Kaua‘i Economic Outlook:

Tourism Woes Mean No Growth Through 2009

prepared for the County of Kaua‘i by the

University of Hawai‘i
Economic Research Organization

July 1, 2008

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EXECUTIVE SUMMARY

The Kaua‘i economy continued to perform better than much of the rest of the state last year, although sharing in the slowing trend. Since the start of the year, there have been several key developments that will impinge on growth in 2008–2009, including the departure of two of three inter-island cruise ships, the failures of ATA and Aloha Airlines, and the surge of oil prices to record-high levels. We expect growth in payroll jobs to slow to 0.2% this year and to decline by a slight 0.3% in 2009. Real income growth will remain barely in positive territory. This is a slightly stronger forecast than for the state as a whole, where we expect small net declines in both jobs and income.

- While Kaua‘i shared in the state's general economic slowing in 2007, the pace of deceleration was somewhat less pronounced than in other counties. The visitor industry continued to expand at a healthy rate, construction was buoyant, and business confidence remained relatively high.

- The Kaua‘i visitor industry will experience net losses in 2008. Arrivals growth will be down more than 11% this year, and visitor days will fall by about 4%. Overall airlift to the state will only gradually be restored, and weak U.S. economic conditions and high oil prices will also restrain travel. Kaua‘i's occupancy rate will fall a bit to 72.5% in 2008 and to 71% in 2009 both because of visitor weakness and additions to the room stock.

- The visitor pullback will have negative impacts across a broad swath of the Kaua‘i economy. The sectoral losses will be largest for businesses oriented toward visitors, particulary toward the cruise industry. A marked—but not dramatic—falloff in spending has already been noted by local businesses. While there is some optimism about summer conditions, many are concerned about the impact of record oil prices on arrivals and spending as the year goes on. High oil prices are also raising costs and squeezing profits.

- We expect a more than 2% drop in wholesale & retail trade jobs over the next two years. Job growth in the accommodations & food sector has continued at a healthy clip during the first part of this year, but we expect that to stall out, with a small net decline in jobs in 2009. Jobs in transportation and utilities will drop by more than 4% this year. Some of these losses will be accomplished through attrition rather than layoffs.

- A downturn in aggregate jobs has not yet occurred, partly because of the booming construction industry, where jobs were up 17% in the first four months of this year, compared with the same period in 2007. A boost may come from the expected approval of long-delayed building permits for several large resort residential projects later this year or in early 2009, but we are also hearing anecdotal reports of some project cancelations because of weak sales and difficult financial market conditions. After rising by 8.5% this year, we expect about a 4% decline in construction jobs in 2009, with moderate slowing continuing for several years.

- Aside from construction, the only large sector to see job gains this year will be health care. The finance, insurance & real estate sector will continue to see jobs losses. Job growth in the large “other services” category, which among other things includes education, business, and professional services, will be nearly flat this year, down from almost 3% growth in 2007. Because of fiscal pressures, government sector jobs will decline by about one percent this year.

- Kaua‘i real income grew just 1% in 2006, and we estimate that it expanded by 1.2% in 2007. With broad slowing in jobs and general economic conditions, we expect real income growth to rise by just three-tenths of a percentage point this year, with relative strength in government transfer payments associated with the Federal income tax rebates offsetting a small net decline in real labor income. We expect aggregate real income growth to remain anemic in 2009, before returning to moderate expansion in 2010.

- The inflation picture has deteriorated with the oil price spike of recent months. We now expect Honolulu inflation to average 5% in 2008, roughly the same as last year. A partial retreat of oil prices from recent highs and continuing softening of the housing component will bring about a fairly rapid deceleration to 2.2% in 2009. (No county-specific consumer price measure is available for Kaua‘i.)

- While this forecast represents our view of the most likely path for the Kaua‘i economy, there are substantial downside risks. High oil prices are damaging the travel sector, and these impacts will get worse the longer prices remain near current levels. A related issue is the risk of additional airline failures. In addition, a deep and long U.S. housing slump could cause a sharper pullback in travel and deeper local construction adjustment. On the upside, the continuing high levels of activity in the Kaua‘i construction sector and the permit backlog means that job and income growth in the sector could be a bit stronger than expected. A rapid improvement in the American mainland economy or a rapid retreat of oil prices could also drive a more rapid recovery in the visitor industry.

Kaua‘i Economic Indicators, Year-Over-Year %Change

	2005	**2006**	**2007**	**2008**	**2009**
Visitor Arrivals	6.8	10.4	5.7	-11.6	-0.1
U.S. Visitor Arrivals	8.5	10.8	5.5	-13.0	-2.1
Japan Visitor Arrivals	-20.4	-23.1	3.8	-21.8	7.3
Other Visitor Arrivals	7.0	19.2	7.4	0.4	11.0
Payroll Jobs	2.7	2.9	2.3	0.2	-0.3
Inflation Rate, Honolulu MSA (%)	3.8	5.8	4.9	5.0	2.2
Real Personal Income	4.1	1.0	1.2	0.3	1.0

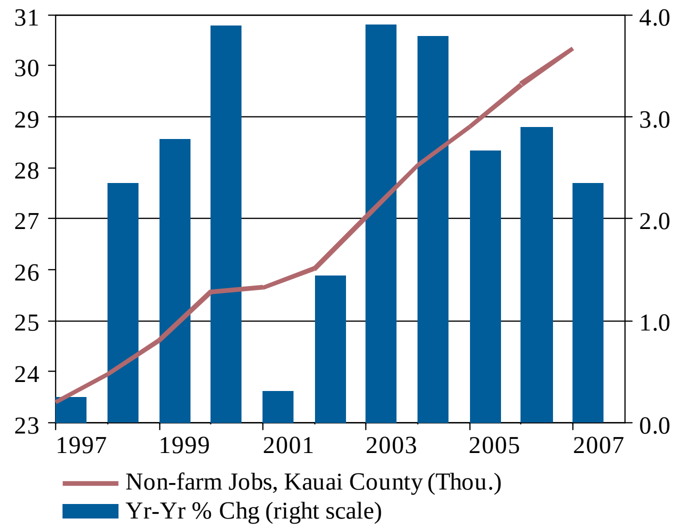
Notes: Source is UHERO. Figures for 2008 – 2009 are forecasts.
Income for 2007 is a UHERO estimate.

The Kaua'i Economy in 2007

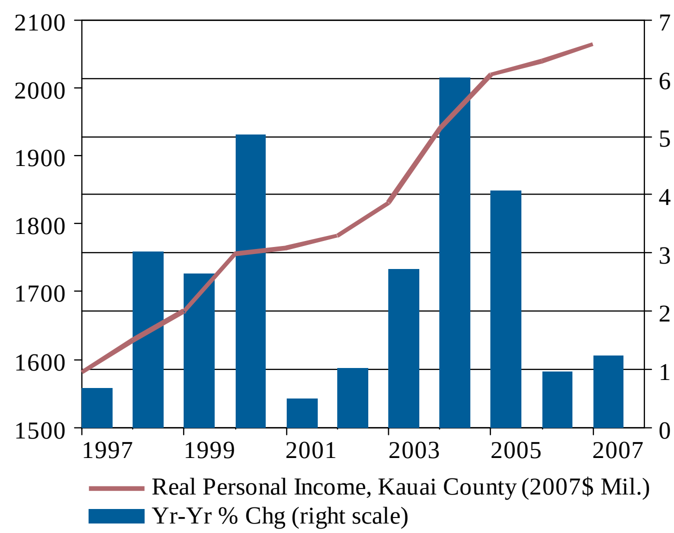
While Kaua'i shared in the state's general economic slowing in 2007, the pace of deceleration was somewhat less pronounced than in other counties. The visitor industry continued to expand at a healthy rate, construction was buoyant, and business confidence remained relatively high. In this section we will review conditions on Kaua'i during 2007. We will then turn in the following section to a discussion of the impact of recent adverse developments on the outlook for the Kaua'i economy.

