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Aviation Policy in South East
Asia: Alliances, "Open Skies"
Bilaterals and Regional
Airline Markets

by

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ABSTRACT: The forces for liberalisation of aviation markets are becoming more and more compelling under the relentless pressure of the economics of the industry. The world’s largest airlines are consolidating their relationships within alliances to give them global coverage and the USA has used this as a lever to negotiate open skies air services agreements. In South East Asia, carriers from the USA now enjoy more advantageous rights to carry passengers within the region than the region’s own carriers. Possibly, the response will be for individual nations to negotiate liberal bilateral agreements with each other. However, already there are several initiatives designed to create a competitive, regional airline market. This paper describes these forces and makes observations about the impact they will have on the development of intra-regional airline service. In particular, we raise the question what South East Asia can learn from experiences with single aviation markets elsewhere, particularly Europe. Inter-related questions concern the benefits that can be expected to flow from a single market, whether the regional airline market is a step towards a more liberal, multilateral framework, whether a particular group of economies is optimal for the airlines and whether new members will be permitted to join.

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Introduction

Over the past decade, booming economies within South East Asia and in adjacent regions, especially North East Asia, have provided a foundation for strong growth in airline travel. Despite the potential for expansion, Thai International, Philippines Airlines and Garuda International have faced financial constraints and their competitive positions have weakened. They have lacked sufficient finance to grow and to upgrade their fleets, they have accumulated sub-optimal mixes of equipment, and they have been expected to provide uneconomic services that governments deem necessary. To a large extent, these same problems have beset Malaysian Airlines while Singapore’s has, by necessity, remained focused on its international markets.

Faced with these challenges, government policies in South East Asia that protected flag carriers have given way to privatisation and a more liberal approach to competition. Increasing reliance has been placed on private sector airlines to supplement capacity as competition in domestic airline industries has been liberalised. A step that has followed soon after has been multiple designation in international markets (Hooper, 1997). In the process, aggressive new entrants have been accommodated in dynamic markets. However, aviation policy in Asia continues to be characterised by a close relationship between the flag carrier, dominant business groups and the government (Bowen, 1997). The underlying approach to policy change can best be described as “pragmatic” (Bowen and Leinbach, 1995) and it is not evidence that governments in the region have committed themselves unequivocally to an ideology of free and open airline markets.

Nevertheless, policies continue to be challenged. The expansion of airlines from source or destination markets outside the region is one of the key ones, particularly since these carriers attempt to align themselves with airlines based in the region. Singapore Airlines, for example, has been linked to Delta Air Lines and Swissair in the Global Excellence alliance. United Airlines and Lufthansa have been associated with Thai International, but as Singapore Airlines shifts its allegiance to the Star Alliance involving these two airlines along with Air New Zealand and Ansett Airlines, the role of Singapore as a regional hub has been strengthened at the expense of Bangkok. Governments in South East Asia have to deal with ever more complex alliance arrangements and a concentration in market power. When the alliances involve airlines from the USA, an additional consideration is the pressure that is exerted to enter into an “open skies” bilateral agreement.

These open skies agreements, with generous provisions for fifth freedom traffic, give the airlines from the USA a competitive advantage through their more advantageous access to intra-regional traffic (Findlay *et al.*, 1997). Bilateral agreements between ASEAN economies¹ have tended to remain restrictive on the issue of fifth freedom rights. As a result, it has been difficult for the airlines to use their equipment to maximum advantage within the region let alone to consolidate hub-and-spoke networks. Alliances among airlines are being used to circumvent the regulations, but the focus has been on agreements with carriers based in Europe and North America. The hubs based in ASEAN play their parts within global networks but their capacity to distribute traffic efficiently within the

¹ ASEAN’s current members are Brunei Darussalam, Indonesia, Lao People’s Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

region is limited. At the same time, there have been impediments to the development of new routes providing direct links between contiguous growth areas.

