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

UHERO STATE FORECAST UPDATE, PUBLIC SUMMARY

Expansion Shifts Into Higher Gear

FEBRUARY 15, 2013

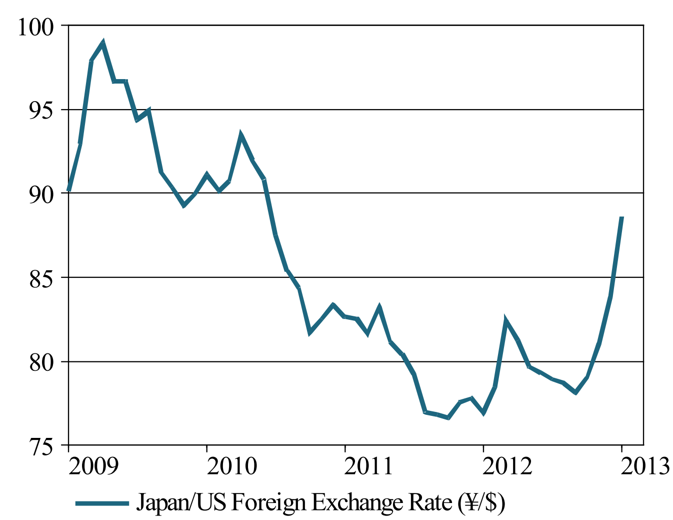
2012 marked a transition to healthier growth. Room for rapid tourism gains is now limited, but other sectors will pick up the pace.

By now we all know that 2012 was a banner year for Hawaii tourism. By some measures, it was also the most positive year for the broader economy since the mid-2000s. Moderate job growth emerged in a number of sectors, even if the extent of progress remains uneven. At long last, tentative signs of life are emerging in construction, which will help drive growth in 2013.

As we discussed in our fourth quarter Asia Pacific Forecast, the global economy struggled last year, with drag from the ongoing European debt crisis and underperformance in the US spilling over to other regions. Conditions in Europe have improved in recent months, and there are signs that China has turned the corner. Meanwhile Japan has experienced two consecutive quarters of real GDP decline, with the likelihood that the fourth quarter will also come in negative. Japanese Prime Minister Abe has proposed a new set of expansionary policies to fight the prolonged deflationary conditions, and the Bank of Japan has signaled a commitment to further expansion toward that end. It is too soon to tell whether policy makers will carry through on this commitment; past efforts to deal with deflation have been short lived and ineffective. Despite the overhang of the fiscal cliff and its successors (see the box, Fiscal Cliff 2.0 and Hawaii's Economy), prospects are good for a gradual firming of US growth, now that residential construction has moved off bottom and state government finances have improved. We expect the US economy to expand by 2.2% this year, while Japan manages just 0.2% growth.

Despite an exceptionally mediocre global economic environment, the Hawaii visitor industry had a phenomenal year in 2012. Total arrivals grew by more than 9%, exceeding their previous 2006 peak by more than 300,000 visitors. Expenditures rocketed upward more than 18%. This surge reflected both the higher visitor census and also higher hotel room rates, which were 7.7% higher than in the first three quarters of 2011. Statewide occupancy rates approached 77%, their highest level since 2006. (Room rate and occupancy rate data are from Hospitality Advisors LLC.)

Tourism activity was strong across all major market areas. Arrivals from the US mainland and from Canada posted healthy gains of 5.5% and 4.3% respectively. The quick recovery of Japanese arrivals after the great Tohoku earthquake in 2011 turned into a more sustained expansion, climbing 17% in 2012. The number of visitors from Japan is now within sight of levels seen in the mid-2000s. Air carriers have optimistically boosted scheduled seats from Japan, although in our view yen depreciation and higher room



YEN/DOLLAR EXCHANGE RATE

Fiscal Cliff 2.0 and Hawaii's Economy

Congress acted on January 1 to address part of the Fiscal Cliff, the worrisome combination of tax increases and spending cuts that had been timed to take effect at the start of the year. The country still faces a series of fiscal speed bumps in the months ahead and longer-term budgetary challenges. For Hawaii there is the added uncertainty of how the passing of Senator Daniel Inouye could affect the level of federal spending in the Islands.

