



3 March 2008

Turbulence Ahead

How economic slowdown will hit European air transport

In 2007 the world economy grew by a healthy 4.9%, a better than expected performance which builds on the 5% growth in GDP reached in previous year. However, the annual figure masks a more disturbing quarterly development, with the buoyancy of the first 6 months and a particularly strong third quarter being followed by a dramatic moderation in the final quarter amid the US mortgage crisis and turmoil in the financial markets which has persisted to date. The IMF outlook for 2008 of 4.4% world GDP growth prepared last Autumn, has now been revised twice, to 4.1 and subsequently to 3.7%, with risk still tilted to the downside. In fact IMF staff reports a 25% chance of growth slowing to 3% or less in 2008 and 2009, equivalent to a global recession. Growth in air travel is strongly linked to overall economic growth and this development will inevitably have an impact on air transport. AEA currently expects traffic to slow to around 3% annual growth in 2008.

USA : Impact of the mortgage crisis

The weakening of the world economy is being driven by events in the US. The crisis began when the US housing market started to crumble in late 2006. Until then consumers had been coaxed into home ownership by low interest rates, easy access to mortgages and the rising value of property. As the bubble burst, mortgage holders came under increasing pressure, resulting in a wave of defaults and repossessions, in particular amongst so-called 'sub-prime' mortgages awarded to buyers with low incomes and/or poor credit ratings. This affected the balance sheets of risk-bearing banks in the first instance, but meanwhile many mortgages had been sold to financial institutions which in turn made them available to investors through pension- and hedge funds across the world. By Q4 2007 fears of a recession brought increasing volatility in the stock markets with lows recorded in early 2008. This has successively been referred to as the worst crisis since 9/11, since WW II or since the Great Depression.

The mortgage crisis went hand-in-hand with a 'credit crunch', as consumer access to bank loans was restricted and spending levels dropped. Meanwhile the US government, anxious to avoid a recession, announced a US\$167bn 'economic stimulus plan' of tax rebates and other measures to bolster consumer spending. This was accompanied by further decreases in the inter-bank rate and short-term interest rate, including a 75 basis point cut in January 2008, the largest single decrease in 25 years, followed by a further 50 basis point cut just days later. By mid-March the Fed again lowered interest rates by a further 75 basis points to 2.25%.

This government response is problematic

for two reasons. Firstly, the stimulus package has the potential to double the size of the US budget deficit (US\$ 163bn in 2007), which together with the large trade deficit – the so-called 'twin deficits' - have long been seen as a threat to the global economy.

Secondly, flooding the market with liquidity harms the purchasing power of the dollar, which has been setting successive record lows against the euro and other currencies, whilst gold, silver and platinum commodity prices are reaching all-time highs. Boosting spending can also fuel inflation, already under stress from the high cost of energy. Although US government figures estimate the 2007 annual rate of inflation at 2.9%, lower than 2006 at 3.2%, they also show a steady rise in monthly rates from mid-year 2007, up to over 4% from November through January 2008.



US GDP growth of 2.2% in 2007 was expected to slip to 1.9% in 2008 according to IMF's forecast of late 2007. This figure was subsequently revised downwards, to 1.5%, in January. By March 2008 IMF recognised that the final figure is now likely to be 'markedly lower' than this.

Fig. 1:

Key Economic Indicators				
	2007	2008 Forecast		
		Issued Oct'07	Revised Jan'08	Revised Apr'08
Real GDP - % growth				
World	4.9	4.4	▼ 4.1	▼ 3.7
USA	2.2	1.9	▼ 1.5	▼ 0.5
EuroArea	2.6	2.1	▼ 1.6	▼ 1.4
Japan	1.9	1.7	▼ 1.5	▼ 1.4
Consumer Prices - % growth				
World	3.9	3.6	-	▲ 4.7
USA	2.7	2.3	-	▲ 3.0
EuroArea	2.0	2.0	-	▲ 2.8
Japan	0.0	0.5	-	▲ 0.6

Source: IMF
World Economic Outlook, October 2007 & April 2008.

