposed between 1995 and 2003. During this period, 25.5 million tonnes of annual new pulp production was proposed. Of this, 41 per cent is now going ahead.

The study reveals that most investors have little experience of forestry issues, and a poor understanding of how to assess the impact of pulp and paper projects on communities and the environment. Issues of critical importance, such as the productivity of plantations and the legality of wood supply, are either poorly assessed or ignored.

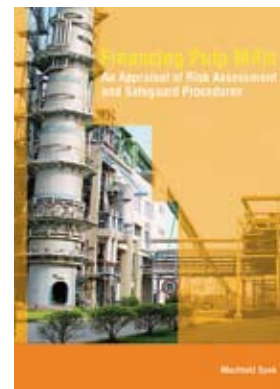
This lack of due diligence, suggests Spek, could lead to a new wave of projects which are risky for investors and potentially disastrous for the environment and forest-dependent communities.

This is particularly disturbing as some \$50 billion of fresh investment in pulp mills will be required to meet growing world demand for cardboard and paper over the next decade. China's demand for wood pulp alone is projected to increase from 9 million tonnes in 2003 to 15 million tonnes by 2010. Much of the new pulp mill development will take place in Indonesia and Brazil, two countries which already suffer from high rates of deforestation.

However, the report is not entirely gloomy. A growing number of financial institutions have introduced stronger safeguards to limit the impact

of forest-related investments. Furthermore, some 33 lending institutions have endorsed the Equator Principles, an initiative which seeks to promote social and environmental safeguards for project financing. However, the report also points out that the Equator Principles currently apply to just a very small portion of the funding for pulp mill projects.

The report recommends that environmental assessments of pulp-mill projects should be externally reviewed; that financial institutions should develop in-house capacity to assess forestry operations, and rely less on the word of the industry itself; and that pulp producers should establish a common, industry-wide 'reporting standard' to provide more comprehensive disclosure about the way in which they source and use wood fibre.



China becomes a major player

China has swiftly become a major player in the global market for forest products, but until recently governments, development agencies and others eager to learn more about China's role have been hampered by a serious lack of reliable information. *China and the Global Market for Forest Products* helps to fill the knowledge gap. It provides a synthesis of the key findings of a five-year research project by Forest Trends, the Center for Chinese Agricultural Policy (CCAP), CIFOR and many local partners in China and the Asia-Pacific region.

Burgeoning domestic consumption has helped to fuel China's demand for a wide range of forest products, from raw logs to wood pulp. Between 1997 and 2005, China's forest product imports rose from 40 million tonnes to 134 million tonnes. During the same period, China became one of the world's leading wood workshops – it now accounts for almost a third of the global furniture trade – and the value of its forest product exports rose from \$3.6 billion to over \$17 billion.

There is much to celebrate about China's spectacular economic growth, but there is a dark side to this story too, as this study explains. Chinese demand for timber has been linked to an increase in unsustainable harvesting in countries like Russia and to widespread illegal logging in Papua New Guinea, Indonesia and many other countries. It has also been associated with human rights abuses and violent conflict as far afield as Liberia and Cambodia.

The researchers estimate that forest product imports to China are likely to double in the next 10 years, and they suggest a variety of measures which could help to mitigate the malign impact of the trade, especially in those countries which supply China with forest products. There is an urgent need for China to reform its forestry sector so that it moves more rapidly towards self-sufficiency in forest products. Chinese customs could also be more aggressive in determining precisely where imported timber actually comes from, and prevent timber which can't be legally verified from entering the country.

But this is not just China's problem: the study makes it clear that demand for cheap Chinese furniture in the West can be directly linked to the exploitation of some of the world's poorest people and their forests. Retailers in the US and Europe have a key role to play in promoting the sustainable and legal trade in timber.

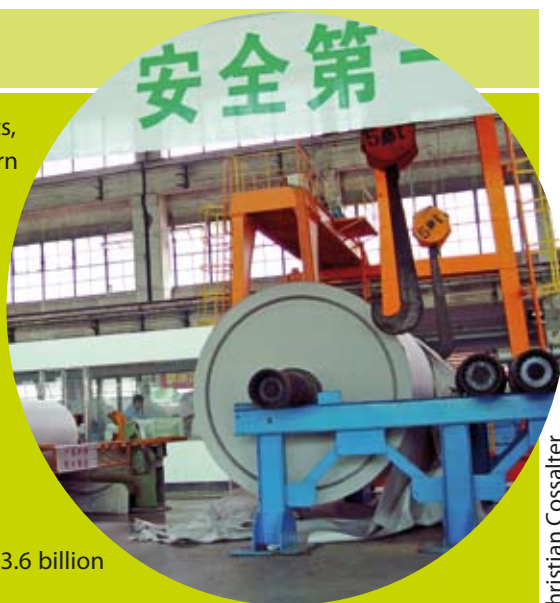


Photo: Christian Cossalter