How worried should we be about Turkey?

A challenging period ahead, but global risks appear small

- The current turmoil in Turkey suggests that the economy and air passenger market are set for a challenging period ahead. The sharp fall in the lira in recent weeks – and many other emerging market currencies – will support inbound tourism flows but add to upward pressure on US dollar-denominated airline costs such as jet fuel.
- Provided that the Turkish crisis remains relatively contained, as we currently expect, the direct risk to aviation at a global level appears relatively small. However, recent developments are a reminder that any shock from the emerging world will have a larger impact on global aviation now than it would have done in the past.

Introduction

The ongoing crisis in Turkey – which has contributed to the Turkish lira losing more than 40% of its value against the US dollar this year – has emerged as a key factor in the near-term economic and industry outlooks.

While the lasting impact of the crisis is unclear at this stage, this note offers a preliminary assessment of the potential impacts on aviation.

What has driven the recent crisis?

The current crisis in Turkey has been driven in large part by increased diplomatic tensions with the US and a renewed focus on Turkey's heavy reliance on capital inflows. Such inflows have supported strong economic growth in recent years but have contributed to a build-up in economic vulnerabilities, which can be exposed during sharp changes in investor sentiment.

Given the high prevalence of foreign currency loans in Turkey, investor concerns can prove self-fulfilling, with the fall in the value of the lira making it harder for companies to service their foreign currency debt. The situation is still fluid, but the consensus is that it may be difficult for Turkey to avoid a recession.

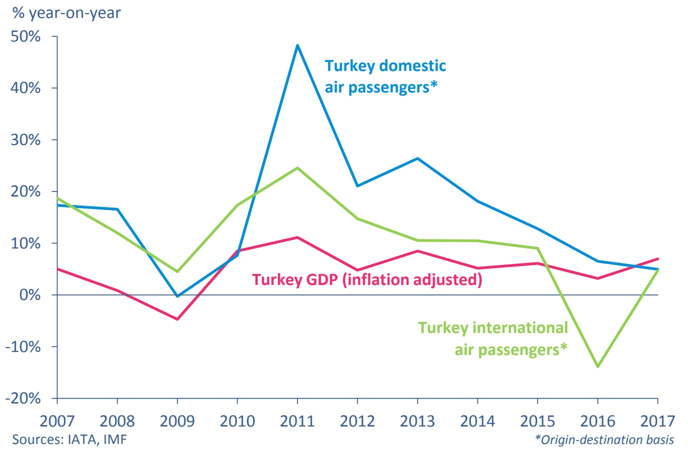
Clear potential for volatility in Turkish aviation

Clearly an economic downturn in Turkey is not going to be good news for origin-destination air passenger demand to, from and within the country.

International passenger demand to/from the country is still recovering from the detrimental impacts on demand in 2016, including the failed coup, terror attacks, and the deterioration in diplomatic ties with Russia. (See Chart 1.) Meanwhile, domestic passenger growth, which accounts for around 45% of the total, has also been slowing in recent years.

Of course, Turkish Airlines is an important global 'super-connector' airline, as well as a freight carrier, which will help to offset some of the potential adverse domestic developments. That said, its worldwide reach makes it more vulnerable to any indirect impacts on economic activity and passenger demand in the rest of the world, particularly Europe and Asia.[1] At this early stage, though, it is too soon to speculate on such indirect impacts.

Chart 1 – Turkey economic activity and passenger growth



It is unclear how large the shock to the Turkish economy will be, or how long it will last, but fundamentally, the impact that any economic disruption will have on air passenger traffic depends on how sensitive passenger demand is to changes in incomes. We estimate that developing countries have an income elasticity of 1.8, which implies that a 1% reduction in incomes will typically reduce air passenger demand by around 1.8%.[2] It follows that any recession in Turkey – perhaps on a similar scale to that seen in 2009 – could see passenger numbers fall in annual terms in the coming years.

