

Economic Forecast

2009 GUAM-CNMI EDITION

Despite the Deep U.S. and Global Recession, Guam's Economy Stands Out as One Hopeful Spot

The deterioration of the U.S., Japanese, and Hawaii economies make Guam stand out as one of the few places in today's world that has a brighter economic future. Nonetheless, Guam has not escaped the fallout from the global economic deterioration.

The coming military buildup occupies center stage on Guam in 2009, just as it did in last year's First Hawaiian Bank economic report on the Territory. It is assured that the buildup will come, and parts of it are already underway, even though some uncertainty still exists as to the exact timing of the transfer of the III Marine Expeditionary Force from Okinawa, Japan.

The biggest changes since 2008 have come in the economic environment elsewhere. The island has felt the impact in its external investment and real estate sectors, and this is likely to continue to be the case. Also, Guam tourism has been impacted negatively over the past year. Declines in visitors from Japan and Korea, its two main markets, are signs of the hard times that now plague the world economy.

Over the longer haul, the military buildup will make Guam's economy more resilient, similar to other economies that have a significant federal spending component. Various industries in the private sector such as tourism and construction are always subject to some kind of cyclical variation. Tourism may be affected by exchange rates and economic cycles in visitors' own economies, for example. But the military provides an underpinning that is always there. Guam can be thankful for that.

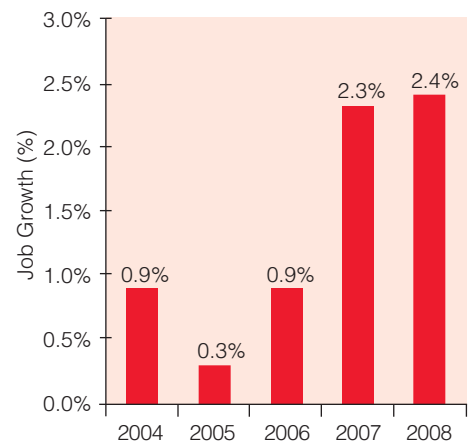


Guam Overall Economy Stable Over Last Year

Guam's overall macroeconomic performance has been about stable since early 2008. Job growth (total payroll employment) rose 2.4% in 2008, just barely above the pace of 2007. (See Chart 1.) Practically all of this job growth occurred in the private sector, which was up 3.2% for the year. Public sector jobs, which include both federal civilian jobs and the Government of Guam employees, were about flat. (Private sector jobs on Guam are about three times as large as public sector jobs.)

As in 2007, the fastest growing jobs category was construction, which added 18% more jobs on average in 2008 over 2007, on the heels of an even larger 26% growth in 2007. This growth occurred despite the imposition of a moratorium on all new construction development in central Guam, due to inadequate infrastructure.

CHART 1 • GUAM JOB GROWTH



The surge in construction jobs serves as evidence that the economy is already beginning to ramp up, even though the Marine transfer is not actually scheduled to begin until 2010. Much of the construction activity now underway is in some way directly or indirectly related to the military buildup, even though some of it is just in anticipation of it. Thus, Guam has construction activity to thank for its healthier job growth, which languished below 1% for several years before the military buildup was announced.

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ON THE INSIDE

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Guam Overall Economy Stable Over Last Year (continued from page 1)

Guam's inflation rate (Chart 2) also held in a steady range for 2008. Consumer price inflation registered 6.2% for the year, after a 6.8% pace in 2007. The increased economic activity does not yet seem to be causing extraordinary pressures on prices. The average range of inflation in the Guam economy is higher now than it was in the late 1990s and earlier this decade, when economic activity was anemic. (As mentioned in last year's report, higher inflation in both 2005 and 2006 was likely attributable to inconsistencies in measuring health care costs.)

As the military buildup continues and the Marine transfer actually gets underway, the economic growth rate on Guam will likely increase further. Along with that, higher inflation will likely occur also.

Guam Tourism Suffering In Both 2008 and 2009

Guam's total visitor arrivals (Chart 3) fell over 7% for 2008 after two years of approximately stable visitor arrivals. Total arrivals are somewhat misleading because Guam totals include the military. Its two major tourism markets, Japan and Korea, dropped 9% and 10%, respectively. That puts the island roughly on par with Hawaii, which saw a drop of almost 11% drop in total arrivals for 2008. Also like Hawaii, arrivals in Guam got worse as the year progressed, with the fourth quarter by far the weakest.

Also like Hawaii, higher energy prices raised the price of air travel to Guam in 2008. The fuel surcharge was higher over the summer, and it was raised again in October. But this surcharge was dropped in the spring of 2009, and it is expected to be gone by July 2009.

