Slower Rate of Growth Forecast on Many Fronts As Hawaii’s Economic Expansion Reaches Age 11

Hawaii is in its 11th consecutive year of economic expansion in 2007, longer than the previous boom that ended in the early 1990s. However, the rate of growth has slowed on many fronts and this slower rate will likely be a feature of the Islands’ landscape for the next several years. Consider these developments:

- The local real estate market has continued to cool.
- Purchases of big ticket items like autos have declined.
- General Excise Tax revenue growth is still respectable, but has fallen into the single-digit range (8% so far in 2007), down from prior boom years.
- Though the construction industry is still robust in many areas, most of that activity received permits some time ago. Across the state, recent permit numbers generally have been weaker.
- Visitor arrivals have been disappointing in 2007, especially due to the Japan market.
- Hawaii’s inflation rate began rising in 2006 and, if past experience is any guide, this rate will remain high and diminish only slowly, even with a cooling of economic activity.

Forecast for 2008

- Jobs: +1% A somewhat slower economy is likely to cause a deceleration in job growth from the estimated pace of 2.0% in 2007 to around 1.0% in 2008. If the labor market remains tight, the unavailability of workers will serve as a constraint on new job growth. As the construction cycle tops out, that source of job growth will diminish.
- Unemployment: 2.8% The unemployment rate will likely stay low in 2008, because it usually lags the overall economy. The 2.8% forecast is still very better than most other economies.
- Inflation: +4.0% We’re not going to get much relief on inflation in the near future. We will have some deceleration in 2008, to about 4.0% — still relatively high.

(continued on page 2)
Hawaii Outlook for 2008

■ Visitor arrivals: +1.5%. A decline in 2007 visitor arrivals leaves room for somewhat better performance in 2008. However, a slower Mainland economy and the chronic drag of the Japan market may bring only 1.5% growth. Visitor spending will continue to fare better, possibly about 4%. This, of course, is the best of both worlds — more dollars with lower growth in bodies.

■ Real personal income: +1.5%. Slightly lower inflation will take a somewhat smaller bite out of real (inflation-adjusted) personal income growth in 2008, but the slowing economy will also hamper current dollar personal income growth. Hawaii’s personal income growth can come in at +1% in 2007, which avoids recession but comes closer to one. That implies current dollar growth of 0% this year, adding forecasted 5% inflation and real growth together. In 2008, we could get a little relief on inflation. If it drops to 4% and we see a drop in current dollar personal income growth, to 5.5%, that leaves 1.5% real personal income growth in 2008, actually a little higher than this year.

Real Estate Boom is Over, Entering a Period of Plateau

The local real estate boom is over. The speculators expecting to flip a property quickly are gone, and those wanting to buy a place to live are shopping more carefully. The charts at top right are just for Oahu, but a similar picture emerges on the Neighbor Islands.

In 2006, sales of Oahu single-family homes fell 12%, and condos fell 20%. That alone is significant because the real estate industry itself is very important in our economy. If the performance in the first half of 2007 is extended to the entire year, there will be another 6% drop in activity.

As for prices, the median is still rising but the acceleration of 2004 (a 21% increase) and 2005 (a 28% increase) has halted. In single-family homes, 2006 saw a 7% rise in the median price, the first half of 2007, a mere 1.6% increase.

Neighbor Islands have seen price declines. So far in 2007, Maui single-family median prices are off about 12%, while Kauai and the Big Island have dropped about 3-4%.

Typically, price accelerations like those earlier this decade are followed by several years of a plateau — with mild oscillations in price, but no big increases or declines. Of course, the more rapid the acceleration, the greater the likelihood of a more severe downward adjustment that brings us back to equilibrium. That’s why we should actually be thankful for an end to the boom.

This doesn’t mean that real estate is a bad investment. For example, average buyers who bought at the 1994 price peak in Honolulu would have lost a total of 20% through 1999. But if they held on through 2006, their total return would have been 75% — an average annual return of over 6.25% for the entire period.

