

Hawaii’s tourism juggernaut powers onward, but growth elsewhere remains elusive. Broader—and a bit stronger—expansion is in the pipeline.

The visitor industry has seen impressive growth this year. Arrivals were up 10% in the first eight months of 2012, nearly half a million more visitors than in the corresponding period of 2011; year-to-date visitor days were also up 10%. Although growth in visitor expenditures has decelerated a bit recently, they remain 19% higher than in the first eight months of 2011.

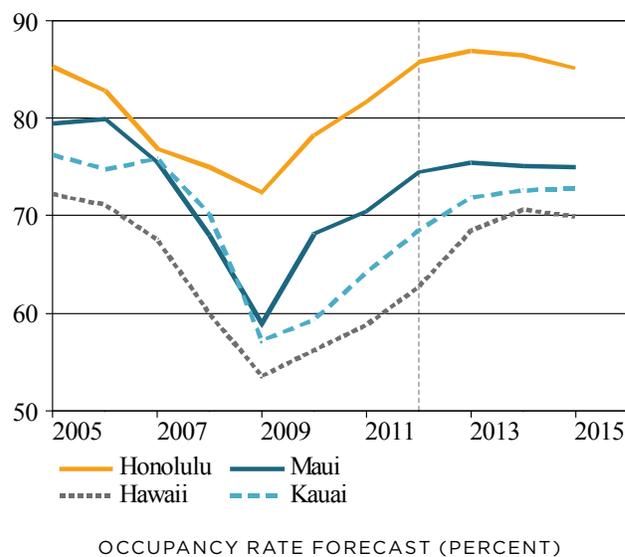
Arrivals from international markets have been particularly strong. After surging back from last year’s post-quake plunge, Japanese arrivals are running 17% higher than a year ago, their best showing since 2005. Canadian arrivals have plateaued in recent months, but they stand at roughly twice their number in the middle of the last decade. Visitors from destinations other than Japan, US and Canada show 28% year-to-date growth, with the largest gains in Australian, Chinese, and Korean markets. While less dramatic, there has also been a revival of growth in the US market, which had weakened considerably in the first half of 2011. Through August, arrivals from the US market are up more than 5%.

The airline capacity outlook for the next three months is favorable, with the total seats up 14%. The gains will be spread across all counties. A significant increase in the number of flights is scheduled from Oakland, San Diego, and Los Angeles airports. Recent entrant Allegiant Airlines has announced plans to add several new flights from smaller West Coast airports this fall. The number of international flights is projected to increase as well. A bit further down the road is an anticipated Hawaiian Airlines flight to Kona and the possibility that Southwest Airlines may finally enter the

Hawaii market.

Visitor days have picked up in all counties, with a year-to-date growth rate of 12% on Oahu and over 8% on each of the Neighbor Islands. Having surpassed their pre-recession peak, statewide total visitor days are on target to log a record year. Occupancy rates were fairly stable over the first three summer months, averaging 77% for the State as a whole. This is almost five percentage points higher than in June-July 2011. The occupancy rate on Oahu has now roughly matched its previous peak level seen in 2005. Occupancy rates on the Neighbor Islands have yet to impress: they remain well below their previous peak on the Big Island and Kauai.

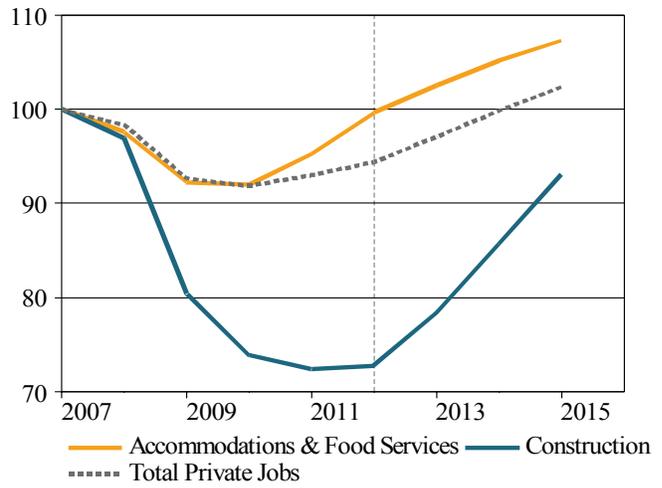
The recent strong arrivals numbers and projected seats going forward support a strong outlook for the remainder of the year. We expect growth to ease in 2013, in part because of poorer prospects for global growth, but also because we have now reached a point of high capacity utilization within



the Hawaii visitor industry. There is simply not enough room to accommodate significant further growth in the near term. After 9.1% growth this year, we expect only 3.6% more arrivals in 2013 and less than 2% growth in 2014. Total visitor spending will expand by 11% next year.

