Hawai'i Outlook: Brief Recession Likely Over

April 11, 2002

Carl Bonham and Byron Gangnes
University of Hawai'i Economic Research Organization
Introduction

Hawaii's economy had begun to slow in the first half of last year, due primarily to the mainland recession that began in March. Still, the state was in relatively healthy condition. Tourism's pace had moderated, yet other sectors—such as construction, real estate, and other areas not linked directly to tourism—supported modest job growth and some of the best income numbers we had seen in years.

The terrorist attacks of September 11 precipitated a much broader downturn. Tourism was completely disrupted for several days and recovery is still underway. At the time of this writing, U.S. mainland tourism is essentially back to 2000 levels, but Japanese passenger counts continue to fluctuate between 70% and 90% of the previous year's levels.

Outside of tourism, the state has weathered the downturn fairly well. Job losses have been significant—total non-agricultural jobs fell 2% in the fourth quarter of 2001 compared with 2000—but job recovery appears to have already begun. Hawaii will likely experience only a mild and short-lived recession in real personal income. Growth in the broad economy is probably already underway, and will strengthen as the year proceeds.

Recent Developments

Hawaii's recession has been an uneven one in many respects. In the tourism sector, which bore the brunt of the post-9/11 downturn, segments dependent on Japanese visitors have been hurt much more than mainland-oriented businesses. Outside of tourism, interest sensitive sectors—construction, real estate, auto sales and consumer durables—have benefited from the Fed's succession of interest rate cuts. With mortgage rates at 30-year lows, the refinancing pipeline at local banks has been full, which boosts profits for banks and mortgage brokers but also puts extra money into the pockets of local consumers.

The unevenness of Hawaii's recession also has had a geographical dimension. The Neighbor Islands have fared better than Oahu, in part because of their relatively smaller dependence on Japanese tourism, but also because of strength in areas such as agriculture and budding high tech that continue to perform fairly well.
Looking back at 2001 as a whole, notable developments include:

- Payroll jobs grew only marginally in 2001, down from a projected growth of about 2% prior to the 9/11 attacks. The State unemployment rate jumped from 4.5% in September to 5.4% in October, a one month increase of about 5,700 people. More than 60% of layoffs came in hotels, retailing, transportation, and other tourism services. The job losses were somewhat less than feared because businesses reduced worker hours in many cases rather than resorting to even larger layoffs.

- Visitor arrivals to Hawaii set a record in 2000, just shy of the 7 million mark. Tourism had already begun to slow in the first half of 2001, as a result of the global economic downturn. Arrivals underwent a severe contraction following September 11.

- Real personal income for the State was up 3.1% in the first three quarters of 2001, among the best performances in recent years. The recession since then augurs anemic real personal income growth into the first part of this year. (Fourth quarter income data will not be available until later this month.)
• Inflation in Hawaii fell below the national average during the past decade of stagnant growth here, and that difference continued in 2001. Local inflation will remain in check in 2002, but rise moderately in 2003 as the recovering economy puts some upward pressure on prices.

• Hawai'i's housing market remained robust in 2001, due to continued low interest rates and perhaps recent income growth. On O'ahu, the total value of home resales grew 2.7 percent to $2 billion, continuing the upward trend of the last five years. The number of single-family home sales rose 7.1% and condominium sales increased 8.5%. Prices remaining fairly stable on Oahu. On the Neighbor Islands, there is a similar pattern of strong sales and steady prices.

• The value of private building permits increased by 3% in 2001. This was largely due to a 6.9% increase in the value of residential permits and a 33.7% increase in the value of commercial and industrial permits. Permits for additions and alterations dropped by 19.7%.
The state budget situation worsened. General fund revenues for the first eight months of the current fiscal year declined 1.4% after a 6.9% increase in 2000. The decrease is primarily due to sharp decline in withholding taxes on wages, an increase in corporate income tax refunds, a drop in public service company taxes. A 10% drop in the transient accommodations tax and a small decline in the general excise and use tax also reduced revenues.

At the sectoral level, the tourism-related industries of transportation, trade and hotel services saw the biggest proportional job losses in 2001, but construction and business services also saw net losses between December 2000 and December 2001. Government and health were the only sectors adding jobs over this period.

The Year Ahead

While still burdened by weak Japanese tourism, there are clear signs in Hawaii of an economy on the mend. Given the recent signs of expansion on the U.S. mainland, we expect Hawaii to emerge from recession early this year, and proceed to moderate growth as the year progresses.

The U.S. national recovery now appears to be well underway, with a surprisingly strong 1.7% growth of output in the 4th quarter. The unemployment rate in March edged up slightly to 5.7%, and employment declined 0.3%, but overall the labor market appears to have stabilized. Business inventories have been declining and industrial production grew for the second consecutive month in February. Consumer confidence has been on the mend, with the University of Michigan survey showing a 17% rise in the past four months.

While a recovery may now be firmly underway, it is not clear how strong that recovery will be. Among the chief concerns is that consumers and firms enter the recovery with unusually high debt levels, which may limit the pace of spending in coming months.