This year did not begin well for the Guam visitor industry, as downward trends continued. January 2009 data, released at the end of March, showed a

CHART 2 • GUAM CPI INFLATION

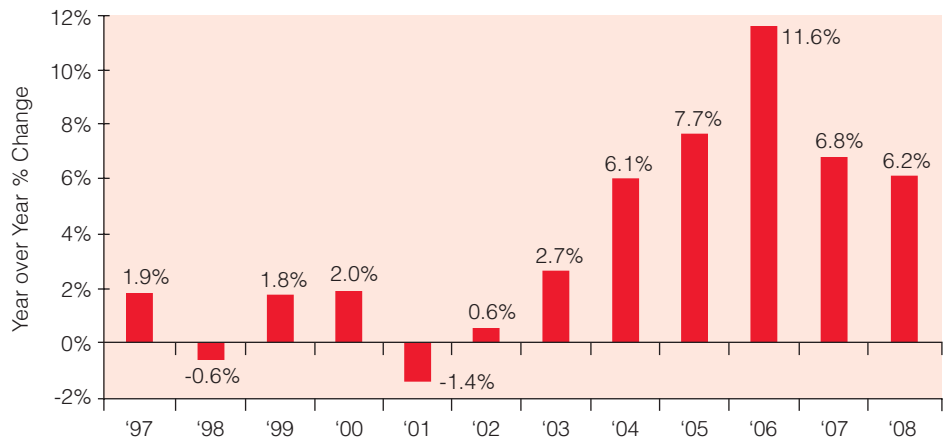
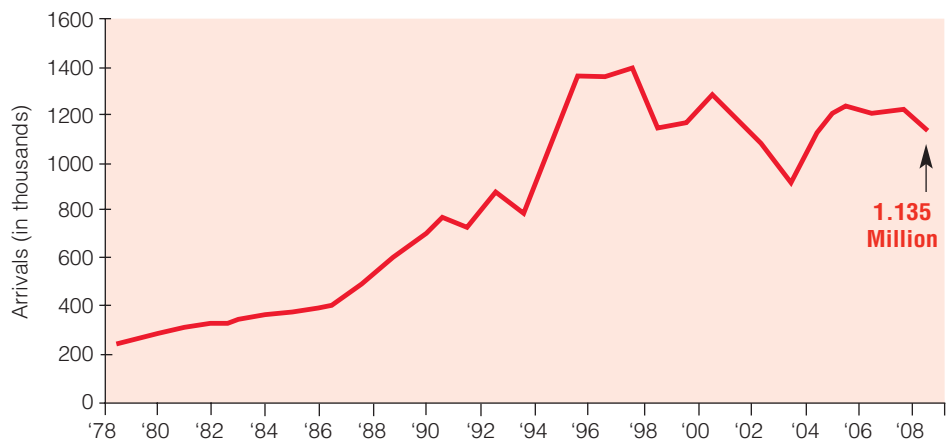


CHART 3 • TOTAL GUAM VISITOR ARRIVALS



“Higher fuel costs raised price of air travel to Guam.”

6% decline in visitors from Japan, while Korea arrivals fell 39%. Those declines were partially offset by a larger increase in arrivals from Taiwan, though those numbers are much smaller.

Previously, Guam enjoyed an exclusive, shorter Guam-only visa waiver for Korea, but now it does not have that comparative advantage because of the expanded program that went into effect for other U.S. areas in 2008. In our survey this year, however, local sources discounted this effect. The poor performance in the Korea market was attributed more to the exchange rate effects of the weak won.

CHART 4 • YEN/\$ EXCHANGE RATE

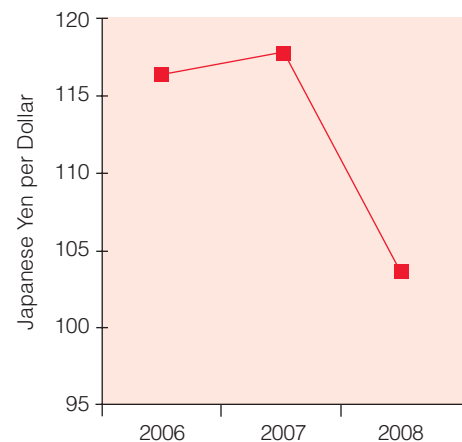
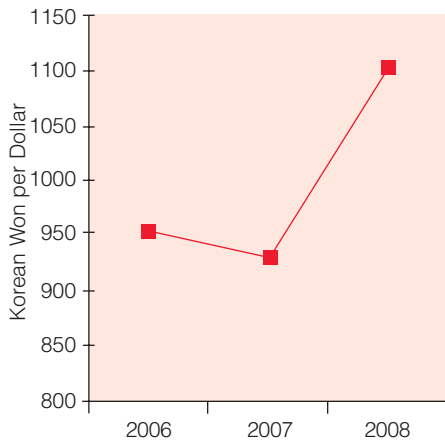


