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# International Tourism and Oil

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*Although oil prices rose rapidly in the last years and continued into 2006, a UNWTO study concluded that the impact on tourism was limited. Firstly, when the increase is analyzed in light of previous oil crises in constant US dollars or constant euros, it suggests that oil prices are catching up with inflation, rather than speeding ahead of other price indices. Secondly, the rise in oil prices has had limited impact on tourism prices. In 2004, 2005 and further in 2006, increases in the prices of tourism products and services have not been significant enough to influence consumer behavior. It seems that airlines absorbed the extra burden and did not pass on the full increase in cost to passengers for fear of losing customers in a very competitive market.*

The rise in oil prices, accelerated considerably in 2005, has come in a context of multiple crises and uncertainty, with the wars in Afghanistan and Iraq, the rise of terrorism (e.g. the recent attacks in London and Bali), natural disasters (Hurricane Katrina and the earthquake in Pakistan), and the threat of a bird flu epidemic. In such a context, these risks could accumulate and create an economic and political climate of a nature to jeopardize a number of advances made in world tourism development, and in particular continued growth in international tourism demand. In view of these uncertainties, it is fundamental to assemble the capacity to analyze and diagnostically assess the current impact of rising oil prices on tourism with a view to proposing measures to consolidate the basis for current growth in tourism flows and contend with the consequences of successive oil price increases and the recent proliferation of crises.

The price of oil reached the historic level of US\$ 70.85 per barrel in New York on 30 August 2005 (the average price was only US\$ 13.11 in 1998). In view of this accelerating trend, questions have been raised about the current and future effects of very high oil prices on international tourism and on one of its major components, air transport.

## **Statistical analysis of oil price increases in nominal and real terms**

Every oil shock has two contradictory effects: inflationary (on the supply side by raising business costs, particularly for transport); and deflationary. Tourism is right in the middle of these competing forces. Oil shocks have until now resulted from market tensions between strong demand and political crises in the Middle East, which can momen-

tarily interrupt supplies. The economic consequences of these distortions can be considerable: the first two oil shocks in the 1970s and 1980s led to severe inflation followed by a rapid rise in interest rates and a collapse in growth rates for crude oil importing countries.

The current situation is very different, for two reasons:

- First, the recent rise in demand is not a temporary phenomenon. It mainly reflects economic growth in the emerging countries –starting with China, whose annual growth rate of more than 9 per cent accounts for more than 40 per cent of the increase in world oil production and sales. China has become the world's second largest importer of oil, after the United States. Certain forecasts to the contrary, China's economic growth has not weakened (the IMF's latest growth forecasts have just been raised from 8.5% to 9%) and has been accompanied by strong growth in South-East and South Asia. In the latter region, India has substantially increased its imports of oil products. It is also emblematic of this trend that Indonesia, a major producer, became a net importer of oil in 2005.

- Second, on the supply side, oil supplies from the Middle East have not been interrupted.

On the other hand, instability in Iraq, recurrent tensions in Nigeria, and certain exogenous shocks –such as Hurricanes Katrina and Rita, which damaged production and refining facilities in Louisiana– have fuelled speculation in the markets. As a result, growth in supply could prove chronically inadequate to meet increases in demand –particularly considering the countries that once exported oil and that now have become importers– and the fact that reserve estimates for the world's largest producer and exporter, Saudi Arabia, could be revised downward.

Under these conditions, according to the Centre for Global Energy Study (CGES), the chances of a significant rollback in prices during the next two years are minimal. Additional pressure is expected to come from decisions by oil consuming countries to replenish, and by China to create, strategic reserves. For these reasons, the impact of rising oil prices on international tourism should be analyzed in terms of a scenario of high prices for the near and even medium term. This price increase, however, cannot be fully understood in terms of current dollars or euros alone. When we look at the rise in current prices, we have to distinguish between what amounts to a form of “catch-up” –particularly relative to inflation rates– and increases directly attributable to tensions in the oil markets. To appreciate the effects of rising oil prices on tourism flows, it is therefore useful to compare movements in current dollars and constant or real dollars. It is also important to compare movements in constant dollars with movements in constant euros. Hence, the following sections will cover:

- Oil price movements in current dollars.
- Oil price movements in constant dollars.

