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Tourism faces escalating security and economic challenges

Executive Summary

- The alleged terrorist plot uncovered in the U.K. in August was yet again another reminder of the vulnerability of global tourism. Although the event did not appear to have a significant lasting impact on travel demand, air security was tightened further in response to the foiled plan, which was said to involve the use of liquid explosives disguised as innocuous carry-on baggage items. As a result, liquids and gels are now banned from cabin baggage, increasing the inconvenience of air travel. Some travellers view these new restrictions as a reasonable price for safety, while others-business travellers, in particular-are finding airline security issues an increasingly burdensome challenge.
- Meanwhile, other clouds have appeared on the horizon for the U.S. travel market. U.S. consumer confidence fell sharply in August, as pressures from surging gasoline prices, a weakening job market and falling housing prices took their toll. The overall outlook for the U.S. economy has become more pessimistic, which suggests that heading into 2007, the weak trends in U.S. visits to Canada will continue.
- Up to now, the solid performance of the domestic and overseas markets has offset some of the softening trends in U.S. visits. The latest *Canadian Industrial Outlook* forecast by The Conference Board of Canada suggests the profitability of the Canadian tourism industry will reach a new high of $1.05 billion this year, mainly because of strong domestic demand. In particular, a greater focus on marketing Canadian destinations by provincial and regional tourism agencies has been a major factor in the resurgence of domestic travel. Canada's solid economic fundamentals should ensure Canadian individuals and businesses retain the financial means necessary to travel in the coming months.

Emerging Trends and Issues: Online Channels Net Growing Number of Canadian Travellers

- The landscape of Canadian travel distribution has been transformed in recent years, shaped by forces such as world events, the vertical integration of tour operators, and-most significantly-rapid growth in the online travel market. In fact, over the last four years the way Canadians purchase their travel has changed significantly. Since 2002, there has been a precipitous decline in Canadians' reliance on travel agency services when planning a vacation. At the same time, a growing number of Canadians view the Internet as a valuable resource for planning their trips.
- However, the propensity to move from looking to booking has not really changed over the past several years. A major barrier for many Canadians reluctant to make an online purchase is concerns about security. As consumers grow more comfortable with online technology, and as e-commerce security features become more sophisticated, the potential for converting online "lookers" to "bookers" will also expand.

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Consumer (Traveller) Overview - North America

- The near-term outlook for Canadian travel demand remains relatively solid, although high gasoline prices are expected to keep Canadians closer to home. According to the latest Travel Intentions Survey by the Canadian Tourism Research Institute (CTRI), nearly 44 per cent of Canadians polled in June said they planned to take a vacation between November 2006 and April 2007, a slight decline (-1.2%) from a year earlier. However, the percentage of respondents planning a vacation in Canada this winter rose to 17.4 per cent, up from 16.6 per cent in the 2005 survey. In addition, more travellers planning a winter domestic trip intend to travel by automobile to their destination this year.
- In the United States, sky-high gasoline prices have encouraged a significant number of Americans to alter their vacation plans. A July survey by The Conference Board, Inc. revealed that a third of the U.S. households polled said the recent run-up in gas prices had caused them to change their vacation plans. Of those reporting a change, 74 per cent said they would be driving less, and 63 per cent said they would be staying closer to home. Other changes include postponing or shortening vacations (each cited by 26% of respondents) as well as cancelling vacations altogether (25%).
- Meanwhile, the latest corporate benchmarking study by HRG North America revealed that in 2005, its Canadian corporate travel clients paid an average of 7 per cent more for domestic air tickets, while prices for U.S. and international flights fell 8.5 per cent and 1.3 per cent, respectively. For 2006, HRG expects average airfares to increase for all markets, as higher fuel costs continue to drive up air ticket prices. Given the growing demand for accommodations, the company also expects a "substantive" rise in hotel rates this year, following the 2 per cent average increase in rates their clients paid in 2005.

Travel Supplier Overview - North America

- Air Canada and WestJet have both increased their domestic capacity, and so far the market appears to be absorbing the additional seats. This capacity expansion did keep airfares down early this summer, although by August, they had registered a modest increase over the previous year. So far, the U.K. security alert does not appear to be significantly deterring air travel, however, analysts remain cautious about the outlook for the Canadian airline industry, mainly because of climbing fuel costs.
- In the United States, soaring jet fuel costs have prompted further airfare hikes, which have held up reasonably well, providing U.S. carriers with a significant revenue boost. Airlines have reduced domestic capacity even further, and demand is holding strong, lessening competitive pressures in the U.S. market. At the same time, capacity on international flights continues to grow, as airlines try to capitalize on their more lucrative routes. In fact, flights between the U.S. and Europe have increased 21 per cent over the last three years; of this increase, two-thirds has come from U.S. airlines, expanding the U.S. share of the U.S.-Europe market from 45 per cent in 2003 to 49 per cent in 2006.
- The performance of the Canadian hotel industry continues to gain momentum, as average daily rates remain on an upward trend and lodging demand grows. Increases in Canadian hotel room supply, on the other hand, have been minimal, allowing occupancy rates to continue rising. As a whole, the Canadian hotel industry is expected to return to profitability this year, as a result of revenue improvements and a slowdown in cost increases.

