Robust Tourism Drives Hawaii’s Growth

THE FORECAST: GROWTH CONTINUES IN 2016

To date, 2015 has been a very good year. Based on the 2015 year-to-date figures that are available, tourism numbers and spending have been stronger than I had forecast last year. However, statewide construction completed, total jobs and personal income have not lived up to expectations, and inflation has been less than I predicted.

As to the rest of 2015 and 2016, a familiar story: state growth will continue, led by tourism and construction. (See Chart 1.) Next year will be the seventh consecutive year of Gross Domestic Product (GDP) growth for Hawaii.

■ TOURISM: I am forecasting visitor arrivals to grow by 4.0% for all of 2015 and 2% for 2016. The reduction in growth next year is a reflection of capacity constraints described below. In addition, high room rates plus the continued strong dollar relative to the yen, and the Canadian and Aussie dollars, all suggest that tourism will continue to contribute to growth but at an attenuated pace. Visitor expenditures will remain positive, but only modestly above the rate of inflation.

■ CONSTRUCTION: This sector has been accelerating in 2015. Construction permit data plus continued pent-up demand for housing will show up in double-digit percentage growth in completed activity. Studies by the Hawaii Department of Business Economic Development and Tourism show that there is a demand for 65,000 housing units statewide from 2015-2025. In addition, a healthier fiscal position for state and county governments means that deferred maintenance and infrastructure renewal spending will continue to contribute to construction’s growth. All of this should help bring back some of the 6,000 construction jobs that we have yet to recover since the Great Recession.

■ LABOR MARKET: The return of more construction jobs will contribute to improvements in the overall Hawaii labor market. I expect total job growth to pick up for the rest of this year and into 2016 and that the state’s unemployment rate will continue to improve, reaching 3.2% next year.

■ PERSONAL INCOME: As the labor market improves, inflation-adjusted personal income will continue to expand at a rate of about 2.3-2.5%.

■ INFLATION: Lastly, concern about resurgent inflation is overstated. Hawaii inflation is most affected by national price patterns for such things as energy and foods, and there seems little fear of national inflation through 2016. However, I do expect that higher housing and rental prices, along with higher wages in tighter labor markets, will be reflected in the Hawaii price data. I am thus expecting an increase in inflation to 2.0% in 2016.

MACRO PICTURE LOOKS GOOD

Thanks to a strong tourism sector, 2015 will be the sixth year of Hawaii’s GDP growth post 2008-09, leaving the Great Recession as an increasingly remote memory. (See Chart 2 on page 2.) Nominal state GDP is now over $80 billion, equivalent to $72 billion in 2009-dollar values. While growth is expected to remain positive into 2016, the rates of inflation-adjusted GDP growth have been modest, by standards of prior recoveries.

Another measure of overall economic activity is state personal income. Economic growth has translated into higher income levels. Statewide personal income, adjusted for inflation, has continued to expand to record

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STATE OUTLOOK (Continued from page 1)

levels and is now 8% above the low point in 2009. (See Chart 3.)

Normally at this stage of the economic recovery we expect inflation to be picking up steam. However, both nationally and in Hawaii, inflation — as measured by the Consumer Price Index — has been both low and in fact trending downward. In the first half of 2015, the Honolulu CPI was effectively unchanged. Consumers benefited from significantly declining energy prices as well as lower costs for clothing.

However, I do not expect this to last. In the past, differences between Hawaii inflation and the rest of the country have been due to our housing prices. (See Charts 4A and 4B.) Higher housing costs, both for home ownership and rentals, will eventually affect our inflation rates.

WORKERS (MOSTLY) BENEFIT FROM EXPANSION

Labor markets in Hawaii represent another manifestation of the improving economy. As seen in Chart 5, total state jobs have returned to the pre-recession level of 635,000 and the unemployment rate has dropped below 4%.

Not surprisingly, labor market trends are not uniform among the state’s counties. Oahu and Maui have both recovered the jobs lost since the Great Recession. (See Chart 6.) However, on Hawaii Island and Kauai, job growth came to a halt in late 2013 and has only recently rebounded. Total jobs are still 5% below their pre-recession peaks on these islands.

