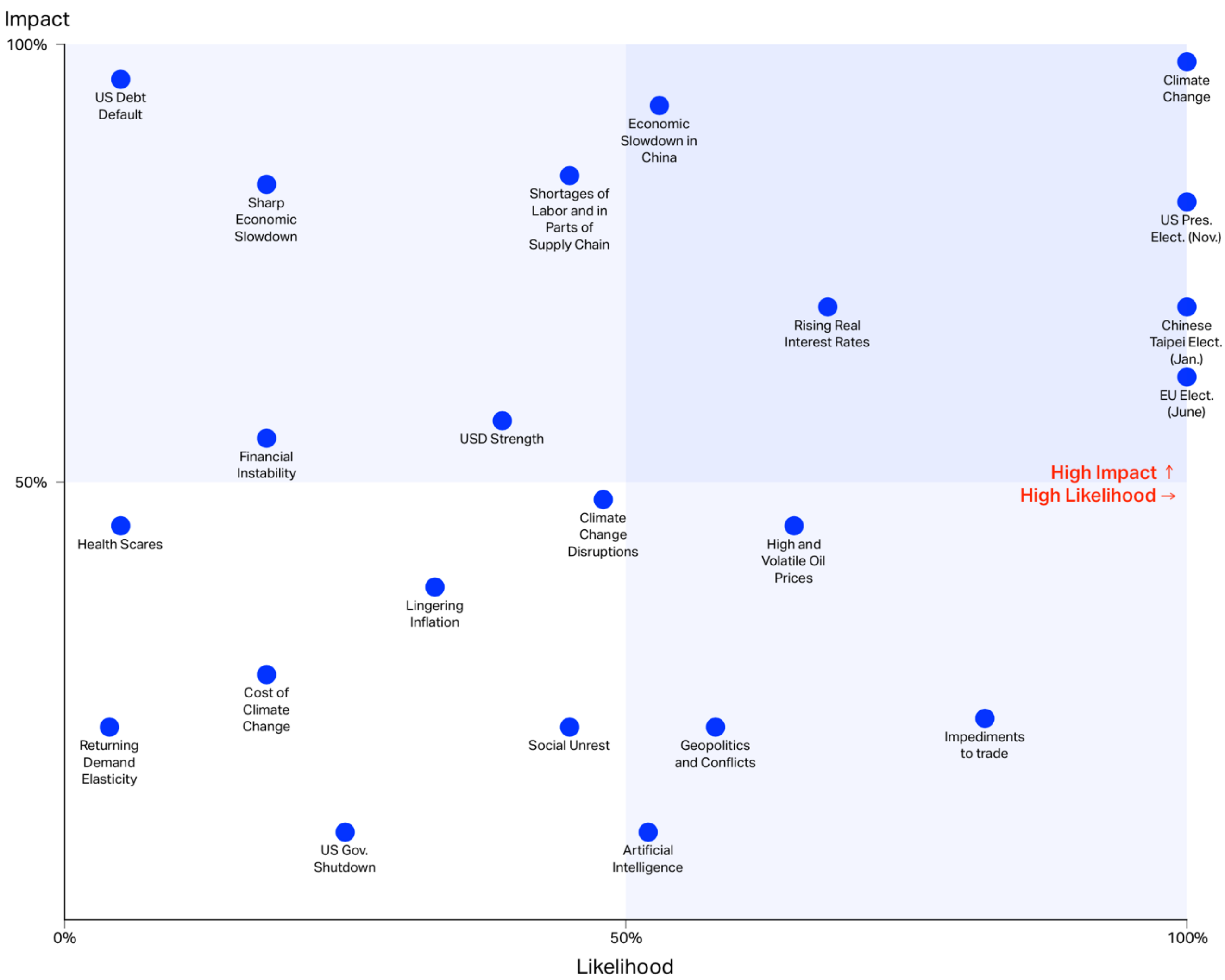
Heightened Policy Uncertainty

Key risks facing the global economy and the air transport industry in 2024

As 2024 kicks off, we look at key risks to the global economy and to air transportation in this qualitative assessment of likelihood of occurrences and potential impacts of a selection of events (Chart 1). The overarching assessment is one of heightened policy uncertainty in a historic election year and against a backdrop of armed conflict and systemic challenges.

