

E C O N O M I C F O R E C A S T

First Hawaiian Bank

Kauai's Economy Remains Strong in 2007 Construction boom, tourism growth lead the way

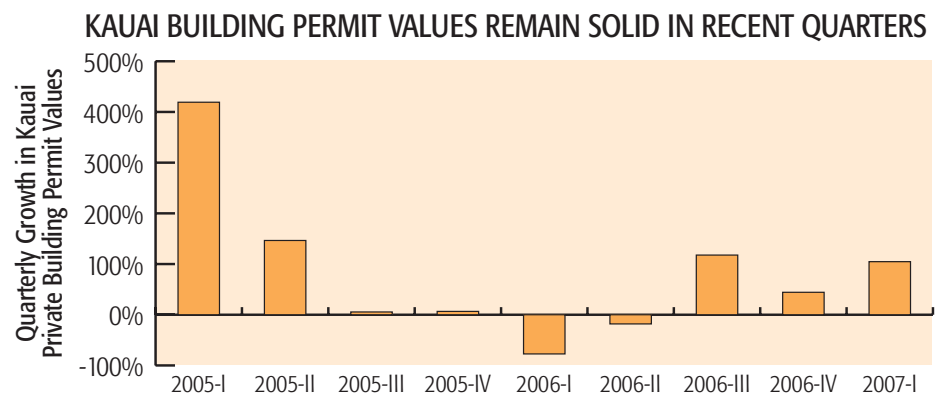
Despite a downturn in the housing market, the Kauai economy in 2007 remains strong — more heated than the rest of the state, where a slowdown is occurring. There has been a staggering explosion of Garden Island construction, building permits remain strong and the island leads the state in visitor arrival 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 hotels are apparent in projects on the island. The busiest 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 (320), Wainani (70 single-family), Kiahuna-Poipu Beach Estates (108 lots) and Poipu Beach Hotel (125 rooms.)

In addition, 1,500 units are planned in the Kukui'ula luxury development plus these others in the wings: Knudsen Estate's Village at Poipu (428 potential units), Kiahuna-Poipu Golf Resort (282) and 107,000 square feet at Poipu Town Center

On the east side, Kauai Lagoons development near Lihue includes Kalanipuu Condos (78 units), Ritz-Carlton Residences (14) and the Ritz-Carlton Club (28). Moving ahead with plans dormant for almost 20 years, the new owners of Kauai



Lagoons plan to spend \$1.5 billion to complete the expansion of the 327-acre property.

Just north of Kapaa, the planned Kealanani project is an agricultural sub-division with a mandate for actual agricultural activity on the lots. On additional plots, both taro and tea are planned.

Plans to enhance Princeville Resort are coming to fruition. In 2008, Princeville Hotel will be upgraded to become the first St. Regis Hotel in Hawaii. Princeville Shopping Center is undergoing a facelift and planning continues for the resort's remaining 7,000 acres of undeveloped land.

Also, on the North shore: single-family residential construction continues in Phase I of the Resort, and a new 36-lot Phase II has been created; Brookfield Homes is nearing completion of Nihilani condo; and Kaiulani has started delivering units in its upscale, 77-unit duplex development.

Though all of this is aimed at the off-shore

market, Kauai County continues its emphasis on affordable housing. Housing aimed at the local market is being planned on the South side by Alexander & Baldwin, such as 60 single-family gap range homes at Kealaulu. 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, signaling 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.

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Economic analysis by:

Dr. Leroy O. Laney Economics Consultant to First Hawaiian Bank, Professor of Economics & Finance, Hawaii Pacific University

Kauai's Economy Remains Strong (continued from page 1)



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've 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 down. This is not only inevitable, it's required for infrastructure to catch up and for slowly rising incomes to help bring affordability back.

Escalation in Kauai home prices has been phenomenal — 37% in 2004 and 28% in 2005. In 2006, the market began to soften with a 5.5% increase. In 2006, the median Kauai single family home price was \$675,000 — highest in the state except for Maui.

