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

UHERO STATE FORECAST UPDATE, PUBLIC SUMMARY

No Shutdown For Hawaii Growth

OCTOBER 25, 2013

Growth is holding up in Hawaii, driven by still-strong tourism and rising construction. Recent hints of slowing make Washington worrisome.

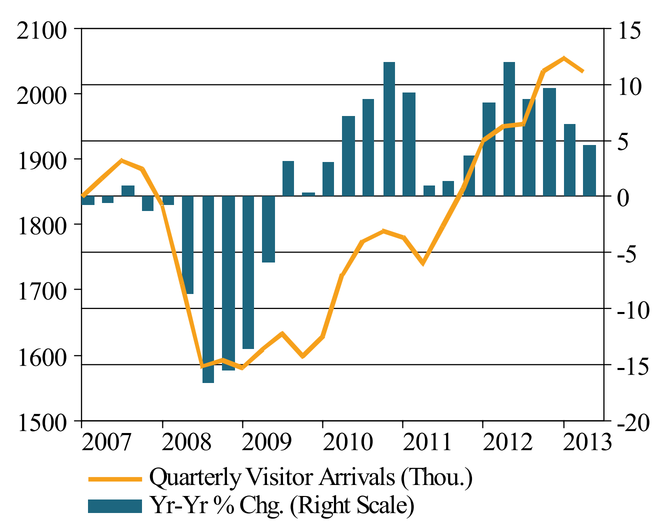
Although economic conditions have continued to improve this year, visitor budgets have been impacted by federal fiscal tightening, a weaker yen, and the rapid rise of hotel room prices. As the vigor of the tourism boom abates, the growth impetus is shifting to other sectors, including an accelerating construction industry. Against a generally healthy backdrop, there have been some signs of softening recently, with both job creation and income growth slowing since the beginning of the year.

2013 is shaping up to be another record setting year for tourism, although growth has eased considerably. Visitor arrivals were up 4.1% during the summer season, and year-to-date arrivals are up 4.9% compared with the same period in 2012. The length of stay has edged downward as room prices, reported by Hospitality Advisors LLC, have soared. As a result, the gain in visitor days has been more modest, up just 3% through August. Visitor expenditures are rising along with room rates, but the pace of these gains has slowed sharply from last year. Spending for the year so far is up 5.1%, compared with last year's 18% surge. Tourism growth will be further muted going forward, now that the industry has regained a high level of activity.

The state's tourism industry was adversely affected by the federal government shutdown, which left sites such as the Arizona Memorial and the state's national parks closed for more than two weeks. (See the box, *Shutdown Economics*.) Even before this, fiscal tightening was exerting negative pressure on US tourism. The elimination of payroll tax cuts and the furloughs associated with the sequester have had a direct effect on family budgets and on decisions about holiday destinations. After strong growth in the first quarter, year-on-year US arrivals gains tapered off and were a lackluster 3.1% during the peak summer season. With room price appreciation far outstripping US income growth, and with further fiscal challenges ahead, we don't expect domestic arrivals to fully recover to their 2006 peak until 2015.

Japanese arrivals have also decelerated over the course of the year, and they were up just 3.5% through August. Here the moderation is primarily exchange rate related. The yen has depreciated 25% over the past year, and the significant decline in the purchasing power of Japanese travelers affects their spending. While yen denominated expenditures have grown almost 12% through August, Japanese tourists have spent nearly 8% fewer dollars in the state compared to a year ago. In addition to their declining purchasing power, Japanese visitors have to cope with higher room rates. As a result, the traditionally big-spending Japanese visitors report spending 19% less than last year at local retail outlets.

Visitors from other countries around the Pacific Rim continue to flock to the state in record numbers. Arrivals from Australia and New Zealand surged ahead as air carriers

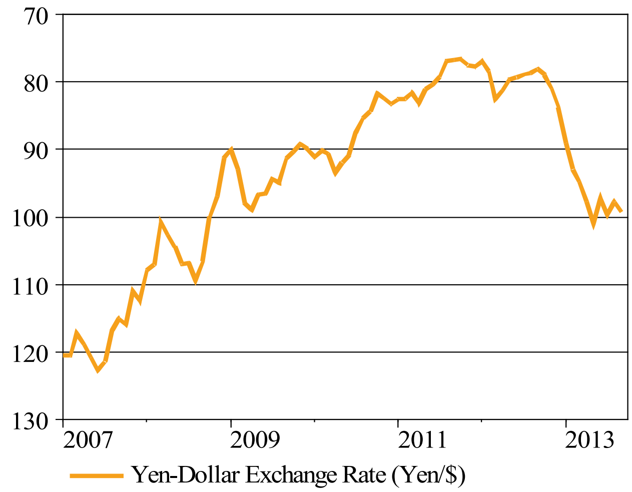


QUARTERLY STATEWIDE VISITOR ARRIVALS

added a number of new direct routes. Arrivals from Oceania are up 33% through August, a net gain of nearly 56,000 visitors, and Korean arrivals are up 23% through August. Despite a rather weak summer, Chinese arrivals are up almost 20% for the year to date. Following its inclusion in the US Visa Waiver program, the number of visitors from Taiwan has increased dramatically. Between June and August of this year more Taiwanese visitors flew to the state than in all of 2012. Gains in these five markets combined for a total gain of more than 102,000 visitors through the first eight months of 2013, almost 40% of all arrivals gains.

