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STUDY ON GLOBAL IMBALANCES AND TOURISM GROWTH

Note by the Secretary-General

In accordance with decision 3(XXXVIII), the Secretary-General presents to the Council a study on global imbalances and their influence on tourism growth, which should make it possible to propose to the Members the necessary actions in the event of a severe and prolonged economic and financial crisis.

Global Economic Imbalances and Tourism Growth: How can world tourism face the new risks and uncertainties?

Report to the Secretary General of the World Tourism Organisation UNWTO

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Executive Summary

1 Background: brakes on the global economic growth machine

The current year sees the world economy slowing down, after having experienced one of the longest periods of sustained strong growth. The ongoing globalization process has showed its downside, in unexpected ways. ***The fact that the world is growing closer together not only makes it richer, but at the same time creates problems of a global nature which are interconnected.*** The strong price increases in the markets for oil, food and commodities and the turbulences on the financial market had an impact on the world economy as a whole. They contribute to global imbalances which will take time to overcome.

The present report aims at analyzing the short impact of the current economic situation in tourism demand and travel behavior.

2 Economic slowdown: understanding global imbalances

Crises happen unexpectedly and demand quick solutions. They also provide an opportunity to learn lessons from misguided developments. Overcoming a crisis can take a shorter or longer time. The outcomes may often be very different: some crises can be mastered in short order, whereas others lead to important structural changes and need long-term solutions.

- **The current economic slowdown has been triggered by the financial crisis which has threatened the international banking system and contributed to an overall reduction of liquidity and tighter credit conditions.**

The financial crisis began one year ago and its full impact is most probably yet to be known. It started locally as the price bubble in the booming real estate market of United States exploded, and has become a global problem of the international banking system. Banks had accepted to give cheap mortgages in the sub-prime segment and taken big risks. They are still suffering from heavy losses as real estate prices fell and borrowers were unable to keep up their repayments.

Since the loans given had been guaranteed by Central Banks, the latter had to put new money into circulation in order to ensure that the banks concerned survived. Using cheap money from the Central Banks, lending banks will need a certain time to give their customers expensive credits and so compensate for their equity losses. As a consequence, banks are expected to allow credit more cautiously and at a higher price in the future.

The present financial crisis has brought to light a series of market imbalances. The self-healing power of the financial market is intact. The crisis demonstrates weaknesses in the governance of the private and public banking system, which was not able to master a cyclical credit boom. The consequences of the financial crisis to the real economy – except in the United States where indebted households lost fortunes and had to reduce consumption – have been relatively limited. But the financial crisis contributed to a downturn in the world economy.

➤ **Oil prices consolidate at a somewhat lower level after peaking in July.**

In only five years, to mid-July 2008, the price for light oil (WTI) increased from US\$ 30 per barrel to US\$ 145. This price increase was stronger than during the last four significant oil crises (1974, 1979 and 1990). Also for the first time since the oil shock of 1979, prices in real terms exceeded previous peaks. In the meantime, the economic slowdown and the consequent drop of the global demand has eased prices to a level at about US\$ 100 (mid of September 2008). In comparison with the earlier oil crises, the present one is ***probably the first that is really global in scope, and the first originated in the fundamentals of the market, i.e. driven by an increase in demand, and not as before derived solely from external factors such as geopolitical turmoil.*** And it is no longer restricted to the industrial countries only.

The question is whether the “fundamentals” of the market have been the only cause of the dramatic price increases, or whether the reason lies also in the financial market, with its speculative trading. The increases can largely be explained by the laws of the real economy: they were driven by the astonishing, ***strongly growing demand from the major emerging countries and the impressive growth of the world economy in 2004-2007.*** Until now, the increasing need has always been covered by present supplies, but there is growing uncertainty about the scale of existing worldwide reserves; additionally, oil production is often inefficient and there are geopolitical tensions in the oil-producing countries. In the long run, demand is likely to continue to increase, oil will become scarcer, and therefore more expensive.

It cannot be denied that speculation makes the oil price more volatile. Since the beginning of the sub-prime mortgage crisis, a great deal of new liquidity has flowed to the forward markets in oil, which are very sensitive to fluctuations. ***Speculative trading with paper oil (futures trading) also contributes its part to higher prices (though in itself future trading makes the market function more efficiently by providing higher liquidity).*** As already seen in the past months, the impact of substitution and crowding out may drive the oil price down, but in the longer term prospects are of a sustained higher price as before. Also, the trends in oil price, economic growth and dollar exchange rate seem strongly interrelated variables.

