Group Economics

Northern Ireland Quarterly Economic Review April 2008

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Overview

- ***NI economy set to grow at 1.0% in 2008 but to pick up to 1.5% in 2009***
- ***Public expenditure growth slows as downturn in private sector & housing market intensifies***
- ***Consumer spending to be curtailed by rising food and energy costs alongside credit crunch***
- ***Despite a record year for public sector investment, construction is expected to bear the brunt of the slowdown***
- ***Sterling weakness against euro will benefit exporters in eurozone markets***
- ***Labour market set to weaken with job losses in construction & manufacturing expected to outweigh any gains in service sector***
- ***Tourism sector is expected to follow up on last year's record performance with another strong year***
- ***Housing affordability set to improve sharply as average house prices are expected to fall a further 12.5% from current levels***
- ***But ongoing credit crunch is making availability of credit more restricted and the cost of credit more expensive***

10 Years on - Significant Progress Has Been Made

April 2008 represented the tenth anniversary of the signing of the Good Friday Agreement. On reflection, the NI economy has made considerable progress and exceeded many people's expectations. Looking at the labour market, the unemployment rate has halved and more than 100,000 jobs have been created over the last decade. It is also pleasing to note that NI's trend of net outward migration has been reversed with migrant labour now a more important source of labour supply. Clearly the increased political stability has improved NI's brand image in the eyes of the world and this has assisted many sectors notably tourism – which had a record year in 2007. The housing market has also benefitted from the renewed confidence in the economy with the average house price rising by a staggering 240% over the last decade which compares with a 165% rise for the UK. Beyond housing, there has been a notable transformation in the physical regeneration of the economy in a variety of aspects such as the development of the Laganside area in Belfast and the recent arrival of the Victoria Square shopping complex.

More recently business confidence has received a boost with the NI Executive making the economy its No.1 priority over the next three years. This commitment to improving the economy and addressing the key long-term weaknesses of low productivity, high rates of inactivity and an under-investment in infrastructure offers optimism for the prospects of the NI economy in the medium to longer-term. Recent announcements by the NI and RoI Finance Ministers regarding the potential for NI to provide skills for financial service firms in Dublin offers further grounds for optimism. However in the short-term there is no escaping the fact that 2008 will be a more challenging year with the economic growth rate slower than at any other time over the last 10 years.

2008: *Slowdown under construction*

Economic growth - The NI economy is experiencing simultaneous slowdowns in public expenditure, private sector activity and the housing market. This has been compounded by the credit crunch and the negative knock-on effects on consumer expenditure and on the house building sector are more severe than in our January forecast. As a result, we have revised down our economic growth forecast to 1.0% in 2008. This compares with an estimated growth rate of 2.5% in 2007 and 3.0% in 2006. The expected growth rate of 1.0% for 2008 compares with the previous lows of 1.4% recorded in 2002 and 1991. Despite this slowdown it should be remembered that the economy is still growing and is expected to increase by 1.5% in 2009.

***Labour market* -** NI's improved economic performance has been most apparent in the labour market. However with the economic conditions in 2008 far from ideal the resilience of the NI labour market will be severely tested. It should be remembered that labour market data are lagging economic indicators and the slowdown in economic activity will become apparent in the labour market later this year. The current level of vacancies offers some protection against rising unemployment. Nevertheless we expect the overall number of employee jobs to fall this year as a result of job losses in construction and manufacturing outweighing job gains elsewhere.

Service Sector - The service sector has been the mainstay of NI's impressive employment growth. This is under threat in 2008. While labour market data provides a lagging measure of economic performance the Index of Services suggests that a significant service sector slowdown has been in train since the second half of 2007 with two consecutive quarterly contractions. 2007 proved to be the weakest annual expansion in the service sector since 2003 with output just one third of the level in 2006. Forward looking indicators such as the Ulster Bank PMI point to a marked slowdown in service sector activity in early 2008.

Consumption - Unfortunately 2008 is going to prove to be a difficult year for the NI consumer. The rapid rise in inflation - particularly soaring food and energy costs - has been outpacing average wage growth. As a result household disposable incomes are being eroded with the impact most noticeable on those individuals on low incomes who spend a disproportionate share of their incomes on heat, light and food.

***Housing* -** In recent months property prices have been aggressively reduced but some of these house price falls in our view have still not fed into the official statistics. We believe that the current NI average house price is closer to £200k and we are anticipating it to fall by a further 12.5% to reach £175k by the end of 2008. This decrease would take average house prices back to the levels of autumn 2006. While the market is hoping for a revival in the first time buyer (FTB) market this year, the ongoing credit crunch is going to reduce the availability and increase the cost of credit for these borrowers.

Construction - The long-term prospects for the construction sector remain positive but the combination of a sharp downturn and a credit crunch have been unprecedented. As a result the construction sector's fortunes are going to be more closely tied to the speed and scale of planned public sector investment in the short term. Ironically while 2008/09 will see record levels of capital investment pumped into the NI economy, the construction sector is likely to see significant job losses. This is largely attributable to the downturn in the housing market although concern about the delivery of public sector procurement has been voiced by the industry.

The Budget highlighted that part of the capital investment will be funded from the sale of surplus public sector assets. In 2008-09 capital receipts totalling almost £500m have been earmarked for expenditure. It remains to be seen to what extent these receipts are linked to property or land sales. Given the state of the property market, there is a question mark over whether the asset sales will provide the necessary receipts in the timescale envisaged to fund the planned expenditure that the construction sector is now reliant upon.

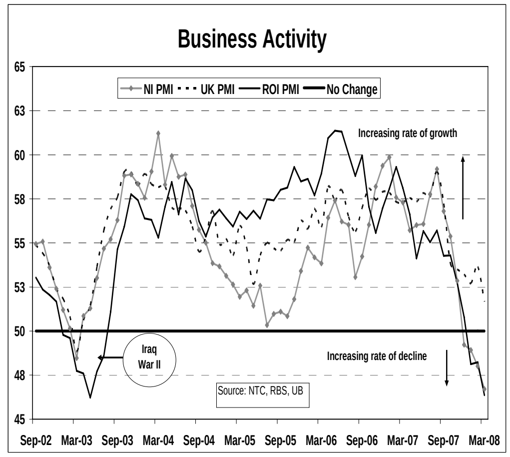
The number of house completions has increased annually since 1999, peaking in 2006. However indications are that completions were 25% lower in 2007 representing the lowest level of house completions since 2000. In light of the current market conditions which are characterised by falling prices, steeper borrowing costs and a reduced availability of credit, house builders are expected to scale back building further. As a result, it is anticipated that house completions could fall by a further 20% to below 11,000. With house building accounting for around 40% of construction output this would have a significant impact on thousands of construction jobs and have spillover effects on other sectors of the economy.

With the construction industry north and south of the border in the midst of a significant downturn the timely delivery of NI's public sector investment is more important than ever. This highlights the importance of proceeding quickly and efficiently with Government procurement and infrastructure investment in 2008 and potentially bringing forward future spending plans - such as the social housing plans - to counteract weakness in the house building sector. It is noted that capital investment is set to fall by over 10% in real terms in 2009/10.

I Economic Growth Performance & Prospects

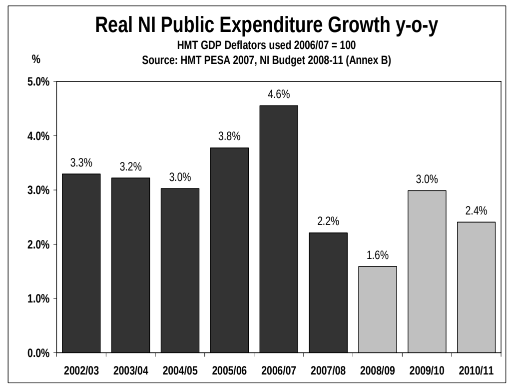
UK, RoI & NI experiencing significant slowdowns

According to the IMF forecasts, global growth is set to slow from 4.9% in 2007 to 3.7% in 2008. Despite this slowdown it remains significantly above the rate recorded in 2001 (the last downturn). While the global economic environment remains buoyant NI's economic performance and prospects are more closely tied to the UK and to a lesser degree the RoI. All of these economies are experiencing significant slowdowns according to their respective composite - all sectors - Purchasing Managers Indices (PMIs). However the UK economy is currently faring better than NI & RoI with its private sector still recording growth – albeit at a slower rate. The NI & RoI economies are more exposed to the construction industry than their UK counterparts and the current downturn is impacting on this sector in terms of employment on both sides of the border. NI's private sector output has eased for seven consecutive months with an outright contraction occurring in each of the last four. This has propelled NI to the bottom of the UK regional league table for the first quarter of 2008 with all other regions registering an increase in business activity.



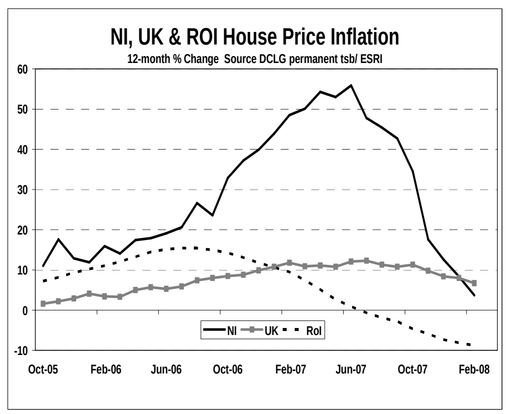
Slowing public expenditure growth

NI is a public expenditure (PE) driven economy with total PE accounting for over 60% of economic activity. As a result economic prospects are sensitive to changes in PE growth. NI has enjoyed PE increases averaging 3.7% per annum in real terms since 2000. However the latest UK Comprehensive Spending Review (CSR) reduced the average annual rate to one third of that figure – just 1.2% over the next 3 years. When expenditure outside of the control of the NI Executive such as social security expenditure is included NI's total levels of public expenditure is set to grow by 1.6% in real terms in 2008/09.



