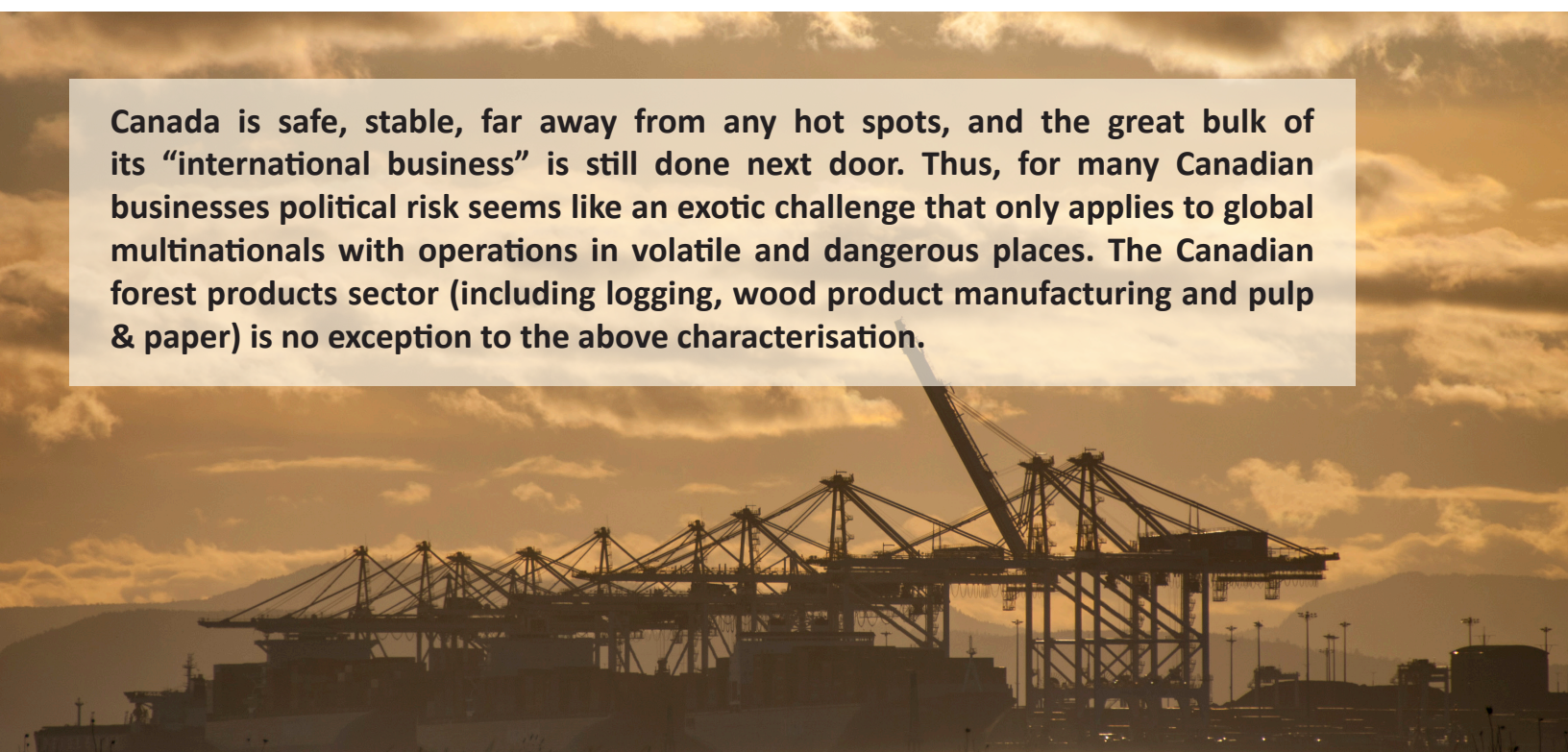


IS IT TIME FOR CANADIAN FOREST PRODUCTS FIRMS TO FOCUS ON POLITICAL RISK MANAGEMENT?

Part one of a two part series

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Canada is safe, stable, far away from any hot spots, and the great bulk of its “international business” is still done next door. Thus, for many Canadian businesses political risk seems like an exotic challenge that only applies to global multinationals with operations in volatile and dangerous places. The Canadian forest products sector (including logging, wood product manufacturing and pulp & paper) is no exception to the above characterisation.

The US has long been the largest market for all sub-sectors, and until the early 2000s Japan and Western Europe—safely “normal” markets—took the bulk of the remaining exports. From the early 2000s, China dramatically grew as a significant market, but until quite recently the country was almost univer-

sally regarded as a secure trading partner, not a strategic rival to the US and its allies. And most of the sector’s international business was simply shipping products abroad, a mode which largely avoids the exposure of people and reputation to different political environments.

