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

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As Growth Ebbs, Risks Swell

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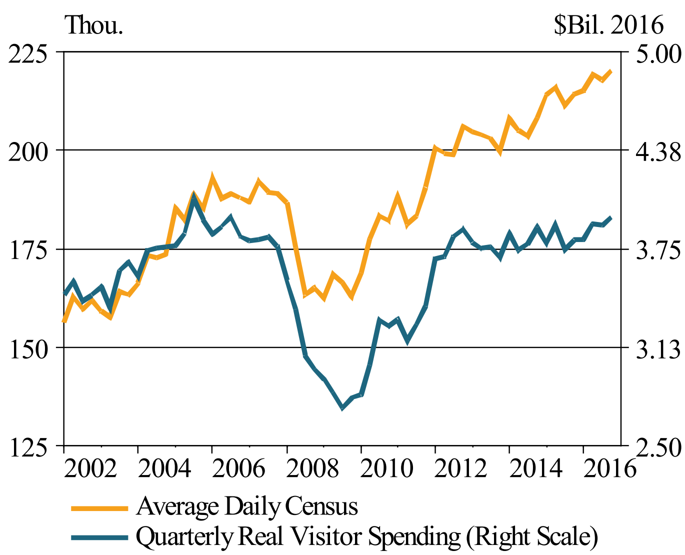
Hawaii's long economic expansion continues, but the pace of growth is beginning to slow and policy uncertainties loom.

After seven years of sustained growth in the Islands, deceleration is now underway. In part this stems from the slowing pace of construction industry expansion. But it also reflects a generalized slowing as demand growth eases and labor markets tighten. Tourism has kept up a record-breaking pace longer than expected; still, there will only be room for so much additional growth. The economic outlook remains generally positive, if clouded by the many things that could go wrong in Washington or closer to home.

TOURISM GROWING DESPITE LIMITED CAPACITY

The Hawaii tourism industry continues to break records. Last year saw 8.8 million visitors to the Islands, 3% more than in 2015. The state is now hosting significantly more visitors than in the decade before the Great Recession. In part because of the adverse effects of the stronger dollar on international travelers, aggregate visitor spending in real (inflation-adjusted) terms is essentially unchanged from the level a decade ago.



VISITOR VOLUME SOARS, SPENDING LAGS

Last year's gains were primarily driven by visitors from the US mainland. Lackluster economic conditions in the Asia-Pacific region and weak currencies limited growth in the Japanese and other international markets. (See our recent *Annual Hawaii Forecast with Asia-Pacific Outlook* for more detail.) Uneven performance across source country markets has driven stark differences across counties. On Oahu, which receives most of the international visitors, real visitor spending declined by nearly 3% last year. The Neighbor Islands, more dependent on domestic visitors, have seen stronger expenditure gains in the 4-9% range.

Growth in visitor numbers has continued longer than we had anticipated given what appeared to be binding capacity constraints. In part this reflects a shift of visitors into the spring and fall "shoulder seasons." We are also seeing some increase in the traditional visitor plant. The rise of online marketplaces for home-share vacation rentals is playing a role in accommodating Hawaii's rising visitor population, although the size of this effect is hard to pin down. In any case, pending additions to the hotel and timeshare stock will facilitate limited incremental growth.

Total arrivals will rise 2.2%, edging above the 9 million mark this year. They will be driven by continued gains in visitor traffic from the US mainland, while international visitor markets will remain soft. Growth in the number of visitors will taper toward the 1% range late in the decade.

PROSPECTS GOOD FOR HAWAII'S WORKERS

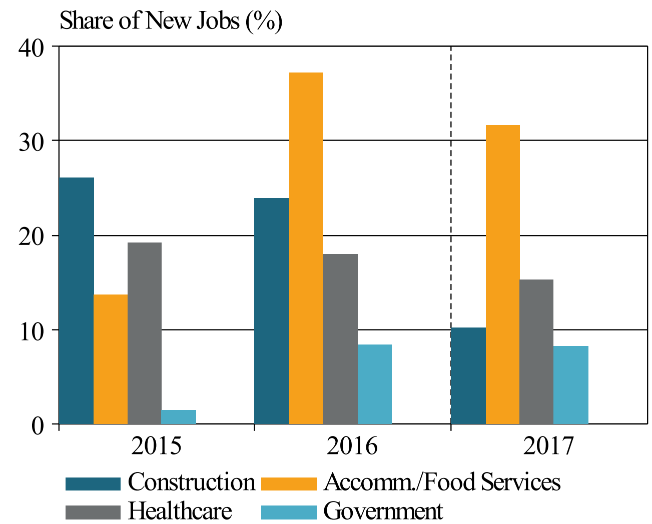
Hawaii's healthy labor market conditions will continue. Much of the recent hiring has been in accommodation and food services, facilitated by new and newly-reopened resort facilities. We expect an additional 2% rise in employment in the sector this year. As the arrivals expansion eases, job growth in the sector will slow to less than 1% by 2018. (Our job statistics reflect UHERO's estimate of the forthcoming government benchmark revision.)

