Group Economics

Ulster Bank

Northern Ireland Quarterly Economic Review October 2008

Contact: Richard Ramsey
Group Economics
02890 276354 or 07881 930955

richard.ramsey@ulsterbankcm.com

www.ulsterbank.com/economics

NI Economy is in recession

- ***NI economy is currently in recession and is expected to contract by 1.5% in 2009***
- ***NI's key trading partners, the US, UK, Eurozone and the RoI are all in or entering recession***
- ***New Ulster Bank Private Sector Output Index shows output in Q2 2008 was 2.2% lower than Q2 2007***
- ***NI's housing & construction downturn triggered the slowdown which has spread to services***

Slowdown is widespread across all sectors

- ***Retail & Business Services have driven private sector employment growth but these sectors are currently experiencing the slowest rates of output growth***
- ***NI is to fare relatively worse than the UK due to its exposure to retail and the construction sectors***
- ***Housing downturn is more marked than UK – with house prices to end 2009 40% below the August 2007 peak***
- ***The majority of NI's house price correction has already occurred but yet to feed into the surveys***

Labour market is weakening

- ***NI employment has peaked in Q2 2008***
- ***Unemployment is set to push above 6% by the end of 2009***
- ***The numbers claiming unemployment benefit rose at its fastest rate since 1986 in September***
- ***The number claiming unemployment benefit is set to more than double by the end of 2009 from last year's record low***

Global policy response has been unprecedented to stimulate a recovery

- ***Global economic environment has deteriorated markedly but financial Armageddon has been avoided by unprecedented intervention by central banks and Governments***
- ***UK base rates to hit 3.0% - their lowest level since 1954 in 2009 – with the risk they may go lower***
- ***NI economy is expected to return to positive growth in 2010***
- ***Oil prices have fallen by 60% since July peak***

THE EARLY 1990S AND 2008/09 – A TALE OF TWO DOWNTURNS

Arguably the most notable achievement of the local economy during the 1990s was the fact that NI avoided the UK recession. However, while the economy avoided the last UK recession, it has not avoided the current one. In our view the NI economy is already in recession with economic growth forecast to remain flat in 2008 and is set to contract by 1.5% in 2009. This compares with corresponding growth rates of 0.8% and -1.0% for the UK. NI private sector output in Q2 2008 was 2.2% below the corresponding quarter in 2007 and in our view the NI economy will continue to experience growth below the UK average in 2008 & 2009.

The most significant development since our July QER has been the near collapse in the global financial system and a rapid deterioration in the global economic outlook. Practically all economic forecasters underestimated the scale of the credit crunch. The impact has been more pronounced and more prolonged than the Federal Reserve, the Bank of England, the European Central Bank and others had anticipated. The seriousness of the situation was succinctly summed up by the Governor of the Bank of England, Mervyn King, who recently stated *"Not since the beginning of the First World War has our banking system been so close to collapse".* However, the response by central banks and Governments, to the current financial crisis has been unprecedented. Fortunately, the threat of financial Armageddon has subsided as global policy makers have been determined not to let the financial crisis turn into an economic disaster. Nevertheless, despite this intervention, the global economic outlook has deteriorated markedly. Clearly the NI economy cannot insulate itself from global economic developments. Prospects for trade, tourism and investment, alongside business confidence, have all deteriorated markedly in recent months. This is the single most important factor that has led us to revise down our forecast.

The factors that contributed to NI's recession proof status in the 1990s were quite unique and are either no longer applicable in the current downturn or will no longer insulate the economy to the same extent. These factors included: a large public sector; extremely high levels of financial assistance to manufacturing industry; the absence of a contruction (*notably housing*) boom and bust; an underdeveloped private sector, particularly in relation to consumer demand sensitive sectors such as retail; continuous employment growth with only a very modest rise in unemployment. All of these factors insulated the economy against the worst ravages of the UK recession. Unfortunately, NI is not going to fare as well in the current downturn. In a sense the economy has become a victim of its own success with substantial economic progress of the last decade making NI more exposed to economic slowdowns than was previously the case.

The NI economy began its current economic slowdown before the UK with the property downturn triggering a slowdown in the construction sector. NI house prices have already fallen by 20-30% over the year, depending on which survey you use. NI's property bubble would have deflated on its own accord; however, the credit crunch has exacerbated the downturn and will delay a recovery. We anticipate the average house price will end 2009 some 40% below the August 2007 peak. As a result of the housing market downturn and the credit crunch, housebuilders are in the midst of their worst downturn to date. House completions in 2009 are set to fall to around 5,000 next year which would be below the previous low in 1983 and over 70% below the peak in 2006. Given that NI's house builders have recently been building at three times the rate of their GB counterparts, the house building industry is falling from a much higher peak. Therefore the downturn will be much greater in NI than in the UK.

The malaise in the construction sector quickly spread to the service sector in the second half of 2007. This has been most noticeable in service sector output with the Executive's priority area of Business Services & Finance seeing output plummet. This has filtered into the labour market with NI's service sector recording the slowest employment growth this year since 1984. The growth in private sector services was one of the key factors that prevented NI going into recession in the 1990s. However, this is proving to be one of the sectors experiencing the sharpest declines in 2008. While NI is less exposed to the downturn hitting the financial intermediation sector in the UK, NI's business services and finance sub-sector is more exposed to property slowdown. We anticipate the service sector will experience net job losses in 2009 for the first time since 1981.

NI is now also more exposed to a consumer downturn than in the 1990s. The NI economy was underweight in consumer demand sensitive sectors such as retail, wholesale distribution, hotels and restaurants. However, NI has played catch up with the UK with employment in these consumer sensitive sectors rising by 71% since 1991 (UK=+21%). In these consumer demand sectors, the NI and UK are now of comparable size. NI's lower disposable incomes and higher energy costs suggest that NI will not weather the consumer downturn as well as the UK. Indeed, NI's Distribution output (retail & wholesale) and declining levels of car sales highlight that the current consumer downturn is hitting NI harder than the UK. The rising cost and reduced availability of credit will continue to curb consumer spending in the year ahead.

In our previous forecasts, the strength of NI's production and manufacturing sectors has been seen as the key factor that would determine whether the NI economy, as a whole, would record positive growth in 2008 & 2009. The Index of Production and Manufacturing surveys have pointed to robust growth in the first half of 2008, and indeed stronger than we had anticipated. However, these sectors are the most exposed to global economic developments and the global economic environment has deteriorated markedly since Q3 2008. The Ulster Bank PMI also confirmed a marked contraction in manufacturing output over this period. While input costs, notably oil, have been falling and exchange rates are making exports more competitive, the key challenge going forward is a fall in demand. All of NI's main export markets, the RoI, the Eurozone and the US are either in or going into recession. As a result, NI's overall manufacturing exports are expected to experience a notable decline in 2009 and by significantly more than we had previously expected. It should also be remembered that one of NI's top exporters over the last decade – Seagate Limavady – closed at the end of September 2008. As a result, the manufacturing sector is expected to contract in 2009 and we anticipate further job losses in the sector over the next 18 months.

Against the backdrop of falling output, NI's labour market has begun to weaken significantly during the second half of 2008. While NI's unemployment rate remains low at 4.3%, and compares favourably, with the UK and RoI, it is set to rise. We expect to see the unemployment rate hitting 5% this year and 6.2% by the end of 2009. The strength of the labour market, alongside cheap and readily available credit supported strong consumer spending in recent years. However, rising unemployment and the credit crunch will mitigate against this in 2009. Given the current economic conditions NI really is in unchartered waters.

Summary Table

Economic Growth (real terms)			Forecasts		
	2006	2007*	2008	2009	
NI – Gross Value Added (GVA)	3.0%	2.5%	0.0%	-1.5%	
UK - GDP	2.9%	3.1%	0.8%	-1.0%	
RoI - GNP	6.3%	4.1%	-2.0%	-3.0%	
* Estimate for NI					
Financial Market Forecasts (end period)	**Current Period**	**Dec-08**	**Mar-09**	**Jun-09**	**Sep-09**
Interest Rates					
- Fed Funds Rate	1.50%	1.00%	1.00%	1.00%	1.00%
- ECB refi rate	3.75%	3.00%	2.50%	2.50%	2.50%
- UK Base Rate	4.50%	3.50%	3.00%	3.00%	3.00%
Currencies					
- Eur/USD	1.254	1.35	1.25	1.25	1.20
- GBP/USD	1.56	1.67	1.58	1.60	1.58
- GBP/Eur	1.24	1.23	1.27	1.28	1.32
- Eur/GBP	0.80	0.81	0.79	0.78	0.76

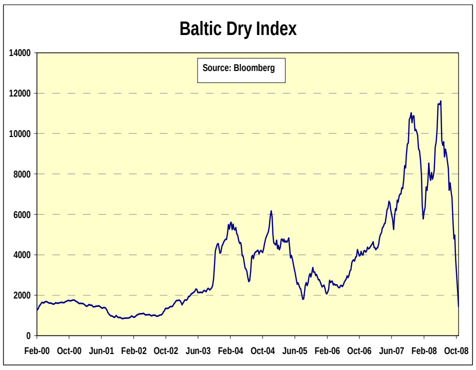
I Global Economic Overview

Global Economic Conditions have deteriorated

Practically all economic forecasters and commentators underestimated the scale of the credit crunch. The impact has been more pronounced and more prolonged than the US Federal Reserve, the Bank of England, the European Central Bank and others had anticipated. Financial markets have been under tremendous strain since the implosion of the US sub-prime mortgage market in August last year. However, the distress in market conditions reached fever pitch in mid-September. The forced bankruptcy of Lehman Brothers was the trigger for the latest and most extreme bout of financial market turbulence which led to significant falls on global stock markets. The seriousness of the situation was succinctly summed up by the Governor of the Bank of England, Mervyn King, who recently stated *"Not since the beginning of the First World War has our banking system been so close to collapse".* However, the response by central banks and Governments, to the current financial crisis has been unprecedented. As a result, the threat of financial Armageddon has subsided as global policy makers have been determined not to let the financial crisis turn into an economic disaster. Nevertheless, despite this intervention, the global economic outlook has deteriorated markedly. This has important implications for the interest rate outlook as the rapid slowdown in economic activity will help to bring inflation down. A synchronised and co-ordinated 0.5% interest rate reduction occurred for the first time ever at the beginning of October.