Overall, the level of visitor industry activity has been coming in a bit weaker than we had anticipated earlier in the year. We now expect that for the year as a whole arrivals will rise 4.3%, with spending coming in 4.7% higher than in 2012. Next year may be more challenging, since there are signs that global growth is slowing. (More on that in our upcoming Asia-Pacific Forecast.) In any case, now that we have reached high levels of capacity use, we expect visitor growth to continue to cool going forward. Arrivals will expand by a bit more than 3% in 2014 and just above 2% the year after.

The labor market appears to be adding jobs at about the same pace as in 2012. The preliminary payroll employment statistics have exhibited some erratic behavior this year and are expected to undergo substantial revision. Following methods and data similar to those used by the Bureau of Labor Statistics to perform their annual benchmark revision, we estimate that during the first half of the year total nonfarm payrolls rose 2%, a net gain of roughly 12,000 jobs. Construction jobs are finally returning after a deep and prolonged contraction. Through the first six months of the year construction jobs are up 5.5% according to UHERO estimates, resulting in more than 1,600 new jobs. (Note that UHERO's estimate for construction job growth is a little more than half of the preliminary estimates from the BLS.) Related industries are also hiring. Transportation and utilities jobs are up 4.7%, and wholesale trade jobs are up 3.9%; the two together have added almost 2,000 jobs. Other industries adding jobs include healthcare (+3.3%), professional/business services (+3.2%), and accommodation/food services (+3%).



YEN-DOLLAR EXCHANGE RATE

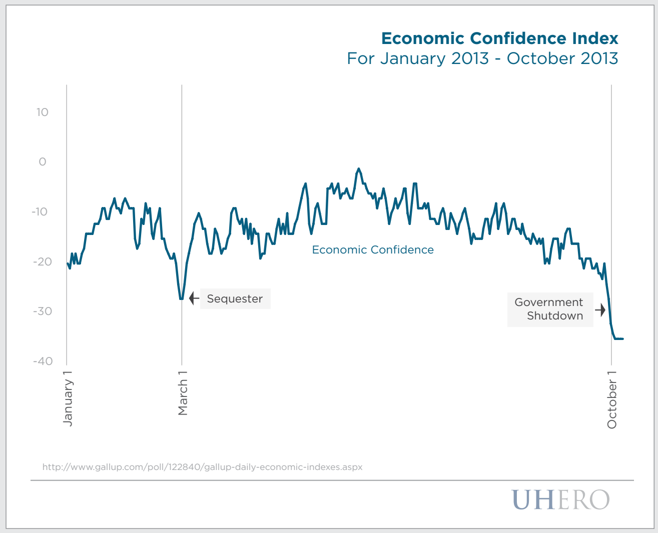
The public sector continues to be a drag on overall job growth. The number of state and local government jobs was unchanged through the first half of the year. Federal government jobs were down 2.3% through June, with most of the job losses in civilian Department of Defense positions. So far most of the job losses have been the result of departmental hiring freezes and expiration of temporary worker contracts as opposed to layoffs of permanent employees. Federal civilian workers were furloughed for 6 days between July and the end of September. Workers in "non-essential" positions in the federal government were placed off duty beginning October 1, although military personnel and civilian defense workers responsible for maintenance on military bases continued to be paid. Other Department of Defense workers were brought back to work on October 7, and with the recent Congressional deal all workers were back on the job late last week.

The seasonally adjusted unemployment rate dropped to 4.3% in August, the lowest rate since July 2008. Over the past 12 months the unemployment rate has fallen by 1.6 percentage points, but this presents an overly positive assessment of recent labor market performance. While there

SHUTDOWN ECONOMICS

With the government shutdown and possible debt default in the rear view mirror (for now), it's time to tote up the damage. Of the roughly 34,000 civilian federal employees in Hawaii, a fraction were deemed essential and were not furloughed. Many of the 18,000 Department of Defense employees were ordered back on the job after the first week of the shutdown. Still there were a significant number of federal employees who saw a multi-week delay in pay. But the effect of the shutdown went beyond that. Among other things, it cut into the income of government contractors, hampered the investigation of the molasses spill in Honolulu Harbor, and left all seven National Parks in the state closed, souring the mood of many visitors and choking off a revenue stream for hundreds of tourism-dependent businesses.