It is no surprise that most job growth has been in visitor-related sectors. (See Chart 7 on page 3.) Professional and business services have also seen high growth largely due to the expansion of contract labor firms. Only government jobs have shrunk since 2010, but this is entirely due to fewer Federal government jobs.

While the overall labor market has improved, the market is not as healthy as headline unemployment numbers suggest. If we also count discouraged workers not in the labor force and those who are not working full time because of economic conditions, then we get the so-called “underutilization rate” or “U6”. As we see in Chart 8. This rate has also improved in Hawaii since 2010. However, there has been a troubling shift in the difference between the two rates. Prior to
the recession U6 was 3-5% above headline unemployment (U3). It is now 6%, indicating that a higher portion of the population isn't benefiting fully from the recovery.

TOURISM LEADS THE WAY
The health of Hawaii’s economy remains tied to tourism. In 2014 tourism growth sputtered early in the year, but came back strong in the second half. As a result, 2014 total visitor arrivals grew a modest 2% over 2013, but this still represented a record 8.16 million. (See Chart 9.) Starting in September 2014 and through the summer of 2015, visitor arrival growth has been robust. Length of stay by visitors has not diminished and thus total visitor days were up by 4% for the first eight months of 2015.

The news for total visitor spending has been somewhat less upbeat. Since 2013, visitor-spending growth has been erratic on a month-to-month basis. (See Chart 10.) Total spending remained relatively flat over the last two years and has not kept up with what little inflation we have had. Nevertheless, recent months have seen some up-ticks in this important metric.

Even so, the battle for the tourist dollar is never ending. The good news is that average daily spending has increased, but the composition of spending has also changed. (See Chart 11 on page 4.) For example, average daily spending per Oahu visitor has increased by nearly $25 since 2007 to $210 in 2014. But how tourists are spending has changed. Lodging and transportation have seen their share of the tourist dollar increase at the expense of shopping and other spending.

The growth of tourism is a statewide story with some differences among the islands. Oahu has led the growth and Maui has not been far behind; both are setting records. (See Chart 12 on page 4.) Hawaii Island and Kauai are just now returning to their pre-recession peaks.

The growth of visitor counts has been so good that now the conversation is shifting to the issue of capacity. Future growth rates are expected to be modest because additions to lodging capacity are limited, mostly to some Neighbor Island areas. In addition, the capacity for community acceptance of tourism volumes and the accompanying development is an increasingly visible issue.

The good news in the tourism sector is due to and reflected in airline flight decision. Through August of 2015 airline seats statewide were up 6.8% from domestic origins

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with Maui and Kona attracting the most. This reflects airline confidence in the Hawaii market. Lower fuel costs may also contribute to airline optimism since they can provide more seats with less risk if these seats go unsold.

The outlook for airline seats is also positive into the fall as capacity is expected to expand from both domestic and international (mostly Canadian) origins. If the U.S. government works out a pre-clearance arrangement for visitors traveling from Narita and other Japanese airports, direct service from these markets to some Neighbor Island locations such as Kona will become more likely. In addition, if this reduces the bottlenecks associated with entering through Honolulu, the entire state will benefit.

**CONSTRUCTION INDUSTRY FINALLY BREAKS OUT, PROBABLY**

For five years we have been anticipating that construction would start to contribute to overall growth. 2014 was another year of waiting, but 2015 shows more promise. Over 12,000 construction jobs were lost statewide after 2007. (See Chart 13.) As of mid-2015 only about 6,000 of those jobs had been recovered. Given the visible signs of construction activity and anecdotal evidence from industry insiders, stronger growth was expected. Only recently have the numbers started to show this. The construction tax base actually declined for five consecutive quarters starting in July 2013 and only recently returned to positive growth. (See Chart 14.)

But there are reasons for optimism. Private construction permits and government contracts awarded (Chart 15) are accelerating in 2015 to their highest growth since 2012. This confirms what we see on the ground and leads to optimism for 2016.

One constraint may be the labor market, where industry insiders say it’s increasingly difficult to find qualified workers, especially in the skilled trades. Many former construction workers found other, more steady, jobs during the downturn. It seems hard to attract them back.

