

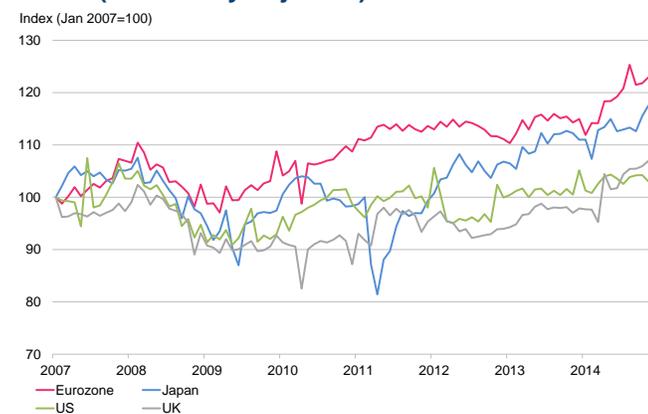
## What would a ‘Grexit’ mean for the eurozone air passenger market?

### Eurozone tensions once again come to the fore

The election of the anti-austerity Syriza party in Greece earlier this year has re-awakened fears about the country potentially leaving the eurozone. Indeed, the situation has once again raised questions about the future of the currency bloc itself.

There remains sizeable uncertainty about what a so-called ‘Grexit’ would mean for the global economy and financial markets, particularly in the long run. With this in mind, this note examines how the eurozone’s air passenger market has fared over the past few crisis-hit years, and constructs a number of scenarios to help to assess the potential impact of a ‘Grexit’ on the region’s air passenger market.

### Chart 1 – Eurozone air passenger market vs. selected others (seasonally adjusted)



Source: PaxIS, IATA

### The eurozone air passenger market looks to have fared pretty well for a region in crisis...

For a region that has lurched from crisis to crisis and has experienced just a lacklustre economic recovery since the global financial crisis (GFC), the eurozone’s air passenger market looks to have done remarkably well. Indeed, the eurozone market has expanded by more than those in the US, UK and Japan over the past five years or so.<sup>1</sup> (These other markets have had their own problems of course, including the 2011 tsunami in Japan

<sup>1</sup> Total air passenger market is defined as the number of origin-destination passenger trips to, from and within each passenger market.

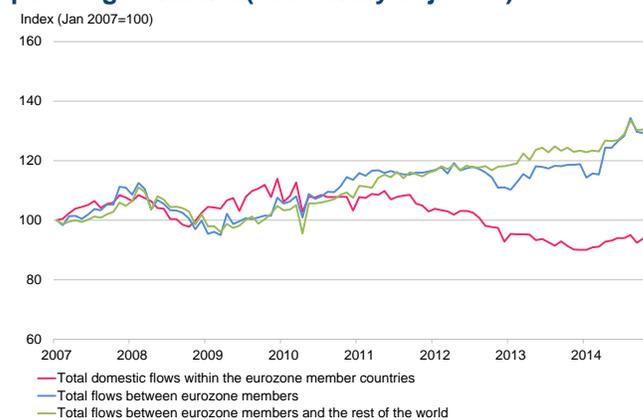
and the 2010 Icelandic ash cloud.<sup>2</sup>) Total eurozone passenger flows picked up particularly strongly throughout 2014, with solid year-to-date growth in November of 4.3%. Total passenger flows in the eurozone are now over 20% higher than they were at the start of 2007.<sup>3</sup> (See Chart 1.)

However, looking beneath the surface shows that the expansion in the eurozone air market has not been felt uniformly across the different air passenger flows to, from and within the region. To illustrate, we have broken down the total air passenger market into three components:

- 1) Total domestic air passenger flows within all of the eurozone member countries (ie, total trips within Germany plus total trips within France, and so on).
- 2) Total air passenger flows *between* the eurozone members (ie, intra-eurozone flows).
- 3) Total air passenger flows between the eurozone and the rest of the world.

These components are shown in Chart 2 and the following sections analyse each of them in turn.

