

The Airline Industry is at a Crossroads: What is the Impact on the U.S. and Japan?

Michael E. Levine
Professor (Adjunct) of Law
Yale University

The U.S. airline industry is in a state of upheaval, the most profound since deregulation was introduced between 1977 and 1982. Japan's industry is also in the middle of a profound, if glacially slow, restructuring, one which in many ways can be seen as a response to the forces unleashed by the last upheaval in the U.S. How will the present forces affecting the U.S. industry affect Japan? Will the changes now taking place in the Japanese industry prepare it for the world that will be created by the present upheaval in the U.S.?

To address these questions, we must start by looking more closely at where we've been.

The Post WWII era has had two global phases so far:

Phase I:

Phase I was the highly controlled reconstruction and further development of the world aviation industry from 1945 to 1977. In the U.S. market, this era was managed by the Civil Aeronautics Board, which had a powerful mandate to control entry, route development, and pricing, but had no power to control capacity and only indirect ability to control technology.

The CAB's control of entry and route structures allowed it to limit international service to two airlines in each major market area – Pan Am and Northwest to Asia, Pan Am and TWA to Europe, the Middle East and North Africa and Pan AM and Braniff to Latin America. The cost to Pan Am of being allowed to serve virtually all international markets was that it was prohibited from having a US domestic presence.

The CAB couldn't control what equipment was used by U.S. airlines, but it could control the prices they charged, forcing increases and preventing decreases that reflected any cost savings that might accrue from the introduction of new and superior technology. This tended to bias technological development in the direction of higher performance rather than lower cost, and provoked excess service competition and overcapacity. The required adherence to uniform rates also reduced pressures to hold down costs. By immunizing IATA ratemaking through tariff conferences conducted according to the unanimity rule, the CAB allowed the least efficient airlines to set international prices as well, setting off service contests and promoting overcapacity among the more efficient. In Phase I, airlines grew bloated and soft.

The CAB's powers and policies were mirrored in the agreements that governed the bilateral regime introduced when the Chicago Convention could not agree on an international economic framework:

Strict bilateralism, in which no airline could fly in international markets without the agreement of both countries whose points it served.

As a consequence, tightly enforced nationality rules, so that countries could control who their airlines competed with. No country was allowed to designate airlines that were not owned and controlled by its own nationals.

This in turn meant that there could be no "right of establishment" for international service, and all major aviation countries applied this restriction, along with a ban on cabotage, to their domestic service as well. Since airlines had highly political aspects, foreigners were not allowed to do the job and this led to the designation of "national champions", many of which were government owned. In many countries big enough to have a significant domestic market, other airlines were allowed, often privately owned, but those airlines were often strictly confined to domestic service. Of the major aviation countries, only the U.S. had large privately-owned international airlines (the UK and France had some smaller ones at various times), and even the U.S. had an unofficial "national champion" in Pan Am.

Where possible, capacity controls were put in place, except in many markets involving the U.S., whose CAB did not have an effective legal mechanism for enforcing them on U.S. airlines and preferred to resist them rather than to cede this power to foreign regulators.

This regime was never uniform. As noted, bilaterals involving the US tended to have fewer limitations on designations, frequency and capacity. At the other extreme were arrangements involving individual frequency approvals, filed schedules and required pooling. There was strict tariff enforcement in some regimes, looser enforcement in others, except for tariffs filed by airlines regarded as "interlopers". There was relative freedom for charter and inclusive tour operators (as long as they avoided scheduled service in markets with business passengers) in some regimes, but they were tightly controlled in others. Nevertheless, governments retained tools to micromanage industry structure and competition, exercising them as they saw fit. And pressures for efficiency were systematically muted.

The Japanese MOT shaped its industry in ways entirely consistent with this regime. Its "national champion" was government-owned Japan Airlines, a largely international operator that was allowed to fly some of the larger domestic routes. The largest domestic carrier was privately-owned ANA, which was not allowed to fly in international markets. These carriers developed very high standards of service with high costs. A second privately-owned domestic-only carrier was Japan Air Systems, previously Toa Domestic Airways, loosely tied to JAL but also competing with it in domestic markets. This carrier

struggled to keep up with the Big Two. There were also a few other, much smaller, domestic airlines with no international presence.