Fig. 2:

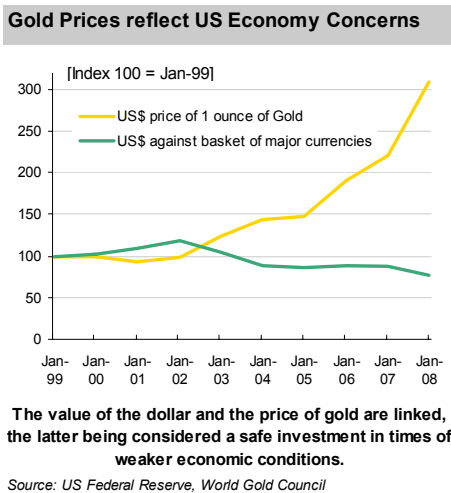
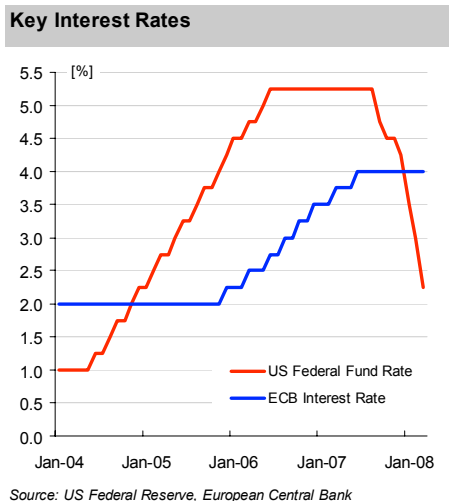


Fig. 3:



Europe : Low growth, Inflation rising

Throughout 2007 Europe's economy was performing well, until the US mortgage crisis caused turmoil in the world's credit markets. Eurostat estimated economic growth of 2.9% for EU27, 2.6% for Eurozone.

The outlook for 2008 prepared by the Commission in the Autumn of last year recognised the 'tightening financial conditions', but still assumed continued 'solid fundamentals', resulting in a forecast GDP growth of 2.4% and 2.2% for EU27 and Eurozone respectively. By late February these were revised down to 2.0%, although they were still optimistic compared to the IMF update, which was lowered by 0.5%-pts to 1.6%. Here too IMF expects a lower final figure.

Private consumption was once again the main driver of growth in Europe, although softening as business and consumer confidence reached their lowest level for two years. At



the same time inflation has been rising. Eurozone inflation is at a record high and is growing at a rate not seen since records began in 1997. It could reach 2.6% in 2008, far above the European Central Bank's guideline of under 2%. Economists fear that the continuing increases in oil prices could lead to a wage-induced upward price spiral and even higher inflation.

The ECB faces a difficult balancing act on interest rates. A rise would cool inflation but could also stunt growth, while a cut may stimulate demand but fuel inflation. So far the ECB has resisted temptation and left short-term interest rates unchanged at 4% since last Summer. Meanwhile the Bank of England has cut its rate three times. Both are anxious to avoid a repeat of the stagflation of the 1970s . Japan,

China, BRIC

Japan's economy has posted only modest growth amidst weakening consumer and business confidence. GDP of 1.9% in 2007 is expected to slow to 1.5% in 2008, a downward revision by 0.2 %-pts in IMF's recent forecast update and a rate on a par with that of 2003, the year SARS affected the Asian region. Consumer prices which have long been in deflationary mode in Japan are now shifting to a moderate level of inflation.

China's government has been raising interest rates to prevent its economy from overheating – 6 times in 2007 – but GDP growth is still estimated at 11.4% in 2007. Growth is driven by exports and construction. The trade surplus increased by half in 2007 compared to 2006, with the low value of the Chinese currency – the Yuan – making exports from China cheap and competing difficult. Consequently there are renewed calls for Beijing to make currency reforms.