The world economy is not helpless against oil price increases. ***As long as the economy is growing, the impact of oil shocks can be partly or fully absorbed by higher incomes.*** When enterprises and households have bigger budgets they are able to pay more for fuel and energy.

In highly developed economies, industrial production uses energy more and more efficiently and the share of oil in total production costs diminishes. The situation is at the moment ***more critical for emerging and developing countries*** as they often rely on the production of energy-intensive goods which are outsourced to them by the industrial countries. If they are not net exporters of oil or other raw materials, they lack the resources to compensate for the increasing price of oil. Their balance of payments deteriorates, which leads to macroeconomic imbalances. The cost of high oil is a burden both for households and companies.

➤ **There is enough food for everybody, but no country is fully autonomous in its food production.**

The strong price increases in basic, tradable foodstuffs came as a surprise. This is the consequence of ***the increasing demand for food of good quality in a growing world economy.*** The high prices also have to do ***with the historically weak US dollar and with fluctuations in the prices of food commodities on the future markets.*** Growing economies can absorb price increases if the purchasing power of the population goes up. Elsewhere, in the poorest countries, the high price of basic foods can lead to hunger and starvation, since the share of household budgets devoted to them is often large. In this case, aid by the international community is a must.

Increased food prices can, in the longer term, represent an opportunity for rural areas if present agricultural structures are improved and access to the global markets by developing countries is effectively secured. If the relatively high price level of food remains stable for a few years, the economy of rural areas could be revitalized.

➤ **Soaring commodity prices coupled with financial crisis led to inflationary pressure and a slowdown of economic growth.**

The strong price increases in the field of energy, food and other commodities in general, which overlay the financial crisis, have led to higher inflation and to a slowdown of the economy from the second quarter of 2008 and expected to last into 2009. The increased integration of the world economy makes this slowdown global. The ***weaker demand from the developed countries and the increased transport costs for the export of manufactured goods reduces the growth rates in emerging countries.***

3 Present global imbalances and impacts on tourism growth

➤ Economic slowdown does not change the long term growth trend.

The globalization process has accelerated the growth of demand for international tourism in unexpected ways. The price to be paid for the rapid, massive internationalization of tourism is **a higher volatility of demand, but also a proven strong capacity of resilience and recovery**. Past economic downturns, if not coupled with other disturbing factors such as was the cases of 11 September in 2001 or the Iraq war and SARS in 2003, have so far not halted the growth of international tourism. In times of slower economic growth, as seems to be the case for 2008 and 2009, international tourism has grown slower but steadily. And history also shows that generally once the economic cycle picks up, tourism demand outgrows economic growth.

The liberalization of the world economy makes imbalances more transparent and linkages stronger. **But it is spreading risks all over the world**. Nonetheless, up to the moment, the impact of the present economic shock has been lower in emerging countries, which are growing faster. Economies characterized by higher consumer confidence, especially when there are positive perspectives in terms of employment and income, can absorb external shocks better.

➤ Economic slowdown impacts on purchasing power of potential visitors and may alter their travel behaviour in the short run.

Between 2004 and 2007 international tourist arrivals grew at an extraordinary rate of 7% a year, well above the 4% long-term average, boosted by a buoyant world economy and pent-up demand after the challenges in 2001-2003 (a period in which a global economic downturn coincided with 11S and various other terrorism attacks, the Afghanistan and Iraq wars and the SARS outbreak).

For 2008, a **slowdown of international tourism demand** as a whole is expected, due to the uncertainties posed by the global economy affecting consumer confidence and constraining disposable income. But, overall growth is still anticipated to be at a positive level. The impact will of course vary in degree from region to region. The Middle East, for example, where increased oil revenues are boosting demand and investment in tourism infrastructure will probably face a softer slowdown than Europe where 80% of the traffic originates within the region and many source markets face stronger economic constraints.

Nonetheless, changes in current travel behaviour may emerge. Prices in market economies are independent variables which have a direct impact on demand patterns. Consumers might try to cut down on costs by choosing shorter stays in closer by and/or cheaper destinations.

The most immediate potential changes currently being discussed refer to transport, and in particular, to air transport, which account for half of the world's international tourist arrivals.