Progress on reform of airline regulation on a multilateral level has proven to be a slow process, but broader initiatives to liberalise trade accelerated the process in Europe and in North America (Button, 1997). Various regional trade agreements in South East Asia have been developed, including the ASEAN Free Trade Area, the Northern Growth Triangle (IMT-GT), the East ASEAN Polygon (BIMP-EAGA), the Southern Growth Triangle (IMS-GT), the Greater Mekong and Golden Quadrangle Growth Areas. The geography of South East Asia, however, places considerable reliance on efficient air and maritime transport to promote regional integration. The need for more flexible aviation arrangements has become clear and this prompted the ASEAN transport ministers to commit themselves to an “open skies” policy. The policy requests member countries to remove many of the current restrictions on market entry to international aviation with their markets and to support free competition between the airlines. Within APEC there is even broader commitment to free trade and an agreement to review ways to achieve a more competitive environment for air services.

The current economic situation in Asia will force the airlines to consolidate their positions for at least the short-term. All of the region’s carriers are facing gloomy economic prospects and it is possible governments will adopt a more protectionist stance. However, the IMF bail-out packages require governments to commit themselves to free trade. The economies of the region have prospered by broadening markets and it is likely that the drive to expand intra-regional trade will remain a strong force. In addition, the major airlines in South East Asia are participating in “global” alliances that demand better systems of feeder services. Also, the USA already has concluded several open skies agreements and it will continue to exert pressure on other countries to follow suit.

There is sufficient momentum behind the formation of alliances and the creation of regional markets that airline competition in South East Asia will become more and more competitive over time. This paper describes these forces and makes observations about the impact they will have on the development of intra-regional airline service. In particular, we raise the question what South East Asia can learn from experiences with single aviation markets elsewhere, particularly Europe. Inter-related questions concern the benefits that can be expected to flow from a single market, whether the regional airline market is a step towards a more liberal, multilateral framework, whether a particular group of economies is optimal for the airlines and whether new members will be permitted to join. Finally, we examine the global forces of alliance formation and open skies agreements with the USA and ask whether regionalism will combine with these forces to create a more competitive international airline sector.

Aviation Policies In Asean

Airline services in South East Asia developed initially as a set of links in a network radiating from European countries to their satellites. This network was strengthened in the two decades following World War II, but it was the introduction of long-haul, wide-bodied jets and the emergence of aggressive airlines in South East Asia that transformed

the market. Singapore and Bangkok, in particular, were located strategically as stopovers and interchange points on the rapidly growing long-haul services between Europe and Australasia (Rimmer, 1996).

The emerging carriers in South East Asia possessed competitive advantage in terms of the location of their home base and their lower input costs and they were able to establish a strong presence in the long haul markets (Findlay, 1985). Furthermore, the rapid economic growth in Asia over the past fifteen years has presented ample scope for these airlines to pursue expansionist strategies. As a result, airline services between ASEAN and North-East Asia have undergone considerable development (Rimmer, 1996). Economic growth and broadening intra-regional markets did have an impact and the network of airline services within South East Asia was beginning to improve. For example, the network in 1979 included Hanoi, Vientiane, Yangon, Bangkok, Kuala Lumpur, Singapore, Jakarta, Manila and Bandar Seri Begawan (Brunei) and 11 other cities. By 1996, Phnom Penh and another 17 non-capital city airports had been added to the network (Bowen, 1997). Most of the new airports were in Malaysia and Indonesia, but all of the South East Asian nations were opening up secondary ports for cross-border traffic.

The key airports in South East Asia now have the potential to be used by the airlines as hubs to consolidate regional traffic from feeder routes. An additional feature at Singapore is the use of these hubs by carriers based in the United States and Australia to transfer on-line passengers between various points in their home continents and countries other than Singapore. These arrangements allowed the carriers to make more efficient use of their wide-bodied aircraft and have permitted increases in frequencies into the hub. Singapore took a lead when it agreed to the UK’s request for break of gauge rights within their air services agreement, increasing the potential for traffic consolidation and feeder services. The strategic placement and use of these hubs have mitigated some of the weakness in the region’s route network development.

The aviation policies adopted by the ASEAN economies have adapted to their changing circumstances. All promoted a single, government-owned flag carrier that was expected to take on unprofitable services to assist in nation-building. This was particularly important for Malaysia to link the Peninsula with East Malaysia and for the Philippines and Indonesia, both archipelagos. Each of the ASEAN carriers faced the challenge of establishing their presence in a market very much under the control of the metropolitan powers generating the bulk of the traffic. During the 1970’s, though, a more liberal environment began to emerge. Competition among the carriers made it progressively more difficult for governments to control fares. Promotional fares proliferated as scheduled airlines learned to cope with floating currency exchange rates and competition from charter airlines (Lyle, 1995). Progressively, there was less attention to pricing regulation in the bilateral agreements and the major objectives for the ASEAN carriers were to gain access to markets and to get approval to increase their capacity. However, the pace of change varied from country to country.