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Statewide Economy Still Expanding, But at a Slower Rate

The recent slowdown in Hawaii's statewide economy has several sources. The real estate sector has cooled, causing repercussions in residential construction, development planning, and even consumer spending as people feel their wealth growing more slowly.

Slightly higher interest rates have begun to have an effect, too, and Hawaii is also experiencing its second straight year of flat visitor growth, after a strong 2005. And Hawaii inflation has accelerated significantly in the past year or so.

Still, the labor market remains very tight, and Hawaii continues to have one of the lowest unemployment rates in the nation. But as we've pointed out in recent years, the inability of employers to find workers slows the economy also.

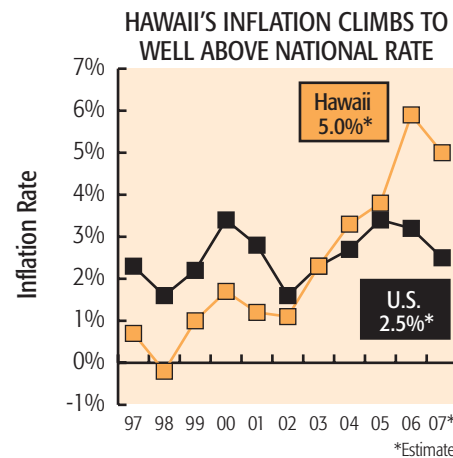
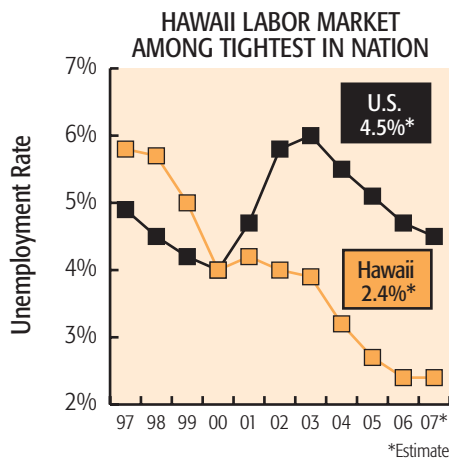
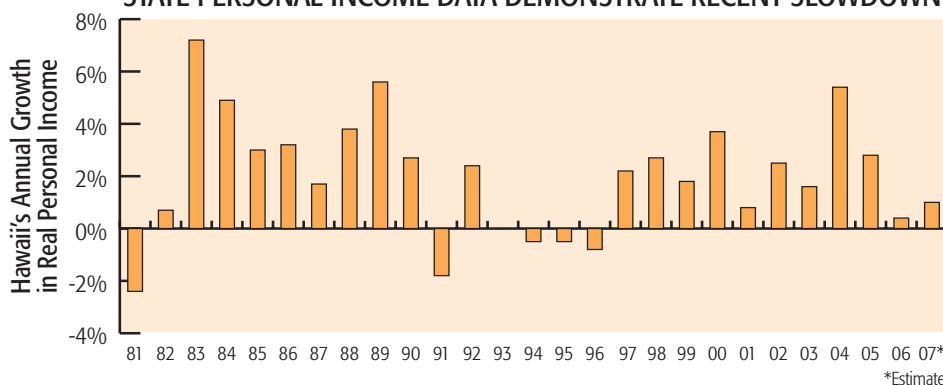
One frequently used aggregate measure of economic activity is inflation-adjusted personal income growth. As you can see in the chart at upper right, its growth fell noticeably in 2006, because skyrocketing Hawaii inflation took a bigger bite. In 2007, somewhat slower current dollar personal income and a continued high inflation rate — maybe just a little lower than the 2006 surge — could yield about 1.0% real growth.

But if that happens, Hawaii's current expansion will still total 11 years, two years longer than the last one that ended in the early 1990s.

