Hawaii's Economy In Need of An Engine

OCTOBER 24, 2014

Weak tourism and federal downsizing are holding down growth. Construction has disappointed this year, but is poised for gains.

Prospects for Hawaii growth remain muted. Despite a pickup over the summer, visitor arrivals have been soft this year, and the period of robust visitor spending increases is behind us. A mixed global economic environment and limited visitor industry capacity will keep a lid on future gains. While the construction expansion continues, it does so at a slower pace than anticipated and has created few new jobs in 2014. The building trades nevertheless remain the most likely drivers of expansion over the next several years.

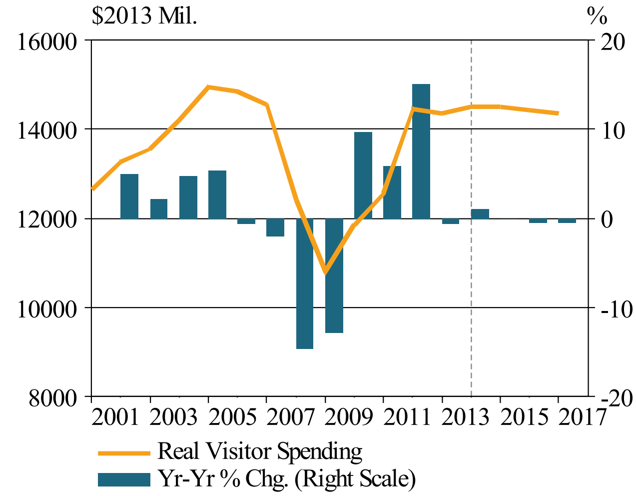
After a lackluster start to the year, the state's visitor industry experienced somewhat stronger growth during the peak summer season. Between June and August, visitor arrivals were roughly 1% higher compared with summer 2013. This was not sufficient to offset weak conditions earlier in the year, leaving year-to-date arrivals up less than 1%. And, with a shorter average length of stay, visitor days have fallen slightly year-to-date. Nominal visitor expenditures (not adjusted for inflation) continue to post marginal gains, up 2.2% year-to-date, largely thanks to higher room rates.

Weakness in the US mainland visitor market has been a significant drag on growth. Arrivals from the US mainland were up nearly 1% this summer, but in the year to date the state has seen roughly 1% fewer US visitors. The slowdown in US arrivals earlier this year was likely, at least in part, the result of a runup in the cost of a Hawaii vacation: the latest figures from the US Department of Transportation indicate that round trip airfares from the US mainland jumped 17% year-over-year in the first quarter. Air carriers flew 5.5% more seats on US domestic routes during the summer months, which may have put downward pressure on fares, but detailed information on summer airfares will not be available for several more months. US air carriers are planning to fly nearly 9% more seats on domestic routes during the fourth quarter, which could bode well for US visitor traffic during the holiday travel season.

Japanese visitor growth has been volatile from one month to the next, but for the year as a whole we've seen only marginal gains overall, with arrivals up less than a half-percent. In addition, any increase in arrivals has been more than offset by falling length of the stay, bringing Japanese visitor days down 2.6% year-to-date. As we have discussed in the past several reports, Japanese visitors have been impacted by the significant depreciation of the yen against the US dollar, which reduces the purchasing power of Japanese visitors. Japanese visitor spending is down 2.8% in the year so far. And after hovering in the 100-102 yen per dollar range much of the year, the currency has depreciated further to a low of 109 yen per dollar in recent weeks.

Tourists from other international markets, mainly from around the Pacific Rim, have been the only drivers of arrivals growth so far this year. Through August, the number of visitors from international markets other than Japan are up more than 6%. Arrivals from China and Korea continue to increase at a rapid pace, up 30% and 20%, respectively. Arrivals from Oceania have edged up only 5% through August, entirely the result of a 37% surge in visitors from New Zealand while visitors from Australia are relatively flat.