In fact, consumer confidence nationally has taken a nosedive since the first day of the shutdown. The current temporary fix still lacks a credible plan for the long term resolution of the perennial impasse in Washington and will not fully restore confidence. If the decline in sentiment persists, it may have a greater effect than lost/delayed income during the shutdown. In times of uncertainty people tend to cut back on discretionary spending such as leisure travel. Even if many would-be visitors end up eventually booking their trip to Hawaii, it may take a while before they do so. People also tend to put on hold the purchase of big ticket items and homes during unpredictable times. In addition, the prospect of a government debt default has rattled global financial markets, leading to higher short term borrowing costs. The impact of uncertainty gets magnified as the reluctance to spend filters through the economy. Unfortunately, given the appetite of this Congress for spawning artificial crises, we may have to wait for calmer times, at least until the next elections.



have been incremental employment gains, a significant number of people have exited the labor force altogether, which also causes the unemployment rate to fall. The labor force in August had roughly 3,600 fewer individuals compared to 12 months earlier and 12,400 fewer individuals compared to 2 years ago.

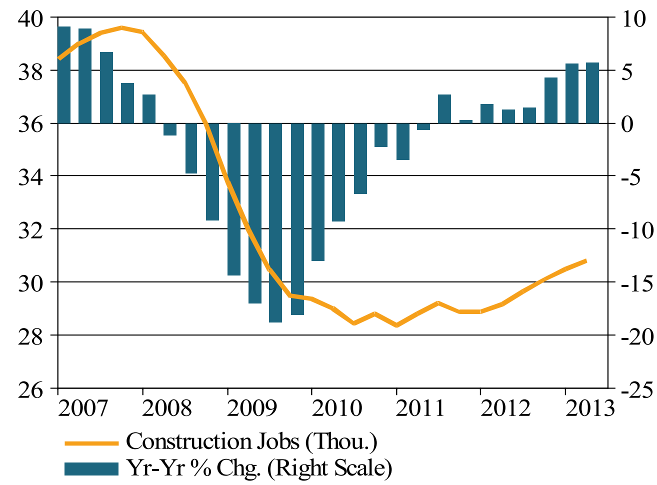
We expect labor market gains to continue to firm. Payroll job growth will reach 2.4% next year, and the unemployment rate will edge down to 4% as employment picks up steam. The construction sector will add more than 3,000 jobs, a nearly 11% jump in employment. All other broad sectors will also see expansion. Drag from the public sector should ease, although this will continue to be an area of very weak job growth and will depend in large part on the outcome of budget negotiations in Washington.

Despite the rapid hiring pace in construction this year, permitting for new building has been typically volatile, and has slowed since the start of the year. The end of the summer was particularly weak; the value of statewide private permits issued in August was 30% lower than the same month in 2012. Still, through the first eight months of the year private construction permits were up 6% in the state and up 11% on Oahu. Most of the growth on Oahu has come in the residential sector, principally a number of Kakaako condo projects. After several years of rampant growth, the photovoltaic installation boom is beginning to lose some steam. In the year to date, 4.3% fewer permits have been issued on Oahu for residential PV systems. New City and County of Honolulu fees for PV projects have added a modest additional cost to new projects, and customers are now required to contact HECO to check the solar energy saturation level in their neighborhood before beginning the process of installing a PV system.

On the Neighbor Islands, private permitting activity has fallen 3% through August. Residential permitting still remains depressed, far below pre-recession levels. Commercial construction activity on Maui got a nice boost from more than $80M in permits for a new Hyatt luxury timeshare project on Kaanapali Beach; this one project accounted for almost half of the value of all Neighbor Island commercial permitting so far this year. On the other hand, after very strong performance through 2012 thanks to Andaz Maui's $90M mega-renovation, additions and alterations permitting on the Neighbor Islands has taken a tumble. This is still a construction upswing that is focused on Oahu.

Work on the City and County of Honolulu's $5.2 billion rail project restarted in September 2013 after nearly 13 months in legal limbo. The Honolulu Authority for Rapid Transit (HART) was cleared to resume construction in mid-September after completing an archaeological study of the full 20-mile rail route as ordered by the Hawaii Supreme Court. Work resumed in East Kapolei to erect concrete pillars that will eventually support the rail track as well as at a maintenance facility in Leeward Oahu. Meanwhile a ruling on a separate legal challenge is still pending before a federal appeals court. In addition to rail, a number of public infrastructure projects are moving forward, including improvements to roadways, harbors, airports, and Honolulu sewers. Government contracts awarded, which do not include rail work, surged ahead this year; through August total government contracts awarded are up 40% from the same period in 2012.

