

ISSUE NO. 08 | OCTOBER 2022

Fare game: How inflation is impacting the airline industry?





In this report

Introduction

Brief introduction to the central bank's reaction to fight soaring inflation

01

What is causing inflation?

Factors causing increasing inflation and worldwide central bank's reaction

02

How long will current inflation continue?

1980s stagflation and how long this period of inflation will last

03

How inflation is impacting air travel

The impact of inflation in the current aviation industry context

04

The background of the page is a close-up, slightly blurred image of several US dollar bills. The focus is on the '100' and 'ONE HUNDRED' text on the bills, which are arranged in a way that creates a sense of depth and texture. The colors are muted, with greys, blues, and hints of yellow from the paper.

Central banks and economists believe inflation has not even peaked yet

Central banks around the world are tightening monetary policy to fight soaring inflation, which shows no signs of abating soon. Indeed, many central banks and economists believe that it has not even peaked yet (1). On July 27, the U.S. Federal Reserve, the most powerful central bank in the world that is often used as a touchstone for the health of the global economy, made a huge interest rate rise of 0.75 percentage points to tame surging prices. The Fed is now targeting a range of 2.25 percent to 2.5 percent. Raising rates makes borrowing more expensive, something in theory that is meant to reduce demand and curb price rises – but it also slows economic activity and could trigger a recession. The U.S. economy shrank over the last six months, signalling the start of a recession.

Food and living costs have soared, as well as the price of oil – as of July 29, a barrel of crude cost \$103, nearly double the cost it was before the COVID-19 pandemic in early 2020. The cost of living is getting more expensive and social instability is rising. The higher cost of living is having an impact on people's daily lives, as well as their travel plans. The wide-ranging impacts on consumer behaviour and discretionary spending will be acutely felt by the air travel industry.

What is causing inflation?

The war in Ukraine has brought geopolitical uncertainty, spurring a spike in prices. Western countries have imposed crippling sanctions on Russia’s economy and restricted the use of its oil. Russia is the world’s largest oil and natural gas exporter and the second largest crude oil exporter globally after Saudi Arabia, meaning that the sanctions have roiled energy markets. Ukraine meanwhile is often called “the breadbasket of Europe” due to its high wheat and grain imports, but the conflict has meant that it has been unable to export as many food products and prices have gone up as a result. Tens of thousands of people, particularly in the Middle East and North Africa, are vulnerable to falling into famine due to food shortages.

But inflation began before the conflict started in February this year. Since early 2021, inflation has driven prices up in economies around the world, both advanced and developing, as pent-up demand for goods clashed with stock and staff shortages caused by the pandemic. At least 75 central banks raised interest rates at the start of the year, many of which kept rates at historic lows. This has been felt more acutely in emerging economies, which on average have raised their rates by 3 percentage points, nearly double the 1.7 percentage points for advanced economies. Inflation more than doubled between March 2021 and March 2022, from 3.7 percent to 9.2 percent (2).

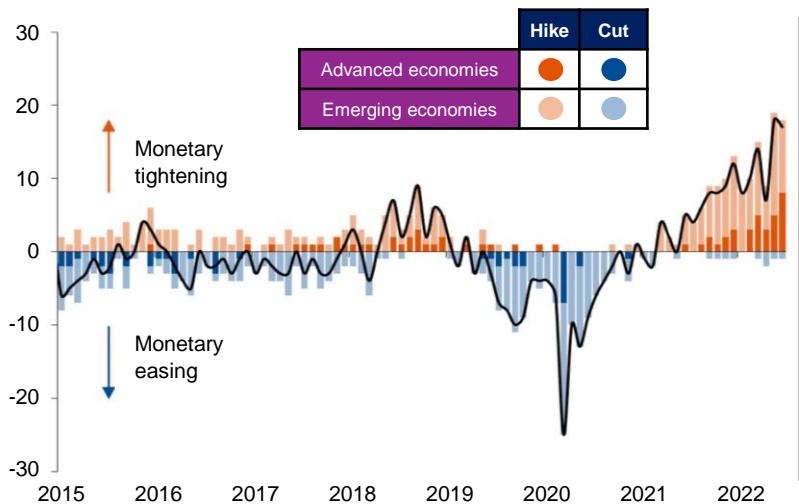
“It is going to be a tough 2022 — and possibly an even tougher 2023, with increased risk of recession,” International Monetary Fund Managing Director Kristalina Georgieva said in a blog post on July 13 (3). She urged central banks to react to inflation sooner rather than later, to reduce the damage to livelihoods and the global economy.

