

A Synopsis of the Outlook for the U.S. Economy and the Hospitality Industry

by M. Ray Perryman, Ph.D.

The last few years have been particularly good for economic forecasters, at least for those prognosticating on the U.S. economy. Not only has overall U.S. economic performance been exemplary, but it has also gone generally as expected. Although there have been some mixed economic signals in terms of magnitude, the overall direction of most indicators has been relatively clear. From a historical perspective, the current combination of good performance and relative predictability has not occurred often in recent history.

While the current economic conditions are favorable enough to make even economic forecasters look good (not an easy task, either), the conditions not coincidentally create an outstanding climate for many businesses. With abundant opportunities for expansion and increased profits, most sectors and industries are riding the crest of an unheralded wave of prosperity. Although the slight variance in economic signals has triggered considerable speculation over the intentions of the Federal Reserve Board (Fed) on a few occasions, this fact has not interfered with what has become a long-term pattern of steady growth that has boosted the nation's gross domestic product (GDP or output) above \$7.0 trillion (yes, that is with a "t").

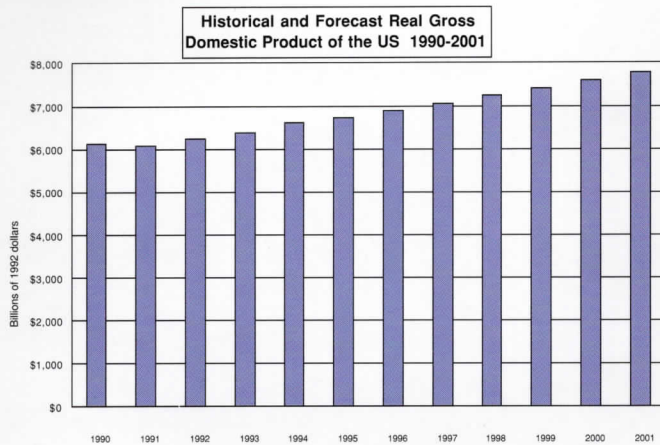
During 1996, U.S. output expanded at an annual growth rate of approximately 2.3 percent. Although the final numbers for 1997 are yet to be seen, it appears likely that gross domestic product should close about 2.5 percent higher than last year, representing an increase of over \$171.4 billion.

The Perryman Group (TPG) forecasts that GDP growth through 2001 will follow this trend, increasing by approximately 2.6 percent per annum. By 2001, total real GDP should rise to approximately \$7.8 trillion, accompanying an increase of nearly 1.0 percent per annum in the population. U.S. employment growth should continue to exceed the growth of the population and closely track that of the labor force, keeping the unemployment rate well below historic norms (although cyclical fluctuations are to be expected).

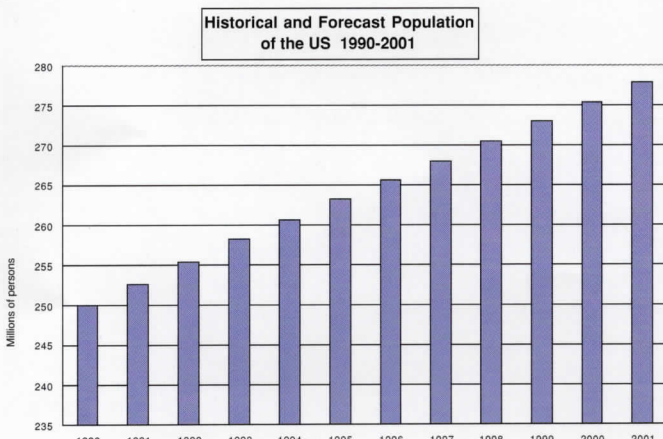
Furthermore, while turning in reasonably good levels of output growth over the past few years, the nation has also experienced extraordinary levels of price stability and historically low rates of unemployment.

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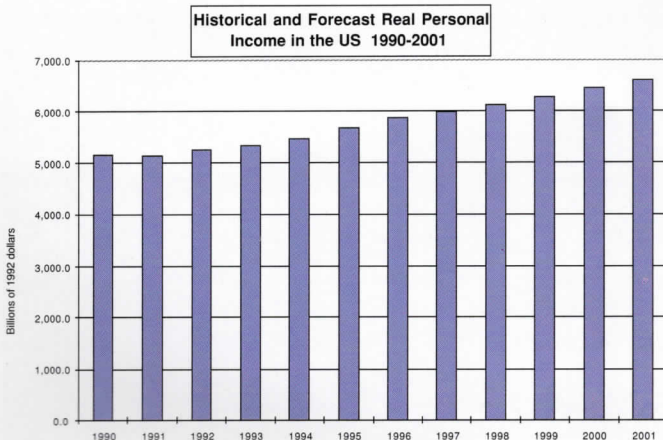
The hospitality industry, which has historically been relatively susceptible to economic downturns, appears to have reaped considerable benefits from the current economic expansion. The following charts show the historical and expected performance of key economic indicators for the national economy.