The separation between international and domestic systems was so extreme in Japan that when there was a perceived need for a second airport for Tokyo, it was designated an international airport and the domestic and international route systems of Japanese carriers were virtually entirely separated. JAL couldn't connect even with its own domestic system.

The MOT protected JAL from the consequences of this isolation by signing bilateral agreements that were highly restrictive and protectionist with those countries that would accept them, and acceded to a somewhat more open regime with the US, a regime similar to that which the US had signed with the UK. This regime theoretically allowed the designation of multiple US carriers, but airport restrictions were used to limit US designations to two, and it theoretically allowed open Fifth Freedom operations without capacity predetermination, but the MOT used a combination of airport capacity restrictions and its right to approve fares to new destinations to limit *de facto* the amount of Fifth Freedom service that Pan Am and Northwest could offer. And, of course, Pan Am didn't have access to a domestic U.S. system of its own, and Northwest's domestic system was small. The result of this regime on both sides was that the national champions, JAL and the unofficial Pan Am, developed under highly protected umbrellas with very limited integration of domestic and international systems. Combined with the relatively limited domestic networks of other countries whose airlines served Japan, this protection allowed the MOT to pursue its airports policy without serious consequences to JAL, since no international airline serving Japan had better access to the Japanese market, and most did not have significant domestic feed of their own. JAL was particularly helped by the fact that its most important transpacific rival, Pan Am, had poor access to its own domestic market, although both JAL and Pan AM could at least make interline connections with U.S. domestic airlines at their U.S. gateway airports.

This era of protection reached its apogee for the U.S. international market with 1977's Bermuda 2 agreement, where the British amazed the world by effectively using the desirability of serving London, by far the most important transatlantic destination, to terminate the liberal features of the old regime and force a very reluctant U.S. to accept strict mirror designation, capacity controls, limits on Fifth Freedoms and a strict fare regulatory regime. This regime with its highly restricted access to Heathrow also helped protect BA from the newly integrating U.S. hub and spoke systems that were being formed through U.S. deregulation.

The Japanese were profoundly impressed and intrigued by this development, and the MOT spent the next two decades trying to emulate this regime in its dealings with the U.S., using control of Tokyo, the most important transpacific gateway to Asia, as its principal weapon. It did surprisingly well, but economic and political forces gathering around the world ultimately forced it to change policy.

Phase II:

Ironically, overwhelming negative reaction in the U.S. to the renegotiated U.S.-U.K. regime that the Japanese envied helped bring about Phase II, a period of unprecedented liberalization that has continued worldwide to the present day.

Bermuda 2 was signed by the U.S. just as a major movement for domestic deregulation was reaching fruition. Within little more than a year of the signing of Bermuda 2, the U.S. had eliminated domestic regulation of entry, routes and fares and was on its way to abolishing the specialized regulatory agency (the Civil Aeronautics Board) itself. The domestic industry was revolutionized in a process that continues to this day:

Those historic airlines that were able to survive built domestic networks focused on hubs from which radiated an extensive structure of spokes that provided connecting traffic. These major hubs helped provide frequent service in thinner markets that couldn't support frequent, or any, nonstop service. They ultimately collected so much traffic that they became logical places to integrate domestic and international service. All the large U.S. network carriers sought to operate international spokes from their hubs. Historic coastal gateways diminished greatly in importance as large amounts of international traffic destined for interior points sought the highly coordinated online connections that the major hubs provided. Non-U.S. carriers could no longer count on finding airlines restricted to domestic service that were happy to exchange traffic with them at coastal or even interior gateways. Constructing these new routes systems required the U.S. to determinedly pursue new degrees of route freedom and real, exercisable, multiple designation.