Unemployment: Still No Relief on Labor Market Front

Despite a slowing economy, Hawaii has gotten no relief on the labor market front. Across all sectors of the economy, businesses still report worker scarcity at all levels, from entry to professional ranks. As the chart above shows, even though the national unemployment rate has fallen, Hawaii's jobless rate remains over two percentage points lower than the U.S. average.

STATE PERSONAL INCOME DATA DEMONSTRATE RECENT SLOWDOWN



Island Inflation Rate is High and Will Remain So

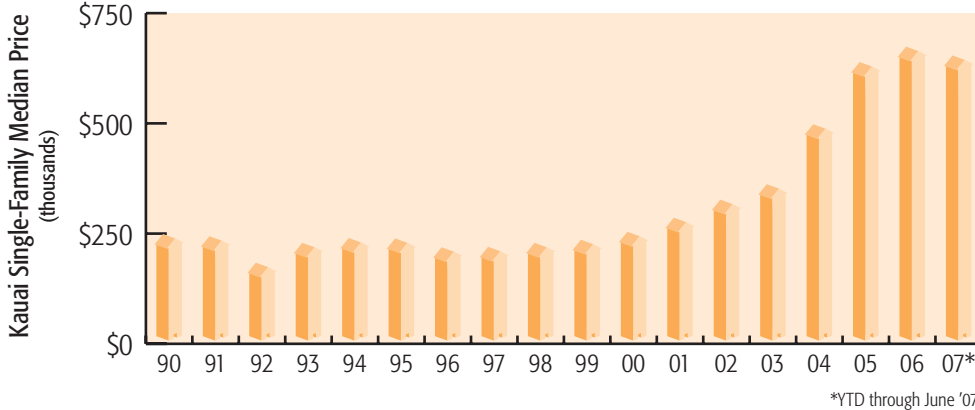
Boosted by energy and especially home prices, Hawaii's inflation rate has climbed very high. In 2006, the Honolulu Consumer Price Index rose almost 6%. We expect continued high inflation, because the recent rise in home prices feeds into the index slowly — as rents rise, leases are re-negotiated, and price pressures spill over into other parts of the economy. The chart above

illustrates that the Hawaii inflation rate was almost twice the national average in 2006, and we can expect more of the same in 2007.

That high inflation rate is going to make it harder in 2007 to achieve positive rates of "real" — or inflated-adjusted — growth. For example, 5.0% growth in personal income or business sales looks pretty good, until you realize that when you subtract 5.0% inflation it leaves 0% real growth.

Kauai's Economy Remains Strong (continued from page 2)

KAUAI MEDIAN HOUSING PRICES COOLING OFF SOMEWHAT IN 2007



However, year-to-date in 2007, prices are off about 3% and sales down 4%. That's less than a lot of areas in Hawaii, but is actually welcome because affordability is a serious issue on Kauai.

Once a cooling starts, it usually doesn't reverse in just one year, though there usually aren't sharp declines, just a plateau. (One caveat to the interpretation of real estate numbers for a place as small as Kauai: price data can be distorted by the mix of properties sold in a given year.)

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 1997, there was a decline of 11.6% in single-family home prices. Then the present run-up started — a staggering 205% rise from 1997 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%.

For builders, the new environment will mean more attention to pricing and more marketing. For buyers, it will mean more shopping for price and more motivation to buy to live in or rent rather than for quick turnover. For government officials, the challenge is to make intelligent decisions based on market forces rather than trying to fix the situation with perhaps well meaning but counter-productive policies.