Outside of tourism, economic growth continues to be sub-par. Since the beginning of the year there has been a net increase of 6,500 jobs statewide; 2,900 of these are in the accommodation and food service sector. Jobs in the industry are 5.4% higher than during the first eight months of 2011. Transportation and utilities jobs are up 4%, with most of this driven by utility jobs. The number of jobs in the trade sector is up 1.3%. Significant gains have been seen in administrative and waste management services (5.7%), and in both finance (3.3%) and real estate (2.9%). The number of jobs in the information sector is down significantly for the year to date, but has rallied a bit over the summer, presumably due to the shooting of Hawaii 5-0 and ABC's new action drama Last Resort. Further increases are expected toward the end of the year when The Hunger Games sequel starts filming on Oahu. For the past two years a downward trend has dominated in professional, scientific, and technical service jobs, as well as other service jobs that include repair, maintenance, personal, and laundry services among other things. Compared to last year, these sectors fell 6% and 1.3%, respectively. Management of companies is off 2.4%. Last year's closure of the Saint Francis Healthcare System leaves health care sector jobs flat compared with 2011.

The public sector continues to subtract from growth. As of the end of August, public sector jobs were down 0.3% compared to the first eight months of 2011, with weakness in federal, state, and local components. The state government job base is off by about 3,000 jobs compared with the early 2009 peak; federal jobs grew throughout the recession and have continued to hover above 34,000 positions for the past two years.



JOBS BY SECTOR FORECAST (INDEXED TO 2007)

Total non-farm jobs expanded by 1.2% in the first eight months of the year, but this may overstate the extent of labor market strength. These preliminary data are subject to sometimes-substantial later revisions. Based on incoming data from the US Bureau of Labor Statistics that will be used in the revision process, we expect there may be a sharp downward adjustment when final figures are announced next March.

The statewide unemployment rate has continued its slow decline, but remained just above 6% in August. Unfortunately, unemployment is falling largely for the wrong reason: more people are taking themselves out of the labor market, with the number reporting that they are employed actually declining. (The divergent performance of non-farm job and employment counts can sometimes occur because they are based on entirely different surveys.) The broader measure of unemployment that includes marginally attached workers and involuntary part-time employees remained unchanged at 14.8% in the second quarter of 2012.

We expect the number of payroll jobs to close the year 1.1% higher than in 2011. This is a slight downgrade from our forecast of 1.3% growth made in the third quarter. Payroll jobs will grow a more satisfactory 2.2% in 2013 and 2.4% in 2014.

The number of jobs in construction is running nearly 1%

Compassionate Deficit Reduction versus the Fiscal Cliff

In September, the Federal Reserve announced that it will buy \$40 billion worth of mortgage backed securities every month for the foreseeable future. The move is designed to keep long-term interest rates low, and thereby spur investment in plants and equipment by businesses, and incentivize purchases of homes by consumers. But monetary policy is facing an uphill battle if the government implements austerity programs aimed at reducing deficits. The bleak fiscal situation has come to be known as the fiscal cliff, an evocative name for the set of expiring tax cuts, new taxes, and automatic spending cuts agreed to as part of last year’s debt ceiling compromise.

On January 1, 2013, the Bush tax cuts are set to expire for the second time, as are the temporary payroll tax holiday and extended unemployment benefits. According to recent estimates by the Congressional Budget Office (CBO), the tax increases and spending cuts written into current law will lead to a recession in 2013. While Congress is unlikely to permit the full brunt of these changes to be felt, election year politics and an uncertain November result will make compromise extremely difficult. But compromise is what is called for to address both the need for short-term restraint in deficit cutting and an honest medium- and long-run plan to reduce deficit spending.

The table shows the projected impact of various CBO scenarios on real gross domestic product. The baseline scenario assumes that all current laws

requiring greater austerity remain unchanged. In other words, we drive off the fiscal cliff, and the economy goes into recession, contracting at an annual rate of 1.3% in the first half of 2013. Deficits as a percentage of GDP decline steadily towards more sustainable levels. In contrast, if all of the scheduled cuts are removed, real GDP grows 4.4% in 2013, but the national debt burden continually increases to unsustainable levels. The alternative scenario assumes that Congress pulls back from the fiscal cliff by extending some of the current fiscal policies, but at the same time fails to make meaningful progress towards long-term deficit reduction. While there is no significant short term change in economic growth under this scenario, the national debt balloons from 69% of GDP in 2011 to 93% by 2022, and the government faces soaring interest payments.

To avoid these radical outcomes, what is called for is a balanced backing away from the fiscal cliff, along with a long-term plan to reduce deficits through a combination of tax increases and spending reductions that are phased in gradually so as not to throw the US economy back into recession. For example, increasing revenue through an overhaul of the US tax system that broadens the base and eliminates most deductions and credits, gradually increasing the retirement age and raising Medicare copays, and means testing both Medicare and Social Security. The bi-partisan plan released by the Debt Reduction Task Force in November 2010 is a great place to start.