- Oil price movements in constant euros.

### **Oil price movements in current dollars**

The price of oil has increased more than six times in six years. The price per barrel barrel., which averaged US\$ 9.40 in December 1998, rose to US\$ 60 in October 2005. These crude prices have well surpassed the record levels of the Gulf War or the second oil shock, when crude prices momentarily pierced the US\$ 30-per-barrel level.

Unlike the other oil shocks, however, this increase in prices has been more gradual, and above all, more lasting:

An analysis of oil price movements in current dollars shows that the rise has extended over a longer period of time than during the two earlier most comparable shocks. In addition, the downward price correction observed following earlier shocks has failed to materialize; just the opposite: prices have held at a new plateau, well above US\$ 50 per barrel.

### **Comparison with earlier oil shocks**

A comparison with earlier oil shocks shows that the latter have thus far done very little to

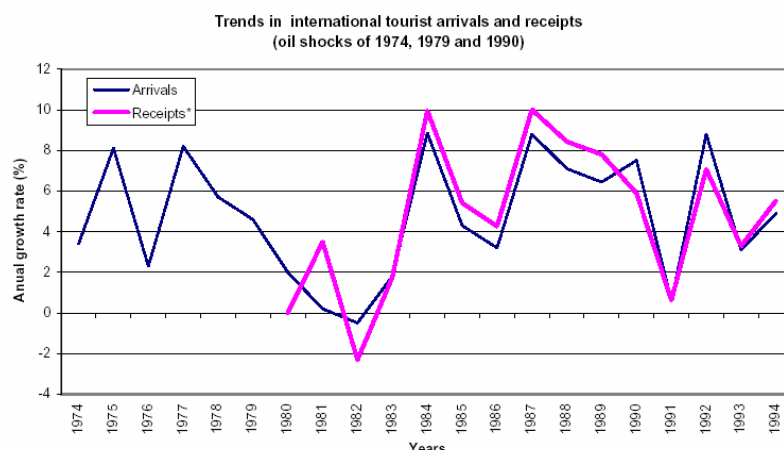
affect continuing growth in world tourism. Where tourism has been affected negatively by the shocks, however, has been in terms of what inflation, high interest rates, and slower economic growth have done to diminish purchasing power.

*Today, the effects of oil shocks on tourism are more indirect than direct.*

World tourism flows are more directly affected by declining economic growth rates in the importing countries, as a result of increased oil prices. Slower economic growth is accompanied by reduced purchasing power, which in turn dampens consumption, including the consumption of tourism products.

That was the case in 1982, when international tourist arrivals stagnated (-0.5%) and receipts declined (-2.3%, local currencies, constant prices). Similarly, when economic growth faltered in 1993, particularly in Europe, growth in world tourist arrivals as well as receipts declined significantly.

Today, in certain "mature" generating countries the consumption of tourism products, relative to income is somehow, incompressible. Consumers prefer to reduce some items of expenditure such as clothing or more durable goods as furniture, rather than forego their planned tourism trips. Consequently, a sharp decline in international tourism demand is very unlikely. However, transfers among countries as well as regions tend to develop.



It is particularly interesting to note that from 1990, the year of the oil shock, to 1993, international tourist arrivals increased by more than 12 per cent. The region benefiting most from this increase was Asia and the Pacific.

### **Analysis of short-term effects 2000-2005**

Unlike the earlier oil shocks, the rise in oil prices from 2000 to 2005 was not abrupt but gradual, coming in stages spread over the entire period. On the other hand, a “ratchet effect” was observed: prices rose in successive stages without ever actually decreasing. Most importantly, all indications suggest that this trend will not be significantly reversed: oil prices should remain high over the medium term because demand in America and Europe is still so great, and demand in countries like China and India, now major consumers as well, is growing so rapidly.

Analyzing the short-term effects, and taking into account the new trends in tourism demand in different regions (particularly to and from the Middle East), we see that international tourism flows do not appear thus far to have been affected by oil price increases. One of the reasons for this unusual situation is the limited impact of higher crude prices on other links in the tourism chain (apart from transport), particularly in terms of hotels and other forms of accommodation, including cruise ships.