Real estate affects the broader economy. People usually spend more on other things when they feel their wealth is increasing fast, and spend less if they feel their wealth is declining. This may play an important role in a slower overall economy here in the next few years. And I do think we have several years of hiatus before any new boom begins.

Construction Pipeline Strong For Some Time to Come

Construction is one major sector of Hawaii’s economy that has continued to show strength. That’s important especially because this relatively volatile component drives the business cycle.

Visitors to Hawaii increased by about 2.1% in 2006. However, a slowdown in Mainland visitor arrivals in 2007 will leave room for somewhat better performance in 2008. Visitor spending will continue to fare better, possibly about 4%. This, of course, is the best of both worlds — more dollars with lower growth in bodies.

Visitor arrivals will continue to increase, but at a slower rate. In 2008, we could get a little relief on inflation. If it drops to 4% and we see a drop in current dollar personal income growth, to 5.5%, that leaves 1.5% real personal income growth in 2008, actually a little higher than this year.

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Hawaii is much less affected than the Mainland by the “sub-prime loan” situation that’s gotten so much attention. Major banks in Hawaii don’t make such mortgages. However, it would be naïve to think that Hawaii is completely immune from some of the fallout.

As borrowers who have such loans fail to make mortgage payments, foreclosures can rise. In a market with declining prices, borrowers can’t sell and recover their investment or re-finance at better terms. More foreclosures add to the supply of homes on the market, and the collapse of sub-prime lending leads to fewer buyers. Thus, more supply and less demand adds to downward pressure on prices that are already weakening.

The brighter side of flattening home prices is some increase in home affordability. That’s a trade-off that Hawaii always has faced and always will face. We can’t have a strong housing market as well as affordable housing.

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Many contractors report enough projects permitted or underway to sustain construction activity for some time to come. The numbers in the first chart at right are from the construction tax base, a good concurrent gauge of the industry. Activity has actually picked up in the last couple of years, with 2006 setting a record in current dollar terms. But the flow of private building permits (chart at far right)—a forward-looking indicator in construction—gives premonitions of a slowdown to come. Private permits dropped slightly in the first part of 2007, the first such decline in nearly a decade. The second quarter of the year did show a strong surge that reversed declines in the previous three quarters. This was centered both in new residential as well as commercial and industrial permits.

That increase in permit activity was concentrated on Oahu. Neighbor Islands, where resort areas continue to underpin construction, were weaker. The sustaining factor in these markets is the continuing trend toward timeshare, condo hotels, and other fractional ownership.

Construction will also get a boost from government contracts, where permits in 2007 may exceed the previous two years, though not likely at the record level of 2004. Thus, there is construction activity in the pipeline—even though the pace of permit numbers has started to decline. And those somewhat further out in the development process—such as entitlements and land use planning—indicate they are seeing fewer and smaller projects discussed.

To summarize the construction picture for 2008:

- Construction costs will continue to be steep, driven by higher prices for energy and building materials.
- New residential activity will weaken, affected by the turnaround in home prices.
- Nonresidential activity may also drop, despite a growing need for light industrial space.
- Government work will grow, buoyed mostly by military housing construction.
- Construction jobs will continue to grow, but at a more muted pace than in recent years.

**Visitor Industry Having A Down Year in 2007**

The visitor industry is having a down year in 2007, after final 2006 numbers showed 0% growth in arrivals and just under 3% growth in spending. The Japan market remains the weak spot. Mainland numbers just aren’t enough to offset continued anemic performance from Japan, which has been slumping for a decade now. This is mainly Watanuki’s problem. The Neighbor Islands are doing better: Kauai leads in 2007, followed by the Big Island. Maui is having a harder time topping its very good 2006 performance.
Hawaii's CPI Inflation Rate
Will Remain High Despite Slowdown
We can’t sustain frenetic growth without inflationary pressures building. (See chart at bottom.) Even though the economy is slowing down, earlier price increases take time to feed into the Consumer Price Index. A good example is higher shelter costs which gradually escalate into rents and property tax valuations. If past experience is a guide, inflation will remain high and diminish only slowly, even with a cooling of economic activity in Hawaii.

