Navigating through High Maritime Freight Rates

Key Takeaways

- Freight rates have been growing at an exponential rate since the second half of 2020. The Drewry World Container Index composite score as at 23rd September, was about 299% higher than the same period a year ago.
- A multitude of reasons such as COVID-19 disruptions, container inventory imbalances, Suez Canal blockage and, a lack of competition in shipping lines and alternatives for shipping have been the key drivers for soaring freight rates.
- Exporters in Sri Lanka are facing a shortage of containers and lack of shipping space on vessels for exports in addition to the rise in freight rates, making the country's exports relatively expensive as well as creating delays in fulfilling export orders. It is also a greater challenge for exporters that require imported material.
- The increase in costs for importers with high freight rates and potentially high demurrage charges with limited foreign currency for import bill payment through the banking channels, are adding to inflationary pressures of the country.
- The private sector recommendations to navigate through high freight rates include strategic planning, optimizing markets and shipments while the recommendation to the government is to reduce other trade costs through digitalization.

Context

Ocean Freight rate[1] have been on an upward trend since the second half of 2020. In recent weeks, Drewry's composite World Container index (WCI)[2] increased to USD 10,377 per 40ft container as at 23rd September, which is 299% higher than the same period in 2020. The average composite index of the WCI (Drewry), for year-to-date, was about three times higher than the five-year average of USD 2,396 per 40ft container. This brief aims to understand the causes of the increase in shipping freight rates, the impact it has on various economic sectors of Sri Lanka and solutions to mitigate the impact of this exponential growth in freight rates.

[1] Ocean Freight rate which is the price paid to transport goods from one place to another via ships
[2] The Drewry World Container Index is a composite of 40-foot ocean container freight rates on 8 major routes to/from the US, Europe and Asia. Trade lanes covered are; WCI.SHALAX – Shanghai to Los Angeles; WCI.SHANYC – Shanghai to New York; WCI. RTMNYC – Rotterdam to New York; WCI.NYCRTM – New York to Rotterdam; WCI.SHARTM – Shanghai to Rotterdam; WCI.SHAGOA – Shanghai to Genoa; WCI.GLOBCOMP – Global composite of all trade lanes

Causes for the Skyrocketing Freight Rates

The historic highs of shipping freight rates have been a result of many factors. These include COVID-19 disruptions, container inventory imbalances, Suez Canal blockage and a lack of competition, that has been weighing into the growing trend of freight rates. Industry experts believe that the freight rates would not recover to pre-pandemic levels in the short term[3]. However, one of the world's largest carriers, CMA CGM Group, has decided to put off any further increases in spot freight rates and freeze the rates for next six months until February 2022. Following this announcement, HAPAG-Lloyd too capped their spot rates[4]. Therefore, as two of the world's top container lines have pledged to freeze spot rates, this may persuade other carriers to follow suit.

1. COVID-19 Related Disruptions

At the start of 2020, when the world witnessed lockdowns across the globe amidst the COVID-19 outbreak, major carriers sought to blank sailings in order to address low demand and overcapacity during this period[5].

In the second half of 2020, as global economic activity and trade witnessed a sharp rebound driven mainly by the manufacturing sector, the blank sailings had disappeared to a large extent. However, the services sector and especially the most contact intensive activities such as port operations, lagged behind owing to the continued need for social distancing, labour shortages and other limitations of the pandemic. This resulted in delays and congestions at ports that led to increased turnaround time for vessels causing disruptions to regular schedules of shipping lines. Furthermore, the delays in consignees clearing cargo due to lockdowns, labour shortages etc. also affected the smooth clearance of cargo at the ports, which further intensified the delays and congestions as well as led to a container inventory imbalance.

A similar scenario of port congestion was observed in Sri Lanka during the second wave of COVID-19 where vessels were bypassing the port of Colombo due to berthing delays that arose due to labour shortages and COVID-19 restrictions in the country. This led to urgent import shipments for export-oriented manufacturing and essential local commodities being delayed with some being discharged at other ports in the region.

Fast forward to 2021, the recent outbreak of the Delta variant has significantly disrupted trade in Asia where around 42% of global exports are sourced according to United Nations estimates. China being the main contributor to this trade share, saw port traffic flows being disrupted after the month long shutdown of Shenzhen's Yantian Port in late May and the

[3] Short term is defined as the period from 6 to 12-month period
[4] https://lloydslist.maritimeintelligence.informa.com/LL1138159/Hapag-Lloyd-joins-CMA-CGM-in-freezing-spot-rates
[5] Blank sailings or void sailings is when a port call is cancelled

Meishan terminal at China's Ningbo-Zhoushan port - the world's third busiest port in terms of container traffic - being shut down for two weeks after a worker tested positive in mid-August. These disruptions to global supply chains are coming at a time when the industry is preparing to ramp up for the Christmas holiday season, which could cause a further acceleration of freight rates in the near future.

