

PILARSKI SAYS...

Stability can be dangerously deceptive

Stable environments can be boring and very unhelpful, writes Adam Pilarski, senior vice-president at Avitas.

Right now things look quite stable. Economic forecasts call for fairly low growth but the forecasts do not change from quarter to quarter like they did during the 2008/09 period. Then forecasts for profits were a vision of earthquakes.

For example, the International Air Transport Association (Iata) forecast of net profits for 2008 went from \$4.5 billion in the first quarter to a loss of \$2.3 billion issued during the second quarter down to a loss of \$5.2 billion at the end of the third quarter. The revised numbers for 2008 indicated a loss of \$16 billion for the worldwide industry.

This is not incriminating evidence of the weakness of Iata's forecasting prowess but rather an indication of how realities have changed dramatically in a fairly short time.

Now things are different. Iata forecasts for 2013 net profits issued during the first three quarters show a very stable and boring set of numbers – with profits at \$10.6 billion, \$12.7 billion and \$11.7 billion, respectively.

Although forecasts are more stable, they indicate a fairly slow growth. The Bric (Brazil, Russia, India and China) countries show significant slow downs in expected growth rates: Brazil's economy, which grew by 7.5% in 2010, has expected growth of 2% in 2013; Russia goes from 4% to 2.2%, India from 9.7% to 5.5% and China from 10.4% to 7.5%. The US economy has slowed from 2.4% to 1.6%, and the world economy, which grew at 4% in 2010, is expected to grow by only 2.1% in 2013.

Some of the reasons for the slow down of economies are related to political phenomena influencing economic realities.

Let us take China as an example. Bo Xilai, who was expected to join the standing committee of the Communist Party's Politburo (the top seven officials in a country of 1.3 billion people) instead ended up sentenced to a life term in jail. Even more unusual is Zhou Yongkang, a retiring member of the standing committee and former head of security, who may be tried in court. Such a trial would upset the existing status quo in China where former high executives are invulnerable, especially in light of Zhou's close ties to a previous leader of China, Jiang Zemin.

How are the political developments influencing the Chinese economy? Chinese composition of its gross domestic product (GDP) is

very different from that of other countries.

Investments are the largest component of the economy, while private consumption is relatively modest. Investment accounts for 48.8% of national GDP, while the comparable number in western Europe, the US and Japan is about 20%. Private consumption is only 36.3% of the total economy, while the proportions in western Europe, the US and Japan range from 57.5% in Germany to 68.6% in the US.

Most economists recommend that China should expand consumption and reduce the relative share of investments. Exports, which account for about one-third of the economy, have been a problem recently because of the slow down in Europe and the US, which are major consumers of Chinese goods. But, importantly, new political uncertainties tighten political oversight of consumption, with executives being warned not to buy expensive dinners and no longer accept free flights, directly affecting traffic.

Both the slow down in exports and politically mandated consumption restrictions on luxury spending (aviation is in that category) are the reasons for a significant slow down of the Chinese economy.

The situation in the Middle East is even worse. The glimmer of hope that existed a short time ago has been replaced with a total catastrophe. We have gone from the Arab Spring to a Nuclear Winter, where it will take a long time before meaningful reforms and progress can happen.

So what are the most likely risks to the aviation markets? Oil remains one area of concern because uncertainties in the Middle East will continue causing high oil prices for the next few years. Political conflicts will inhibit travel in afflicted areas. The economies may continue at a low growth trajectory for some time.

The aircraft market still faces a bubble environment: so far this year Airbus and Boeing have recorded an extra 1,700-plus net orders, while their production schedule for the whole year calls for about 1,250 deliveries.

The situation in the US is still quite fluid, and were I not living there I would find it humorous: Congress voted on the repeal of an existing law more than 40 times while complaining that government is evil because it does nothing. The trouble is that this can lead to much lower GDP, loss of a decent credit rating for the US government and many other problems. ▲