For the year as a whole, Kaua'i's non-farm jobs expanded by 2.3%, matched only by Maui county. The unemployment rate averaged 2.6%, up just slightly from the 2.4% rate experienced in 2006. As in other counties, these annual figures mask labor market softening that occurred over the course of last year. The 3% unemployment rate in the fourth quarter of 2007 was a full percentage point higher than the 2% rate seen in the fourth quarter of 2006. Payroll jobs, which were expanding at a 4.4% rate in the final quarter of 2006, slowed to 1.1% growth by the end of 2007. (There was an uptick to 2.5% year-on-year growth in the first quarter of this year, due primarily to increased construction hiring.) Total employment, taken from the household survey, had expanded at a 2% rate in the first quarter of 2007, but was down 0.9% in the final quarter of the year.

Continuing strength in construction and the visitor industry were the primary contributors to Kaua'i's above-average performance last year. While slowing from the torrid 19% growth pace of 2006, the number of construction jobs averaged 5.7% higher in 2007 than in 2006. There was strong 3.6% job growth in accommodations and food services, propelled by 4% growth in visitor days. The visitor industry also contributed to the 3.4% growth seen in wholesale and retail trade. Job growth in the broad "other services" sector, which includes such areas as education, entertainment, management and professional services, came in a 2.8%, although growth in this category decelerated to a near-standstill 0.5% growth in the year's second half. The big job losses last year came in finance, insurance and real estate (–2.7%) and transportation and utilities (–0.5%). (The latter category was down 3% year-on-year by the fourth quarter.) Agriculture continued the trend of annual job losses that we have seen in recent years. Job additions in the Federal sector offset small losses in state government employment.



Non-Farm Payroll Jobs, Kaua'i County



Real Personal Income, Kaua'i County (2007 is UHERO estimate)

Among business leaders we spoke with during 2007, confidence remained relatively strong and most pessimistic comments continued to center on the negative aspects of growth. (Things have shifted noticeably since the recent airline failures and surge in oil prices.

We’ll discuss these very recent developments below.) As has been the case for a number of years, the top complaints last year were home affordability and traffic congestion. The county’s population growth, while still positive, has been slowing in recent years. There continues to be anecdotal evidence that Kaua‘i’s high cost of living is forcing some residents to leave the island for other Hawai‘i locations or the U.S. mainland. In this regard, the single-digit decline in home prices for 2007 was welcome news to many island residents.

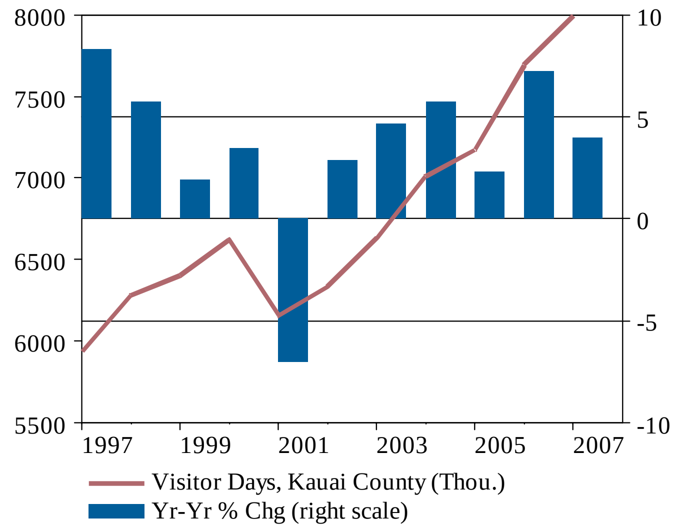
Alleviating traffic congestion is a rather intractable problem. Route 50 coming into Līhu‘e from the West and Route 56 running into Līhu‘e from the North along the East side of the island are still the primary choke points. Delays along these thoroughfares not only inconvenience local motorists but have reached the point that they negatively impact the visitor experience. It is unfortunate that significant progress addressing these problems was not made during the recent period of rapid growth. Funding for infrastructure upgrades will become harder to find now that the state and county economies are slowing.

The following describes in greater detail developments during 2007 in key sectors of the Kaua‘i economy, beginning with the leading tourism industry.

Tourism

In a year in which total visitors to the state declined, Kaua‘i easily stood out with the best performance in the visitor industry. Total Kaua‘i arrivals rose 5.7% in 2007, after a 10.4% expansion in 2006. Visitor days rose 4% last year, compared with declines of 1.0–2.1% in the other three counties. Both U.S. Mainland and Japan visitors rose, although the latter represent less than 3% of Kaua‘i’s visitor base.

Last year was the second year in a row that Kaua‘i led the state’s four counties in visitor arrivals growth. In part this reflects the gains from the inter-island cruise boom. The nearly 450,000 cruise visitors to Kaua‘i last year represented a disproportionately large fraction of the island’s 1.27 million visitor arrivals, compared with the other counties. This means that Kaua‘i’s arrivals losses from the NCL cruise ship



Visitor Days, Kaua‘i County

departures will also be disproportionately large, as we will discuss in the next section, below. The effect of the cruise passengers on visitor days is much smaller than the effect on arrivals, because of their short stay on Kaua‘i.

Other indicators of tourism activity were also positive in 2007. Kaua‘i’s total visitor spending growth led the state, at 4.5%. The closest major island in this category was the Big Island, with 4.1% growth. O‘ahu saw 1.6% growth, and visitor spending on Maui Island declined by 3.6%. If we adjust for inflation using he Honolulu CPI, even Kaua‘i’s 4.5% growth represented a slight decline in real terms. Hotel occupancy firmed a bit to 75.5%, and the average daily room rate climbed 9.2%, following statewide trends.

The Kaua‘i visitor plant has a higher share of timeshare and condo units and independent vacation rentals than any other market in the state. The shift away from traditional hotels toward timeshares and condohotels continues statewide. In recent years, the timeshare component on Kaua‘i has been stable, but this will jump when units now under construction come on line. The growing number of timeshare visitors and their impact on the character of the local community are viewed negatively by some longtime Kaua‘i residents.

Kauaʻi's independent vacation rentals are a genuine asset to the local industry, because they provides visitors with an experience far different from that of hotel, condo, or time-share units. Among vacation rentals, there is a huge range in price and amenities, with some properties at the very high end. Recently, there has been a debate about whether vacation rentals reduce housing available to local residents. For units that are clearly located in tourist areas, there may be little substitutability between vacation rentals and local housing. At the same time, it has been observed that homes seem to turn into vacation rentals without much notice or fanfare. To the extent that vacation rentals are creeping into local neighborhoods, there may be legitimate concerns. The Transient Vacation Rental (TVR) bill was passed in March 2008 by the County Council. It forbids any new TVR activity outside of the Visitor Destination Areas (VDA), but allows any existing TVR that can supply the required information to the County by a deadline in September 2009 to continue to operate. The ordinance also specifically outlawed TVRs on Agricultural lands.