Real Personal Income Growth
Hit by Bigger Inflation Bite
Hawaii's inflation-adjusted personal income is one of the broadest measures of our state economy, including not just wages and salaries but also investment income, transfer payments, and other income sources.

With any positive number at all for 2007, the current expansion will have exceeded our last one—one 11 years compared to 9. As you can see from the top chart at right, that expansion built steam in the early years of this decade, stoked by low interest rates and hampered only marginally by the national recession and the immediate aftermath of 9/11. But in recent years, the slowdown is quite apparent.

Current-dollar income growth minus inflation yields the “real” (inflation-adjusted) number. Current-dollar personal income growth for Hawaii has been running about 6%, but that may slow some as the economy cools. And CPI inflation has risen dramatically (to almost 6% in 2006), driven mainly by shelter costs.

That doesn’t leave a lot of room for much “real” growth. The higher inflation rate of 2006 caused almost negligible real growth. My current estimate for 2007 current-dollar personal income growth is 6.0%, with inflation of 5.0%. Thus the 1% real growth estimate for 2007.

When real growth gets into negative territory, we have a “recession.” In fact, that’s how we actually define one. So we’re skirting closer to that line.

Job Growth Remains Strong;
Unemployment Rate Still Low
Over the long haul, job growth (chart above), shows about the same cycle as real personal income growth. So far in 2007, job growth has been running about 2%, not bad at all, especially considering the labor shortage after the long recent boom that exhausted the state labor supply. Job growth continues to be especially strong in construction, as well as in business and professional services.

Another measure of labor market tightness is Hawaii's remarkably low unemployment rate. In recent years, the state has often had the lowest jobless rate in the nation. If the state economy is slowing down, you certainly couldn’t tell it from this rate. I think in 2007 it will remain very low overall, finishing at 2.5% for the year.

New Car and Truck Sales in Islands
Reflect Lower Consumer Confidence
Sales of big-ticket items like new cars and trucks are a good indicator of consumer confidence. It’s remarkable how well this chart (above) from the Hawaii Auto Dealers Association tracks the state’s business cycle. With the effects of low interest rates and rebates in earlier years wearing off, a slowdown is evident here also.

Hawaii Outlook for 2008
Maui County Still Growing, But More Slowly in 2007 & 2008

Several things have happened on Maui over the past year that have put brakes on the county’s economy — notably, a turn in the housing market, a continued slowing in tourism, and some county-level public policy moves that will have an effect on the economy.

Thus, the Maui economic picture is somewhat more downbeat in 2007 and 2008 than in recent years. However, remember that any economic cycle inevitably contains periods of cooling down; it’s required for infrastructure to catch up and for slowly rising incomes to help bring affordability back.

Maui’s Housing Market: Downturn Arrives in 2007

We’ve warned about an impending turn in the Maui real estate market for a couple of years. In 2007, it’s happening. It’s hard to overestimate the effect that a dampening of real estate has on the overall economy.

The market obviously affects construction.

If home prices drop, buyers stay on the sidelines.

Home furnishings and durable goods sales will be to make intelligent decisions based on market forces rather than trying perhaps well meaning but counter-productive policies.

Maui’s Labor Market is Even Tighter Than Statewide

If the Maui economy is slowing, you couldn’t tell it from the unemployment rate. The state’s labor market may be tight, but Maui’s is even tighter — and actually seems to be getting more so, as the chart at top right shows.

Maui job growth has showed signs of slowing, though some of that is due to the labor shortage.