2. Pent up demand and high container demand from China

The sharp rebound seen during the latter half of 2020 was driven by the manufacturing sector. This led to the strong rise in demand for intermediate inputs on the back of stronger manufacturing activity. However, the recovery was seen at different levels across countries with China – the first country to bring the virus under control – already returning to its pre-crisis level in June 2020 and the recovery in trade in other key global economies starting towards the end of the year.

China is the largest manufacturer in the world and, western destinations such as the US and Europe are dependent on China for various goods. This coupled with the increase in savings seen in the west owing to the stimulus packages as well as limited spending on travel and other leisure activities, raised demand for manufactured goods. This increased China's exports to the west and thereby increasing demand for container shipments. Since, countries were willing to pay double or triple the price to procure goods from China. However, with delays in clearing cargo at the ports in Europe and USA, led to empty containers not being returned back to the Far East and Asia, creating a large scale container imbalance as well as leading to soaring global freight rates.

3. E-commerce – Split shipments

As lockdowns and limitations on movement became the new normal, consumers opted for electronic modes of purchasing goods and services and, businesses followed suit by improving their e-commerce channels. E-commerce retailers have been relying on split shipments[6] particularly for international shipment of goods owing to the cross-country nature of goods where inventories had to be picked from different locations. This, therefore, leads to more shipments and higher freight costs.

Therefore, this coupled with the surge in e-commerce trade and the shortage of containers, further aggravated the freight rates while also creating a harmful ecosystem of increased shipments and freight costs.

4. Less Competition in Shipping Lines and Alternatives for Shipping

The limitations on belly capacity in passenger aircraft due to the decline in passengers travelling by air, has led to goods that were transported by air being transferred to ocean

[6] Spilt shipment is when an online order that contains multiple products is broken down to separate shipments to enable fast and efficient delivery.

freight[7]. Therefore, the lack of alternatives to ocean freight will mean the difficulty in avoiding a surge in ocean transport costs.

The shipping industry in order to reduce their unit costs, invested in bigger carriers to achieve economies of scale and procure more fuel-efficient ships. However, the older ships were not scrapped, and the overcapacity remained, which in return led to low freight rates in the decade prior to 2020. Therefore, a trend of carriers recovering their lost revenues were seen during the past year.

At present, the strong earnings have triggered new orders for container ships in 2021 with orders for this year doubling the orders received for all of 2019 and 2020. Baltic and International Maritime Council (BIMCO) observed that the container ship order book holds 5.3 Mn TEU of shipping capacity, which is scheduled to be added to the fleet from 2023 onwards. At the start of 2021, the order book stood at 2.5 Mn TEU[8], however, by late August, a record high of additional 3.3 Mn TEUs have been ordered. Therefore, with carriers going big on investing in new capacity, this could ease the capacity constraints from 2023. It should also be noted that most of these new ships on order will be fitted with a scrubber in order to be compliant with the low Sulphur regulation on ship fuel.

5. Decarbonisation

At the start of 2020 the International Maritime Organisation (IMO) imposed a minimum Sulphur limit of 0.5% on the ship fuel used (often referred to as IM02020, Sulphur Limit) under the Annex VI of the International Convention for the Prevention of Pollution from Ships (MARPOL)[9].

In June 2021, a further amendment was made to the MARPOL Annex VI by the IMO Marine Environment Protection Committee (MEPC) to reduce the Greenhouse Gas (GHG) emissions by ships. These new measures, which are expected to come into force on November 2022, will require all ships to calculate their Energy Efficiency Existing Ship Index (EEXI) and, to establish an annual operational Carbon Intensity Indicator (CII) and CII ratings. The requirements for EEXI and CII certification will come into effect from 1 January 2023[10].

A study done by UNCTAD[11] on the impact of the above measures by IMO, revealed that it will lead to slightly higher freight rates as a result of internalizing external costs and also as a result of going at lower speeds to reduce CO2 emissions. While the magnitude of these

[7] Total air freight throughput in Sri Lanka declined by 43% in 2020 when compared to 2019. Comparing the last 5 years, it was also the lowest throughput seen during the period from 2016 to 2020

[8] Of which, 500,000 TEUs have been delivered in 2021

[9] More details on the IMO2020 Global Sulphur cap, can be accessed at; https://chamberlk-my.sharepoint.com/:b:/g/personal/imesha_chamber_lk/EfgpVhqLglxMl7Iy8nGytdgBeUKX-oGZDxic8J8CM2XRSw?e=e7ipof

[10] This refers to the first annual reporting, which will have to be completed in 2023 and the first rating will be given in 2024.