Thailand maintains tight regulatory control over all aspects of international aviation. In its bilateral regulations it has sought “order in the air” through the balancing of economic benefits in the exchange of traffic rights, a careful monitoring of controls over capacity, the multilateral establishment of tariffs through IATA and a general acceptance of airline cooperative practices such as pooling. Thailand also is reluctant to deregulate its domestic

market because its minor domestic airlines are not strong enough to withstand open competition. However, Thailand recently ended its policy of designating only one international carrier and Thai International is being privatised to enhance its capacity to manage more commercially and efficiently.

In contrast, Singapore has pursued expansion of its international air transport links with a very open approach to setting capacity. Singapore has signed numerous bilateral air agreements that do not require reciprocal capacity entitlements for Singapore Airlines. Wherever possible, Singapore exchanges rights based on opportunities rather than on absolute reciprocity in traffic or operational terms. Nevertheless, Singapore has had to be ready to reach a compromise and in many of its agreements it has accepted some restrictions on route access, traffic rights, capacity and tariffs. When the USA turned its interest in concluding open skies agreements to Asia, Singapore was the first to move. From April 1997, US carriers have been permitted to fly beyond Singapore while Singapore Airlines enjoys similar benefits in the USA. The privatised Singapore Airlines has been free of community service obligations and it is noted for its commercial success.

The Philippines has ended Philippine Airlines’ monopoly in the domestic market and five new carriers have been free to compete on domestic routes. One of these new entrants (two more had applied) was given the second official flag carrier status for regional routes. Indonesia has opened 23 gateways for international tourism and air traffic rights have both Indonesia and the Philippines have liberal air services agreements with Singapore.

Partners in bilateral agreements have been under similar pressures and multiple designation and capacity increases have been negotiable in many situations. However, cross-border links in ASEAN are under-developed as a result of the bilateral system. Bowen (1997) has argued that there is over-servicing of the routes between Malaysia and East Malaysia and under-servicing on routes from Malaysia to adjacent Sumatra and that the “...pace of change is slow and distorted by the inherent biases in the bilateral system” (Bowen, 1997, page 136). We now examine how alliances can alleviate this problem.

Alliances And Airline Services In South East Asia

International airlines have used alliances to circumvent restrictive regulations that prevent them from pursuing network strategies within which a hierarchy between feeder and trunk services would emerge. These alliances are organised around code-sharing, joint frequent flyer programmes and marketing, shared computer reservations systems, joint use of resources, combined purchasing and co-ordinated schedules. Thus far, the airlines based in South East Asia have been more interested in forming alliances with major carriers from the USA and from Europe. This gives credence to the argument that alliance formation among international airlines is an attempt globalise within the regulatory constraints (Gialloreto, 1988; Tretheway, 1991; Doganis, 1994).

According to one line of argument, the major airlines will determine the location of key hub airports and the lesser airlines will be relegated to feeder roles (Shenton, 1995). When United Airlines and Lufthansa formed their alliance in September 1993, United had to choose whether to use London/Heathrow as its mini-hub in Europe, but chose to use its

code-share flights with Lufthansa for intra-European services. Similar effects are emerging as Singapore Airlines is admitted to this alliance. Lufthansa’s link to Thai International is weakening and a consequence is that Lufthansa will concentrate its services to South East Asia through Singapore. As this Star Alliance adds new partners such as Air New Zealand and Ansett International, Singapore’s role as a regional hub is enhanced.

However, there are concerns that the smaller carriers within these alliances will be relegated to the role of feeder airlines. The proposal for British Airways and Qantas Airways to extend their code-share agreement on routes between Australia, Singapore and Europe raised the concerns of Australia’s International Air Services Commission (IASC) for this reason (Findlay *et al.*, 1997). The IASC refused to approve the proposal when it was first raised in 1997 on the grounds that the Australian carrier would play too small a role within the alliance. From Australia’s point of view, the emerging alliance between American Airlines and British Airways ensures Qantas is part of a powerful airline group. However, if this comes at the price of Qantas being relegated over time to being a feeder airline there are important implications for Australia (Bureau of Transport and Communications Economics, 1994).