Chart 1. Key risks in 2024



Source: IATA Sustainability and Economics

Climate change

The major risk facing the global economy and our industry is climate change. Climate change is a wholly systemic phenomenon that will touch all human endeavors and this over many decades to come. The fundamental challenge of weening the global economy off its dependency on fossil fuels is unprecedented. The relative positive in this regard is that replacement energies do exist, though not even remotely near the required scale. Any replacement of air transportation does not exist – no other mode of transportation can go as far and as fast. This makes air transportation a necessary and indispensable part of the global economic system and safeguarding its access to sustainable fuels should be a global priority in the quest for improved economic outcomes for all, people and planet.

In the near term, climate impacts are already severe. Rising temperatures are causing premature deaths and curtailing labor productivity, weighing on global GDP growth. Coupled with floods and other natural disasters, climate change is threatening food security and forcing millions of persons to migrate. This, in turn, risks provoking social unrest and adds to already fraught geopolitics, all of which lower our collective capacity to collaborate effectively and address climate change holistically.

Operational disruptions from climate change can also be systemic in our industry when large hubs are affected by weather events. The costs of disrupted traffic as well as those pertaining to the energy transition are significant and will likely increase gradually as more sustainable aviation fuel comes to market, and as CORSIA decarbonization obligations need to be met.

The upside to climate change is the scope to develop new energy industries in many countries. Not only will this create jobs and boost GDP growth, but it will also foster an entirely new form of energy independence and transform the global energy space over time. Energy supply will grow more varied, with production becoming more regional and local, as opposed to the current dominance of a single energy source and the geographic concentration of its supply. This will have far-reaching and transformational effects on all aspects of the global economy. If successful, vastly expanded access to cheap and sustainable energy could propel an entirely new era of economic development, arguably surpassing the economic gains produced by the fossil-fuel economy.

Elections and geopolitics

2024 will be a historic year in politics, with more than 70 national elections due to take place in countries that are home to around 4.2 billion people, thus involving a majority of the world's population for the first time ever[1], together representing around 60% of global GDP. Not to diminish the importance of the many elections in Latin America, Africa, and elsewhere, the votes that will be of outsized importance include those in the US, Russia, India, Pakistan, Iran, Chinese Taipei, as well as the European Union. There is a high risk of election surprises, and the outcomes may well add to an already fraught geopolitical environment, amid a general trend of increasingly less free elections.

The first key date is the 13 January presidential election in Chinese Taipei, and the outcome is likely to determine China's geopolitical stance for the foreseeable future. In the European Union, elections will take place on 6 / 9 June. The composition of the European Parliament will likely change, as will several EU Commissioners; and there is the possibility of a new Commission President. There will also be a new President of the European Council. The anticipated evolution is for gains on the right, at the expense mostly of the center, and this can be expected to alter the EU agenda in meaningful ways.

[1] https://www.economistgroup.com/group-news/the-economist/2024-will-put-a-spotlight-on-the-global-state-of-democracy-as-more-people

The US elections on 5 November are difficult to predict given the legal risks faced by the presumptive Republican candidate Donald Trump. Were he to become the 47th President of the US, the repercussions on the global political and economic landscape could be profound. The current wars in Europe and the Middle East could expand and insecurity in Asia would likely rise. Impediments to trade, already increasing, could multiply, and oil-price volatility would in all probability be exacerbated. The price of brent crude oil was boosted into the 2023 year-end and will continue to be impacted by restricted traffic through the Suez Canal and the Bab-al-Mandeb Straight in the Red Sea. Moreover, traffic through the Panama Canal is curtailed because of drought. Some 12% of world trade goes through the Suez Canal, representing 30% of global container traffic. Coupled with the 5% of global trade that is transported through the Panama Canal, nearly one fifth of global supply chains is disrupted and might contribute to keeping both energy and goods prices elevated.

US debt default

Should the US default on its debt, it would likely provoke a major financial crisis with devastating consequences for the global business cycle. However, the debt limit was suspended by President Joe Biden until 1 January 2025, and the Treasury Department will have an additional few months' worth of "extraordinary measures" that can be used to pay the bills. Hence, the risk in 2024 is more that of a potential government shutdown than of a debt default. Nevertheless, the deadline for a new agreement on the debt ceiling is perilously close to the November 2024 US election, the result of which will have important implications for the county's debt service and issuance capacity.

