UHERO
THE ECONOMIC RESEARCH ORGANIZATION
AT THE UNIVERSITY OF HAWAI'I

UHERO STATE FORECAST UPDATE, PUBLIC SUMMARY

RAIL WILL ADD TO MOMENTUM

FEBRUARY 11, 2011

As last year's strong tourism rebound tapers off, Oahu rail transit work will lead an upturn in construction. Hawaii's recovery will strengthen and expand beyond the visitor industry to the broader economy.

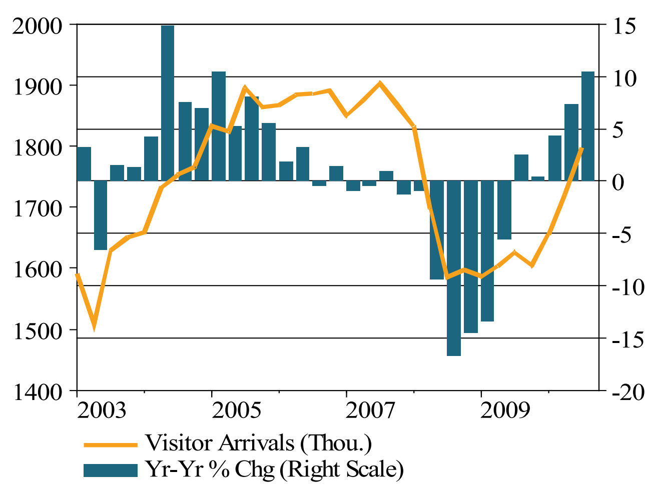
If last year's story was the surprisingly strong tourism revival, this year's will be Oahu rail transit. Now that the Governor and Federal Transit Administration have signed off, we have incorporated the project into our statewide forecast. Rail transit work will accelerate what would otherwise be a very anemic construction upturn, contributing to a gradual broadening and deepening of Hawaii's economic recovery.

The US economy has continued to struggle through a recovery that so far has been insufficiently robust to generate satisfactory job creation. Gross domestic product grew at only a 3.2% annual rate in the third quarter, and unemployment, while ticking down to 9.4% in December, hovered between 9.5 and 9.8% throughout the rest of 2010. At the same time, there are signs that the economy will strengthen in 2011. Real (inflation-adjusted) consumer spending growth has trended upward from a less than 1% annualized rate at the end of 2009 to 2.8% in the third quarter of 2010. The pace of spending likely accelerated to 4% or higher in the final quarter of the year. The Federal Reserve continues to provide very accommodative monetary policy, and the new stimulus package adopted in Congress's lame duck session will also add to growth. (See the box, How Much Lift from New Federal Stimulus?) We expect 3.1% real GDP growth for the US in 2011, strengthening to 3.8% growth in 2012.

There are also clear signs of improvement in Hawaii. Data on tax receipts and personal income indicate that economic activity in the Islands expanded at a respectable rate in the second half of 2010. General excise and use tax revenues averaged $199.5 million per month in the calendar year through October, a 4.2% increase over the same period in 2009. Nominal labor income of Hawaii residents expanded at a nearly 4% annual rate in the third quarter, the strongest performance since the beginning of 2007.

As at the national level, recovery is not yet making serious inroads in the local labor market. After improving from 6.9% in January to 6.3% in June, the seasonally adjusted statewide unemployment rate has remained stuck at 6.4% through December 2010. The limited gains that have been seen in payroll jobs—the fourth quarter job count was 5,000 higher than a year earlier—are attributable almost exclusively to growth in just three areas: accommodations, food services and drinking places, and federal government. In the large retail trade sector, gains early in the year were wiped out by losses late in the year.

The biggest positive change in the employment picture is a much slower rate of worker layoffs. Total claims for unemployment compensation in December were almost 20%



STATEWIDE VISITOR ARRIVALS

How Much Lift From New Federal Stimulus?

In last fall's lame duck session, Congress passed a package of tax cuts and spending extensions totaling nearly $1 trillion. How much economic stimulus will this provide?

One indication comes from the experience with the first big round of stimulus. The February 2009 American Recovery and Reinvestment Act (ARRA) provided $787 billion in tax cuts, support for social programs, and direct government spending. That stimulus program provided crucial support to an economy in deep recession, although the limited scope, structure, and implementation delays prevented a bigger impact.