Policy makers in South East Asia will have to balance their concerns about increasing market power of the major alliances (Burton and Hanlon, 1994), the possibility that the region’s airlines will be relegated to the status of feeder airlines and the benefits of concentrating traffic through hub airports. The USA has the clearest policy regarding these types of alliances – they are acceptable provided they operate within an ‘open skies’ regime and if dominant positions on less competitive routes are weakened. Interest among the world’s airlines to enter into alliances with their counterparts in the USA has given the latter country the leverage to negotiate very liberal air services agreements. Ten European nations have acquiesced (Jennings, 1996; Odell, 1997) and the USA is pursuing a similar approach in Asia (Ballantyne, 1997; Jennings, 1996). The protectionist approach taken by some of the key nations in Asia has discouraged alliances with airlines from within the region, but even Japan has not been able to sustain its opposition to alliances under the pressures of competition from the European and North American airlines.

In April 1997, Singapore entered into an open skies agreement with USA and similar agreements have been concluded between the USA and Brunei, New Zealand and Taipei with discussions in place with Malaysia and South Korea. The Singapore - USA agreement allows for access to all gateways in the USA and beyond, greater flexibility in code-sharing and the freedom to create a wide variety of commercial relationships with US and third party carriers. Key points of the agreement are (Chin, 1997):

- Termination of restrictions on pricing, capacity, type of airlines, and number of flights and routes
- Liberal charters
- Right to fly between any point in the US and any point in the other nation and beyond to third nations
- Open code-sharing
- Prompt conversion and remission of hard currency
- Self-handling provisions for carriers to perform or control airport activities that support their operations
- Non-discriminatory operation and access to computer reservations systems

- Fair competition in commercial activities such as airport charges
- Membership of international conventions on safety and security

The USA is attempting to draw a critical mass of Asian countries into these liberal agreements.

It is realistic to assume that countries in South East Asia will be unable to stand in the way of alliances involving the mega carriers and it will be very difficult to resist the pressure to enter into open skies agreements. This poses difficult questions about how to promote effective competition while positioning regional airlines in such a way that they can exercise influence within the alliance (Oum and Taylor, 1995). At the same time, the open skies agreements that have been negotiated with the USA put the regional carriers at a disadvantage – their access to intra-regional traffic is less favourable than is becoming the case for the US airlines (Findlay *et al.*, 1997). In addition, if the hub airports are to live up to their potential, the South East Asian airlines will have to develop strong regional, feeder services. It is not so much a question of whether a more liberal regime will emerge in Asia as it is a question of timing and form. It is possible that more liberal access to markets and more competitive conditions will be granted on a bilateral basis, but another path is within regional airline markets.

Towards A Competitive, Regional Airline Market Within South East Asia

Although the matter will be raised again by the World Trade Organisation (WTO), air traffic (landing) rights or services directly related to the exercise of traffic rights remain outside the framework of GATS. The principles of bilateralism and reciprocity dominate negotiations concerning international trade in airline services. As a general proposition, though, multilateral initiatives to promote free trade tend to become bogged down in complex sectoral issues. More substantive progress has been achieved in recent years through regional trade agreements. Associations of states agree to reduce barriers to trade within their region in order to allow industry access to larger markets and to reap economies of scale and to improve efficiency. Alternatively, a regional trade agreement can be formed to give the member states greater negotiating power in external markets. The regional trade agreement also can be an agent of change designed to promote regional political co-operation and possible integration.

It is more likely that regional trade agreements will be formed by economies that are located in the same geographic area, but it is helpful if the participating states share a common history and that they have reached similar levels of economic development and have compatible trade policies. Regional integration generally is the result of a combination of market and policy factors, but it can proceed in a variety of ways. For example, the European Union (EU) is an attempt to achieve broad regional integration based around a single market. The North American Free Trade Agreement (NAFTA) has progressed along the lines of a traditional approach to free trade among member countries based on tariff reductions. The EU has been able to set up supranational institutions whereas the NAFTA approach relies upon enforcement by national authorities.