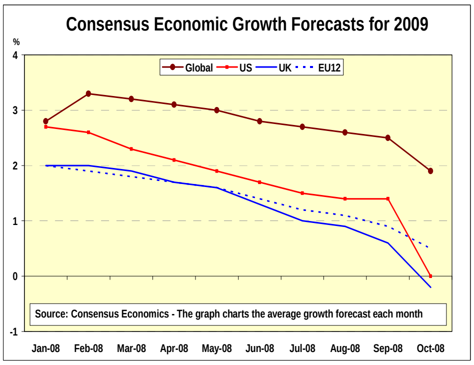
Shipping news points to a global slowdown

The Baltic Dry Index (BDI) measures the shipping rates for transporting materials on the world's main shipping routes. The BDI essentially provides an indication of shipping capacity versus the supply of dry bulk carriers. As a result, the index indirectly measures the global supply and demand for commodities, such as coal, iron ore and grain. Given that these commodities are the raw material inputs for other intermediate or finished goods, the index is seen as a leading indicator for future global economic growth. In recent years, the rise in the index has mirrored the sharp increase in China's demand for the world's resources and the global commodity boom in general. The BDI recently peaked in May 2008, on a monthly basis, but the latest figures for October are almost 90% lower than this recent peak. Indeed, the BDI is now at its lowest level since November 2002.



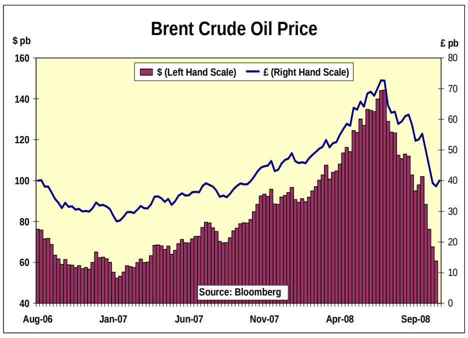
Economic forecasts are being scaled back as a result

The economic growth prospects for most economies in 2009 has deteriorated markedly in recent weeks. The G7 is expecting 2009 to be its weakest year of growth in 27 years. Economic growth is set to contract for several quarters in the US, Eurozone and the UK. In the UK, quarterly GDP was flat in Q2 2008 and fell by 0.5% in Q3. This represented the first contraction in output since Q2 1992 and the largest fall since Q4 1990. For the UK, like other economies, the rapid deterioration in economic growth - which will bring inflation down – will enable the BoE to cut interest rates aggressively and quickly. In the UK, we expect rates will be lowered to 4.00% in November, 3.5% in December and finally coming down to 3.0% in Q1 2009. This would represent the lowest base rate since 1954. Clearly the risks are that even lower rates may be required.



A global slowdown is not all bad, Oil price has fallen significantly

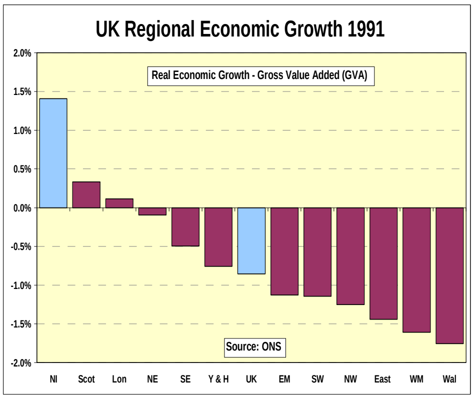
Every cloud has a silver lining with the deteriorating outlook for global economic growth leading to a significant fall in oil prices. The Brent Crude oil benchmark fell from $147 per barrel in July to around $60 at the end of October. Fluctuations in the sterling / dollar exchange rate affects have sterling price of oil. However, it too has fallen markedly from around £73 per barrel in July to around £40 pb now. This fall in the price of oil is already feeding through into lower petrol prices in NI.



II NI Economic Growth Performance & Prospects

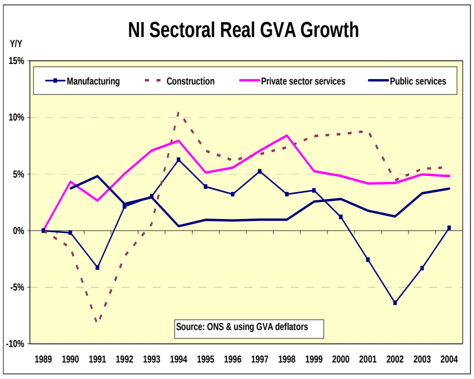
NI, alongside Scotland, was recession proof during the 1990s

Arguably the most notable achievement of the local economy during the 1990s was the fact that NI avoided the UK recession. Indeed, the NI economy was the fastest growing economy of all the UK regions each year over the period 1990-1995. In 1991, the trough of the UK recession, the NI economy recorded real economic growth, in terms of Gross Value Added (GVA) of 1.4%. This compared favourably with all other UK regions and a national decline of 0.9% (-1.4% in GDP). This follows a similar story in 1990, when NI again recorded the strongest rate of economic growth (+0.7% v -0.5% for UK) of all the UK regions. NI and Scotland were the only two UK regions not to record negative economic growth in 1990 and 1991. Meanwhile, the manufacturing heartlands of Wales and the West Midlands fared the worst in 1991.



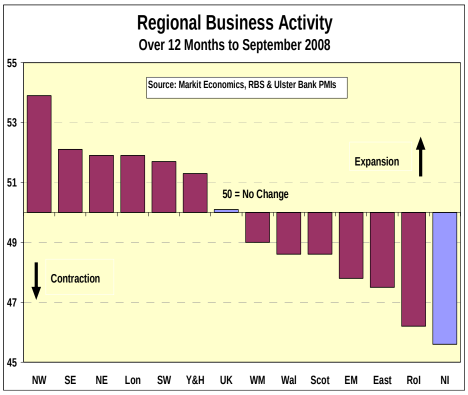
In the early 1990s NI manufacturing & construction contracted

During the early 1990s, NI's construction and manufacturing industries were the only sectors to contract. However, the scale of output decline was much less than in the UK (see Appendix). NI's manufacturing sector contracted by over 3% in 1991, following a marginal decline in 1990, before rebounding into positive territory for the rest of the decade. Meanwhile, UK industry recorded 3 consecutive years of contraction 1990-92 with a hefty fall of over 7% in 1991. During this period NI industry availed of significantly higher levels of Government financial assistance which minimised the manufacturing downturn in NI. The UK and NI both recorded strong growth in public sector services in 1991 (+4.8%), which given NI's proportionately larger public sector had a positive impact on growth. The key difference between NI & UK in 1991 was the growth in private sector services. The UK experienced a real increase of just 0.3% as opposed to 2.7% in NI.



But NI is not faring as well in the 2008 downturn

The Purchasing Managers' Indices, or PMIs, are internationally reknowned as leading indicators of economic activity. The latest surveys for September point to a marked weakening in economic activity in NI and its two most important trading partners – GB and the RoI – during Q3 2008. Both the UK and NI PMIs hit new record lows in September with the NI PMI some 10 points below the equivalent UK survey. The NI & RoI September composite – all sectors - surveys represent the tenth consecutive month that the private sectors in both economies have contracted. At a sector level, the construction sector has borne the brunt of the downturn, in terms of declining output and employment, during the first half of 2008. However, the local manufacturing sector recorded the sharpest falls in output and employment in the third quarter.



NI's downturn is more pronounced than elsewhere

Since the middle of 2007 the NI economy has slowed down rapidly and at a much faster rate than the UK average. At a regional level, NI has experienced the sharpest contraction in business activity of all the UK regions during the last twelve months to September 2008. We expect the economy to record no economic growth during 2008 which compares to 0.8% for the UK. The global economic outlook for 2009 has deteriorated significantly since our last QER. With NI's key trading partners either in or entering recession this will affect exporters. As a result, we expect NI's manufacturing exports to fall next year. Overall we expect NI's economy to contract by 1.5%. This will be above the 1.0% contraction for the UK forecast but below the expected 3.0% fall for the RoI.

	Real Economic growth			
	2006	2007	2008f	2009f
UK *GDP*	2.9%	3.1%	0.8%	-1.0%
NI *GVA*	3.0%	2.5% est	0.0%	-1.5%
RoI *GNP*	6.3%	4.1%	-2.0%	-3.0%

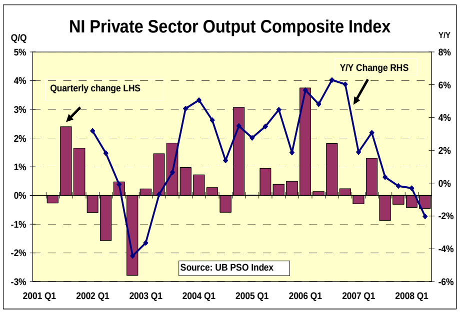
Source: Ulster Bank, ONS & CSO

III IS NORTHERN IRELAND'S PRIVATE SECTOR OUTPUT REALLY CONTRACTING?