To be able to function, the government needs both the authority to spend, as well as the capacity to issue new debt. The debt ceiling controls the Treasury's ability to borrow to finance the spending decisions already authorized by Congress. However, Congress routinely struggles to pass the bills which authorize spending and have managed to do so on time on only four occasions: fiscal 1977 (the first full fiscal year under the current system), 1989, 1995 and 1997[2]. To buy extra time, Congress passes short-term (continuing) resolutions to allow the government to keep operating. The current continuing resolution funds some agencies to 19 January 2024, and others to 2 February 2024. If lawmakers cannot agree on appropriation bills once these expire, there may be a government shutdown. The US government has shut down five times since 1995. In addition to the disruption that not having a functioning government inflicts upon all activities of households and businesses, government shutdowns tend to reduce GDP growth for their duration, with mostly offsetting gains in activity over the subsequent months or quarters.

The global business cycle

Expectations of a recession in the US and of a sharper downturn in the global economy have been rife since the US first lifted its policy interest rate in the current cycle in March 2022. The US economy has been remarkably resilient in the face of the subsequent 10 rate hikes totaling 500 basis points, and the global economy has continued to evolve at its long-term average pace of GDP growth in the vicinity of 3%.

Many pundits are now betting on multiple rate cuts in 2024, and these expectations might turn out to be as exaggerated as those pertaining to a recession have proven to be. It is noteworthy though that the Federal Reserve itself hinted to a decline in the policy rate in 2024 at its December 2023 meeting. However, the same projections see inflation reaching the 2% target only in 2026. Moreover, the unemployment rate is thought to increase most marginally to 4.1% over the years 2024-2026, from 3.8% in 2023. This strongly suggests a

[2] https://www.pewresearch.org/short-reads/2023/09/13/congress-has-long-struggled-to-pass-spending-bills-on-time/

continued need for a restrictive monetary policy, limiting the likelihood of any significant rate cuts going forward. Meanwhile, further monetary policy tightening is of course delivered through the shrinking of the Fed's balance sheet and through the strength of the US dollar versus the currencies of most trading partners. The Fed has reduced the assets on its balance sheet ("quantitative tightening", as opposed to quantitative easing when the Fed accumulates assets) by nearly USD 1 trillion since 2022, and the US dollar has appreciated by over 13% in trade-weighted and inflation-adjusted terms since January 2021. The mix of these policy tools could allow for limited policy rate cuts while leaving the policy stance on the tight side. The sum of these impacts will reduce credit availability, keep the cost of credit elevated, and add to energy bills settled in US dollars, as it will add to the amounts of local currency needed to service debts denominated in US dollars.

As long as the world economy evolves at or close to full employment, it is difficult to anticipate any major economic downturn. The "recession proofing" that this provides comes at the price of lingering inflation. Nevertheless, the net effect is positive at the current junction and arguably puts a floor under the global business cycle. Evolving along a rather different trajectory is the Chinese economy, where unemployment is on the up and prices actually fell by 0.2% year-on-year in October 2023. China could undershoot its 5% GDP growth target if the crisis in the property sector were to lead to broader financial turmoil as banks are impacted by failing property developers. Households too are hurt by the non-delivery of properties paid for up front. China contributes most of the world's GDP growth today as the advanced economies lack fizz, and therefore holds the key to sustaining global growth at around 3%.

Any marked increase in unemployment would likely boost the price elasticity of demand in air transportation. In the wake of the Covid pandemic, demand for air transportation has appeared rather insensitive to increases in ticket prices. It must be stressed though that ticket prices have mostly evolved in line with consumer price inflation since 2019, and demand has thus not yet been meaningfully tested on that score.

Further threats to the global business cycle could come in the form of health scares. While pandemics are difficult to predict, it is a fact that poor health caps GDP growth globally each and every year. As fiscal spending is reallocated to the military, areas such as health and education run the risk of attracting less funding, reducing the long-term economic growth potential. Maybe artificial intelligence can aid with prevention and preparedness, and bring about gains in productivity in general which can counteract some of the labor-related drag on growth. Artificial intelligence also poses its own risks to labor markets as certain categories of jobs are likely to be heavily impacted and transformed. These forces are already at play though their immediate impact might be hard to discern in 2024.