In January 1992, the Association of Southeast Asian Nations (ASEAN) announced its intention to form the ASEAN Free Trade Area (AFTA) by 2008. In September 1994, ASEAN Member Countries agreed to accelerate progress with AFTA by reducing the initial time frame from 15 to 10 years. The primary objective of AFTA is to enhance ASEAN's position as a competitive production-based economic region geared towards servicing the global market. This is to be achieved by expanding trade relations, making it possible to increase specialisation and exploit economies of scale. ASEAN members also participate in Asia Pacific Economic Cooperation (APEC) and share in the commitment to remove trade barriers by 2020.

These regional trading agreements have provided a foundation upon which more liberal airline regulations can be introduced for a group of countries. Since April 1997, for example, there has been a single aviation market in the European Union and airlines from member economies are able to operate anywhere within the region. Canada has signed an open skies air services agreement with the USA, but this is separate from NAFTA (Tretheway, 1997). Argentina, Bolivia, Brazil, Chile and Paraguay recently signed a regional agreement (Mercosur group) and this has been mooted as a step towards a pan-American “civil aviation network governed by a single multilateral regional air transport agreement” (Pereira, 1996). The single aviation market between Australia and New Zealand is another example of a regional approach within the context of a broader trade agreement. ICAO has identified 50 such groupings of states that are, or could become, involved in the regulation of aviation. Clearly the potential exists to form a similar arrangement in Asia particularly to cater for the new airlines.

In 1994, Indonesia, Malaysia and Thailand signed a joint Memorandum of Understanding under which regional flights would be encouraged within the ‘Northern Growth Triangle’. Each of the signatories was free to designate two airlines that would be permitted to operate whatever capacity they wish between secondary airports on a scheduled or charter basis, carrying passengers and/or cargo. In situations where this arrangement was at variance with air services agreements, the latter were to take precedence.

Since then, the Philippines and Brunei have joined and the group is known as BIMP-EAGA (Brunei, Indonesia, Malaysia, Philippines - East Asia Growth Area) and it covers a market with a potential of 250 million air travellers (Ballantyne, 1996). Discussions between Thailand, Myanmar, Vietnam, Cambodia, Laos and Yunnan Province of China have mooted another aviation bloc. The EAGA group has been working together to improve transport links that have been neglected. Indonesia has declared Kalimantan and Sulawesi unrestricted to foreign carriers from other Southeast Asian countries. EAGA governments have agreed to set up a new regional airline, Saega, a joint venture between a Malaysian company and the State governments of Sabah and Sarawak. Saega has been designated as Malaysia's second airline for points in EAGA.

Although Japan has a more protectionist approach to aviation policy, it attempted in 1995 to create an Asian aviation forum to achieve regional cooperation on aviation policies (Ballantyne, 1995). APEC, through its Transport Working Group, also is examining ways to promote a more competitive air services regime. More tangible progress, though, was made in ASEAN in February 1997 when the transport ministers reiterated the importance of the development of a Competitive Air Services Policy as a gradual step towards open skies in ASEAN. The first step is to introduce air services liberalisation within or between

sub-regional groups such as BIMP-EAGA, IMT-GT, IMS-GT. The second step is to develop the ASEAN Open Sky Policy. The final step is to implement the ASEAN Multilateral Agreement on Commercial Rights on Non-Scheduled Services among ASEAN countries.

The intention in AFTA is to accelerate the growth in business and foreign investments, tourism and trade. Deregulation within individual economies is an additional force. ASEAN transport ministers have stated that “The competitive environment in international air transport within ASEAN shall be developed and promoted, with no restrictions in frequency, capacity and aircraft type for point to point access”. However, the proviso was added that this competitive regime must be based on the progressive, orderly and safeguarded change in international air transport regulations on the basis of fair and equal opportunity for all member countries.”