Unlike the UK and RoI economies, there is no quarterly GDP data for NI to provide a timely indicator of economic growth. Indeed, the latest available Gross Value Added (GVA) statistics, which equate to regional GDP, is for 2006. These figures highlighted robust economic growth of 3.0% in real terms. Despite the considerable lag in obtaining the official economic growth figures, there are a number of sources which provide an indication of private sector output. The Ulster Bank Purchasing Managers' Index (PMI) for NI provides the most timely and frequent (monthly) indication of private sector output. However, the PMI only signals the scale of contraction or expansion, but does not quantify it, The Department of Enterprise Trade & Investment (DETI) produces output indices for the production (predominantly manufacturing) and services industries. Meanwhile, the Department of Finance and Personnel produces an index of construction output. Altogether, these three sectors account for 96% of total NI private sector output, with agriculture, the only sector excluded. An overall indication of ***private sector*** *output can be compiled by weighting the sectors (according to the latest available sector GVA data - 2004) and combining all three indices into a single index. The composite index runs from Q1 2001 to Q2 2008.*

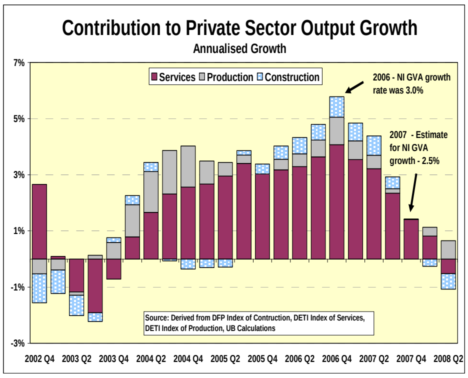
Private sector output falls for 4th consecutive quarter

The composite index of private sector output, derived by Ulster Bank Group Economics (UB PSO Index), peaked in Q2 2007. However, the index has subsequently fallen in the four consecutive quarters to Q2 2008. As a result, the UB PSO index signals that private sector output has declined by 2.2% since Q2 2007's peak. This confirms our view from the start of the year that NI's slowdown in growth occurred before the credit crunch and well before the UK. In Q2 2008, private sector output was 0.5% lower than the previous quarter and 2.2% lower than the corresponding quarter in 2007. The latest figures for the Index of Construction are Q1 2008. For the purposes of the UB PSO index it was assumed that construction output remained flat in Q2.



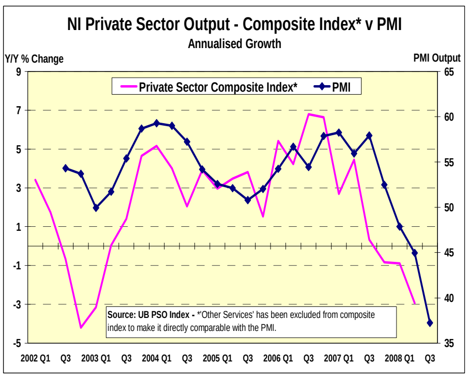
Service sector slowdown and construction is contracting

The NI economy enjoyed robust economic growth in 2006 with GVA increasing by 3.0% in real terms over the year. During 2006, all three sectors contributed to NI's private sector output growth of 5.8% using the UB PSO index. The construction sector recorded the strongest growth rate (+6.7%), followed by services (+6.5%), with the production industries expanding by a healthy 3.7%. The official GVA growth figures for 2007 will not be released until December 2008. Our estimate for NI economic growth in 2007 is 2.5% in real terms. This is the most pessimistic forecast among local commentators. However, given that the Ulster Bank PSO index recorded growth of just 1.5% in 2007, one quarter the growth rate in 2006, this estimate now looks on the optimistic side. The annualised growth rate has been slowing for the last 6 quarters with Q2 2008 dipping into negative territory – due to declining service & construction sector output.



Is the PMI a good predictor of private sector output or crying wolf?

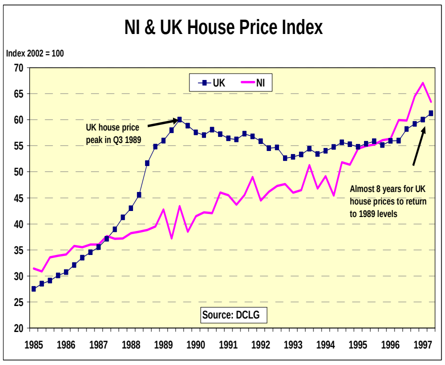
The Ulster Bank PMI has been particularly gloomy in 2008 and has signalled private sector contraction, *(i.e. below the 50 threshold)* for the last 10 months. The chart opposite highlights that the PMI has a reasonably strong correlation with the composite index of private sector output. The PMI peaked in Q3 2007 but has slowed down rapidly since and has been in outright contraction since Q1 2008. The PSO index peaked in Q2 2007 and dipped into contraction territory in Q2 2008. With the PMI signalling contraction, at an accelerating rate in Q3, viewed alongside our wider forecasts for the economy to deteriorate further, we expect the UB PSO index to contract sharply in the second half of 2008 and into 2009. The UK is not expected to go into technical recession – 2 quarters of negative GDP growth – until Q4 2008. However, the NI economic slowdown is more marked and has occurred earlier than the UK. As a result, we believe that the NI economy is currently in recession.



IV PROPERTY DOWNTURN HAS TRIGGERED THE DECLINE IN PRIVATE SECTOR OUTPUT

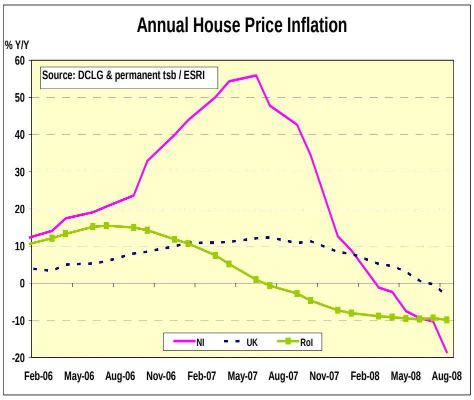
NI escaped the boom and bust of the late 1980s & early 1990s

During the period 1986-1989 the UK housing market experienced strong double digit house price inflation. The average rate of UK house price inflation over this period was almost 20% per annum. This compared with less than 6% for NI. The UK then experienced house price falls each year between 1990 - 1993. Conversely, the NI housing market, having not experienced a boom, continued to record steady house price growth. Indeed, 1981 was the last time that NI house prices ended the year below the previous year. The scale of the housing market downturn in the early 1990s is highlighted by the fact that it took almost 8 years for UK house prices to return to their peak of 1989. As a result, many UK homeowners experienced negative equity whereas their NI counterparts did not.



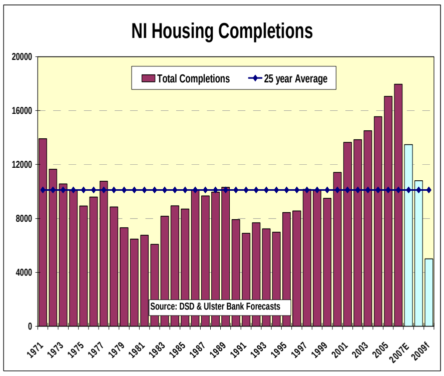
But not the 2007/08 one

The NI housing market has witnessed the most extreme rises and falls of any housing market over the last two years. Annual house price growth topped 56% in June last year with the average house price peaking in August 2007 at £250k using both the DCLG and University of Ulster house price (Q3 2007) figures. According to DCLG, house prices have fallen to £205k in August, a 19% y/y fall, while the latest Nationwide survey has reported annual falls of 30%. Our April QER forecast **average** house prices to fall to £175k by the end of 2008. Clearly the risks beyond this time horizon lie to the downside. While house price averages conceal vast differences between property types and locations we do not expect NI's **average** house price to fall back to 2005 levels. We forecast the average price, by the end of 2009, to be 40% below the August 2007 peak. This would only take prices back to mid-2006 levels and still some 45% higher than 5 years ago. In our view the majority of the house price correction has already occurred but has not yet fed into the surveys.



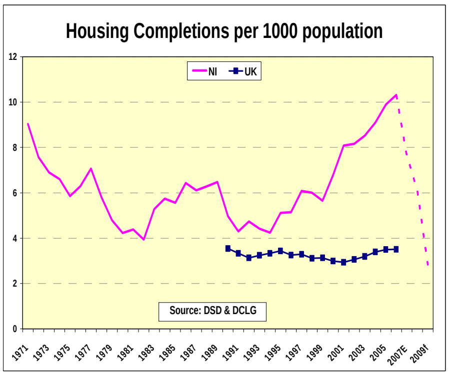
House building sector is in the midst of its worst downturn

The house building sector has enjoyed a boom period in recent years. However, given the rapid and unsustainable rise in land and house prices house building tailed off in the second half of 2007. The credit-crunch has made difficult trading conditions significantly worse with debt finance more expensive and less freely available than during the boom years. The slowdown continues with housing starts in the first nine months of 2008 some 60% lower than the same period last year according to the latest NHBC figures. This compares with a decline in the UK of over 40%. The decline in starts will translate into fewer completions next year and we anticipate this falling to 5,000 – if not lower. This would represent a reduction in completions of up to 70% or 13,000 fewer from the 2006 peak. This would be below the previous low of 6,100 in 1983.



NI's housebuilding sector is falling from a higher peak than the UK

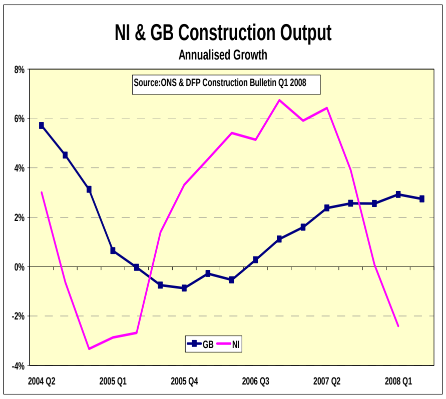
In order to understand the magnitude of NI's housing downturn it is necessary to consider the scale of house building that has taken place. In the UK the rate of house building has remained relatively static over the last 15-20 years. Conversely, NI has witnessed a steady increase in the rate of house building relative to population. In 2006, NI's rate of house building peaked at 10.3 units per 1,000 population. This was about half the rate in the RoI but almost three times the rate in the UK. Clearly, NI's housing downturn is coming from a much higher peak than the UK with the rate of building forecast to hit a new record low next year. In our view, the sustainable rate of house building is closer to 13-14k as opposed to the peak of 18k. This would imply an overhang of around 9-10k properties which need to be worked off.



