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

UHERO STATE FORECAST UPDATE, PUBLIC SUMMARY

Japanese Quake Won't Derail Recovery

MAY 6, 2011

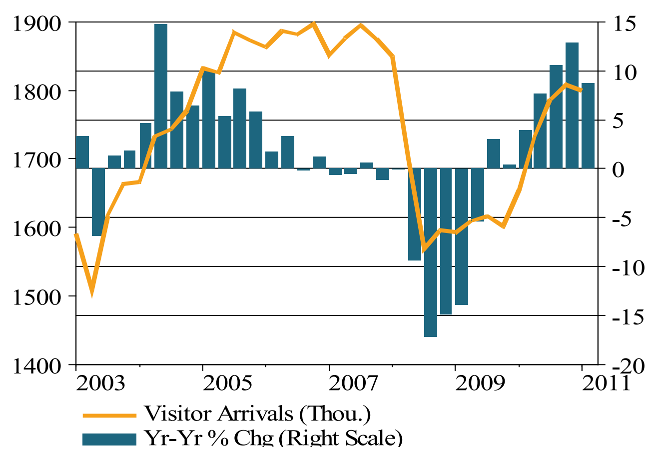
The Japanese earthquake has led to a pause in visitor industry growth, but unless we see a further spike in oil prices, Hawaii's economic recovery will continue to build strength.

After dramatic improvement in 2010, the visitor industry has suffered a setback with the sharp falloff in Japanese travel following the March earthquake and tsunami. Because of the damage to travelers' confidence and willingness to spend, the Japanese market recovery will be gradual, slowing the pace of the Hawaii visitor industry expansion in 2011. Baring a further sharp increase in energy prices, the drop in Japanese visitors will not derail Hawaii's economic recovery. Limited job growth has taken hold in recent months, and we expect that to continue to broaden and deepen this year.

Economic recovery spearheaded by gains in tourism continued through March with the sixteenth straight month of positive arrivals growth. Japanese arrivals were up 16% in the first two months of the year, although they fell off sharply after the earthquake. Performance was strong across all other major market segments: first quarter US visitor arrivals were 8.5% higher than a year earlier, and Canadian arrivals were nearly 25% higher. Visitor expenditures continued to climb in March, posting their eleventh straight month of 10% or better year-on-year gain.

The pace of visitor recovery will be slowed, but not halted, by the aftereffects of the March 11 Great Tohoku earthquake. Although damage to Hawaii infrastructure was limited, the earthquake and tsunami have had a significant adverse effect on Japan and on the willingness of Japanese consumers to spend on luxuries. In recent weeks, airline passenger counts from Japan have been running about 25% below year-earlier levels. While there are recent promising signs, such as the decision by Japan Airlines to restore a Narita-to-Honolulu flight that it had suspended after the quake, the Hawaii Tourism Authority reports that scheduled airline seats from Japan are expected to be almost 10% below year ago levels for the April-June period. Recovery to nearly normal levels will take more than a year. (See the Box, "How Much Will the Japanese Earthquake Hurt Hawaii?") The recently announced 30% increase in fuel surcharges on ANA and JAL flights will also weigh heavily on Japanese travel. For the year as a whole, Japanese arrivals will post a nearly 11% loss, but rebound by more than 10% in 2012.

Prospects for the US market remain good, although we expect a tapering off of gains after the buoyant performance in 2010. This year US arrivals will expand by 4.7%, with an additional 1.5% gain in 2012. Visitors from countries other than the US and Japan will expand by 8.7% this year, compared with last year's very strong 19.6% growth. Total arrivals will grow 2.7% this year and 3% in 2012. By next year, the annual average for both visitor arrivals and visitor days will be just 1.5% lower than the level in 2007. Visitor industries on the Big Island and Kauai will continue



STATEWIDE VISITOR ARRIVALS

How Much Will The Japanese Earthquake Hurt Hawaii?