CHART 5 • WON/\$ EXCHANGE RATE



In fact, exchange rates played a large role in Guam tourism during 2008, and those effects will likely continue this year. About the only thing helping the Japan market for Guam in 2008 was a stronger yen (Chart 4). At the same time, Korean travelers to Guam were hurt as indicated by the weaker won/dollar exchange rate (Chart 5). But the stronger yen and the weaker won combined in recent experience to make Korea a much more attractive destination for Japanese outbound travelers, which hurts Guam with respect to the Japanese market. And another factor cited by industry sources this year is the fact that distribution channels in Japan appear to be promoting destinations that are closer to home.

Nonetheless, Guam has managed to retain its market share of about 5.4% of outbound Japan travelers in the past two fiscal years (ended in September). Other favorable signs are hotel occupancies that are about stable (Chart 6) on average and room rates that actually have been rising some (Chart 7).

Marketing strategies targeting higher-income and repeat Japanese visitors seem to be meeting with some success. The wedding market is also a growing segment of Guam's Japanese tourism. The Territory has grown to 24% of Japan's total overseas weddings, up from 10% just three years ago.

The visa waiver program now

CHART 6 • GUAM HOTEL OCCUPANCY

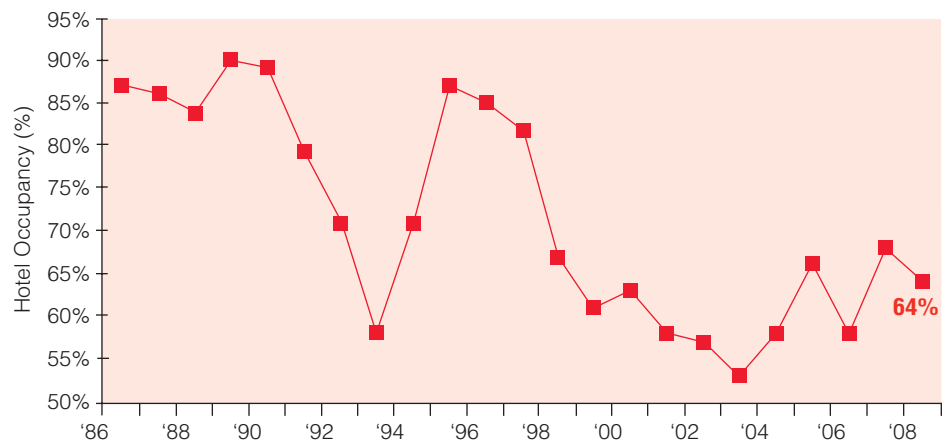
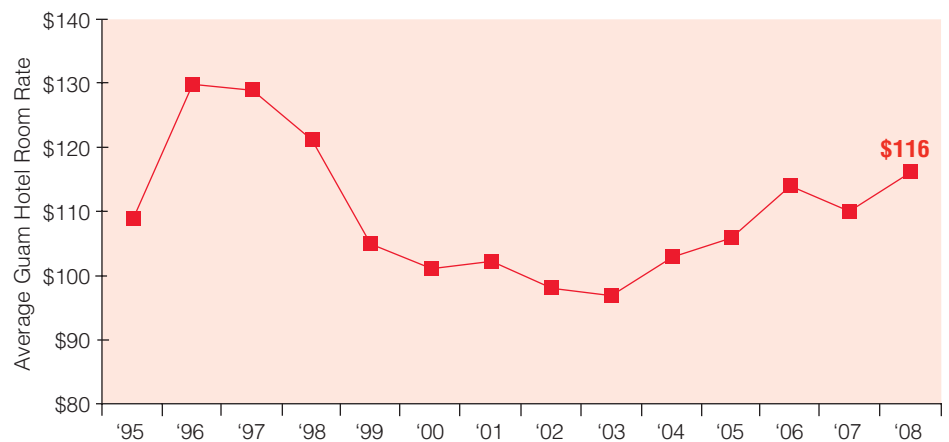


CHART 7 • GUAM HOTEL ROOM RATE



“Guam tourism industry targeting higher-income Chinese visitors.”

scheduled to be imposed by the U.S. Department of Homeland Security this year excludes China, which Guam hopes to cultivate as a new market. It was stressed among those interviewed this year that there is a strategic need to work on this aspect of the visa waiver program. Failing that, at least an expedited visa granting system needs to be developed.