V THE DECLINE HAS SPREAD QUICKLY FROM THE CONSTRUCTION SECTOR TO SERVICES

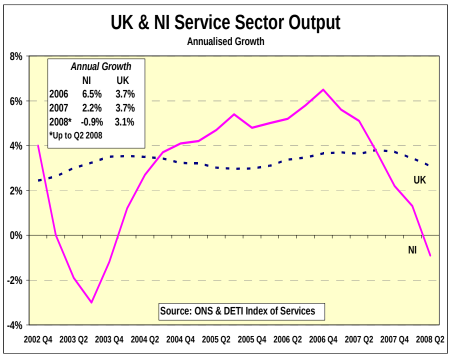
Construction slowdown remains more pronounced in NI

NI's construction sector accounts for a larger relative share of the economy than any other UK region. Therefore the NI economy is likely to fare relatively worse than the UK if they experience a similar shock. However, what is more important is how significant the construction downturn has been in NI relative to the UK. The sharp slowdown in NI's construction sector pre-dates the credit crunch and the construction boom has been more marked than in GB. For example, NI's construction output was almost 6 times higher than the corresponding growth rate in GB. NI's construction output began to contract in 2006 Q4 and has declined ever since. On an annualised basis, NI's construction activity has fallen by 2.4% over the year to Q1 2008 while the GB construction sector has still managed to record growth (+ 2.9%). In construction output & employment terms, NI is falling from a much higher peak than GB. Unlike the recession in the 1990s, the NI construction sector is going to be more adversely affected in the current downturn than other UK regions.



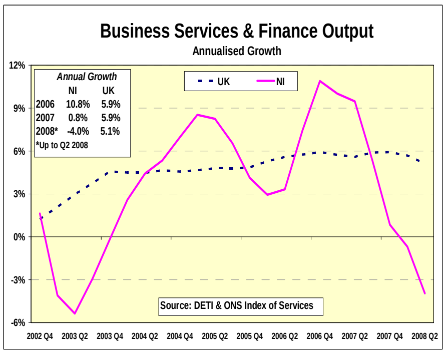
Services output is slowing at a much faster rate than the UK

The health of many other sectors is inextricably linked to the fortunes of the property / construction industry. NI's property downturn has therefore had a more significant impact on Business Services & Finance (*e.g. estate agents, solicitors, advertising, surveyors, banks etc)* and the Distribution sector (*e.g. construction supply chain)*. These two sectors account for 70% of private sector services output. According to DETI's Index of Services (IoS), output decreased for the fourth consecutive quarter whereas the UK economy continues to report robust output activity. As a result, NI's service sector output recorded an annualised rate of decline of 0.9% in Q2 2008, which compares with 3.1% growth for the UK. This supports the view, that we have held since the start of the year, that the NI economy will experience overall economic growth below the UK average in 2007, 2008 and 2009.



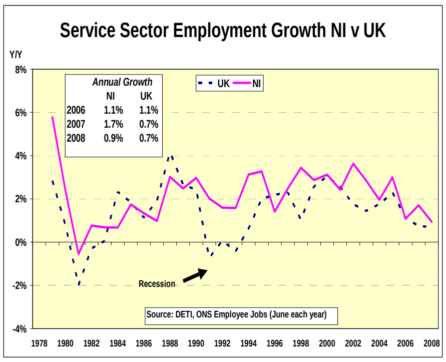
Output has plummeted in the priority area of Business Services

The rapid slowdown in NI's service sector is most apparent in the *Business Services & Finance* sector. This has been highlighted by the NI Executive as a priority area for economic development as it contains high value added sectors. What is striking about the chart opposite is the downturn in the *Business Services and Finance* sector has mirrored the downturn in the NI property market. While the UK has experienced robust growth of 5% over the year to Q2 2008 NI has recorded a 4% decline. Moreover, the latest quarter (Q2 2008) is down almost 8% on the same period in 2007 – at the height of the property boom. Falling output will lead to job losses in the service sector employment in the months ahead.



Slowest employment growth since 1984

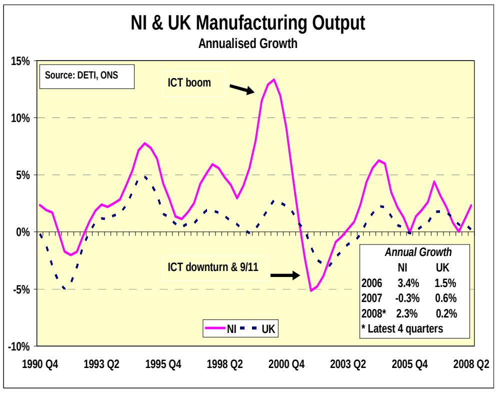
The NI economy has created 110,000 net jobs over the last decade. Over the year to June 2007, NI's service sector witnessed an increase of 1.7% in employment, a full percentage point above the UK. In June 2008, employment figures revealed that NI's employment growth had slowed to 0.9% over the year whereas the UK maintained its growth of 0.7%. The latest annual employment growth for NI of 0.9% (+5,160) represented the slowest rate of employment growth since 1984. NI's service sector helped the NI economy avoid recession during the 1990s as employment growth continued at a robust pace. This was largely due to the private sector growing from a relatively small base. NI's service sector has recorded 27 years of unbroken employment growth. However, the sector will experience net job losses in 2009 for the first time since 1981.



VI MANUFACTURING IS THE BEST PERFORMING SECTOR DURING THE FIRST HALF OF 2008

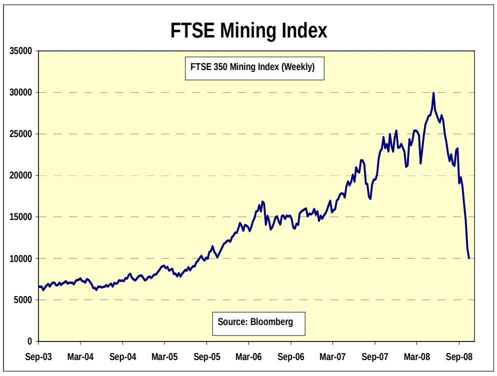
NI's Manufacturing & Production sectors outperform the UK

The latest Index of Production survey for Q2 2008 is arguably the most positive piece of economic news regarding the NI economy at present. In previous economic downturns, the manufacturing industry was traditionally the first sector to be affected. In the current slowdown, which was triggered by the property downturn, NI's manufacturing sector is towards the back of the queue. It is encouraging to note that NI industry is the one sector of the local economy that has been growing during the first half of 2008 while its UK equivalent has been contracting. NI's production industries recorded output growth – due to the manufacturing sector - for the second consecutive quarter in Q2 2008. NI's manufacturing sector recorded a rise in output of 1.1% over the quarter and was 4.6% higher than the same period last year. Conversely, UK manufacturing output is down 0.9% on both the pervious quarter and the same period last year.



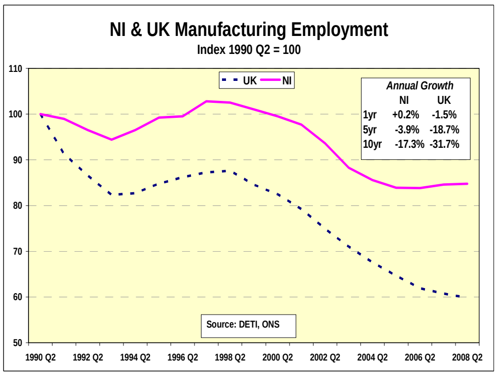
The end of the commodities boom is a mixed blessing for NI firms

NI's mining and quarrying industries have benefited from the construction boom in the UK and the RoI. However, output has declined from the record levels of output in Q1 2007 for 5 consecutive quarters up to Q2 2008. According to the latest employment survey, from the Quarry Products Association NI, companies involved in the industry indicated that they have laid off up to 1,000 workers since the beginning of the year with a further 500 expected in Q4 2008. The recent sharp falls in the FTSE Global Mining Index suggests that the five-year commodity boom has come to an end. While many firms will benefit from lower commodity prices others will suffer from the decline in global demand. NI has a number of firms in County Tyrone (*e.g. Powerscreen & CDE Ireland)* which are some of the world's leading exporters of quarrying machinery. This slowdown is expected to have a negative impact on exports and employment within this sector in the year ahead.



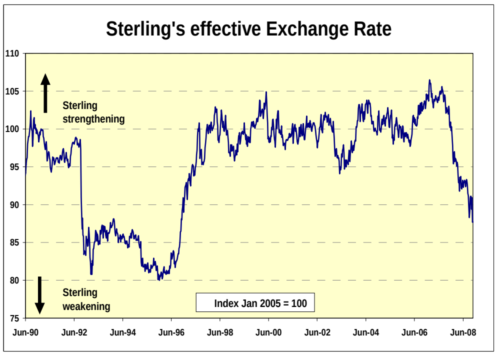
NI records employment growth for the first time in 11 years

Despite the rising cost base and deteriorating economic conditions, NI's manufacturing employment has held up much better than expected. The manufacturing sector which has shed almost 18,500 jobs over the last decade and gained 200 jobs over the year (+0.2%). Conversely, manufacturing employment in the UK fell by 1.5%. In NI, the increase in manufacturing employment growth was the first annual rise in 11 years. During the last recession NI industry experienced a more muted downturn relative to the UK. This was partly due to NI's comparatively high levels of financial assistance to industry which safeguarded employment. For example, over the period 1990-1993, the UK's manufacturing industry saw employment fall by 847,000 or almost 18%. Meanwhile, NI experienced a decline of just 5.6% or 5,800. Indeed manufacturing employment subsequently rose year on year in 1994-1997. This was due to an influx of FDI such as the arrival of Seagate *(Springtown site)* in 1993.