Much rests on how Russian visitor flows hold up

That said, given the importance of inbound international tourism-related travel in Turkey, there are other factors to consider – particularly the extent to which US travelers are put off from visiting Turkey, as well as the extent that

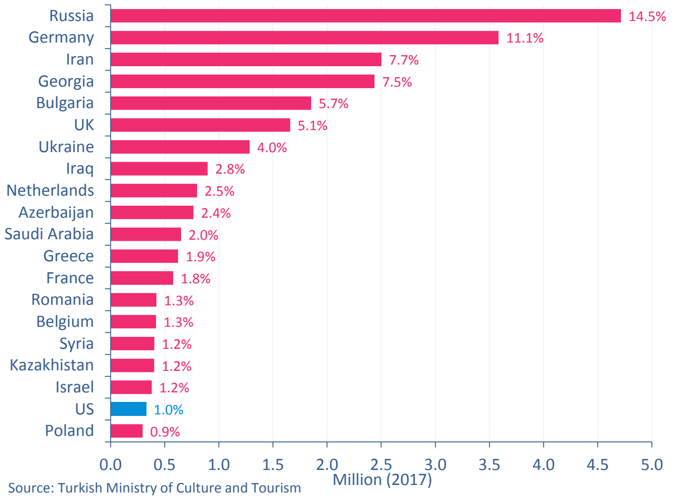
[1] Note that 20% of connecting passengers through Istanbul are travelling between Europe and Asia, with a further 18% travelling between Europe and the Middle East; 43% of connecting passengers are on trips *within* Europe.
[2] https://www.iata.org/publications/economic-briefings/air_travel_demand.pdf

the weaker lira helps to boost tourist arrivals, including from Russia.

The former factor is less of a direct risk, with foreign visitors to Turkey from the US accounting for just 1% of the total. Arithmetically, any detrimental impact could be easily offset by visitors from Russia, which is Turkey's dominant source market.

Visitor arrivals from Russia fell sharply in 2016 but have rebounded as diplomatic ties with Turkey have normalized. All else equal, the pick-up in oil prices and favorable exchange rate movements (even though the rouble has fallen in recent weeks, the lira has fallen by more) should support inbound visitors from Russia (and other countries, of course) to Turkey and help to mitigate the overall impact on domestic passenger flows.

Chart 2 – Foreign visitors arrivals to Turkey by nationality

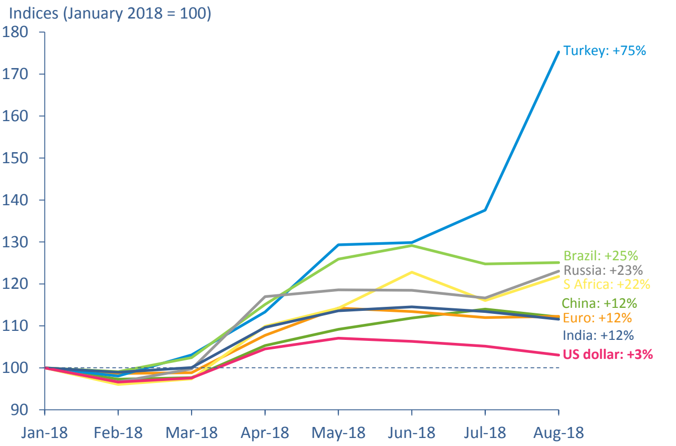


Source: Turkish Ministry of Culture and Tourism

…with FX falls adding to rising cost pressures

Passenger demand is not the only factor that will be affected by the crisis: the falls seen in the value of the lira – and many other emerging market currencies – will exacerbate rising pressure on US dollar-denominated costs, notably jet fuel prices. Indeed, while jet fuel prices have risen by around 3% in US dollar-terms since the start of the year, in Turkish lira-terms they have surged by around 75%. (See Chart 3.)

Chart 3 – Exchange rate-adjusted jet fuel prices



Sources: IATA, Platts, Thomson Reuters Datastream

Different hedging practices throughout the industry mean that the size of the impacts, as well as their timing, will differ from airline-to-airline.