As mentioned in last year's report, Guam wants to target a particular kind of China visitor — those with higher incomes, and more seasoned travelers. But with shrinking outbound travel in

Japan, combined with reduced airlift, there is a need for Guam to cultivate new markets. This new visa waiver program applies to both Guam and the CNMI, and it hurts the CNMI more than Guam. The two destinations together requested a delay in the imposition of that visa waiver program.

Other points made by those interviewed this year included a need to develop a unified brand image for Guam. Efforts that go beyond marketing are needed, including cleaning up the local scene — e.g. erasing graffiti and cutting the grass. In the early days, for example, most of Guam's Japanese visitors had never traveled abroad. Now they have seen other places and have higher standards.

Military Buildup Is Main Engine Driving Growth

The anticipated military buildup obviously continues to be the main engine driving current Guam economic activity. The official time frame continues to concentrate on the 2010-2014 period. Skepticism remains about both ends of that time frame, however — whether it will actually begin in 2010, and if so whether it can be completed by 2014.

Some of this skepticism prevails even among higher ranking military personnel involved. (Admiral Timothy Keating, Commander of the U.S. Pacific Command in Hawaii, was quoted recently by Reuters as saying: “We are behind a timeline to achieve that goal of 8,000 (Marines) down to Guam, and we don’t have enough money to make it happen right now, . . . I don’t think it will happen on time. I think it will be more expensive. . . . A case can be made that a more measured, longer term approach. . . could be beneficial.” He partially retracted these words later.)

Some slippage in timing, and spreading out of the buildup activity over a longer period, could actually be better for the Guam economy. There will be plenty of growth even if it is spread out, and doing so may avoid some bottlenecks and inflationary pressures. Less workforce housing would also be required, if somewhat fewer workers are on-island at the same time. (Contractors will be expected to provide housing for the workers they require, but discussions are underway to make this housing amenable for other uses on Guam once the buildup is complete.)

One recent development of significance occurred in February when Secretary of State Hillary Clinton, on the first stop of her first overseas trip, signed the Guam International Agreement with Japanese Foreign Minister Hirofumi Nakasone in Tokyo. The agreement gave greater certainty to the relocation of the 8,000 Marines from Okinawa to Guam. For the present Japanese administration, the agreement

was held as proof positive of a close-knit defense relationship between the two nations. In Clinton’s words, it “reflects the commitment we have to modernizing our military posture in the Pacific.”

Under terms of the agreement, Japan is to provide \$6.1 billion of the now estimated \$10.3 billion total cost of the move, including housing construction and other infrastructure.

“Funding for military moves to Guam is controversial in Japan.”

The transfer does depend, however, on Japan making “tangible progress” on moving the operations of the Marine Corps’ Futenma Air Station to a new facility to be built at the existing Camp Schwab on the northeast coast of Okinawa. And there are environmental concerns involved there. Two runways are to be built on an area that is home to rare flora and fauna, including coral reefs and protected dugong sea cows.

It should be noted that the transfer plan remains controversial in Japan, and funding it may be an obstacle to the project being implemented by the 2014 deadline. The opposition party will likely take a hard look at any agreements if they gain power, which could happen in a general election that must be called by October.

Another stepping stone in the process is the required Environmental Impact Study for Guam. A draft inviting public comments is expected to be set forth in June 2009 with a final Record of Decision targeted for January 2010.

The phrase “military buildup” is often associated only with the Marine relocation. That alone is big enough. Consider the implications of adding 8,000 military personnel and 9,000 dependents — 17,000 in all — to an island where the existing population is only about 170,000. Adding 10% to any population has huge economic and infrastructure consequences.

But the Marine transfer is not the only aspect involved for Guam. The Navy and the Air Force are also part of it, and much of that is already underway. The Navy is in the process of improving its harbor facilities to accommodate newer and larger submarines and supply ships, as well as visiting aircraft carriers.

Matson and Horizon Lines chipped in to purchase three refurbished Hitachi gantry cranes for the harbor. Matson and Horizon will also provide operators for testing and training. These cranes will enable the port to handle more cargo and through-put of containers, more easily meeting customer demands, maintaining inventory levels, and keeping vessels on time. All this is necessary because of the vastly increased volume of material that the port must handle in the buildup.

The Air Force has already established a very large fuel storage capacity at Andersen Air Force Base, and is constructing facilities to house and support its most sophisticated aircraft. Four B2 bombers are there all year now, for example. A new runway is also under construction at Andersen, the second to be completed there. These runways are critically important for all forces on Guam.

Another addition to the Andersen arsenal is the expected early 2010 arrival of the RQ-4A Global Hawk. This is a state-of-the-art high altitude, long endurance, unmanned aerial reconnaissance aircraft that can cover large geographic areas. This aircraft has civilian as well as military applications — such as reconnaissance of hurricanes, earthquakes, and other natural disasters.