**REAL ESTATE SECTOR BOOMS**

More jobs, higher incomes, and favorable interest rates continue to stimulate demand for housing that is unmet by greater supply. As a result, single-family and condominium sales and prices are up on all islands. The Oahu single-family residential median price (Chart 16) reached $700,000 in mid-year, 11% above the pre-recession peak. Markets on all Neighbor Islands are also expanding, but have yet to achieve their prior peaks. On all islands, distressed sales are down and Realtor membership is up — sure signs of recovery.
CONSUMER SPENDING REFLECTS CAUTIOUS OPTIMISM

Hawaii consumers and visitors are being careful in spending their money. A broad measure of this is the state general excise tax base for retailing that has experienced only modest expansion for the last three years. Part of the reason for lackluster growth may be that buyers are shifting to on-line retailers and thus avoiding the Hawaii tax base.

Another good indicator of retail activity is First Hawaiian Bank’s Business Activity Report (Chart 17) that monitors merchant credit and debit card sales. Quarterly growth has been consistently positive for the last five years, but the extent of growth has been modest, averaging 5.6% since 2013. The Business Activities Report also provides a glimpse of where consumer and business spending is occurring. Between the first three quarters of 2014 and the same period in 2015, credit and debit card sales increased by $142 million. Hotels and restaurants accounted for $62 million of that increase.

Finally, car sales (Chart 18) reflect consumer confidence and pocketbooks. The Hawaii Automobile Dealers Association is expecting its fifth consecutive year of unit sales growth.

PUBLIC FINANCES IMPROVE

The rising economic tide has lifted many boats, including the State’s treasury. General Fund tax collection growth rates have been erratic on a quarterly basis due to swings in economic factors such as tourism spending, but also in tax collection practices such as income tax refund timing. On average, General Fund revenues increased by 4.9% annually for the last three fiscal years. Part of the good news is that the State has reached a legal settlement with on-line hotel and car rental bookings companies for past and future general excise tax liabilities. It is estimated that the settlement will add about $40 million to the General Fund in Fiscal 2016 for liabilities between 2000 and 2011, with an additional $10-15 million per year in regular annual payments. Another case is pending for the 2012-2014 period. Hence, the revenue side of the fiscal equation is looking relatively good for the State.

Likewise, county government revenues are also doing well. (See Chart 19, where Honolulu revenues are plotted on the right axis to make it easier to see the similar growth pattern with the Neighbor Islands, plotted on the left.) Property tax collections, which represents the major source of revenues under their control, have snapped back nicely from the consequences of the recession.

The state and local fiscal challenges are on the expenditure side. Pressures to spend money are constant: dealing with homeless, cooling schools, Medicaid expansion, etc. In addition, the State (as well as Hawaii’s counties) must increase payments to fund retirement and employee health care cost obligations as well as collective bargaining increases.

From a macro-economic perspective, the increased state-local revenues will eventually be spent through worker paychecks and discretionary spending, and this will further boost economic activity.

NOTES OF CAUTION

To no one’s surprise, forecasting errors are inevitable. In part, errors arise from assuming external conditions that may not occur as expected. These are my forecast assumptions:

- The Fed will raise the Federal Funds target rate by 25 basis points before the end of 2015, and the global markets will adjust without panic.
- The world will shrug off Chinese equity market gyrations and currency devaluation, but China’s growth will be subdued.
- Appreciation of the yen is finished and Japan will increase its growth.
- The euro zone will survive Greece and refugees.
- Putin will stay put, but who knows where that will be.

There are plenty of local issues that could affect this economic forecast:

- Stop and go for the rail project.
- Telescopic ups and downs on the mountains.
- The future of the Hawaiian Electric Industries merger.
- Regulation of seed corn companies and other so-called “big agriculture.”

Depending on how this plays out, some jobs could be lost or not created. However, I look forward to 2016 being another solid year of economic growth for Hawaii’s economy.
The global economy just can't catch a break. Policymakers responded aggressively to the 2007-09 economic and financial meltdown, yet the recovery has been the weakest of the post-WWII period. After deep recessions, growth typically goes from strength to strength for several years, and that is what the IMF predicted would happen. The reality has been different with growth losing momentum over the past couple of years, without ever having gained much vigor in the first place. Chart 1 shows how the growth and inflation picture has evolved during the recovery compared to the IMF projections made four years ago. Growth forecasts have suffered persistent downgrades because every year there has been some new unanticipated headwind or shock. Meanwhile, inflation has been far weaker than previously anticipated.

