

# ANALYST VIEWPOINT

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## CHINESE AVIATION GROWTH PROSPECTS

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One feature that has been very clearly evident since the start of this year has been the multispeed recovery in the fortunes of the airline industry. Whilst we might tend to talk in terms of cyclical growth (or recovery) and structural growth, the reality is that all economies are cyclical and those airlines that operate in areas that would be described as offering structural growth in fact are benefiting from higher rates of GDP growth and increasing household income; furthermore when there is a cyclical downturn in these areas it is more likely to be a short lived dip before the economies continue on their upward path. However as the problems of the 2007-2009 downturn, or even in some parts of the world events that were more accurately categorised as a recession showed, no economy operates in an environment of “splendid isolation.” To a greater rather than a lesser extent economies are part of inter-connected systems. Against this background, and although the data in some regions remains mixed, the concerns are that the recovery in the US and indeed much of Europe is not only slowing but may also flat line. Clearly this has wider consequences ultimately feeding through to the GDP and household income of the exporter nations and almost by definition on air transport in their country/region. In this respect whilst the latest IATA Business Confidence Survey (October 2010) is broadly positive, unsurprisingly there are concerns over 2011 and the economic outlook and its impact.

We have recently spent a few weeks in China travelling and just generally observing; we thought that it might be of some interest to look at the underlying economic and demographic issues in more detail and the outlook for the key drivers of airline traffic; namely GDP, per capita income as well as the structure traffic flows, in particular in the domestic market. Against a shorter time horizon it is perhaps also of interest to consider what the impact might be of a slowing, or indeed in some cases the stalling, of economies of the developed world might have on Chinese GDP growth .

Much of the economic data for 2009 makes interesting reading ; we have identified a few statistics which show both similarities and differences in respect of some of the key elements underlying the GDP change; particularly whilst China’s exports fell particularly sharply the near 17% increase in consumer spending clearly underpinned the still high rate of GDP growth.

**Figure 1: Selected Economic data 2009 vs. 2008**

	Real GDP	Exports	Imports	Consumer spending
	% change	% change	% change	% change
USA	-2.6	-9.5	-13.8	-0.8
Europe	-4.2	-16.5	-18.1	-4.2
China	9.1	-16	-11	16.9*

\* Retail Sales

Sources: BEA, Eurostat, US China Business Council, ADB Outlook

In the near term however there is the prospect that economic developments in the countries that are major importers of Chinese goods could have an impact if, as feared, their economies slow or at worst stall. However the experience of the last downturn was muted by the increase in domestic spending and indeed the first indications of some of the targets in the 5 year plan for 2011-2015 period that have begun to emerge perhaps unsurprisingly suggest a greater focus on strengthening domestic demand and away from what some have described as a reliance on export led growth. Whilst the plan will not be published until March 2011, there is a general expectation amongst China observers that the targets for GDP growth will be in the order of 8%; this is seen as high enough to both sustain employment and to enable the wages of the rural population to increase. Whilst the world is clearly not a controlled laboratory experiment, China seems to meet if not exceed its growth targets.

For much of 2010 there have been headlines in the press about US-China trade and in particular the fact that the US in value terms imports just over 4 times the amount that it exports to China. In 2009 out of total Chinese exports of some \$1201bn the US accounted for some \$296bn (24.6%) and the EU27 some \$299m<sup>1</sup> (24.9%); By implication from table 1 these were both sharply down on the levels reported in 2008. However some observers in the US (The Economic Policy Institute) consider that its \$230bn trade gap with China<sup>2</sup> is costing some 0.5m US jobs a year and will doubtless point to the fact that in the first 8 months of 2010 exports of Chinese manufactured goods to the US have increased by some 30%<sup>3</sup>. Indeed in what is an election year in the US there is not just rhetoric but also the prospect of legislation and in the extreme case a trade war – although this is perhaps unlikely given the likely wider consequences. Notwithstanding this, GDP growth for China is forecast to be 9.6% in 2010 and 9.1% in 2011.

It is important to put China's airline industry in context; in terms of passenger numbers the main focus is domestic. In 2009 there were some 215 million domestic passengers and some 16m international passengers carried by the Chinese airlines<sup>4</sup>. Clearly another slowdown in the developed economies would have an impact on cargo traffic (which it did in 2009 and not just for the Chinese airlines – Cathay Pacific for example was particularly affected where cargo and mail carried fell by some 7% in 2009 but is some 20% up in the first 9 months of 2010).

Whilst there are a range of factors that impact upon passenger traffic growth the two main ones are considered to be GDP, and its rate of change, and GDP and income per capita. Both in absolute as well as relative terms, even with GDP growth at some 8% for the next five years China will not only be one of the world's fastest growing major economies but will establish itself as the second largest economy in the world. Clearly the need is to continue to strengthen domestic demand - in part to offset any near term fluctuations (or worse) in the economies of its main export partners and this is clearly recognised from what has come out from the next 5 year plan so far. It is important to recall that China has a particularly high savings ratio which, when measured as a percentage of GDP, reached a figure of 58% in 2008. Within this, household saving expressed as a percentage of GDP is estimated to be greater than 20%. On the other side of the equation, investment (gross capital formation) as a percentage of GDP is some 45%. At the simplest level the 2 times real GDP multiplier suggests average airline traffic growth of 16% or so.