International Overview

- The foiled terrorist plot uncovered on August 10, 2006, disrupted an estimated 400,000 passengers on that day alone, according to OAG estimates, and it took a week for U.K. airline operations to return to normal. Fortunately, the event did not appear to have a significant impact on travel confidence in the U.K. A British survey commissioned by the Guardian about two weeks later indicated that 81 per cent of those polled said the security alert would have no impact on their future travel plans whatsoever. Only 15 per cent of respondents said that the threat of terrorism made them less likely to fly.
- German tour operators reported weak sales in the period leading up to 2006 FIFA World Cup. The latest figures from Statistics Canada suggest that the staging of the World Cup dampened visitation from Germany and many other western European countries in June. Fortunately, tour operators throughout Europe have reported a solid recovery in bookings since mid-July.

- Meanwhile, the competition to target international travellers continues to heat up. Visit Britain and Tourism Australia have each recently announced they will focus on wooing back Japanese visitors now that Japanese outbound travel is recovering. Visit Britain said it would target Japanese baby boomers in particular, because they are "very much celebrating life after work." Tourism Australia intends to change the perception among Japanese travellers that Australia has become "stale and unfashionable." As well, United Airlines recently moved its regional sales and marketing office from Miami, Florida, to Mexico City because of the large growth in Mexican travellers it has experienced in recent years.

Economic Overview

- More and more signs point to a slowdown in U.S. economic activity. Retail sales have been declining, labour market growth is weakening, and housing markets are cooling rapidly. The dramatic slowdown in the housing market signals an end to the wealth effect in the U.S. The Canadian economy will remain somewhat insulated from the slowdown in the U.S. since it also relies heavily on domestic demand for growth. With consumer spending and business investment still growing at a healthy pace, the Canadian economy will likely weather the storm. Overall, growth in real gross domestic product (GDP) for North America is expected to slow to 2.5 per cent next year.

- Europe's economy continues to perform very well. Led by strong growth in France and helped by improvements in Germany and Italy, overall GDP for the eurozone advanced by 2.4 per cent in the second quarter of 2006. Rising business confidence and increasing French and German business investment have been largely responsible for the recent upswing. Going forward, the European economy is expected to perform well for the rest of 2006 but will slow heading into 2007. With oil prices remaining high and inflation a concern, further interest rate hikes are likely. As a result, economic growth in Europe is expected to slow from 2.4 per cent in 2006 to 2.1 per cent in 2007.

- Strong export growth continues to be the main driver of the Asia-Pacific economy. China is still leading the pack, with another year of near double-digit growth. However, other countries, such as Japan, are also faring well. Aside from exporting directly to the United States, more and more Asian countries are starting to export their wares to China, which then incorporates them into products to be sold in the United States. However, problems could arise when export growth from Asia slows because of the sharp downturn in U.S. consumer spending. Already, the slowdown in demand for high-technology equipment has hurt the economies of Taiwan, Thailand and Malaysia. Other countries will likely follow once the slowdown in demand becomes more broad-based.

Opportunities

- **Asian "grey" market offers enormous potential:** Abacus International, a travel company serving the Asia-Pacific region, recently reported that "grey travellers" are one of the fastest-growing segments of the Asian travel market, according to eyefortravel.com. More and more seniors are remaining healthy and fit well into their sixties, and are seeing travel as a natural thing to do with their spare time and money. The market is expected to continue expanding over the next 10 years, as the Asian population continues to age. However, travel suppliers will need to be creative and customer-focused in the way that they cater to this market, tailoring their services to meet the market's specific needs.

- **Turning lemons into lemonade:** With U.S. passport deadlines (as part of the Western Hemisphere Travel Initiative) looming on the horizon, some travel suppliers are implementing proactive measures to mitigate the negative impact of the new regulations. Apple Vacations, a U.S.-based tour operator, is offering to help offset the cost of acquiring a U.S. passport through its "You Fly, We Buy" promotion. When booking a seven-day vacation package for 2007, Apple will offer clients a $100 per person discount, which can then be used to cover the fee for purchasing or renewing a U.S. passport.

- **Rapid growth in Internet use could benefit Canada's tourism industry:** As Internet access expands in China, so does the Chinese online travel market, which is poised for huge growth, according to reports from the Travel Distribution-China conference hosted by eyefortravel.com. According to eLong, an online travel agency, Chinese Internet usage surged by nearly 20 per cent in the first half of 2006, year-over-year, to 123 million individual users. Meanwhile, high-speed Internet access in Mexico appears poised for considerable growth in coming years, driven by strong consumer demand, according to a recent Datamonitor Market Research Report. The country's largest telecom company, Telmex, is planning to spend up to US$2 billion upgrading Mexico's telecommunications infrastructure, which will support a substantial expansion of high-speed Internet access across the country.