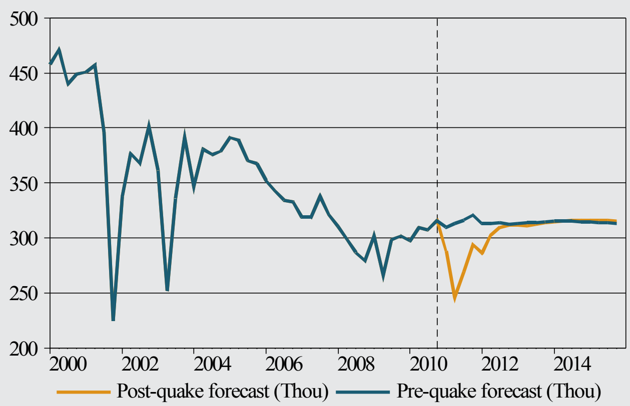
The March 11 Great Tohoku Earthquake represents the most profound human tragedy in Japanese experience since World War II. Current estimates are that nearly 28,000 people are either dead or missing, and perhaps 130,000 people have been displaced from their homes. Bringing the largely destroyed Daiichi nuclear power plant under control is expected to take most of the year, perhaps longer. In Hawaii, we have seen a tremendous outpouring of support for quake victims, but we are also feeling the indirect economic impact of the quake. How large will these effects be?

In Japan, the economic effects of the quake have been very large. According to one industry estimate, direct insured losses to property, death and injury will range between $21 and $34 billion. Beyond the direct losses, factory damage and power disruptions in Northern Japan have reduced production, with ripple effects extending throughout the country because of resulting parts shortages. We expect Japanese real gross domestic product to contract for the first half of this year, but then to pick up speed as rebuilding begins in earnest. Total economic costs from lost production and productive capacity could top $300 billion, according to Japanese government estimates.

Economic costs are not limited to Japan, but to some extent have spread globally. Production of many goods now takes place in global production networks, with parts and components manufactured in many countries before final assembly and delivery take place. US automakers, for example, have had difficulty obtaining key parts, forcing some temporary reductions in production. On the flip side, some American companies may see increased demand because of production problems at Japanese competitors. In our view, the net effect of the Japanese quake on the US economy will be limited and will not interrupt the current recovery.

In Hawaii, the primary economic effects will of course come through tourism. (The tsunami also caused some direct damage, primarily on the Kona coast of the Big Island.) Visitor arrivals from Japan have fallen off sharply since the earthquake. More worrisome, the Japanese consumer's new attitude of jishuku, or "voluntary self-restraint," in the face of the quake devastation may limit willingness to spend on luxury vacations for some time to come. While it is highly speculative, we estimate that the quake will reduce Japanese arrivals by 21% in the current quarter, with gradual recovery to within 3% of the pre-quake forecast by the second quarter of 2012. At this point, we do not expect the global spillover effects to be large enough to reduce traffic from other markets, and in fact we could see some offsetting gains as travelers from the US and other countries respond to marketing incentives designed to shore up Hawaii tourism.

Hawaii will see a significant slowdown this year in overall arrivals growth, but not an outright decline. Job recovery in tourism-related sectors will be somewhat more restrained than if the quake had not occurred. Outside of tourism, the impact of the quake on job and income growth will be very limited.



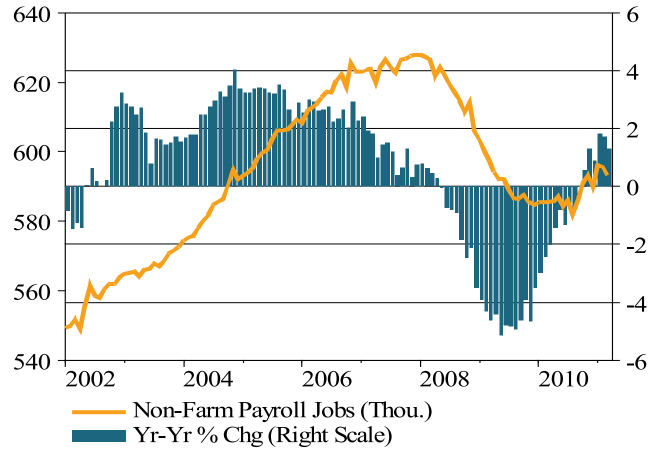
JAPANESE PRE-QUAKE VS. POST-QUAKE QUARTERLY VISITOR ARRIVALS FORECAST to lag somewhat behind Maui and well back of Oahu's performance. We'll have more to say about differences in county experiences in our County Forecast Report, to be released later this month.

Hotel occupancy took a hit on Oahu and the Big Island in the weeks following the quake, although there was little effect on Maui or Kauai, who receive few Japanese visitors. Still occupancy remains above last year's levels on all islands, and room rates are up sharply. Statewide occupancy will average 72.8% this year, firming to 74.7% in 2012.