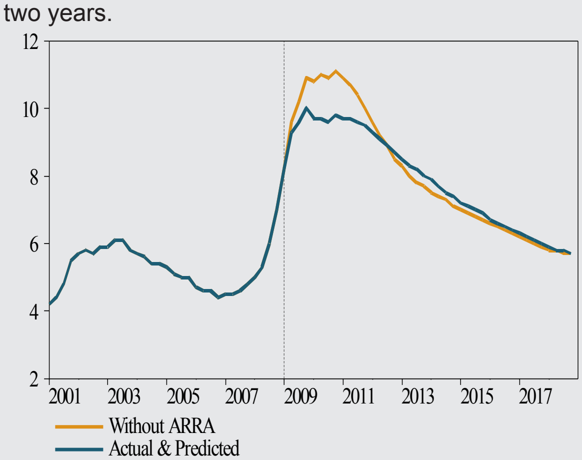
Despite its eye-catching price tag, the ARRA program paled in comparison to the size of the recession then underway. Spread over several years, the program peaked at about $315 billion in 2009, just over 2% of US GDP. However, US output fell by 7-10% below its potential growth path during the downturn and employment fell by 8.3 million. Even with a substantial multiplier, the stimulus package could only close a fraction of the output and employment gap.

The other problems were composition and timing. The pace of "spend out" of program funds was much slower than policymakers had anticipated, partly because much of the ARRA support was funneled through the states, who were slow to start spending, particularly the monies earmarked for infrastructure projects. Hawaii was no exception: by mid 2010, the state had received $1.3 billion in awards, but only $585 million of that money had been used, primarily to shore up unemployment insurance and Federal medical assistance.

The slow pace of government spending left tax cuts as the dominant form of stimulus in the early quarters of the ARRA program. While this was welcome relief for households, tax cuts have a low bang-per-buck because a portion of the funds may be saved or used to pare down debt rather than to increase spending.

Our research suggests that the ARRA program created (or saved) about 3 million jobs. Unemployment would have risen an additional 1.3 percentage points without the program.[1] But the peak effects were delayed until mid-2010, and were therefore unable to prevent the worst of the economic hardship.

What does that mean for Stimulus 2.0? Ignoring funds to extend Bush era tax cuts, roughly $594 billion will be spent on extended unemployment compensation and an array of tax cuts. This represents roughly 4% of US GDP spread over two years, which by 2012 will reduce the unemployment rate 1-1.5 percentage points below what it would otherwise be. While the tax cuts will have a limited dollar-per-dollar impact, they were implemented rapidly, as workers have already observed in higher take-home pay. Overall, the additional fiscal stimulus will provide useful support as the recovery gains momentum over the next two years.



SIMULATION: US UNEMPLOYMENT WITH AND WITHOUT ARRA

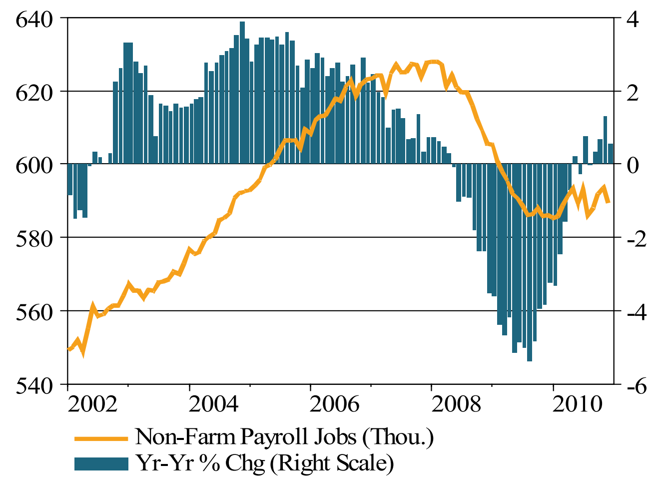
1 "F. Gerard Adams and Byron Gangnes, The Employment Effects of Fiscal Policy: How Costly Are ARRA Jobs? UHERO Working Paper No. 2010-16, December 20, 2010. http://www.uhero.hawaii.edu/assets/WP2010-16.pdf"

lower than they were a year earlier. Much of this decline is due to fewer newly unemployed people filing claims. Initial claims for unemployment insurance have fallen on a year-on-year basis for thirteen consecutive months.

Essentially all of the job recovery to date has occurred in Honolulu County. From the start of 2008 to early 2010, Oahu's seasonally adjusted nonfarm job count fell from 458,000 to 434,000. By the fourth quarter of 2010, about 25% of those 24,000 lost jobs had returned. Over the same peak to trough period, Kauai, Maui, and Hawaii Counties all lost roughly 10% of their nonfarm job base, but no comparable upturn has yet materialized. Job counts for all three Neighbor Island counties remain 10% below pre-recession levels.