Total authorizations for new construction will rise nearly 19% for this year overall and push ahead by more than 20% in 2014. The general excise and use tax base for contracting, a good summary measure of current activity, will rise by



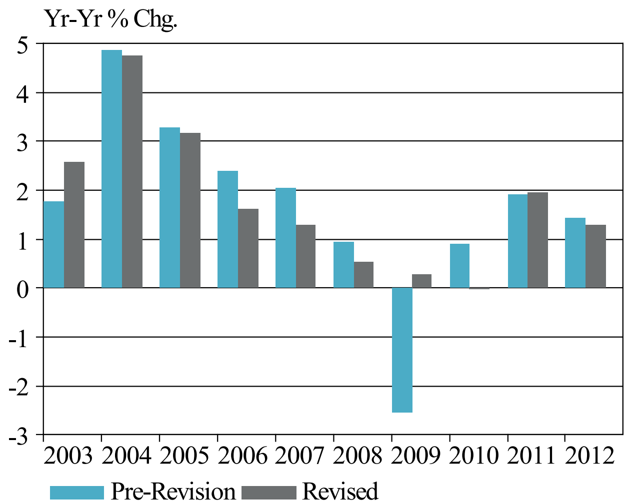
STATEWIDE CONSTRUCTION JOBS

double digits for the next three years, before easing as the building cycle approaches its peak.

Real estate market performance has been mixed this year. Despite increasing sales volume and limited inventory, median single family home prices on Oahu have ticked up only 3.3%, while condo prices have risen 5.4%. Neighbor Island homes have seen more substantial price appreciation this year, albeit from much lower levels. Through the first nine months of the year, median resale prices for homes on Maui are up 16%, while prices on the Big Island and Kauai are up 18% and 12% respectively.

Consumer prices in Honolulu rose 1.8% in the first half of 2013, with somewhat softer energy prices offsetting higher inflation in food and medical care. Inflation will average 2% for 2013 as a whole, with a similar rise expected in 2014. Inflation will mount thereafter as the housing and construction upswing raises shelter costs.

Since our last forecast, the Bureau of Economic Analysis has released state personal income estimates for the second quarter of 2013 with benchmark revisions going back to 2001. The revised estimates incorporate conceptual and accounting changes that had a significant effect on estimates of personal income in the state. The new data suggest that the economic downturn had a less severe effect on aggregate



STATEWIDE REAL PERSONAL INCOME BENCHMARK REVISIONS

personal income than previously thought. And the new data for the second quarter of 2013 show only limited real income growth, just 0.8% higher than the revised year earlier numbers. The key source of weakness this year has been the ending of the payroll tax holiday. January's restoration of normal social security rates will chop nearly 1% from annual real income growth. Once we get beyond this, and as labor income growth firms, total real personal income will surge to 3.5% in 2014.

This has been another year of moderate, if unremarkable, growth in Hawaii. As expected, the torch is gradually being passed from tourism to construction and the broader service economy. As the building cycle accelerates, growth will strengthen in the Islands. At the same time, fiscal tightening is clearly weighing on the economy, and the endless federal shenanigans pose a continuing threat. The relative brevity of the shutdown means that the direct damage to Hawaii's economy will be limited, as back pay is made up and civilian workers return to work. But the reckless march towards a debt default impacted the global economy, with bond markets reacting to the prospect that short-term government debt maturing at the end of October might not be repaid. All this mess led to economic confidence taking a hit that could last a while. And in three months we get to play this game again! With some evidence of local slowing in recent months, the prospect of further self-inflicted federal damage is particularly worrisome.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2011	2012	2013	2014	2015	2016
Visitor Arrivals	3.7	9.7	4.3	3.2	2.3	1.1
U.S. Visitor Arrivals	2.3	5.2	2.9	3.0	2.4	0.9
Japan Visitor Arrivals	0.2	18.0	3.7	1.8	1.1	-0.2
Other Visitor Arrivals	13.4	17.6	9.2	5.0	3.0	2.7
Payroll Jobs	1.2	2.1	2.1	2.4	2.1	1.8
Unemployment Rate (%)	6.5	5.8	4.6	4.0	3.7	3.5
Inflation Rate, Honolulu MSA (%)	3.7	2.4	2.0	2.1	2.8	3.9
Real Personal Income	2.0	1.3	1.6	3.5	2.9	2.3
Real GDP	0.3	1.0	3.1	4.3	4.0	3.3

Note: Source is UHERO. Figures for 2013-2016 are forecasts. Payroll Jobs for 2012 are UHERO estimates.

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