Agri-tourism is growing on the island. Kauaʻi Coffee offers a visitor center and self-guided tours, and Kilohana now operates a train ride through the countryside. A new Cacao farm above Kapaʻa offers a *Chocolate From Branch to Bar* tour. A loss last year was the closure of Guava Kai on the North Shore.

Social trends are also emerging that may influence the future shape of island tourism. For example, the visitor industry is beginning to talk more about what each property can do to become more environmentally conscious. And "voluntourism"—giving visitors an opportunity to give back to a place while vacationing via organizations like Habitat for Humanity or the Kauaʻi Foodbank—is another emerging idea.

The Kauaʻi economy got a lift last year from the introduction of two additional non-stop flights, one by ATA and another by Alaska Airlines. The Alaska Airlines flight was the first direct Seattle–Līhuʻe flight. These gains were disrupted in recent months by the bankruptcies of ATA and Aloha Airlines, to be discussed below.

While we never know quite where to place it, some discussion of the movie industry is certainly warranted. The marketing aspects of entertainment for Kauaʻi tourism may be significant. Possibly because of the the recently-implemented 20% Neighbor Island tax credit for productions with budgets of $200,000 or more, the 2007 summer season was a busy one for film making statewide. Kauaʻi's biggest feature was *Tropic Thunder*, the Ben Stiller comedy set in Vietnam. This production, perhaps the biggest film project ever produced on Kauaʻi, spent more time than normal filming on-island, and reportedly dropped $70 million in expenditures into Kauaʻi's economy in 2007. There were a number of other features filmed on Kauaʻi last year as well.

Before leaving tourism, we would like to return briefly to a discussion of the cruise industry. Cruise ship visits to Kauaʻi continued to constitute a large source of demand for Kauaʻi activities in 2007, often crowding out independent tourists and requiring visitors to make advance bookings in many cases. Local activities have also increasingly catered to cruise passengers. In addition to the Plantation Railway mentioned above, Kilohana has added a multi-million dollar luau pavilion that was envisioned to cater primarily to cruise passengers. We will discuss the potential impact on businesses of the cruise ship departures in the forecast section of this report, below.

In addition to high operating costs and pricing pressures, lagging infrastructure has been a problem for cruise vessels. This represents a challenge to many other sectors of the local economy, as well. Problems at Kahului Harbor on Maui are perhaps the worst in the state, and fortunately Nawiliwili Harbor is somewhat better prepared to handle increased traffic. Kauaʻi also has another smaller harbor, Port Allen, which can take some kinds of activity. A large statewide harbor modernization plan was approved by the 2008 legislature.

Construction and Visitor Plant Development

A discussion of Kauaʻi visitor plant development provides an appropriate segue to the booming Kauaʻi construction sector. The trends toward timeshare and condo hotels we have mentioned above are apparent. We’ll review recent developments in various areas of the island in turn.

Po‘ipū saw a virtual explosion of activity in 2007. A number of large projects took off at about the same time. This confluence of activity is not the result of last-minute planning by developers, but rather from the nearly simultaneous final approval of a number of projects that had been in the works for many years. This is not uncommon at late stages of a building boom, when a knot of pending projects bring on a grand finale. (The end of the 1980s boom had a similar finale, but mainly in hotel construction.)

A partial list of projects on the South side includes:

- Royal Palms Condos – 164 units
- Pili Mai Condos – 191 units
- Koloa Landing – 320 units
- Wainani – 70 single family units
- Kiahuna-Po‘ipū Beach Estates – 108 lots
- Po‘ipū Beach Hotel – 125 hotel rooms

In addition, there is the huge Kukui‘Ula luxury development, which will eventually include 1,500 units. Other projects in the wings include Knudsen Estate’s Village at Po‘ipū (428 potential units), Kiahuna-Po‘ipū Golf Resort (282 units), and Po‘ipū Town Center (107,000 square feet of commercial space).

On the East side of the island, there is the Kaua‘i Lagoons development near Līhu‘e, which includes:

- Kalanipu‘u Condos – 78 units
- Ritz-Carlton Residences – 14 units
- Ritz-Carlton Club – 28 units

Moving ahead with plans that have been dormant for almost 20 years, new owners of the Kaua‘i Lagoons plan to spend $1.5 billion to complete the expansion of the 327-acre property.

Waipouli Beach Resort Condos in Kapa‘a beat the rush and is now mostly sold. Just north of Kapa‘a, the planned Kealanani project is an agricultural subdivision with a mandate that there must be actual agricultural activity on the lots. Both taro and tea are planned crops, and perhaps others.

On the North shore, plans by Princeville Associates, the Jeff Stone-Morgan Stanley partnership, to enhance the Princeville Resort core facilities are now coming to fruition. The new Westin Princeville Ocean Resort had a soft opening in April 2008, with the completion of 124 of their 300-plus timeshare units. Beginning this fall, the Princeville Hotel will be renovated to become the first St. Regis hotel in Hawai‘i. The Princeville Resort will be fully closed during the renovation, expected to last from September 19, 2008 through April 19, 2009. The Princeville Shopping Center is undergoing a major facelift and change in the tenant mix. Planning continues for the remaining 7,000 acres of undeveloped land in the Princeville Resort.

In new residential construction on the North Shore:

- Single family residential construction continues to fill in the lots of Phase I of the Princeville Resort, and a new 36-lot Phase II has been created.
- Brookfield Homes is nearing completion of the Nihilani condo project.
- Kaiulani has started delivering units in its upscale 77-unit duplex development.

Observers of North Shore real estate last year reported that, although sales volume was declining, prices were holding steady. Time-share activity continued to be strong. North Shore residents continue to be affected by difficult Kapa‘a traffic and rising housing costs.

Though all of this construction is aimed at the offshore market, the County continues its emphasis on affordable housing. Housing aimed at the local market is being planned on the South side by Alexander & Baldwin (A&B), including 60 single family gap-range homes at Kealaulu. A&B is also about to start on a 75 unit multifamily component in this area, aimed at the same market.

Kauaʻi builders that we spoke with in 2007 continued 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. Increased anti-growth sentiment is also a concern.

Real Estate

As is true for the state and national economies, the real estate market has continued to be a center of attention on Kauaʻi, with a sharp slowing in transaction volume and a moderate decline in prices. A turn in the market was evident in 2005, as resale activity began to fall back from historically high volumes. In the period from 1995 to 2005, single-family resale volume had grown 435%; median home prices had risen 280% by 2006. The median Kauaʻi single family home price of $678,000 was second only to Maui in 2006.

In 2006, prices in the market began to soften, and the annual increase in the median price was only 8%, down from a 27% rise in 2005. In 2007, prices declined by 5%, and the number of resales continued to fall at a double-digit rate. The price decline on Kauaʻi has been roughly in line with the Hawaiʻi County, but half the nearly 10% drop seen on Maui.

In many respects the home price retreat is welcome news on Kauaʻi, where the huge price surge of the past decade has severely eroded affordability, particularly on an island where higher-income jobs are scarce. The downward swing of the housing cycle will nevertheless lead to a pullback in a number of areas of the economy, ranging from construction to sellers of furnishings and durable goods, and to retail sales more broadly as people respond to their lower housing wealth and reduced access to equity credit.

The County recently opened an additional 40 units of affordable rental housing at its Kalepa Village complex in Hanamaulu. Phase IV of the project (40 more units) is due to start construction this month. There will be 82 affordable rental units at the Courtyards at Waipouli, expected to be completed in August 2008. A number of other affordable housing projects are on the drawing board or in various stages of development. If all are completed, this will eventually add more than 700 rental and owner-occupied units to the affordable housing inventory.