For example, according to Turkish Airlines' public statements, 46% of their fuel consumption in 2018 is hedged at US$57/bbl, and they also hedge between 25-35% of their anticipated US dollar needs over the next 24 months.[3]

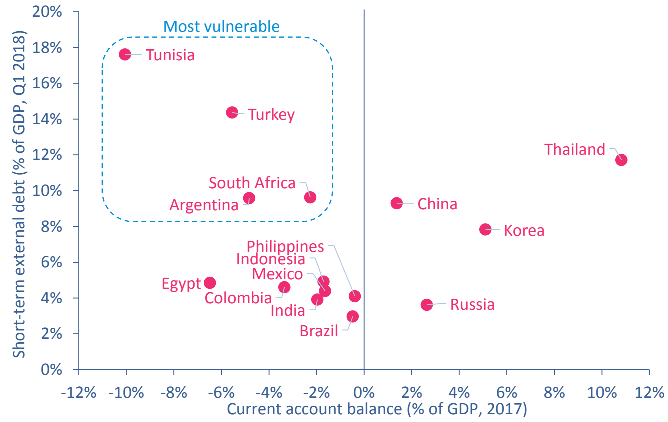
Nonetheless, at least part of the impact will be felt immediately and the longer the currency weakness lasts, the more its impact will be felt as and when existing hedges expire.

How will the crisis affect wider passenger demand?

So long as the economic crisis remains confined largely to Turkey, the corresponding impact on global passenger demand is also likely to be relatively small. Despite strong growth over much of the past decade, Turkey is still just the 16th largest passenger market in the world, accounting for around 1.7% of global O-D air passengers. For context, this is broadly in line with Canada and Korea, but less than half the size of India, and less than one-tenth of the size of the US.

The worry is that contagion will see the crisis in Turkey spread to other vulnerable economies. As shown in Chart 4, Tunisia, South Africa, and Argentina are all similar to Turkey with regard to their reliance on capital inflows, and their significant levels of short-term external debt.

Chart 4 – Financial vulnerabilities in selected emerging market economies



Sources: IATA, IMF, World Bank

That said, financial vulnerabilities currently appear manageable in other key emerging countries, which should limit the chance of contagion. Moreover, the fact that most emerging market economies now have floating exchange rates is a key difference to the predominately fixed regimes at the time of the 1998 Asian crisis, which contributed to the spread of the crisis throughout Southeast Asia.

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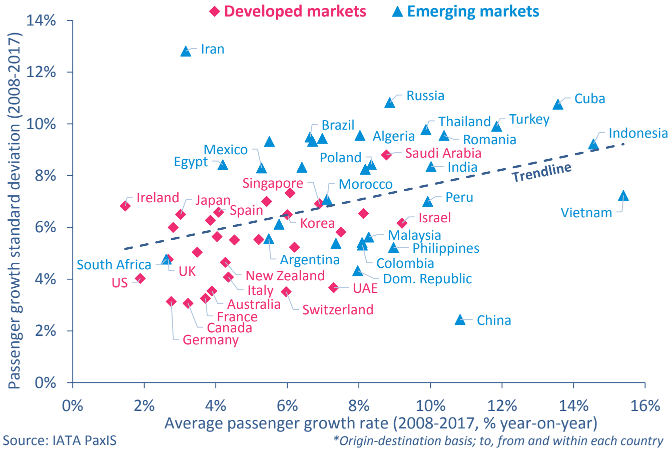
[3] http://investor.turkishairlines.com/en/creditor-relations/risk-management

At this stage, the crisis in Turkey looks unlikely to trigger an emerging market crisis along the lines of that seen in Asia in 2008.