The feeble job gains of the past year do not portend continuing labor market stagnation. Instead, more broadly based improvement will be seen in 2011 and 2012 as the Hawaii recovery strengthens and Oahu rail transit construction gets underway. Among the broad categories that we forecast, 2011 will see greater than 1% growth in all private sector areas except for wholesale & retail trade; finance, insurance & real estate; and agriculture. Only federal and state & local government sectors will see net job losses. The overall non-farm payroll job count will expand by 1.4% this year, roughly on par with our previous forecast. By 2012, the job base will be expanding at a 2% rate, up from the 1.8% pace envisioned in our last forecast. The statewide unemployment rate will average 6% in 2011, down from last year's 6.5% average. It will edge down to 4.6% by 2013.

We have noted above the firming that has occurred in general excise and use taxes. Data for the first four months of FY 2011 suggest a favorable outlook for public finances generally. Setting aside tax refunds that were shifted from the previous fiscal year, tax collections were up about 8.6% through October. Because of the delayed refunds, general fund distributions began the current fiscal year down $190



STATEWIDE NON-FARM JOBS

million, but revenue growth has since recouped more than $110 million of the shortfall. The pace of revenue growth has accelerated in recent months. Despite these revenue improvements, it may yet be difficult to achieve the 3% growth for FY2011 forecast by the State Council on Revenues, because we will soon be making year-on-year comparisons to the period at the end of the last fiscal year when disbursement of tax refunds was delayed.

Nevertheless, growth in public revenues is welcome news in light of large expected budget deficits for the next biennium. In December, the initial budget for FY 2012-2013 included a projected deficit of $772 million over the next two fiscal years. A primary reason for these shortfalls is the expiration of federal support programs enacted under the ARRA in 2009. Discontinuation of these federal programs, combined with the annual $158.8 million cost of ending state furloughs, explains essentially the entire shortfall.

Hawaii's recovery continues to be led by the resurgence of the visitor industry. By the middle of the fourth quarter of last year, the number of visitors finally broke back above levels seen prior to the early 2008 failures of Aloha Airlines and ATA. Domestic passenger lift, which had fallen from nearly 2 million seats prior to the recession to 1.56 million at the end of 2009, is on the rebound. Nearly 40% of the lost seats have now been restored as airlines respond to improved

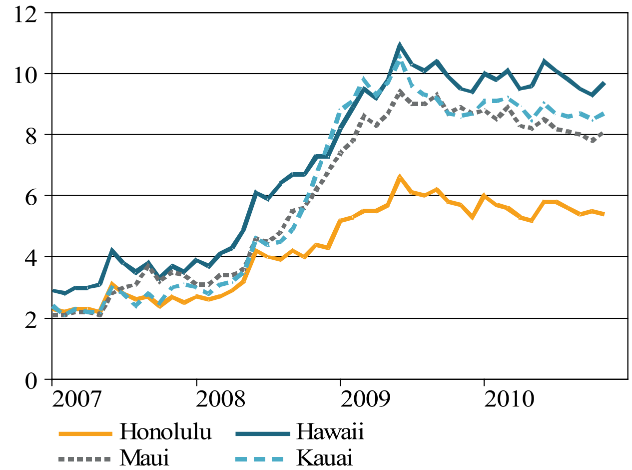
US economic conditions with expanded schedules and new routes.

Visitor strength in the second half of 2010 was driven by strong growth in travel from the US, which has been running 12% higher than year-earlier levels since June. There was a 15% surge in the Pacific Coast market. Also contributing to the rise in domestic passenger traffic were 66,800 Canadian citizens who flew to Hawaii from American airports, a 34% increase over 2009. After what had been a weak first half, this strong second half growth pushed both US Pacific and Canadian domestic visitor counts up roughly 10% for the year to November.[1]

Increased visitor traffic has led to a sharp increase in visitor spending. Through November 2010, visitor expenditures were nearly 16% higher than in 2009. Spending by visitors from the US was up more than 12%, and Japanese visitor spending was up 5%. A dramatic increase of more than 50% occurred in the combined spending by visitors from other international markets, including Korea, Australia, and Europe. International visitors continue to be particularly attractive to the industry because of high per person spending, which in the August to November period was roughly 60% higher than that of a typical American visitor.

The surprisingly rapid pace of visitor industry rebound is unlikely to persist. Despite gradually improving US economic conditions, the recovery path remains rocky. Abroad, the sharp initial Asian pickup is now past, while rising energy prices and sovereign debt problems will weigh on growth elsewhere. Hawaii's tourism recovery will continue at a more modest pace, with an anticipated increase of 3.4% in arrivals this year, slowing to 1.9% growth in 2012.

