Transport Policy 43 (2015) 61–75

Contents lists available at ScienceDirect

Transport Policy

journal homepage: www.elsevier.com/locate/tranpol

Dominant carrier performance and international liberalization – The case of Northeast Asia

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ARTICLE INFO

Available online 29 May 2015

Keywords:
Air transport liberalization
Dominant airlines
North East Asia
Airline competition

ABSTRACT

This study investigates the links between domestic market regulation, dominant airline performance, and international market liberalization in Northeast Asia (NEA). The study focuses on China, where substantial regulations are still present in the aviation market, particularly in areas such as route entry, airport slot allocation, input supply, and aviation support services. These regulations limit the ability of entrant airlines to compete in hub airports, and allow dominant airlines to strengthen their market power and achieve substantial growth at the expense of their competitors. Current Chinese regulations assist major state-owned carriers by suppressing domestic competition, particularly in markets linked to hub airports. If national policy in China continues to be guided by requirements created to support the dominant airlines, in the short term there will be limited liberalization on routes linked with hub airports. Promoting LCC services in the region is one practical alternative for the short term which could prevent major disruption to network carriers. This investigation suggests that Chinese airlines would be less resistant to bilateral liberalization with ASEAN, Oceanian or European nations than they would with other regions, as they are well positioned in these markets, and may be able to develop their hub airports into Asia's gateways to Europe. In the long term, however, there is no substitute for full liberalization if NEA governments want their nations to fully benefit from enabling their carriers and hub airports to achieve global competitiveness.

1. Introduction

Numerous studies of the aviation industry have confirmed that significant benefits can result from liberalizing the international market. Fu and Oum (2014), after a comprehensive review of the literature, concluded that there is strong evidence that liberalization brings substantial economic benefits to the countries involved. Liberalization has led to increased airline competition, lower average fares, increased frequency, improved load factor and airline productivity, increased traffic volumes, and new route services. These changes have not only resulted in higher employment and economic output in the aviation industry, but have also led to improvements in related sectors such as tourism, trade, and logistics. Despite these obvious benefits, many governments have been cautious towards embracing full liberalization. In 2003, 57 liberalization agreements out of a total of 87 involved the U.S. As of October 2012, over 400 liberalized agreements were reached among 145 economies, of which more than 100 were U.S. open-skies agreements (International Civil Aviation Organization (ICAO), 2013). Hooper (2014) noted that liberalization has gained a certain degree of momentum, but many countries are yet to eliminate restrictive regulations due to the concern about fair competition, and the fear that foreign airlines may dominate liberalized markets.

Though slow, limited progress in aviation liberalization has been achieved in the Northeast Asian (NEA) region. These achievements have led to substantial growth in air traffic and service frequency for liberalized markets. In 2006, an open skies agreement was signed between Korea and the Chinese province of Shandong. In 2007, Korea and Japan signed their bilateral open-skies agreement, with the exclusion of Japanese metropolitan markets involving Tokyo's Narita and Haneda airports, which have capacity constraints. An agreement to liberalize services between Tokyo's Narita International Airport and Incheon International Airport was subsequently reached in 2010, thanks to the airport capacity expansion projects in the Tokyo area. Considering the potential of this region, which comprises the world's second, third,

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http://dx.doi.org/10.1016/j.tranpol.2015.05.010
0967-070X/

and fifteenth largest economies (i.e. China, Japan, and Korea[1]), with a combined population totaling over 1.5 billion, the NEA international aviation market could have grown much faster had there been more liberalized bilateral air service agreements (ASAs). Therefore, it is valuable to investigate why governments in this region have not achieved more, and whether a clear roadmap can be designed to accelerate the process of liberalization in the coming years.

Despite an increasing body of literature on air transport liberalization in recent years, there has been little examination of performance changes resulting from the liberalization process with dominant airlines, nor has there been an examination of the ways in which the competitiveness of a country's aviation sector influences government policy on international transport. Dominant airlines often exert significant influences throughout the liberalization process. In fact, many governments have a history of supporting their "flag carriers". For example, many European flag carriers involve state ownership, and governments have repeatedly helped their failing carriers (e.g. Sabena, Air France, Iberia, Alitalia). However, over time a number of airlines have been privatized, and under the EU requirement of "market economy investor principle" EU country governments are no longer allowed to provide state aid to their airlines.[2] This is not the case in the NEA region. In China, other than a few niche players such as Spring and Juneyao, most airlines are majority-owned by either the central or local government. The Chinese government now recognizes the "decisive role" played by markets in allocating resources,[3] but there is still no clear separation between its role as airline owner and airline regulator. The influence of dominant airlines in China on aviation policies will not fade away quickly.