A brief comment about the Kauaʻi commercial real estate picture is also in order. On Kauaʻi, as elsewhere in the state, we continued to hear that commercial space is in short supply, particularly for light industrial space.

Retail

Retail trade expanded at a brisk pace in 2007, adding 4.2% to the sector's payroll job count. But the year was a mixed bag for industry prospects overall. In May of 2007, the County Council passed an ordinance banning any retail or wholesale establishment bigger than 75,000 square feet. The ban was proposed by the mayor and received the unanimous support of the Council. Existing big-box stores, such as Costco, were grandfathered in. But never has there been a bigger split between consumers, who benefit from the stores, and some of the smaller retail outlets that must compete against these Goliaths. The irony was not lost on some that the stores best able to address Kauaʻi's high cost-of-living have now been outlawed.

Prices of goods and services are perennially high on Kauaʻi in part because the island is too small for firms to achieve necessary economies of scale or to provide sufficient competition. Wal-mart, which would like to expand, has challenged the new ban.

Last year's announcement that two of three interisland cruise ships would leave Hawaiʻi waters in 2008 was unambiguously bad new for local retailers, particularly outlets positioned to take advantage of tourist traffic, such as Anchor Cove near Nawiliwili Harbor. The failure to successfully launch Superferry service was also a concern. We'll discuss the changing prospects for retail further, below.

Energy

Another way in which the Kaua‘i economy is punished by its size is in the provision of electricity. It is hard to achieve the necessary economies of scale in this high fixed cost industry. Kaua‘i usually has higher costs of power than any other county in the nation. The County has been investigating intra-governmental wheeling of electricity—renting the grid to ship electricity from a renewable energy producer to governmental facilities—as well as alternative sources of power such as photovoltaics. The County is also pursuing various energy efficiency measures.

High Tech and the Missile Range

The Pacific Missile Range Facility on the West Side of Kaua‘i is a bigger contributor to the island's economy than many realize. Its 850 employees make it one of the island's bigger employers. Only 70 of these are active duty military, and only 130 are government civilians. Most are local hires are long-term employees, who remain even when there are changes in the principal contactors at the Range. Range employment is especially important because many of the jobs pay relatively high salaries, hard to find on on Kaua‘i. The largest contractor at PMRF is now ITT, with about 500 employees.

Testing at the Range brings in additional money, several million dollars per missile test. And tests nowadays are more frequent, six to eight each year. Over the past year, the Range has begun actively testing the THAAD (Theater High Altitude Antimissile Defense) system. Recently the Facility was upgraded to a Command, more assurance that it will remain on Kaua‘i.

An important spin-off of the Missile Range is the Kaua‘i tech sector, which would be virtually nonexistent without it. The Kaua‘i Economic Development Board (KEDB) works closely with the Range, various contractors, and Kaua‘i Community College to determine the kinds of skills that students need to find employment in the sector.

The Waimea Visitor and Technology Center, which houses a number of Missile Range contractors, now has two phases in operation, and there has never been a vacancy. KEDB has applied to the Economic Development Administration to fund a third phase, to be housed in the old Waimea dispensary. About half of this new phase would be devoted to offices, and the rest to student training.

Agriculture

Diversified agriculture has been advancing on Kaua‘i, after a period of dormancy. Some recent developments include:

- Ranching is now the predominant use for former cane lands. A new County funded weighing and loading facility was recently completed in Hanamaulu by the Kaua‘i Cattlemens' Association. Ranchers can now load cattle into "cowtainers" off-dock and hold them there until dockside delivery times.
- The County has appropriated $300,000 for control of coqui frogs on a 20-acre site at Lawai.
- As the result of a longstanding zoning condition, the County has received a 75-acre parcel in the Crater Hill area of Kilauea for an agricultural park. Master planning is underway and development of the park should take place over the next few years based on the availability of funds.
- Work continues on re-opening the papaya disinfestation facility near the airport. The facility is refurbished, and processing and marketing will be conducted by non-profit organizations.

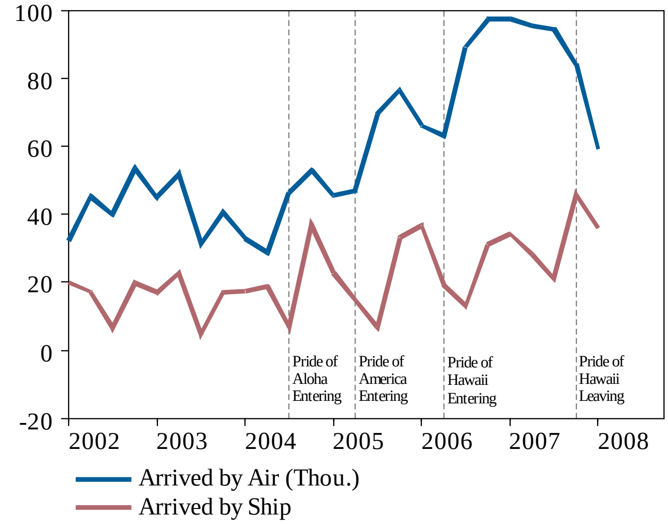
Kaua‘i's remaining sugar operation, 118-year-old Gay & Robinson (G&R), announced that it intends to transform itself into an alternative energy provider, leaving the commodity raw sugar business behind. Partnering with Pacific West Energy, G&R plans to develop the nation's first fuel ethanol plant generating renewable power from sugarcane. Also being investigated are biodiesel, hydro and solar power, and a methane recovery system from municipal solid waste. The ethanol plant is intended to produce up to 12 million gallons of ethanol annually, almost one-third of the state’s ethanol needs. The feedstock will come from the 7,500 acre sugar plantation. Sugarcane is a superior feedstock compared to other sources of ethanol such as corn. Original plans were to break ground in 2008, although they have encountered some permitting and other hurdles. G&R will retain the flexibility to get back into sugar production should prices rise in the future.

The County of Kaua‘i is undertaking an engineering study of the irrigation system that feeds 20 farmers in Kilauea from the Ka Loko Reservoir. The intent of the study is to determine the feasibility of that Reservoir to continue to supply the farmers under current conditions and with their projected growth, and also to study alternative water delivery systems those farmers could utilize should Ka Loko become unavailable.

Recent Developments and Outlook

The picture we have painted above is of a Kaua‘i economy that in 2007 continued to perform better than much of the rest of the state, while nevertheless slowing along with the state economy. Since the start of the year, there have been several key developments that will impinge on growth in 2008–2009, including the departure of two of three inter-island cruise ships, the failures of ATA and Aloha Airlines, and the surge of oil prices to record-high levels. In this section, we describe our forecast for the Kaua‘i county economy, with particular attention to the likely impact of these recent developments.

As we noted above, Kaua‘i has had by far the strongest visitor industry performance over the past two years, powered in part by increased cruise traffic. Last year, visitor arrivals rose 5.7%, following a 10.4% expansion in 2006. Visitor days rose 4% last year, compared with a statewide decline of 1.6%. There was considerable slowing as the year progressed, and fourth quarter 2007 arrivals were off a half-percent compared to the previous year. Visitor arrivals fell off a sharp 5.4% in the first quarter of this year, although an increased length of stay propelled visitor days ahead by 2.7%.