The labor market has lagged behind improvements in tourism. In fact, according to data from the recent benchmark revision by the US Bureau of Labor Statistics, overall job growth in Hawaii did not begin until September of last year. By March 2011, the number of non-farm payroll jobs in the Islands was running 1.3% above the year-earlier level, up about 11,300 jobs from the low point last August. Because of the very large downward revisions that have been made in recent years, some caution is advised in evaluating estimates for recent months—they could yet be revised downward themselves in the next benchmark revision a year from now.

The job gains through March 2011 were distributed among Accommodations (1,459), Food Service and Drinking Places (2,241), Education (1,800), Information (1,300), and Administrative and Waste Services (3,447). The private education bounce is a surprise considering that the industry, which includes trade schools, test preparation, and after school tutoring, generally peaks in the fall. Separate data showing a decline in real labor income in the sector suggests that the reported job growth may be an anomaly. Non-telecommunication job gains in the Information sector are most likely linked to film and TV productions such as Hawaii Five-O, Battleship, and Pirates of the Caribbean. The gains in Administrative and Waste Service jobs appear to be centered in employment services and temporary help.

Unemployment data provide some hope that the



STATEWIDE NON-FARM JOBS

recent improvement in jobs will be sustained. The statewide unemployment rate held steady at 6.3% for the fourth consecutive month in March. And in the first quarter, initial claims for unemployment dropped 7.6% from last year. Combined initial and continuing claims fell 18.2% during the first quarter. Labor market conditions will improve slowly over the next several years. We expect non-farm payroll job counts to rise 1.6% this year, firming to above 2% growth for the next three years. At 609,400 the job count in 2012 will have climbed back to within 2.5% of its level in 2007. Statewide unemployment will average 6% this year, falling below 5% by 2013. Neighbor Island labor markets were hit harder by the downturn and will be slower to return to relative health.

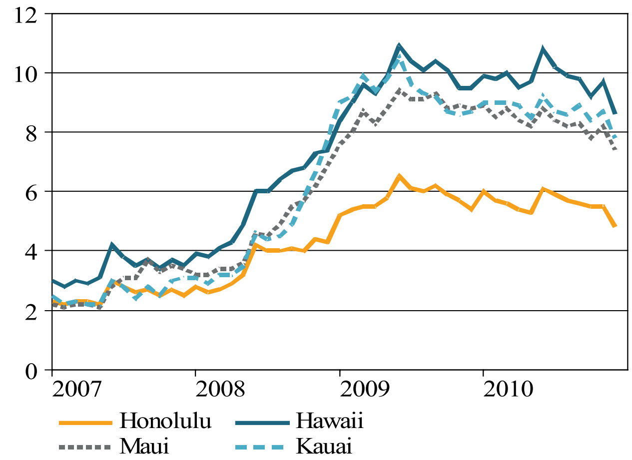
After falling by more than 2% during the first half of 2010, real labor income rose by almost 1% in the fourth quarter. For the year as a whole, labor income was down less than 1%. Total personal income, which includes non-labor income and government transfer payments, was essentially flat in 2010. This year, total real income will rise by about 2%, with labor income gains in all major sectors other than State and Local Government.

A significant concern at present is the effect that high energy prices are having on spending by both local consumers and tourists. Honolulu consumer prices rose 1.7% from the second half of 2009 to the second half of 2010, with almost all of the increase due to energy costs. According to the web site gasbuddy.com, Hawaii's state average regular unleaded gasoline price as of April 23 exceeded $4.50, compared with the national average of about $3.82. UHERO expects the price of oil to remain near its recent value of $112-$114 per barrel through the end of the year, dropping to $90/bbl by the second quarter of 2012. At these prices we expect any falloff in US consumer spending to be relatively mild and not large enough to significantly undermine the ongoing recovery of travel to Hawaii. But forecasting oil prices during a period of political unrest in North Africa and the Middle East is clearly a risky business, and any significant further move upward in energy prices has the potential to take all of the wind out of Hawaii's sails.

Home prices remained weak across the state in the first months of 2011. The seasonally adjusted single-family median home price on Oahu sank to $548,500 in March, its lowest level since January 2009. On Maui, the March median single-family price of $450,000 was 2.2% lower than in March 2010. First-quarter data for Kauai and Hawaii Counties showed the same pattern of weak median prices and high resale volume that we observed throughout 2010. According to Hawaii Information Service, prices tumbled on the Big Island, with both single family and condo median prices slipping below $250,000 in the first quarter.

Private construction permitting has been dismal since last fall. The $53.5 million monthly average in residential permits for the past five months is a 7% drop from already low levels the previous year. Nonresidential permits for this period rose 16% on the strength of February additions and alterations data, but the fourth quarter of 2010 showed essentially no increase over the fourth quarter of 2009. Construction at the end of 2010 was helped immensely by $268.2 million in government contracts to close out the year. While total private authorizations fell 1% for all of last year, government contracts rose nearly 36% in 2010.