The challenges facing the global economy in recent years have included aggressive deleveraging by U.S. consumers, the euro crisis, widespread fiscal restraint, and more recently, a marked slowdown in China’s economy and sharply lower export prices for oil and commodity producers. A common thread running through most of these developments has been the inevitable restraint and fallout following a rapid buildup in debt. Mortgage debt in the U.S. surged during the housing boom of the 2000s, the euro area peripheral economies went on a debt binge after the adoption of the single currency caused interest rates to plunge, policy easing in China during the Great Recession triggered a credit-fueled real estate bubble, and many other emerging economies used rising commodity prices and low interest rates as an excuse to go on a borrowing spree. Finally, public sector finances deteriorated almost everywhere during the recession, leading to a dramatic increase in government debt burdens.

In all cases, excessive debt creation has been followed by an inevitable pendulum swing in the other direction. Put simply, the long-running Debt Supercycle has ended. Over-leveraged borrowers have been forced to focus on rebuilding balance sheets while increased regulatory pressures and a lingering overhang of bad loans has made banks less willing to lend. At the same time, governments in most countries have been struggling to restore order to public finances, making them reluctant to embark on renewed stimulus to boost economic activity.

Taking on excessive debt is dangerous because it leaves economies very vulnerable to negative shocks. Thus, a renewed focus on financial prudence would normally be a good thing. The problems occur when too many people try to rebuild savings at the same time because it can lead to a shortfall of aggregate demand. The world currently is characterized by excess savings and sluggish demand, and this shows up in low inflation and the very depressed levels of real long-term interest rates (Chart 2). Meanwhile, it is hard to lower debt levels when growth is low with the result that the global debt-to-GDP ratio has continued to move higher (Chart 3).

Central banks are leaning hard against the headwinds to growth, but with decreasing effectiveness. The problems facing the global economy are not related to the level of interest rates and thus not easily solved by...
easy money. When a central bank eases policy, the primary transmission channel to the economy is via a boost to credit supply and demand. A steeper yield curve makes it more attractive for banks to lend while lower interest rates make it cheaper to borrow. The other two main transmission channels are via asset prices and the exchange rate —pushing the former up, and the latter down — but these are less powerful than the credit channel.

The end of the Debt Supercycle means that the credit channel is severely impaired, forcing policymakers to rely more on the other two channels: asset prices and exchange rates. There certainly has been success on the asset price front with equity markets up sharply from their March 2009 lows. The rise in equity prices has provided help to economic growth via a wealth effect and general support to confidence, but there is a limit to how far this can be pushed.

Low interest rates give a huge incentive to shift out of low-risk assets into stocks and corporate bonds in a desperate search for higher returns. Yet, equities also require support from rising corporate earnings. Zero short rates are not enough to guarantee rising equity prices if earnings are flat or declining. And the higher the level of valuations, the more important that earnings validation becomes. It is not a coincidence that U.S. equities started to struggle this year soon after earnings flattened off (Chart 4).

What about the exchange rate channel? The problem there is a classic fallacy of composition. A country can get competitive benefits from pushing its exchange rate down as long as other countries do not respond in kind. However, the failure of Japan’s export volumes to show any major revival despite the yen’s sharp decline highlights that a weak exchange rate does not guarantee gains that the global economic climate is adverse (Chart 5). Moreover, once all the major players engage in competitive devaluations then it rapidly becomes a self-defeating game that threatens to degenerate into more dangerous policies such as protectionism.

With central banks increasingly pushing on a string, there is a compelling case for more aggressive fiscal policy. Many leading economists such as Larry Summers and Paul Krugman have argued strongly for more infrastructure spending, especially given that governments can borrow at extraordinary low interest rates. And there is certainly much spending that needs to be done: real government infrastructure spending in the U.S. is running far below pre-crisis levels (Chart 6). Unfortunately, Congress has little appetite for increased government spending and there also are political constraints on fiscal stimulus in most other developed and emerging economies. The notable exception is China where there is lots of fiscal space for more spending and the government does not have to worry about political opposition.