Sources: Bureau of Economic Analysis and The Perryman Group



Sources: US Census Bureau and The Perryman Group

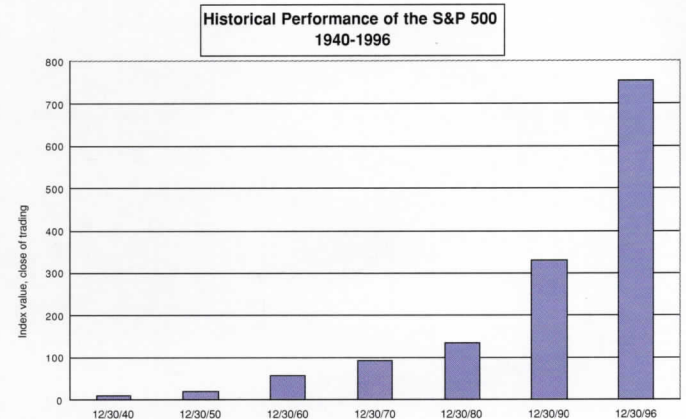


Source: Bureau of Economic Analysis and The Perryman Group

Key factors influencing the U.S. economy

U.S. Financial Markets and the Wealth Effect. Despite the fact that economists are not in agreement on the magnitude of the impact of increased asset values on consumer and investment spending, the potential consequences of the incredible perfor-

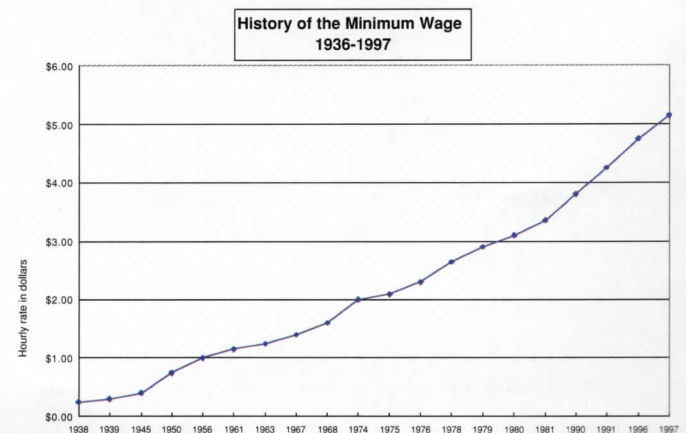
mance of the U.S. financial markets over the past two-and-a-half years cannot be ignored (see chart below). By September 1996, the financial wealth of the nation as reflected by the Standard and Poors (S&P) 500 Index had increased, depending on the chosen reference, by more than \$2.7 trillion—a figure greater than the total value of the annual output of most countries. TPG predicts that strong consumer and investment spending associated with this increased financial wealth will continue to be a driving force behind the national economy.



Sources: Federal Reserve Database (FRED) and The Perryman Group

Labor Availability and Cost. The current economic expansion has created an unprecedented arena for job seekers and employers alike. During 1997, the public has been inundated with one news story after another regarding the historically low unemployment rates the United States is enjoying. Although perhaps good for job seekers, the relative shortage of skilled laborers at all employment levels has left many human resource managers scratching their heads as they struggle to fill vital positions. Managers in the hospitality industry are acutely aware of the shortage of skilled workers.

However, the relative lack of an available labor pool may have a silver lining as it potentially renders recently mandated increases in the minimum wage irrelevant. As shown in the accompanying chart, the second increase in the minimum wage since 1991 took effect in September 1997, pushing the mandated minimum hourly rate to \$5.15, an increase of \$0.40. This hike brings the total increase since 1996 to \$0.90, or nearly 22.0 percent of the pre-1996 \$4.25 per-hour base rate.



Sources: The Associated Press and The Perryman Group

Notwithstanding the magnitude of this increase and its potentially negative consequences for businesses (including formidable cost pressures on many hospitality industry firms, which, historically, have exhibited particular sensitivity to upward wage shocks at the lower end of the labor market spectrum), the supply and demand conditions in the labor market make it unlikely that this action will trigger significant signs of inflation. Although some firms, including those in the hospitality industry, will undoubtedly see marginally higher costs from the mandate and likely attempt to pass on the increased costs to their customers, the major impact will probably be seen in the form of reduced levels of service. TPG expects the current level of competitiveness in many industries will serve to keep potential cost increases to a minimum. As has often been the case with minimum wage legislation, any detrimental impacts will likely be borne primarily by the lowest-skilled group of workers in the economy.