Conditions continue to be challenging for hoteliers. The good news is that statewide occupancy rates have



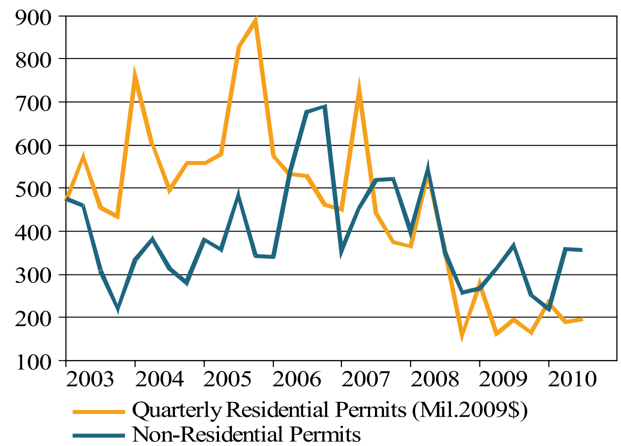
UNEMPLOYMENT RATE BY COUNTY

remained above 70% for each of the past six months ending in November 2010. Unfortunately, nearly all of the gains were concentrated on Oahu and Maui, which saw average occupancy near 80% and 70%, respectively, throughout the second half of 2010. Kauai occupancy improved a few points mid year, but now seem stuck in the low 60s. The Big Island has not broken the 60% barrier since June 2008. We expect statewide hotel occupancy to average 73.1% in 2011, firming to 74.9% in 2012.

Aggressive expansion by Alaska Airlines could provide a boost to the beleaguered Kauai and Big Island markets. This winter the carrier added a total of seven seasonal flights from Portland and Seattle-Tacoma to Kona. A new daily flight from Bellingham, WA to Honolulu began service recently, and seven weekly flights to Lihue from San Jose and Oakland will start up in late March. This new capacity could help these markets the same way that new flights by Alaska Airlines and Westjet boosted Maui visitor traffic in 2010. Honolulu has not been left out, with new Hawaiian flights from Tokyo-Haneda and Incheon. We'll discuss county differences in prospects for tourism and other sectors in our second quarter UHERO County Forecast.

The deep slide in construction is coming to an end. Employment, which had fallen from 39,700 jobs in late 2007 to below 29,000 in the third quarter, edged back up during

1 Visitor data for December 2010 was not available at the time this forecast was prepared.



REAL PRIVATE PERMITS (MIL. 2009$)

the final quarter of the year, and monthly private construction permits have increased. Gradually recovering residential and non-residential construction will contribute to growth over the next several years. More important will be massive public infrastructure investment, particularly for the Oahu rail transit system. As we discuss in our separate UHERO Construction Forecast, the project will drive a much more rapid pickup in construction employment than would otherwise have been the case. After a 3.7% gain this year, construction job growth will accelerate to 7.7% in 2013. Rail-related hiring will reduce unemployment by more than one-half percentage point at the project peak in 2013-2014.

Data on Honolulu inflation for the second half of 2010 is not yet available. In the first half, local inflation was 2.5%, with energy and nondurables (such as clothing, batteries, and paper goods) making the largest contributions. While firming home prices and rising energy costs will provide some upward pressure, we expect relatively mild inflation in the 1.4-2.6% range to persist for the next three years. Inflation-adjusted personal income, a broad summary measure of local economic growth, will average 2.2% in 2011, firming to 2.6% by 2013. This year will mark the first year since 2007 that real per capita income increases in Hawaii.

Hawaii's recovery will grow in strength during 2011. Growth will extend beyond the tourism-linked sectors that were the sole beneficiaries of last year's visitor industry rebound. Oahu rail transit will provide an important lift, helping to move the ailing construction sector more rapidly back on track. There are risks to the downside, including rail project delays, resurgent energy prices, and the possibility of an early rise in interest rates if national inflation fears mount. And Hawaii growth will likely remain modest by historical standards, so that labor market and fiscal challenges will take time to abate.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2008	2009	2010	2011	2012	2013
Visitor Arrivals	-10.5	-4.4	8.2	3.4	1.9	1.9
U.S. Visitor Arrivals	-13.5	-3.9	6.4	3.3	2.0	2.0
Japan Visitor Arrivals	-9.4	-0.6	4.5	0.6	0.9	0.8
Other Visitor Arrivals	3.0	-10.5	20.6	6.4	2.8	2.7
Payroll Jobs	-0.9	-4.4	-0.4	1.4	2.0	2.0
Employment	-0.5	-4.1	-0.2	1.2	2.3	2.0
Unemployment Rate (%)	4.1	6.8	6.6	6.0	5.3	4.6
Inflation Rate, Honolulu MSA (%)	4.3	0.5	1.7	1.4	2.6	2.5
Real Personal Income	-0.3	-0.7	0.2	2.2	2.4	2.6
Real GDP	-1.5	-0.1	1.0	2.7	3.4	3.8

Note: Source is UHERO. Figures for 2011-2013 are forecasts. Except for labor market data, figures for 2010 are UHERO estimates.

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