Impact from the present increase in oil prices has come in three distinct phases:

*The lasting effects of this new oil shock can be analyzed in terms of the aforementioned three phases –2000-2003 (phase I), 2004 (phase II) and 2005 (phase III)– as follows:*

### Phase I – 2000-2003: moderate rise in oil prices and slowed growth in tourism flows

A number of circumstances distinguished this phase from the earlier oil shocks: Between

2000 and 2003, the increase in oil prices was moderate and highly irregular: from US\$ 25.20 in 2000 to US\$ 28.60 in 2003. During the same period, there was a clear slowdown in international tourist arrivals, with growth of only 1.1 per cent between 2000 and 2003 resulting, in particular, from the economic situation and the consequences of SARS in Asia, the war in Iraq, and the heat wave in Europe during the summer of 2003.

#### Indicators 2000, 2002, 2003

Indicators		2000	2002	2003
<i>OIL:</i>	Price per barrel (US\$)*	25.2	26.7	28.6
	Variation (%)	+3.4%	+5.9%	+7.3%
<i>TOURISM:</i>	Arrivals (millions)**	689.1	708.9	696.6
	Variation (%)	+ 7.4 %	+ 3.0 %	- 1.7 %

Source: \*Price in December: IRAC Refiner Acquisition Cost of Imported Crude Oil, US Energy Information Administration. \*\*International tourist arrivals, World Tourism Organization (UNWTO).

An analysis of trends in international tourist arrivals reveals that:

- The Middle East is the only region where international tourist arrivals have continued to increase rapidly from 2001 to 2003, with an increase of nearly 20 per cent in three years. In 2000, the region's good performance results in part from celebration of the Holy Land Millennium. The positive effect ended with the start of the new *Intifada* in September. The growth since 2001 can be attributed to increasing intraregional flows, which in turn resulted from two factors: an increase in purchasing power for consumers in the region, owing precisely to the rise in oil prices; and the increased difficulty for Middle Eastern residents of traveling long distances, owing to the obstacles (visa requirements, etc.) put in place notably by the United States, which have discouraged travel outside their own region.

- In Europe and Africa, tourist arrivals stagnated from 2001 to 2003, before recovering in 2004.

- The Americas and Asia and the Pacific saw a slight decrease in tourist arrivals from 2001 to 2003, following the drop in economic growth rates in 2001 (only 0.7 per

cent for the OECD countries), followed by strong recovery (with 3 per cent growth) in 2004. Arrivals during this period were also seriously affected by September 11 and the SARS epidemic in 2003.

Thus far, Asia and the Pacific and the Middle East appear to be the main beneficiaries of the evolving international tourism demand.

### Trends in world tourism 2001-2004

#### International arrivals (millions)

Regions	2001	2002	2003	2004
<i>World</i>	688.5	708.9	696.6	766.1
Africa	28.9	29.5	30.7	33.3
Americas	122.2	116.7	113.1	125.8
Asia-Pacific	116.6	126.1	114.2	145.4
Europe	395.8	407.4	408.6	425.6
Middle East	25.0	29.2	30.0	35.9

Source: World Tourism Organization (UNWTO)

**Phase II – 2004: accelerated rise in oil prices and strong recovery of growth in world tourism.** In 2004, the rise in oil prices accelerated significantly, reaching US\$ 34.30 in December 2004. On the other hand, the stagnation in world tourism flows gave way to a brisk recovery, with growth of nearly 11 per cent for 2004.

Indicators		2004
<i>OIL:</i>	Price per barrel (US\$)*	34.32
	Variation 2003/04 (%)	+19.8%
<i>TOURISM:</i>	Arrivals (millions)**	766.1
	Variation (%)	+10%

Source: \*Price in December: IRAC Refiner Acquisition Cost of Imported Crude Oil, US Energy Information Administration. \*\*International tourist arrivals, World Tourism Organization (UNWTO).

From the standpoint of regional trends, Asia and the Pacific, with the SARS episode behind it, experienced strong growth in 2004, with 31 million additional tourist arrivals, accounting for nearly half of worldwide growth that year. The rise in oil prices, therefore, in did not prevent a strong recovery in world tourist flows thanks in particular to strong growth throughout Asia, not only in China.