A Regional Aviation Market In South East Asia: Some Issues

Attempts to create a competitive, regional airline market in South East Asia have been motivated by the desire to strengthen ties between economies in the region through an improved network of airline services. Given the experience with aviation in the European Union, it is worth examining what is similar in South East Asia and what can be learned from Europe. For that matter, what can be learned from other attempts to create single aviation markets within Mercosur and Closer Economic Relations (CER) between Australia and New Zealand? Several inter-related questions arise. One is what benefits can be expected to flow from a single market, particularly in terms of new routes and strengthening of feeder services and hubs? Is the regional airline market a step towards a more liberal, multilateral framework? These questions cannot be answered without also considering whether any particular group of economies is optimal for the airlines and whether the defined group remains the optimal set in a dynamic industry. On what terms are new members permitted to join? Finally, to what extent are the global forces of alliance formation and open skies agreements with the USA complementary to the formation of regional markets? Will the two sets of forces combine to create a more competitive international airline sector or will one be set against the other?

Button (1997) has commented on the lessons that Asia can draw from the European experience. He pointed out that the formation of the single aviation market lagged behind trade liberalisation and built upon experiences of deregulated domestic markets. The European Union had developed prior experience in the transport sector through the road transport sector. Europe presents the airlines mostly with short-haul markets that were relatively mature. In some respects South East Asia shares some of these characteristics. Key among these is that liberalisation of aviation competition is dealt with as a part of a much broader programme of trade and cultural integration. However, it is notable that progress on aviation reform was slow in Europe. Despite Europe’s ability to agree on supra-national organisations to manage competition policies, it has been difficult to establish a level playing field in the competitive airline industry. Arguments about state subsidies to airlines, unfair competition, consumer protection, safety and environmental issues continue to arise. The comprehensive framework within the European Union,

though, has allowed it to deal with issues such as a code of conduct for computer reservation systems and to examine the pricing of packaged travel products.

The pace of economic growth has been a major factor motivating liberalisation of airline markets in South East Asia. The recent economic difficulties might ease the pressure on regulatory reform, though it is possible it will give even more reason why airlines should be set free to adjust to prevailing conditions. There are good reasons to believe that the time frame for liberalising airline markets will be shorter in South East Asia. One of the interesting developments to come out of the currency crises of 1997-98 has been that the Asian Development Bank will take on a central role in setting standards for financial management and reporting. This is a long way from the European model that created supra-national regulatory mechanisms, but it is an important step nevertheless.

The formation of a single aviation market in Europe has resulted in the formation of new airlines, the expansion of services on secondary routes, altered relationships among the carriers and increasing competition among hub airports. The charter airline sector has been highly influential in Europe, carrying at least as many passengers as the scheduled airlines. Charter airlines provide strong price competition in leisure markets, but they also have played a key role in the development of new routes. In South East Asia, the charter market is not such a strong force and this could prove to be a constraint on the expansion of cross-border routes between growing sub-regions.

To some extent, South East Asia has more to learn from Latin America's attempts to improve intra-regional services. Through the 1990's, the airlines in Latin America realised that their costs were higher than those incurred by their large US rivals. Government policies prevented the region's airlines from working together within cross-border alliances (Cameron, 1996) At the same time there were few impediments to the Latin American airlines entering into alliances with the USA's carriers. This has allowed some of the region's carriers to improve their financial position, but they have had to play a secondary role. When the Mercosur trade group was formed, though, there was immediate interest in the development of new north-south routes to connect growing sub-regions. Within the group of member countries, a liberal approach appeared conducive to the establishment of new services, but an added attraction is that these would operate free of direct competition from the powerful carriers from the USA. Thorough studies of the Latin American experiment with a regional airline market would be likely to provide valuable insights for policy makers in South East Asia.

There is a distinct possibility that the formation of regional aviation markets could result in greater competition within, but the barriers could rise for airlines from outside the region (Ballantyne, 1996). ICAO has addressed this matter, but there is insufficient experience with trade blocs to make any firm predictions. Protectionist blocs with large internal markets could use their power to the disadvantage of smaller parties. Spurred on by competition from within the bloc, efficient airlines drawing upon a large market could become dominant carriers on inter-bloc routes (Nuutinen, 1992). Indeed, the Director General of the International Air Transport Association was reported to have urged African nations to pursue a strategy of liberalising competition within a bloc to promote efficiency and development, but to use the bloc as a countervailing force to deal with powerful external interests (Vandyk, 1995).