If we look at the forecasts for per capita income; this is forecast to rise from some \$3735 in 2009 to reach \$5000 by 2015 However it is perhaps more appropriate to look at it on a purchasing power parity (PPP) basis and here the World Bank estimates that in 2009 China's per capita GDP on this basis was some \$6770 – there has long been a rule of thumb that once per capita GDP gets to some \$10,000 there is an

<sup>1</sup> €214.8bn (source Eurostat converted at 2009 average €/\$ rate of 1:1.39)

<sup>2</sup> The gap in Europe is \$185bn source Eurostat converted at 2009 average €/\$ rate of 1:1.39)

<sup>3</sup> Source China's Customs Statistics at <http://www.hktdc.com/info/mi/ccs/en/China-Customs-Statistics.htm>

<sup>4</sup> Excluding Dragonair which operates out Hong Kong carried 6.4m international passengers (Source IATA WATS 54 published June 2010)

acceleration in the number of passenger journeys; slightly mixing and matching per capita GDP in current \$ and putting them on a PPP basis suggests that \$5000 in 2015 could have the purchasing power in China of between \$9000 and \$10,000; close to the point of acceleration with an increasing propensity to travel, although as we discuss later it is necessary to relate the travel propensity to the “relevant” population i.e. those who will be able to afford to travel.

This then focuses attention on the likely size of the market and what it might mean. Whilst China has a population of some 1.4bn, the World Bank has estimated that some 200m people have less than \$450 a year (RMB 3000). Indeed one of the other likely objectives of the 2011-2015 Plan will be to narrow the gap between rural and urban earnings. The latest available figures are for 2008<sup>5</sup> published by the government. These show not only that per capita annual disposable income in urban households is some 3.3 times that of rural households but that the gap has widened markedly over the 10 or so years. Between 2005 and 2008 per capita disposable income in China increased by 50%<sup>6</sup> and in the rural areas by 46%. Furthermore whilst the population in the urban areas accounts for some 46% of the total it has almost three quarters of the disposable income. Similarly within this there is a wide distribution where the average per capita disposable income for the population in for Shanghai province is some 69% greater than the national average; for Beijing 57% higher; in Zhejiang which is adjacent to Shanghai 44% higher; in Guangdong 25% higher and in Tianjin (the site of the Airbus assembly facility and the home of some good vineyards) some 23% above the average; conversely Chongqing (a major industrial city and an important centre for machine tool and car manufacture) has average disposable income equivalent to 90% of the overall average.

Rising disposable income has resulted in a number of changes in the key indicators of economic well being; between 2000 and 2008 the number of colour televisions per 100 households had increased from 117 to 132 in urban areas and from 49 to 100 in rural areas. The number of cars per 100 urban households over the same period has increased from 0.5 to 8.8, and the number of mobile phones per 100 of the total population from 6.8 to 48.5.

Whilst business travel will be important, the real volume will – as it is elsewhere in the world – be provided by the leisure market not just in terms of volume but total if not per capita value; In 2008 there were some 23m international visitors to China, by comparison the statistics show some 1.7bn domestic tourists (more than double the number in 2002/03).

We are clearly not alone in concluding that the necessary conditions for significant growth exist for Chinese aviation - something that is borne out by the focus of the aircraft manufacturers’ sales teams and campaigns. Whilst international traffic will increase, the greatest growth in terms of passenger numbers will be within the Asian region. It is the domestic market which is of the greatest interest – despite the building of high speed rail networks. It is of interest to compare and contrast the development of the US domestic airline industry since the start of the jet age in 1958. At that time the population was 174m and there were 48m domestic passengers suggesting a propensity to travel of 0.28. By 1980 the population had increased to 227m and the number of domestic passengers to 271m; a travel propensity of 1.2 times. By 2009 the population had increased to 310m and journeys to 630m, a propensity of just over 2 times. Last year China, with a population of 1.4bn, reported 215m domestic journeys – statistically a propensity to travel of 0.15. At the simplest level if we say that the relevant market perhaps for a generation will be the urban population, currently 46% of the total but expected to be 50% by 2012, then the adjusted propensity to travel is 0.33; not too much different from the US in 1958. The intention and ambition of China in economic terms is clear not just from its statements but from the infrastructure and related investment. If, as is likely, the economic growth translates into domestic air travel and the propensity

<sup>5</sup> China Statistical Yearbook 2009

<sup>6</sup> Annual per capita disposable income in urban households in 2008 was RMB 15781 and in rural households RMB 4761

increases much in the same way as the US then there could be close to 1bn domestic passenger journeys by 2035. Looking more widely this could itself provide a market base for a domestic offering in the 150 seat segment – a fact that has perhaps not gone unnoticed either. Time of course will tell but this is a market to watch closely for some very good reasons.

***The views expressed in this article are the author's and not necessarily those of IATA.***