Health care has also seen strong job growth, expanding by nearly 3% last year. Part of the recent strength may be related to increased federal Medicaid funding under the Affordable Care Act. Needless to say, prospects for the ACA are unknown, although Hawaii's exposure may be smaller than some states, because of widespread coverage that already existed under the Hawaii Prepaid Health Care Act. A bill in the State Legislature would write many aspects of the ACA into Hawaii law. At this point we expect healthcare job growth to be somewhat slower than in the past, expanding by 1.6% this year.

CONSTRUCTION WILL HOVER NEAR ALL-TIME HIGHS

The construction industry hit a speed bump in 2016. After a first-quarter surge, employment edged down over the course of the year. The next wave of resort and retail related construction and the ramping up of single-family home building will sustain activity near its current level through 2019. After that, the sector will begin to ebb. We will provide a detailed outlook for construction in the third quarter.

Prospects for state employment have been complicated by a run of very weak tax revenue numbers, which by December resulted in a General Fund balance that was essentially flat compared with the previous fiscal year. Then in January there was an upward revenue surge. Despite this, Governor Ige has presented a revised budget plan with steep cuts to previously announced increases in spending on education, state pension pre-funding, and other areas.



HOSPITALITY NOW LEADS CONSTRUCTION AS THE BIGGEST JOB CREATOR

Federal government hiring faces uncertain prospects, now that President Trump has issued an across-the-board hiring freeze. While the Department of Defense has clarified that public Naval shipyards are exempt, the impact on other positions remains unclear. Department of Defense jobs account for more than 55% of federal government jobs in the state, so ultimate decisions on coverage will have significant impacts here.

Ongoing job creation has brought a tightening of labor markets. The unemployment rate dropped to 2.9% in December, the lowest rate since early 2007. This is good news for laborers, who have seen little wage growth so far. At the same time, a significant acceleration of labor costs would pose a challenge for some employers. Unemployment is expected to remain low for the next several years at least.

HOME PRICES DRIVE INFLATION UPWARD

Falling energy costs have kept a lid on overall inflation so far, but that effect has now ended. Rising home prices and rents will propel local inflation above 2.5% this year and next, still relatively tame compared with past economic expansions.

Overall measures of economic activity will continue to rise, if at a slower pace than earlier in the expansion. For now, the construction sector continues to be the growth leader, posting a nearly 10% gain in real income in the first nine months of last year. That contribution will gradually recede, as will the pace of growth in many other industries. Overall, real income will manage just 2% growth this year, tapering below 1.5% late in the decade. Gross domestic product, the broadest measure of local economic activity will expand by 2% this year and 1.7% next.

GROWING, GROWING, ...GONE?

Against a generally upbeat outlook are an array of risks, most linked to politics in the nation's capital. Policy shifts by President Trump and the Republican Congress could disrupt health care, government employment, and public services. Shifts in the tax law or public spending could also have positive effects, although they might aggravate long-term budget challenges.

There are clear downside risks to travel and tourism. The temporary ban on immigration and refugees from seven predominantly Muslim countries caused a sharp, if temporary, drop in flight searches for travel to the US. While that ban has been halted by the Courts, uncertainty around US immigration policy could hamper travel to the US. And the already strong dollar could become even stronger if there is a significant fiscal expansion, sharp Federal Reserve interest rate hikes, or corporate tax reform that increases dollar demand.

Not all downside policy risks are related to actions in Washington. The global economy also appears fragile. At the state level, some cuts from the Governor's original budget are clearly in the offing, even if recent revenue numbers are more reassuring. If our forecast remains optimistic on balance, it would be best to characterize it as *guardedly* optimistic, given the many clear dangers in the external and local economic environment.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2014	2015	2016	2017	2018	2019
Visitor Arrivals	2.4	4.5	3.1	2.2	1.1	0.9
U.S. Visitor Arrivals	1.1	6.9	4.1	3.0	1.4	0.8
Japan Visitor Arrivals	-0.4	-1.9	0.4	1.6	-1.0	0.9
Other Visitor Arrivals	9.2	3.1	2.6	0.1	1.8	1.4
Non-farm Payrolls	1.4	1.7	1.7	1.1	0.9	0.6
Unemployment Rate (%)	4.4	3.6	3.2	2.9	3.0	3.3
Inflation Rate, Honolulu MSA (%)	1.4	1.0	2.0	2.6	2.7	2.6
Real Personal Income	3.6	3.7	2.5	2.1	1.8	1.5
Real GDP	1.1	3.9	2.5	2.0	1.7	1.6

Note: Source is UHERO. Non-farm Payrolls for 2015 and 2016 are UHERO estimates of the benchmark revision. Figures for income and GDP for 2016 are UHERO estimates. Figures for 2017-2019 are forecasts.

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