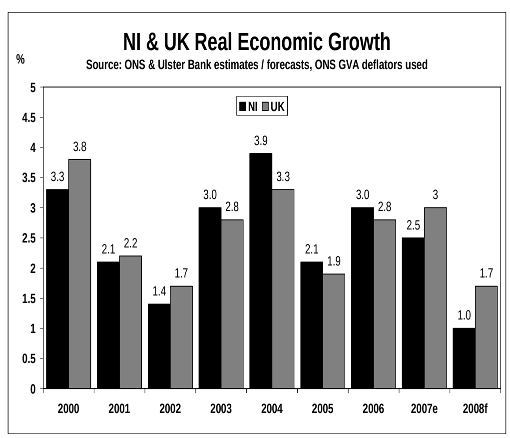
Housing market downturn continues

NI average house prices have fallen in five out of the last six months with NI's average house prices recording annual growth of just 3.7% (UK = +6.7%) in February 2008. This is the slowest rate of annual house price inflation since November 2003 and the first time since November 2004 that NI's growth rate has fallen below the corresponding UK rate. Further falls in average house prices are anticipated. The main consequence of the slowdown and uncertainty associated with the housing market is a significant decrease in transactions and a significant scaling back in house building. According to the Council of Mortgage Lenders the number of loans issued for house purchase in the latest 3 month period to Feb 08 is less than 40% of the equivalent figure a year ago.



Economic growth set to slow to 1.0% in 2008

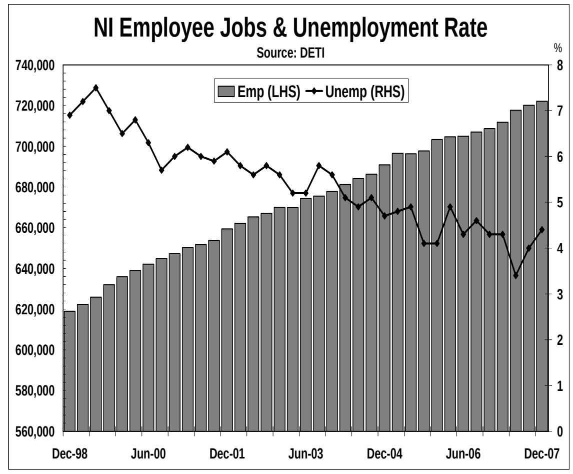
The NI economy cannot insulate itself from the slowdown in the economies of its most important trading partners – the UK and the RoI. Both of these economies are expected to see economic growth slow sharply in 2008. The UK is expected to see GDP growth ease to 1.7% in 2008 from 3.0% in 2007. Meanwhile the RoI's economic growth rate (GNP) is forecast to fall back from 4.5% in 2007 to below 1.0% in 2008. The NI economy is experiencing simultaneous slowdowns in public expenditure, private sector activity and the housing market. This has been compounded by the credit crunch and the negative knock-on effects on consumer expenditure and on the house building sector are more severe than in our January forecast. As a result, we have revised down our economic growth forecast to 1.0% in 2008 (from 1.5%). This compares with an estimated growth rate of 2.5% in 2007 and 3.0% in 2006. The expected growth rate of 1.0% for 2008 compares with the previous lows of 1.4% recorded in 2002 & 1991. Economic growth is expected to rise to 1.5% in 2009 (UK = 1.8%).



II Labour Market Overview

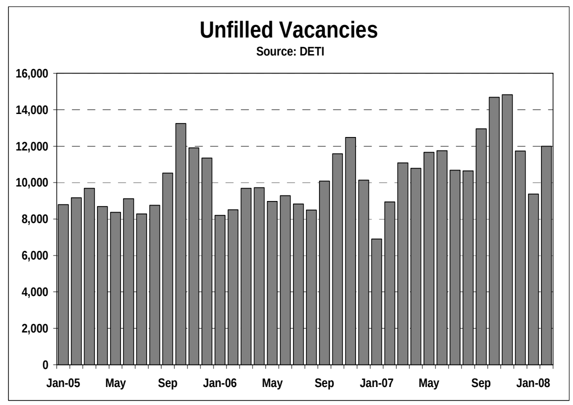
Record employment continues but for how long?

NI's improved economic performance has been most apparent in the labour market. However with the economic conditions in 2008 far from ideal the resilience of the NI labour market will be severely tested. The Quarterly Employment Survey which measures the number of jobs (rather than persons in employment) recorded its tenth consecutive quarter of employment growth in December 2007 and reached a record high of 722,070 employee jobs. This represented an increase of 1,900 jobs over the quarter. Over the year (Dec 2006 – Dec 2007) employment rose by 13,410 jobs (+1.9%). Meanwhile NI's unemployment rate eased by 0.1 percentage points over the quarter to 4.2% for the period Dec-Feb 2008 but remains above the low of 3.6% recorded last summer. The current ILO unemployment rate compares favourably with the UK (5.2%) and is well below the EU27 rate of 6.8%. However we expect the overall number of employee jobs to fall this year as a result of job losses in construction and manufacturing outweighing job gains elsewhere. The unemployment rate is expected to rise towards 5.0%.



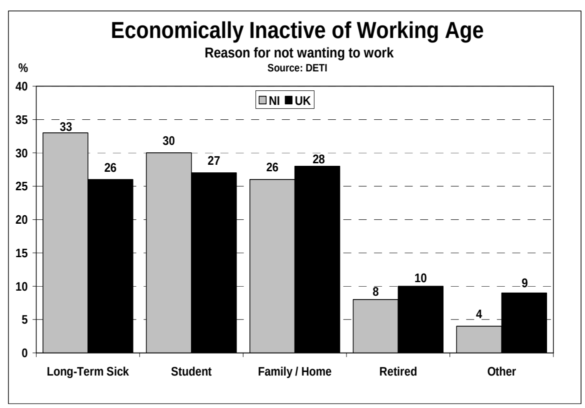
Job opportunities remain

Clearly the outlook for the NI labour market in 2008 is less rosy than we have become accustomed to. However it is apparent that the number of unfilled vacancies in early February remains relatively high at 12,000. This remains close to the recent peak of almost 15,000. This signals that there is still a relatively strong level of demand in the local labour market. Although it should be remembered that employment and unemployment data are lagging economic indicators the slowdown in economic activity will become apparent in the labour market later this year. The current level of vacancies offers some protection against rising unemployment.



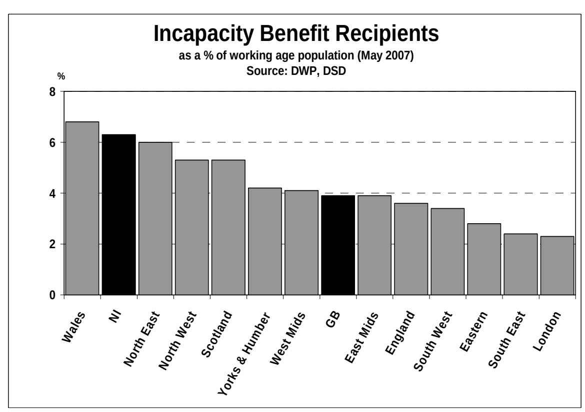
Why do the economically inactive not want to work?

NI's unemployment rate remains low but economic inactivity remains stubbornly high. The working age economic inactivity rate for NI currently stands at 26.9% the highest of all the UK regions (UK = 20.9%). 90% of the economically inactive do not want a job while the remainder want work but are not actively seeking or available for work. The reason given for people not wanting to work fall into five broad groups with the largest categories being students (30%), long-term sick (33%) and those looking after the family / home (26%). Clearly the student cohort represents an investment for the future but the scale of NI's long-term sick population is more concerning and more marked than in the UK.



Incapacity benefit uptake well above the GB average

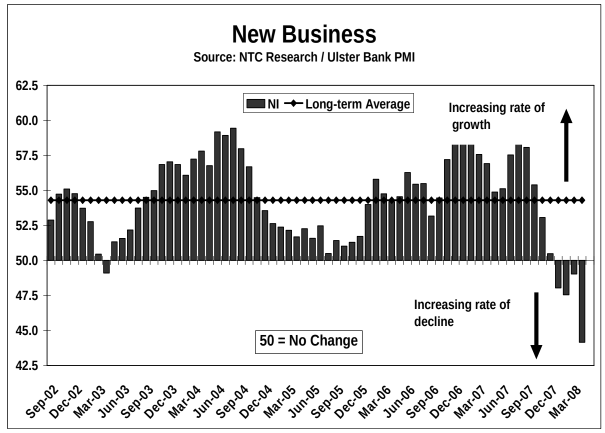
Looking at Incapacity Benefit (IB) in a regional context it is apparent 6.3% of NI's working age population are in receipt of IB (GB = 3.9%). The scale of NI's uptake of benefits is also evident with Disability Living Allowance (DLA). NI has the highest uptake (173,000 allowances) of all the UK regions and double the UK rate. Despite NI's higher uptake of social security benefits this has no bearing on the Executive's budget as it is controlled at a UK level. Therefore while reducing overall economic inactivity is one of the Executive's key economic goals it lacks a public expenditure incentive to tackle it.



III Private Sector Performance & Prospects

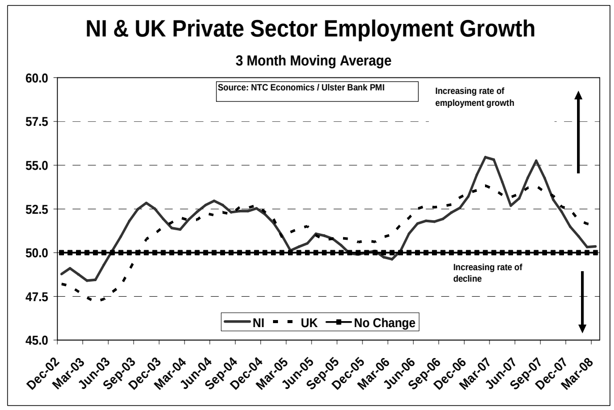
Incoming new business dips into negative territory

According to the March PMI, new orders have dropped below the long term survey average of 54.3 for the sixth consecutive month and have fallen below the 50 no change mark for the fourth month in a row. This is in marked contrast with UK firms which continue to report growth in new business. The new orders index for March represented a new survey low with construction and retail experiencing the sharpest declines in new business. It is also interesting to note that the service sector had never experienced a monthly decline in new business until January 2008. Since then service sector firms have recorded decreasing levels of new business for three months in a row. This is further evidence that the loss of economic momentum is impacting on all sectors of the economy.