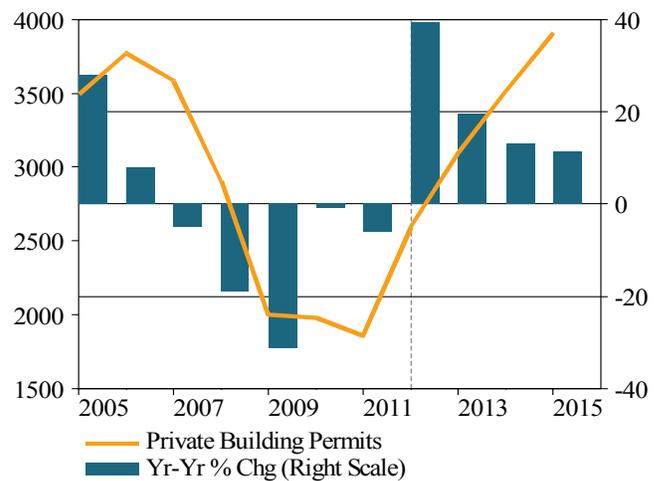
	FIRST HALF 2013	SECOND HALF 2013	ENTIRE YEAR 2013
BASILINE SCENARIO	-1.3	2.3	0.5
WITH NO FISCAL RESTRAINT CENTRAL ESTIMATE	5.3	3.4	4.4
ALTERNATIVE FISCAL SCENARIO CENTRAL ESTIMATE	1.7	2.5	2.1

REAL GROSS DOMESTIC PRODUCT GROWTH

behind the average for the first eight months of 2011, but there have been tentative signs of a trend reversal recently. In August construction job counts totaled 29,200, more than 6% higher than the recent low of 27,400 in November 2011. We think prospects are very positive going forward, with pending improvements in private building activity poised to offset the adverse impact of delayed rail construction.

After receiving a green light earlier this year and incurring cumulative costs of 493 million as of August 31, 2012, Oahu's rail transit project faces significant new setbacks. A discovery of human bone fragments in the city's Kakaako neighborhood in September (and more in October) was accompanied by a Hawaii Supreme Court ruling requiring the City and County to survey the entire 20-mile rail route before proceeding with construction (the original plan was to conduct the survey in four phases). The rail authority estimates a delay in construction until April/May of next year, but it is likely that surveying and addressing any detected *iwi* will take longer. We have pushed back our forecast for rail work by one year compared with our previous estimates. And of course we await the outcome of November's mayoral election, which could affect rail prospects beyond that.

Luckily for the construction industry, strong permitting for private construction suggests that commercial and residential building will offset some of the lost rail activity, although Honolulu will still be adversely affected. Statewide private building permits have expanded for three consecutive quarters, the first time this has happened since 2006. Non-residential permit growth has been driven by additions and alterations, a significant portion of which can be attributed to renewable energy installations spurred by generous state tax credits. Commercial permitting is up by a much smaller fraction. Residential permitting has picked up 20% since last year, and the firming of prices on Oahu supports our view that the next home building cycle is getting underway. After a very weak start in the first quarter, government

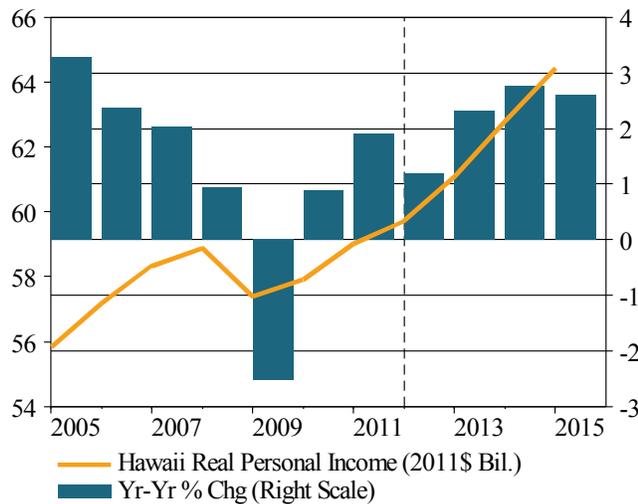


PRIVATE BUILDING PERMITS FORECAST

contracts awarded tripled in the second quarter. We expect construction jobs to edge up 0.6% this year before accelerating to a brisk 7.7% gain in 2013. More details on the developments for the construction sector will be given in our 2013 Hawaii Construction Forecast, due out in the first quarter of next year.