Maui Visitor Picture Benefits From Upscale Reputation

During the first half of 2007, Maui tourism didn’t do as well. It lagged all but Oahu in arrivals, and the 2006 surge in spending is proving hard to top. The clear trends in the visitor industry remain in 2006 surge in spending is proving hard to top, and the 2006 surge in spending is proving hard to top. The clear trends in the visitor industry remain in the chart at the top of page 6 shows. Although these growth numbers say nothing about absolute market shares, they speak volumes about gains and losses in those market shares. Hotels often express concern about time-share and cruise visitors absorbing air seats that might otherwise go to occupants of their properties.
Economic Forecast • Page 6

Maui Still Growing, But More Slowly (continued from page 5)

Trends Toward Time-Share, Condo Hotels Apparent on Maui

The trend toward time-share and condo hotels is quite apparent in changes in the Maui visitor plant:

- Kapalua Bay Hotel has been razed for a new Kaanapali Ocean Resort Phase II time-share development.
- In Makena, Dowling Company has partnered with Morgan Stanley Real Estate to acquire property that includes both resident and transient units.
- Kapalua's Ritz-Carlton is being renovated, with an expanded banquet facility and additional guest rooms.
- The Renaissance Wailea Beach Hotel is being torn down for a luxury condo hotel resort under the Baccarat label.
- In Kaanapali, Marriott's Maui Ocean Club has just finished the first of two new time-share towers.
- In Kama' ha, the Baccarat label is poised to open a new $22-million, 400-bed student housing project in the Haliimaile area.

Maui Community College

Still on a Growth Path

Positive developments at Maui Community College include:

- The new $22-million, 400-bed student housing project is slated to leave, at least temporarily, for Europe because stateroom inventory has outstripped demand.
- The student life center reopened in 2007 after an $8-million renovation.
- In Makaha, Dowling Company has partnered with Morgan Stanley Real Estate to acquire the entire resort property from Prince Resorts Hawaii. Development plans are likely to include more residential units.

Growth of Isle Cruise Industry

Limited by Pricing, Harbor Issues

One obstacle to the growth of the cruise industry is the high cost of operations on the Hawaii circuit and pricing pressures, which will result in the loss of one of the state's four Norwegian Cruise Line vessels. The Pride of Hawaii is slated to leave, at least temporarily for Europe because stateroom inventory has outstripped demand.

Another problem for the industry, as well as all other users of Hawaii's harbors, is lagging infrastructure. There is a clear consensus that the problems at Kahului Harbor — a lack of space and room to expand — are worse than anywhere else in the state. Yet as dire as the waterfront problems are, land-side problems are even greater, with no space to accommodate cargo, cars, cruise passengers and other demands.

The main reason we neglect harbor infrastructure is that other problems of growth — highway and airport congestion, for example — are more visible. The harbors are out of sight, and thus out of mind — even in a relatively small island economy. Maui's population has grown 24.5% in the last 15 years, far outstripping harbor infrastructure growth. Kahului Harbor is a modest three-pier facility built years ago for a plantation economy, not for a tourist-dominated island whose population has grown so fast.

Maui’s Agriculture Picture:
Sugar, Ethanol, Pineapple

Highlights in Maui agriculture in 2007:

- HH&S reports that 2007 production is up some but prices are down from 2006. Sugar yields have been affected by drought.
- HH&S reports that, at today's energy prices, it is a toss-up between the return on sugar versus ethanol production. So the ethanol option is not being pursued aggressively, but is still being evaluated for the future. (HH&S potentially can produce more ethanol than can be consumed on Maui, which means exporting — something the company may not wish to undertake.)
- Maui Land & Pine is still committed to pineapple, with emphasis on the higher-end fresh fruit niche.

Construction: Housing Law, Permit Process are Worries

Maui construction is still booming — several Maui builders report they will be busy for at least the next several years — but there are signs of a cooling off further down the pipeline.

The chart below clearly shows a slowdown in permit growth. Builders report that the permit process is getting longer and harder; a more involved bureaucratic process, with the involvement of more agencies, gets most of the blame. There is also an underlying anti-growth sentiment on Maui, a natural outcome of the recent construction boom.