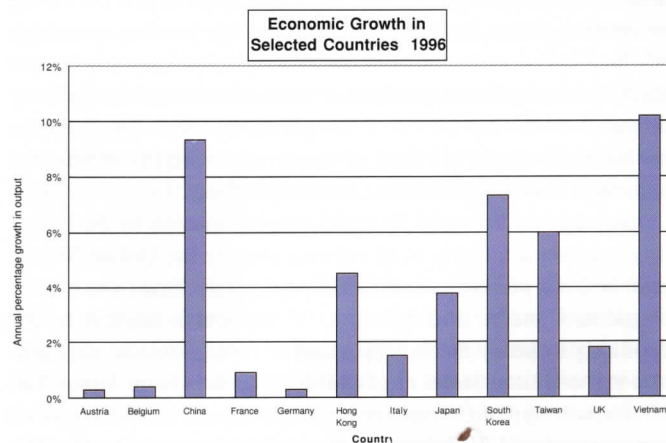
International Trade and the Global Economy. As business activity continues to evolve in a global context, economic projections must, by necessity, incorporate the complexities of an international framework. As a result, international issues will remain a front-page item in the story of the nation's economy; large companies involved in the entertainment and hotel/motel industries are in the fray. The current economic outlook therefore includes projections of international activity around the globe; it offers a glimpse of the myriad factors likely to shape economic conditions well into the upcoming millennium.

The increasing dependence of the export-driven U.S. economy on the health of its trading partners will continue to be a major factor affecting domestic economic conditions. Predicted growth patterns of export sales, particularly for the hospitality industry (as represented by international tourism), are integral components of our forecast. They are strongly correlated with both foreign exchange rates and the general economic performance of our main trading partners. In addition, the continuing impact of NAFTA (North American Free Trade Agreement) coupled with the prospect of a trade pact with Chile, intensifies the strength of this trade-dependent relationship.

With regard to exchange rates, the outlook on foreign currencies shows a picture very similar to what was forecast last year—a strong dollar. The U.S. dollar has strengthened considerably against the currencies of its major trading partners since 1995, making U.S. exports more expensive overseas and reducing the cost of imported goods. (Note: in this context, U.S. exports would include the sale of hospitality services to foreign tourists in the United States—hence, any increase in the dollar relative to other currencies makes a trip to the United States more expensive and less appealing.) However, the good news for the hospitality industry may rest in the fact that the trade-weighted value of the dollar is unlikely to strengthen significantly more than it already has. This development will mean that the vast majority of upward price pressure on exporters has already been absorbed. This trend may tend to mitigate further erosion of the relatively strong performance of U.S. goods in overseas markets that we have seen in recent periods.

Turning to the health of our trading partners' economies, the story is, generally, one of slow but steady growth with moderate or no price inflation. Look for modest growth in the major tourist-source markets as they continue their relative economic expansions. Specifically, the Mexican economy should continue to

regain the ground it lost in 1994 and 1995 due to the devaluation of the peso. Because Mexico is the United States' second largest export market (after Canada), its economic resurgence should generate increased levels of U.S. exports which translate directly into increased U.S. output. The following chart illustrates the widely divergent growth rates currently being exhibited by various participants in the world economy.



Sources: WEF and The Perryman Group

The Federal Scene. The significance of the government sector and the impact of political forces on business decisions are major factors in shaping the course of economic activity. Despite rhetoric to the contrary by both parties, the deficit is very likely to be with us in 2002, the near-mystical date at which the red ink is currently slated to disappear (although specific factors may temporarily bring the reported budget into balance over the near-term horizon). Regardless, the battle to tame the deficit can only be won by a combination of two events: higher taxes and/or decreased spending. Irrespective of the final balance, many forecasters no longer expect federal spending to have the stimulative effect it once did. In fact, as the national economy grows and the deficit shrinks, the pattern of U.S. government expenditures may actually have been transformed into a sort of braking mechanism, providing a certain level of fiscal drag on the economy. However, the reduced levels of expenditures are not expected to significantly restrain economic growth; state and local government expenditures, in addition to consumer and investment spending, are forecast to remain strong. In particular, the recent modest efforts to slow the rate of growth in federal spending have often represented little more than a transfer of responsibility to other levels of government.

