UHERO Hawai‘i Quarterly Forecast Update

Inflation Shock Means Sharply Lower “Real” Growth

by

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EXECUTIVE SUMMARY

Key Changes in This Forecast.

Our inflation forecast has been raised to 5.2% from our 3.8% forecast made in May, based on the nearly 6% inflation experienced in the first half of the year. Inflation will exceed 4% in 2007.

Because of higher inflation, real income growth is now expected to manage just 1% growth this year, down from our May forecast of 3%.

The visitor arrivals forecast has been marked down to 1.5% growth this year (compared with our 2.8% forecast from May) based on poor Japanese-market performance.

Inflation in Hawai‘i has reared its ugly head. For the first half of the year, Honolulu consumer price inflation topped the nation, with average prices rising nearly 6% over the previous year. Rising prices are cutting into the purchasing power of local residents and will lead to a sharp drop in measured real income growth this year. While an orderly process of economic slowing continues to be evident, the inflation impulse introduces some new risks.

- The outlook for Hawai‘i’s key external markets has become somewhat less favorable. We expect relative weakness in the U.S. economy into the first half of 2007. After real GDP growth of 3.3% this year, U.S. growth will be only 2.7% in 2007. We have also reduced to 2.5% our forecast for Japanese growth for this year, and about 2% for next year.

- In Hawai‘i, the inflation outlook has clearly worsened. Housing cost pressures are the primary driver, but energy prices have also been important. Because of lags between home price increases and measured inflation in shelter costs, we expected inflation to remain high for some time. Overall Honolulu inflation will top 5% this year, and exceed 4% in 2007.

- Nominal incomes will not keep pace with inflation in the near term, so measured real (inflation-adjusted) income will suffer. After rising 3% last year, real personal income will manage just a 1% gain this year. This represents a full two percentage point downgrade from our May forecast. Real income will rebound to 2% in 2007. Actual purchasing power of Hawai‘i residents will probably not slow to the degree these figures suggest, since many homeowners do not face the full housing cost increases estimated by government statisticians.

- The visitor industry is healthy, but slowing compared with recent years. Based on activity through July and fall scheduled air seats, we have reduced our forecast for 2006 visitor arrivals from the 2.8% forecast made in May to 1.5%. U.S. arrivals for the year will be 2.9% higher than in 2005. Japanese arrivals will be 7.4% weaker for 2006 as a whole, a stark downward revision from our flat second-quarter forecast. Overall arrivals are expected to rise 2.4% in 2007.
- The labor market has now begun to show the expected cooling trend. Job growth has dropped below three percent, and unemployment, while still very low, has eased a bit. With tourism peaking, construction decelerating, and continuing labor market constraints, we expect a more pronounced slowing over the coming two years. After 2.5% growth this year, aggregate job gains will slow to 1.2% in 2007. The unemployment rate will average 2.8% for this year and move up above 3% in 2007.

- The housing market has now clearly turned, with a significant decline in resale activity, rising inventories and decelerating price gains. With the slowing of the housing market, the residential construction sector will also continue to slow. We continue to believe that a sharp correction is unlikely, largely because we do not expect an abrupt decline in prices. Construction job growth will decline from last year’s 13.7% pace to 2.3% in 2007.

- UHERO 2006 job forecasts are largely unchanged from our May forecast update for most sectors. Trade job growth is looking to be a bit weaker, and health care job gains are anemic. The “other services” category, which includes business, administrative, and professional services, has been running a little stronger than expected earlier in the year. There are no significant changes to sector job forecasts for 2007.

- While this year’s inflation surprise will take a big bite out of measured growth, the state economy remains on the same path of gradual slowing that we have been forecasting for the past year. The surge in inflation does present a new risk, since it is difficult to know how business and consumers will react to sharply rising prices.

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

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
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<tr>
<td>Visitor Arrivals</td>
<td>-0.1</td>
<td>8.3</td>
<td>6.4</td>
<td>1.5</td>
<td>2.4</td>
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<tr>
<td>U.S. Visitor Arrivals</td>
<td>4.8</td>
<td>7.3</td>
<td>7.0</td>
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<td>1.7</td>
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<tr>
<td>Japan Visitor Arrivals</td>
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<td>10.6</td>
<td>2.7</td>
<td>-7.4</td>
<td>2.3</td>
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<tr>
<td>Payroll Jobs</td>
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<td>2.8</td>
<td>3.2</td>
<td>2.5</td>
<td>1.2</td>
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<tr>
<td>Employment</td>
<td>0.9</td>
<td>1.4</td>
<td>3.0</td>
<td>2.1</td>
<td>1.1</td>
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<tr>
<td>Unemployment Rate (%)</td>
<td>3.9</td>
<td>3.3</td>
<td>2.8</td>
<td>2.8</td>
<td>3.1</td>
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<tr>
<td>Inflation Rate, Honolulu MSA (%)</td>
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<td>3.3</td>
<td>3.8</td>
<td>5.2</td>
<td>4.2</td>
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<td>Real Personal Income</td>
<td>2.4</td>
<td>4.6</td>
<td>3.0</td>
<td>1.0</td>
<td>2.0</td>
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Notes: Source is UHERO. Figures for 2006–2007 are forecasts.
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