Maui builders report they will be busy for at least the next several years — but there are signs of a cooling off further down the pipeline.

Maui Land & Pine is still committed to pineapple, with emphasis on the higher-end fresh fruit niche.
Hawaii County’s Economy Continues to Grow, But At a Slower Pace

The Hawaii County economy is still showing definite strength in many respects, with lots of visible signs of economic activity. However, there are also many of the same indications of slowdowns — especially in the construction and real estate sectors — as in other areas of the state.

As a result, a more muted pace of growth can be expected in Hawaii County for the near future. Many leaders on the island have suggested that a bit of a slowdown would actually be welcome.

County’s Construction Cycle
Peaked in Early ’06, Then Declined

The Big Island construction cycle peaked in the first half of 2006, with a decline later in the year that has continued into 2007. Industry leaders expect a continued drop into 2008. Luxury condo projects on the West side are winding down, and speculative building in areas like Puna on the East side has slowed markedly.

Data on permits in the chart at top left clearly signal that trend. After a surge in late 2005 and early 2006, the contraction in private permit growth is clear. Some of that obviously has to do with the long awaited turn in the real estate market.

Dropping Off from High in ’05
Island’s Real Estate Prices
Peaked in Early ’06, Then Declined

One of the biggest economic stories on the Big Island in recent years has been the island-wide median single-family home price. In 2005, it peaked at $440,000. In the first half of 2006, it fell to $420,000 — a 4.5% drop.

It’s difficult to generalize about Hawaii County’s real estate market because of the disparity among areas across the island. The top right chart looks at trends in the various areas.

Clearly, 2005 was the biggest increase, followed by a leveling off in 2006 and continuing to 2007. Puna (off 5%) and North Kona (off 7.5%) had the biggest price declines in the first half of 2007. (A 4.7% increase for South Kohala is likely due to transactions in higher-end second homes, a market segment that has remained firm.)

The number of sales has shown even bigger reversals. In the first half of 2007, the number of sales was down 15% island-wide, with declines of 12% in Puna, 20% in South Kohala, and 19% in North Kona.

Once such a cooling starts, it usually doesn’t reverse in just one year, though there usually aren’t sharp declines, just a plateau. I frankly believe there are more contractions to come, as the market returns to equilibrium.

Hawaii County Visitor Industry
Having a Strong Year in 2007

In the first half of 2007, some of the visitor industry’s major indicators show that the Big Island is doing quite well. The state as a whole is having another flat year with respect to total arrivals, but the Big Isle had the second highest growth rate in the state, trailing only Kauai.

With respect to total spending growth, the Big Isle leads the state in 2007.

Hawaii County’s comparative tourism advantage remains in size, and the diversity of the visitor experience. But the perpetual search continues to find things that are new and unique to attract visitors in what is becoming an increasingly competitive environment.

Hawaii County’s hotel occupancy rate usually runs below the state average, and that continues to be the case in 2007. Of course, the industry will get a boost sometime in 2008 when the Mauna Kea Beach Hotel reopens after repairs from the earthquake.

Economic analysis by: Dr. Leroy O. Laney Economics Consultant to First Hawaiian Bank, Professor of Economics & Finance, Hawaii Pacific University
The three larger Big Island dairies are struggling. Dry conditions elsewhere on the island have reduced coffee, which also benefits from good rainfall, is at a relatively healthy rate of 2.8%, compared to higher unemployment rate. But it’s still growing some from 2006, which bears out the slightly strong in recent years. In early 2007, it decelerated find workers is itself a constraint on growth. This isn’t necessarily a bad thing, because the inability to and an easing of labor market pressures. This isn’t probably even the state as a whole. In 2007, there has been a slight uptick in the county’s jobless rate from 2006, an indication of a slowing economy and an easing of labor market pressures. This isn’t necessarily a bad thing, because the inability to find workers is itself a constraint on growth. Big Isle job growth has been running quite strong in recent years. In early 2007, it decelerated some from 2006, which bears out the slightly higher unemployment rate. But it’s still growing at a relatively healthy rate of 2.8%, compared to statewide job growth of only 2.2%.