[11] The United Nations Conference on Trade and Development (UNCTAD)

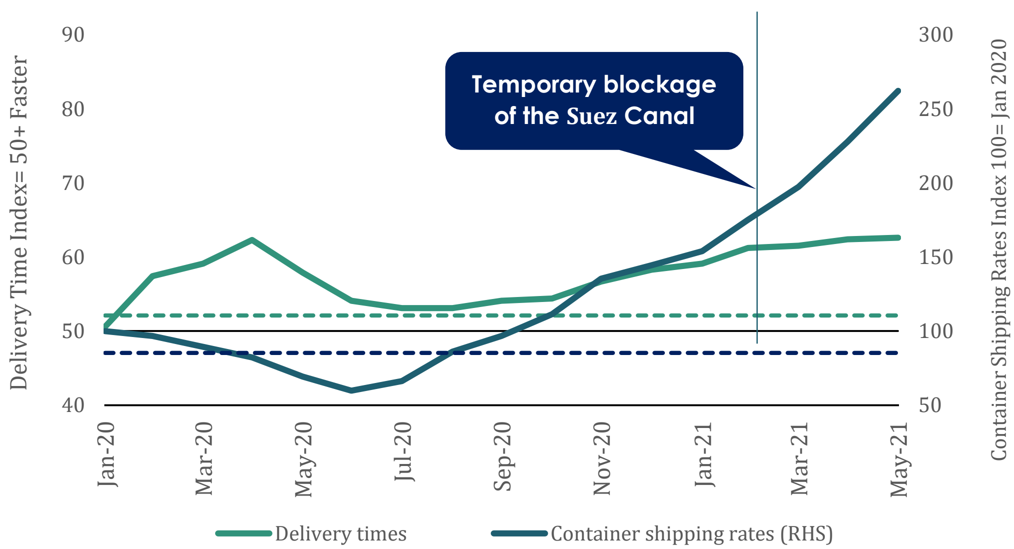
increases are relatively small when compared to current fluctuations in freight rates, these will be relevant for many years to come until the sector has reached the energy efficient level.

6. Suez Canal blockage

The container ship that had been wedged in the Suez Canal at the start of the year, though for a short period, had rippled effects on the industry, which further aggravated the already stretched shipping market. As the ships took longer to reach their destinations, the shortage of empty containers increased further in this period. This led to higher pressure and increased freight rates not only for the routes passing through the Suez Canal, but also for the routes nearby.

According to industry experts, Europe was the region that felt the strongest impact due to the blockage of the canal. Companies located in Asia were also impacted not only by the delay of shipments from Europe, but also by a shortage of empty containers returning to their region, which further stalled their abilities to deliver goods around the world.

Figure 01: Global Shipping Times and Costs



Note: Dashed lines represents the long-term averages
Source: World Bank

Impact on Sectors

Exports

Factors such as Sri Lanka's strategic location (being the last port of call to destinations such as UK, Europe and USA) and regulations such as "All in Freight Rate" where all charges of shipping had to be consolidated into one rate, has supported exporters to receive competitive freight rates prior to the pandemic. However, some of these factors are no longer working favorably for Sri Lankan exports, given the current constraints in capacity.

A significant component of raw material used for export products in Sri Lanka is imported. According to statistics by the Central Bank, intermediate imports account for around 50-60% of total imports in the country. This increases the export cost due to increased procuring cost of imported raw materials. Even though, exports such as apparel, which consists of a larger portion of the country's export basket is exported Free-on-Board (FOB)[12], this still increases the final price of the export as the buyer incorporates the freight cost into the final price of the product, making Sri Lanka's exports relatively expensive. Therefore, all exports of the country are affected by the surge in freight rates and it is a greater challenge for exporters that require imported materials.

Sri Lanka historically had an imbalance between the 20ft containers and 40ft containers. This imbalance was further aggravated by the imposition of the import ban on certain items such as vehicles, which limited the 40ft container imports. Therefore, exporters in Sri Lanka are facing a container shortage, which in return adds to the already high freight rates.

According to industry experts, the increase in freight rates are likely to affect the smaller players to a greater extent than the established players as most established firms have long term contracts with the shipping lines that can cushion themselves from higher freight rates.

Imports

Importers usually pass on their freight costs to the consumers. Under almost every conceivable scenario (whether FOB, Cost and Freight - CNF etc.), an importer will bear the cost of any increase in transportation costs including paying for insurance and other related costs, which too have increased. The higher freight costs also increases the duties and levies. All of these costs are eventually passed on to the consumers. This could further intensify the inflationary pressure in the economy given the expansionary monetary measures followed by the Government during the past year. The inflationary pressure will also affect consumer welfare with the unprecedented challenges posed by the current pandemic.

On top of exorbitant freight rates comes the limited availability of dollars in the country to settle import bills. This creates delays initially at the banks, which then in most cases leads to delays in the customs clearance process, adding further demurrage charges that have to be borne by the importer. These again exacerbates the cost of imports to the country.