So the Guam military buildup has actually begun before the announced 2010 starting date. The Navy has been designated to play the central role in managing all this under the military’s new joint basing arrangement, which is expected to contribute to greater economic efficiency.

An Army contingent to defend all of this has also been planned. But that will not occur until near the far end of the buildup.

One fact frequently forgotten is how much more costly such a buildup is in an isolated island location like Guam. (One military estimate is that something that would cost \$1 to build on the U.S. Mainland on average costs \$2.64 on Guam.) But military sources emphasize that 50-year decisions are now being made on Guam, to underpin 50 years of growth.

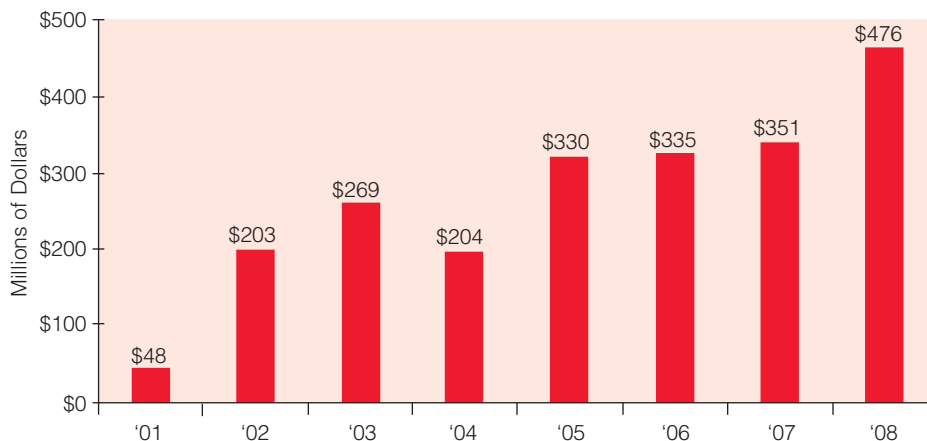
The challenges and hurdles to impending growth discussed in detail in last year's report loom as large as ever. These include not just port facilities but other infrastructure challenges in the areas of power, water and waste water, solid waste disposal, labor shortages (where workers will come from and where they will be housed), transportation, telecommunications, health and social services, and environmental challenges.

“Guam’s government faces fiscal challenges due to military plans.”

Local government is not fiscally prepared to do its part. That would be the case for any local government in face of such demands. An example of the fiscal constraints facing the Government of Guam came in March 2009, when the District Court of Guam ordered government to catch up with required payments of \$1 million a week toward a sorely needed new landfill. Government did not challenge the order, but announced that payments for other services and tax refunds would suffer as a result.

Certain Federal funds can be counted upon. For example, \$50 million in Department of Defense money has been included in the 2010 budget for roads, specifically Marine Corps Drive. This artery that runs from the port to the site of future Marine housing construction is critical. As well, Guam military contracts awarded continued to rise markedly in FY 2008. (See Chart 8.)

CHART 8 • GUAM MILITARY CONTRACTS AWARDED



There is also money for Guam in the American Recovery and Reinvestment Act, the stimulus package passed by Congress. It will receive more than \$44 million for repair and modernization projects at its Navy and Air Force bases, including the Naval Hospital. That funding is separate from the military buildup itself. The biggest chunk of this funding, \$29 million, will go to Andersen for more than a dozen projects — including runways, roofs, roads, and water tanks. These projects were selected on the basis of operational need and the ability to execute quickly. Outside the military, another \$20 million in the stimulus package has been set aside for energy efficiency programs on Guam.

As the military buildup goes on, part of the expected labor shortage can be met by the growing number of military dependents. In this regard, a Presidential Executive Order signed September 25, 2008 will help. This order authorized certain noncompetitive appointments in the federal civil service for spouses of various members of the Armed Forces being relocated to Guam.

Central Guam Moratorium Affects Construction Industry

One of the most significant things affecting residential building activity on Guam in the past year concerns a moratorium on building in the central part of the island. This was based on inadequate infrastructure, specifically a

lack of water and inability to dispose of sewage. It was imposed last spring, but removed on April 1, 2009, which could stimulate new building. The moratorium creates uncertainty, in that other such moratoriums, perhaps based on something else next time, can be imposed in the future.

A great deal of commercial construction is now underway at the Guam commercial airport. A second runway is under construction there, for example. It is hoped that this may eventually provide greater access to other Asian tourism markets. In addition, a freight distribution center that adds to warehouse space has recently been completed.