One other overall indicator of economic health at the County level is the financials of the County at Hilo Harbor. Both home price valuations and property taxes the recent run-up in home prices has a silver lining. The chart below left shows that 2008 will likely be the first year in almost a decade when the number of disembarking passengers at Hilo Harbor hasn’t mushroomed, as a result of the loss of one Norwegian Cruise Line vessel and fewer ship visits. And an added Pier 4 at the harbor is slated for funding.

A new $14 million Student Life and Events Center, slated for early 2008 opening, should help with student attrition. The first College of Pharmacy class enters in 2007, about 80 students. The building to house the college is planned for a 2008 start. Agriculture is More Crucial in Hawaii County Than Elsewhere As a share of the economy, agriculture remains more important for Hawaii County than for any other part of the state. In 2007, the agriculture picture is a mixed bag:
- Macadamia nuts are experiencing a glut in the market, due to a bumper crop in Australia, and a good-crop locally as well. Ironically, Kona has been getting good rain while the rest of the state has been drought.
- Coffee, which also benefits from good rainfall, is anticipating a 2007 crop that is slightly better than 2006.
- Dry conditions elsewhere on the island have reduced feed for cattle, which encourages early shipment to the Mainland. Ranchers are being squeezed by higher feed prices, due partly to corn demand for ethanol production. But cattle prices are holding up due to strong demand, and locally grown range finished and organic beef, which demand higher prices, are gaining a foothold in the market.
- The three larger Big Island dairies are struggling. Higher milk prices can’t offset rising operating costs. State subsidies may help, but are not a long-term solution.

Future of Hawaii County Astronomy Is Tied to Objections and Delays Astronomy in Hawaii County has always been an exotic and clean industry, providing higher-income jobs in an economy where they are scarce. The Mauna Kea summit is also perhaps the best site in the entire world for astronomy. Projects now talked about are the Pan-STARRS project, an observatory that will search for dangerous asteroids, and the new generation Thirty Meter Telescope, which dwarfs its predecessors in lens size. The Mauna Kea summit is also perhaps the best site in the entire world for astronomy. Projects now talked about are the Pan-STARRS project, an observatory that will search for dangerous asteroids, and the new generation Thirty Meter Telescope, which dwarfs its predecessors in lens size.

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Kauai’s Economy Remains Strongest in the State in 2007

Despite a downturn in the housing market, the Kauai economy in 2007 remains strong — more heated than the rest of the state, where a slowdown is occurring. There has been a staggering explosion of Garden Island construction, building permits remain strong and the island leads the state in visitor arrival growth.

Construction Industry Booming

With Tourism-Related Projects

A lot of the activity in Kauai’s booming construction industry is related to tourism. Statewide trends toward time-share and condo lots are apparent on projects on the island. The hottest place is Poipu, where a number of projects planned for years seemed to get final approvals simultaneously. It is often like that in building booms, when a knot of projects bring on a grand finale. Now going up are: Royal Palms Condos (164 units), Pili Mai Condos (191), Koloa Landing (300), Wainani Estates (70 single-family), Kaluakoi Poipu Beach Estates (108 lots) and Poipu Beach Hotel (115 rooms).

In addition, 1,900 units are planned in the Kalaniana’ole luxury development plus three others in the wings: Kiahuna-Poipu Beach Estates (327 acres) and Poipu Beach Hotel (125 rooms).

Baldwin, such as 60 single-family gap range homes on the South side by Alexander & Baldwin, such as 60 single-family gap range homes at Kekaha. A&B is also about to start on a 75-unit, multifamily component in the same area.