China is also battling with high and rising levels of inflation, which were at an 11-year high of 7.1% in January thanks to the spiralling cost of food. IMF calculates that food price increases contribute over 75% of headline inflation rates, a figure which is less than 25% for Europe or the USA.

The outlook for 2008 is for another year of double-digit GDP growth, 10.0%, described by the Chinese authorities as an economy with 'speedy growth' rather than 'overheating'.

Amongst the leading emerging economies (known as BRIC countries - Brazil, Russian Federation, India and China), India is also expected to perform well again in 2008, with GDP growth of 8.4%.

That overall economic growth at world level is still relatively sound is due to a large extent to the emerging giants which for now are still growing strongly. But US and European growth rates will slow and it is clear that for some the peak of this business cycle has passed.

How will this affect air transport?

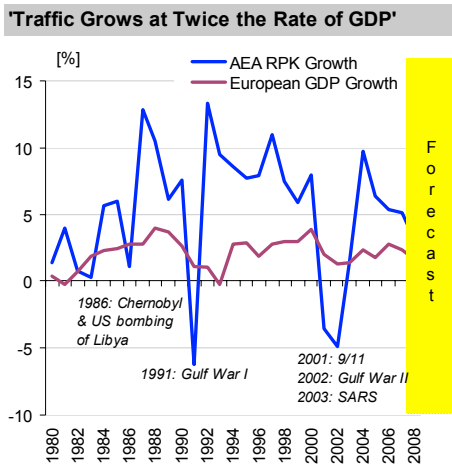
An economic slowdown will inevitably translate into weaker demand for air travel.

Since 1980 the European economy has grown at an average rate of 2.1% each year. AEA airlines' traffic growth during the same period was 5.0% per year. Thus traffic (measured in RPK) grew at a factor of 2.3 over GDP, reflecting the 'rule of thumb' adage that demand for air travel grows twice as fast as GDP. During the last 25 years, negative growth rates were recorded only in three years of crisis: 1991 with Gulf War I and in 2001-02 because of the terrorist attacks of 11 September. At all other times rates were firmly positive, even hovering around the 10% mark during the 1990s. In recent years rates have come down, closer to 5% but still above European GDP.

Why is airlines' growth a multiple of general economic growth? Demand can be broken down into 'underlying demand' and 'induced demand'. The former is natural and is driven by external factors such as increases in population, income, trade or changes in taste. It is also largely dependent on GDP per capita. Increasing GDP per capita triggers an increased demand for long haul flights. A study by Boston Consulting Group estimates that the underlying demand growth for long haul flights is about 1.2 times GDP growth, far below the 1.5 to 2.0 times GDP which is often used by forecasters and planners.



Fig. 4:



The difference between historical growth and 'underlying demand' growth is 'induced demand', which occurs when airlines expand their capacity above the 'underlying demand' growth. The additional seats cannot be sold at the regular price, as there is no natural demand for them. Airlines therefore often decide to lower prices for these excess seats rather than leave them empty. Special offers and discount prices fill the seats and attract passengers, who are 'induced' or persuaded to travel more often than they would have done at higher prices. The process is likely to contribute to the industry's problem of overcapacity and accelerates the trend of declining yields.

Indeed our analysis shows that real yields of AEA airlines have declined by an average of 3.0% per annum on European routes since 1991. Airline growth for the same period was 5.3%. There is striking evidence that the more demand growth exceeds GDP growth, the more the yields decline.

The profitability of AEA members in recent years has been predominantly and increasingly driven by volume. Softening economic conditions should bring a fall in demand. How far the fall goes will depend on how much 'profitability' is sacrificed to retain customers. In either scenario the end result will be a worsening financial result.

Outlook 2008

Traffic results for AEA members in 2008 show a fall-back, with growth of just 1.9% based on the 14 weeks up to 6 April. Although with Summer still to come it is too early to call this a trend, we nevertheless expect year-end traffic growth of around 3.0% in 2008. Discounting the years affected by significant external events - war, 9/11, SARS - growth has not been this low since early 1980s. [SL]

Disclaimer

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