Outlook for the hospitality industry

In any discussion of the national economy, the vital role of the tourism and hospitality industry cannot be overlooked. Recent estimates from the U.S. Department of Commerce peg the total impact of foreign tourism in the United States at more than \$400 billion. Approximately \$61.0 billion of that amount represents direct annual expenditures by foreign visitors to the United States. Coupled with the substantially higher impact of domestic travel and entertainment, it becomes very easy to visualize the importance of the sector. While the direction and magnitude of overall economic activity certainly play a significant role in determining the fortunes of the hospitality industry, there are a number of key driving factors that have particular influence on it. Among the

factors thought to exert significant influence on the hospitality industry are (1) international tourism, (2) population and demographic trends, (3) overall consumer confidence, (4) public perceptions of violent crime, and (5) changes in the level of consumer debt.

In addition, by factoring in a likely continuation of relatively low airline ticket and petroleum product prices, an excellent climate for an expanding hospitality industry emerges. However, one caution is that despite the strength of the current expansion and the likely increase in demand for hospitality services, the presence of intense competition in many sectors of the industry will put downward pressure on margins and profits. This squeeze may have the perverse effect of decreasing margins of affected businesses even while revenues are expanding.

International Tourism. Notable areas of interest to the hospitality industry are likely to be nations that are the United States' major sources of international tourists, namely Japan, the United Kingdom, Canada, and Mexico. Of particular interest to the hospitality industry is the proportion of foreign tourist expenditures in the United States attributable to visitors from Japan. The U.S. Department of Commerce estimates Japanese tourists spend approximately \$17.0 billion in the United States annually. The United Kingdom comes in at a distant second place in the expenditures race, with less than \$9.0 billion annual outlays.

Overall, international travel should provide a reasonably strong source of additional demand for services in the hospitality industry. To summarize, TPG expects moderate economic growth (to exceed 1.5 percent) in the economies of most of our major trading partners, thus bolstering their respective roles as important tourist-source locations.

Crime. Although not always considered a direct economic issue, one particularly poignant phenomenon affecting the U.S. hospitality industry concerns the relationship between tourism and crime. A wide variety of criminal activities are thought to affect overall revenues flowing to the hospitality industry, but more than anything else, it is the perception of violent crime that carries the potential to choke off travel volumes (and therefore, dollars). Florida, in particular, has been victimized (perhaps somewhat unfairly) by worldwide notoriety following a few well-

publicized incidents of extremely violent criminal outbursts.

The primary impact of a concentration of criminal activity, or the public's perception of its presence, is manifested by the reallocation of economic activity from one locale to another (to the extent that any particular country is not shunned by foreign visitors). Regardless, the clear incentive to anyone involved with the delivery of hospitality services is to reduce the reality and perception of criminal activity. Vigorous public relation efforts have historically been fairly effective tools in mitigating potential reductions in guest volumes following negative publicity concerning crime.

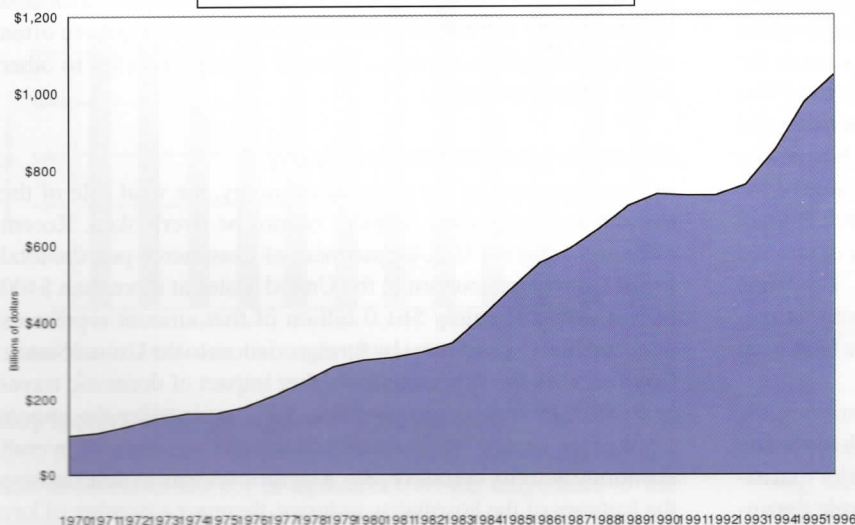
Population and Demographic Trends. The U.S. population is in the midst of significant changes in the composition of its population. The massive bulge created by the Baby Boom, and the aging of the resulting Boomers has enormous implications for business activity in general and the hospitality industry in particular. As the Boomers begin to reach their mid-50s, look for more changes to come. One of the primary influences relates to the increasingly short-term time frame many Boomers have to engage in retirement planning—and the economic sacrifices that must accompany thrift. Another notable factor is the magnitude of wealth now being transferred across generations as the parents of the Boomers (historically very effective savers) begin to pass on the financial rewards from their cost-conscious attitudes.

