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Hawaii and the Pacific Basin

The following is adapted from a speech given by Robert T. Parry, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, on August 27, 1990, before the Pacific Rim Foundation in Hawaii.

Hawaii's performance in the second half of the 1980s was nothing short of outstanding. The pace of output growth exceeded the national pace every year after 1985, and in 1989, personal income was up nearly 11 percent over the prior year. Moreover, unemployment, which averaged over seven percent in the 1970s, was down to around 2½ percent last year. Such booming growth has led to income per capita in Hawaii that is higher than the average for the U.S. as a whole. In 1988, the latest year for which data are available, Hawaii's income per capita averaged nearly $17,000, compared to $16,444 for the U.S. (However, Hawaii's cost of living is also higher.)

Hawaii's economic performance is in large measure the result of its well-developed economic ties both to the U.S. mainland and the Asian Pacific Basin, notably Japan. This *Letter* reviews some of the features of Hawaii's economic growth in the 1980s, the implications of Hawaii's close economic links with Japan, and the prospects for closer ties with other economies in the Asian Pacific Basin.

Sources of growth

Several factors explain the staying power of Hawaii's economic expansion since the mid-1980s. First, there was rapid growth in Hawaiian exports of goods and services to the mainland United States and to foreign countries. As might be expected, the tourist sector led this expansion in export revenues. Revenues from visitors to the Islands rose more than 17 percent a year between 1985 and 1988, compared to 11 percent a year in the period from 1983 to 1985.

Exports of non-tourist services also grew steadily, in excess of seven percent annually. These services reflect strong growth in communications, business services, and professional services, notably in the legal and health sectors. The recovery in commodity export growth in the second half of the 1980s, after declines in commodity exports in the first half, also boosted export revenues. All told, revenues from exports (including revenues from the U.S. mainland) accounted for over half of Hawaii's nominal gross state product of $21.6 billion in 1988.

Hawaii also experienced a sharp increase in investment spending. In the mid- to late-1980s, investment in physical capital grew over 20 percent annually, led by construction expenditures. This boom in investment was a response to the rising demand for services, particularly in the tourist sector.

External financing

Non-Hawaiian capital has funded the lion's share of increased investment spending in Hawaii, and has also been associated with non-resident's purchases of Hawaiian real estate. This combination of externally-financed investment and the strong growth in Hawaii's export sector implies that Hawaii's growth in recent years has been fueled largely by the spending of non- Hawaiians.

Part of the increases in spending have come from the mainland United States and Western Europe, but the bulk has been from Japan. It is estimated that the rapid increase in Japanese tourist and investment spending accounted for nearly 50 percent of the growth in Hawaii's output in 1988.

Reflecting a sharp increase in Japanese travel abroad, Japanese tourist arrivals in Hawaii increased from around 700,000 in 1985 to 1.2 million in 1988. Although the precise amounts are uncertain, some sources estimate that these Japanese visitors spent over $500 a day, about five times as much as tourists from the mainland did.

In addition to increased tourism, the Japanese also stepped up the pace of their direct investment in Hawaii. At the end of 1987, the Japanese owned an estimated $2.5 billion in commercial property in Hawaii, or roughly 90 percent of total foreign-owned commercial property on the Islands. And in 1988, Japanese invested another $1.6 billion in Hawaii.

Japanese spending

Increased Japanese spending in Hawaii reflects a number of developments in Japan. First, Japan grew faster in the second half of the 1980s than did the other major OECD economies. Faster growth in Japan meant stronger demand for goods and services from abroad.

Second, from the beginning of 1985 to the end of 1988, the Japanese yen appreciated 106 percent against the dollar, from Yen 257 to Yen 125. This reduced the cost of foreign travel for Japanese residents, and made the acquisition of foreign assets relatively more attractive.

Third, in the last half of the 1980s, the Japanese government sought to stimulate domestic spending. These policies led to an acceleration in growth, and contributed to a boom in the Japanese stock market and in real estate values. Between 1985 and 1989, Japan's Nikkei stock index increased at a compound annual rate of 31 percent, up from 13 percent in the 1980-85 period. The annual rate of increase in land prices in urban areas accelerated to 7.5 percent in the second half of the 1980s, compared to 4.6 percent in the first half. The resulting increase in Japanese wealth stimulated Japanese spending abroad, to the benefit of Hawaii.

Clearly, then, developments in Japan have worked in Hawaii's favor in recent years. But Hawaii's dependence on Japanese spending raises some questions for the future. Specifically, what is the outlook for continued growth in Japanese spending in the Islands? And what does that mean for Hawaii's outlook?

The outlook for Japan

The outlook for Japan is generally favorable, although its economy is expected to slow for several reasons. For one thing, beginning in the late 1980s, Japan tightened its monetary policy in response to rising inflation. CPI inflation in Japan increased from a little over ½ percent in 1988, to 2¼ percent in 1989 and is likely to accelerate further in 1990, partly as a result of the runup in oil prices. To bring inflation under better control, the Japanese central bank, the Bank of Japan, has attempted to rein in investment spending and growth through higher interest rates.