### Chart 2 – Components of the total eurozone air passenger market (seasonally adjusted)



Source: PaxIS, IATA

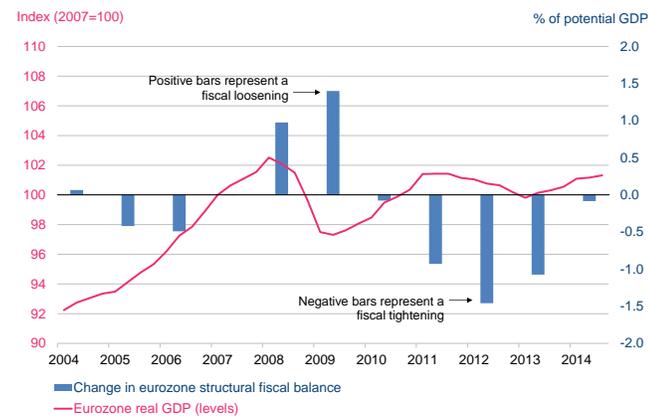
<sup>2</sup> Assessments of the impacts of both events on the air industry can be found here: <http://www.iata.org/publications/economics/market-issues/Pages/shocks-old.aspx>

<sup>3</sup> By way of context, note that the Chinese air market is now 1.3 times larger than at the start of 2007 (ie, if included on Chart 1, the line for China would reach 230 on the y-axis).

### ...but domestic travel has been hit hard...

Perhaps the most eye-catching aspect of Chart 2 is the dire performance of domestic travel (the pink line), which accounts for just under one-fifth of the total eurozone market. Having recovered to their pre-GFC peak in late 2009, total domestic travel flows tracked broadly sideways until mid-2011 and then trended steadily downward until early-2014. It is not difficult to work out the reasons why this was the case; as shown in Chart 3 the period since 2011 coincides with a significant fiscal tightening in the eurozone and a prolonged double-dip recession. The good news is that domestic passenger flows at least now look to have troughed, in keeping with an easing in the pace of fiscal contraction and a modest pick-up in real GDP in 2014. However, total domestic flows remain 6% below their level at the start of 2007 and some 17% below their post-GFC high.

### Chart 3 – Eurozone GDP and fiscal conditions



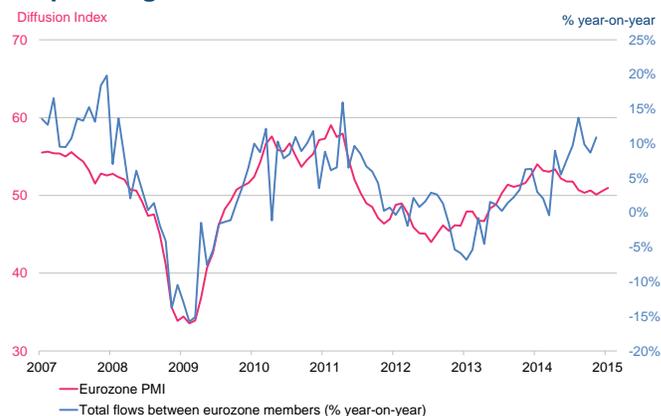
Sources: Thomson Datastream, IMF, IATA

### ...and intra-EZ travel has been fitful too

The intra-eurozone air travel market, which accounts for around one-quarter of the total eurozone air market, has fared slightly better, although its performance has been fitful. Up until early-2014, year-on-year growth in intra-eurozone flows closely followed the rises, falls and fluctuations in eurozone business conditions – as represented in Chart 4 by the eurozone Purchasing Managers' Index (PMI).<sup>4</sup> Intra-eurozone travel recovered reasonably quickly during the post-GFC rebound in 2010. However, the difficult economic backdrop in the region took its toll and growth weakened considerably throughout 2011 and 2012. All told, intra-eurozone passenger numbers remained broadly static in level terms from late-2010 into 2014.

<sup>4</sup> Recall that PMIs are constructed so that a reading above 50 represents an expansion in economic activity, and a reading below 50 represents a contraction.

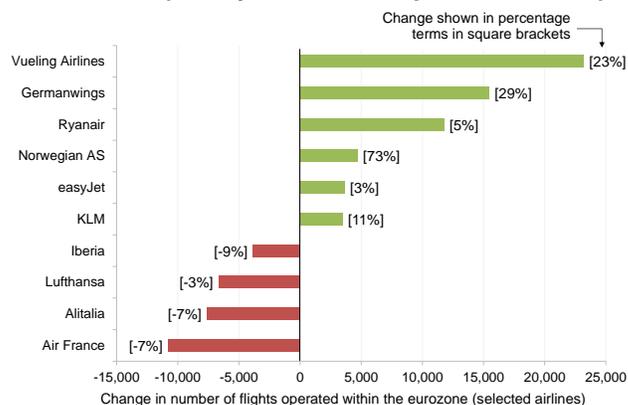
### Chart 4 – Eurozone PMI vs. growth in intra-eurozone air passenger flows



Sources: Markit, PaxIS, IATA

Since early 2014, the close relationship between intra-eurozone growth and business conditions has broken down. The PMI weakened throughout most of 2014, indicative of the weak economic conditions that contributed to the European Central Bank (ECB) launching its quantitative easing (QE) programme earlier this year. However, year-on-year growth in intra-eurozone travel has jumped. There appear to be two explanations for this divergence. The first relates to an increase in flight capacity and non-stop routes connections within the eurozone in 2014, driven by an increase in low-cost carriers – particularly relatively new entrants to the market. Interestingly, two of the largest increases were from low-cost subsidiaries of network airlines (Vueling and IAG Group, and Germanwings and Lufthansa). (See Chart 5.) This highlights the ability of low-fare/no frills services to stimulate demand within weak economies, and even highly mature markets.