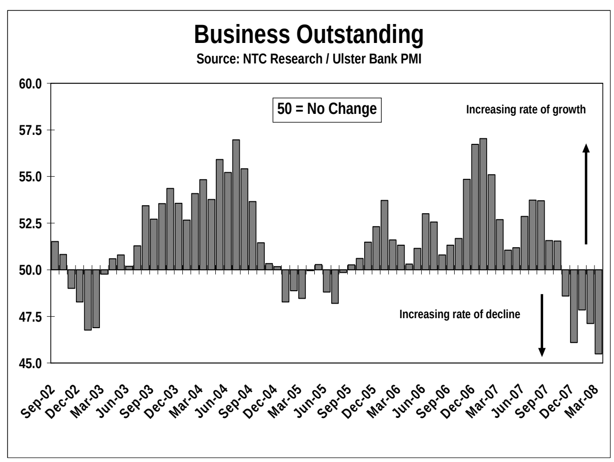
Employment growth continues to slow

The NI Budget placed a particular emphasis on efficiency within the public sector. As a result public sector employment is likely to be on a downward trend over the next few years. This means the NI economy will be increasingly reliant on the private sector for employment gains. While private sector employment has been increasing at an accelerating rate in recent years this rate of growth is slowing. The Ulster Bank PMI points to a further slowdown in private sector employment growth in Q1 2008 with the employment index remaining just marginally above the no change mark of 50.0. In March 2008 the employment index fell marginally into negative territory with job losses concentrated in construction & retail.



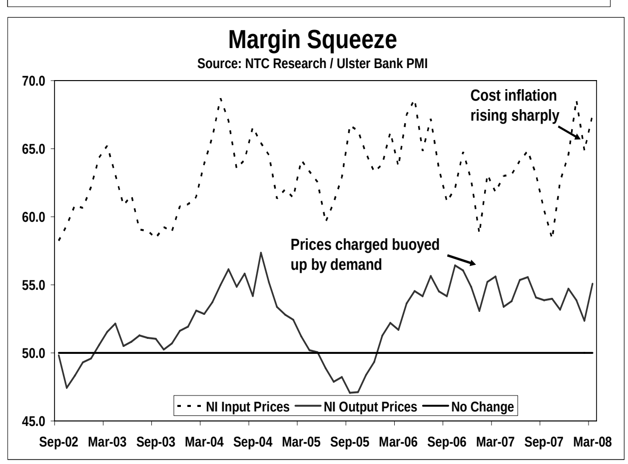
Lack of orders leads to a further reduction in backlogs

An indicator of the buoyancy of the NI private sector and the strength of demand over the last two years has been the rising levels of backlogs (or business outstanding). However the sharp slowdown in business activity and the fall off in new orders has led to a rundown of these backlogs. In the absence of new orders, NI firms have been rapidly depleting their backlogs of work to their lowest levels to date. This continuing trend does not bode well for employment growth for the remainder of the year as falling workloads will lessen the need for firms to hire staff as they battle against a rising cost base. Decreasing backlogs have been evident across all sectors since November 2007 with the retail sector experiencing the sharpest declines in Q1 2008. This supports our view that the NI labour market will weaken later this year.



Inflationary pressures keep squeeze on profit margins

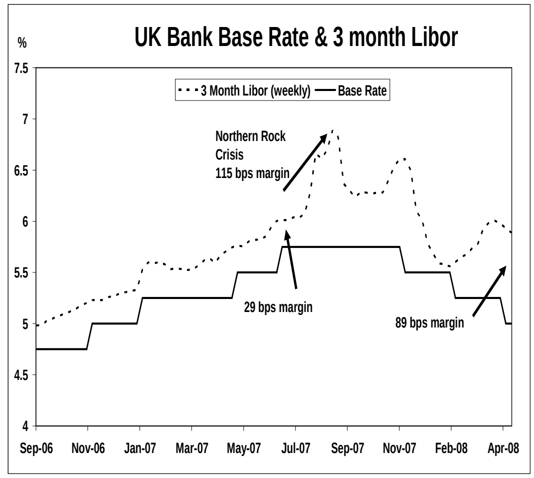
According to the Ulster Bank PMI, cost inflation within NI firms accelerated in to 67.0 which remain close to the survey high of 67.2 in Q2 2004 and well above long term average of 63.0. Nevertheless the overall input cost inflation was below the rate recorded in the UK as a whole (68.0). According to those firms surveyed, key sources of inflationary pressure included fuel, energy, wages, and raw materials such as plastics and steel. At an industry level, the inflationary pressure was most intense within the retail sector. NI firms have continued to retain a degree of pricing power throughout however this has failed to rise by the same amount as input costs. As a result the squeeze on profit margins has intensified in Q1 2008. Looking ahead increasing commodity price inflation and the continued slowdown in global & UK demand will erode corporate profit margins. The Brent Crude Oil measure has recently reached a new record high of $117 per barrel.



IV Credit Crunch – Impact on Businesses

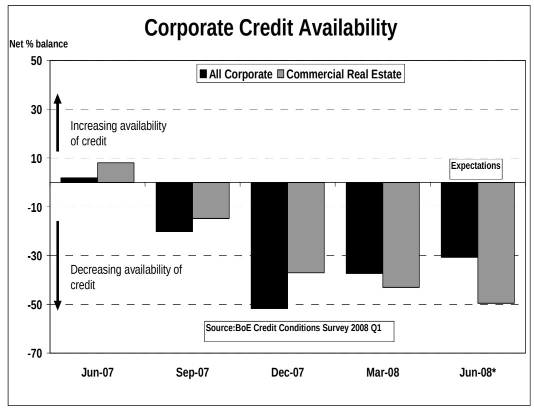
Corporate borrowing costs remain elevated

A key benchmark determining corporate borrowing costs is the 3 month London Interbank Offered Rate (LIBOR). Libor is an inter-bank rate and is traditionally around 7-12 basis points above the prevailing UK base rate. However due to the losses arising in the US sub-prime loan market and the subsequent developments with Northern Rock, banks across the globe became hesitant to lend to each other. As a result, 3 month Libor spiked up to a high of 6.9% on 11 September some 115 basis points above the base rate. While some confidence returned to the money markets in 2008 this has risen sharply again in recent weeks with the differential between Base Rate and 3 month Libor currently some 87 basis points (or 0.87 percentage points). This has impacted on businesses whose borrowing has been linked to these elevated Libor rates and these higher rates have also fed through into higher mortgage rates. It is likely that it will take several months for this gap to narrow significantly.



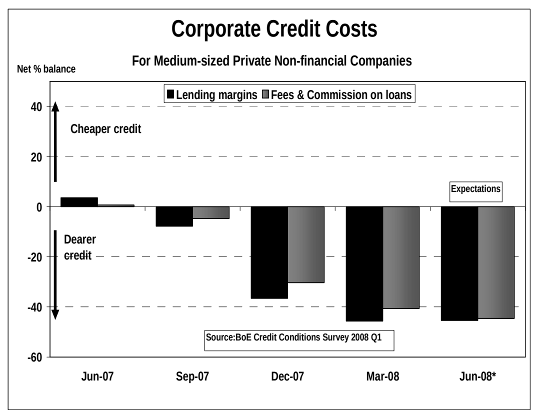
UK corporate sector feels the squeeze on credit availability

The latest Bank of England Credit Conditions Survey confirmed that UK lenders signalled a reduction in credit availability during the first quarter of 2008 and this was particularly marked within the commercial real estate sector. The credit squeeze by lenders was more pronounced in the corporate sector than in the case of mortgage borrowers. A further reduction in credit availability is anticipated in the next three months with the commercial real estate sector set to experience an even greater squeeze than in Q1. Default rates have increased for both medium-sized and larger corporates and these are expected to increase more rapidly in Q2.



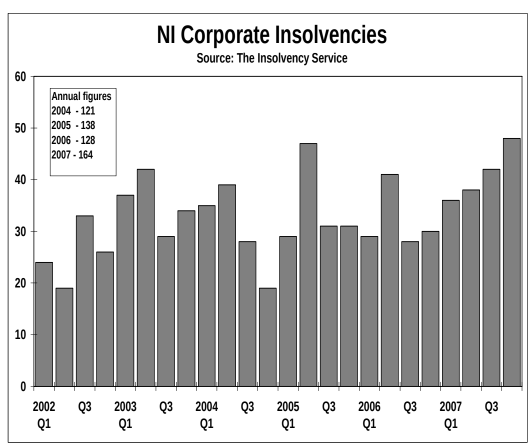
Corporate credit costs on the rise

The latest Credit Conditions Survey also confirms a further rise in the cost of credit for the corporate sector. UK Lenders reported a significant rise in lending margins (or spreads) alongside increased fees and commission income on loans during Q1 2008. This trend is expected to continue into Q2 2008.



Corporate insolvencies remain low but rising

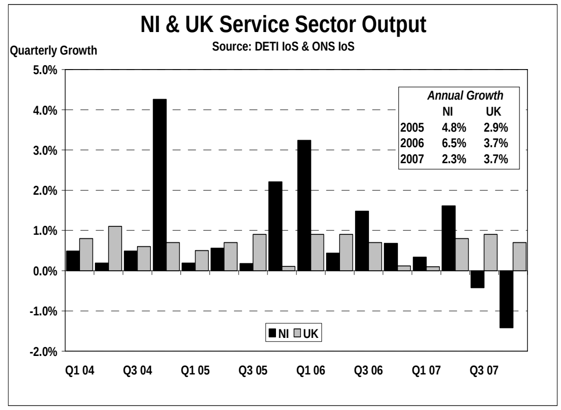
Corporate insolvencies rose for the fifth consecutive quarter with 48 firms declared insolvent in Q4 2007. This compares with a quarterly average of 33 and takes the total in 2007 to 164 some 28% higher than the corresponding 2006 figure. This represents the highest figure since the series began in 2002 but still only represents around 0.2% of NI's total business base. The comparable figures for England & Wales and Scotland are 0.5% and 0.4% respectively. The most recent figures represent the first set of figures since the financial market turbulence began in August 2007. Given the slowdown in economic growth, the rising cost of finance and the subsequent squeeze on profit margins, corporate insolvencies in NI (& the UK) are expected to continue this upward trend into 2008/09. Firms exposed to the NI property market are expected to feature to a greater degree during 2008/09.



