

HIGHLIGHTS

- The eruption of the Icelandic volcano Eyjafjallajökull has caused flight cancellations across the world since 14 April.
- In the short term, the most immediate economic impact will materialize in the form of higher prices in those markets which have seen supply disruptions; however, this will only translate into small increases in overall headline inflation.
- The economic cost in terms of trade on a global basis have thus far been very limited, as the bulk of merchandise trade across Europe takes place through sea and land.
- Assuming that the disruptions from volcanic ash diminish in the near-term, the impact of this event would not warrant a material change in our forecast. However, the downside risk would be a lower profile of growth in the range of 0.7% to 1.2% if the disruption continued over several months.

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THE ECONOMIC IMPACT OF ICELAND'S VOLCANIC ERUPTION

The eruption of the Icelandic volcano Eyjafjallajökull has caused flight cancellations across the world since 14 April. According to International Air Transport Association (IATA), a conservative estimate of the financial impact on airlines is in excess of US\$250 million per day in lost revenues. In addition to lost revenues, airlines will incur added costs for re-routing aircrafts, and care for stranded passengers alongside stranded aircrafts at various ports. Airlines typically are uninsured against this type of event. Most European carriers have been asking governments to ease the bans, as the test flights they conducted showed no damage on the aircrafts.

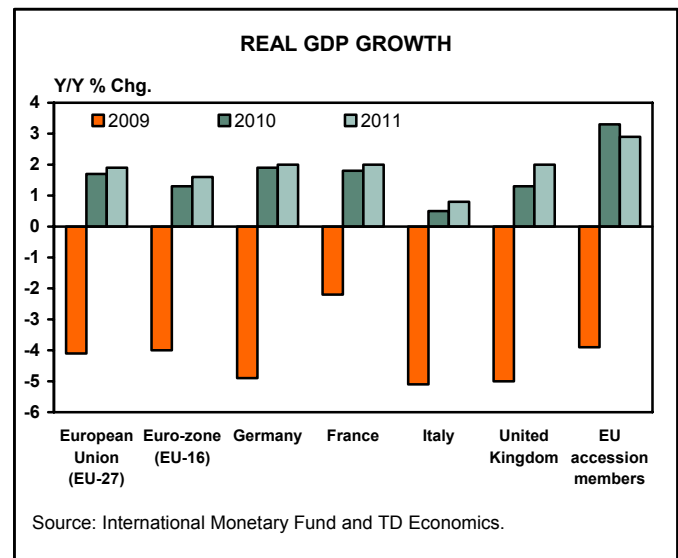
The impact on the tourism industry is very difficult to assess. Although arrivals were almost completely halted for about five days, hotels in most countries affected by flight bans are packed with stranded passengers, and demand for car rentals and train service

has boomed, fueled by people trying to get around Europe in the absence of air-lifts. Thus, what has been detrimental for airlines, in contrast, has had positive or no impact in other tourism areas. Although flight restrictions were starting to ease today, particularly in Germany and France, the detrimental impact to airlines may linger

through the summer vacation season. There could be a high incidence of vacationers originally destined for Europe deferring or altering travel plans due to uncertainty of possible future flight disruptions from the volcanic ash.

The economic cost in terms of trade on a global basis have thus far been very limited. Only some perishables such as fresh fish and cut flowers, which are flown to Europe from countries such as Japan and Kenya, have suffered supply bottlenecks. Some other sectors which also rely heavily on air freight such as pharmaceuticals and electronics were able to withstand the flight paralysis by drawing down their inventories. However, this would no longer be a viable option if the ash cloud prolongs flight disruptions into the coming weeks. Nonetheless, it should be stressed that the bulk of merchandise trade across Europe takes place through sea and land.

In the short term, the most immediate economic impact will come from prices. Those markets which have seen supply disruptions will experience a spike in prices. Barring flight cancellations are extended for a longer period, this will only





translate into small increases in overall headline inflation, as the products involved have a very small weight on CPI indexes and those price jumps will be temporary.

The critical issue is how long will the volcanic ash disruption on air travel last? This volcano's previous eruption in December 1821 continued until January 1823. If such a phenomenon were to repeat itself this time around, the consequences would be far reaching. According to the European Travel Commission, based on data from Eurostat, tourism directly generates 5% of total GDP in the European Union, with revenues around EUR 322 billion in 2008. Therefore, if flight disruptions persist, the impact on tourism alone could carry a sizeable effect on overall economic activity. All other things equal, a 10% drop in tourism activity would bring real GDP growth down by 0.5 percentage points. Agriculture is also a candidate that could suffer under this scenario, as crops may become damaged by ashes.

To sum up, beyond the costs and lost revenues incurred thus far by airlines and some perishables' producers, if the impact of the eruption continues to abate in the next few days, its economic impact would be limited to some spikes in a small set of prices. However, the longer this phenomenon persists, the higher its economic impact on lost output. The fact that some airports in Europe have been reopened earlier today and flight bans are being lifted is a positive sign, but it does not mean volcanic activity has stopped. Before the eruption we were looking for a sluggish recovery in the European Union, with a growth forecast of 1.7% in 2010. Assuming that the disruptions from volcanic ash diminish in the near term, the impact of this event would not warrant a material change in our forecast. However, the downside risk would be a lower profile of growth in the range of 0.7% to 1.2% if the disruption continued over several months.

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