Unlike Other Counties, Kauai’s Building Permits Remain Strong

One leading indicator of construction activity is building permits issued. As the chart above shows, Kauai permit growth is holding up well indicating substantial construction activity likely to extend out several years.

Kauai is unique among Hawaii’s four counties in this regard. Elsewhere, there has been a marked slowdown in permits issued, reflecting builder apprehension of the turn in the housing market. Kauai builders continue to report that the permit process is getting longer and harder. A more involved bureaucratic process, with the involvement of more agencies, gets most of the blame. An increased anti-growth sentiment may underlie that.

Housing Market Turndown

Finally Happening in 2007

We’re warned about an impending turn in the real estate market for several years. In 2007, it’s happening. At times like this, it’s important to remember that any economic cycle contains periods of cooling and maybe even of declines. Just a plateau.

Kauai’s example over the last cycle is instructive. An earlier run-up for Kauai home prices came to an end in the early 1990s. From 1990 through 1992, there was a decline of 11.6% in single-family home prices. Then the present run-up started — a staggering 205% rise from 1992 to 2006. Such an acceleration can’t be good for any economy, and doesn’t continue forever.

This does not mean that real estate is a bad investment, even today. People “unlucky” enough to buy at Kauai’s 1990 median might have kicked themselves for the next few years as the value of their homes declined. But had they held on to that home until 2006, they would have seen a 170% appreciation — a hefty annual gain of 10.6%.

Kauai County Job Creation Remains Strong in 2007

Job growth in Kauai County has remained remarkably strong in 2007, considering the scarcity of workers to fill jobs and slowdowns elsewhere in the state. Incoming construction workers have pushed Kauai construction jobs up over 10% so far in 2007. (continued on page 10)
Guava Kai on the North Shore.

blow to Kauai agri-tourism was the closing of a country, and a new cacao farm above Kapaa offers have a new agriculture-based ride through the communities. Of course, this depends on the substitutability of vacation rentals and local housing. As vacation rentals creep into local neighborhoods, however, concerns may be legitimate.

**Growth of Cruise Industry**

Limited By Pricing, Harbors

Despite its phenomenal growth, the cruise industry has encountered stumbling blocks. The high cost of operations and pricing pressures will cost us one of the state’s four Norwegian Cruise Line vessels when the Pride of Kauai leaves in early 2008, at least temporarily, for Europe. Norwegian said the vessel’s debut caused stateroom inventory to outstrip demand.

Another problem for cruise vessels, as well as all other users of Kauai’s harbors, is lagging infrastructure. Fortunately, Kauai’s Nawiliwili Harbor is somewhat better prepared than some other islands to handle increased traffic. And Kauai has another smaller harbor, Port Allen, which can take some activity.

**Kauai Retail Market Faces Big-Box Store Controversy**

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**Kauai Tourism Leads the State in Arrival Growth in 2006 & 2007**

The feedstock will come from the 7,500-acre sugar plantation, some of the highest yielding sugar acreage in the world. Sugarcane is superior to other ethanol sources such as corn. If you have water you can grow more energy per unit of sunlight than anything else.
Exactly 25 years ago this month the United States economy entered a new era, which in my view is best described as the ‘Long Boom.’ It was in November 1982 that the U.S. economy ended one of the most severe recessions in our history. And during the 15 years prior to 1982 we had a recession about every three or four years in the United States. In contrast, since 1982 the average length of expansions has more than doubled. We have had three long expansions — from 1982 to 1990, from 1991 to 2001, and now six years of expansion since 2001. This most recent expansion, the first of the 21st century — has been the third longest in United States history, excluding periods of major mobilizations such as during World Wars I and II. And the recessions since 1982 have been very short and mild. Since the Long Boom began, nearly 50 million jobs have been added to U.S. payrolls and the Dow Jones Average has gone from under 1000 to over 14000.