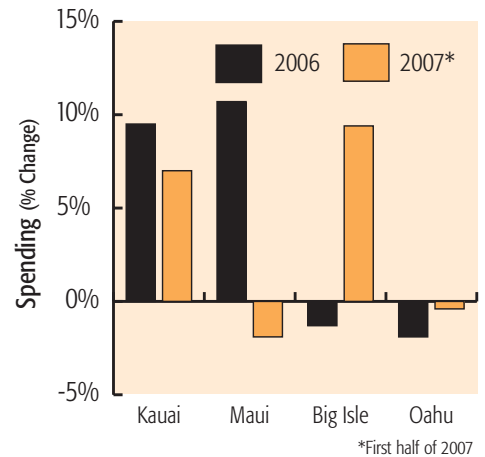
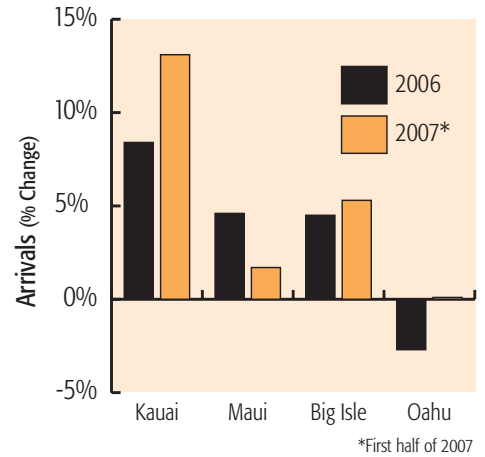
Kauai County Job Creation Remains Strong in 2007

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.

Kauai's Visitor Industry Leads State in Arrival Growth

In 2006, the Kauai visitor industry had a very good year, as the charts above right show. Kauai easily led all other counties in growth in total

KAUAI TOURISM LEADS THE STATE IN ARRIVAL GROWTH IN 2006 & 2007



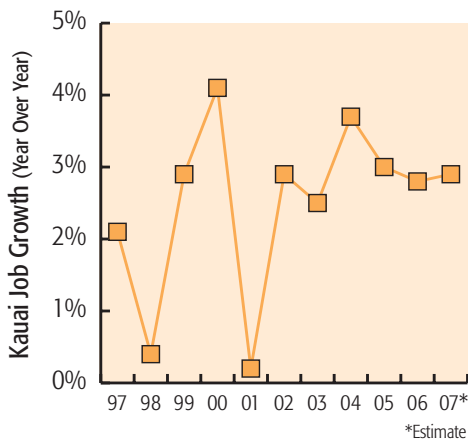
arrivals, a trend that continues in 2007, and ranked high in spending growth as well.

Non-stop flights have been added by ATA and Alaska Airlines, the first Alaska Airlines flight for Kauai and the first direct Seattle-Lihue flight. United will add its first Denver-Lihue flight in early 2008.

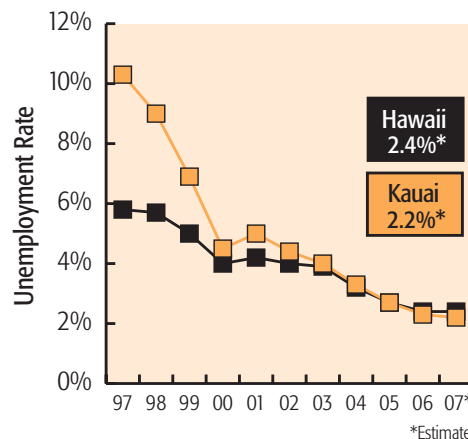
Agri-tourism is growing. Kauai Coffee continues its tours, Kauai Plantation Railway at Kilohana has a new agriculture-based ride through the country, and a new cacao farm above Kapaa offers a *Chocolate — From Branch to Bar* tour. One blow to Kauai agri-tourism was the closing of Guava Kai on the North Shore.

Independent vacation rentals are a more important part of the Kauai visitor plans, providing an experience far different from a hotel, condo, or time-share. However, the County Council has proposed limiting this market because of fears that it reduces housing for local residents. 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.