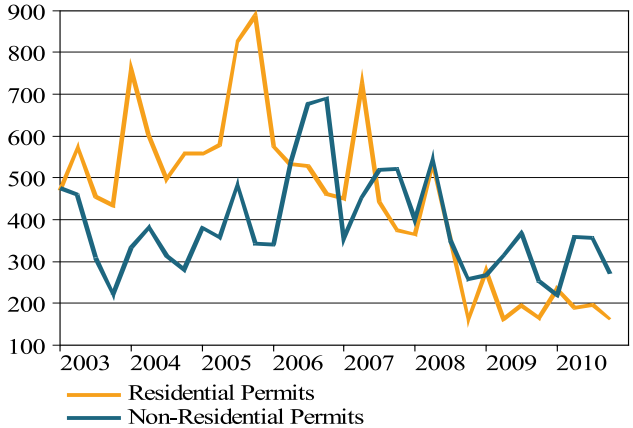
The role of public projects deserves emphasis because the emerging budget situation at all levels of government will



UNEMPLOYMENT RATE BY COUNTY

make a similar performance tough to repeat in 2011. Kauai County's proposed FY 2012 budget adds less than $1 million in additional CIP projects to what was appropriated in the previous budget. Of the $177 million in the proposed Hawaii County budget, more than half is actually for a police radio system. The City and County of Honolulu is considering a 34% reduction in non-rail CIP spending. At the state level, $1.2 billion in increased capital spending in the Governor's proposed budget for FY 2012 relies on legislative approval of $800 million worth of new general obligation bonds. Federal ARRA programs are beginning to phase out and, by our estimate, the suspension of congressional earmarks has prevented appropriation of at least $170 million in local projects. Large grants of new federal funding for infrastructure projects are unlikely to be forthcoming in the current congressional climate.

Overall construction activity will begin to turn the corner this year, but primarily on Oahu and largely on the strength of rail-related government contracts. The Honolulu County construction job base will expand by 5% this year, and by more than 10% in 2012 and 2013. By comparison, the Neighbor Islands as a group will see a small additional net loss this year before modest expansion begins in 2012. Despite the weak housing market and approval delays to some major projects, residential building will begin to turn up over the next few years. The pace of a commercial construction recovery will be somewhat more attenuated. See



REAL PRIVATE PERMITS (MIL. 2009$)

our first quarter UHERO Construction Forecast for details.

Compared with our first quarter forecast, the notable differences in this report are an anticipated loss for the Japanese visitor market and expectations of somewhat higher inflation due to higher oil prices. Not surprisingly, these areas also represent the greatest downside risks. The quake effects in our forecast reflect lower Japanese growth in the months following the disaster and fairly persistent damage to the Japanese traveler's psyche. If quake damage leads to more extensive disruptions to global supply chains than currently envisaged, then there could be a broader negative impact on the US economy and global tourism. Similarly, oil prices could become a bigger problem if unrest in North Africa and the Middle East were to worsen, sending prices to levels that further undercut US consumer confidence. That is not to say that all the risks—or even the preponderance of risks—lie to the downside. As the economic recovery strengthens, we may well begin to see positive surprises in job and income growth that outstrip the moderate path of recovery reflected in the current Hawaii forecast.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2008	2009	2010	2011	2012	2013
Visitor Arrivals	-10.5	-4.4	8.8	2.7	3.0	1.8
U.S. Visitor Arrivals	-13.5	-3.9	7.2	4.7	1.5	1.0
Japan Visitor Arrivals	-9.4	-0.6	5.3	-10.8	10.3	3.2
Other Visitor Arrivals	3.0	-10.5	19.6	8.7	2.7	3.3
Payroll Jobs	-0.9	-4.5	-0.8	1.6	2.2	2.3
Employment	-0.7	-4.1	-0.2	1.3	2.3	2.3
Unemployment Rate (%)	4.1	6.8	6.6	6.0	5.3	4.8
Inflation Rate, Honolulu MSA (%)	4.3	0.5	2.1	1.9	2.3	2.2
Real Personal Income	-0.2	-0.7	0.1	2.1	2.3	2.7
Real GDP	-1.5	-0.1	0.9	2.6	3.3	3.8

Note: Source is UHERO. Figures for 2011-2013 are forecasts.

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