OnTheRecord

A Conversation with **Herb Kelleher**

Staying Aloft in Today's Turbulent Skies

Southwest Airlines executive chairman Herb Kelleher, a member of the Dallas Fed's board of directors, gives a front-line executive's view of the economy and the changes buffeting one of Texas' most important industries.

When asked about the secret to Southwest Airlines' success, Herb Kelleher jokingly replies, "Charismatic leadership." Beyond that, being the only major U.S. airline to make a profit every year since 1972 has come down to three factors: having a contrarian strategy and sticking to it, keeping costs down in good times so the company is prepared for the bad times and—perhaps most important—treating employees well and trusting them to do their jobs.

Kelleher joined with Rollin King to create Southwest Airlines in 1967. After four years of legal challenges from existing carriers, the fledgling airline finally began operations in 1971 with a fleet of three Boeing 737s that served Dallas, Houston and San Antonio. Southwest began to grow by emphasizing low fares, friendly service and quick ground operations that kept planes in the air. With a fleet of more than 500 aircraft, Southwest now offers more than 3,300 flights a day, serving 63 cities coast to coast.

Q. Some analysts worry that the U.S. economy is slowing. What do you see from your vantage point?

A. What we have seen is a gradual softening that started at the beginning of this year. If you look at the consumer confidence readings from the Conference Board or the University of Michigan, you can see there has been a downward trend.

For us, the trend wasn't totally manifest until the second quarter, but there's little doubt that many people are getting a little more cautious with their discretionary spending. Consumer demand is looking somewhat dicey, and the public seems increasingly skittish about the prospects for the U.S. economy.

Q. What about the Eleventh District, consisting of Texas and parts of Louisiana and New Mexico? How are things faring in our neck of the woods?

A. We had been saying for some time that the Eleventh District was a standout, a star with respect to airline bookings. But from the perspective of passenger traffic, we can no longer say that the district is head and shoulders above the rest of the country. Today, it's sort of in the middle of the pack relative to the rest of the country and continuing to exhibit a gradual downward trend in demand for domestic travel.

Q. Are there areas of the country that remain standouts?

A. At this juncture, we're characterizing "no change" from last year's bookings, on a capacity-adjusted basis, as doing "pretty well" relative to peer districts. On that basis, Cleveland and Kansas City appear to be strengthening, and Boston and New York are still relatively strong.

Q. How is the glum turn in the consumer's psyche impacting the way airlines conduct their day-to-day domestic business?

A. All major U.S. airlines are now reducing domestic seating capacity and/or paring back the rate of domestic expansion in response to weakening absolute demand across the nation. That's part of why load factors right now are so great. So much capacity has been taken out. The players that had been growing fast are slowing down, and we have started to see some airlines cancel or delay plans to add planes to their domestic fleets.

Q. How has the recent run-up in oil prices affected the outlook?

A. Thanks to the globalization of business and the weakening dollar, the major international airlines reported good third quarter earnings. But I suspect that the increase in jet fuel prices will translate into flattish to down earnings for the industry as a whole for the fourth quarter. It's also probably impacting how passengers view travel.

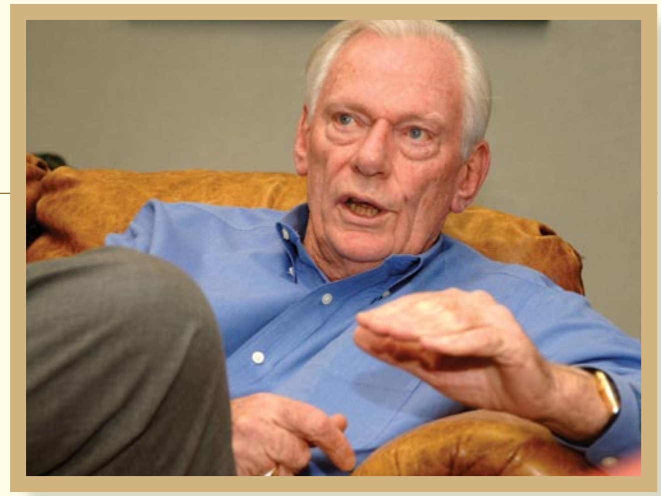
In the past, a big spike in gasoline prices would push more travelers to fly. But today, because of the pocketbook toll of high gasoline prices and the angst about the economy, I suspect some people are deciding not to take discretionary trips at all.

There are other possible responses to the long rise we've seen in oil prices. It has caused airlines to try to persuade engine makers to expedite efforts to make more fuel-efficient engines. On this count, we've made much greater strides in efficiency than other industries. In the past 25 to 30 years, we've decreased fuel use per seat by 50 percent. Of course, we can go only so far. You can't realistically expect to fly an airplane using wind power or electricity.