KAUAI'S JOB CREATION REMAINS REMARKABLY STRONG IN 2007



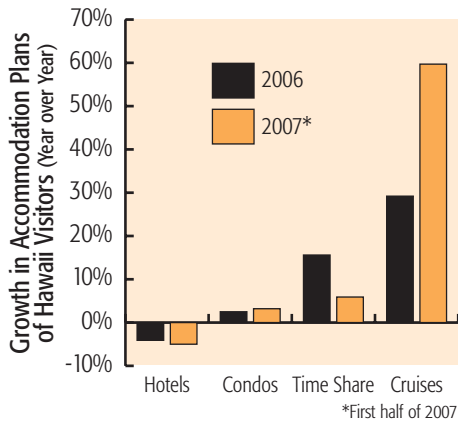
KAUAI'S LABOR MARKET TIGHTER THAN STATEWIDE MARKET



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Kauai's Economy Remains Strong (continued from page 3)

VISITOR INDUSTRY TRENDING TOWARD TIME-SHARE, CRUISE SHIPS



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 Hawaii* 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 Hawaii'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.

Nawiliwili Harbor now has to contend with another demand — the Superferry. How that will impact the economy remains to be seen.



Kauai Retail Market Faces Big-Box Store Controversy

Kauai retailing isn't without its controversy. In May 2007, the County Council unanimously passed an ordinance proposed by the mayor to ban any retail or wholesale establishment bigger than 75,000 square feet. Existing big-box stores, like Costco, are grandfathered. Wal-Mart, which wants to expand, has challenged the ban.

Never has there been a bigger split between consumers, who may benefit from the stores, and some smaller retail outlets that such stores hurt. The irony is that something that promises to reduce Kauai's high cost of living is disallowed.

Pacific Missile Range Is a Strong Economic Force

The Pacific Missile Range Facility's 850 people make it one of the island's bigger employers. Only 70 of these are active duty military, and only 130 others are government civilians. Most are local hires, long-term employees who remain even when the major contractors change.

Range employment is especially important because many of the jobs there are higher income, scarce on Kauai.

The Range is now actively testing the THAAD (Theater High Altitude Antimissile Defense) system. Recently the facility was upgraded as a command, more assurance that it will remain on Kauai.

The Kauai tech sector would be virtually non-existent without the Missile Range. There never has been a vacancy at the Waimea Tech Park, which houses a number of Missile Range contractors, and there are plans for a third phase for both offices and student training.

Kauai's Sugar Plantation Looks to Ethanol in Its Future

Kauai's remaining sugar operation, the 118-year-old Gay & Robinson, 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.

The plant is intended to produce up to 12 million gallons of ethanol annually, almost one-third of the state's ethanol needs. Plans are to break ground in early 2008.

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.

Also, diversified agriculture on Kauai is getting a new life:

- Ranching is currently the predominant use for former cane lands. A new County-funded weighing and loading facility for cattle was completed in Hanamaulu by the Kauai Cattlemen's Association.
- The County has received a 75-acre parcel in the Crater Hill area of Kilauea for an agricultural park as a result of a longstanding zoning condition. Work will begin shortly on developing the parcel.
- Work continues on re-opening the papaya disinfestation facility near the airport.

2008 U.S., Global Outlook: Different Year, Same Story?

By **Dr. Jack Suyderhoud** Professor of Business Economics, Shidler College of Business, University of Hawaii-Manoa

The U.S. and global economic forecast for 2008 looks very much like the one a year ago:

- Global economic growth remains good, especially in Asia.
- The U.S. economy is expected to do pretty well.
- Commodity prices are feeling the effects of the seven-year global economic expansion.
- Concerns about inflation are affecting both central bankers around the world and world financial markets.
- U.S. interest rates will not come down until the Federal Reserve is satisfied that U.S. growth has slowed and/or until their inflationary fears can be put to rest.

Global Economic Forecast: Average of About 5% for 2008

I expect global economic growth to continue in 2008 at around 5%, but that solid global average masks the variations across economies. The developed economies of the U.S., Europe and Japan will expand at substantially slower rates of 2 - 3%. While Japan's growth appears relatively anemic, it is reassuring that its economy is expected to be in the fifth year of slow-but-steady expansion.