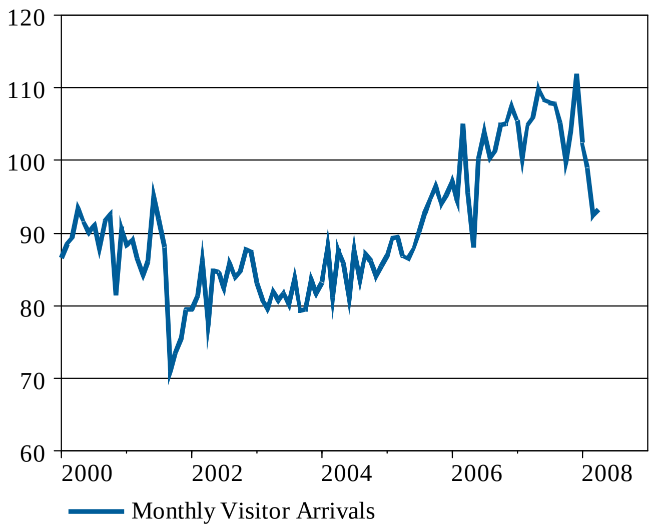


Cruise Visitors to Hawai‘i by Air and by Ship

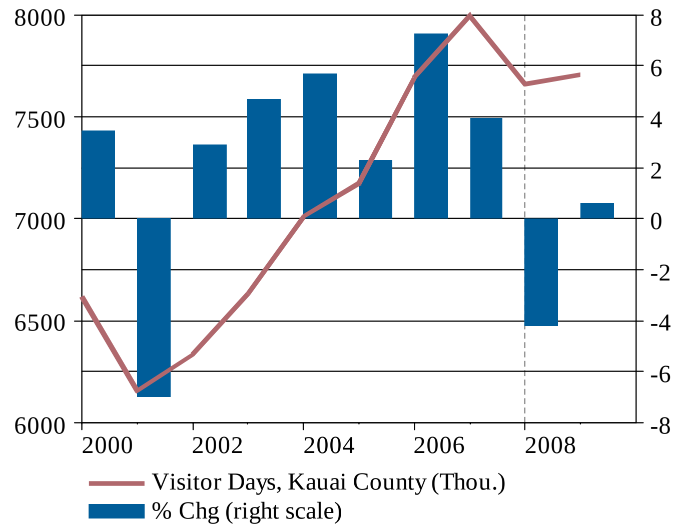
A good portion of the decline in arrivals can be attributed to a reduction in cruise visitors in the wake of the NCL Pride of Hawaii’s February departure. Statewide, cruise passengers arriving by air peaked at about 100,000 per quarter in late 2006, and they declined to about 60,000 in the first quarter of this year. Total cruise visitors to Kaua‘i were down by 62,000 in the first four months of 2008, a decline of nearly 47%.[1] The fallout from the additional departure in May of the Pride of Aloha will have a pronounced negative effect on Kaua‘i visitor arrivals for 2008.

The visitor industry took another hit with the failures of ATA and Aloha Airlines in late March and early April. Kaua‘i’s U.S. visitor arrivals for April dropped nearly 20% compared with April 2007, after being down 10.5% in March. Three direct flights from the mainland were lost with the airline closures: one daily ATA flight from Oakland and two Aloha flights from California, (the latter also stopped in Kona). But even with the loss of these three direct flights (representing about 10,000 seats per month), the number of passengers arriving to Līhu‘e on domestic flights continued to

[1] Total arrivals to Kaua‘i were down by about half this amount, suggesting that non-cruise passengers are picking up some of the slack. We are uncertain about how cruise visitors actually report their islands visited, so this comparison needs to be taken with a grain of salt.



Monthly Kaua'i visitor arrivals (seasonally adjusted)



Visitor Days Forecast, Kaua'i County

outpace the 2007 level. This was due to the Alaska and US Airways flights that had been added over the course of last year.

Direct flights are a small part of the airline capacity that serves Kaua'i, and the visitor industry clearly felt a bigger impact from the general reduction in airline capacity to Hawai'i and between the islands. The extent of the negative impact on Kaua'i from the airline failures will depend in part on how rapidly the lost airline capacity is replaced. Statewide, more than 1 million seats were lost initially, although the implied reduction in arrivals is probably closer to 600,000 when the figure is adjusted for airline occupancy rates and travel by residents. Still, this is a big number, equal to 8% of total arrivals to Hawai'i in 2007. For direct Kaua'i flights, by June seats from the mainland had recovered to March levels due to a new (but previously-announced) Delta Airlines flight from Los Angeles and the shift to the use of larger planes by United. United will add two more Lihu'e fights for the peak summer period. For the state as a whole, new flights by Delta, Hawaiian, Alaska, and United will offset some of the lost capacity this summer. At present, our projection is that about 50% of lost capacity statewide will have been recovered by August 1 and 80–90% by November.

Oil costs and weak U.S. economic conditions may well be a bigger obstacle to visitor recovery than a shortage of airline seats. The recent surge of oil prices to $130 per barrel and beyond adds an important additional burden to the travel industry. High energy costs directly raise travel prices, and perhaps more importantly they reduce disposable household income. Indications are that travel has already been significantly reduced nation-wide. Airlines are finding it impossible to pass along to customers their higher fuel bills, and so are resorting to an array of new special charges as well as cutting back their flight schedules and laying off workers. If oil prices remain in their current range for an extended period, there will likely be bankruptcy filings among the major carriers. Given the poor credit market conditions and cost-savings measures already undertaken, it is unclear whether they could continue to operate during bankruptcy work-outs.

However, we do not expect oil to remain this pricey for too much longer. Our expectation is that prices will fall below $100 per barrel by the end of the year and average $90 per barrel in 2009. They may well fall further than this depending on the extent of slowing in the global economy and the supply response. Admittedly there is considerable uncertainty about the path that oil prices will take. See the box, *The Price of Pricey Oil*.

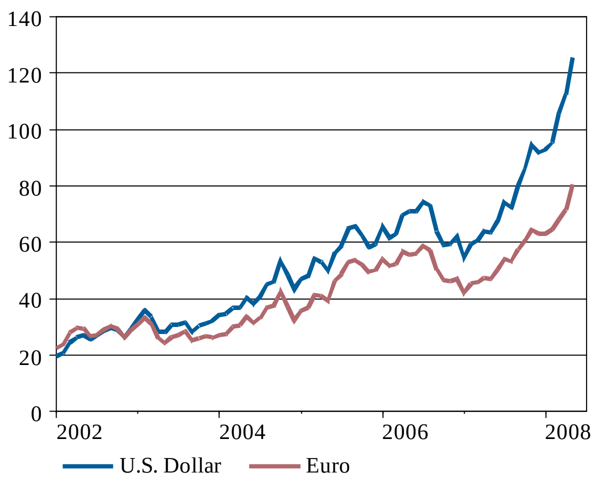
The Japanese market has been even weaker than the U.S. side, but this is a very small market on Kaua'i, representing less than 3% of all visitors in 2007.

The Price of Pricey Oil

"Oil price sets new record"—this headline is becoming a sad cliché. Oil prices have doubled over the past year and have increased more than 50 percent since the year began. Yesterday, oil prices set an all-time intraday high of 143.67 dollars per barrel (dpb). What's driving these high oil prices and what does it mean for the economy?

Economists have identified at least four fundamental factors behind the recent oil price surge—booming world demand, expectations about future market tightness, the weak dollar, and fear of supply disruptions. World oil demand has risen rapidly in recent years, thanks to fast-growing China, India and other emerging economies. But the timing of the recent oil price spike suggests that this is not the sole cause.