THE ECONOMIC OUTLOOK

The global economy continues to battle the headwinds resulting from earlier debt overshoots. Lower oil prices are certainly a positive for growth because it leads to a wealth transfer from high-saving to lower-saving countries. But the impact is not enough to deliver a significant improvement in the pace of activity given other headwinds. The good news is that absent some new major shock, the global economy is not facing a recession. There is lots of pent-up demand around the world and monetary policy will remain accommodative for the foreseeable future. The outlook is for continued sub-par growth and low inflation rather than stagnation. Let’s take a quick tour around the major economies.

The U.S. has been the best-performing major economy, yet the pace of real growth has averaged only 2.2% during the past five years, far below earlier expectations. The housing sector has been slow to rebound from its deep downturn, consumer spending has been held back by sluggish growth in real wages, and business caution has kept a lid on investment. Looking ahead, a tightening labor market points to an acceleration in wage growth and an aging capital stock should lead to some pickup in the pace of investment spending. But the recent strength in the dollar and weakness in global trade is taking a toll on export growth and corporate profits. Overall, growth is likely to remain in a 2% to 2.5% range over the coming year.

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The euro area crisis receded following the bailout of Greece and the easing of fiscal austerity. Growth rebounded in the first half of 2015 and the index of leading economic indicators points to continued moderate growth (Chart 7). Yet, the economic environment remains difficult given weak consumer and business confidence and ongoing private sector deleveraging. With little chance of any meaningful fiscal stimulus, euro area growth will remain stuck below 2% for the foreseeable future.

In Japan, the economic impact of the much-touted “Abenomics” set of reflationary policies has ended up being a big disappointment. The Bank of Japan’s quantitative easing was supposed to end deflation and trigger stronger growth in real wages, but the impact has been limited. Meanwhile, as noted earlier, the yen’s large decline has not led to a sustained rebound in exports. The leading indicator for Japan does not point to any near-term revival in growth. Overall, the economy is on track for growth of around 0.5% in 2015, and no more than 1% in 2016.

China’s economy continues to suffer from the unwinding of its real estate bubble and over-expansion in manufacturing capacity. As a result, the industrial sector of the economy has weakened significantly over the past year. At the same time, the services side of the economy has continued to expand, supporting the overall growth rate (Chart 8). Nonetheless, real GDP is growing by less than the official target of 7%, explaining the government’s efforts to stimulate growth via cuts in interest rates, targeted fiscal measures and a lower exchange rate. Unlike most other countries, China has lots of room to keep easing policy and further stimulus seem inevitable. Yet, economic growth will struggle to stay above 6% over the next year, although the official data may still show growth near 7%.

Other emerging economies face a variety of challenges. Those dependent on commodity exports have suffered from the double whammy of weaker prices and reduced import demand in China. And the latter problem also has affected those Asian countries with close ties to manufacturing activity in China. Finally, capital flight has led to currency weakness, forcing some countries to raise interest rates. Overall growth in the emerging country universe (including China) is likely to average less than 3.5% in 2015, an extremely low level by the standards of the past two decades. A rebound back above 4% in 2016 will require a stabilization in resource prices. In many hard-hit economies such as Brazil, South Africa and Russia, an improved longer-term outlook will depend on major structural reforms and these are difficult to implement in a weak growth environment.

**CONCLUSIONS AND POLICY IMPLICATIONS**

The global economy is stuck in mediocre growth implying that inflation will remain tame and monetary policy will stay accommodative. The Federal Reserve is desperate to raise interest rates and remains intent on moving before the end of 2015. Nonetheless, future hikes will proceed at a very gradual pace and it will be quite some time before the Fed’s policy stance is even back to a neutral level. Meanwhile, it could be several years before the European Central Bank and the Bank of Japan are able to raise interest rates.

The combination of divergent monetary policies and relative growth rates have pushed the U.S. dollar higher and this trend has further to run. However, commodity currencies and emerging economy currencies will remain more vulnerable than the euro and yen. Commodity prices should stabilize next year, but any rebound will be limited given weak global demand, especially given China’s shift toward more service-oriented and thus less commodity-intensive growth.

An environment of sub-par growth and low inflation leaves the global economy vulnerable to negative shocks, especially as monetary policy is largely exhausted. Political aversion to fiscal stimulus would reverse in the event of a renewed economic downturn, but that would only kick in after the problems had occurred. Watch trends in money and credit growth and in corporate profits for signs that the growth outlook is continuing to deteriorate.