V Sector Trends & Prospects

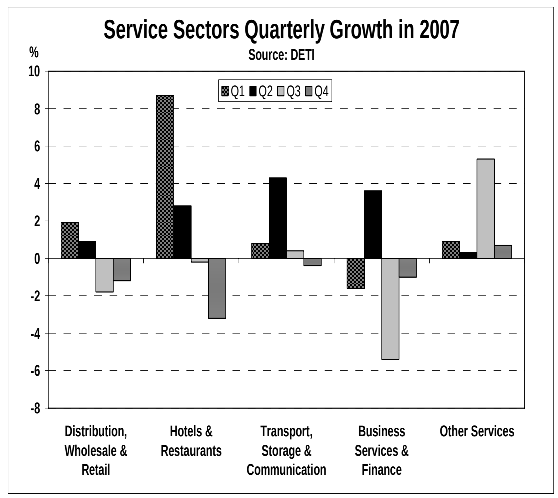
Service sector experiences slowest growth since 2003

According to DETI's Index of Services (IoS), output decreased by 1.5% in Q4 2007 which compares to a rise of 0.7% in the UK. The service industry has lost a significant amount of momentum in the second half of the year with two consecutive quarterly contractions. In 2007 Service sector output growth increased by 2.3%. This was just over one third of the growth rate in 2006 (+6.5%) and the weakest annual expansion since 2003. A further slowdown in service sector output is expected in 2008.



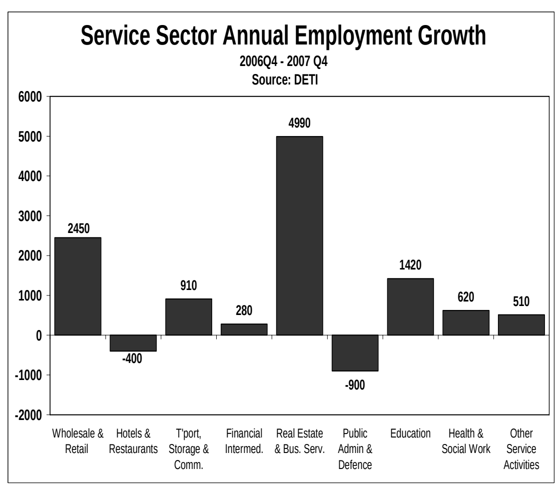
Slowdown in activity evident across the services sector

The "Other Services" sub-sector which includes the public sector was the only category to record growth during the the second half of 2007. Service sector firms sensitive to consumer demand have witnessed a noticeable fall in output growth. The Hotels & Restaurants sector has seen output weaken for the 4th consecutive quarter with Q4 2007 contracting by 3.2%. However Hotels & Restaurants still recorded a robust increase of 5.4% during 2007 which was strongly influenced by the record year for the NI tourism industry. Distribution (Wholesale & Retail) recorded a solid growth rate of 3.1% in 2007 but this was again due to a strong performance in the first half of the year. Q3 & Q4 saw output growth decline by 1.8% and 1.2% respectively. In 2008 these sectors are going to be vulnerable to the continued slowdown in consumer demand. Higher food & energy prices alongside the credit crunch – increased cost and reduced availability of credit – will reduce disposable incomes and consumer demand. The business services & finance sector has witnessed a sharp reduction in output in the second half of 2007 falling by 5.4% and 1.0% in Q3 & Q4 respectively. The PMI for Q1 2008 pointed to a contraction in private sector output. Therefore we anticipate more subdued business service activity in 2008.



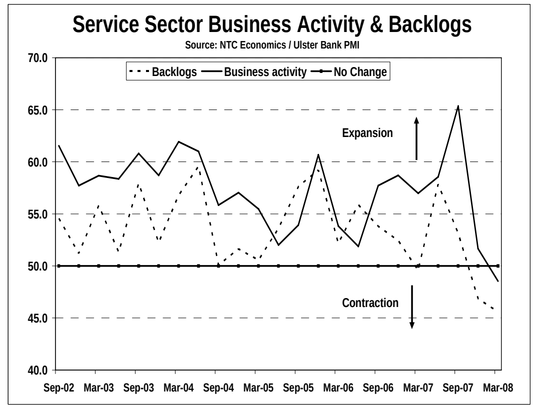
Service sector has been the main driver of employment growth

Despite the slowdown in output growth NI's service sector firms still managed to record employment growth in Q4 2007. The overall increase in NI employee jobs was driven by the services sector with an additional 2,030 jobs added in Q4 2007. Service sector employment has increased by 10,800 (+1.9%) since December 2006 which represents over 80% of NI's total annual employment growth. Looking at the service sector employment growth in closer detail reveals that 47% (or 4,990 jobs) of the employment growth was accounted by the Real Estate & Business Services sector while the Wholesale & Retail trade sector added 2,450 jobs or 23% of the net employment growth over the year. Meanwhile the public sector dominated categories of Public Administration & Defence; Education; and Health & Social Work accounted for 1,140 (or 11%) of the net annual employment growth in 2007. With the public sector, manufacturing and construction sectors all expected to reduce their headcounts this year the NI labour market will be pinning its hopes on private sector services for employment growth in 2008.



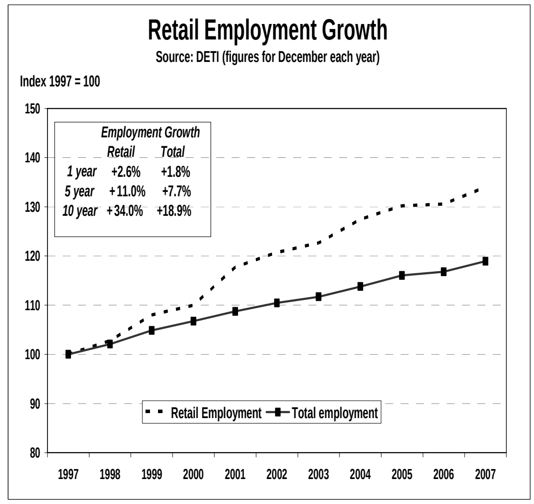
Declining business activity with backlogs decreasing

While labour market data provides a lagging measure of economic performance the IoS suggests that a significant service sector slowdown has been in train since the second half of 2007. Forward looking indicators such as the Ulster Bank PMI point to a marked slowdown in service sector economic activity in early 2008. NI's service sector activity has weakened for 6 consecutive months with an outright contraction in Q1 2008. The service sector employment index having weakened for 4 months in a row to March 2008 still remained above the 50 mark signalling private sector firms were still adding to their workforces in Q1 2008 (52.8). Meanwhile the levels of outstanding work (backlogs) have fallen for five months in a row due to a lack of new orders. This does not augur well for future service sector employment growth.



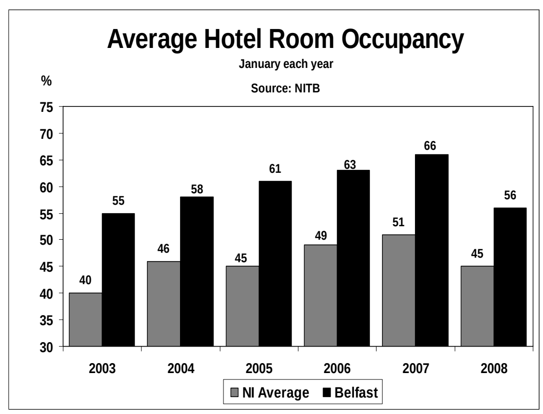
Robust retail employment growth to hit the buffers

Over the last decade retail employment growth (+34%) has increased at almost twice the rate of overall employment growth (+19%). In 2008, consumers are expected to rein in their expenditure with household finances coming under increased pressure from the credit crunch and soaring energy and food costs. This will lead to greater competition within the retail sector - competition has already been intensifying in certain sectors following the arrival of new retailers e.g. Ikea & the Victoria Square shopping centre. Further employment growth in 2008 is unlikely and the latest PMI report for March pointed to job losses in the retail sector. This trend is expected to continue this year. While NI retailers are expected to experience a fall off in local demand the RoI consumer may limit the declines in employment. An increasing number of RoI consumers are heading North to take advantage of the weak £ which is at record lows against the euro. The service sector has been the mainstay of NI's impressive employment growth. This is under threat in 2008 and we expect service sector employment growth to remain flat in 2008.



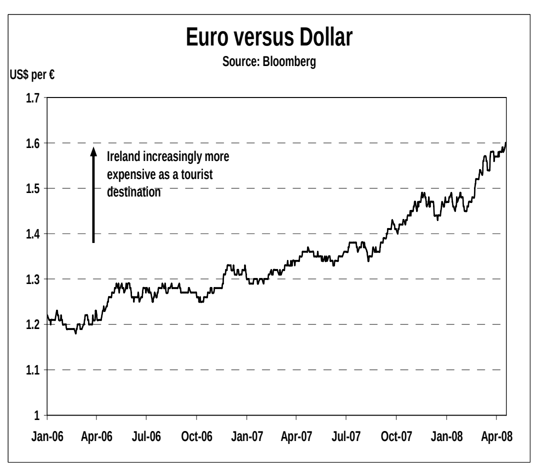
Tourism – Hotel Occupancy rates dip in January

Last year proved to be a buoyant year for NI's tourism industry according to the latest NITB Tourism Barometer (Dec 2007). 90% of NI hoteliers signalled an increase in bed nights when compared with 2006 while 84% also reported an improvement in room yield over the same period. However since the turn of the year the hotel industry has reported a slowdown in activity particularly within Belfast. The average hotel occupancy rate for NI was 45% in January some 6 percentage points lower than the same period in 2007. Hoteliers in Belfast recorded the steepest falls in their occupancy rates with January 2008 down by 10 percentage points relative to the corresponding level in January 2007. This represents the lowest January figure since 2003. Tourism is expected to be one of the NI economy's better performing sectors this year and while 2008 is not expected to be a record year like last year the sector is still expected to perform strongly.