Japan's economy (See Japans Economy in Recessions Grip, March 7, 2002) remains mired in recession. The downturn deepened at year's end, creating the first three-quarter contraction for
Japan in nearly a decade. The Japanese government continues to display an inability or unwillingness to get the economy moving again. Repeated application of fiscal policy over the past decade has failed to lift the economy above 1% average performance, but have led to a debt-to-GDP ratio that is the highest among major industrial economies. The Bank of Japan has resisted calls to increase bank reserves aggressively, although high-powered money has been permitted to expand somewhat more rapidly in recent months. At base, Japan's corporate and banking sector bad loan problems coupled with ongoing deflation has undercut business and now consumer spending.

As result, weak Japanese tourism can be expected to weigh on Hawaii in the near term. At the same time, a relatively weak yen will restrain Japanese visitor spending here.

The combined effect of a strengthening U.S. and struggling Japanese economy leaves Hawaii with a visitor sector, which, though much improved, continues to lag behind 2001 levels. In February, U.S. visitor arrivals were actually 99% of last year's levels, and Japanese arrivals had improved to 73% compared with the previous year. Occupancy rates remained near 64% in January, compared with 76% the year before.

On an annual basis U.S. mainland visitors are expected to rise 4.3% this year, after falling 4.1% in 2001. Japanese arrivals will recover just 0.2% of the 18.8% drop seen in 2001, but will expand by 12% in 2003. At this rate, it will take several years for Japanese visitors to regain their 2000 levels, let alone the record levels seen in 1997. Occupancy rates for 2002 will average about 75% for the state as a whole, compared with 70% in 2001.

Job losses in tourism related sectors have been somewhat less severe than we had originally expected. In January, there were 2600 fewer jobs in the hotel sector, an 8.4% decline. The transportation sector shed 3300 jobs after 9/11, and trade jobs declined by 5200. But jobs will be added back only slowly as the tourism sector recovers, and hotel revenues will take time to fully recover.
Areas that are not directly related to visitor spending will fare better. The stimulative effects of lower interest rates in 2001 will abate as the Federal Reserve begins monetary tightening in the second half of the year, but a strengthening U.S. economy will support growth in Hawaii.

Some sectors have either continued to add modest numbers of new jobs in recent months or have been able to maintain previous high employment levels. These include construction, finance, insurance and real estate, and government. In those sectors most affected by the tourism slump-trade and services areas-job losses appear to have ended by the beginning of the year. Across the board we expect to see a resumption of job growth this year, although it will take a while to recover jobs lost in tourism areas. Overall non-agricultural job growth on Oahu will recover to pre-attack levels by early 2003.

Real (inflation-adjusted) personal income gives us the best aggregate measure of Hawaii’s economic activity. Income growth almost certainly slowed after September 11, and we expect negative year-on-year growth for the 4th quarter of 2001 and the 1st quarter of this year. After that, real income growth will resume, rising to better than 2% growth by the end of the year. For 2002 as a whole, income will rise just 0.5%, before strengthening to 2.1% growth in 2003.

Hawaii’s brief respite from inflation will also end this year. As growth picks up, some acceleration of inflation can be expected, rising to 2.1% in 2003.
Concluding remarks and forecast risks

The general economic health that Hawaii enjoyed in 1999-2000 had already been challenged in mid-2001 by a slowing global economy. The disruptions from the September 11 terror attacks dealt another blow to the Hawaii's expansion. Nevertheless, recovery is now underway, in fact proceeding a bit faster than we envisioned back in November because of the renewed strength in the mainland US economy.

At a macroeconomic level the biggest risk to our recovery are the uncertain prospects for Japan. If anything, our outlook for Japan has worsened since November, and while the bottom may have been reached, signs of recovery remain elusive. A new risk is the possibility of much higher oil prices linked to the widening Palestinian-Israeli conflict. Oil prices have already spiked on Iraq's announcement of a temporary embargo. While no global capacity shortfall appears imminent, any oil shortage in the face of growing global demand could result in much higher prices.

Prospects for the War on Terrorism continue to be of utmost importance. Unfortuantely, further disruptions cannot be ruled out. At the same time, we hope to see a continual gradual improvement in the security environment that supports ongoing recovery in Hawaii's tourism sector and the broader local economy.

Hawai'i Economic Indicators (Annual Growth Rates)*

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Visitor Arrivals</td>
<td>3.5%</td>
<td>-9.1%</td>
<td>3.0%</td>
<td>6.4%</td>
</tr>
<tr>
<td>US Visitor Arrivals</td>
<td>6.9%</td>
<td>-4.1%</td>
<td>4.3%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Japan Visitor Arrivals</td>
<td>1.7%</td>
<td>-18.8%</td>
<td>0.2%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Payroll Jobs</td>
<td>3.1%</td>
<td>0.4%</td>
<td>-0.3%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>4.3%</td>
<td>4.6%</td>
<td>4.5%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Inflation Rate, Honolulu MSA (%)</td>
<td>1.8%</td>
<td>1.2%</td>
<td>1.0%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Real Personal Income</td>
<td>2.3%</td>
<td>2.3%</td>
<td>0.5%</td>
<td>2.1%</td>
</tr>
</tbody>
</table>

*2001 real income figures are estimates. All 2002 figures are forecasts. Real values adjusted for Honolulu CPI inflation.

Copyright © 2002 Carl Bonham and Byron Gangnes. All Rights Reserved.