So far, regional integration agreements have proved to be compatible with multilateral free trade. Possibly there has been a “honeymoon effect” within which liberal attitudes are reinforced and as awareness and commitment to international rules governing trade relations grows (Chichilnisky, 1995). However, this could give way to more protectionist approaches as vested interests realise the potential to divert trade and to extract rents. Since free trade agreements emphasise rules of origin, it is likely they will face resistance to open membership rules that would allow them to become a genuine step towards multilateral free trade (Krueger, 1995). Regional trade agreements are more likely to foster global free trade when they are formed in order to reap external economies of scale and to eliminate inefficiency (eg. optimising cross-border airline services). Bowen (1997) argues that the strong links between governments in South East Asia and the airlines and the politicisation of the industry has resulted in powerful vested interests in maintaining the status quo and he has raised the possibility that AFTA will be undermined by exclusions. Furthermore, he regards the consensus approach within ASEAN as an obstacle to progress.

APEC is committed to non-discriminatory liberalisation but there are practical issues to consider such as the problems airlines have in gaining access to congested airports. The terms upon which new members can join the free market are important, but this begs the question whether there is an optimal set of members. It is not difficult to appreciate that an airline market based on ASEAN member countries focuses attention on Singapore and Bangkok as hub airports, but some of the busiest routes in the region are concentrated on Hong Kong (Rimmer, 1996; Bowen, 1997). Airlines plan their services based upon groups of countries that make up natural markets and the networks they have been able to develop. The conflicts that emerged between Australia and Hong Kong during 1996, for example, highlight the problems that can occur. Disputes arose because Qantas Airways was carrying passengers originating in Hong Kong to Bangkok and Singapore. A region defined as ASEAN or some sub-regional grouping might make sense from the point of view of economic and cultural integration, but it might not make good sense from the point of view of the economics of airline operations. The bilateral approach to negotiation of air services agreements constrains the way regulators and airlines consider markets (Findlay and Round, 1994; Alamdari and Morrell, 1997), but regionalisation is likely to encounter similar problems.

Generally, airlines do not derive a cost advantage by extending their networks, but there is an argument these are more important in international market (Findlay *et al.*, 1995). We have pointed out that alliance formation is focused on relationships with carriers from outside the region rather than from within South East Asia. However, the greatest potential to increase traffic exists by encouraging alliance partners to co-ordinate beyond-gateways is to (Park and Cho, 1997). Some of the new entrants in South East Asia have provided feed traffic to their country’s flag carrier with equipment suited to lower density routes. In Europe, though, the major carriers have consolidated their positions by acquiring regional airlines or at least entering into appropriate, vertical alliances. KLM, for example, has a small home market and it has been dependent upon concentrating European traffic through Amsterdam. Its investments in regional carriers have been designed to protect this position. At the same time, British Airways and Lufthansa have expanded their influence across Europe via their relationships with regional carriers.

Singapore Airlines had expressed interest in taking equity in Indonesia's Sempati Airlines, but generally there has been little evidence thus far that the South East Asian carriers will be permitted to invest in each other. The experience in Australia has been that liberal policies, coupled with financial constraints on airlines makes it necessary to have an open attitude to foreign investment. Air New Zealand has become a 50% owner of Ansett Airlines. Singapore Airlines is forging an alliance with both of these carriers and is evaluating an investment in Ansett. Possibly Singapore is responding in the same manner as KLM, but it emphasises again that the optimal market might not be bounded by ASEAN.

Concluding Comments

Regionalism is not a force that acts alone. It has been pointed out that the Latin American airlines see the Mercosur regional airline market as an opportunity to develop markets as they cope with the pressure of competition from the major US carriers under liberal bilateral agreements. In Asia, the USA has concluded several open skies agreements and its carriers now enjoy opportunities to carry intra-regional traffic on more advantageous terms than the airlines based in the region (Findlay *et al.*, 1997). One way to counter this is to enter into liberal bilateral agreements with each other. New Zealand and Singapore already have done this. The formation of regional aviation markets takes this a step further. However, the USA becomes a de facto member of the groups where it has signed its open skies bilaterals with the significant partners. This is a factor that could lead to a more open approach to membership of the regional groups. Bowen (1997) argues that the US open skies agreements are a progressive step in an opening salvo to liberalise the transpacific market in the same way the Atlantic was liberalised in the mid-1990's. Much will depend, though, on the way the governments in South East Asia respond to the open skies agreements and in the way they cope with their current economic problems and the pressure that these are placing on their airlines.

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