On July 21, the European Central Bank raised interest rates for the first time in 11 years, in a bid to tackle Eurozone inflation that had risen to 9.1 percent last month (4). The bank raised rates by 0.5 percentage points, taking many analysts by surprise who had expected a 0.25 percent point hike. Furthermore, the European Central Bank’s Governing Council decided on September 8th to raise the three key interest rates by 75 basis points, the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will be increased to 1.25%, 1.50% and 0.75% respectively (5).

The Bank of Japan is a notable outlier in terms of maintaining ultra-low interest rates. However, inflation in the country has been much lower than in many other countries, including the United States, Britain, France, Canada, Germany and South Korea (6).

All together now Central bank policy rates

Figure 1. Central bank policy rates.
Sources: Bloomberg, and IMF.
Note: The AE sample consists of Australia, Canada, Czech Republic, Japan, New Zealand, Norway, Sweden, Switzerland, United Kingdom, United States, and the countries in the European Union (under ECB jurisdiction). The EM sample consists of Brazil, Chile, Colombia, Mexico, Peru, Indonesia, Malaysia, Philippines, Thailand, Hungary, Poland, Romania, South Africa, Turkey, Pakistan, Croatia, Russia, Ukraine, Egypt, and Ghana.



How long will today's inflation continue?

Such rapid inflation has not been seen since the 1980s. A Federal Reserve policy of “easy money” and low interest rates was one of the main reasons for that crisis (7). Going back further into history, cheap money spurred rapid short term growth during President Richard Nixon’s election year in 1972, which the Republicans won within a landslide victory. High budget deficits and the collapse of managed currency rates meant that it was not long before the economy went into a period of “stagflation” – a combination of slow growth and prices rising at much faster rates than expected.

This was compounded by several shocks, including the Arab oil embargo, which saw oil prices increasing fourfold in 1973 and 1974 and double between 1979 and 1980. Several recessions occurred in the 1970s that worsened unemployment and failed to control the soaring inflation (8). Inflation rose to a high of 14.4 percent and it was only controlled in 1982 when Fed Chairman Paul Volcker applied an aggressively tight monetary policy. The Great Inflation of the 1970s and 1980s prompted central bank economists to change their strategy to focus less on fighting unemployment and focus more on staving off high inflation.

Economists’ and policymakers’ opinions vary on how long this period of inflation will last. The Bank of England believes that the rate of inflation will continue to rise for the rest of the year, but will slow down in 2023, and be close to 2 percent in about two years. The bank says that is because the main causes of the current high rate of inflation are not likely to last.

Investment bank Goldman Sachs meanwhile believes that automobile prices and health insurance – two of the largest contributors to inflation during the pandemic – should start falling significantly by the end of the year. The bank expects that this will push inflation down to 5.5 percent at the end of 2022 and 2.4 percent in December 2023 (9). However, Goldman’s economists warn that inflation could linger for “many years”.

The International Air Transport Association (IATA) believes that inflation should start declining again next year and said in its recent report that it did not expect “a structural upward shift” in the level of inflation (10).