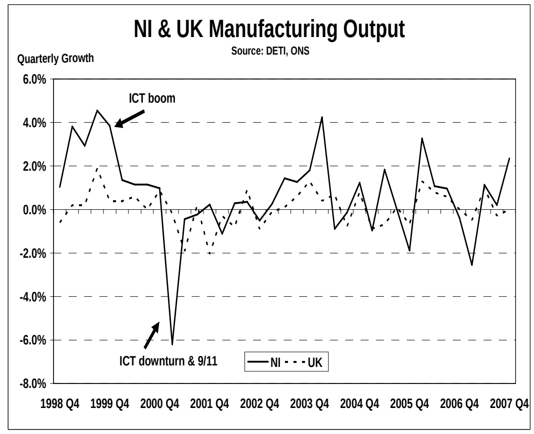
NI is more price competitive in European markets than ever before

The NITB Tourism Barometer cites unfavourable exchange rates (namely the weak US dollar) as the most significant negative factor impacting on performance during 2007. The weak dollar is expected to continue in 2008 as it plumbs new record lows against the euro. This will make it more difficult to attract North American visitors to the Island of Ireland. In recent years the new direct air routes from Belfast to the US and Canada have improved access to the North American market and this should yield further growth in tourist numbers over the longer-term. The key exchange rate that will work in NI's favour is sterling / euro. With the £ continuing to hit record lows against the euro, NI's tourism product is going to be more price competitive in European markets than ever before.



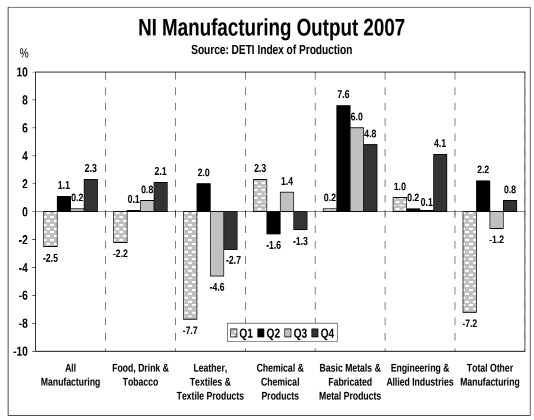
Manufacturing output rises in Q4 but down over the year

NI manufacturing output rose in Q4 by 2.3% while the UK remained steady. However manufacturing output was 0.6% lower in 2007 overall relative to 2006 (UK = +0.6%). Despite the rising cost base and deterioration in the economic conditions within NI's two most important trading partners (GB & the RoI) manufacturing employment continues to hold up. The manufacturing sector added 220 jobs in Q4 2007 which recouped almost two-thirds of the 340 jobs lost in Q3. Over the year manufacturing employment rose by 610 (+0.7%). Nevertheless 2008 is expected to see a resumption of the longer-term decline in the overall levels of manufacturing employment. Pre-announced closures such as the Seagate Limavady plant with 900 jobs have still to take place. Despite these anticipated job losses it is encouraging to note that the manufacturing sector continues to experience productivity gains. In Q4 2007 manufacturing productivity increased by 2.1% over the quarter and is 1.1% higher than the same period in 2006.



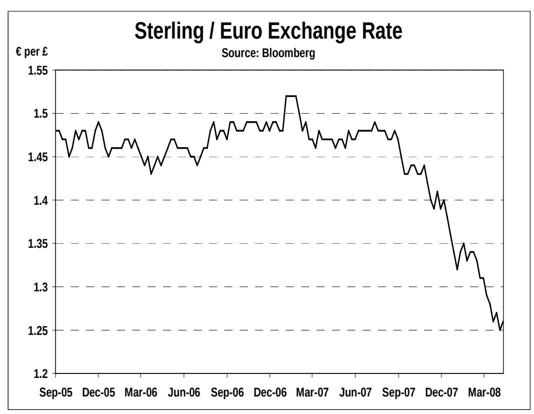
Some sub-sectors performing better than others

The strong pick up in Q4 manufacturing was driven by strong quarterly rises by the Basic Metals & Fabricated Metal Products (+4.8%); Engineering (+4.1%) and Food, Drink & Tobacco (+2.1%) sectors. Meanwhile the Textile & Textile products sector (-2.7%) and Chemicals & Chemical products category (-1.3%) both recorded quarterly falls. In 2007 three broad sectors recorded growth over the year namely Basic Metals & Fabricated Metal Products (+17.8%); Chemicals & Chemical Products (+4.0%) and Engineering & Allied industries (+1.3%). While Food, Drink & Tobacco (-3.5%); Textile & Textile products (-9.3%); and Other manufacturing (-2.9%) all experienced falls in output during 2007.



Export competitiveness in Eurozone boosted by strong euro

The manufacturing sector is the most exposed sector to external economic developments. Sales to customers outside of NI account for more than three-quarters (76%) of total sales while exports (sales outside the UK) account for over one third (34%) of total manufacturing sales. The UK and RoI are the two most important trade partners for NI firms. Given that economic growth in these two economies are expected to ease back significantly in 2008, NI firms will experience reduced demand as a result. However the export competitiveness of the sector has been boosted in EU markets. Over half of all manufacturing exports are exposed to the euro and while local firms have been experiencing rapid rises in input costs they have benefited from sterling's record lows.



VI Interest Rate & Currency Outlook

UK Interest Rate Outlook

The BoE has continued to cut official rates in view of the UK's softer growth outlook and the risks to demand stemming from the credit squeeze. The first cut in December has been followed by two more this year (in February and April), taking Bank Rate down to 5% from the cyclical peak of 5.75%. These moves are best described as a normalisation rather than an outright easing of monetary policy. The MPC has been proceeding cautiously in its approach to lowering rates because of the presence of significant inflation pressures in the UK economy. CPI stood at 2.5% in March and has been above the 2% target since last October. The impact of further price rises in the food and energy sectors in the months ahead means that the CPI is likely to hit 3% later this year, and maybe even higher. Inflation at 3.1% or higher would require the BoE Governor Mervyn King to write a letter to the UK Chancellor explaining why inflation was so far from target and what the Bank were doing about it. Sterling's sharp depreciation on the currency markets is adding to upward pressure on import prices. Furthermore inflation expectations (including the BoE's own survey) have risen.

The MPC currently faces the extremely difficult challenge of trying to balance the upside risks to inflation from the combination of sources above against the downside risks to inflation over the medium term from the possibility that the tightening of credit conditions in the UK and elsewhere will slow demand by more than is necessary to keep inflation on track to meet the target. We anticipate that the UK economy will grow below trend this year. A weaker sterling will help support external demand and a rebalancing of the economy more broadly. However, the tightening of credit is likely to see a softening of both business and household spending relative to the strong gains recorded last year, and we expect GDP growth of around 1.7% for this year. The MPC is clearly signalling that it will not play fast and easy with monetary policy with inflation risks such as they are. However, the April Credit Conditions survey has confirmed that further tightening, both in terms of availability and price, is likely in the period ahead. Furthermore the severe strains in sterling money markets means that 3-month libor at over 5.9% is only very slightly below where it was last July despite the MPC having cut rates by 0.75% since then, which means that the effective easing of policy has been negligible. In effect, the MPC has been cutting rates to stand still in terms of this dimension of financing conditions. All of which leads us to the view that the MPC will cut rates further in the coming months. We anticipate two further 0.25% rate cuts, which would take Bank Rate down to 4.5%.

FX Outlook

Stg/Eur

Like the dollar, sterling has proved to be weak of late and has fallen steadily from the €1.37 level recorded at the start of this year to the recent record low of €1.2348.The UK currency has been even weaker than we had anticipated for a number of reasons. The UK economy is looking softer, property markets have been extremely weak and remain a key vulnerability given tighter credit conditions, and the Bank of England has already cut interest rates on three occasions. In contrast, the euro area economy has so far proved resilient to both the US downturn and the tighter credit environment, with the ECB focussed firmly on upside inflation risks. In addition, adding to sterling's woes have been rising concerns about the UK current account position. Notwithstanding a sharp if somewhat erratic -looking decline in the final quarter of last year, the deficit stood at a sizeable 4.2% last year on average. Finally, the nationalisation of Northern Rock in February added to perceptions in some quarters that the UK policy framework has fallen short in terms of its ability to handle the recent crisis.

Sterling remains out of favour at present given the weight of negatives pulling it lower and momentum clearly points to further downside for Stg/Eur, as does the likely path of interest rates in the two economies over the coming months. That is the ECB is expected to keep rates on hold at 4.00% while the BoE is expected to cut to 4.50%. As a result, we anticipate a move to around the €1.20 by mid-year however we think there is an element of overshooting going on at present with the euro. Over the past nine months sterling has fallen by a massive 16% against the single currency and its losses in trade-weighted terms have been of a similar magnitude over the same period. To put this in context, this is the largest and steepest decline for the UK currency since it crashed out of the ERM in 1992. Also, recent moves have taken sterling far from estimates of long-run equilibrium of perhaps in the region of €1.35 – 1.37. So while the prospect of more rate cuts from the Bank of England will likely keep sterling on the back foot for a while yet, we look for the UK currency to recover some of its recent losses later in the year and into 2009, and we target a year-end level of €1.30.

GBP /USD

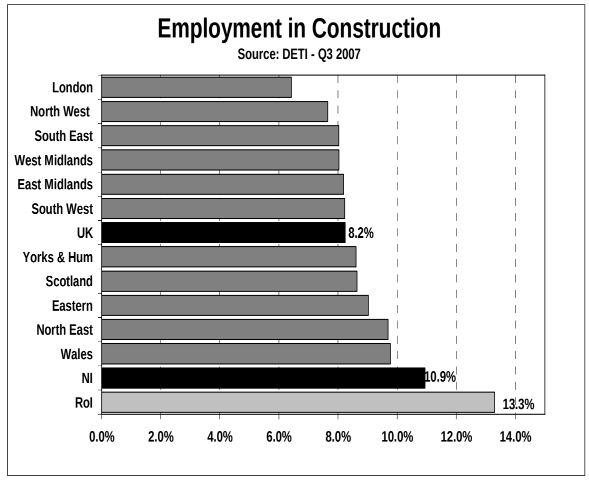
At times over the past three months it has felt as if sterling and the dollar were competing with each other for the title of ugliest duckling within the group of major currencies. It has seen sizeable moves in both directions at various points, hitting a low of under $1.9370 in February and a high of close to $2.04 in mid-March around the time of the Bear Sterns rescue at which point the dollar was particularly out of favour. However overall GBP/USD is not much changed over the past three months, trading at around $1.99 at present. We believe that both sterling and the dollar are likely to remain under pressure in the short term, which leaves us broadly neutral on GBP/USD to the middle of the year. Beyond then, we favour a move to the downside for cable (GBP/USD) reflecting a couple of considerations. First, we see the trough in official rates coming sooner in the US than in the UK, which would argue for dollar gains versus sterling. Second, while we think both currencies have fallen by too much of late, we are of the view that the dollar has more scope to rally back as it has arguably overshot to the downside by more than sterling. Thus, while both currencies are likely to stage a rally against the euro later in the year, we look for the dollar to make larger gains, a combination which leaves GBP/USD on track for around $1.91 by Q1 of next year.