Sterling weakness good for exporters but bad news for importers

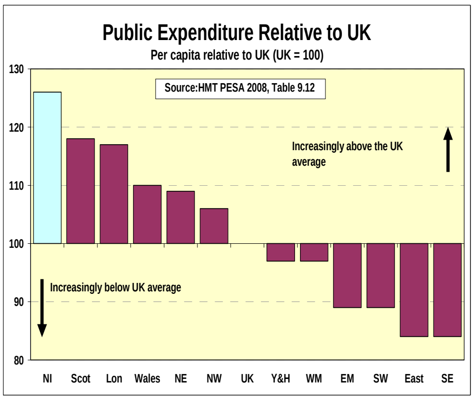
Sterling has weakened considerably in recent months with its trade weighted value falling by some 18% since August 2007. On this basis, sterling is now at levels not seen since the mid 1990s. Sterling's recent decline, in percentage terms, is on a par with its collapse following its exit from the ERM in 1992. Sterling's weakness will make imports more expensive but will make NI's exports more price competitive. However, the key concern in export markets is falling demand with NI's key export markets of the RoI, the Eurozone and the US all either in or entering recession. The deteriorating global economic conditions is the main reason for us slashing our growth forecast for next year with exports set to decline.



VII NI PUBLIC SECTOR WILL NOT INSULATE THE ECONOMY AS MUCH AS IN PREVIOUS DOWNTURNS

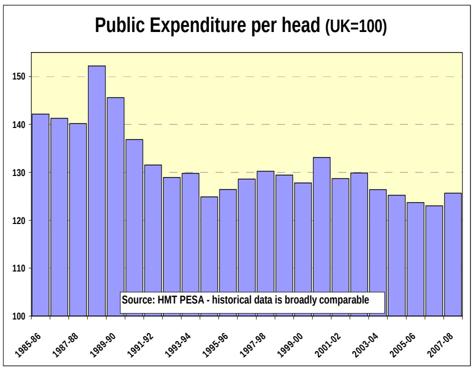
Public expenditure will offer more protection than elsewhere

NI is a public expenditure (PE) driven economy and its performance and prospects are sensitive to changes in the overall levels of PE. NI's higher per capita levels of PE, 26% above the UK average, will provide more insulation to the economic slowdown than in other UK regions. However, it should be remembered that not all PE contributes to growth. One of the largest elements of PE is social security expenditure. This is classed as a PE transfer from GB to NI and is not included in GVA. The key elements of PE that contribute to economic growth are: changes in public sector wages & employment and public procurement (*notably capital investment*). The NI Executive has set ambitious capital investment plans which, in the current economic climate, could provide an important offset to the economic downturn. However, the plans have not translated into action, either on the scale or in the timescale envisaged. 2007/08 was a record year for capital investment but still fell some £300m short of what was planned. Capital investment is already set to fall by over 10% in 2009/10 but the failure to secure capital receipts will see an even greater capital underspend.



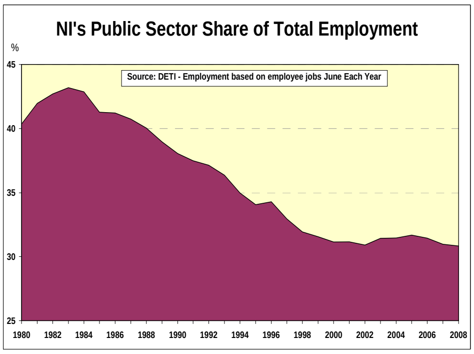
But PE will provide less insulation than in previous downturns

PE per head is still above the UK average but this PE premium is lower than in previous downturns. During the late 1980s, NI enjoyed a relative PE premium in excess of 40%, with 1988/89 representing a peak of 52%. This eased back to just under 32% when the UK recession hit its trough in 1991. Over the last four financial years, NI's PE per head premium relative to the UK has averaged 24.5%. The PE premium was particularly apparent within economic development related expenditure. In 1991, the level of PE per head spent on the HM Treasury's *"Trade, Industry, Energy & Employment"* expenditure category was 4.5 times the level in England and twice the level that Scotland and Wales received. Although there is no consistent historical PE series, HMT has reclassified public expenditure into a similar category called *"Economic Affairs".* The latest figures for 2007/08 highlight that NI's PE per head is now 67% & 29% above England & Wales respectively and 12.5% below Scotland.



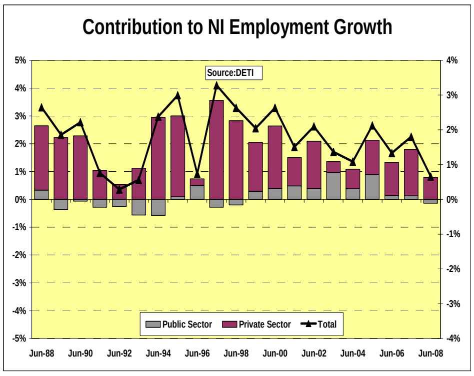
The public sector's share of employment remains high but is falling

During the early 1980s, NI's public sector employment accounted for 43% of total employee jobs and only fell below the 40% mark in 1989. This offered significant insulation going into the economic downturn in the early 1990s. Public sector employment fell for five consecutive years between 1989 and 1994. However, it still accounted for a relatively high share of employment at around 37% during this period. The public sector's share of total employment has generally been following a downward trend ever since. The latest figures for 2008 highlight that there are 220,870 public sector employees in NI, which represents 30.6% of total employee jobs. This compares to 19.6% for the UK.



The public sector will no longer be a source of employment growth

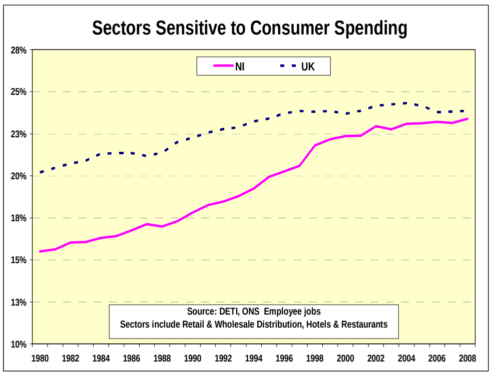
2008 marked the first decline in public sector employment in a decade with the headcount lowered by 1,000 over the year to June 2008. However, the difference between the current fall and previous declines is that the rate of growth of the private sector is much slower in 2008 than previously. Given the deteriorating public finances at a UK and NI level, there is a growing risk that public sector employment will have to fall more quickly than originally planned. We anticipate that the NI Executive will be under significant pressure to deliver even more efficiency savings and accelerate public sector reform, in an even shorter timescale, than they had previously envisaged in January's 2008 Budget. The public sector will act as a drag on employment growth going forward, although the private sector, particularly business services, will benefit from outsourcing which will compensate for some of these job losses.



VIII NI ECONOMY IS ALSO MORE EXPOSED TO A CONSUMER DOWNTURN THAN IN THE 1990s

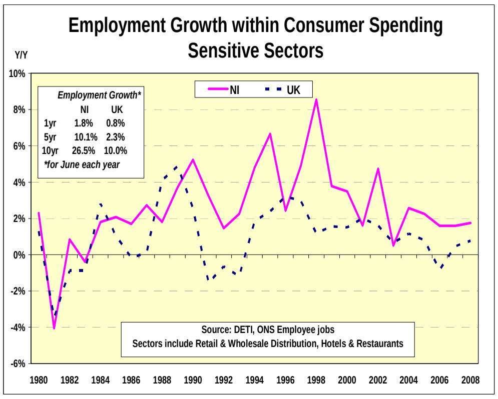
NI is now more exposed to a consumer downturn than in the 1990s

One of the factors explaining NI's escape from the 1990s recession was due to the economy being underweight in consumer sensitive sectors. These include the wholesale & retail distribution sectors alongside hotels & restaurants. In 1990, these sectors accounted for 17.8% of total employment (*employee jobs*) which was 4.5 percentage points below the UK figure of 22.3%. However, since the early 1990s rising economic prosperity in NI has seen these consumer spending sectors prosper whereas the UK has remained relatively stable. Since the early 1990s, and the mid-1990s in particular when UK retail multiples took NI by storm, NI has witnessed a rapid increase in retail, wholesale and hotels & restaurants. Essentially NI has played catch up with the UK. As a result, these consumer spending sensitive sectors now account for roughly the same proportion of employment in both economies, around 24%.



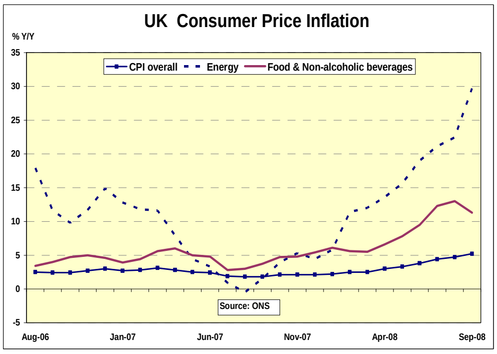
Employment has soared in consumer demand sensitive sectors

Since the 1991 recession, employment within the consumer sensitive sectors has increased by a staggering 71% (+70,000 jobs) which compares to a rise of just 21% for the UK. Annual employment growth has averaged 3.2% over this period which is almost twice the average rate of employment growth for the NI economy as a whole. The net result is that the NI economy is now more sensitive to consumer downturns than before given the change in NI's employment mix. Now that NI's consumer demand sensitive sectors are broadly the same size as the UK, NI will not weather the consumer slowdown better than the UK. Indeed, there are arguments to suggest it fare relatively worse due to lower disposable incomes, higher energy costs etc. While NI's consumer sensitive sectors have enjoyed 25 years of unbroken employment growth, we anticipate fallings levels of employment in these sectors in 2009.