Despite the weak performance so far this year, the overall visitor volume remains at or near record levels. The seasonally-adjusted hotel occupancy rate averaged nearly 77% in the second quarter (data from Hospitality Advisors LLC), the 11th consecutive quarter that the state's hotels have filled more than three-quarters of their rooms. Room rates



ADDITIONAL GAINS IN REAL VISITOR SPENDING WILL BE LIMITED GOING FORWARD.

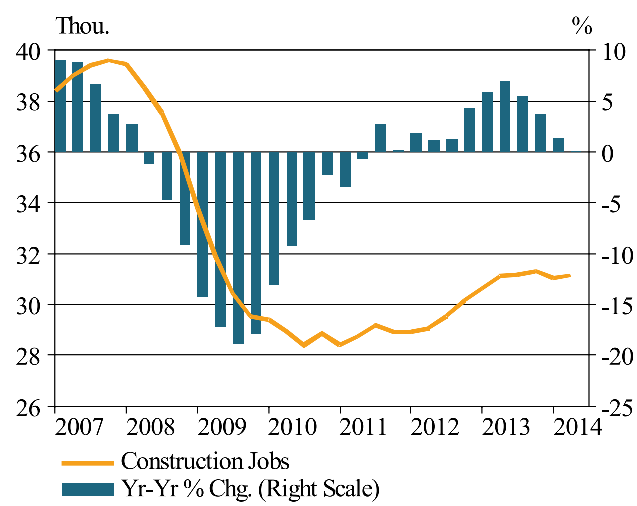
continue to increase, but at a much more moderate pace than we have seen for the past several years. Statewide hotel room rates were up 4.4% (not adjusted for inflation) in the second quarter of 2014, the slowest pace of growth since 2010. In inflation-adjusted terms, real room rates have returned to the pre-recession peak, however the recovery has largely been concentrated on Oahu, where room rates are actually 9% higher than 2007 levels; room rates across all three Neighbor Island counties have yet to recover to pre-recession levels.

We expect marginally faster visitor industry growth in 2015. Arrivals will rise by nearly 2%, principally because of anticipated firming in the US market. This reflects our view that the recent improvements in US economic performance will continue into the new year. The Japanese market should recover most of the losses experienced this year, firming by 1%. Visitors from other markets will show gains, but more modest than those seen this year. Overall visitor spending will rise by just over 2%, leaving spending unchanged in inflation-adjusted terms. Modest arrivals growth will push occupancy above 77% next year and in 2016.

The labor market is adding jobs at a weaker pace than in 2013. Monthly payroll employment statistics have exhibited somewhat erratic behavior, and we expect preliminary figures to eventually be revised upward somewhat. Following methods and data similar to those used by the US Bureau of Labor Statistics in their annual benchmark revision, we estimate that total nonfarm payrolls grew by 1.6% in the first half of the year, compared with 1.2% growth in the preliminary payroll figures. Nevertheless, this represents a meaningful slowdown compared with the 2.2% growth in jobs during the first half of 2013. UHERO estimates indicate that the number of nonfarm payroll jobs across the state in the second quarter of 2014 was roughly 350 below the pre-recession 2008 peak; we expect that revised data will ultimately show that payrolls finally surpassed their pre-recession peak at the end of the third quarter.

The pace of hiring is down in nearly all industries. Importantly, we estimate that hiring in the construction industry slowed sharply this year, with payrolls up less than 1%. (More on construction below.) The wholesale and retail sector also saw 1% growth. Roughly two-thirds of all job gains so far this year have come in the broader service economy, where employment expanded by 2% according to our estimates. Service job growth has largely been concentrated in the still-healthy accommodation and food services industry, as well as the broad "other services" sector. Healthcare has seen only limited job growth.