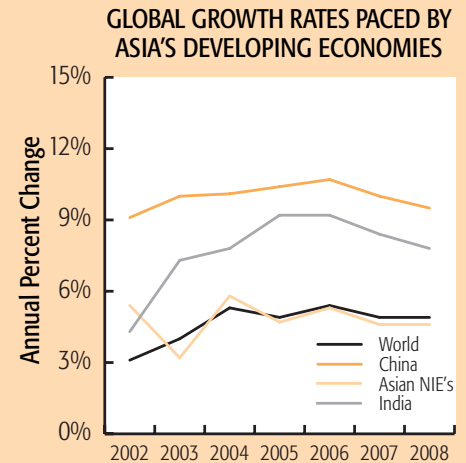
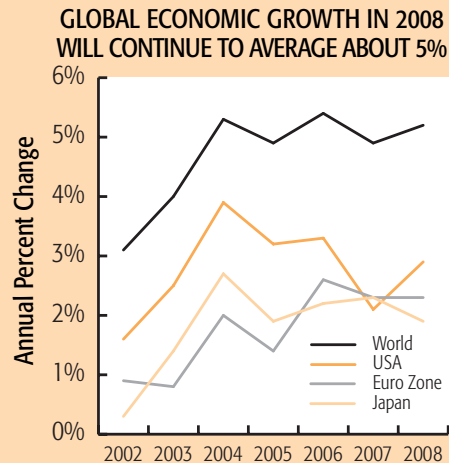
Not surprisingly, most of the global growth is occurring in the recently-developed and developing economies of Asia. China's growth is expected to be over 9% in 2008, with India not far behind, and Korea, Taiwan, Hong Kong and Singapore close to 5% real growth.

Increasing Oil Demand Paces Commodity Price Pressures

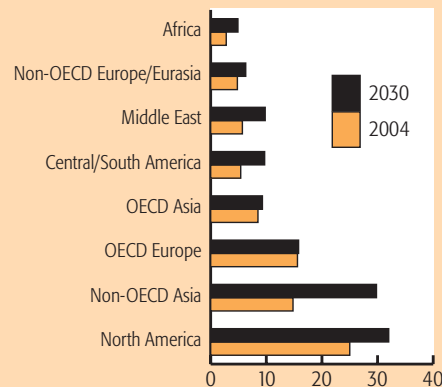
Strong growth has increased the demand for basic commodities including oil. Energy demand forecasts predict that nearly half of the increase in demand for oil up to 2030 will come from the developing economies of Asia (especially China and India).

However, the short-term outlook for gasoline prices is better. As shown in the chart at right, the U.S. Energy Information Agency expects oil prices to vary around the mid-\$60 range and gasoline prices to actually moderate somewhat in late 2007 and 2008 as refining output improves. Of course, this assumes no severe dislocations from political turmoil and extreme weather.

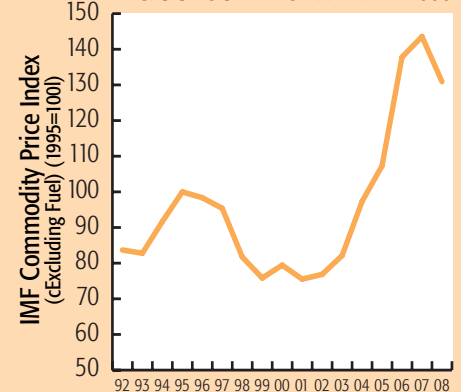
The impact of strong global demand is also being felt in the run-up in commodity prices for items such as foods and metals. The relationship