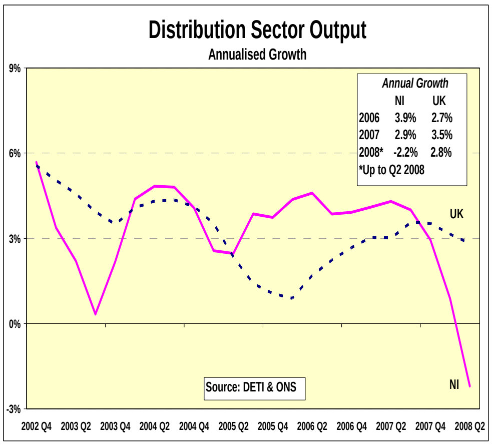
Rising food & energy prices continue to squeeze household incomes

Consumer spending will also be reduced as inflation continues to erode household disposable incomes. Consumer Price Inflation (CPI) – the Government's target measure – rose to 5.2% in September – which represents a new high since the series formally began in 1997. The food and non-alcoholic beverages category eased back to 11.3% in September, down from 13.0% in August. Petrol prices were 20% higher over the year to September, but the falling price of oil has led to significant price falls since. However, energy prices, in the form of gas and electricity prices, will remain high. Over the 12 months to September, retail gas and electricity prices have risen by 50% and 28% respectively. In NI, the electricity and gas rises have risen by 52% this year. CPI inflation is set to plummet below 2% in Q4 2009.



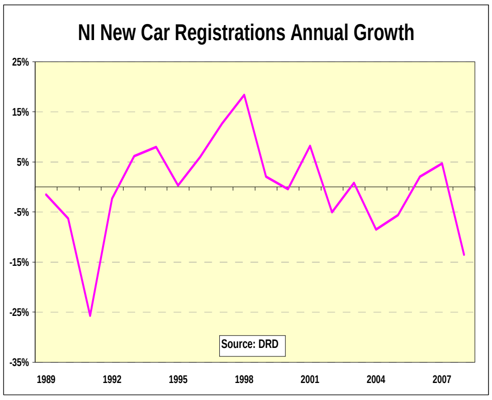
Consumer downturn is hitting NI harder than the UK

In the UK & NI, the *Distribution* sector – this includes wholesale & retail trade - accounts for 12.5% of the economy. However, NI's *Distribution* sector, alongside the *Business Services & Finance* continues to experience the fastest rates of decline of all NI's service sectors. NI's *Distribution* sector recorded strong output growth of 2.9% in 2007 (UK = +3.5%). However, the sector has now experienced 4 consecutive quarters of contraction with output recording a quarterly decline of 2.3% in Q2 2008. This represented a hefty 7% decline on the same quarter last year. The latest sharp fall in NI's *Distribution* sector has pushed the annualised growth rate into negative territory (-2.2%) while the UK continues to record growth of 2.8%. The current economic conditions, in terms of the credit crunch and rising inflation, are bearing down heavily on this sector. Given that NI has higher levels of fuel poverty and lower household disposable incomes the consumer downturn has been and will more acute than in the UK. In these difficult trading conditions, NI's retail sector will be more reliant on RoI shoppers heading north, to take advantage of the favourable euro/sterling exchange rate, than ever before.



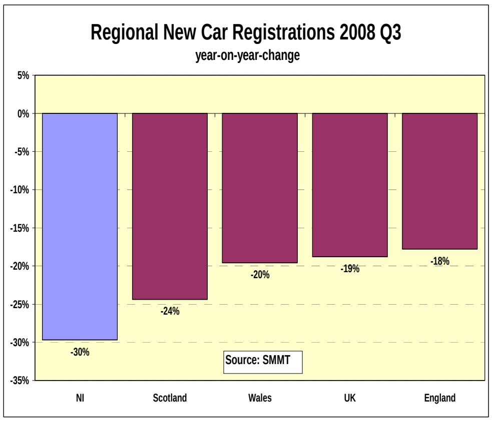
NI's car sales industry was hit hard during the last recession

After housing, the most significant consumer expenditure item is a car. Therefore new car purchases provide a useful barometer of the strength of the consumer. During the last UK recession, which the NI economy as a whole escaped, NI's car sales industry went into recession. In 1991, the number of new car registrations fell by 25% which compared unfavourably to a UK decline of 21%. This represented a fall in new car registrations of 13,500. In 2007, the number of new car registrations surged by 4.7%, its strongest rate of growth since 2001. However, following the slowdown in the economy, and the property downturn in particular, NI's new car registrations have been plummeting. During the first half of 2008, new car registrations fell by 13.5% on the same period last year. This represents 5,000 fewer car registrations.



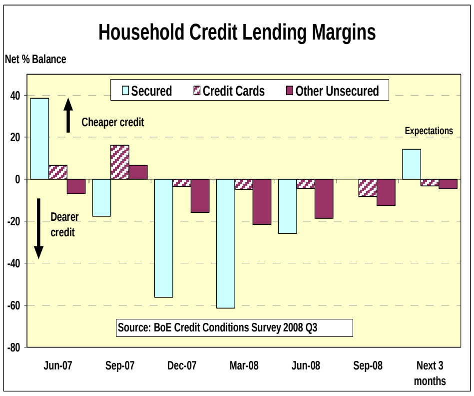
History appears to be repeating itself in 2008

The latest car sales data from the motor industry group (SMMT) suggest that NI consumers are feeling the strain on discretionary spending more than their GB counterparts. During the first 9 months of the year, regional car sales were almost 16% lower than during the same period last year. This represents a decrease of almost 9,300 new car sales this year to date. The trend has accelerated in Q3 2008, with new car sales in NI falling by almost 30% on the same period last year. This represents a decrease of almost 5,500 cars and was the steepest percentage fall of all the UK regions (UK = -19%). Car registrations are expected to fall by around 20-25% during 2008. This would represent around 12,500 - 15,000 fewer car sales. A number of car dealerships have already scaled back on staff numbers and this trend is expected to continue. Car purchases will also be affected by the increasing cost and reduced availability of unsecured loans.



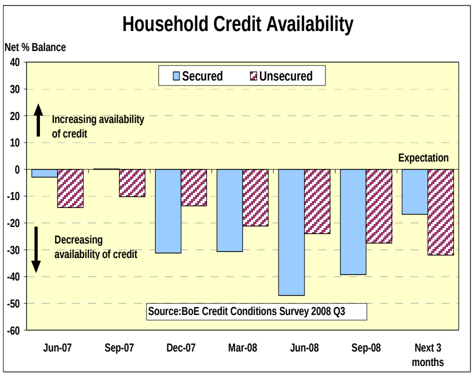
Rising cost of credit will affect consumer spending

The latest BoE Credit Conditions survey for Q3 2008 indicates the spreads on secured lending to household remained unchanged in the third quarter and are expected to ease in Q4. However, this survey was conducted before the sharp deterioration in financial markets following the collapse of Lehman Brothers. As a result, UK lenders may actually seek to increase the cost of credit further in Q4 not reduce it. Meanwhile, the cost of credit card debt and other unsecured credit has increased for the fourth consecutive quarter with a further tightening in credit anticipated in Q4. According to the latest BoE statistics, the average interest rate charged on credit card lending, by UK financial institutions, was 16.13% in September 2008. This compares with 14.99% in September 2007. The average interest rate on some mortgage products has also risen over the past 12 months despite a number of BoE base rate cuts. This is particularly noticeable in higher loan to value (LTV) products. For example, the average interest rate for a 5-year fixed rate mortgage in September 2008 was 7.1% which compared to 6.7% in September 2007.



So too will be the reduced availability of unsecured credit

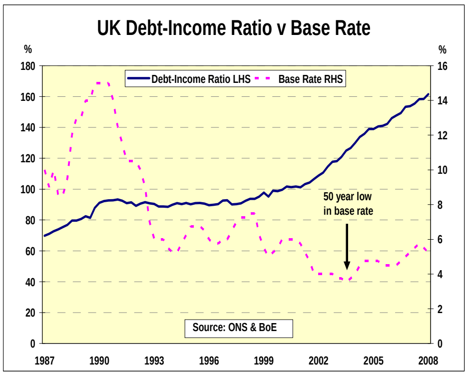
The reduction in availability of unsecured credit – e.g. credit cards & unsecured loans – will continue to have a negative impact on NI & UK consumer spending. UK lenders reduced their availability of unsecured credit in Q3 with approval rates for credit card and non-credit card lending falling significantly. The availability of unsecured credit is expected to be reduced further in Q4 with UK lenders expecting to tighten their credit scoring criteria and decrease the number of approval rates over the next 3 months. The BoE survey stated that the decline in credit availability stemmed from concerns over the economic outlook and a reduced appetite for risk. Overall the reduced availability of unsecured credit will curtail consumer spending. This will exert continued downward pressure on 'big ticket' items such as new cars in the year ahead.



IX CONSUMERS HAVE BEEN BORROWING MORE AND SAVING LESS THAN IN THE 1990s

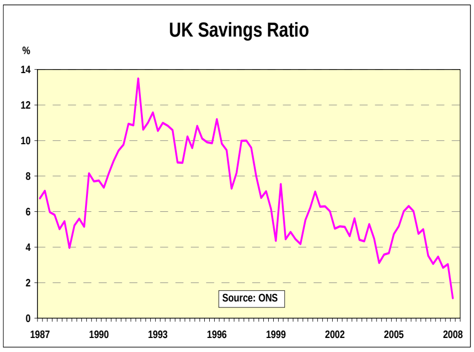
UK consumer has been borrowing more

UK interest rates have followed a downward path since the early 1990s, when interest rates hit 15%. However, as the cost of debt has gone down, the level of household debt has moved in the opposite direction. The rise in house prices in the UK has been accompanied by a marked rise in household debt. As a result, the household debt-income ratio, which had been relatively stable in the 1990s, has risen from under 100% at the start of 2000 to 160% on the latest (Q1 08) data. While no separate indicators are available for NI, it is expected to have broadly followed the same trend. However, as NI has a lower level of personal insolvencies per head relative to England & Wales, it suggests that NI has perhaps been more debt averse. It is often cited that the UK / NI are better placed now relative to the early 1990s as interest rates are a fraction of what they were previously. However, with increased levels of debt, some households will be vulnerable to an interest rate or labour market shock.