Inflation and interest rates in the 1970s and 2020s

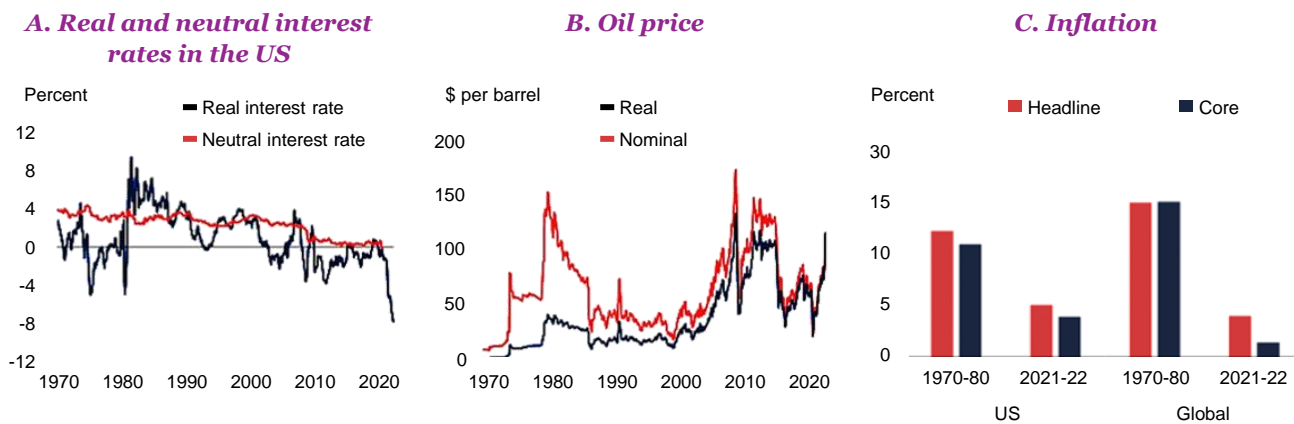


Figure 2. Inflation and interest rates in the 1970s and 2020s.
Source: Holston et al. (2017); Federal Reserve Economic Data; Havers Analytics; World Bank.

How inflation is impacting air travel

What is clear is the longer that inflation drags on, the higher likelihood of a recession, which will negatively impact travel demand. Some airlines took on significant debt during the pandemic and now must deal with rising operating costs, including the price of jet fuel – which IATA says increased nearly 150 percent last year.

In its June Global Outlook for Air Transport (10), IATA sought to play down concerns of rising inflation, saying that it was not yet having a major impact on demand. Airlines will react to the high inflation in different ways, and it will depend on factors including how much debt they have, and whether they have strong liquidity.

Furthermore, inflation helps those with debt because it reduces its real value and hence the real value paid back. Nominal interest rates – the percentage increase in money you pay the lender for the money you borrowed – should remain below the rate of inflation, which should give airlines the opportunity to pay back their debts at a lower cost. But airlines that have high debt levels and do not have the liquidity to pay it back may experience significant challenges and may have to retrench unless they are able to get state support. However, governments provided ample support during the pandemic and patience to continue doing so is wearing thin.

What's fuelling rising airfares?

Inflation and rising operational costs have led to airline fares hikes. A report from June 2 (11) said that ticket prices were up by 25 percent – outpacing the pace of inflation. For example, in the U.S. there have been huge rises in the cost of domestic flying, often larger increases than those seen on international flights. Despite these price rises, it seems that demand is still strong, and many airlines have not seen much of a decline in bookings.

There are many reasons why ticket fare increases are outpacing inflation, namely high oil prices as well as labour shortages that are making it hard to run at the same capacity.

IATA said in its Global Outlook that there was some degree of insensitivity of consumers towards rising prices this year. But the question is how long can that continue amid times of economic hardship and uncertainty? There is a possibility at the end of the summer in the more affluent northern hemisphere, where wage increases do not keep pace with inflation, people will start to feel the pinch, and therefore may have less of an appetite to travel.

There are other factors that can contribute to rising airfares, such as whether an airline has hedged its fuel or not, as much of an airline's operating costs are tied to the price of jet fuel. Airlines that hedge fuel buy fuel at a fixed price over time to protect them against rising fuel costs. Airlines (particularly low-cost carriers like Ryanair, Southwest and EasyJet) that hedge fuel will be more protected against inflation as they will not bear the brunt of rising fuel costs and therefore might not be pressured to increase their airfares much or at all. For example, Ryanair hedged most of its future fuel requirements for the rest of 2022 at \$65 before Russia invaded Ukraine, shielding it from the worst impacts of the rising fuel costs (12). As those hedges roll off, airlines will be exposed to the prevailing fuel price at that time.

Seat cuts and environmental charges

However, airfares can also rise on routes when one airline, faced with staff shortages, must cancel their flights and therefore the demand goes up and supply goes down as consumers turn to other airlines to fly to that same destination instead.

Ryanair's Chief Executive Michael O'Leary said on a call with analysts in July after the budget carrier released its Q1 results for 2022 that travellers would see increased airfares as airlines cut back on seats while fuel prices rise (13). Only a month before, O'Leary told the Financial Times that he anticipated air fares rising for the next five years because flying has become "too cheap" to make profits, as operational costs spiral (12).