Public sector hiring has been mixed. Federal government



HIRING IN THE CONSTRUCTION INDUSTRY SLOWED SHARPLY THIS YEAR.

jobs continue to fall, although the pace of decline has slowed somewhat in recent months. Since peaking in late 2012, federal government employment in the state has fallen by nearly 2,000, with most of the losses concentrated in civilian Department of Defense positions. Local government jobs are flat so far this year. State government employment has seen strong growth, up 4.2% through the second quarter. The strongest growth in state hiring has been in education, where jobs are up 5.6%; excluding education jobs, state government payrolls have increased only 1.4% through the second quarter.

While payroll figures from the industry survey have shown only limited growth, the household survey points to strong growth in the number of people reporting that they are employed. Through the first eight months of the year, employment by this measure increased 2.5%, and the strongest gains have been in the past several months. The statewide labor force has risen 2.1% so far this year. Moderate employment growth outpacing labor force growth pushed the seasonally adjusted unemployment rate down to 4.3% statewide in August, the lowest rate since 2008. As we have noted in past reports, the share of the working age population that is employed still remains quite low by historical standards. While some of this may reflect lower labor force participation as the population ages, there remains an important cyclical component.

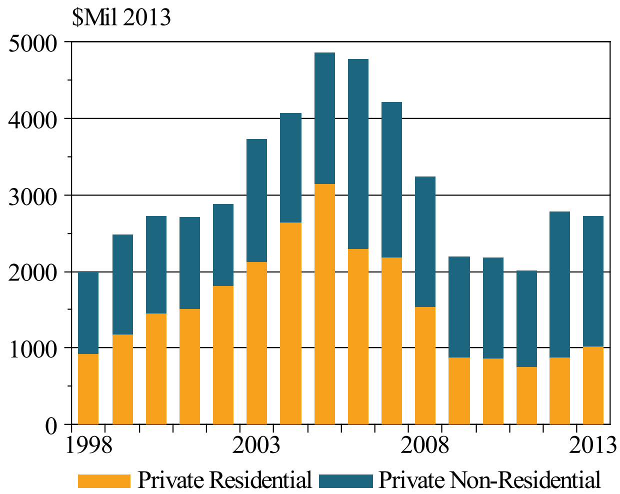
Now that the economic expansion is relatively mature, job growth will continue in the low-to-mid one percent range. Payroll job gains next year will match this year's projected 1.4% rise, easing just a bit to 1.2% growth by 2017. This slow-but-steady job growth will push the unemployment rate below 4% by 2016, roughly on par with the level at the end of the 1990s expansion but still significantly above levels seen at the peak of the 2000s expansion.

After a strong start to the year, conditions in the construction industry across the state were somewhat mixed over the summer. Both private permits and government contracts awarded fell year-over-year in June and July, however these declines were more than offset by a significant surge in private permitting and new government contracts in August. For the year as a whole, the value of total commitments to build (not adjusted for construction cost inflation) is up 11% through August, just a bit less than the 14% growth recorded in 2013.

The relative slowing of permit issuance in recent months is attributable to a slowdown in residential building on Oahu. Despite the large number of residential projects that are working their way through the pipeline, very few new projects have broken ground this year, especially over the past several months. During the first half of 2014, only 513 new residential units were permitted on Oahu, nearly 60% fewer than were permitted during the same period in 2013. As a result, the value of permits issued for new residential structures on Oahu is down more than 45% through August.

Despite this slowing on Oahu, home building on the Neighbor Islands is beginning to resume after several years of extremely weak conditions. The strongest growth has been on the Big Island, where the value of residential permits is up more than 140% in the year through August, overtaking the admittedly low total for all of last year. Along the Kohala Coast, luxury home construction at the Kohanaiki Shores beachfront community, which began earlier this year, and high-end vacation rental homes that were recently permitted at the Mauna Kea Resort have been major contributors to this year's uptick in permitting.

There continues to be moderate appreciation in real estate prices across the state. On Oahu, median single family home resale prices are up 4% year-to-date, and the median price in August was $650,000. For condos, prices are up more than 5%, and the median price was $350,000 in August. Real estate conditions on the Neighbor Islands are improving as well. Home prices on Maui and the Big Island are up 6% and 4% respectively, and on Kauai they are up more than 2% year-to-date.