On the supply side, many analysts believe that oil production from conventional sources may soon peak. Near-term limits to available capacity in the face of growing demand help to explain high current prices. However, there exist vast reserves of unconventional resources such as tar sands and oil shale. Because development and production costs for these sources are well below current oil prices, these will exert downward price pressure going forward. And high oil prices are also leading existing oil producers to ramp up production. Nigeria, Iraq and Saudi Arabia are adding 800,000 barrels per day to the market.



West Texas Intermediate Crude Oil Price in Dollar and Euro

The weakening dollar also contributes to higher oil prices. Over the past 12 months, the dollar has fallen 15% against Euro and 14% against yen. As a result, while the price of oil in U.S. dollar has increased nearly 70% since 2006, the price in Euros has risen only 37%. In addition, when the dollar falls, investors tend to turn to commodities as a store of value. This situation may soon change. The Federal Reserve is sending strong signals that it is through cutting interest rates. Once the U.S. economy picks up strength, the dollar will likely stabilize. As for the fourth factor, the threat of supply disruption, these concerns are of course always there but it is certainly the case that security concerns in important oil producing regions are higher than in many past periods.

Apart from these fundamentals, many also blame speculators in commodity futures markets. Commodity futures became attractive investments with the slowdown of equity markets back in 2001. But the recent run-up shows signs of speculative behavior. For example, while annual Chinese demand for petroleum has increased 920 million barrels over the past 5 years, the increase in demand for petroleum futures almost matched that amount at 848 million barrels. And because commodity futures markets are fairly thin, prices are very sensitive to changes in demand. When futures prices rise, the effect is felt immediately in spot prices.

With their recent surge, oil prices are now above the previous peak reached in April 1980, even after adjusting for inflation. At that time, the cost to the U.S. economy of pricey oil was profound. However, the situation this time around is somewhat different. The economy is less energy-intensive, and we have not seen the supply-disruptions of the earlier period.

Continued on next page

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Where is oil headed next? The quick answer is that no one knows. Goldman Sachs has made the controversial prediction of 200 dpb oil within the next 24 months or so. The U.S. Energy Information Administration predicts prices to average nearly 110 dpb in 2008. A survey of oil and gas industry executives sees the price dropping below 100 dpb by the end of 2008. We share the view expressed in a recent publication of the The Federal Reserve of Dallas that oil prices above 100 dpb (in 2008 dollars) cannot be sustained. They argue that when you add expected additions of oil from unconventional sources, oil prices may recede to the 70 dpb range. We expect the prices to decline to 100 dpb by the 4th quarter and to fall to 90 dpb in 2009.

In the mean time, high oil prices are taking a heavy toll on the travel and tourism industry. A recent Rand McNally survey says two-thirds of Americans planning road trips this summer are either planning to shorten their trips or cancel them altogether. According to a survey by the Travel Industry Association, travelers have already reduced their demand for air travel by 41 million trips over the past year. In areas such as Las Vegas, occupancy rates are on the decline, as are room prices.

Equally worrisome to Hawai‘i is the impact of costly oil on airline capacity. Since the start of the year, eight airlines, including Aloha and ATA, have filed for bankruptcy and several others are on the verge of filing. The cheapest fares of major carries have doubled or tripled from last summer, and new fees such as luggage charges have been added. American, United and Continental have all announced significant reductions in their schedules, and thousands of jobs will be shed over the next year. Poor credit market conditions will make it more difficult than in the past for carriers to fly through bankruptcies. And once travelers get to their destinations, the high travel costs mean there will be much less to spend at the destination.

The bright spot in the tourism picture has been very strong arrivals growth of visitors from markets other than the U.S. and Japan. Arrivals from these markets were up 9% in the year through April, compared with a year earlier, supported by dollar weakness and relatively healthier foreign economies. In April, the share of these visitors rose to 18%, compared with last year's average of 12%. This will likely continue to be a strong market for the next few years at least.

Putting this all together, we expect arrivals to decline by more than 11% this year and to remain flat in 2009. Recovery will not begin until 2010. Because each cruise passenger spends just one day on island, the negative impact of the cruise ship departures on visitor days will be much smaller than the impact on arrivals. As a result, we expect a 4.2% drop in visitor days for Kaua‘i this year, with about a half-percent recovery in 2009. This decline is in line with the expected drop in visitor days statewide. While this represents a significant reduction in visitor activity, it is important to remember that this comes after two years of big visitor industry gains.

The average hotel occupancy rate last year of 75.5% was not substantially different from the previous two years, despite the strong growth in visitor days. In part this can be explained by the role of cruise visitors, with the rest perhaps attributable to the continuing growth of non-hotel accommodations. We do expect the occupancy rate to drift downward to 71% over the next two years because of weak non-cruise arrivals and the addition of new rooms to the accommodations pool.

The visitor pullback will have negative impacts across a broad swath of the Kaua‘i economy. The sectoral losses will vary, depending among other things on the extent of dependence on cruise business. Clearly vendors that have specifically targeted cruise passengers will experience much weaker demand this year than in the past several years. (In a few extreme cases, cruise business had come to represent 70–75% of business for some tour companies.) However, our discussions with a limited number of business leaders representing the retail, activities, and food service industries suggest that the adverse impacts are likely to be both less severe and more widely distributed than one might expect. One long-time observer noted that most businesses have treated cruise visitors like a "bonus," rather than making it a core part of their business plans. In part this reflects past experience with the coming and going of the American Hawaii Cruise lines, which left Hawaiian waters in 2001. For some businesses that have had wait lists in the past, non-cruise visitors are now being accommodated. Several indicated they were more concerned about the impacts of lost airline capacity, high oil prices and the generally poor conditions for travel and tourism.

The past two months have seen a marked, but not precipitous drop in spending, according to the local businesses we spoke with. One visitor-related retailer observed that sales began to fall off somewhat last year, but more noticeably in the past two months. Demand for activities has flattened out, with bigger concerns about the fall and winter when cruise travel is more important. One stabilizing factor is the opening of several new resort properties, including the Waipouli Beach Resort & Spa and the Westin Princeville Ocean Resort, and in coming years the completion of other resort properties at the Kauaʻi Lagoons, at Princeville, and in the Poʻipū area will also be helpful. Tourism-focused businesses are not the only enterprises seeing weaker sales. We hear reports that sales are down at some of the big-box retailers, as well.

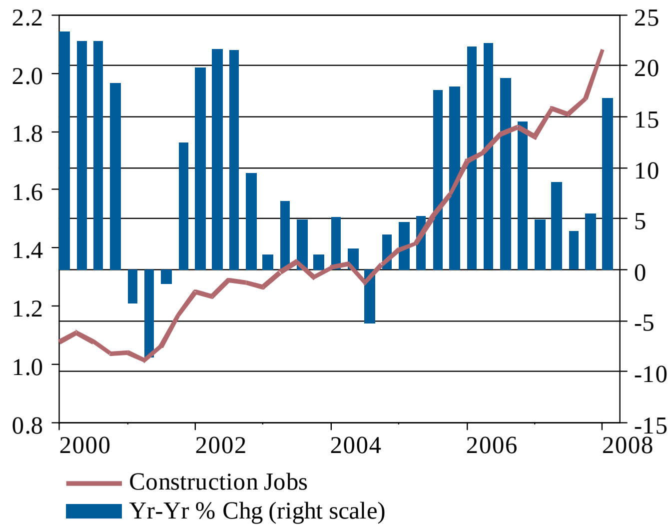
If things have held up relatively well so far, clearly business owners are worried about the impact of record oil prices on arrivals and spending. And this is squeezing them from the cost side as well. Among the several business persons we spoke with recently, more than one raised the issue of higher food, energy and health care costs and noted the difficulty they have in trying to pass these higher costs on to consumers. As a result, profits are getting squeezed.