Forecasts (end period)					
	Current	**Jun-08**	**Sep-08**	**Dec-08**	**Mar-09**
Interest Rates					
Eur					
ECB Refi	4.00	4.00	4.00	4.00	4.00
UK					
Bank Rate	5.00	4.75	4.50	4.50	4.50
Currencies					
EUR/USD	1.59	1.63	1.55	1.48	1.45
EUR/GBP	0.80	0.83	0.80	0.77	0.76
GBP/EUR	1.25	1.20	1.25	1.30	1.32
GBP/USD	1.98	1.96	1.94	1.92	1.91

VII NI Construction Sector Trends & Prospects

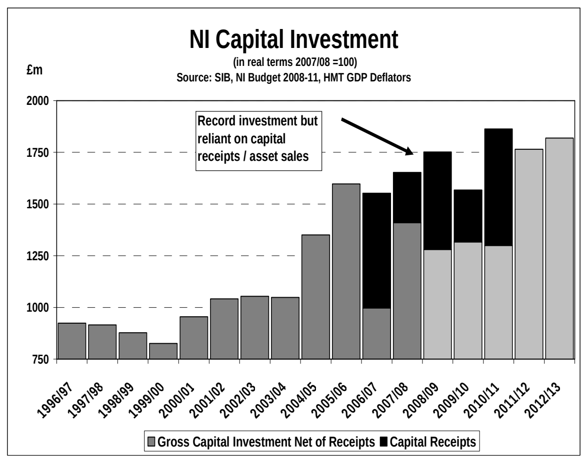
Construction is relatively more important to the NI economy

The construction industry has been a key driver of economic growth in NI in recent years but it has weakened substantially going into 2008. As a result, weakness in the construction sector is going to significantly dampen economic growth and employment prospects in the year ahead. The importance of the construction sector in recent years cannot be understated and the most noticeable impact of the construction boom has been the increasing number of businesses and employment within the industry. Over the last two years the number of VAT registered construction businesses has increased by almost 1,100 or more than 13%. This is twice the rate of growth experienced by the UK overall and greater than any other UK region. When the self employed are included the number employed in the sector is around 84,000. Furthermore NI's construction sector, as a share of total employment (11%), is larger than any other UK region (UK = 8%).



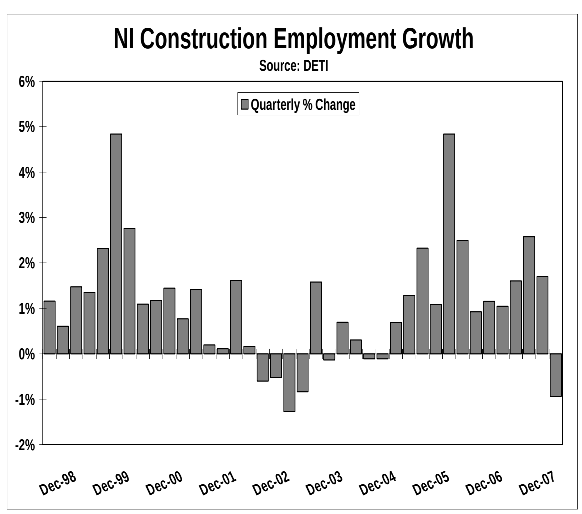
Capital investment plans at record levels

In the context of a slowdown in the private sector alongside a downturn in the housing market the construction sector's fortunes are going to be more closely tied to the speed and scale of planned public sector investment. The proposed £6 billion of infrastructure investment over the next 3 years - part of the Executive's wider £18 billion ten-year investment strategy - will be crucial in this regard. The construction sector will be keen to see that the planned capital expenditure is indeed delivered. The Budget highlighted that part of the capital investment will be funded from the sale of surplus public sector assets. In 2008-09 capital receipts totalling almost half a billion pounds have been earmarked for NI expenditure. It remains to be seen to what extent these receipts are linked to property or land sales. Given the state of the property market, there is a question mark over whether the asset sales will provide the necessary receipts in the timescale envisaged to fund the planned expenditure that the construction sector is now increasingly reliant upon.



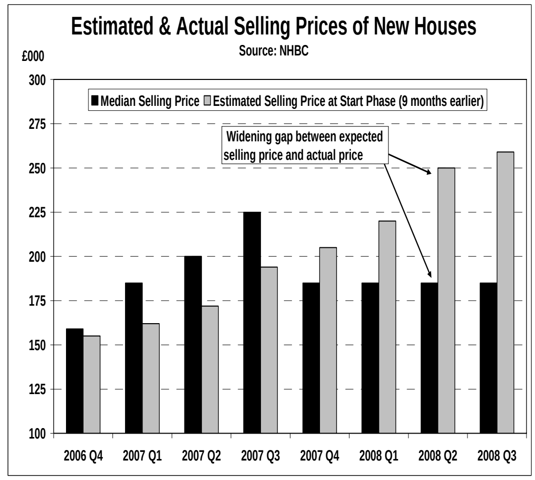
Record investment but jobs are being lost

The construction industry has experienced the strongest rate of growth of the three main sectors in recent years and has added 2,120 jobs (+5.0%) during the last year. Over the last three years the local construction sector has added some 8,000 (+22%) employees which is five times the total employment growth rate for NI. However Ulster Bank's Quarterly Economic Review (January 2008) flagged that the construction's sector's golden run of employment growth was expected to come to an end. This has indeed happened with the sector shedding almost 1% (420 jobs) of construction jobs in the final quarter of 2007. A key reason behind this is the current downturn in the housing market. House building accounts for around 40% of construction output and builders have been dramatically scaling back their building intentions as a result. However the latest RICS (Royal Institution of Chartered Surveyors) Construction survey for Q1 2008 also points to a slowdown in infrastructure work, other public works & private commercial activity. The survey also expressed concerns over delays with public sector projects.



Rising expectations & falling house prices

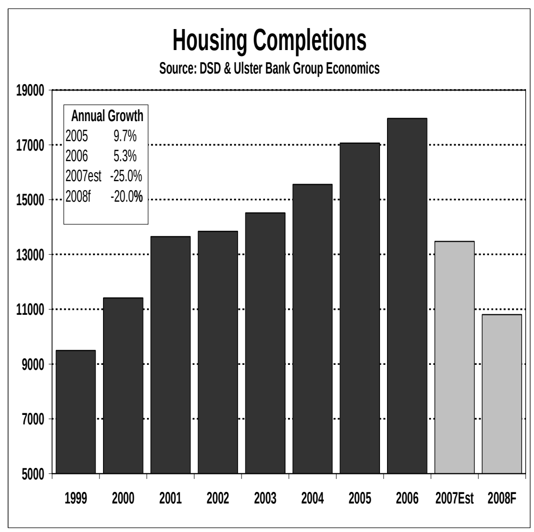
Expectations that house prices would keep on rising was a major factor in last year's housing boom. According to the NHBC's latest New House-Building Statistics for Quarter 4 2007 it is apparent that developers under-estimated the eventual selling prices of the houses they built when the housing boom was in full flow. However, once house prices peaked, they began to over-estimate the eventual selling prices. For example, in 2006 Q4 builders started building houses with an anticipated selling price of £194k. However, the actual price 9 months later (average build time) was £225k. This implies an unexpected rise – or supernormal profit - of £31k. Throughout 2007, the estimated selling prices rose sharply. However, more recently this process has gone into reverse with the median selling prices falling by £40k (18%) from the Q3 peak of £225k. As a result, the actual selling price of NHBC houses was £20k below what the builder estimated it would be at the outset.



This differential is set to widen further with developers estimating the selling price of new houses commenced in Q4 2007 at £259k. If we assume house prices remain static at £185k throughout 2008 this would be £74k or almost 30% below the estimated price when the new houses were started. This will have significant implications for the profitability of many developers in 2008 with underlying profitability eroding significantly relative to 2007. As a result, we anticipate the sharp reduction in housing starts and completions to continue in 2008. Profitability will be particularly squeezed for those developers hoping to build out on land purchased at the height of the house / land price boom.

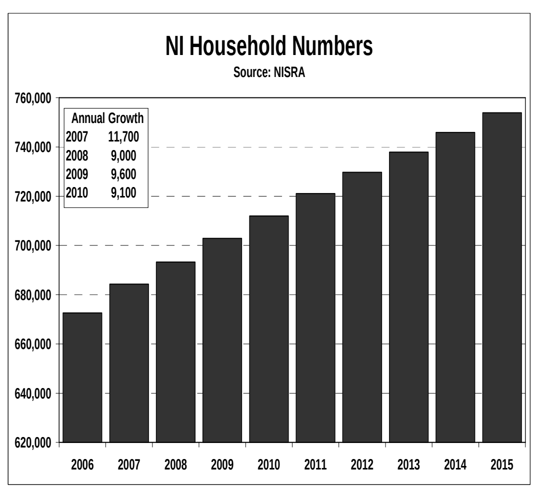
House building & completions being scaled back

In 2007 the rate of housing starts fell by 2,155 or 14% on the recent 2006 peak. This represents the lowest rate of housing starts since 2002 while the number of housing starts in Q3 2007 was the lowest quarterly figure in seven years. This will feed through to lower house completions. The number of completions has increased year on year since 1999 and peaked in 2006 at 17,965. Completions for 2007 are not yet available. However the NHBC figures, which accounted for almost 60% of overall completions in 2006 – fell by 25% in 2007. Assuming this reduction translates to the whole sector completions would fall to 13,475 – the lowest level since 2000. This would represent a drop of 4,500 housing units on the 2006 peak. In light of the current market conditions which are characterised by falling prices, steeper borrowing costs and a reduced availability of credit, house builders are expected to scale back building further. As a result, it is anticipated that house completions could fall by a further 20% to below 11,000. This would have a significant impact on thousands of construction jobs and on other sectors of the economy. This includes estate agents, building suppliers, financial advisors, solicitors, retail etc.