NON-RESIDENTIAL PROJECTS HAVE BEEN THE PRIMARY DRIVER OF PERMITTING GAINS.

Permits for nonresidential construction projects, which include addition and alteration work to existing structures as well as construction of new commercial and industrial buildings, fell sharply in June and July before rebounding in August. However, these substantial year-over-year declines were largely the result of comparison to the June-July period of 2013, when several very large permits were issued. On Oahu, the value of nonresidential permits is up more than 30% year-to-date, while nonresidential permitting on the Neighbor Islands has risen more than 15% through August.

These figures understate the health of nonresidential building, because strong growth in nonresidential construction has coincided with a marked slowing of solar PV permitting, which is included in the nonresidential permitting category. After several years of extremely strong growth, the pace of PV installation slowed markedly last year and has continued to decline in 2014. Figures from DBEDT indicate that through August the value of residential PV permits on Oahu has fallen by more than half. Excluding the impact of PV permits, nonresidential permitting on Oahu is up more than 70% year-to-date. In large part, this strong growth has been driven by a handful of very large projects, including the redevelopment of Kapiolani Medical Center and the Ala Moana Center expansion. Other new projects breaking ground in recent months include the new flagship Walgreens retail store across from Ala Moana Center. A number of new projects in Waikiki have also gotten underway, including room renovations at the Hyatt Regency Waikiki and foundation work for the new Hilton Grand Islander timeshare complex at the Hilton Hawaiian Village.

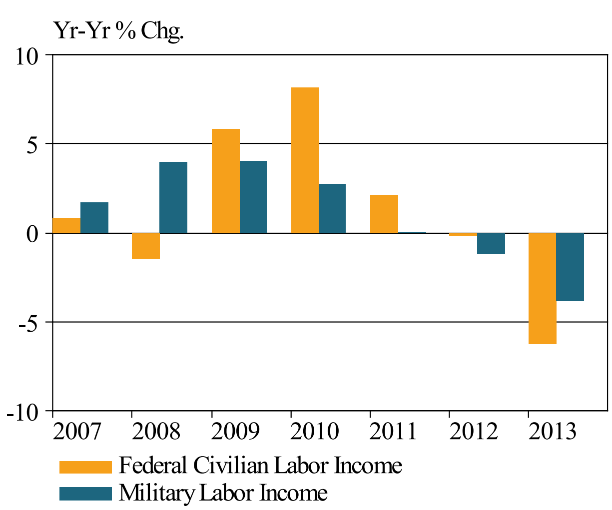
Construction on the Honolulu Rail Transit project continues to advance, but major construction work on the first nine rail stations has been delayed by a recent revamping of bids. This may well push the projected 2017 opening of the East Kapolei to Aloha Stadium sections back one year. Land acquisition for the first few rail sections is also behind schedule, although railcar fabrication is projected to be completed on time. Construction on the airport station is likely to begin next year and is expected to be completed by 2017. HART still expects to have a fully operational rail system to Ala Moana by March 2019, however the latest risk evaluation report from the US Federal Transit Administration (FTA) sees a 50% chance that the project may not be finished by the end of 2019.

We noted above that the pace of hiring in the construction sector has been very limited this year. This is perplexing given the fairly respectable pace of growth in permits. The contracting tax base has also seen a sharp decline, falling 7.5% through the first six months of the year. Special factors, including recent temporary changes in the excise tax treatment of subcontractors and the surge and decline of PV work, may explain part of this weakness. Still, the construction industry is delivering far fewer jobs than we would have expected at this stage of the upswing.

This does not change our view that significant increases in construction activity are coming, based on known plans for development and additional building that will be needed to meet the demands of a growing population, although we have pushed back by one year the anticipated peak of this construction cycle. We expect construction job growth to accelerate from about 1% this year to roughly 6% in 2015-2016. After declining more than 2% this year, the inflation-adjusted contracting tax base will surge 15% next year.