### Chart 5 – Change in number of flights operated within the eurozone (2014 year-to-date up to November)

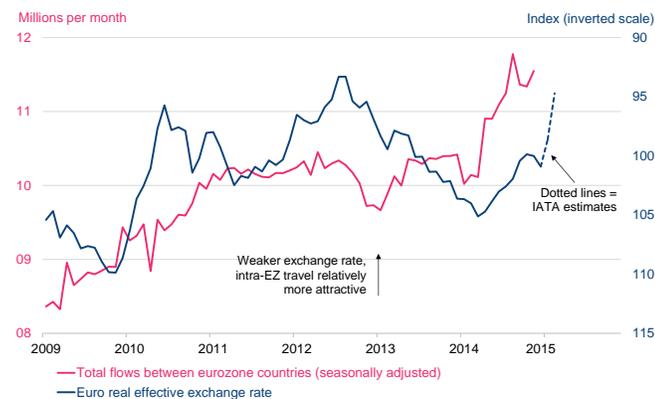


Sources: SRS Analyser, IATA

The second important factor behind the pick-up in intra-eurozone travel during 2014 is the sizeable decline in the euro over the period. Clearly, there are a lot of other

factors than just the exchange rate that influence demand for air travel. However, all else equal, we suspect that the reduction in the foreign purchasing power of the euro has caused eurozone residents to substitute leisure trips originally planned outside the bloc to leisure trips *within* the bloc. For example, given the fall in the value of the euro, a trip for a eurozone resident to the US, say, is now relatively more expensive in euro terms than it was, but a trip within the eurozone is unaffected. Given that leisure travellers are typically more price sensitive than business travellers, this is likely to result in some substitution between destinations.

**Chart 6 – Intra-eurozone air passenger flows vs. real effective exchange rate**



Sources: BIS, PaxIS, IATA

### Steady expansion in flows to and from the rest of the world...

Passenger traffic to and from the eurozone with the rest of the world is the largest component of the eurozone air passenger market, accounting for around 60% of the total. This flow has expanded steadily since the GFC – a fact that should not come as a complete surprise. Indeed, the eurozone is a large, highly diverse and attractive place to visit. (For example, it scores very highly in measures such as the World Economic Forum’s Travel and Tourism Competitiveness report, particularly for cultural attractions.) As air travel comes within the means of increasing numbers of people around the world, the eurozone countries are always likely to attract their fair share of leisure travellers. A similar argument can be made for business-related travel too. Despite the sluggish economic growth in recent years, the eurozone region remains an important business hub.

Meanwhile, although the weaker euro is constraining the purchasing power of eurozone residents, the flipside is that it is providing a fillip to foreign purchasing power in the eurozone too. The latter should support inbound

passenger travel from rest of the world, particularly if the euro falls further over the coming months.

By virtue of the current comparatively weak inflation rate in the eurozone, it is worth noting that the euro’s real exchange rate has depreciated by more than its nominal counterpart since early-2014. (Recall that the real exchange rate adjusts for differences in the change of the cost of living between countries.) The real exchange rate therefore captures the fact that foreign currency now not only buys more euros than previously was the case, but weaker inflation in the eurozone means that goods and services in the eurozone have become relatively cheaper too. This will provide even more support for inbound air passenger arrivals to the region.

### ...driven by travel to non-eurozone Europe

Since the trough in 2009, two-thirds of the increase in passenger flows to and from the rest of the world has reflected a pick-up in flows to and from the European countries outside the eurozone. This mainly reflects flows to/from the UK, Turkey and Russia, which on their own account for 19%, 11% and 7% of the total increase respectively. Longer-haul travel to and from Asia has also been a sizeable driver behind the rise in pax flows to the rest of the world, accounting for around 11% of the pick-up since early-2009. China underpins one-quarter of this growth, alongside solid increases to and from Korea, Thailand and Japan.

All told then, it has been a mixed few years for the eurozone air passenger market. Fiftful economic conditions have weighed on domestic flows within the eurozone members countries as well as intra-eurozone flows too. However, passenger flows to and from the eurozone with the rest of the world have grown steadily, helped by a weaker euro over the past year or so.