Evidence of strong construction activity on Guam already can be seen in the growth in construction jobs. This job category grew 26% in 2007 and 18% in 2008, as discussed in the section above on overall economic growth. This sector will undoubtedly be the leading edge of growth on Guam for the next several years at least.

Guam’s construction industry must be prepared for a significant ramp-up when the military buildup does actually start. This means training programs, and planning with respect to where the needed workers will come from.

Guam Real Estate Doing OK Compared to Other U.S. Areas

Compared to many other U.S. areas, Guam real estate in 2008 was not affected nearly as much by global credit market and liquidity problems, but it did feel some of the tremors. Single-family transactions were down 8.4% for the year, and condo transactions were off a much larger 37.4%. Median prices held firm, however. Single-family prices were up 9.2%, and condo prices dropped only 3.3%. (That came after price increases of about 20% for both in 2007.)

A cooling in the market accelerated toward the end of 2008. Overall, total dollar volume declined 52% in the fourth quarter from a year earlier, a trend that did not bode well for 2009. Most of this decline reflected an absence of offshore investment, which in turn was related to the financial meltdown. Local demand held up relatively better, but the external side will almost certainly continue to suffer from the lack of financing and investment uncertainty. The building moratorium mentioned above also affected 2008 real estate volume.

Local projections are for a continued shrinkage in volume in 2009, especially in the first half of the year, but at nothing like the rate of the 2008 decline. This may create a window of opportunity for buyers. Some recovery in the 2009 market may be driven by extremely low interest rates, limited price declines, and the expected ramp-up in military activity.

A bottoming out seems unlikely in a market that has seen an increase in the median price of a single-family house of 87% since 2003 — including 13% in 2006, 19% in 2007, and 9% in 2008. But the price trends on Guam continue to oppose the hardest hit U.S. Mainland markets. The dominant force continues to be anticipation of the military buildup, and investment is occurring even if the timeline of that buildup slips.

CHART 9 • GUAM REAL ESTATE TRANSACTIONS

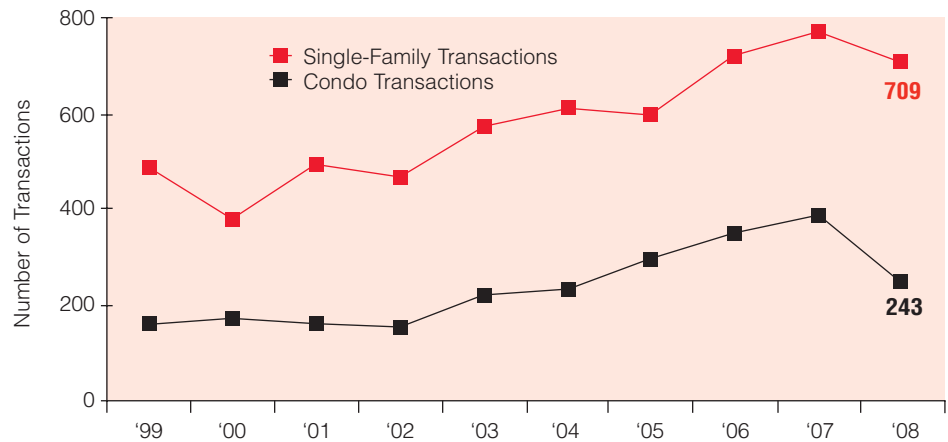
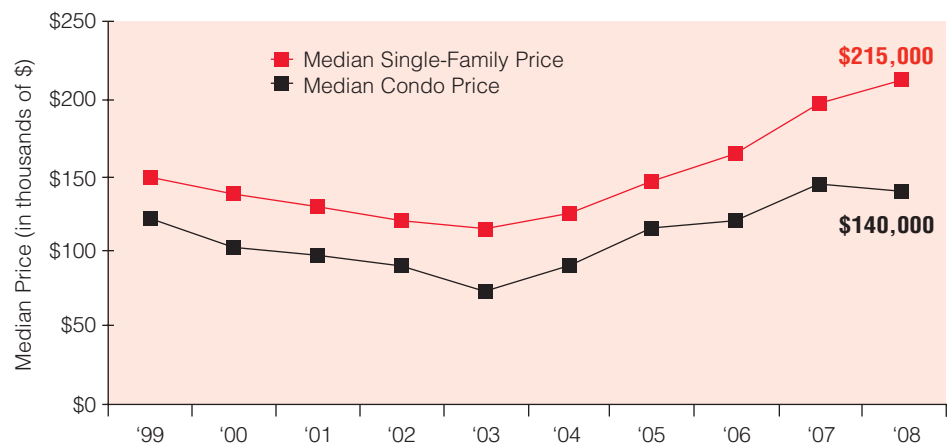


CHART 10 • GUAM REAL ESTATE: MEDIAN PRICES



If the Guam real estate market does slow in 2009, there will still be more activity than there was during the 2002-2004 downturn. The projected surge in economic activity and population places Guam real estate on a long-term growth trend, and the military buildup significantly reduces risk regardless of the exact time frame over which it will occur.

