UHERO Hawai‘i Quarterly Forecast Update:

Growth On Track, But Oil Risks Real

by

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EXECUTIVE SUMMARY

There was some slowing of visitor arrivals growth in the second quarter, but the industry remains buoyant. Residential construction and allied sectors are seeing exceptional job and income gains. Aggregate real (inflation-adjusted) income growth continues to surprise, leading us to upgrade once again our income forecast for 2005. At the same time, we may now be seeing early signs of the gradual slowing that we expect to occur over the next several years. Inflation in Hawai‘i has probably not yet peaked, and the continuing surge in energy prices raises the risk of a more pronounced slowdown for the local economy.

- Aside from risks associated with high oil prices, the external sector looks sound. After a very strong first quarter, Japanese growth continued at a more modest pace in the second quarter, and we now expect Japan to post 2.1% growth in real Gross Domestic Product this year. Further strengthening to 2.4% is expected in 2006. We expect U.S. output growth of 3.4% next year.

- Hawai‘i’s visitor industry slowed just a bit in the second quarter after a phenomenal start to the year. Slower-than-expected U.S. arrivals in the second quarter and what looks to be a weak third quarter for the Japanese market lead us to lower our arrivals forecast for 2005 slightly to 6.4% annual growth. Overall visitor arrivals are on track to easily exceed the 7 million mark for the first time this year.

- Seasonally-adjusted statewide occupancy rates are expected to remain in the 80% range for the next several years. We expect a slowing of expansion for both the Japanese and U.S. visitor markets.

- Developments over the past quarter have led us to make upward revisions to 2005 job growth forecasts for construction and, to a lesser extent, wholesale and retail trade, health care, and accommodation and food services. Government jobs for the year will decline 0.5%. With the exception of the public sector, we expect slower growth in every major sector next year.

- The local labor market remains extremely tight, with statewide unemployment at 2.7%. We may be beginning to see the restraining effect of labor tightness on the economy, as overall job growth has slowed marginally from last year’s pace. We are on track to have about 2.3% growth in payroll jobs this year, but declining to 1.6% in 2006.

- On the basis of upward revisions to fourth quarter 2004 income, we now expect real income growth for 2005 as a whole to be about a half percent higher (3.6%) than forecast in June. We expect marginal slowing to 2.7% in 2006.

- Prices for residential real estate have continued to surge upward. Nationally, rates of price increase have slowed this year, but not yet in Hawai‘i. We continue to believe that the market will cool over the next couple of years as the effects of declining affordability and higher interest rates are felt.

- Measured inflation for the first half of the year came in somewhat lower than we had expected, but it is clear that inflation risks are all on the upside. While we have lowered our estimate of 2005 inflation by half a percentage point to 3.4%, we have raised our forecast for 2006 to 3.8%.

- Oil prices are now a much bigger worry for the global economy than even three months ago. While the current $67 per barrel price remains below the all-time high of $90 per barrel in inflation-adjusted terms set in 1980, this nevertheless represents a tripling of oil prices since early 2002. There is a growing risk that
energy prices could represent a significant drag on consumer confidence and non-energy spending going forward. This poses a particular risk for Hawai‘i’s visitor industry.

- Hurricane Katrina complicates the energy picture. Beyond the near-term spike in oil and gasoline prices, we have not built into our current forecast any longer-term effects from the storm. It will be at least another week or so before we begin to know the extent of the damage to oil and gas infrastructure.

### Hawai‘i Economic Indicators, Year-Over-Year %Change

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<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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<tr>
<td>Visitor Arrivals</td>
<td>1.4</td>
<td>-0.1</td>
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<td>6.4</td>
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<td>U.S. Visitor Arrivals</td>
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<tr>
<td>Japan Visitor Arrivals</td>
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<td>Payroll Jobs</td>
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<td>2.6</td>
<td>2.3</td>
<td>1.6</td>
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<tr>
<td>Employment</td>
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<td>1.2</td>
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<td>Unemployment Rate</td>
<td>4.1</td>
<td>3.9</td>
<td>3.3</td>
<td>2.8</td>
<td>2.8</td>
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<tr>
<td>Inflation Rate, Honolulu MSA (%)</td>
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<td>3.3</td>
<td>3.4</td>
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<td>Real Personal Income</td>
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<td>1.8</td>
<td>3.6</td>
<td>3.6</td>
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Notes: Source is UHERO. Figures for 2005–2006 are forecasts.

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**The UHERO Economic Information Service**

UHERO’s Economic Information Service provides complete analysis and detailed industry-level forecasts for several years. The EIS is a community-sponsored research program of the University of Hawai‘i at Mānoa. The EIS provides the Hawai‘i community with information on economic, demographic, and business trends in the State and the Asia-Pacific region. For more information, visit our EIS information page.

The following are reports scheduled for delivery to sponsors in the coming months. Brief executive summaries will be released to the public.

3rd Quarter: Hawai‘i Construction Forecast Update. Review of construction industry conditions and multi-year forecasts.

4th Quarter: Next Hawai‘i Quarterly Forecast Update.

4th Quarter: The Global Outlook Report. Review of economic conditions in the world economy with particular focus on Asia. Includes forecasts for major countries and regions.