The American Taxpayer Relief Act of January 2013 held the line on Bush tax cuts for all households with income under $450,000, while permitting rates for income, dividends, and capital gains to rise for wealthier households. Extended unemployment benefits were, well, extended, and a permanent fix was implemented for Alternative Minimum Tax bracket creep. The two percentage point payroll tax cut was allowed to expire. (Read Details of the Fiscal Cliff Deal online.)

The significant spending cuts (sequesters) that had been negotiated in the summer of 2011 to force Congress's hand in deficit reduction were postponed by two months. These (mostly) across-the-board spending cuts could have a substantial negative impact on the economy. Having said that, we think it extremely unlikely that the sequesters will be allowed to occur; instead Congress will probably enact further extensions and more measured cuts that, while weighing on economic activity, will not derail the current recovery.

With Hawaii's large military presence—at 9.6% of GDP the highest share in the nation—the sequesters represent a significant threat. Still, it is possible to overstate the potential impact. Spending on salaries paid to uniformed military personnel are protected from the sequestration, and Hawaii depends much less on contracts and procurement spending that would take the brunt of the budget axe. At the same time, the military has already implemented a civilian hiring freeze as a precaution, and sequestration would mean the suspension of nearly all training exercises as well as maintenance and repair work. Civilian DOD employees could be subject to furloughs.

The automatic spending cuts also include an equal reduction in non-defense spending. With social safety net programs largely protected, discretionary spending would have to absorb the brunt of the cuts, including the Social Services Block Grant, a set of federal funds transferred from the federal government to the states for social services. Federal funds make up almost one-fifth of estimated State revenues.

Again, we think Congress will find a way to eliminated most of these looming cuts. But they face other challenges. On March 27, the continuing budget resolution expires. A failure to pass a budget—or at least another continuing resolution—would shut down all non-essential government operations. Additionally the federal debt ceiling, which has been temporarily suspended by Congress, will rear its ugly head again in May. The persistent budget brinkmanship will continue to weigh on the economy, even as the private sector is showing some promising areas of strength.

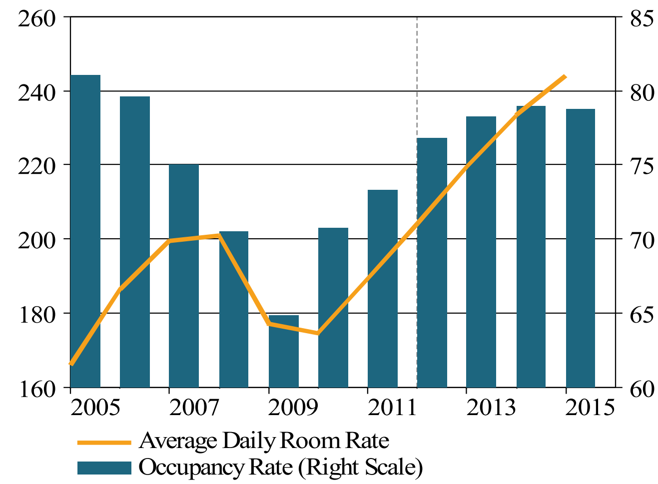
Which brings us to the long-term challenges. Federal contributions to growth have already ended, and the need for fiscal consolidation will serve as a drag on the economy for many years. The loss of Senator Inouye is a further negative factor, but Hawaii's is benefiting from the strategic pivot toward Asia and retreat from some military bases in the region. Our current forecast takes into account recent changes in tax policy and likely overall federal cuts, but it does not assume cuts directly linked to the loss of Hawaii Senate power. It is simply not possible to estimate impacts that might occur as a result of the Senator's passing, particularly in this time of heightened fiscal austerity.

rates will act to limit further Japanese market gains. Non-traditional markets—that is markets other than Japan, Canada and the US—continue to flourish with greater than 20% arrivals growth in 2012. Notable has been the steadily rising market share of Asia and Oceania. The total number of arrivals from China and Korea grew 40% (an increase of 34,000 and 44,000 visitors respectively). Arrivals from Australia increased by over 30%, an additional 64,000 visitors. And these visitors are big spenders: expenditures by visitors from non-traditional markets grew an astounding 50% last year.