### **Phase III – 2005: a new and apparently lasting oil shock, increased air fares and uncertainties about future tourism flows**

The earlier oil shocks created inflationary tensions, a rise in interest rates, and a drop in

economic growth rates. This time the situation has been different.

The latest oil shock, marked by accelerating price increases in 2005, comes in a more favourable microeconomic context, which has tended to limit its adverse effects.

• *From the standpoint of inflation*, the spike in oil prices has not created inflationary tensions in the OECD countries, as it did 25 years ago when prices rose in most European countries by more than 10 per cent per year. The first troubling signs of returning inflation, however, have already been observed in the United States, where consumer prices surged by 1.2 per cent in September following hurricane Katrina, contributing to an annual inflation rate (from September 2004 to September 2005) of 4.7 per cent. According to the US Department of Labor, some 90 per cent of this increase is attributable to oil and gas prices, which rose by 54.8 per cent in one year.

These inflationary tensions are particularly acute in a number of emerging countries.

Under these conditions, the current oil shock appears to be affecting economies differently, and especially the old vs. the new industrial countries. The impact on international tourism flows is obvious, notably in Asia, where intra-regional demand is key to growth in tourism flows. And yet, the competitive pressures of globalization do not allow companies to set prices so as to recover all of their increased energy and raw material costs.

### **Historical and projected economic growth rates 2005-2006**

According to the latest IMF estimates, the negative impact of rising oil prices on economic growth should be limited in 2005 to only -0.2 per cent to -0.3 per cent for the European Union and -0.8 per cent to -1.1 per cent for the NIC in Asia, where growth is more dependent on oil. Given these data, which underlie the current economic growth, it is not surprising that the trend in 2005 has been continued growth of roughly 5 per cent in international tourism flows. According to the UNWTO World Tourism Barometer, tourism demand grew during 2005 at an annual rate of 5.9 per cent, on pace –even with the slowdown expected late in the year– to surpass the record level of 800 million international tourists worldwide, almost certainly in 2006.

INDICATORS		2005
<i>OIL:</i>	Price per barrel (US\$)*	56.4
	Variation 2004/05 (%)	+64.2%
<i>TOURISM:</i>	Arrivals (millions)**	800 / 825
	Variation (%)	+5% / +6%

Source: \*Price at 18 November 2005, WIT, New York. \*\*Estimate based on the 5.9 per cent increase recorded for the first half of 2005 (UNWTO World Tourism Barometer, October 2005)

As a result, the consequences of the oil shock of 2005 on tourism have thus far been very

different from those recorded following earlier oil shocks. This time, the world economy has been relatively unaffected by, and has become more independent of, energy price increases, which in real terms have served largely to catch up to the rate of inflation.. From this point of view, the tourism sector should not be adversely affected so long as the world economy continues to grow by more than 4 per cent per year. This does not mean, however, that certain components of the tourism sector, starting with air transport, have not been severely affected already.

### **Evaluation of the impact on air transport**

Transport, and air transport in particular, is currently the link in the chain of tourism products most perceptively affected by rising oil prices. IATA's latest statistics indicate that the impact of rising fuel prices has already been significant in 2005, but the organization's forecasts through 2007 are relatively optimistic.

Although it is not taxed, kerosene has become the airlines' highest operating cost, now accounting for 20 per cent of all direct and indirect operating costs (having generally accounted for 10-12 per cent in the recent past). Under these conditions, the impact of oil

price increases on air transport is highly significant, with four main consequences:

- The establishment of strategies for coverage and the introduction of oil surcharges.
- Further deterioration in the situation of major US airlines.
- Particularly adverse effects in the developing countries.
- Possibly continued fragility in the growth of low-cost airlines.



## Hedging strategies and the introduction of oil surcharges

The major airlines have adopted a two-pronged strategy for contending with oil prices in purchasing kerosene: hedging or forward transactions to provide cover against anticipated

fuel price increases; and wider use of oil surcharges on current air fares according to changes in price. For such European airlines as Air France/KLM and Lufthansa, surcharge coupons have been used in amounts of about US\$ 10 for short-haul carriage and more than US\$ 40 for long-haul carriage.