With that preamble, we arrive at the question which this article poses: Is it time for companies in the Canadian forest products sector to develop an explicit sense of political risk and how to manage it?

However relatively staid the sector's experience with political forces has been, there are two basic problems with a perception that political risk is not something companies need to explicitly think about. One is that political risk is not just about arcane and dangerous problems in faraway places. What it really means is potential challenges from exposure to the political domain, wherein ideologies, values, power contention, social identities, governance and inter-state relations give rise to rationalities and imperatives that can be very different from those of legitimate businesses. Thus stated, political risk is relevant to any company, and always has been. When the political environment is relatively calm or at least predictable, a tacit approach to political risk suffices, but it still helps to have a clear sense of how political dynamics could affect the organisation.

The second problem is that by not explicitly taking the political dimension into account, companies can easily fail to notice when its political, or more broadly socio-political, operating environment has become more volatile and risky, and continue with business as usual even when it would lead to serious vulnerabilities. If we are aware of political risk, we can still use a tacit approach where it works, but we will know when and how political risk is a significant factor and will have the option of ramping up political risk management capabilities accordingly.

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The answer to this question depends on the specific products produced and markets served but also the company or owner's propensity for risk aversion. Research studies have long established that executives in large corporations are reluctant to advocate for risky projects despite that fact that managers can approach risk strategically and reduce its downside. Thus, the approach here is to look at a four broad political dynamics that are either affecting

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Canadian forest products sector firms or significantly increasing uncertainty, by way of illustrating the potential relevance of political risk awareness and management. Afterwards, readers will have some grist to consider their own answer to the question, and if "yes", what they can do about it.



Western Forest Products, Ladysmith, BC

The four political dynamics are the China-West rivalry; climate action confusion; Canada-US trade friction; and emerging market challenges. Part 1 of this two-part series includes discussion on the 'China-West rivalry' and 'climate action confusion', and Part 2 addresses the political dynamics of 'Canada-US trade friction' and 'emerging market challenges', as well as what a political risk management capability could mean in practice—should you or your company want to do something about it.

CHINA-WEST RIVALRY

If we start with the global level, wherein political risk is often known as “geopolitical risk”, the current rivalry between the West and China presents some challenges. China has been an important market for Canadian softwood lumber, but over the last decade Canada’s market share has been increasingly squeezed by Russian exports. This has partly been driven by increasing overland logistical links, an element of China’s Belt and Road initiative, but a significant driver has also been closer strategic ties between the two countries since Xi came to power in 2012. Trade is an element of the strategic relationship and is partly aimed at reducing both partners’ economic reliance on the West. Russia is now the predominant softwood lumber supplier to China, and its share has further increased with the war in Ukraine. Sanctions have made it hard for Russia to sell its lumber to Western markets, but China is a willing buyer and its purchases help to shore up Russia’s struggling economy. After the Ukraine war ends, whenever that might be, it is likely that closer trade ties will remain intact and potentially even strengthen as either country foresees further friction with the West.

China is also an important market for Canadian pulp and demand for northern bleached softwood kraft (NBSK) has been growing steadily since 2000 (now making up 34% of total Canadian pulp exports). But as with lumber, Canada’s market share of the Chinese NBSK market has been dwarfed by the growth of Russian imports—for the same reasons as with lumber and with the same prognostication.

An extension of the above challenge is that as China increasingly relies on Russian imports, its cost of playing hardball with Canadian lumber and pulp imports reduces. As Australia (2020) and Lithuania (2021) both well know, China is willing to impose what amounts to trade bans on broad sectors in response to perceived slights or changes in a country’s strategic posture. It also routinely sanctions specific companies whose exports are important to the economy of the offending country. Canada has had diplomatic spats with China and likely will again, and targeting imports of Canadian forest products could well be a lever for China.

Less strategically, but importantly from an ethical and duty of care point of view, is that under Xi the Chinese government has used anti-foreign propaganda to shore up nationalist support for the regime, and hostage diplomacy has become an acceptable way of punishing countries who seem to challenge China’s status. Dual citizens from Australia and the US have suffered detention on spurious charges, and most Canadians are well aware of the cases of Michael Spavor and Michael Kovrig, Canadian citizens detained in China in what seemed very much like retribution for Canada’s arrest of Huawei’s chief financial officer in late 2018. Doing business with China, even just exporting, is significantly facilitated by face-to-face interaction and a local sales and liaison presence. It is not paranoid to suggest that executives in Canada’s forest products sector need to be cautious about going to China during periods of tense bilateral relations. More broadly, the regime has imposed stringent oversight over Western companies and business-people in China, and this has extended to local partners and subsidiaries of Western firms.

