ILLUSTRATION: AJAY MOHANTY

Making sense of airline troubles

Interfering with firm entry or exit, price fluctuations, or products and processes: These are the pathways to stagnation

SNAKES & LADDERS

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A few supply shocks have come together in airlines. What happens in a market when supply is suddenly restricted? The price moves until the gap between supply and demand is cleared. We conjecture that with economy class airline tickets, there is ample demand flexibility, and relatively modest changes in the price will restore equilibrium. In the meantime, surviving airlines will get a surge in profitability. They will lease additional planes, thus replacing the gap in supply. Price fluctuations, and firm death, are the beating heart of the market economy.

Difficulties in Jet Airways and the grounding of some planes by Boeing: These events have coincidentally come together as a supply shock in airlines. Will the price of plane tickets go up dramatically? How will the market process work out?

The key idea of the price system is that prices move until supply and demand are equalised. As an example, suppose there is drought and the supply of wheat goes down. Now there is a gap between supply and demand on the market. The price must move until some buyers are rationed out, and then the supply suffices to meet the demand. The trouble is, most people are quite insensitive to the price of wheat. Modest changes in the price of wheat will not induce a significant change in demand. Therefore, the price of wheat has to move by a lot in order to solve the problem of the supply shock.

Contrast this with airlines. In the last 20 years, we have got a great surge of middle class buying of economy class tickets. These are price-sensitive buyers! When the price of plane tickets goes up, there are many people who will travel by train or road (these effects will be strongest for short flights, e.g. Delhi to Jaipur). There are many people who will make do with video calls.

This high demand elasticity means that a relatively modest increase in the price will suffice to choke off demand to the reduced supply. These responses will be stronger as the days go by, as many seats on current flights had been sold earlier and there is reduced room for demand responses.

At first, the surviving airlines will enjoy higher profits. This is a normal and fair market process. The market system requires going through difficult times, at low profit rates, in order to enjoy high profit rates at times like this. The restoration of health in Indian firms requires a great deal of exit by weak firms. The more efficient airlines will survive. They will look to expand capacity when they see the outlook has become better. They will lease new aircraft.

It is useful to focus on the plane. Ultimately, what is required in the economy is that a plane has to fly from Bombay to Nagpur. Earlier, that plane was leased or owned by Jet Airways. An efficient financial system is one where leasing companies shift leased planes from Jet Airways to other airlines, and the bankruptcy process sells off the owned planes. As long as the plane flies, it does not matter what logo is painted on its tail.

Some people are unhappy at the temporary surge in prices. In our socialist instinct, we feel that prices should not change. But price flexibility is the essence of the market process. Supply has declined: We need higher prices to deter some buyers (who will shift to trains, buses or video calls) and allocate the seats to other buyers. A sophisticated market is one where prices change continuously, and rapidly respond to news.

Some people are unhappy at the surge in the profitability of surviving airlines. This is of the essence to get to healthy firms and to get back to high investment in the country. Many industries in India are stalled owing to the lingering survival of inefficient players, who continue to sell at low prices and damage the profitability of the entire industry. The exit of the “zombie firms”, the inefficient players, restores profitability and sets the stage for investment.

A good market economy is one with a steady pace of “creative destruction”: Some firms should die every year, and some new players should enter every year. As an example, we do this in every mall in India: The cast of shops that occupies the mall changes every few months. This level of dynamism is required in all parts of the economy.

What should the government do? The first thing that the government needs to do is let the price system work. If a firm is in trouble, there should be no rescue.

The role for the state lies in bankruptcy reform: We need to build the Insolvency and Bankruptcy Code (IBC) up to the level of capability where firms rapidly finish the IBC process. The IBC process should be fully neutral about whether a Jet Airways gets liquidated or resolved: This is a question for private players to sort out. All that is required from the government is the establishment of law and institutional capacity so that when firms begin on the IBC journey, they finish within the timelines defined in the law.

The role for the state is to undertake the financial reforms that yield sophisticated financing arrangements. A nice feature is the role of leased and not owned planes. This simplifies the reallocation of planes. All that is required is some painting and refurbishing, and a plane can switch from one airline to another. There is work in store, in tax policy and financial regulation, to make leasing work properly. Such financial arrangements should be taking place on a greater scale, so as to achieve a greater separation between the productive assets vs the firm that coordinates production using the assets.

Firm exit and price fluctuations are seen as trouble. We in India need to internalise the intuition of a genuine market economy. Interfering with firm entry or exit, interfering with price fluctuations, interfering with products and processes: These are the pathways to stagnation.

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