Some job losses are likely to occur as a result of the visitor slowdown. Some businesses we spoke with said that they expected these losses to be modest and achieved primarily through attrition rather than layoffs, although at least one business owner anticipated broader job losses. We expect a greater-than-two percent drop in wholesale & retail trade jobs over the next two years. Job growth in the accommodations & food sector has continued at a healthy clip during the first part of this year, but we expect that to stall out, with a small net decline in jobs in 2009. Jobs in transportation and utilities will drop by more than 4% this year.

We have noted above the deceleration of overall payroll job growth that occurred over the course of 2007, a phenomenon shared by all counties. However, the number of Kauaʻi payroll jobs has continued to rise modestly, setting a new record at 31,060 on a seasonally-adjusted basis in March of this year. (There was a slight fall-back in April.) We expect job growth on an annual basis to slow to 0.2% this year, and to decline by a modest 0.3% in 2009, before beginning to recover in 2010.

This job growth performance is a far cry from the near-three-percent growth seen in 2006, but it is a bit better than the state as a whole, where we expect slight 0.2% net declines in non-farm jobs in both 2008 and 2009. One reason for this is the continuing strength of the Kauaʻi construction sector this year. Year-to date growth in construction jobs stands at 17%, compared with 3.8% statewide. We think construction jobs are peaking now, and that they will decline modestly over the next several years.

We have described above the wide range of residential, commercial and visitor plant projects that are underway on the island. Work continues on resort condo, hotel and time-share construction, notably at Kauaʻi Lagoons, at Kōloa Landing in Poʻipū, and at Princeville on the North Shore. Construction on a number of large resort residential projects above Poʻipū has been delayed by the lengthy building permits process. The key holdups have involved infrastructure, including the need to revamp the water master plan for the area. This work may be completed in the next few months, allowing backlogged building permits to be issued later this year or in early 2009. According to County and some industry sources, permitting values



Kaua'i Construction and Mining Jobs (seasonally adjusted)

on the island are likely to peak with these South Shore projects.[2]

Despite the high volume of current activity and of permitting for new construction, adverse developments in the national economy and financial markets are beginning to take a toll. Industry sources tell us that sales of time-share and resort residential properties have slowed sharply. Lenders are also requiring a higher proportion of up-front sales prior to originating construction financing. With slumping sales and more difficult financial market conditions, construction on some projects has ceased, with the builders simply working to sell off existing inventory. Weak conditions on the U.S. mainland and high travel costs will continue to be a drag on offshore sales going forward.

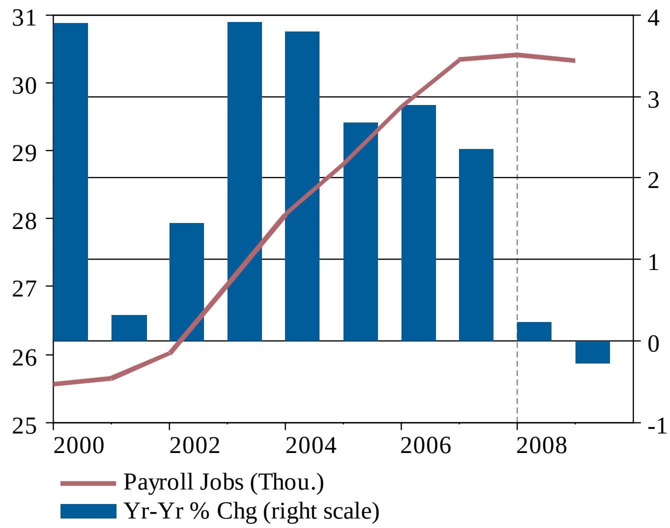
It appears that prospects are better for continuing construction by large property developers and relatively deep-pocketed national visitor accommodations chains. We expect construction to go forward on the major resort-centered time-share, condo and hotel projects that are now underway or where permits are expected soon. The same is true for A&B's long-delayed Kukui'Ula resort residential project near Po'ipū. Projects geared toward the local market are also expected to fair better, including some, such as planned Hawaiian Homelands developments, which have the benefit of public-sector financing.

There are reports that some construction workers have been idled recently or have resorted to lower-paying jobs, in some cases because of projects awaiting permit approvals. Still, the industry continues to face the challenge of maintaining an adequate workforce for the current high level of activity. There will be another up-tick in labor requirements when the remaining large Po'ipū area projects are permitted, probably late this year or early in 2009. Local construction firms hope to be able to tap workers from softening markets elsewhere in the state, and they are also focusing on workforce development.

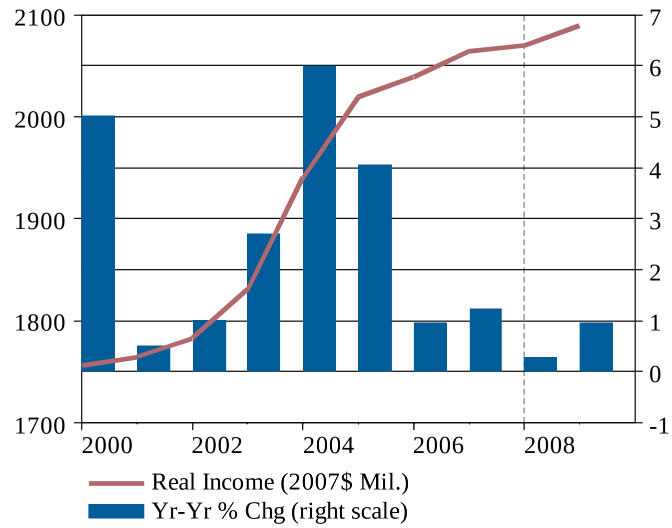
We expect the construction sector to grow by 8.5% in 2008 (growth that has already occurred) and to then begin a gradual decline, contracting by about 4% in 2009. We continue to expect a fairly modest construction adjustment, with the number of jobs remaining in the 1,900–2,000 range for the next few years. Because of the present fluid nature of housing and resort markets, there is the risk that a larger number of permitted projects will not be built, which would reduce activity somewhat below the levels we now expect.

In the related finance, insurance & real estate sector, job counts peaked in 2006 and have declined gradually as the home resale market has cooled. Modest further losses are expected over the next two years. Resales of single-family homes peaked at 699 in 2004 and fell by nearly half to 410 units last year. The drop in condominium resales has been even more pronounced, with volume just 42% of its 2006 peak last year. The home resale boom is clearly over, with volume now back at levels last seen in 1998. Median single-family home prices of $587,500 in the fourth quarter of last year were down more than 20% from their third-quarter 2006 peak. (They picked up to $672,500 in the first quarter of 2008, just 9% below the previous peak.)

[2] Even without these pending permits, residential permit values last year remained up in rarified air at a level of $268 million, compared with levels of $130–170 billion in 2002–2004 period. Unfortunately, Kaua'i County no longer reports non-residential permits, so we have less forward-looking information about this construction component.



Non-Farm Payroll Job Forecast, Kaua'i County



Real Personal Income Forecast, Kaua'i County

Looking at other large sectors, health care & social assistance has been flat for the past two years, but we expect some modest expansion in 2008. On the flip side, job growth in the large "other services" category, which among other things includes education, business, and professional services, will be nearly flat this year, down from almost 3% growth in 2007 and nearly 9% growth as recently as 2005. Because of fiscal pressures, government sector jobs will decline by about one percent this year.