In addition, another significant demographic change witnessed in the past 20 years includes shifts in consumer spending patterns stemming from the two-income household. In general, there seems to be a trend towards consumers' preference for long weekend getaways instead of lengthy vacations to distant places. Ironically, despite increases in the upscale offerings, an increasing portion of the population is now entering middle-age in the 1990s, and appears to exhibit a preference for companies which offer upscale amenities at moderate prices. Finding the ideal way to market to the ever-aging Baby Boomer population will remain a key to success.

Consumer Confidence. U.S. consumer confidence, buoyed by the continued economic expansion, has been running high for many months. Often used by economists as a measure of an economy's overall strength, the benchmark measurement is a critical indicator of the outlook for hospitality services. In fact, many analysts believe that the hospitality industry is more sensitive to changes in consumer confidence than nearly any other segment of the economy.

Recent performance, as measured by changes in the consumer confidence level, indicates a rosy outlook for travel and leisure services and bodes well for the industry. However, one caveat relates to the strong correlation between other economic indicators and confidence levels. It is therefore necessary to look beneath the numbers and attempt to understand the drivers. One of the primary drivers of confidence is security. Since change brings uncertainty and tends to lessen confidence, it is important to note that significant variability in this indicator is to be expected. Sufficiently negative performance in other economic indicators or pessimistic news coverage tends to cloud the confidence picture by introducing additional uncertainty.

**Consumer Installment Credit Outstanding
1970-1996**



Sources: US Department of Commerce, Bureau of Economic Analysis, and The Perryman Group

Outstanding Consumer Debt. The outstanding levels of consumer debt are another primary driver and exhibit a strong negative correlation to hospitality industry activity. Although the level of consumer debt has risen steadily over time, its rise is explained in part by the increased levels of credit card use and aggregate population and demographic trends. In fact, although the total level of such debt is somewhat worrisome, much of the apparent increases are explained by those two factors. Any significant increase in debt levels beyond what is warranted by the underlying structural change in expenditure patterns (increased use of credit cards) or the ongoing population and demographic changes, should be viewed critically by the hospitality industry. The chart on page 10 illustrates U.S. outstanding consumer debt (installment credit) over the past several years.

Examining the industry by sector reveals an outlook that is, for the most part, quite healthy; most sectors mimic the growth of the national economy. For example, in the lodging industry, we expect the relatively strong performance to continue, driven primarily by the economic growth levels experienced in the economy at large. Consolidations in the lodging industry are likely to continue over the near terms as market participants seek to expand capacities while restraining capital expenditures. This cost-cutting environment is likely to prevail through the next several years despite some indications of growth heavily-oriented to the mid and upscale segments of the industry. In fact, existing capital investment patterns indicate a definite trend toward those segments where it is less expensive to acquire than to build.

Note, however, although there appears to be no shortage on the demand side, growth in the supply of available rooms is continu-

ing relatively unabated from last year's rapid pace. Some caution may be warranted to avoid an overbuilt situation that could potentially drive down rates.

Also notable is that solid growth is not certain across the board. As an example of the imperfect distribution of growth potential across sectors, we can look toward the culinary side of the industry. For instance, growth in the restaurant sector has failed to produce the same set of positive results shown by lodging. TPG's forecast predicts the possibility of a modest flattening of revenues across this sector. One recent trend in restaurants that may work to mitigate any slide has been toward the development of "theme restaurants" that sometimes team up with retail and celebrity entertainment efforts to attract customers. Examples include the emergence of Planet Hollywood and the Hard Rock Cafe.

Conclusion

The overall outlook for the United States remains good, although perhaps somewhat less rosy than at this time last year. Specifically, the outlook for the hospitality industry is equally as bright, with strong revenue growth likely in many sectors. Important factors that are likely to influence the outlook for the industry include crime, population and demographic changes, consumer confidence, international tourism, and outstanding consumer debt levels. Furthermore, a number of significant events transpiring in specific segments of the industry bear monitoring. These include issues such as the rapid growth in supply of hotel rooms and competitive price pressures in the restaurant arena. In sum, although some aspects of the hospitality sector bear watching, The Perryman Group is optimistic about the industry's future. •

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