Markets for residential real estate are showing the most improvement on Oahu and Maui, where prices are roughly 6-8.5% higher. Smaller price gains in the mid to upper 3% range have occurred this year on the Big Island and Kauai. On Oahu, single family prices have clawed back most of the losses they incurred during the recession, but Neighbor Island prices remain severely depressed. Generally speaking, resale volumes are not much different from a year ago, reflecting a low number of active listings across the state. Listings have been on a downward trend since the depths of the recession, and are now 50% below peak on Oahu. The low inventory will support further price increases in the next several years.

The renewable energy tax credit has turned out to be a significant weight on the state government budget. The Hawaii Department of Business Economic Development & Tourism (DBEDT) estimates renewable energy tax credits will amount to \$174 million for tax year 2012; the State Council on Revenues estimates that this figure will grow by \$90 million in FY2013. Largely as a result of this, the Council



REAL PERSONAL INCOME FORECAST

lowered its revenue forecast at its September meeting by 0.4 percentage points to 4.9%. Growth rates for FY2014-2019 were also revised downward. Aside from the tax credit cost, tax collections for fiscal year 2013 are off to a strong start. For July - September, general excise and use taxes were up 12.8% and the transient accommodation tax take was 14.6% higher than the same three-month period last year.

Since our last report, the Bureau of Economic Analysis has released state personal income estimates for the second quarter of 2012 as well as revisions going back through 2009. Personal income was revised down for all three years,

revealing that the downturn was more severe and that the recovery has made less progress than previously thought. Real income gains through the first half of this year have barely kept pace with changes in the price level, despite the fact that inflation has cooled (2.8% in the first half of 2012 and 1.5% after exclusion of food and energy). Adjusted for inflation, labor income actually contracted by nearly 1% in the first quarter of the year and was essentially flat in the second. While extensions of the payroll tax holiday and unemployment insurance have kept transfer payments in line with inflation, both extensions are slated to end at the end of the year. We expect real income to expand by 1.2% for this year as a whole, firming to 2.3% in 2013.

The changes in our forecast since the third quarter are generally minor. Job and income growth are marginally weaker this year and next, while visitor projections are right on track with our prior outlook. Despite rail challenges, we continue to expect construction to begin a decisive move upward in 2013. The biggest risks are at the federal level, where failure to address the looming fiscal cliff could derail the US recovery. So far, political posturing has prevented a solution; let's hope cooler heads prevail in the post-election period.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2010	2011	2012	2013	2014	2015
Visitor Arrivals	7.7	3.7	9.1	3.6	1.9	1.3
U.S. Visitor Arrivals	5.9	2.3	5.0	2.3	1.5	1.2
Japan Visitor Arrivals	6.1	0.2	16.0	2.5	-0.7	-1.7
Other Visitor Arrivals	17.6	13.4	17.0	8.7	5.7	4.2
Payroll Jobs	-0.8	0.9	1.1	2.2	2.4	2.2
Employment	1.8	2.0	-0.6	1.1	1.9	1.8
Unemployment Rate (%)	6.9	6.7	6.3	5.6	5.0	4.6
Inflation Rate, Honolulu MSA (%)	2.1	3.7	2.6	2.3	3.1	2.8
Real Personal Income	0.9	1.9	1.2	2.3	2.8	2.6
Real GDP	0.0	-1.5	0.9	2.5	3.3	3.4

Note: Source is UHERO. Figures for 2012-2015 are forecasts.

UHERO

THE ECONOMIC RESEARCH ORGANIZATION
AT THE UNIVERSITY OF HAWAII

UHERO THANKS THE FOLLOWING SPONSORS:

KAWEKI'U - THE TOPMOST SUMMIT

The Bank of Hawaii

KILOHANA - A LOOKOUT, HIGH POINT

Hawaii Electric Light Company, Inc.

Hawaiian Electric Company, Inc.

Maui Electric Company, Ltd.

Kamehameha Schools

Matson Navigation Company

KUAHIWI - A HIGH HILL, MOUNTAIN

American Savings Bank

Central Pacific Bank

First Insurance Company of Hawaii, Ltd.

Hau'oli Mau Loa Foundation

Kaiser Permanente Hawaii

The Nature Conservancy, Hawaii Program

Natural Energy Laboratory of Hawaii Authority

The Pacific Resource Partnership

Servco Pacific Inc.

Kulia I Ka Nu'u (literally "Strive for the summit") is the value of achievement, those who pursue personal excellence. This was the motto of Hawaii's Queen Kapi'olani. Sponsors help UHERO to continually reach for excellence as the premier organization dedicated to economic research relevant to Hawaii and the Asia Pacific region.

The UHERO Forecast Project is a community-sponsored research program of the University of Hawaii at Mānoa. The Forecast Project provides the Hawaii community with analysis on economic, demographic, and business trends in the State and the Asia-Pacific region.

All sponsors receive the full schedule of UHERO reports, as well as other benefits that vary with the level of financial commitment.

For sponsorship information, browse to <http://www.uhero.hawaii.edu>.