In addition to the dampening effects that tighter monetary policy is having on Japanese growth, Japanese spending will tend to be curtailed by the reductions in Japanese purchasing power associated with the yen's 23 percent decline between November 1988 and April 1990 and the sharp decline in the Japanese stock market this year. Furthermore, because Japan is entirely dependent on imported oil for much of its energy needs, the sharp increase in oil prices resulting from Iraq's invasion of Kuwait also will tend to reduce Japanese spending.

The impact of oil price increases on Japanese economic activity should not be overstated, however. Following the first oil price shock in the early 1970s, Japan has improved the efficiency of its energy use. Indeed, Japanese per capita energy consumption in the mid-80s was about 40 percent that in the U.S. Partly as a result, it is likely that even if oil prices settle at a much higher level than the prices that prevailed prior to the invasion, the impact on Japanese GNP will be relatively limited. However, the short-run impact on inflation will be larger.

Other factors also will tend to limit the extent of the slowdown in Japanese spending. For example, planned increases in government investment spending will help to offset the contractionary influence of higher interest rates and reduced wealth. Moreover, hefty wage increases in the spring of this year will tend to boost consumer spending to some extent. Thus, although Japan's economy may not match 1989's five percent growth rate in 1990, it may remain one of the better performers among the industrial economies.

Implications for Hawaii

The slowdown in Japanese economic activity, and in particular, the weaker yen in late 1988 through early 1990, and the declining stock market will reduce Japanese spending in Hawaii. The availability of Japanese investment capital also is likely to be more limited in the months ahead, as Japanese current account surpluses have been falling. And even apart from developments in Japan, the slowing U.S. economy and rising oil prices will have a dampening effect on Hawaii's growth.

Nevertheless, there are some positive elements in the outlook that arise from Hawaii's strong economic ties to Japan. Even if the overall pace of Japanese tourism and foreign investment spending does slow, the huge investments already in place in the Islands will have a stabilizing influence on Hawaii's economy. Japanese firms owning property in Hawaii have a particularly strong incentive to direct Japanese spending to these Islands. And given the growing familiarity of Japanese visitors with Hawaii, the state may be able to offer an increasing range of personal and business services to the Japanese market.

In addition, Hawaii may be able to offset a decline in tourism by expanding its exports of goods and other services to Japan. Hawaiian commodity exports in recent years have been growing about 11 percent annually. Market reforms in Japan will continue to increase Japanese imports, opening an opportunity for Hawaii to exploit the Japanese market for specialty and luxury goods. Agricultural products are a natural starting point, but there may be opportunities in manufacturing, as well.

These considerations suggest that Hawaii's close ties to Japan may actually help stabilize the state's economic outlook in coming months. Over the longer term, Hawaii's close links with an economy as large and strong as Japan's will be conducive to stable growth and continued economic prosperity, particularly since Hawaii also enjoys the benefits of economic ties with the mainland United States.

Diversification

Hawaii can further buttress its economic performance by tapping new markets. One obvious candidate is Europe, where growth has been stimulated by the plan for economic union in 1992. The prospects for diversifying and strengthening Hawaii's economic ties with other economies in the Pacific Basin also are improving rapidly. Two of the so-called newly-industrializing economies, Singapore and Hong Kong, are now classified by the World Bank with the high-income industrial economies. In recent years, Hong Kong money has flowed into Hawaii, and may continue to do so if investment conditions remain attractive.

In South Korea and Taiwan, the progressive liberalization of foreign exchange controls and rapid increases in wealth have enhanced these potential sources of tourist revenue and investment funds. Furthermore, the combination of liberalized import restrictions on consumer luxury goods and government policies designed to stimulate domestic demand could open up potentially significant new markets for merchandise exports to these two economies.

Over the longer term, links also may be developed with the economies of Southeast Asia, particularly since there has been a marked shift in the locus of growth in the Pacific Basin region towards these economies.

Service-based growth

Hawaii's strong economic performance suggests that a service-based economy *can* support sustained increases in income. This should help alleviate concerns about the rapid development of the services sector on the U.S. mainland.

Hawaii's services-led growth was accomplished partly by developing close economic ties with Japan. Although some view dependence on foreign spending as a sign of economic vulnerability, Hawaii's example confirms that small open economies can achieve dramatic improvements in their living standards by exploiting close economic ties with large and stable economies. (This is also the lesson offered by the experience of the small open economies in the Asian Pacific Basin, which have achieved some of the fastest growth rates in the world, largely on account of their strong ties to large industrial economies.)

Although developments in the Middle East and the slowing U.S. economy are causes for concern, Hawaii's close economic links with Japan may help offset some of the adverse effects of recent developments in the world economy, and in the long-run, will continue to provide a basis for sustained growth. Hawaii can further strengthen its economic performance by expanding its economic ties with the rest of the Asian Pacific Basin, as well as with Europe.

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