These markets will continue to play an outsized role in coming years. Oceania is seeing a number of new flights from Brisbane, Melbourne, and Sydney, as well as Auckland, New Zealand. Visa-free travel under the US Visa Waiver Program is spurring new airlift from Taiwan. Hawaiian Airlines has announced an aggressive expansion plan that involves the launch of a Taipei-Honolulu flight in mid-2013, and China Airlines has also launched a new flight. Improved facilitation of visas for Chinese travelers has already supported mainland market growth, and there is of course huge upside potential.

Based on planned air capacity and other early indications, we expect another impressive year for Hawaii tourism in 2013, if off last year's blistering pace. But we are now entering the final phase of what has been an exceptional period of recovery and expansion. With occupancy rates averaging near 85% on Oahu in 2012, industry capacity constraints will begin to bite over the next few years. Room rates and other costs will rise, deterring some potential visitors, and growth in new markets will crowd out visitors from others. After 6.5% expansion in arrivals in 2013, we expect a tapering of growth to 2.1% in 2014 and 1.5% in 2015.

The construction industry is finally beginning to regain its footing. Contracting jobs continued to slip downward in the first half of 2012, although they ended the year with a welcome bounce. By the fourth quarter, the job base had climbed above 29,000, a level not seen since early 2010. (But for a little perspective, note that there were nearly 40,000 industry jobs in 2007!) Forward-looking indicators look positive, with the total value of permits shooting up almost 60% in the first three quarters of the year. Government contracts awarded rebounded by more than 150% through the third quarter, but are estimated to end the year up closer to 80% from very low levels in 2011. Private building permits were up a robust 42%, but more than one-half of this surge was still driven by additions and alterations, which in turn owe a significant fraction of their strength to photovoltaic system installation. Residential building permits grew by more than 20%, and commercial and industrial permits declined by 5%.



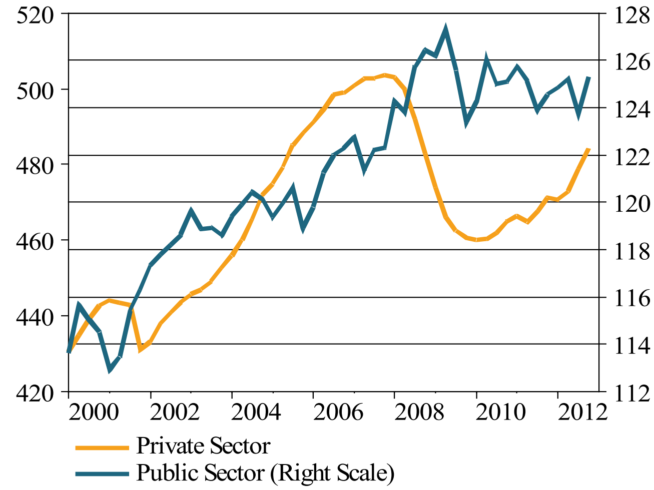
OCCUPANCY AND ROOM RATE FORECAST

The pickup in permitting figures presages what we think will be a strong industry expansion building over the next several years. While we will have much more to say about this in our UHERO Construction Forecast next month, we point here to the construction jobs forecast, which sees mid-single-digit gains this year and growth well north of 9% by 2014. Fueling this expansion will be accelerating gains in home resale prices. Median single-family home prices on Oahu rose 8.5% last year, and condo prices firmed by 5.3%. The median single-family home price will average $741,000 by 2014.

Of course the other factor that will drive construction on Oahu is Honolulu Rail Transit. The project has been on hold as the Honolulu Authority for Rapid Transit has worked to complete an archeological survey along the entire rail route. The survey, which was undertaken to comply with a 2012 Hawaii Supreme Court ruling after the discovery of *iwi kupuna* along the route, was completed recently. Now the transit authority must come up with a plan to address *iwi* discovered at seven locations along the route before construction can resume.