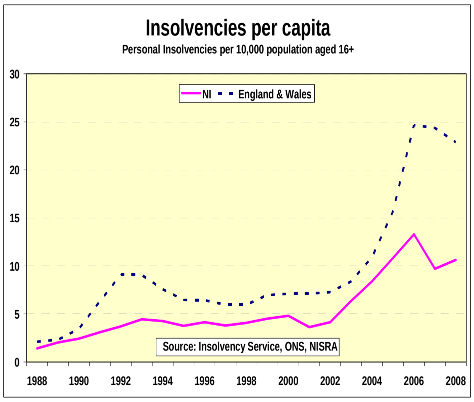
And saving less

Alongside the rapid rise in household debt there has been a corresponding fall in the UK savings rate - this is the ratio of savings relative to post-tax income. The savings ratio has fallen to levels not seen even at the height of the 1980s Lawson Boom. As a result, the UK consumer is saving almost 10 times less during the first quarter of 2008 than they did during the last recession in the early 1990s. Clearly the UK and NI consumers are less well prepared to weather the storm than was previously the case. Those UK regions with lower disposable incomes, notably the North East, Wales and NI will be particularly vulnerable.



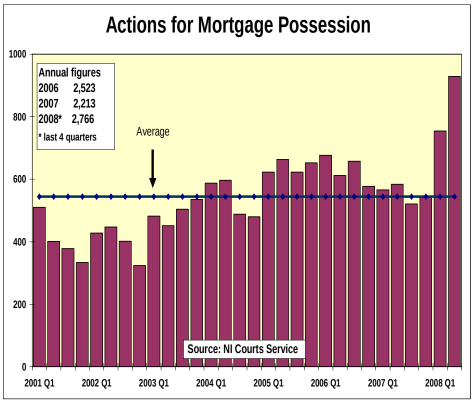
NI's insolvencies relatively low but rising

Total personal insolvencies consist of two elements – Bankruptcy Orders and Individual Voluntary Arrangements (IVAs). IVAs proliferated in the UK in 2005 & 2006 as an alternative to bankruptcy; however the latter has also be on a rising trend and remains the dominant form of personal insolvency. During the last recession the rise in personal insolvencies was much less marked in NI than in England & Wales. Over the period 1989-1993, NI's personal insolvencies increased by 127%. However, this was more muted than the 292% gain in England & Wales. Clearly, the lack of a housing market downturn alongside a relatively large public sector protected NI from an even greater surge in insolvencies. NI's insolvencies have been rising for the last three quarters up to and including Q2 2008. However, NI's current insolvency rate *(over the last 4 quarters)* is less than half the rate in England & Wales. Nevertheless, we expect this gap to narrow in the next 12-18 months and we anticipate a much sharper rise in the number of NI personal insolvencies than occurred in the early 1990s.



Actions for mortgage possession also on the rise

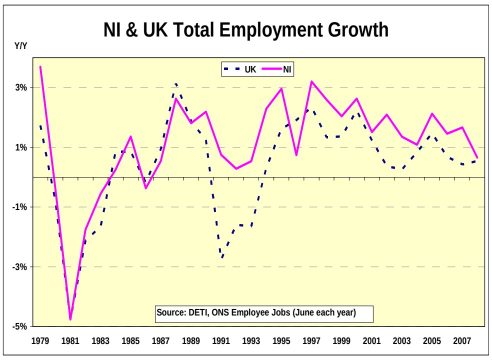
Rising unemployment, the reduced access and increasing cost of credit will all contribute to financial strain within households. Alongside a rise in personal insolvencies, this financial strain will also manifest itself in rising actions for mortgage possession. There were 929 of these in Q2 2008, which represented a rise of almost 60% on the same period last year. However, only one third of these actions actually led to repossession. It is also important to note that the main mortgage lenders only view repossession as a last resort. The key driver behind the rise in actions for mortgage possession has been second charge lenders, such as credit card companies who initiate the proceedings. The NI labour market has recently seen record employment and unemployment at historic lows. However, the ongoing credit crunch and deteriorating economic outlook will put an end to the era of cheap credit and low unemployment.



X SLOWDOWN IN OUTPUT IS IMPACTING ON THE NI LABOUR MARKET'S PERFORMANCE & PROSPECTS

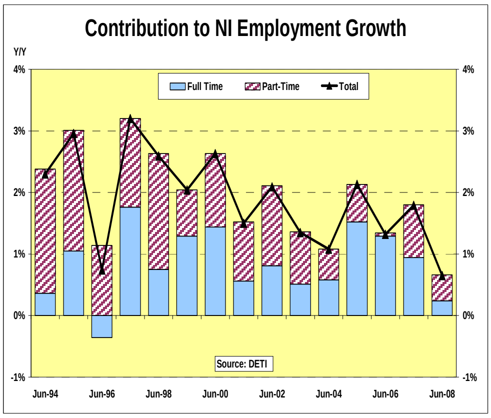
As good as it gets? - Record employment once again in Q2 2008

The latest employment figures for June 2008 (Q2) revealed that the seasonally adjusted employee job count stood at 722,320. This represented the highest figure on record and the twelfth consecutive quarter of employment growth. However, the number of employee jobs rose by just 480 jobs on the revised March 2008 figure. Despite this increase, this represents less than one fifth of the quarterly average employment growth over the last 10 years. On an annual basis, NI has recorded year on year employment growth since 1986. However, while the latest figures signalled an additional 4,490 (+0.6%) jobs over the year, this marked the slowest rate of employment growth since 1993. NI's employment growth is expected to continue on a downward trajectory.



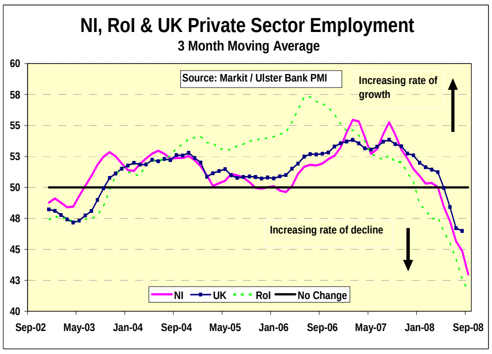
NI's recent employment growth driven by part-time employment

It is interesting to note that NI's robust rates of economic growth in 2006 occurred against the background of strong growth in full-time employment as opposed to part-time. Indeed, almost all of the employment growth in 2006 was full-time employment. In 2007 and 2008 the overall level of employment growth has been increasingly driven by part-time employment. In June 2007, the proportion of employment growth attributable to full-time employment was just over 50%. The latest annual employment figures, over the year to June 2008, illustrate that part-time jobs accounted for two thirds of NI's total annual employment growth. Furthermore, full-time employment increased at its slowest rate of growth (+0.4%) since 1996. This is half the average rate of growth achieved over the last decade.



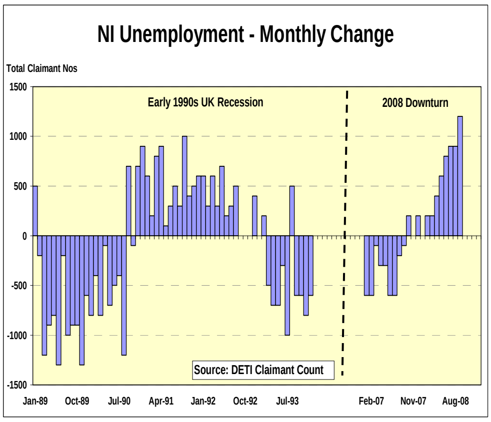
Declining levels of employment in 2009

Labour market data provides a lagging measure of economic performance which trails behind other output measures. The *Ulster Bank PSO Index* has highlighted falling private sector output over the year to Q2 2008. Forward looking indicators such as the Ulster Bank PMI point to a further marked slowdown in economic activity in Q3 2008 alongside a sharp reduction in private sector employment. NI's employment growth in 2008 is going to be much weaker than it has been accustomed to with employment levels falling back in 2009. The weakening labour market is most evident in terms of rising unemployment. The current ILO unemployment rate of 4.3% is expected to rise to 5.0% by year end and 6.2% by the end of 2009 (see appendix for further information).



Claimant count records sharpest rise since April 1986

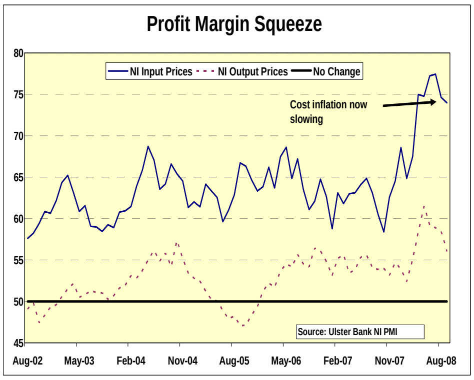
Unemployment has been on an upward trend since October 2007 with a marked acceleration occurring since April 2008. The claimant count measure has risen by 5,600 over the last 12 months with almost 29,000 people now on the register. The last time NI recorded an annual increase above this level was in August 1992 (+6,000).The seasonally adjusted claimant count recorded a monthly increase of 1,200 in September - the sharpest increase since April 1986. The number of people unemployed in NI is going to accelerate at a much faster rate than in the 1990s. This is due to the fact that NI's unemployment rate is coming off record lows. For example, over the period Nov 1990 – Feb 1993 NI experienced 28 consecutive months of flat or rising unemployment with 11,900 added to the unemployment register. We expect the number of unemployed to more than double from last September's low of 23,300. The claimant count measure is expected to witness 4 figure monthly rises to the end of 2009. This would push the claimant count towards 50,000 but still less than half the peak in February 1993 (105,700).