Hawai'i's inflation picture has deteriorated over the past year, because of the sharp rise in oil prices. Although energy is a limited portion of local household budgets, the oil price surge will still be reflected in overall prices. We now expect Honolulu inflation of 5% this year, roughly the same inflation that we experienced in 2007. A partial retreat of oil prices from recent highs and continuing softening of the housing component will bring about a fairly rapid deceleration to 2.2% in 2009.[3]

County real personal income is reported with more than a year lag. Deflated by the Honolulu CPI, Kaua'i real income grew just 1% in 2006, according to recently-released data. This reflects in part the sharp unexpected spike in inflation that occurred in 2006. We estimate that income growth strengthened slightly to 1.2% in 2007. With broad slowing in jobs and general economic conditions, we expect real income growth to rise by just three-tenths of a percentage point this year, with relative strength in government transfer payments associated with the Federal stimulus offsetting a small net decline in real labor income. We expect aggregate real income growth to remain anemic in 2009, before returning to moderately expansion in 2010.

Forecast Risks

This forecast for Kaua'i County sees an end to the strong performance of recent years. Economic growth will be at a virtual standstill this year, with still-strong construction providing some support in the face of a deteriorating environment for tourism. Moderate growth is not expected to return until 2010.

As we noted in our recent state forecast, this year we also have outsized risks that the situation could deteriorate further than currently envisioned. It will surprise no one that high oil prices are at the top of the list. While we believe that they will eventually recede well below current levels, timing may be everything. The longer prices remain near current levels the broader

[3] Inflation statistics for Hawai'i are available only for the Honolulu metropolitan statistical area.

will be the impact on travel plans and the visitor industry. A separate but related issue is the solvency of major U.S. airlines. At some point, many carriers will work through their remaining cash holdings, and it is unclear how severely schedules would be chopped in a new round of bankruptcies. The complete loss of a major carrier would be a body blow to the Kaua‘i economy.

Large risks continue to exist in the housing and financial sectors. Foreclosure rates nationally continue to mount, in the first quarter rising to their highest levels since 1979. This suggests that we have not yet seen the worst of the fallout for financial institutions and the consumer’s pocketbook. A deep and long housing slump has the potential to cause a sharper downturn in economic activity in the important American visitor market. This would likely also raise the risks of a deeper construction adjustment in the islands.

At the same time, there is also some possibility that our forecast for Kaua‘i will turn out to be too pessimistic. Despite the anecdotal evidence of construction slowing, the sector’s continuing high measured job counts and the backlog of projects awaiting permits mean that job and income growth in the sector could be a bit stronger than reflected in our current forecast. Another promising hint of a possible positive surprise comes from the relatively good performance we continue to see in the mainland economy. The U.S. downturn so far has just not been as deep as many expected. And of course the best piece of good news would be a rapid retreat of oil prices back down below $100 per barrel. Oil prices movements are very difficult to forecast, and while markets are bullish on oil today, that could change in a heart beat.

TABLE 1: MAJOR ECONOMIC INDICATOR SUMMARY
KAUA‘I COUNTY FORECAST

	2005	2006	2007	2008	2009
Non-farm Jobs (Thou)	28.8	29.6	30.3	30.4	30.3
% Change	2.7	2.9	2.3	0.2	-0.3
Total Population (Thou)	62.1	62.7	62.9	63.4	63.9
% Change	1.1	0.9	0.4	0.7	0.8
Total Personal Income (Mil $)	1,820.0	1,944.9	2,064.5	2,174.5	2,243.5
% Change	8.0	6.9	6.1	5.3	3.2
Inflation Rate, Honolulu MSA (%)	3.8	5.8	4.9	5.0	2.2
Real Personal Income (Mil 2007$)	2,019.7	2,039.3	2,064.5	2,070.1	2,090.0
% Change	4.1	1.0	1.2	0.3	1.0
Real Per Capita Income (Thou 2007$)	32.5	32.5	32.8	32.7	32.7
% Change	2.9	0.0	0.8	-0.4	0.2
TOURISM SECTOR DETAIL					
Total Visitors (Thou)	1,090.1	1,203.3	1,271.4	1,123.3	1,122.3
% Change	6.8	10.4	5.7	-11.6	-0.1
U.S. Visitors (Thou)	928.0	1,028.5	1,084.9	943.8	924.0
% Change	8.5	10.8	5.5	-13.0	-2.1
Japanese Visitors (Thou)	43.7	33.6	34.9	27.3	29.3
% Change	-20.4	-23.1	3.8	-21.8	7.3
Other Visitors (Thou)	118.4	141.1	151.6	152.3	169.0
% Change	7.0	19.2	7.4	0.4	11.0
Avg. Length of Stay (Days)	6.6	6.4	6.3	6.8	6.9
Visitor Days (Thou Days)	7,172.8	7,693.0	7,997.1	7,659.3	7,706.1
% Change	2.3	7.3	4.0	-4.2	0.6
Occupancy Rate (%)	76.2	74.8	75.5	72.5	71.0
Total Room Stock (Thou)	8.2	8.0	8.2	8.4	8.6
% Change	1.4	-2.7	2.4	2.4	2.7

Note: Source is UHERO. Figures for 2008 – 2009 are forecasts. Figures for 2007 income are UHERO estimates.

TABLE 2: TOTAL NON-FARM JOBS BY DETAILED SECTOR
KAUA‘I COUNTY FORECAST

	2005	2006	2007	2008	2009
Total Non-farm Jobs (Thou)	28.8	29.6	30.3	30.4	30.3
% Change	2.7	2.9	2.3	0.2	-0.3
Agriculture	0.7	0.7	0.7	0.7	0.6
% Change	7.2	-5.6	-3.0	-3.6	-4.1
Construction and Mining	1.5	1.8	1.9	2.0	1.9
% Change	11.3	19.2	5.7	8.5	-4.1
Manufacturing	0.4	0.4	0.4	0.4	0.4
% Change	-4.0	1.1	0.0	-1.1	-4.1
Trade	4.5	4.6	4.7	4.7	4.6
% Change	0.8	0.7	3.4	-1.2	-1.0
Transportation and Utilities	1.5	1.6	1.6	1.5	1.5
% Change	-2.1	6.6	-0.5	-4.3	0.4
Finance, Insurance and Real Estate	1.2	1.2	1.2	1.2	1.2
% Change	3.9	1.7	-2.7	-2.1	-1.0
Services	15.5	15.8	16.2	16.3	16.4
% Change	3.9	2.0	2.8	0.7	0.2
Health Care and Soc. Assistance	2.2	2.2	2.2	2.2	2.3
% Change	2.5	0.0	0.4	1.2	1.5
Accommodation and Food	7.5	7.6	7.9	7.9	7.9
% Change	0.9	1.6	3.6	0.7	-0.4
Other	5.8	6.0	6.2	6.2	6.2
% Change	8.7	3.2	2.8	0.5	0.3
Government	4.2	4.3	4.3	4.3	4.3
% Change	-0.4	2.1	0.9	-1.0	1.0
Federal Government	0.5	0.5	0.6	0.5	0.6
% Change	0.0	1.7	8.2	-0.2	0.2
State and Local Government	3.7	3.8	3.8	3.7	3.8
% Change	-0.5	2.1	-0.1	-1.1	1.1

Note: Source is UHERO. Figures for 2008 – 2009 are forecasts.