Before we turn to aggregate measures of Hawaii activity, some consideration of state finances is in order. The State Council on Revenues expects General Fund tax revenues to grow by 5.1% in fiscal year 2013, and by 6.8% in fiscal 2014. Pointing to recent positive budget balances in his state of the state address, Governor Abercrombie proposed new discretionary spending, including a modernization of the state's technology infrastructure, creation of a preschool program, and increased funding for senior care programs. He also proposed to start funding the state's unfunded pension and health care liabilities, requesting an allocation of $100 million in 2014 and $105.5 million in 2015 for this purpose. The Governor also floated the idea of raising additional revenue from a further increase in the transient accommodation tax from 9.25% to 11.25% sometime in the second half of the decade. These tax and spending measures, along with possible modifications of the state's tax credits for photovoltaic installations, will be key areas of debate during the current legislative session.

Hawaii labor market conditions have improved



PUBLIC AND PRIVATE SECTOR JOBS

over the past year. Statewide non-farm payroll jobs expanded by 1.5%, the strongest growth since 2006 and just shy of our first quarter 2012 forecast of 1.8%. In December the seasonally adjusted unemployment rate dropped to 5.2%, a decline of 1.4 percentage points from the previous December. A broader measure of unemployment that includes marginally attached workers fell to 12.8% at the end of 2012, four percentage points below its peak of nearly 17% at the end of 2010. Total unemployment claims also continued to decline in 2012, and are now roughly 10% lower than their level in 2011. Data on employment from the household survey, from which the unemployment statistics are derived, shows a poorer job performance in 2012 than do the payroll data from the establishment survey. However, it is likely that the annual benchmark revision to be released by the Bureau of Labor Statistics later this year will bring the two series closer in line.

At the sector level, payroll gains in excess of 3% were reported last year in accommodation and food services (+5.3%), administration and waste management (+4.5%), transportation and utilities (4.0%), and financial services (+3.1%). Among sectors that contracted in 2012, professional, scientific, and technical services were hit the hardest with a 5.1%

decline in the number of jobs. Little change was reported in manufacturing, wholesale trade, and educational services jobs. Similarly, the number of government jobs was barely different from a year ago. Total labor income grew 3.2% through the third quarter, only slightly faster than the 2.8% increase in the Honolulu consumer price index through the first half of 2012.

If last year's job and income gains were finally looking respectable, this year will bring a significant further strengthening of growth. We expect the non-farm job base to expand by 2.6% this year, as construction begins to come on line, tourism sees another year of healthy gains, and growth broadens to other areas. Some of this annual growth is already "in the bag," reflecting progress made in late 2012. Inflation adjusted income will firm by 2.4% this year and nearly 3% in 2014. Growth will ease somewhat over the next two years, as a tapering off of visitor industry gains offsets expansion in construction and continued recovery in public sector employment. Still, sustained job growth in the 2% range and income growth in the 2.5-3% range will be welcome after such a long period of economic struggle.

HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2010	2011	2012	2013	2014	2015
Visitor Arrivals	7.7	3.7	9.2	6.5	2.1	1.5
U.S. Visitor Arrivals	5.9	2.3	5.5	5.3	2.1	1.4
Japan Visitor Arrivals	6.1	0.2	17.0	6.1	0.5	0.4
Other Visitor Arrivals	17.6	13.4	15.0	10.8	3.6	2.6
Payroll Jobs	-0.8	0.9	1.5	2.6	2.0	2.0
Employment	1.8	2.0	-1.0	1.1	2.7	2.2
Unemployment Rate (%)	6.9	6.7	6.0	5.1	4.6	4.3
Inflation Rate, Honolulu MSA (%)	2.1	3.7	2.6	2.2	3.0	3.0
Real Personal Income	0.9	1.9	1.3	2.4	2.9	2.6
Real GDP	0.0	-1.5	1.1	3.5	4.1	3.6

Note: Source is UHERO. Figures for 2013-2015 are forecasts. Inflation, Personal Income, and GDP figures for 2012 are estimates.

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