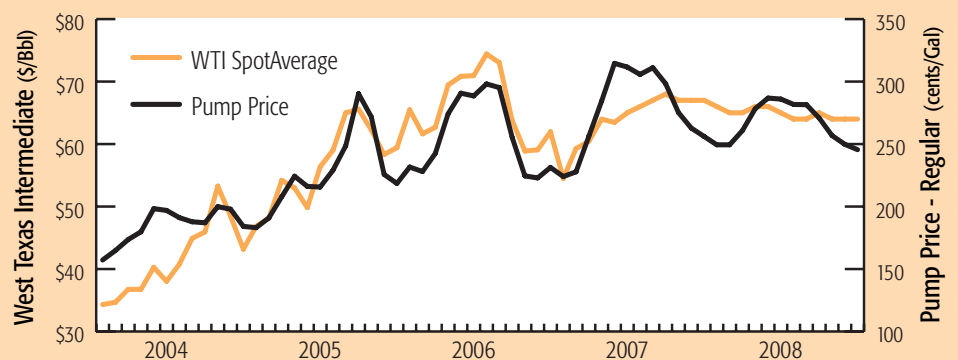
NEARLY HALF OF NEW OIL DEMAND WILL COME FROM DEVELOPING ASIA



RUN-UP IN GLOBAL COMMODITY PRICES SHOULD MODERATE IN 2008



GAS PRICES SHOULD MODERATE AS REFINING OUTPUT IMPROVES



between oil and food prices provides an interesting economics lesson. High oil prices have motivated public policies to substitute bio-fuels, including ethanol, increasing demand (and prices) for crops such as corn, and contributing to higher overall food prices.

U.S. Economy Expected To Be Stronger in 2008

U.S. economic growth is expected to be somewhat better in 2008, but the expected real GDP growth of 2.9% is not good enough to keep

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unemployment from rising slightly from the 4.6% average of 2007 to 4.8%.

Will inflation become an issue? As the chart at right shows, the Consumer Price Index shifted up in late 2006 but has been hard to gauge since then due to volatile food and energy prices. The so-called core inflation (excluding food and energy) has remained in the 2 – 2.5% range.

I believe that the Fed's actions not to lower interest rates in 2007 will help keep inflation at bay, in spite of the oil and food price patterns noted above. I think inflation will be modest in 2008, in the range of 2 – 3%.

I don't expect much of a change in interest rates in 2008. By the end of 2008, I predict that the yield on 10-year bonds will be a bit above the 3-month rate and thus the yield curve is expected to become a bit more normal at the short maturities.

International Aspects of the U.S. Economy

Part of the interest rate story relates to investment decisions of Asian central bankers who hold large amounts of U.S. dollar assets, either in cash or in U.S. government bonds.

Our need for foreign borrowing is caused by a lack of savings by U.S. households and businesses — and certainly the government doesn't save enough. However, the latter is improving. As shown at right, the U.S. budget deficit as a percent of GDP is now less than 2% of GDP — an improvement over time and in line with most countries.

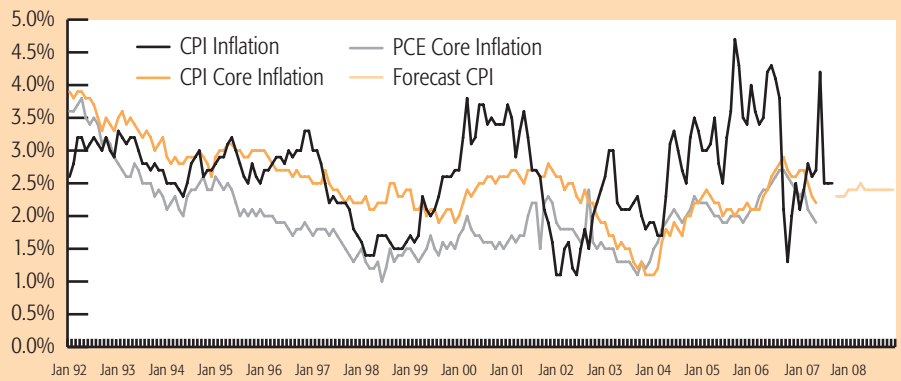
However, our current account (foreign trade) balance has improved only slightly. Our appetite for foreign products remains strong, financed by foreign lending to us or foreign purchases of our real and financial assets. We still borrow over \$2 billion per day from overseas. The trade deficit with China has deteriorated significantly.