In some parts of the world, rising environmental charges are likely to result in an increase in fares. Under the EU emissions trading system, airlines can buy tradable credits to mitigate the amount they pollute under parallel emissions systems in both the UK and the EU. However, the system only currently covers intra-European flights and it has not been extended to long-haul journeys. This has led to some short-haul airlines complaining that there is not a level playing field with long-haul carriers.

Consumers in some countries seem to be cutting back on their flights, suggesting that we have already reached a tipping point in terms of airfares. U.S. airline bookings fell 2.8 percent in June, compared to the previous month, according to data collected by Adobe Analytics (14). Over the same period, online ticket spending fell 5.7 percent to \$7.9 billion.

Staff shortages, longer routes

Many airlines have seen staff shortages in recent months. Some of the reasons for this are strikes, leading to personnel shortages and mass cancellations of flights. These cancellations push up the demand to fly on other flights, which in turn increases the price.

In the U.K., the problem has been particularly acute, as Brexit has made it harder for airlines to recruit European staff, meaning there is a small pool of staff to use and therefore more likely to be shortages. In June, easyJet disclosed it had rejected 8,000 job applicants because of their nationality this year, most of whom were from the EU.

The strikes have happened in many parts of the world. Ground staff at Lufthansa went on strike on July 27, leading to more than 1,000 flights being cancelled. The German airline cancelled nearly all flights at its hubs in Frankfurt and Munich that day (15). Other airlines experiencing some form of industrial relations issues include British Airways, Delta, EasyJet, Ryanair and SAS.

Some airlines have responded proactively to staff shortages or tried to pre-empt strikes, such as American airlines paying pilots more to retain them in a competitive market. Such techniques are likely only to work in the short term as the cost of living gets higher.

The war in Ukraine is also causing many airlines flying to and from Asia to divert their routes around Russia, Belarus, and Ukraine, which often makes them longer and therefore more costly. For example, a British Airways flight flying from London Heathrow to Tokyo now will have to avoid Russian airspace and divert further south or north to reach the destination.

It is difficult to travel on a budget and if inflation continues, it will be hard to see how the cost-sensitive travellers will continue to want to travel. It could threaten the business models of some low-cost carriers as discretionary spending by some consumers will be squeezed until inflation and airfares are reduced. Although they will be less impacted by the rises, air fares charged by low-cost carriers will also increase as airlines cut back capacity. Customers may not believe that the model is attractive if prices pass a certain level, for a stripped back service with reduced seat space and food that is not included in the ticket price. In some short-haul cases, high speed rail might look like a more attractive option, usually having fewer border and security controls and being more eco-friendly.

ABL's view

“



Ali Ben Lmadani

CEO, ABL Aviation

The ways in which inflation impacts aircraft financing transactions are multi-fold. The increased cost of labour and staff shortages have a high impact on input costs. Furthermore, many aircraft purchase agreements and leases will have price escalation terms – namely, lease rates rising as they are linked to the purchase price of the aircraft which is escalated in line with inflation – as the price of the aircraft goes up if a manufacturer's costs to produce it go up. Furthermore, base rates and reference rates are increasing which will make it more expensive for airlines and lessors to raise capital.

In a previous report from September 2021, ABL Aviation said that there was potential to benefit from investing in aircraft amid times of inflation, as they are real assets, rather than abstract assets such as bonds or stocks.

Investing in new technology aircraft and having a strong portfolio before inflation started rising quickly would benefit lessors and investors. Inflation also leads to the value of the aircraft rising over time, which means that it could be sold for more money than it would have been if there was no inflation.

Increased costs of capital should affect the secondary aircraft trading markets. Clearly, buyers of aircraft and fixed rate leases will not be able to pay the same for aircraft as their cost of capital will be higher.

Inflation will lead to increased costs for many airlines who may try and pass these costs on to customers through rising airfares, but the industry can continue to rebound if airlines are consumer centric. In a high inflationary environment, airlines must be able to tow the fine line between recovering and achieving post-pandemic profits, which in some cases will mean charging more without choking demand in order to propel the rebound.

That is, not raising prices to levels that flatten demand and continue to put the customer experience first with their offering, despite the challenges presented by rising operational costs, high fuel prices and labour shortages.