To compete with point-to-point new entrants, network carriers developed frequent flyer programs and other scope-reinforcing devices and highly differentiated fare structures designed to use conditions of purchase and use to separate business and leisure travelers. Development of these devices and fares in turn required substantial pricing and marketing freedom.

Fierce price competition both from new entrants and from periodic fare wars toughened U.S. carriers and forced them to become more efficient. Their efficiency placed enormous pressure on their foreign competitors to become more efficient themselves and very substantially raised the public cost of operating inefficient government-owned airlines.

The toughness developed by U.S. airlines and the large number of domestic carriers seeking overseas service overcame protectionist objections to more open aviation markets. Over the next twenty years, the U.S. pursued episodically but inexorably a process of negotiating and implementing "Open Skies" agreements wherever it could, ultimately signing them with virtually every European country but the UK and with several of the Asian countries with very important aviation markets (Korea, Taiwan, Singapore), as well as many other smaller countries around the world. These agreements were characterized by:

Open route descriptions

Multiple designation
Pricing Freedom
Absence of capacity controls
Loss of incentives to designate and protect “national champions”

As this process continued, other countries were under pressure from the public and from airlines whose growth was restricted to liberalize their own domestic markets and airlines began to experience incentives and pressures that mirrored those in the U.S. As markets were liberalized internally, privately-owned domestic competitors, new or historic, grew through liberalization and put enormous pressure on national champions. Governments could no longer afford to subsidize their publicly-owned airlines and moved to privatize them.

As the privately-owned Asian and European competitors sought to grow, they sought to reorganize into hub-and-spoke systems and to maximize the value of their feed structures. They demanded access to regional and long-haul international markets, and they sought to integrate their domestic or regional operations with their new international long-haul service. Pressures to get access for their airlines forced governments to continue to pursue liberalized agreements with the United States and others.

The Chicago Convention and its bilateral regime remained, as did the importance of nationality, but the forces unleashed by this process stressed that system to the limit. Meanwhile, the U.S. domestic market remained the most fiercely competitive in the world as a half-dozen network airlines struggled with a growing low-fare sector that expanded rapidly in the late 1990's.

The major impetus for liberalization in Europe occurred through phased implementation of the single market in aviation. Intra-European market started out far more restricted than U.S. domestic or international markets, but creation of single market through implementation of the Treaty of Rome changed the political and economic dynamics radically. Since the European market is hybrid of domestic and international, the process is now in some ways more advanced in Europe than in US, which has maintained important distinctions between its domestic and international policies. For example, the single market grants the right of establishment to citizens of any EU member state, which effectively abolishes nationality for airlines of EU member states. (On the other hand, the Commission has micromanaged competition to a greater degree than has the DOT.)

In Asia, process has been much more complicated. Intra-Asia markets have remained relatively highly controlled with respect to designations, frequency and capacity at the same time that internal national markets have been liberalized.

The need to respond to forces from outside the region and from new domestic competitors has created pressures for liberalization in Asia in the form of finding room for multiple airlines, moving away from national champions and even privatization of formerly government-owned airlines. The growth of well-financed privately-owned airlines in such

places as Taiwan and Korea created second systems that integrated domestic and regional markets with long-haul markets to provide competition for historic flag carriers. Large differences in circumstances -- the state of development of national economy, the size and maturity of domestic markets, the degree of strategic location, the efficiency and political influence of home airlines -- have created substantial differences in national policies, but virtually all but the least developed Asian countries have liberalized their home markets and been forced to reflect that liberalization in their international policies. Competitive pressures from airlines whose countries that have signed liberal agreements with major aviation powers such as the US has also greatly influenced policy in those countries slower to liberalize.

Japan, in keeping with the conservative pace at which it changes public policy, has been slow to respond to these trends. As mentioned, for a long time Japan seemed mesmerized by the success of the British in protecting its national champion. (In fact, the British outdid the Japanese, protecting BA even more fiercely as they privatized it, seeking to get the maximum price for it from the market, while the MOT used ANA as a spur to make JAL more efficient.) But the British were becoming more and more isolated in their dogged pursuit of restrictive aviation policies. As the European Commission took away from the British themselves through the creation of the single market the ability to control the development of their own airlines, British policy became confused as they tried to promote opportunity for airlines like BMI on one hand and preserve restricted access to Heathrow for BA and Virgin on the other. The British were forced to liberalize Bermuda 2 in a series of “mini-deals” that set the pattern for U.S.-Japan relations.