Q. Are there other factors impacting the bottom line today?

A. It may surprise most Americans to learn that the industry is beating itself to death to fill airplanes at 1990s fare levels, when we take inflation into account. About 70 to 75 percent of an airline's costs are fixed. On any flight taking off, you've already paid for everything from the crew that's flying the plane to the jet fuel that's providing the power. So if

"In the broadest sense, it seems to me that globalization has for some time held down the cost of living in this country."



you have 20 empty seats, it's best to fill them at some price rather than not fill them at all. That's why you hear about a goodly number of fare increases but see relatively little in the way of higher average fares actually paid.

Q. What are these signals telling us about the outlook for the economy?

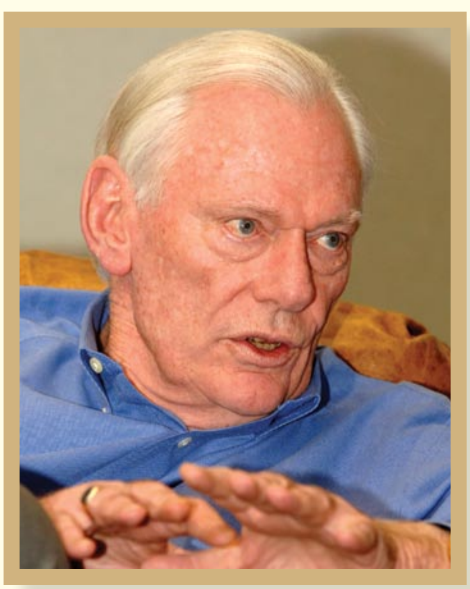
A. Some analysts regard airline bookings as a lagging indicator, but I have always seen them as somewhat of a leading indicator. Saying that always reminds me of a speech I gave in San Antonio back in the 1980s, when things were turning down in Texas. At the time, bookings in San Antonio were down 15 percent, which compelled me to inform my audience that though they might not know it, they were currently in a recession. And it soon became evident that they were.

Q. So are we in a recession?

A. I would say "probably," if I were only looking at the traditional domestic indicators that I always have. But we're not in a recession; if we were, things would look much worse than they do at the moment.

I have thought about this a lot and venture the difference may be globalization and diversification, which have strengthened our overall economy. Something has indeed changed. In the absence of globalization and diversification, I suspect we would be in a recession right now.

In the broadest sense, it seems to me that globalization has for some time held down the cost of living in this country. That's one reason why I suspect that in the absence of globalization, we would be in a recession.



Q. How has globalization affected the airline industry?

A. We've seen a very vivid, concrete and compelling manifestation of the effects of globalization, a trend that really picked up steam three to four years ago and has accelerated ever since. At the time, the United States had begun to succeed in pushing for "open skies," whereas opportunities to fly between two countries had previously been much more curtailed.

Even where you don't have open skies, you have markets that are liberalizing using bilateral agreements. China is a great example. There has been an enormous percentage expansion with respect to the number of flights permitted; the restrictions have been loosened.

Q. How has this shift toward a globalized airline industry affected U.S. carriers?

A. Our big international carriers have benefited from globalization by effectively connecting the business world. It's not only that there is comparatively less competition than on domestic routes. The weakening dollar is also providing a boost to international carriers to the extent they receive payments in foreign currencies, such as the strong euro.

In essence, globalization has produced a prolific source of international passengers at higher fare levels. This is a sea change for the entire industry. I can think back to a time when the international aspects of the industry were not so prosperous, but today that has turned around.

Q. Are there any risks that accompany a globalizing airline industry?

A. There is something looming out there—more flights and new competition. As international restrictions continue to fall away, the number of flights and competitors is growing. Start-up low-fare carriers, for instance, are now operating between the United Kingdom and the U.S. I have little doubt that you will see more low-cost incursions into the global market.

Q. Ryanair has been mentioned as a candidate for just that and been characterized as Europe's Southwest Airlines.

A. We have just begun to hear talk that Ryanair might begin to fly between Europe and the U.S. Michael O'Leary is a fabulous and charismatic leader for Ryanair, and he's built Europe's largest low-cost carrier and exhibited a willingness to break molds. In yet another manifestation of how much things are changing, Ryanair recently tried to buy Aer Lingus, which amounts to a low-cost carrier in this country trying to buy one of the smaller old-line legacy carriers.

Q. Is there a message for existing international carriers?

A. As international flight restrictions continue to disappear, the sustained move toward greater competition will trigger the next major transformation in the industry. If there's a message, I suppose it could be that international travel won't be an endless cornucopia of prosperity for the current players. But that should come as no surprise. In the airline industry, you always have to keep a close eye on the future.