It should also be noted that airlines receive a significant share of their income in euros, whose exchange rate against the dollar has until now been rather favorable. Tour operators, which through charter companies also act as air transport operators, tend to adjust their package prices to reflect surcharges on the air transport component of their operations.

### *The large US air carriers: from bad to worse*

In early September, at a time when two major airlines, United and US Air, were already in bankruptcy proceedings, Delta and Northwest Airlines also entered into default and sought protection under Chapter 11 (bankruptcy law). The situation is directly attributable to the rise in oil prices. Delta's and Northwest's fuel bills, having ballooned by more than 50 per cent in one year, account for more than 20 per cent of their operating costs, leaving both companies unable to service their debts (US\$ 29 billion in the case of Delta and US\$ 18 billion for Northwest). The impact of rising oil prices has been much greater on American than on European and Asian companies because of their inadequate hedging cover and rigid salary costs, which for Delta account for up to 45 per cent of all costs. These companies had also suffered the full brunt of collapsing domestic and international demand for air transport in the wake of September 11, 2001. In addition to this initial handicap, one of the main immediate consequences of the current oil shock has been to make the major American carriers extremely vulnerable, with potentially major implications for the tourism sector should some of them disappear. It should be recalled that Delta is currently the leading air carrier over the North Atlantic and plays an essential role in tourism flows between Europe and the United States. Delta's difficulties could also have consequences for its partnership in Skyteam with Air France and KLM.

## The impact on independent air carriers in the developing countries

In view of their cost structures, a certain number of airlines in the developing countries are virtually unable to continue operating. In September 2005, for instance, companies like Djibouti Airlines saw their fuel costs rise to more than 40 per cent of their total operating costs, compared with the usual ratio of 12 per cent or 15 per cent. A company as dynamic as Qatar Airways is no longer making profits. Accordingly, any new increase in kerosene prices must automatically be passed on to fares if flights are to re-

main financially viable. The result has been a significant increase in airfares that has directly affected the prices of tourism products, penalizing long-haul carriage while favoring domestic and regional tourism in the developed countries.

One of the short-term risks created with the increase in oil prices is that the frequency of tourist visits to some of the developing countries, and in particular the Least Developed Countries (LDC), will decline as the price increases, making their tourism products less competitive with other destinations geographically closer to the major generating markets.

### **Continued, possibly more fragile growth for low-cost airlines**

It should be noted that most low-cost airlines have decided not to apply the surcharge, even though they suffer the effects of rising fuel prices more than the major airlines, which tend to benefit from forward market transactions. And yet, the growth of low-cost airlines, unlike that of most of the traditional carriers, does not appear to have been affected by the increase in fuel costs. For example, their market share in Spain, one of the major tourism markets for air transport, grew by 33 per cent in one year, with 14 million passengers and 29.2 per cent of the total traffic in 2004. During the same period, regular carriers suffered a decline of -1 per cent. The situation may appear surprising in that fuel represents one of the few costs that low-cost airlines cannot do much about, other than using a new generation of more fuel-efficient aircraft. Indeed, fuel represents a costlier item within their cost structures than those of the regular carriers, which have been unable to reduce their structural, administrative and commercial costs to the extent that the low-cost airlines have. *Thus, many of the smaller low-cost airlines could be significantly affected by increased oil prices, although a small number of them have sufficient capital and market share to resist the current rise in oil prices: Southwest, in the United States; Air Asia, in Asia; Ryanair, in Europe. Ryanair's share capital, for instance, largely exceeds that of Air France/KLM or Lufthansa – with less than one-tenth of their annual sales.*

*An analysis of regional scenarios indicates that rising oil prices have not had a negative impact in certain countries, where surplus purchasing power has permitted strong growth in tourism activity:*

**The Middle East** benefits directly in terms of greatly enhanced purchasing power as a result of increased oil export receipts. A new element in the international tourism panorama is the expansion of intraregional tourism and air transport, especially in the Gulf region. Tourism demand originating in Saudi Arabia, Kuwait, and the Emirates, is for travel to Jordan, Dubai, Sharm-el-Sheikh, Cairo, or Istanbul. With a rise of 7.8 per cent in tourist arrivals during the first seven months of 2006, growth in the United Arab Emirates, and Dubai in particular, exceeded the world average. The figure for Egypt was 13.1 per cent. In addition, the mechanisms for recycling petrodollars have changed, such that more of the additional receipts generated by rising oil prices tend to remain in the region, as leisure-oriented real estate investments (tourism and hotel complex construction projects, such as the artificial islands in Dubai and Qatar).