Another name that economists have given to the Long Boom is the Great Moderation, because the long expansions and short recessions have moderated the volatility of the business cycle. You can see this moderation in Figure 1 — which looks a lot like a electrocardiogram. It shows how the ups and downs of growth on real GDP from quarter to quarter have dropped off significantly during the Long Boom.

Given the recent focus on the housing market, it is important to note the great reduction in the volatility of the housing cycle during these years, even with the sharp recent downturn, as shown in Figure 2.

There has been another important development since economists first began noticing the Long Boom: Many other countries around the world have also experienced more stable economic performances. We have what could be called a ‘Global Long Boom.’ Look at the amazing reduction in the number of emerging market financial market crises compared with the 1990s. In Table 1 shown, starting with Mexico in 1994 there was a huge number of major financial crises in the 1990s. These include the spread of the Mexican crisis in 1994 to other parts of Latin America, the Asian contagion of 1997, and the Russian global contagion of 1998, which was still having ramifications in Brazil and Argentina in 2001. The improved global economic performance since then is remarkable. There has been no major emerging market crisis since 2002.

There is currently a debate among economists over the reason for this longer term improvement in economic performance in the United States. Some point to better inventory management on the part of firms. Others point to the greater flexibility of the economy and the role of information technology. Still others point to good luck. In my view the reason is predominantly the improved economic policy since the early 1980s, especially monetary policy. I believe that same explanation applies to the recent improvements globally. In effect we are seeing the globalization of the Long Boom that began in the United States 25 years ago.

Yet we are once again seeing risks to the continuation of the Long Boom. The continuing decline in the housing market and the recent turmoil in the financial markets have increased these risks compared to last year.

Figure 3 shows how the boom and bust in the housing market affected delinquency rates on subprime mortgages. While housing prices were rising, the rates were very low. Now, rates have increased sharply. While housing prices rose rapidly, the falling delinquency and foreclosure rates on subprime mortgages led (continued on page 12)
to more favorable credit ratings than could ultimately be sustained. As the short term interest rate returned to normal levels, housing demand rapidly fell, bringing down both construction and housing price inflation. Delinquency and foreclosure rates then rose sharply, ultimately leading to the meltdown in the subprime market and on all securities that were derivative from the subprimes.

As housing inflation began to fall, the relatively low delinquency and foreclosure rates reversed sharply. Before the reversal many mortgages and mortgage backed securities were issued with credit ratings that reflected the unusually low delinquency rates. Only later were the credit ratings reduced. Assessing the risk was particularly difficult when such mortgages were packaged into securities that combined other types of risk profiles. Hence, people purchased these securities not knowing the risk that they entailed. Pricing these securities was difficult with the unusually high inflation rates in the housing markets, but eventually the risk premia adjusted to reflect the reality. For example, the Markit ABX Index of securities consisting of subprime mortgages securitized during the second half of 2006 has fallen from about 82 to 38 since February 2007.

The turmoil in the subprime market has spread to other markets. Fortunately, it appears that much of this spread is based on fundamentals, or the perception of fundamentals, rather than the broader type of contagion we saw in the 1990s. The indices of option-adjusted spreads of high-yield securities and corporate bonds of comparable ratings (either BBB or A) are shown in Figures 4 and 5. The spread between U.S. Treasuries and emerging market debt is shown in Figures 5 and 6.

As we assess the weakness caused by the housing market and the turmoil in the financial markets, we should put them into the perspective of this Long Boom. Because of the stronger and more stable U.S. and world economies, the impact of each of these risks is less than in the past. The sharp drop in housing price inflation and the slump in the housing market are obviously a serious drag on the economy, but they are less likely to be enough to bring growth rates down into a recession. Hence, the greatest probability now is for a continued economic slowdown into 2008. But, even if there is a recession, it is very likely to be of the mild variety that we have seen since the Long Boom began 25 years ago. Even in this case, I believe that the Long Boom will continue for a long time into the future. However, this forecast is contingent on monetary and fiscal policy, and my working assumption is that good policy will continue in the United States and other major countries.