Asian central banks (led by China) have used their trade surpluses with the U.S. to accumulate vast amounts of international reserves, evidence that these countries are keeping their currencies cheap to facilitate exports.

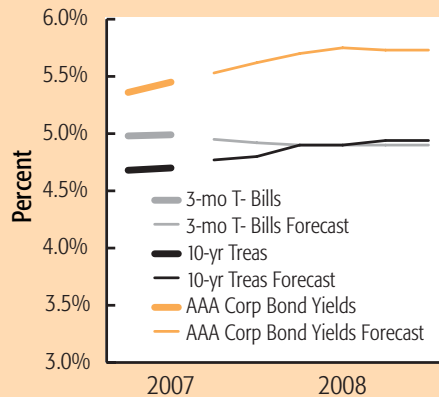
Given the large trade deficit and our relatively low interest rates (until two years ago), one would expect the value of the dollar to decline. As the figure at right shows, it has done so against the free-floating currencies such as the Euro. However, most analysts believe the Japanese yen should be stronger. China has only recently begun to allow the yuan to appreciate, but the extent of appreciation has been minimal.

Until the U.S. increases its savings rates and Asian economies allow their currencies to reflect fundamental economic forces, the U.S. will continue to run large current account deficits and be dependent on foreign capital.

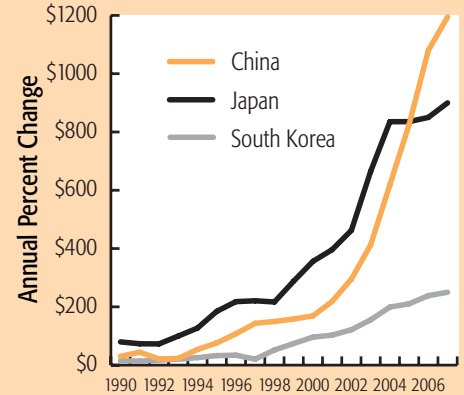
U.S. INFLATION RATE HAS BEEN HIGHLY VOLATILE SINCE 2006



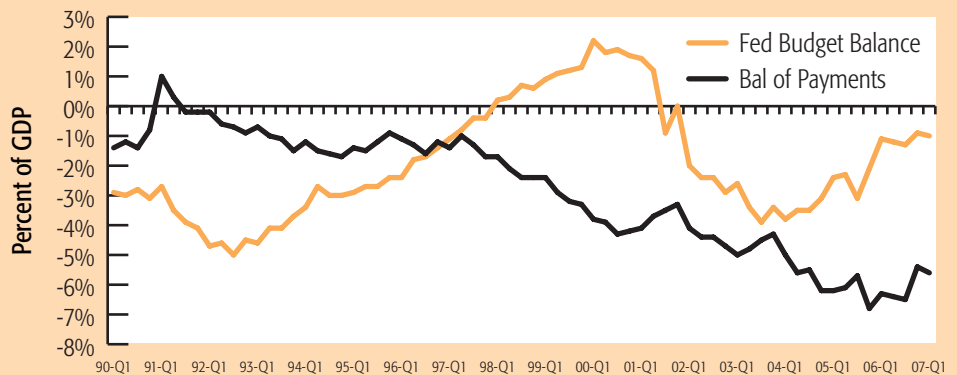
INTEREST RATE NOT MUCH CHANGE EXPECTED DURING 2008



CHINA LEADS THE WAY IN BUILDING INTERNATIONAL RESERVES



U.S. BALANCE OF TRADE LEVELS OFF, BUDGET GAP NARROWS



EXCHANGE RATE CHANGES VERSUS U.S. DOLLAR