A prevailing sentiment that the buildup will be delayed by one or two years already seems to have been factored into the market. So if the initial timelines happen to be met, market conditions might improve. But appraisers interviewed this year expect residential real estate prices to soften as 2009 progresses. Sellers will not likely be holding out for higher prices.

Local observers also note disparities in the mix of properties sold in 2008. Some of the larger and more expensive projects have not sold as hoped, and some buyers in that range have been cancelling. These are out of the price range for military personnel, and the initial enthusiasm to build in that higher range has cooled. More moderately priced homes sold more quickly, and part of the demand for these derives from the potential for resale in the future to military families.

In nonresidential real estate, there has not been much activity on the industrial side. But on the commercial side, several larger properties have been the subject of transactions, something of an improvement over 2008.

CNMI Economic Outlook in 2009: Going from Bleak to Bleaker

Last year's economic report on the economy of Guam's neighbor, the Commonwealth of the Northern Marianas (CNMI), painted a bleak picture. This year, if anything, the situation is worse.

Negative impacts of the federalization program described in our 2008 report have aggravated the situation. The CNMI garment industry is now gone entirely. The gradual imposition of a U.S. minimum wage means that an economy that once survived on low wages must find some other means of support.

“Desperate economy must reinvent itself, but possibilities are elusive.”

Emerging markets for CNMI tourism will be impacted negatively by the exclusion of both China and Russia from the federal visa waiver program scheduled for late 2009. The recent postponement of the federalization program to a later date in 2009 amounts to little more than a stay of execution for the beleaguered CNMI economy.

Also, there has been no progress on the issue of land tenure in Article XII of the CNMI Constitution restricting land ownership to those of Northern Marianas descent. That means outside investors have little incentive for new investment or the maintenance of existing investments that approach the 55-year lease limit for those not included under these restrictions. It seems the now desperate CNMI economy must, now more than ever, find some way to reinvent itself. And the possibilities for this are increasingly slim.

A Longer-Term Look at the History of the CNMI

It might be useful to take a longer-term look at the CNMI before summarizing its present economic condition.

Spain took possession of the entire archipelago in 1565 and ruled it for more than 300 years. Even today, there is a strong Spanish cultural heritage in both Guam and the CNMI. The United States took possession of Guam following the Spanish-American War in 1898; at about the same time, the rest of the Northern Marianas chain was sold to Germany, which concentrated on the production of copra, a source of coconut oil.

Japan then took possession of the Northern Marianas at the beginning of World War I in 1914. The Japanese developed Saipan for sugar production and processing. By the outbreak of World War II in 1941, the population of Saipan was over 80,000 — including Japanese military and foreign workers from Okinawa and Korea.

After World War II, the Northern Marianas became part of the United Nations' Trust Territory of the Pacific Islands, administered by the United States. The U.S. military was in charge until 1961, when the Department of the Interior took over. Until 1977, the Marianas generally were not permitted to develop the economy through tourism or foreign investment.

In 1976, the U.S. Congress approved a mutually negotiated Covenant that joined the U.S. and the Northern Marianas in a political union. That Covenant was not fully implemented until 1986, when U.S. citizenship was conferred upon legally qualified CNMI residents. Under the Covenant, the CNMI was permitted to control its own minimum wage and immigration system, but the U.S. government reserved the right to impose the federal minimum wage and federal immigration laws in the future. And that is what is happening now.

New U.S. Wage Laws Will Shrink the CNMI Population

Earlier, it was expected that — after June 1, 2009 — foreign workers whose contracts expire were to be subject to U.S. immigration law, but a brief reprieve was granted until November 28, 2009. The CNMI minimum wage also will be raised in annual increments of \$0.50, in May of each year, until it reaches the federal level. Because the CNMI has survived on low wage labor, this will have a debilitating effect on its economy.

The CNMI is likely to see substantial population shrinkage; about 30% of the population is immigrant labor, many of whom will not qualify under the new rules. And with significant economic growth now expected on neighboring Guam, even many local residents may leave to seek employment where the jobs are.

“CNMI's minimum wage will gradually rise to U.S. federal level.”

Mainstay Garment Industry Now Totally Out of Business

The CNMI economy has been suffering in recent years anyway because of a massive contraction in what formerly was one of its major sectors, the garment industry. The garment industry began its inevitable decline several years ago when new trade rules removed tariffs and quotas on textile imports into the United States from other sources, encouraging firms to leave for locations with even cheaper labor.