The medium-term direction of the Western-China rivalry remains to be seen, but a second Trump presidency would likely ratchet up the tension, particularly through an increase in American tariffs on Chinese imports (and other efforts to contain China, or to “de-risk” the bilateral relationship, would likely continue more or less as under Biden/Harris albeit with stronger rhetoric). China would retaliate, and Canada, including its forest products sector, could be caught in the middle.

CLIMATE ACTION CONFUSION

A very different driver of uncertainty for the Canadian forest products sector is action on climate change. At a global level the forest products sector now lives under a socio-political spotlight because of the potential of wood as a “green” building material, bioenergy as a substitute for fossil fuels, and the effects of logging on forests which are an important carbon sink. The logging industry is particularly exposed to climate action dynamics. The science on what constitutes sustainable logging is creeping towards consensus, but scientists do not create regulations. Politicians do, and in turn they are largely steered by social expectations, or the popular mood. The popular mood is capricious.

On the one hand we see committed climate activism. This tendency would hardly ban logging, but it would, and has, introduced weighty regulatory constraints and stringent sustainability expectations. A recent example is the new EU deforestation-free law, which marks a step-change in demand-side solutions to regulate products entering the European Union. The regulation—part of a broader EU plan to bring down greenhouse gas emission and biodiversity loss—seeks to leverage consumer consumption of commodities linked to deforestation and forest degradation. Unfortunately, the dearth of clarity on deforestation definitions, compliance measures, tracking technology and supply chain implications, raised serious doubts as to its regulatory efficacy and efficiency. Despite these practical shortcomings, EU politicians are confident that they are catering to the mood of the day, which according to a recent study sees 8 out of 10 Europeans favouring a ban on products that drive deforestation.



Not long ago, it was a reasonably safe bet that this climate activism tendency would remain very influential and outweigh climate change sceptics and deniers. However, the increasing influence of ultraconservative nationalist attitudes and politicians in all regions, North America included, has injected considerable uncertainty into the pace of climate action.

The nationalist tendency generally sees climate change as either hyped or as someone else’s fault, and this means that “our nation” should not have to limit its own near-term prosperity when it comes to exploiting natural resources. So far this attitude has mainly manifested in political decisions about hydro-

carbons, but it is easy to see parallels to logging (in fact in Brazil, Bolsonaro's attitude to logging was pretty much the same as Trump's "drill, baby, drill"). In the case of oil and gas, an irony is that many players in that sector had been scaling back exploration and preparing themselves for a green future, only to find that the shift to green was nowhere near as fast as they had expected, partly because of the shift in socio-political attitudes.

Climate change is a real and pressing challenge and it makes long-term sense to stay ahead of the curve. But how far ahead is hard to gauge given the lack of consistency in socio-political attitudes about sustainability and uncertainty about how these could affect logging. Get too far ahead of the curve, and a company might find itself out on a limb while its less conscientious competitors do the bare minimum at less cost. Do the bare minimum and a company could be in for some nasty surprises if and when sustainability regulations harden. This already challenging question becomes a conundrum when we factor in export markets, which have their own attitude swings and between which sustainability standards can significantly vary.

With respect to Canada specifically, it might have a less pronounced populist nationalist tendency than the US or several European countries, but there has been a widening gap between the political centre and centre-right at the national level. Environmental policy would change quite dramatically with electoral changes. Provincial politics broadly mirrors national trends, and for the Canadian logging industry both levels matter. Thus, uncertainty arising from capricious climate action commitment at the global level is reflected domestically.

A noteworthy twist in the story of climate action stems from forests as a source of carbon credits. Carbon credits have become a massive industry, and large funds have seen a strategic opportunity in gaining control, directly or by enrolling landowners in offset schemes, of huge tracts of forest. This has occurred in a number of regions. Perhaps the most grandiose example is Blue Carbon (based in the United Arab Emirates) which intends to buy millions of hectares in Africa. Closer to home, most readers would be familiar with Manulife's Forest Climate Fund.

The main point for purposes here is that land which could potentially support sustainable logging, with a balance between lumber production, local jobs and forest management, is now susceptible to being cut off from the real economy. In effect, the logging industry is in competition with carbon markets, as evidenced in a recent New Hampshire law (HB1697) seeking to offset the impact of carbon offsets on the state's timber tax revenues. Debates about the real impacts of carbon offset schemes aside, on a practical level the effect for logging companies is tangible constraints and additional uncertainty.

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