➤ **Kerosene price increases accelerate structural change in the airline industry**

The increase of kerosene price which doubled in only one year, and the slowdown of the world economy are a challenge for the airline industry which is strongly related to international tourism. By beginning of September, IATA has revised downward its traffic forecast. Passenger traffic (domestic and international markets combined) is expected to grow on average by 3.2% (previous forecast was at 3.9%). This is half the pace of expansion seen in 2007 and is boosted by the stronger growth seen at the start of the year. For IATA "strong traffic growth allowed the industry to partly absorb the rise in fuel costs from 2003-2007. This is no longer the case". Carriers with scheduled flights have to devote some 30% of their revenue to the cost of fuel; for low-cost carriers, it amounts to almost 50%. The high price of kerosene impacts directly on the profitability of airlines, which are often unable to pass the cost onto the passenger.

Airlines will have to concentrate further on their results, contain costs, and giving up unprofitable destinations. ***The high price of jet fuel may contribute to strengthening the ongoing consolidation process in the airline industry.*** In Western Europe, the merger and acquisition process is expected to continue, while in future the new competition from Middle Eastern and Asian airlines may even lead to a stronger, intercontinental integration of American and European carriers. The situation is also very challenging for the low cost carriers. ***As their variable costs are higher, many companies are forced to cut back flights and give up routes in the coming winter season.*** Some will probably fight for survival, particularly if they cannot reduce costs any further.

Until now, increasingly ***lower fares owing to innovations in jet aviation and to increases in productivity and market competition have been important drivers of international tourism.*** Increasing productivity in the airline industry and a recovery in the incomes of the households may compensate for the consequences of the present oil shock in the medium term. In the short run, airlines, and low cost carriers in particular, face yet bigger challenges. Higher fuel prices and the difficulty of saving substantially in other costs, may lead to changes in the low-cost model, in particular in Europe and in Asia, where this is a more recent phenomenon. The difficulties of low-cost carriers, which may be conducive of a consolidation process among the several existing players, could impact on short-haul trips and hyper-mobile lifestyles. In future, this could also affect the development of the second homes market. At the same time, it should also be considered a parallel scenario where the increase cost of long-haul travel on the short-term may induce a transfer of traffic to closer,

cheaper to access, destinations. In comparison, though, to travel by car the paradox is that travelling by air is often less expensive, in particular in the case of one or two persons. Car traffic is even more impacted by higher fuel prices, so some substitution in favour of air travel might also take place. Higher fuel cost in itself is a strong incentive to invest in modern, more fuel efficient aircraft. However, airlines need to have a sufficient healthy balance sheet to be able to.

➤ **Real estate market is one of the drivers of growth in the accommodation sector but it is often linked to speculative price increases.**

The accommodation, or lodging, sector is one of the core businesses of tourism. Tighter credit conditions and lower financial results from accommodation companies may also put temporary limitations on further investment and property development in the accommodation sector.

The globalization of the industry has enlarged its capacities. In recent years, residential tourism, which is based on the ownership of real estate, has been one of the key driver of tourism development. In the most fashionable areas, the gross value added by the sale of holiday properties amounts to 10% or more of the total gross regional product.

The real estate crisis in the United States had an important impact on the worldwide financial market. It has been largely *homegrown* like the leisure real estate crisis in some Western European tourism countries. The exploding of price bubbles had in all cases to do with easy lending conditions to borrowers, the saturation of product life cycles and the shrinking of the demand after prices fell. Some European countries such the UK, Ireland and Spain face similar problems, though, to a lesser extent.

4 Strategic responses to the current crises in the field of tourism

➤ **Tourism is an essential of modern lifestyles and resists to crises.**

Humanity is more and more mobile. The travel and tourism intensity increases when countries get richer and life takes place in urban areas. The higher the level of development the more tourism becomes an essential feature of modern societies. Crises may reduce for a shorter term the number of trips, the length of stay and the amount of expenditure. They do in general not dampen the overall flows of visitors. The capacity of absorption of shock impacts has strengthened in the last years since world tourism has become more resistant to crises.

➤ **Different impacts for internationalized tourism industry and for destinations.**

The current economic crisis has again proved that ***world tourism growth is closely interrelated with economic conditions*** and as tourism demand today is strongly internationalized, the situation of the world economy impacts more and more directly on tourism.