**Europe** benefits to some extent from growth in domestic and intraregional tourism. The oil surcharge for air transport is already perceptible and tends to favor short-haul travel. Some of the Mediterranean destinations, moreover, are benefiting from new customers with increased purchasing power from Eastern Europe, and in particular the Russian Federation.

This is the case for Turkey, where international tourist arrivals increased at an average annual rate of 23.2 per cent during the first seven months of 2006. Growth is strong in Croatia (7.9%) and Spain (6%), as well. The Eastern European countries have also benefited from continued growth in tourism as a result of EU expansion to 25 member countries and the future membership of Bulgaria and Romania. Mediterranean Europe, and Italy in particular, have suffered from the Euro zone's weak economy and the lifeless tourism generating market in Germany.

**Africa** Many African countries, and particularly the more advanced, oil-importing countries, bear the full brunt of rising oil prices. Thus far, however, growth in the main tourism receiving countries in Africa has remained strong, thanks in particular to cooperative behavior from the euro, given the region's fundamental dependence on West European generating markets. From January to July 2006, the annualized growth rate for international tourist arrivals was 9.9 per cent in Tunisia, 7.2 per cent in South Africa, and 6.2 per cent in Morocco. The chilling effect of the attacks in Djerba and Casablanca appears now to have been forgotten.

**The Americas** and the Caribbean islands in particular, enjoy the benefits of proximity to US and Canadian markets, but their greater distance from European markets has become a handicap, partially offset by a strong euro. The region has been helped by its largest economies (Brazil, Argentina, Venezuela), which are now performing well, having stabilized politically and maintained strong raw material export levels. Accordingly, the region as a whole has thus far not suffered significant detriment from the oil price increases. Growth in international tourist arrivals has been particularly strong in the United States, the region's leading destination, at 7.8 per cent, thanks in particular to a favourable euro/dollar exchange rate, which has partially offset the oil surcharge on trans-Atlantic air travel.

**Asia and the Pacific Pacific**, now the world's second-largest tourism region, has seen continuing growth still well above the world average: 8.7 per cent on average for the first seven months of 2006. The countries of northeast and southeast Asia in particular have been less vulnerable to oil price increases because they have diversified the composition of their international tourist clientele, including regional as well as intercontinental travelers. These destinations could therefore benefit from increased clientele from distant markets (Europe, North America), as well as from regional (NIC, Japan) and domestic markets (particularly in such cases as China, India, Indonesia, and Thailand).

May. The growth rate in Oceania (5.9%) has been considerably lower than in the Asian countries. Given their greater geographic distance from such major generating markets as Japan and the Republic of Korea, the Oceanic countries have borne more of the brunt of rising fuel prices.

***In conclusion***, the analysis of the current and potential impact of rising oil prices on international tourism flows suggests that certain segments of the tourism and transport sectors are suffering more than others. The airlines, cruise lines, and tour operators specialized in long-haul travel are suffering more from repeated oil price increases than business travel domestic tourism, cultural tourism, sports and health activities, short-stay tourism, rural tourism, or some of the cruise lines. The available information indicates that some of the trends observed after the attacks of September 11 and the climate of insecurity that ensued should be accentuated by the impact of current oil shocks on world tourism. This refers in particular to a wide range of technological innovations and new patterns of tourism consumption behavior, designed to "offset" the increased cost of travel and tourist stays.

The following trends in particular should continue if not accelerate:

- *Reduced duration of business travel* and the development of meeting and seminar facilities in airports.
- *Greater use of the Internet* for the organization of personal and business travel.
- *Proliferation of last-minute sales* as well as discounts and promotional fares.
- *An increase in short distance travel* by surface transport for weekend stays, accentuating the fragmentation of annual holidays.
- *Development of trips centred on ecotourism* and discovery of the natural environment (hiking trails, VTT, cycling excursions) as well as pilgrimages on foot (the St. James Way).
- *"Do-it-yourself", independent travel*, with tourists assembling their own travel packages.

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