The first acceptance by the Japanese that the world was changing came with pressures to promote ANA as an international and intercontinental airline. This required negotiation of rights for ANA, which in turn required the expansion of rights of the airlines of other countries to Japan. It also put enormous pressure on JAL, as ANA simultaneously added competition, its own and the foreign competition unleashed by its push into international markets, and used its 50% share of the domestic market to try to develop traffic support for its international system. This pressure was reflected in the privatization of JAL and subsequent attempts at cost-cutting, and also in JAL's intense interest in acquiring or controlling JAS so as to create a domestic system more nearly equal to ANA's. Pressure to create these two huge domestic systems in turn created new pressure on the MOT to find a way to liberalize the Japanese domestic market to satisfy public demand for competition, and it has taken very cautious steps in that direction in the last few years.

In taking these steps, Japan has started down a road which others have been traveling for more than a decade. It has been hampered in this regard by infrastructure decisions made years ago, and compounded in recent years by new decisions along the same lines. Japan is the only major aviation nation whose airlines cannot integrate their international and domestic route systems, and the only major nation that cannot easily encourage development of a low-cost sector to provide domestic competition for its own big airlines.

The government has accepted movement limits at its airports that force them to remain underused in the face of two trends: domestic demand for more low-cost service and an international trend toward integrating domestic and regional service with long-haul service. Concentrating domestic traffic at Haneda and later Itami and forcing international service to Narita and Kansai has been an understandable (because of the capacity limits it has accepted) but very costly mistake for Japan and has made it difficult to adapt quickly to a changing international environment.

The fact that Narita and Kansai are much more expensive and less convenient than their domestic counterparts has made it difficult to remedy this error. If given a choice, all airlines would rather serve Haneda and Itami than Narita and Kansai, because almost all passengers would prefer to use them. And attempting to integrate Japanese airline service at, for example, Haneda, now that both JAL and ANA will have comparable service networks there would create a major international aviation crisis unless foreign carriers were permitted to serve there also. Haneda probably could be expanded to do this by more intensive runway use to reach international standards of activity, but this would create problems with the air traffic controllers' union and with some environmental interests (although Haneda's location next to Tokyo Bay is much better than Narita's or Itami's in this regard). Perhaps more important, it would relegate to secondary importance a very expensive infrastructure at Narita which is already in financial difficulty as well as abandon a thirty-year political battle which is almost won.

Now, finally, we come to the crossroads: Will there be a Phase III and what will it look like? The incredible growth of the airline industry over the last twenty years, partly in response to world trends of development and globalization and partly in response to liberalization itself, has been a major factor in relieving the stress and frictions that radical adjustment creates. It has been said that a rising tide floats all boats. Even if this tide didn't float all the boats, many of those stranded apparently far from the water's edge found in this high tide enough time and enough lift to repair their bottoms and to sail!

But the tide has ebbed in the wake of September 11 and the bursting of the bubble economy. Only low-cost, low-fare airlines are doing well anywhere in the world, and they are mostly prospering in short-haul markets. Given the instability and fear in the world, as well as the sluggishness with which all the major markets are recovering from the slump that ended the bubble, it is difficult to say when and by how much recovery in international aviation will occur.

If the tide flows again, I would guess that we will see a continuation of the trends I have been describing. Phase III will probably involve like-minded states to forming groups in which they exchange very open access, including the right of establishment, to each other's markets and cease to enforce nationality rules. This group will probably start as a group including the EU, the US and Canada. This formation of this group will create friction as recalcitrant states try to invoke nationality clauses to hinder access to their markets by newly formed airlines (some as combinations of older ones) of ambiguous nationality, but the rising tide will give them time and the ability to adjust.