Investigating the performance of major airlines, both overall and within the domestic market, helps predict their performance in the international market, and therefore informs the development of international strategies. Thus the attitude of regulators toward alternative liberalization policies can be examined. Many studies have examined the relationship between domestic market structures and export services. There are broadly two streams of literature here: the national-champion theory argues that with suppressed competition in domestic markets, firms can achieve large scale operations which enable them to obtain large market shares and profits in export markets (see Pagoulatos and Sorensen, 1976; Marvel, 1980; Krugman, 1984; Chou, 1986, for example). The second literature stream supports the competition theory, in which stiff competition in the domestic market forces firms to improve and innovate, thus achieving global competitiveness in the export market (see Audretsch and Yamawaki 1988; Porter 1990; Clark et al. 1992; Kim and Marion, 1997; Sakakibara and Porter, 2001, for example). Clougherty and Zhang (2009) examined the airline market, and found that if an airline can improve its domestic performance, it is more likely to successfully compete in overseas markets.

This study aims to investigate the links between domestic market regulation/deregulation, airline performance, and the liberalization of international markets in the NEA region, with a focus on China. As the world's second largest aviation market after the US, the effects of China's liberalization policies on the NEA region, and globally, are significant. Japan and Korea have made major progress in opening their skies to each other and to a few other countries. In comparison, the Chinese government has been more conservative after some initial opening up in 2007, when the bilateral service agreement between China and the US allowed the operation of more flights and designated airlines. Airlines in Korea and Japan have been privatized for some time, but the principle carriers in China are still majority-owned by the state. These close government ties may allow Chinese carriers to exert great influence over national policy. Despite the implementation of certain deregulation policies, there are still legacy regulations in the Chinese domestic market which limit competition. If these internal regulations for the domestic market cannot be phased out, it is unlikely they will be removed from the international market any time soon. An examination of the status of the Chinese domestic market, in particular the performance of major airlines, will contribute to a better understanding of Chinese regulator's aims and priorities. It will also help predict the future policy decisions of regulators. For the reasons mentioned here, this study will focus on the aviation market in China, while those of Korea and Japan will be discussed only if it is necessary to benchmark across the three countries.

The remainder of this paper is organized as follows. Section 3 reviews the development path and current status of aviation markets in the NEA region, including domestic deregulation, international liberalization and the performance of major airlines. Section 4 discusses possible concerns of the Chinese government if a "national champion" philosophy is adopted to help major carriers to achieve large scale and global competitiveness. Section 5 reviews the development status of LCCs in the region, and whether they can promote liberalization in the NEA region without generating substantial market disruptions. The last section summarizes and concludes the study.

2. Domestic market development and status of major airlines

Over the past few years the Chinese aviation sector has experienced tremendous growth as the economy rapidly expanded and major investments were made in transport infrastructure such as airports and air traffic control systems. The number of air passengers grew at an annual rate of 14.9% between 1990 and 2010. However, measuring the performance and competitiveness of Chinese airlines is not straightforward. In 2010, the earnings of Chinese carriers reached RMB35.1 billion (USD5.18 billion), about 60% of the industry's global profits that year. However, China Eastern Airlines, the second largest carrier in the country, received a government capital injection of RMB10 billion (US$1.45bn) in 2009, and over RMB3 billion (US$0.44bn) in 2012, to reduce its exceedingly high debt ratio. The other two largest airlines, China Southern and Air China, also received capital injections in 2012, of RMB2 billion (US$0.29bn) and RMB1 billion (US$0.15bn), respectively. There was no economic recession during this time, nor any major disruptive event such as the SARS outbreak or terrorist attacks. Therefore, though Chinese airlines appear to have grown rapidly in terms of scale, their performance needs to be carefully examined. This section reviews market structure and development paths in performance of the Chinese aviation market. Strategies of Chinese carriers towards liberalization and deregulation can be interpreted and evaluated based on reviews of market performance.

2.1. The development path of Chinese domestic market

Before 1978, the Chinese aviation industry was operated as a quasi-military unit. Commercialization of airlines began in March 1978, when the management/regulatory authority was transferred from the air force to the State Council. It was not until 1987 that airlines were corporatized. At that time six major state-owned

[1] At 2012 current price in US dollars, based on estimates by the United Nations Statistics Division.

[2] These principles however were not strictly followed in EU. For detailed discussions see Lykotrafiti (2008).

[3] Decision made at the third plenary session of the 18th Communist Party of China Central Committee, held in November 2013.