The consequences of the actual economic situation are different for the tourism industry, such as tour operators or airlines, than for destinations, with their fragmented structure of small and medium enterprises. ***The international companies with a global presence suffer from the global crises, but their geographically diversified business strategies also gives a higher degree of flexibility to manage them.*** Destinations, which also have a supply and demand structure that is also diversified, can resist crises better in spite of depending naturally on the framework conditions and the risks of their source markets and segments.

➤ **Emerging destinations to cater better for the slowdown.**

The current economic difficulties have an impact for all tourism destinations in the different countries. ***Emerging destinations***, many of which have been motors of recent strong economic growth, are also suffering from the slowdown of their economies and their tourism demand. But, despite the overall slowdown in international arrivals, their growth rates are still expected to be above world average.

The ***developed countries*** still have a share of about some 60% of the tourism world market. Tourism exchange takes place particularly between these countries with similar consumer preferences and products. Since most of the visitors come from developed economies with current economic problems, the slowdown in the field of international tourism is expected to be stronger than the one of the emerging countries.

Developing countries which export commodities for increasing prices are also able to continue developing their tourism facilities. ***The poorest countries***, however, which are not exporters of commodities such as oil and food, may be the more affected by the current situation.

➤ **Increasing energy efficiency for improved competitiveness.**

International tourism needs sufficient fuel and fuel oil at affordable prices. Destinations all over the world have an interest in being accessible at affordable cost to international business and leisure visitors through a developed transport infrastructure both over land and by air. The dependence on oil obliges enterprises, destinations and tourism countries to work towards using energy efficiently and reducing the consumption of non-renewable forms of energy in order to be more competitive.

Recent developments on the oil market show ***that reducing consumption is a way of maintaining fuel and fuel oil prices at an affordable level.*** Drops in the consumption of oil products can moderate prices. A more efficient use of fossil energy can increase productivity and in the longer term bring tourism-related firms higher profits. In the longer run, a persisting high price of oil may contribute to encourage the search and investment in alternatives which offer a more efficient use of energy, and will accelerate the introduction of renewable sources. Various countries also (re)consider nuclear energy.

Simultaneously, energy efficiency and moderating consumption can help to reduce the emission of greenhouse gases. ***Protecting the climate is a task with a long horizon but which demands measures to offset it now.*** An example here is the investment in advanced rail infrastructure currently undertaken in several countries.

➤ **Higher food prices could make rural areas richer if they adapt their structures to the needs of the market.**

The food crisis does not have a major direct impact on the demand for tourism. The higher catering costs can be absorbed by the market. ***Since the price of basic foods is expected to stay at a higher level for the next decade, farmers and rural areas can get wealthier.***

The prerequisite for this is a form of agriculture which is appropriately structured and efficient, able to attract necessary investment and apply appropriate technology, and with adequate access to markets, not only for the local markets but also for the urban areas nearby and for international markets.

Rural areas are often resources for tourism which can be made productive by investments in the necessary facilities. Agriculture and tourism are both territory-bound economic activities, and can help to fight poverty in rural areas.

5 Repercussions for the national and intergovernmental policy agenda

➤ **The self-healing capacity of the market forces helps to overcome economic crises.**

External shocks reflect imbalances in the growing world economy. They reveal structural problems and weaknesses which must be solved in the longer run. The self-healing forces of the market will accelerate structural changes of the world economy and world tourism.

➤ **World tourism needs favourable framework conditions for steady growth**

The current economic problems are not restricted to the territory of any one State. They are of a global nature, and must be approached by the international community. In the field of tourism, UNWTO, as a specialized organization of the UN system, has a significant advantage, through being linked with the other organizations which influence framework conditions which are relevant to tourism.

The instruments of the organization can contribute to strengthening the self-healing power of tourism-related industries and destinations, and to enhancing resistance to future crises.

➤ **The tourism policy agenda**

The following strategies should be taken into account for the future agenda setting by both countries and UNWTO as an intergovernmental body committed to the United Nations Millennium Development Goals, geared toward reducing poverty and fostering sustainable development:

- **Market intelligence and monitoring**: better understanding of the relationship between economic cycles and tourism demand and a closer follow-up of market conditions and behaviour, with a special focus on products and segments, source markets and transport;

- **Sustainable tourism development and climate change**: enhancing energy-efficient and productivity-oriented growth; reduce waste and pollution in the field of non-renewable fossil energy;

- **Poverty alleviation**: support for less developed countries to increase their competitive situation and be better prepared for economic downturns; contributing to the revival of rural areas.