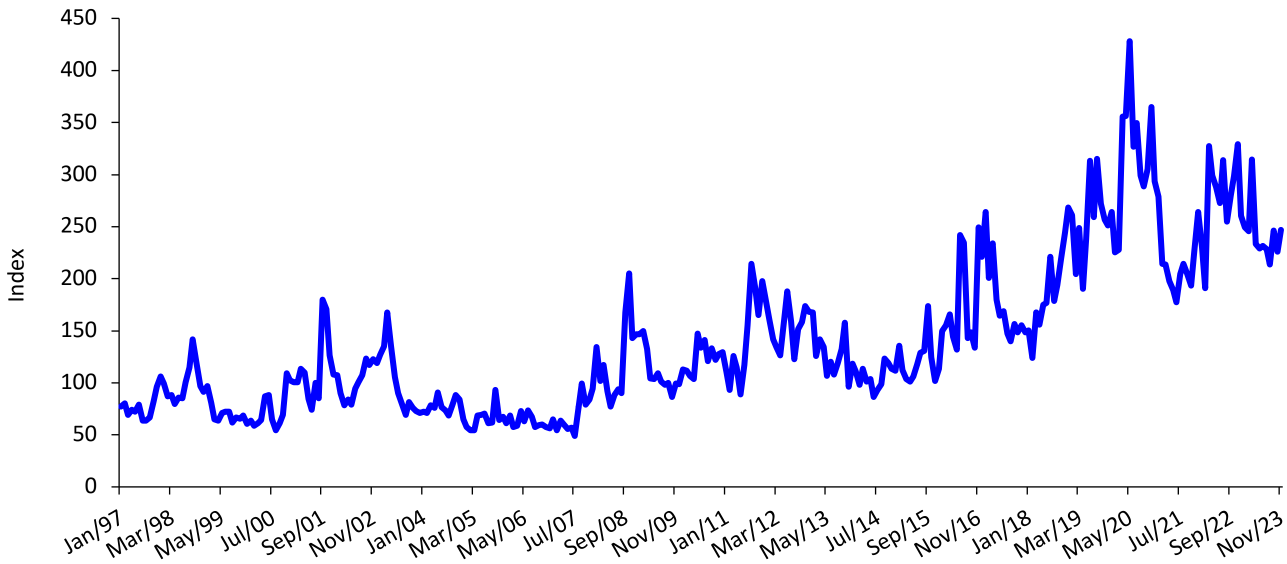
After a spike in financial stress in the US and Switzerland in March 2023, it would be wrong to assume that all is now well. Global debt has hit record highs, and the IMF reports as of November 2023, that 10 countries in the world are in a state of debt distress, with an additional 26 countries facing moderate risk, and 7 countries at low risk of debt distress, totaling 43 vulnerable countries. An associated impact on the airline industry is the amount of blocked funds that airlines are prevented from repatriating in hard currency from countries facing a shortfall of such reserves. IATA estimated global blocked funds at USD 2.3 billion in June 2023, and the number is rising. Weak banks with low capital adequacy ratios, many of which are found in emerging economies and notably in China, might be too small to represent systemic risks but still be able to destabilize financial markets if depositors lose confidence and seek to withdraw their funds. Banks might have mostly absorbed the mark-to-market hit to their bond portfolios in 2023, but loan quality could be on the wane. If this does not spell a high risk of a global financial crisis, it certainly suggests slower credit expansion and at a higher price – capping GDP growth and the financial performance of our industry.

Policy uncertainty

2023 was a local sweet spot for the airline industry - a year when traffic was nearly restored to 2019 levels and financial performance returned to profitability after the seminal loss of close to USD 140 billion that was recorded in 2020. Such a stellar rate of improvement in traffic and profitability would be hard to replicate even under the best of circumstances. 2024 looks set to fall short of such fortunate circumstances and will instead be marked by an exceptionally elevated level of political risk coupled with intensifying military conflicts. We see a significantly more challenging environment in 2024 than in 2023 and believe that the balance of risks is negative. While we expect continued growth in air transportation and in the profitability of our industry, this growth will be at a much slower pace than in 2023. Positive surprises do of course occur, and these could notably come in the form of a rebound in the Chinese economy, and sudden peace in conflict areas.

For some perspective, we note that the Global Economic Policy Uncertainty Index (Chart 2), seems to corroborate the relative détente in stress seen in 2023.

Chart 2: Global Economic Policy Uncertainty Index



Source: Federal Reserve Bank of St Louis, Macrobond

Apart from the banking-related spike seen in March 2023, uncertainty has been on the wane and recorded an index value of 246 in November 2023. Even so, the level remains high compared to the 40-200 range within which it mostly held until 2016 – the year when the UK voted to leave the EU and the US elected Donald Trump as president. We would expect to see renewed spikes in this index later in 2024, potentially around the January elections in Chinese Taipei, the June elections to the European Union bodies, and around the US elections in November, the outcome of which will have far-reaching consequences for the world.