Since the time of our last report, the US Bureau of Economic Analysis has released state personal income statistics for the second quarter of 2014, as well as revised figures for 2011-2013. The latest estimates indicate that real income gains over the past several years were even weaker than previously thought. The latest data indicate that between 2010 and 2013 statewide real personal income increased at an average annual rate of 1.1%, compared to average growth of 1.4% in previous data. The revisions were part of a regular benchmarking process that occurs annually as the BEA incorporates new source data—primarily tax filings—into the personal income estimates. The largest negative revisions came in non-labor income categories: the data now show that dividends, interest, and rental income did not begin to recover until 2012. Labor income was generally revised upward, with large positive revisions in real estate earnings partially offset by large negative revisions in military earnings, which bring the latter more in line with anecdotal evidence.

The new figures for 2014 point to accelerating personal income gains this year. Statewide real personal income in the second quarter of 2014 was up 2.7% compared with the same quarter last year, the fastest income growth since 2012. In large part, stronger income growth this year has been the result of an uptick in transfer payments, which have risen nearly 6%, primarily resulting from expanded Medicaid coverage associated with the Affordable Care Act (ACA). Excluding transfers, income gains were more modest, up 2.1% in real terms. For this year as a whole, we expect real personal income to rise 2.8%, followed by similar growth in 2015.

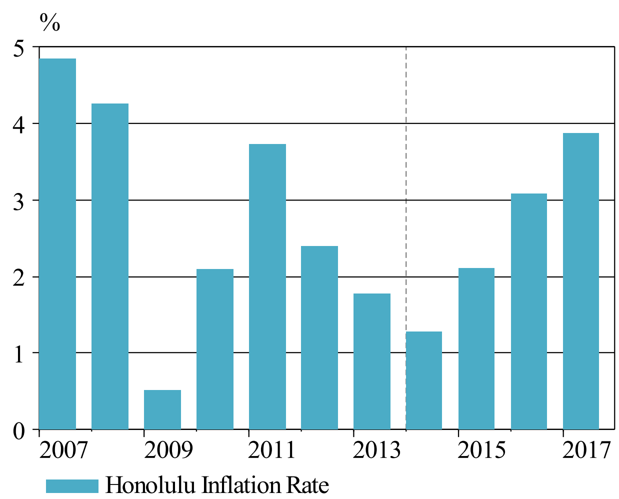


FEDERAL DOWNSIZING HAS BEEN A MAJOR DRAG ON INCOME GROWTH IN RECENT YEARS.

Consumer prices in Honolulu increased just 1.1% in the first half of 2014, down from 1.8% inflation in the first half of 2013. Food prices rose about 1%, with the impact of higher restaurant prices tempered by very modest increases in grocery costs. Energy prices rose about one-half percent, with higher electricity rates offset by lower gasoline prices. Core inflation, which excludes the volatile food and energy prices, was 1.1%, roughly the same rate as the headline number. Shelter costs, the single largest component in core CPI, advanced by only 0.6%. Stable shelter costs were offset by higher prices for medical care (+1.7%) and education and communication services (+2.7%).

While these inflation figures are notably mild, price pressures will mount, particularly as rising home prices drive up shelter costs in coming years. After 1.3% inflation this year, the rate of price increase will firm to just above 2% in 2015 and above 3% in 2016. (As this report went to press, world oil prices had moved down by more than 5% in the past week. If sustained this would lead to lower inflation in Hawaii.)

Measured by visitors or job gains, the pace of expansion in Hawaii has decelerated to a lower level than we have seen in the recovery so far. Simply put, none of the three legs of Hawaii's growth stool—tourism, federal spending, and construction—are delivering the goods this year. The first two are mostly done growing for now, given the lack of visitor



PRICE PRESSURES, DRIVEN BY RISING HOME PRICES, WILL MOUNT IN THE COMING YEARS.

industry headroom and the miserable federal budget outlook. We are still waiting on the third, but expect it to make a significant contribution over the next several years.

