**Taming the Bull?**

Jose Miguel M. Abito U021579H EC5880 Assignment 3

It is highly unlikely that the top carriers are simply myopic and lacking in foresight hence the argument that these carriers are not aware that larger and more ships alone do not lead to the benefits of scale economies is weak. On the other hand, though they might understand that economies of scale will only be realized once a certain level of capacity utilization is achieved, there is a possibility that these carriers are just overly optimistic. However, as stated in BRS's *The Container Market in 2003* (2004b) report, the "value of such warnings [that the fleet is entering the 'danger zone' of overcapacity in the second half of 2005] is however relative, because it is impossible to forecast level [*sic*] of the demand with a sufficient accuracy in two or three years time. After all, supposing that Chinese exports remain sustained (even at a lower rate than observed in 2003) and that both the USA and Europe economies are healthy, driving with them other countries as well, it could lead to a transportation demand which could absorb the huge capacity which is to come on steam." Similar to when governments developed there own ports, these carriers are definitely creating capacity for anticipated demand. For them, even if the Chinese boom will not be sustained, it might be better to have overcapacity for a year or two and hope to have a tighter market by 2008 (BRS, 2004a) than completely lose their market share by being too risk averse[1], especially if the Chinese miracle materializes. Nonetheless, it is worth examining deeper this 'bigger (and more) is better' attitude of the top carriers. For this extremely short essay, I will not propose my own projections of the prospects of international trade particularly the sustainability of the Chinese boom since as mentioned, forecasting is rather difficult and the effort might turn futile. Rather, it is better to look at the possible reasons why carriers insist on creating overcapacity and whether such behavior is consistent with their own objectives.

It seems carriers don't bother much about ROI, *per se*. Though newer and bigger ships might have led to cost reductions in terms of slot costs, as Lim (1998) notes, operators have not truly benefited from these cost savings since tariff rates have dropped more than the cost reductions. Also, return on assets in the 1990s varied from 1% to 8% per annum compared to a long-term

[1] According to this statement, carriers might "ignore" transient losses in order to maintain their market share and as will be discussed later, increasing ships (or making them bigger which leads to more TEU capacity) increases the common and available measure of market share (the ranking in terms of market shares are based on TEU of the company, both existing and in the order book (BRS, 2004c)).

return on the US stock market of about 11% (Stopford, 2004).[2] Why then do these large mega-carriers continue to stay in their business? One can argue that these carriers have invested substantial costs that are sunk[3] and thus, exit would not be profitable. Not completely unrelated, it can be observed that when ocean rates are increasing, orders for new ships are also increasing and hence understating the real ROI. A more important question is why do carriers behave in such a way that would lead to an erosion of ocean rates due to overcapacity? One explanation is that ordering behavior among carriers might be strategic complements. If this is the case then it is a carrier's best response to order new ships when others are also ordering. Such a complementary nature of strategies can arise in a noncooperative situation whereby carriers compete in terms of lowering costs, and since larger and more ships bring economies of scale (assuming they are full), an ordering spree can occur. This can even happen inside alliances when members lower their slot costs in order to profit from the alliance. Another explanation is that the tolerance for excess capacity is actually a strategy of the major dominant carriers. Excess capacity can deter prospective entrants (Sjostrom, 2004; Fusilo, 2003). However, Sjostrom (2004) notes that entrants might mistakenly overestimate demand and consequently enter[4], which leaves the market (conference in Sjostrom's case) with further excess capacity. Then again, those who cannot manage their cashflows properly during market troughs would eventually leave the market and those who can are in for a much bigger reward once the market swings back into action since their market share is either preserved or even increased. In this framework, the fittest and the leanest in terms of cashflows and efficiency, will get all the spoils of the market.

From the above discussion, surplus capacity can be seen as an inevitable mechanism of the market to correct and flush out inefficient players and as such, dominant players won't really be too much worried about it. Nonetheless, it remains a possibility that China would actually exceed expectations and not succumb to overheating pressures, as Tomas Dyrbye of Maersk Sealand described the container market in 2003 (Sjöfartens Analys Institut, 2004). And maybe it's just

[2] This is not to imply that carriers do not take into consideration tariff rates in their investment decisions. They do. In fact, such ordering behavior in 2004 would not have occurred if not for the bullish container demand (combined with the tight market) and prospects for future growth in the East.

[3] According to Prof Haralambides' lectures, ships themselves are not considered sunk. It is the infrastructure that is built that can be considered sunk costs in liner shipping.

[4] Entry here does not necessarily mean a new shipping company enters for the first time. It can also mean "non-dominant" or high cost players that are currently in the market. Entry in this case can mean ordering new ships and expanding their respective fleet.

that surplus capacity for a year or two[5] is not enough to tame the raging Chinese bull…and also the herd that comes with it.

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[5] In my opinion, 2008 looks promising considering that the container market might be tight again and for the fact that the Olympics is to be held in Beijing on the same year.