In March 2009, the last garment plant closed for good. Thus, what was once a \$1 billion industry with 34 factories — producing clothing for brands such as Tommy Hilfiger, Calvin

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Mainstay Garment Industry Now Totally Out of Business

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Klein, Gap, Levi's, Abercrombie & Fitch, Polo Ralph Lauren, Ann Taylor, and Liz Claiborne — ceased to exist. The last user fee collected by the CNMI government came in February 2009 with only \$746, down from about \$3 million a month in the days before the industry started shrinking. (The garment industry was controversial and attracted attention because the products often included a "Made in USA" label.)

Retail stores, other commercial buildings, and housing complexes for workers now stand vacant. Most of the foreign workers have returned to Thailand, China, and the Philippines.

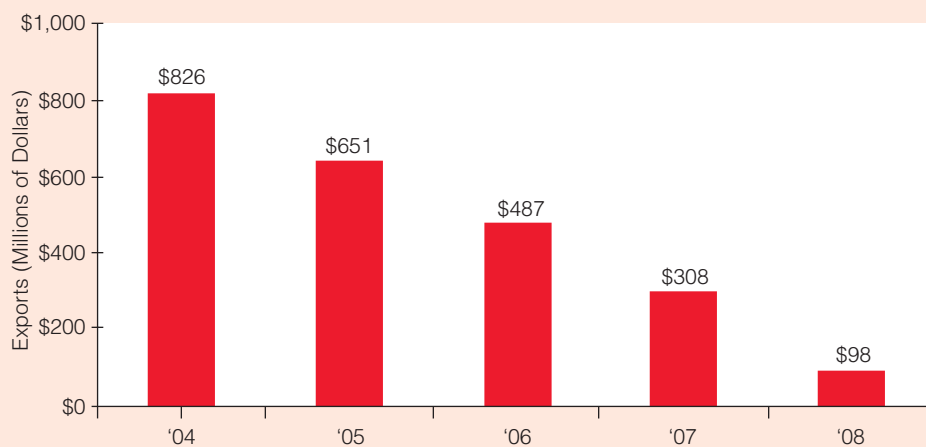
Tourism Industry Suffering From Fewer Flights, Visitors

Without the garment industry, the CNMI economy now relies solely on tourism. And that industry is in trouble also due to fewer flights, declining tourists, and global economic turmoil.

Actually, for 2008, visitor arrivals increased, something of a rarity among travel destinations in these times. Total CNMI arrivals grew 2.0%, with Japan up 6.6% and Korea up 2.6%, thanks to increased air seats. With seats held constant in late 2008 and early 2009, Korea arrivals have been down well into double digits due mainly to exchange rate effects, just as for Guam. Both hotel occupancies and room rates did see a slight increase for the year 2008.

But another major problem now looms for the CNMI visitor industry. The new visa waiver problem includes Japan and Korea, but excludes China and Russia, and the CNMI has been counting on the latter two as emerging

CHART 11 • CNMI GARMENT EXPORTS



"New U.S. visa waiver program could hurt CNMI tourism."

markets. Unlike Guam, those two markets account for about 10% of CNMI visitor arrivals. And the economic effect is estimated to be much greater, perhaps 20%, because especially the Russians stay a long time when they come.

There is another way the exclusion of China from the visa waiver will hurt CNMI. Practically the only form of economic activity on Tinian in recent years has been its gambling casino, and the island has even considered more casinos. In addition, Rota recently legalized gambling. But the target market for this gaming activity has been China. So this industry also is severely threatened unless it can find other markets.

Other CNMI economic indicators bear out the grim picture. Due to the exodus of foreign workers, overseas remittances dropped 18% in 2008. New car and truck sales dropped 12% for the year. Banks saw a 15% drop in deposits, and loans fell by 13%. None of this bodes well for the future.

Constitutional Land Tenure Limits Affect CNMI Economy

Article XII of the CNMI constitution states that permanent and long-term real property ownership is restricted to those of Northern Marianas descent. Naturally this discourages immigration and foreign investment, discouraging the injection of new funds and talent into an economy that so desperately needs them.

Property can be leased for 55 years, but as expiration of that lease nears, there is much less incentive to fund property improvements. Those interviewed for this year's report indicated that there was insufficient interest among legislators and the general public in changing Article XII; as long as that is the case, the CNMI will have to deal with another stumbling block.

To summarize, significant economic uncertainty pervades the CNMI, with no source of optimism for the longer term. One positive note is that the Marines, when they come to Guam, are expected to conduct at least part of their training on Tinian. But environmental decisions have yet to be made even in this area.