Volatility is not unusual in emerging markets…

It is important to note that periods of instability and uncertainty are not unusual for passenger markets in emerging economies. Indeed, as shown in Chart 5, emerging passenger markets have typically seen higher growth and higher volatility than their developed world counterparts over the past decade.[4]

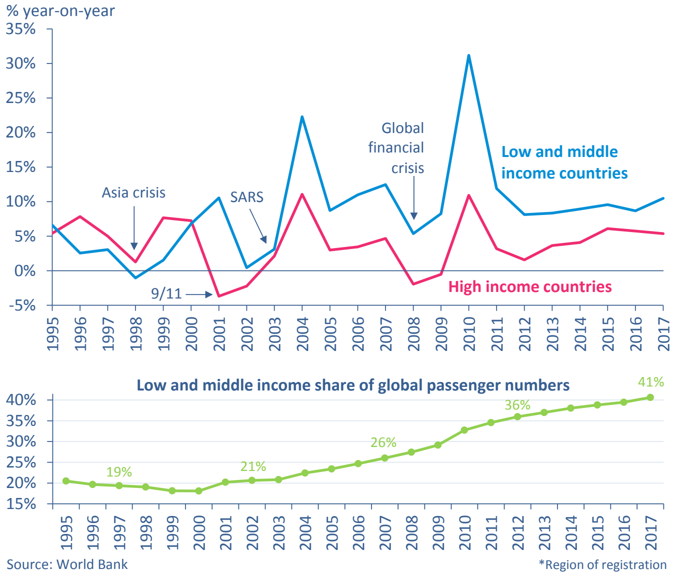
Chart 5 – Passenger market growth and volatility



…but EMs matter more than ever

Nonetheless, while we think the current crisis should be relatively contained, it is worth noting that any downturn in emerging market passenger demand would have a much bigger impact on aviation now than it did in the past. The share of the emerging markets in global passenger demand has more than doubled over the past 20 years, from around 18% at the time of the Asia crisis in 1998 to 41% last year. (See Chart 6.)

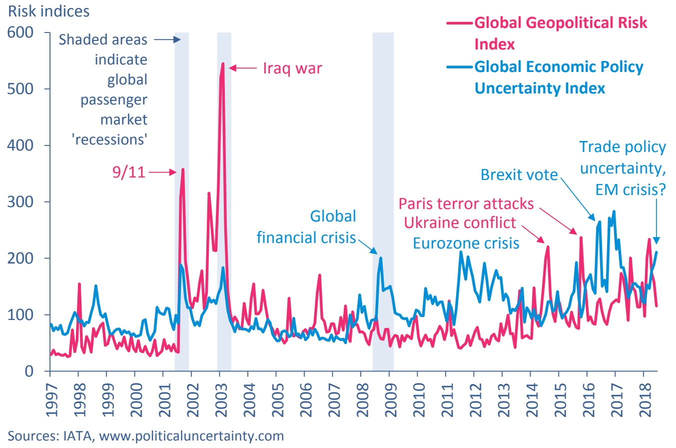
Chart 6 – Passenger growth by economic grouping



Moreover, the Turkey crisis comes at a time of already heightened global economic policy uncertainty stemming from recent trade tensions, as well as an upward trend in geopolitical risks. (See Chart 7, which was the subject of a recent note – link.)

With economic forecasters including the International Monetary Fund warning that the balance of risks to the global economic outlook lie on the downside, the economic crisis in Turkey only adds to the factors to monitor.

Chart 7 – Global economic policy uncertainty and geopolitical risks



The longer-term perspective

Despite the current challenges, it is worth bearing in mind that the fundamental drivers of air passenger demand for Turkey are positive over the longer-term.

Over the next 20 years, the number of passenger journeys is forecast to grow at an average rate of 3.6% per year. If met, this would mean a doubling in the current number of journeys to/from and within Turkey, to around 167 million in 2037.

Concluding comments

The current turmoil in Turkey suggests that the economy and air passenger market are set for a challenging period ahead.

The sharp fall in the lira in recent weeks – and many other emerging market currencies – will support inbound tourism flows but add to upward pressure on US dollar-denominated airline costs such as jet fuel

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[4] The major exception is China, which has seen the lowest volatility in passenger growth of all the major markets shown in Chart 3, which partly reflects the strong state involvement in the industry in the country.