One by one, first the eager free traders then countries whose international airlines belong to alliance groupings and then later more conservative states whose airlines will come to fear being left out of this market, will adhere to this core group. I would guess that this process would get an early foothold in Asia, but how rapidly it becomes widespread in Asia will depend almost entirely on what Japan and China do and how fast they do it. Once Japan and China feel compelled to join this group, Asia will go from early Stage II (with holdovers in Stage I) to full Stage III, since adhesion to the group will require accepting its very liberal rules and the economic power of Japan and China will be irresistible. The initial resistance to and subsequent profound influence of the GATT and the WTO come to mind as analogies.

For the U.S., this will be a familiar environment. But this will present a particular challenge to Japan. Its two large airlines still have relatively high costs, especially compared to their Asian competitors, and the infrastructure problem is a very difficult one. For Japan to reverse course in its airports policy would require an extraordinary act of political courage. Such acts are not common anywhere, and are certainly especially difficult in a consensus-oriented culture like Japan's. But in this scenario, at a certain point Japanese airlines will face a stark reality. Japanese cities other than Osaka and Tokyo will become spokes on fully developed hubs located outside Japan. Japanese airlines will not be able to access this traffic as well as airlines in Korea, China and Taiwan, since they won't be able to offer seamless connections to their own countrymen. While Tokyo and Osaka are huge O&D markets, foreign airlines will be able to use flows over their own hubs to support more frequencies than will be supportable by Japan's two non-hubbing carriers. If Japan tries to use infrastructure restrictions to protect its own airlines, it will fall behind as an aviation nation.

This is a grim scenario for Japan, but what happens if the road goes in another direction? If terror prevails or economies stay soft or both, the current crisis in air transportation will continue. The U.S. market may support fewer hub airlines and will certainly provide less flow to support U.S. international hubs as U.S. domestic traffic continues to move to non-integrated low-fare carriers. The same may happen in Europe. In such a world, there will be fewer large international network carriers and less international network traffic to go around. The tide will float fewer boats, but (and I am pushing the metaphor here), the boats will be fitter and faster as economic pressures mount, because they will have survived a process in which others have failed. They will be formidable, efficient competitors for whatever traffic exists and will demand the institutional freedom to reinvent themselves geographically and commercially.

In this scenario, Tokyo's and Osaka's traffic volumes and access limitations will temporarily help protect Japan's airlines, but they will face price pressures from shrinking traffic volumes and struggling competitors. Unless high-cost airlines dramatically lower their costs in the face of these competitive pressures, they will shrink relative to others. In this struggle, Japanese policy and infrastructure constraints will make it harder for Japanese airlines to adapt. If the MOT is forced by public pressure in a sluggish economy to provide

more opportunity to Japanese low-cost carriers, this will add to the difficulties faced by ANA and JAL, but from this distance this does not seem to be a realistic prospect at the moment.

Growth in alternative Asian markets, coupled with stagnation in Japan, may give other Asian airlines more opportunity to adapt and become relatively more important regionally. The center of gravity in East Asian aviation may shift. And access to larger markets will make those carriers that survive from other parts of the developed world even tougher competitors than at present.

At first blush, it may seem that I am abusing the hospitality of the organizers in laying out this unattractive dilemma between a challenging prosperity and a challenging aviation recession. But I am a great admirer of Japan and of its resourcefulness in the face of challenge. And, for what it's worth, I have been equally grim in other forums in describing for my American colleagues the tough situation faced by U.S. network airlines. I suppose that I am an "equal opportunity" bringer of challenging news. My hope is that it will become apparent that Japan's two great airlines must continue to take harsh measures to cut costs and that the government needs to help them not by protecting them but by figuring out how to free them from the straitjacket of an airports policy that greatly disadvantages them. Then, just as U.S. hub airlines have begun to take the unpleasant steps necessary to ensure their survival, Japanese airlines and the MOT will do the same.

If the tide rises once again, all this will be easier to do. But wherever the air transport economic environment goes from here, survival and prosperity can only come from sizing opportunity, not suppressing it.