There are other ways that could provide alternatives to people struggling with ticket prices, such as flexible payment instalments. For example, Fly Now, Pay Later flexible payment instalment options have been around since 2015, and now that option is being made available for more than 650 airlines around the world. Such service could help some consumers continue to fly even if fares are high.

”

References

1. Global Inflation Hasn't Peaked Yet, Singapore Central Bank Says. Bloomberg. July 19, 2022. <https://www.bloomberg.com/news/articles/2022-07-19/global-inflation-hasn-t-peaked-yet-singapore-central-bank-says>
2. Inflation more than doubled between March 2021 and March 2022. International Labour Organization. May 10, 2022. <https://ilostat.ilo.org/inflation-more-than-doubled-between-march-2021-and-march-2022/>
3. Facing a Darkening Economic Outlook: How the G20 Can Respond. IMF Blog. July 13, 2022. <https://blogs.imf.org/2022/07/13/facing-a-darkening-economic-outlook-how-the-g20-can-respond/>
4. European Central Bank raises interest rates for the first time in 11 years. The Guardian. July 21, 2022. <https://www.theguardian.com/business/2022/jul/21/european-central-bank-raises-interest-rates-for-first-time-in-11-years>
5. Monetary policy decisions. European Central Bank. September 8, 2022. <https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.mp220908~c1b6839378.en.html>
6. Inflation Hits Fastest Pace Since 1981, at 8.5% Through March. New York Times. April 12, 2022. <https://www.nytimes.com/2022/04/12/business/economy/inflation-report-march.html>
7. How the Great Inflation of the 1970s Happened. Investopedia. <https://www.investopedia.com/articles/economics/09/1970s-great-inflation.asp>
8. Today's inflation and the Great Inflation of the 1970s: Similarities and differences. VoxEU. March 30, 2022. <https://voxeu.org/article/today-s-inflation-and-great-inflation-1970s>
9. Inflation May Get Much Worse This Summer—And Could Linger ‘Many Years’—Experts Warn. Forbes. July 4, 2022. <https://www.forbes.com/sites/jonathanponciano/2022/07/04/inflation-may-get-much-worse-this-summer-and-could-linger-many-years-experts-warn/?sh=43e629012e4d>
10. Global Outlook for Air Transport. Times of Turbulence. IATA. <https://www.iata.org/en/iata-repository/publications/economic-reports/airline-industry-economic-performance---june-2022---report/>
11. Airline ticket prices are up 25%, outpacing inflation — here are the ways you can still save. CNBC. June 2, 2022. <https://www.cnbc.com/select/airline-ticket-prices-are-up-25-percent-why-and-how-to-save/>
12. Ryanair chief warns fares will rise for 5 years because flying is ‘too cheap’. Financial Times. July 2022. <https://www.ft.com/content/32108696-9ef5-49ad-8a07-fa30375702bf>
13. Travellers face rising air fares, O'Leary predicts. Irish Times. July 25, 2022. <https://www.irishtimes.com/business/2022/07/25/ryanair-earns-170m-profit-as-passenger-numbers-surge-five-fold/>
14. Summer Airfares Show Signs of Peaking on Inflation Pressure. Bloomberg. July 18, 2022. <https://www.bloomberg.com/news/articles/2022-07-18/summer-flight-prices-drop-as-inflation-cuts-travel-demand>
15. Lufthansa strike: More than 1,000 flights cancelled as staff walk out over pay. Euronews. 27 July, 2022. <https://www.euronews.com/travel/2022/07/27/lufthansa-strike-more-than-1000-flights-cancelled-as-staff-walk-out-over-pay>

ABL AVIATION

NEW YORK | DUBLIN | HONG KONG | CASABLANCA | DUBAI | TOKYO



NEW YORK

445 Park Avenue,
1604, New York, NY
10017, United States



DUBLIN

33 Fitzwilliam Street
Upper, Dublin 2,
Ireland



HONG KONG

25/F, Oriental Crystal,
46 Lyndhurst Terrace,
Central, Hong Kong



CASABLANCA

197 Boulevard
Zerktouni,
Casablanca, Morocco



DUBAI

Gate Village 4, Level
3 DIFC, P.O Box
507276 Dubai, UAE