Solutions to Navigate through High Freight Rates

The solutions to navigate through the growing freight rates is twofold. The first set of solutions are for the private sector, which can be carried out by individual exporters and importers prior to the shipment of goods in order to mitigate high freight rates. The recommendation for Government entities is to reduce other trade costs and lower business operational costs for traders, as, price controls would not resolve the current supply chain congestion and, may further aggravate the

[12] i.e. the overseas buyer pays for the transportation of goods

situation by creating more supply chain bottlenecks. A brief overview of these solutions are set out below.

1. Solutions for the Private Sector

a) Strategic Planning

Strategic planning can aid in limiting the exposure to high freight rates and be a cost saving for traders as rush orders can incur heavy costs on the traders. Through careful planning these high freight rates can potentially be managed.

Strategic planning also includes analysis done on freight rates both historic and future estimates in order to better understand the trends and to plan accordingly. This will enable traders to make informed decisions backed by data and information.

b) Optimising Markets and Shipments

The best freight rates can be achieved by focusing on numerous factors such as route, market, shipment and terms of sales.

Deciding between Full-Container-Load (FCL) or Less-than-Container-Load (LCL) or as groupage i.e. grouping your goods with others in the same route to make up full containers, can help optimize the freight rates as there are multiple charges involved in an LCL or groupage shipment compared to FCL. Using the right type of container for the cargo such as 20ft container for weight based cargo and 40ft container for volume based cargo, can also help optimise freight cost. It is also imperative to identify the right incoterm or terms of shipment such as FOB, CIF (Cost, Insurance and Freight), CNF (Cost and Freight), FAS (Free Alongside Ship) etc. as these aid in identifying who pays for the various charges of the shipment and the responsibilities thereof.

Route and market optimisation is another option to lower freight rates by analysing the routes used by the various carriers for the delivery of the cargo and markets that have a container deficiency. Carriers may offer special deals to customers who are able to ship cargo where a container is already being repositioned. This would also offer an opportunity for exporters to diversify into new markets such as China, Japan, Taiwan, Korea etc. where there is a container deficit. This will induce shipping lines to drop off empty containers in Sri Lanka for exports to these markets and defray carriers empty re-positioning costs. This will also remedy the current issue of lack of shipping space on vessels for Sri Lankan exports. Triangulation of container is another method where preferential freight rates can be obtained by the carriers. Triangulation refers to the use of the same container for export and import needs i.e. the trader export cargo from ‘A to B’ and also bring back imports from ‘B to A’ using same container and same carrier.

2. Solutions for the Government

Reducing Other Costs through Trade Facilitation

Automation of all trade related agencies are pivotal to have a resilient industry and bring in a strategic transformation, leveraging on the opportunity presented by the pandemic to the industry. Under Category C commitment for Sri Lanka under the World Trade Organisation (WTO) Trade Facilitation Agreement, Article 8, a mechanism to develop a Border Agency Corporation is required by Sri Lanka. Although, automation of a few individual agencies were seen, the lack of integration and inter-agency connectivity is a deterrent for this process.

Implementation of the National Single Window (NSW) is the long term permanent solution for the country to keep the business operational costs low to face situations of this nature or worse scenarios in the future. Therefore, Government can look to accelerate the implementation of this long-overdue project without any further delay. The blue print for the National Single Window, which is a Category C commitment for Sri Lanka under the WTO Trade Facilitation Agreement, Article 10.4 implemented by the National Trade Facilitation Committee (NTFC) of Sri Lanka has already been developed.

Key Informant Interviewees (KIIs)

- Mr. Iqram Cuttilan, Managing Director, Aitken Spence Shipping Ltd/ Former Chairman, Ceylon Association of Shipping Agents (CASA)
- Mr. Romesh David, CEO, South Asia Gateway Terminals (SAGT)/ Chair, National Agenda Committee (NAC) on Logistics and Transport
- Mr. Niranjan Dissanayake, Country Manager, Ferrero Lanka (Pvt) Ltd/ Chairman, Import Section of Ceylon Chamber of Commerce
- Mr. Dinesh de Silva, Trade Facilitation Expert/ Former Chairman, Import Section of Ceylon Chamber of Commerce
- Mr. Suren Abeysekera, Head of Logistics (South Asian Region), MAST Industries Ltd/ Former Chairman, Sri Lanka Shippers' Council
- Ms. Shehara Jayawardana, Joint Managing Director, McLarens Holdings Ltd/ Chairperson, Ceylon Association of Shipping Agents (CASA)

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Prepared by the Economic Intelligence Unit (EIU) of the Ceylon Chamber of Commerce:

Author:
Imesha Dissanayake, Research Associate
imesha@chamber.lk

Series Editors:
Shiran Fernando, Chief Economist
shiran@chamber.lk

Jayani Ratnayake, Economist
jayani@chamber.lk