Armed with this knowledge of how eurozone air passengers markets have fared over the past years, we are in a good starting position to assess the possible implications of a ‘Grexit’ on air travel in the region.

### If compromise is reached, eurozone air market looks set for further solid, albeit unspectacular, growth

Of course, it is possible that some compromise between Greece and its official creditors may be reached in the coming days and weeks. If this occurs, and the economic status quo continues, we expect that the total eurozone air passenger market would continue its modest upward growth trend. In terms of the framework developed earlier, total domestic travel flows within the eurozone

members at least now look to have troughed. As long as the economy does not fall back into recession, passenger numbers should grind higher, albeit slowly. Key uncertainties in this regard include the effectiveness of ECB's QE programme and the extent that lower oil prices induce households to increase discretionary spending.

The intra-eurozone air passenger traffic should also remain supported, underpinned by market stimulation from low-cost services and some degree of substitution by eurozone residents following the drop in value of the euro. That said, in the absence of even more capacity growth, we expect the relationship between business conditions and intra-eurozone travel growth will begin to reassert itself, which is likely to cause the pace of year-on-year growth to ease throughout 2015.

Last but not least, the region appears to be reasonably well-placed with regard to passenger flows to and from the rest of the world too. While global economic growth remains uneven and patchy, the inherent attractiveness of the eurozone countries for leisure travel, as well as the boost from the weaker euro, should support inbound passenger travel from rest of the world.

### **Grexit-type scenario would be expected to cause significant volatility in the near term...**

However, if a compromise between Greece and its creditors cannot be reached, a Grexit-type scenario would become increasingly unavoidable, with Greece (and possibly other countries over time) leaving the eurozone. There are a number of opposing views as to how pronounced the economic impact and market fall-out of such an event would be in the near term. On the one hand, given that European banks' are less directly exposed to Greece than they were just a few years ago, some economists think that the scope for fall-out/contagion may be relatively limited.<sup>5</sup> On the other hand, other economists think that the impact could be larger than that which followed the collapse of Lehman Brothers at the start of the GFC.<sup>6</sup> Either way, a lot will depend on how policymakers and politicians react to any such event.

### **...but need not necessarily be disastrous over the longer term**

From a longer-term economic perspective, though, the lasting impact of a Grexit, or even a partial break-up of

<sup>5</sup> For example, see: <https://insights.abnamro.nl/en/greek-exit-3-scenarios>

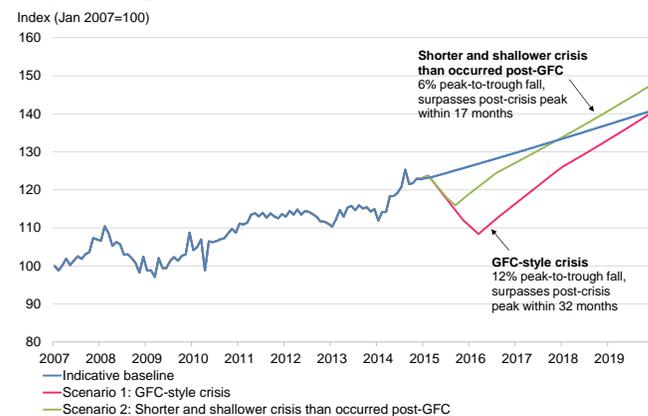
<sup>6</sup> <http://www.marketwatch.com/story/greek-euro-exit-would-be-lehman-brothers-squared-economist-2015-01-03>

the eurozone, need not necessarily be disastrous. Indeed, some economists think that euro exit could actually present the weaker members of the eurozone with better long-term prospects than remaining in the euro, and potentially lead to faster growth in the region as a whole in the long term. This would particularly be the case if some Grexit-type event resulted in a pick-up in domestic demand in the 'healthier' parts of the region – notable in Germany.<sup>7</sup>

### **Scenario analysis**

Bearing in mind the acute uncertainty as to how things may pan out, Chart 7 illustrates three indicative scenarios of how economic developments may shape eurozone air passenger market over the coming five years. The blue 'baseline' scenario represents a plausible outcome if a compromise between Greece and its creditors is reached (ie, this is the economic status quo scenario discussed in detail earlier on). Crucially, the upward trend in passenger traffic is expected to continue, with steady – albeit unspectacular – total annual passenger growth in the region of 2.75% over the next few years.

### **Chart 7 – Possible Grexit scenarios for the eurozone air passenger market**



Sources: PaxIS, IATA

Given the range of opinions as to how severe the near-term economic impact of a Grexit would be, we have turned to the previous experience of eurozone air passenger flows during and following the GFC as a guide of what to possibly expect following a Grexit. As shown in Table 1, the individual components of the eurozone air travel market experienced peak-to-trough falls in the range of 8-15% following the GFC, and took between nine and twenty two months to surpass their pre-GFC peaks.