At a time when demand is growing

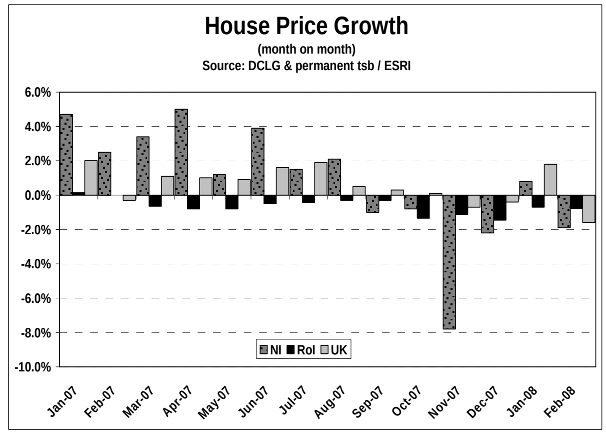
In 2006 & 2007 the NI housing boom was driven by a surge in demand from investors which reduced the availability of houses for 'home-buyers'. This represented a demand-side shock that led to the rapid house price growth. This year the fall off in housing completions will occur against a backdrop of a rising population and increasing household numbers. The latest household projections (released March 2008) highlight the steady rise in the number of households with an additional 9,000 households added this year. A slowdown in the rate of house completions does potentially represent a significant supply-side shock. However in recent years completions did not fully translate into a rise in available stock as the number of vacant dwellings soared by over 10,000 in the last two years. This potentially resulted from speculators and developers drip feeding properties onto a rising market. We anticipate a proportion of these vacant properties will come back into the available stock this year.



VIII Housing Market

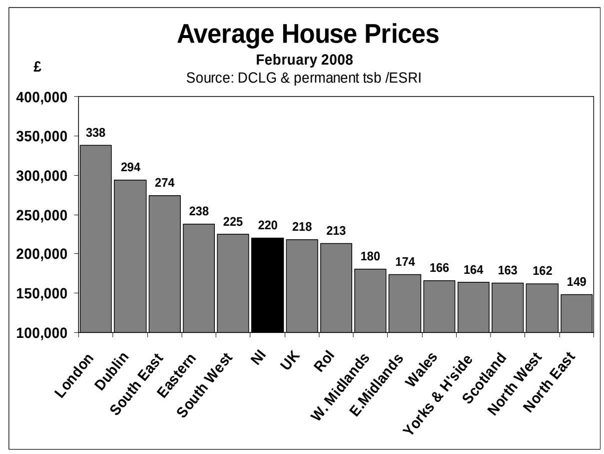
NI's house price falls are more marked than elsewhere

Looking at NI's house price growth on a monthly basis reveals that the rises and subsequent falls have been more marked than in the UK or the RoI. The average house price in NI has fallen in five out of the last six months and has shed 12% or £29k since the August 2007 peak and now stands at £220k. UK house prices have held up rather better than in NI with the average UK house price peaking in January 2008 with a subsequent 1.7% decrease in February. Meanwhile, the average house price in the RoI has fallen for 12 months in a row but the overall decline (8.8%) is still below that recorded in half the time in NI. The trend in falling average house prices is expected to continue in 2008. The balance of NI chartered surveyors reporting house price falls improved in March from very weak levels. The RICS (Royal Institution of Chartered Surveyors) housing survey, reports that 71% of respondents reported house price falls in March down from 95% in February.



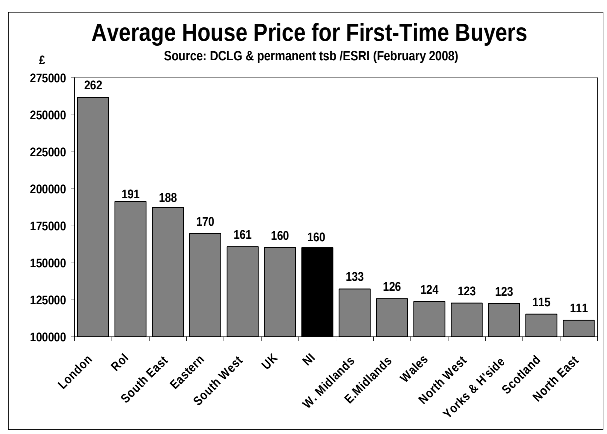
House price gap with UK & RoI continues to narrow

During the period April-October 2007 NI became the 3rd most expensive region in the UK after London and the South East. However since November NI has moved back down the regional house price table with the South West and Eastern regions overtaking NI. At the house price peak in August, NI had a price premium of almost 14% above the average UK house price. This has since narrowed to less than 1% while the differential with the RoI differential just over 3%. We maintain our view that NI's average house price will fall back below the respective UK & RoI averages in the coming months.



NI's average First-time buyer house price in line with UK average

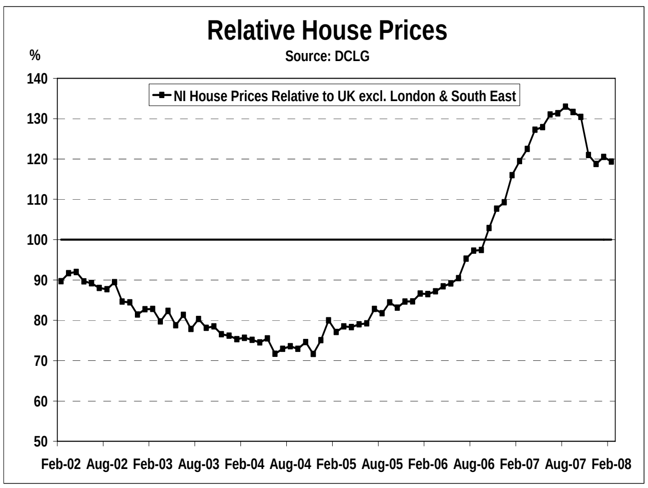
NI's house price falls have been most marked in the first-time buyer market (FTB) with the average house price falling from £189k (August 2007 peak) to £160k in February. This represents a 15% decrease. The average house price for FTB fell by 2.1% in February (£3.5k) and is now back in line with the UK average. NI's FTB share of the mortgage market has slumped over the last 2 years and at 29% in 2007 this was the lowest share of all the UK regions (UK = 35%). Property prices have been cut aggressively in recent months to attract the FTB back into the market. While the market is hoping for a revival in the FTB market this year the ongoing credit crunch is going to reduce the availability and increase the cost of credit for these borrowers. Under such conditions Co-ownership takes on more importance as the only viable option for some FTBs. Given that the demand for the scheme has outstripped the available funds more funding is urgently required.

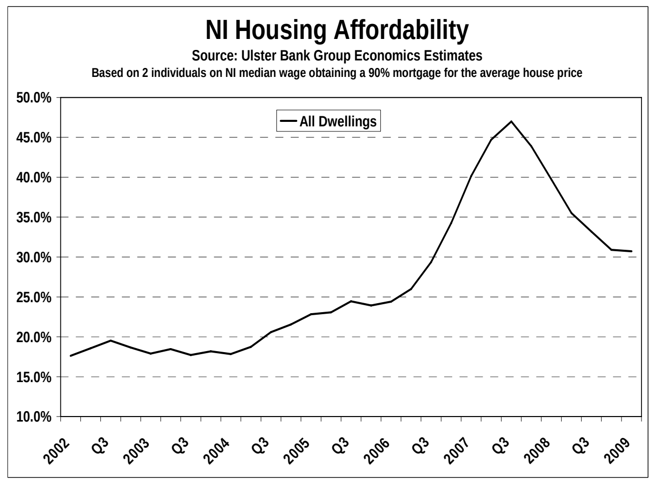


How low can they go?

Previous QER's have highlighted the view that NI's average house prices had overshot its economic fundamentals such as relative economic prosperity (GVA per capita) & wages. This was driven by investor speculation and a belief that NI house prices would keep on rising. The ongoing credit crunch which has coincided with the NI housing market slowdown is expected to hasten the current house price correction. The Chart below highlights the rapid growth in NI's house prices relative to the UK average excluding London and the South East (LSE). The latter two regions are excluded as they tend to distort the overall UK picture. It is not unreasonable to assume that NI's average house prices should be no more than the UK average excluding LSE. In August 2007 NI's average house prices peaked at 33% above the this average and while they have subsequently fallen back they still 19% or £35k above the UK average (excluding LSE) at February 2008.

In recent months property prices have been aggressively reduced and these house price falls in our view have still not fed into the official statistics. This should become more transparent in the next few months. We believe that the current NI average house price is closer to £200k and we are anticipating the average house price to fall by a further 12.5% to reach £175k by the end of 2008. This would still remain above the UK average (excluding LSE) if the UK housing market was to experience house price falls of between 5-10% as some forecasters are predicting. The forecast NI decrease would take average house prices back to the levels of autumn 2006.





Falling house prices will improve affordability

In August 2007 NI's average house prices were approaching 12 times median full-time earnings. This was the highest house price to earnings ratio of any UK region. The subsequent falls in local house prices have brought this figure down to 10.5. In 2008 this ratio is set to improve further – to around 8.5 - if average house prices fall in line with our expectations.

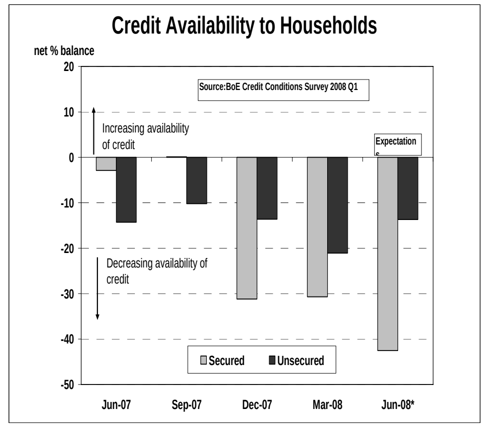
The Chart above indicates that affordability should improve rapidly in 2008 as a result of falling average house prices and further interest rate cuts. We anticipate two more quarter point interest rate cuts this year in June & August bringing the UK base rate down to 4.5%.