What factors could alter this forecast, either in a positive or negative direction? Two areas of potential upside risk are an accelerating US expansion and stronger impetus to local construction. The US economy has posted some very promising gains recently, particularly in the labor market; should this finally prompt a strong consumer response, mainland demand for Hawaii vacations could surge. Construction industry growth could end up a bit stronger than anticipated if additional renovation projects are launched in Waikiki or development takes off around Honolulu rail stations.

Unfortunately, there are also clear downside risks. In recent reports we have highlighted the particularly perilous state of Japanese outbound tourism, struggling both with domestic weakness and a depreciated yen. Planned reductions in the size of the active duty military nationwide could also reduce troop strength here in coming years. Perhaps the most worrisome threat—and the hardest to predict—is the potential impact of the unfolding Ebola epidemic. While at this point the concerns are largely contained to Africa and areas with direct flights from the affected region, we know from the SARS epidemic of 2003 how severely fears of contagion can affect people's willingness to travel. Should public concern in the Americas or Asia mount, tourism could take a big short-term hit.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2012	2013	2014	2015	2016	2017
Visitor Arrivals	9.7	1.7	1.2	1.9	1.0	1.1
U.S. Visitor Arrivals	5.2	0.7	0.5	1.9	1.2	0.8
Japan Visitor Arrivals	18.0	3.6	-1.1	1.0	-0.1	1.5
Other Visitor Arrivals	17.6	3.2	5.7	2.8	1.4	1.6
Non-farm Payrolls	2.2	2.1	1.4	1.4	1.3	1.2
Unemployment Rate (%)	5.7	4.8	4.4	4.1	3.9	3.8
Inflation Rate, Honolulu MSA (%)	2.4	1.8	1.3	2.1	3.1	3.9
Real Personal Income	2.2	0.6	2.8	2.8	2.4	2.1
Real GDP	1.5	1.9	2.9	3.5	2.7	2.3

Note: Source is UHERO. Figures for 2014 are UHERO estimates. Figures for 2015-2017 are forecasts.
Non-farm Payrolls for 2013 and 2014 are UHERO estimates of the benchmark revision.

UHERO

THE ECONOMIC RESEARCH ORGANIZATION
AT THE UNIVERSITY OF HAWAIʻI

UHERO THANKS THE FOLLOWING SPONSORS:

KAWEKIʻU - THE TOPMOST SUMMIT

Hawaii Business Roundtable

KILOHANA - A LOOKOUT, HIGH POINT

Bank of Hawaiʻi

Hawaiʻi Electric Light Company, Ltd.

Hawaiian Electric Company, Inc.

Kamehameha Schools

Matson Company

Maui Electric Company, Ltd.

KUAHIWI - A HIGH HILL, MOUNTAIN

American Savings Bank

Central Pacific Bank

First Insurance Company of Hawaii, Ltd.

Hauʻoli Mau Loa Foundation

HGEA

The Howard Hughes Corporation

Kaiser Permanente Hawaiʻi

Natural Energy Laboratory of Hawaii Authority

The Pacific Resource Partnership

Servco Pacific, Inc.

Young Brothers, Limited

Kulia I Ka Nuʻu (literally “Strive for the summit”) is the value of achievement, those who pursue personal excellence. This was the motto of Hawaiʻi’s Queen Kapiʻolani. Sponsors help UHERO to continually reach for excellence as the premier organization dedicated to economic research relevant to Hawaiʻi and the Asia Pacific region.

The UHERO Forecast Project is a community-sponsored research program of the University of Hawaiʻi at Mānoa. The Forecast Project provides the Hawaiʻi community with analysis on economic, demographic, and business trends in the State and the Asia-Pacific region.

All sponsors receive the full schedule of UHERO reports, as well as other benefits that vary with the level of financial commitment.

For sponsorship information, browse to http://www.uhero.hawaii.edu.