<sup>7</sup> For example, see: <http://www.investmentweek.co.uk/investment-week/news/2223782/bootle-why-grexit-would-not-be-a-disaster-but-beware-second-wave>

**Table 1 – Key indicators from GFC**

	Peak	Trough	Peak to trough fall	Surpassed peak in...
1) Domestic flows within the eurozone member countries	Feb 2008	Nov 2008	-8.0%	Aug 2009
2) Flows between eurozone members	Feb 2008	Mar 2009	-15.6%	Nov 2010
3) Flows between eurozone and the rest of the world	Feb 2008	Mar 2009	-13.5%	Jan 2011

Sources: PaxIS, IATA

Scenario 1 (the pink line in Chart 7) illustrates a case in which the negative impact from a Grexit-type event follows the same magnitude and duration as was seen following the GFC. In other words, this scenario assumes that the three components of the total air market experience similarly-sized peak-to-trough falls as shown in Table 1, and recover back to the previous peak at a similar speed as they did post-GFC. This ties in with some economists' expectations that the near-term impact of a Grexit would be very large (see footnote 6). By contrast, Scenario 2 (the green line in Chart 7) illustrates a scenario in which the peak-to-trough falls in each of the components are half the size of that seen post-GFC, and they recover to their previous peak in half the time. This scenario is intended to proxy the view that the fall-out/contagion from a Grexit may be relatively limited (see footnote 5).

### A silver lining to Grexit?

Crucially, though, once the uncertain initial impact of the shock passes in each of the scenarios in Chart 7, air passenger growth is assumed to grow faster than in the baseline case – broadly in line with its pre-GFC rates of growth. This is predicated on the theory that Grexit and/or partial euro break-up could unlock faster growth in the region as a whole in the long term – particularly if it coincides with a pick-up in domestic demand in the 'healthier' parts of the region. Given that a healthy eurozone economy holds the key to reinvigorating domestic and intra-eurozone passenger flows, this would be expected to translate into domestic and intra-eurozone flows growing faster than they do in the baseline case. A weaker euro in both cases would be expected to lend even stronger support to inbound passenger travel from rest of the world too.

As shown in Chart 7, total eurozone air passenger flows under Scenario 1 recover to a similar level at the end of the five-year scenario time horizon than in the baseline. Accordingly, the compound annual growth rate (CAGR) of total eurozone air passenger flows in Scenario 1 is

**Table 2 – Scenario summary statistics**

	Implied CAGR* over next five years	Passenger flows relative to baseline (next five years)
Baseline	2.75%	-
Scenario 1: GFC-style crisis	2.75%	-6.5%
Scenario 2: Shorter and shallower crisis than post-GFC	3.75%	-0.6%

\* Compound annual growth rate

Source: IATA

the same as that in the baseline. (See Table 2.) However, given the magnitude of the impact in the near term, *cumulative* passenger flows are 6.5% lower over the next five years than in the baseline.

Scenario 2 is a more positive case – one in which the Grexit is reasonably well handled and its near-term impact is more muted. While the Grexit-type event in this scenario causes a slump in the near term, the faster growth potential assumed in the scenario further out contributes to total eurozone air passenger flows actually *exceeding* the baseline level in late-2017. CAGR growth in the scenario is in the region of 3.75% over the coming five years. Moreover, cumulative passenger flows are just 0.6% lower over the next five years than in the baseline case. In this case, short-term pain eventually gives way to gains in the long run.

### Conclusion

The past few years have been mixed ones for the eurozone air passenger market. On the plus side, passenger flows to and from the bloc with the rest of the world have grown steadily, helped by a weaker euro over the past year or so. However, weak economic conditions have weighed on domestic flows within the members countries, and the fitful economic recovery has dogged intra-eurozone passenger flows too.

A Grexit-type event would be expected to cause considerable disruption to air passenger markets in the near term. However, to the extent that a Grexit-type event could help to facilitate a more balanced – and ultimately healthier – European economy in the long run, it could also provide the basis for faster long-run growth for air travel too. In fact, as our scenario analysis illustrates, the lasting impact of a well-managed and

relatively contained Grexit-type event may not be appreciably worse than the status quo scenario.

All told, even if some compromise is reached between Greece and its creditors in the coming weeks and months, the inherent economic tensions within the eurozone will persist. In the absence of lasting policies to alleviate debt burdens and to tackle competitiveness mismatches within the bloc, a Grexit-type event will remain a possibility for the foreseeable future.

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