However a critical feature of the ongoing credit crunch has been that lower base rates have not led to lower mortgage rates. As a result we have assumed that only a small proportion of the expected rate cuts will feed through into mortgage rates. Nevertheless the rapid deterioration in affordability over the period 2006 Q4 – 2007 Q3 will be reversed and affordability should return to the levels of late 2006. In 2007 Q3 mortgage payments (interest & capital) associated with purchasing the average priced NI home represented 47% of gross income. This is expected to fall to 31% by the end of the year. While housing affordability is set to improve in principle it will be dependent upon the availability of credit alongside disposable incomes. The latter are under severe pressure with soaring food and energy prices while mortgage availability will be more restricted in 2008. The implications of the ongoing credit crunch for households are examined in the following section.

IX Credit Crunch – Impact on households

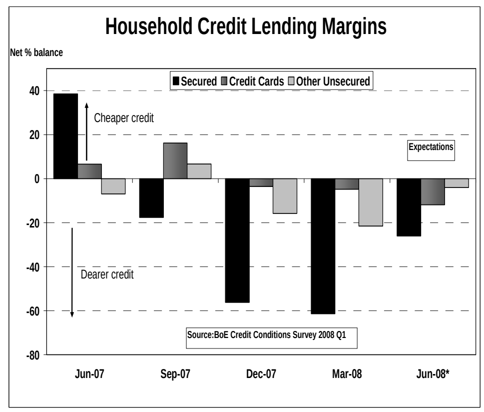
Reduced availability of credit to households continues

The latest Bank of England Credit Conditions survey signals a significant reduction in the availability of all forms of credit to households in Q1 2008. This confirms the general tightening in credit conditions that has been in train over the last 6-9 months and UK lenders expect a further tightening in credit availability in the next 3 months. This will impact on mortgage borrowers and will represent a negative influence on the UK & NI housing markets. Over the past 6-9 months lenders' appetite for risk has declined markedly in view of increased concerns over the economy and housing market. This has led them to reduce credit availability in a number of ways such as: applying more rigorous credit scoring and by scaling back the maximum loan to value (LTV) and loan to income ratios. These trends are expected to continue in Q2 2008 and will make it more difficult for prospective borrowers (particularly higher risk ones) to obtain a mortgage. The reduction in availability of unsecured credit – e.g. credit cards & unsecured loans – will also have a negative impact on NI & UK consumer spending.



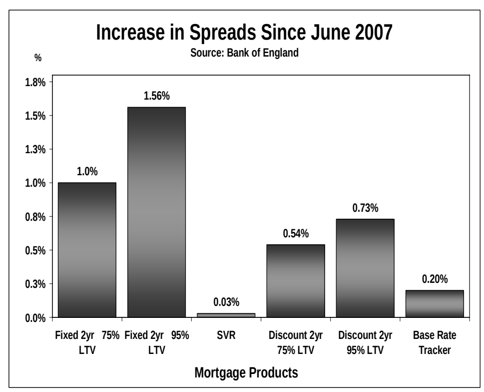
The cost of credit is also on the rise

Not only is credit availability being reduced but the terms and conditions attached to credit are also becoming less favourable. In the three months to mid-March, UK lenders reported a sharp rise in spreads on secured lending for all types of borrowers and this trend is expected to continue in Q2 2008. A similar pattern is also evident with unsecured credit such as personal loans and credit cards also experiencing wider lending margins (more expensive credit) during the last 6 months. Over the next 3 months lending margins on credit cards are expected to increase slightly while spreads on other unsecured lending is expected to remain largely unchanged.



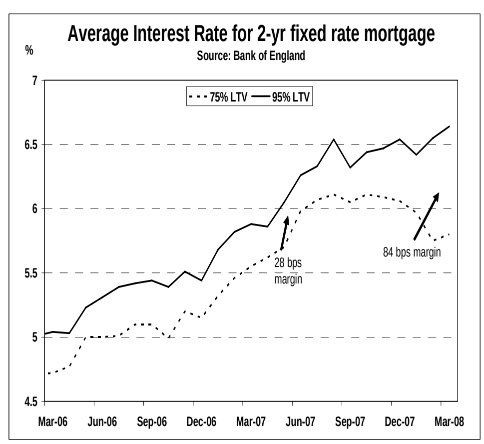
Some mortgage products are becoming more expensive

The Bank of England Credit Conditions Survey provides a qualitative picture of the changing credit conditions. However the impact in quantitative terms has been quite marked. Over the period June 2007 – March 2008 there has been a marked widening of spreads in a range of mortgage products. This indicates the rising cost associated with credit. For example, the average interest rate of a 2 year fixed rate mortgage (95% LTV) has risen by almost 1.6 percentage points. Similarly discounted 2 year mortgages have seen their spreads (difference between average interest rate and UK base rate) widen by up to 0.73 percentage points. Even the average interest rate of base rate trackers has increased by 0.2 percentage points. The upshot of this is mortgage rates are becoming more expensive despite the fact that the Bank of England has been cutting rates.



Re-pricing of risk with mortgage products

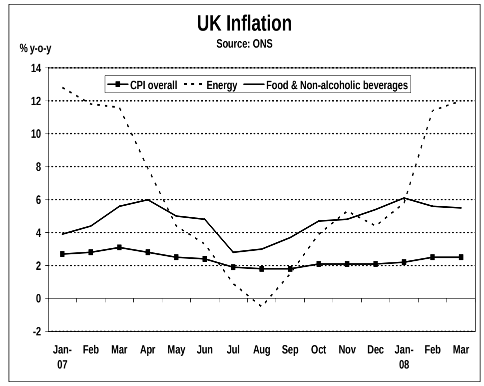
Not only are UK lenders increasing the average interest rates on mortgage products but they are also re-pricing risk between mortgage products. This is most apparent with 2-yr fixed rate mortgages where the differential between 75% and 95% LTVs have shot up from 0.28 percentage points to 0.84 percentage points. This will have a significant impact on first-time buyers who naturally have smaller deposits. Not only has their access to 100% mortgages been restricted they will have to pay a higher rate. This is in marked contrast with the position 10 years ago when there was no additional premium between a 75% and 95% LTV. Despite improving affordability in terms of lower house prices, FTBs will have to stump up larger deposits and pay higher interest rates and fees. Ironically they may be more reliant on the Bank of Mum & Dad than when house prices where actually higher.



X Consumer Sector

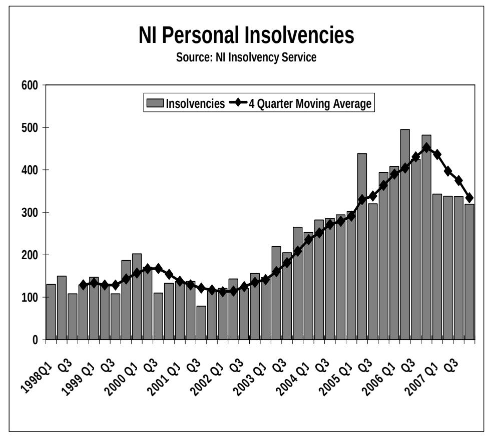
Consumers face energy & food price rises

Rising inflation has been a growing concern within businesses and households. Consumer Price Inflation (CPI) – the Government's target measure – remained unchanged at 2.5% y-o-y in March. This is the sixth successive month that inflation has remained above the 2% target rate. Core CPI inflation (headline CPI excluding – energy, food, alcoholic beverages and tobacco) remained unchanged at 1.2% y-o-y its lowest level since August 2006. Rising food (+5.5% y/y) and energy prices (+12% y/y) are the key drivers of the current inflationary pressures. Further food & energy price rises are expected to see inflation push higher in coming months towards the 3% mark. The Retail Price Index (RPI) which includes mortgage costs stood at 3.8% in March. These higher prices will further erode household disposable incomes with the impact most noticeable on those individuals on lower earnings.



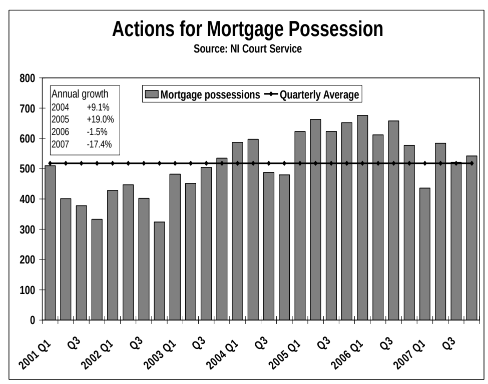
Tightening credit conditions expected to hit consumer

Personal insolvencies have been on an upward trend over the last 5 years although figures have dipped significantly in 2007. During 2007 NI's personal insolvencies amounted to 1,337 which represented a decrease of 26% on the previous year. In Q4 2007 there were 319 personal insolvencies which represent a fall of almost 34% on the same quarter in 2006. Looking forward in 2008 personal insolvencies and mortgage repossessions will be strongly influenced by the strength of the labour market, interest rates and affordability. The labour market is set to weaken with high profile redundancies such as Seagate Limavady (900 jobs set to go) expected to have a significant impact in specific localities. Housing affordability is set to improve in terms of lower average house prices. However this must be weighed up against a tightening of credit conditions with credit in 2008 more restricted and more expensive than in 2007. Insolvencies are expected to rise in 2008.



Actions for mortgage possession remain subdued

An action for mortgage possession is a key indicator of financial distress with mortgage payments deemed to be the primary expenditure item for consumers. These actions have been following an upward trend in recent years. While we expect to see rises in the number of actions for mortgage possession in 2008 as household incomes suffer from the credit crunch and declining disposable incomes we do not expect a very rapid rise. In 2007 NI's had the lowest loan to value (LTV) ratio of any UK region at 65% as compared to 80% for the UK. Similarly with the FTB market the average LTV for NI was 77% as opposed to 90% for the UK



New car purchases on the rise in 2007 but expected to fall in 2008

After housing, the most significant consumer expenditure item is a car. New car purchases provide a useful barometer of the strength of the consumer. In Q4 2007, new car registrations rose by 8.7% on the same quarter in 2006. In 2007 new car registrations were some 4.5% higher than the previous year. Since 2002 new car registrations account for a decreasing share of overall car registrations falling from 79% to 65%. This suggests a deterioration in affordability as housing costs are accounting for a greater share of household income. With household finances under pressure this is expected to impact significantly on new car sales. We expect the number of new car purchases to fall this year while the used car market should see a significant rise. The credit crunch will make car loans more costly and more difficult to obtain. The latest car sales data from the Motor industry group (SMMT) for March 2008 signalled a 11% decrease on the March 2007 figure (UK +0.6%).