XI CORPORATE SECTOR TO BENEFIT FROM FALLING INPUT COSTS BUT CREDIT CRUNCH COSTS CONTINUE

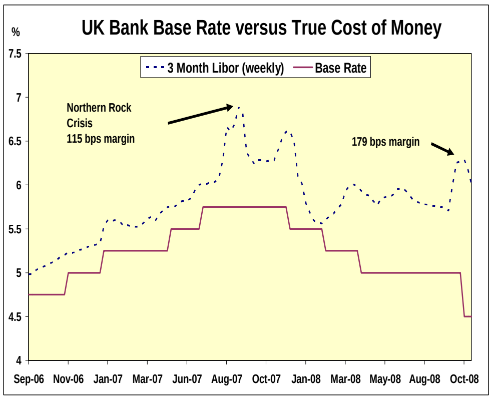
Profits squeeze continues in Q3 2008

According to the Ulster Bank PMI, cost inflation within NI firms reached a record high in July and was above the corresponding UK rate of growth. Inflationary pressures have remained high but have subsequently eased to a six month low in September. In the latest survey, around half of panellists noted a rise in their operating costs during September, citing higher energy prices paid for energy, raw materials, transportation and labour. Retailers signalled the sharpest inflation of input prices, with manufacturers also recorded a substantial rise. While input cost inflation has reached a turning point in Q3 and is expected to trend downwards in the year ahead, so too has output prices. The deteriorating economic outlook and weakening demand will impact on the pricing power of NI firms. Output prices increased at their slowest pace in six months in September. Competitive pressures will continue to squeeze profit margins despite an easing of cost pressures.



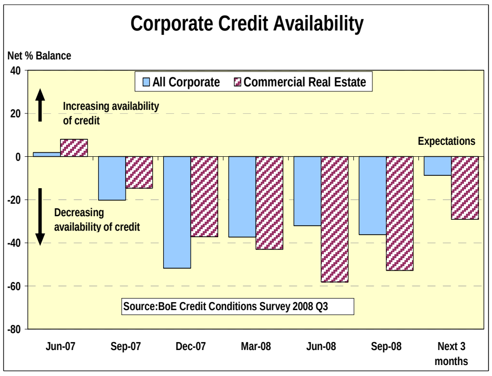
The true cost of money is being passed onto businesses

One of the most immediate impacts from the credit crunch was that Banks became more reluctant to lend to each other. This was due to a rise in counterparty risk - that is a fear that banks would not get their money back. The key inter-bank rate is the London inter-bank offered rate or Libor. The 3 month Libor rate is a benchmark rate for borrowing and traditionally this interest rate was around 7-12 basis points above the prevailing base rate. However, since the onset of the credit crunch the Libor rates shot up significantly. Banks initially thought this widened differential would prove to be relatively short-lived *(and many banks absorbed this additional cost without passing it on to firms & households)* and the gap between base rate and 3m Libor would narrow significantly from the extremes experienced last September. However, since the collapse of Lehman Brothers, the counterparty risk premium ballooned with the gap between 3m Libor and the current base rate (4.5%) hitting almost 180 basis points or 1.8%. Libor rates have begun to fall in response to the significant actions on the part of the BoE.



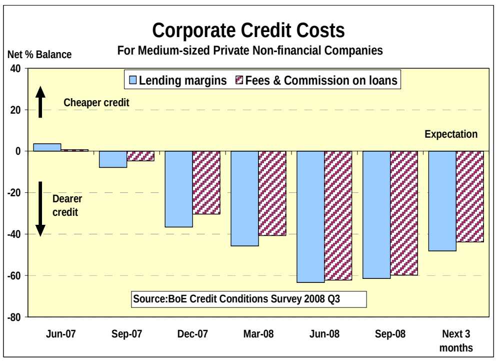
UK firms experience a further squeeze on credit availability

The latest BoE Credit Conditions Survey was conducted before the latest bout of financial turbulence which followed the collapse of Lehman Brothers. The latest survey reported that corporate credit availability had been tightened in Q3 and by more than had been expected in the previous survey. UK lenders expect a further reduction in corporate credit availability in Q4 2008. Given the events that have taken place since this latest survey the reduction in credit supply by UK lenders may prove more severe. The credit squeeze continues to be most notable within the commercial real estate sector. As in previous surveys, the reduction in credit availability stems from concerns about the economic outlook and a reduction in risk appetite. In Q3, default rates for medium sized firms had risen by more than UK lenders had been expecting with further increases expected in Q4. The survey also reported a sharp fall in demand for credit for capital investment while credit for balance sheet restructuring increased.

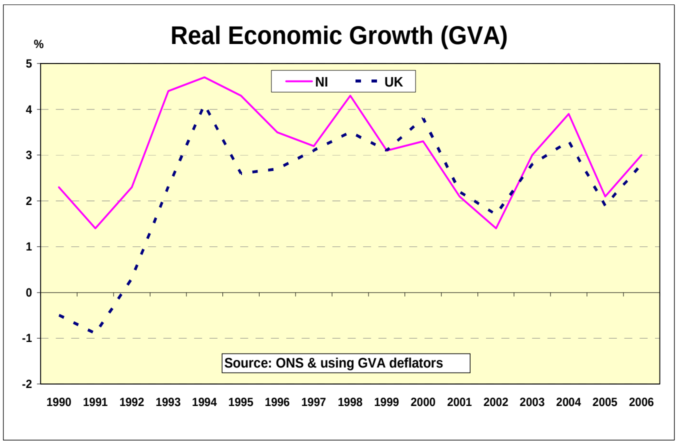


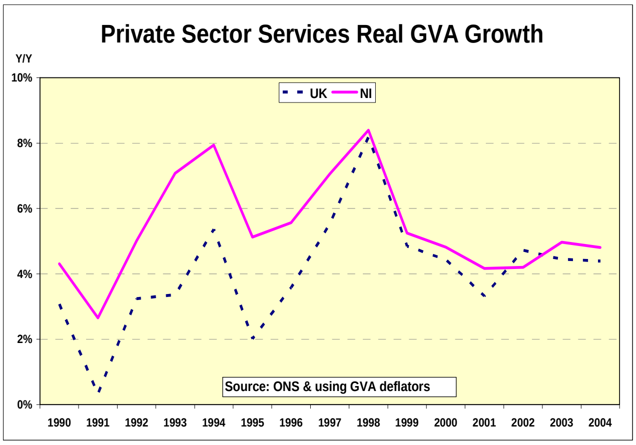
Corporate credit costs intensify with further rises expected in Q4

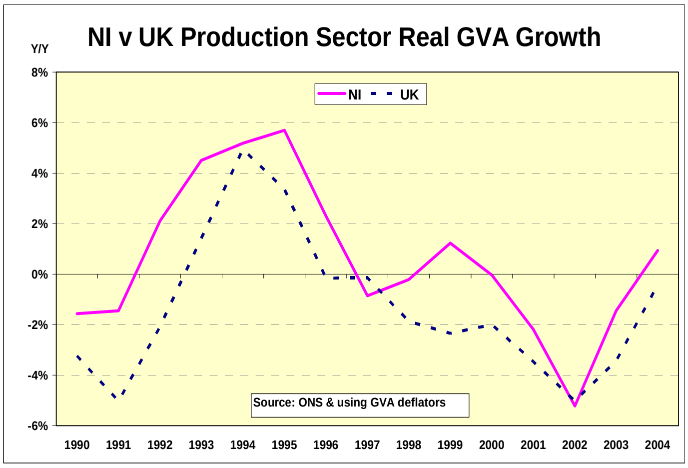
The Credit Conditions Survey also confirms a further rise in the cost of credit for the corporate sector. UK Lenders reported a significant rise in lending margins (or spreads) alongside increased fees and commission income on loans during Q3 2008. This represents the fifth consecutive quarterly rise in corporate credit costs. The increase in lending spreads was more than the UK lenders had anticipated in the Q2 survey. Lenders expect further increases in spreads and fees in Q4 2008. Clearly the ongoing credit crunch will continue to bear down on economic growth prospects in the year ahead.

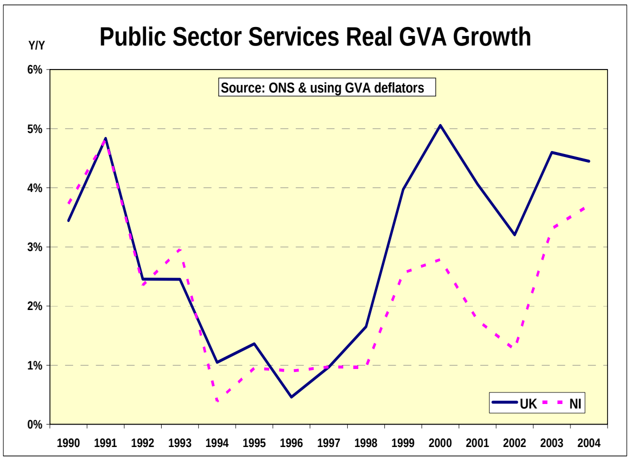


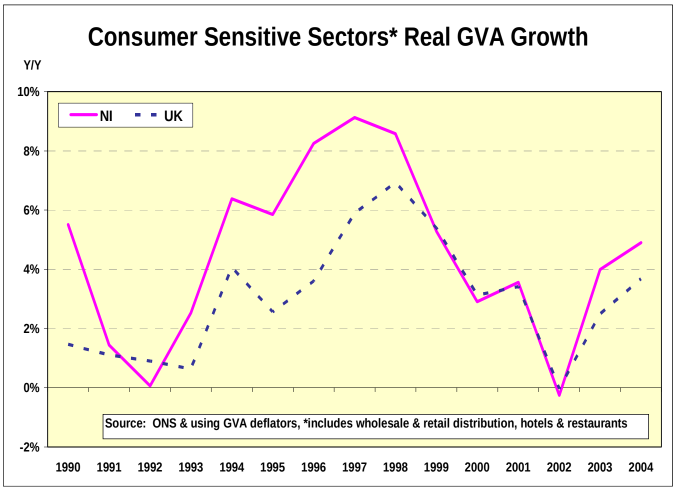
APPENDIX I - Real Economic Growth (GVA)

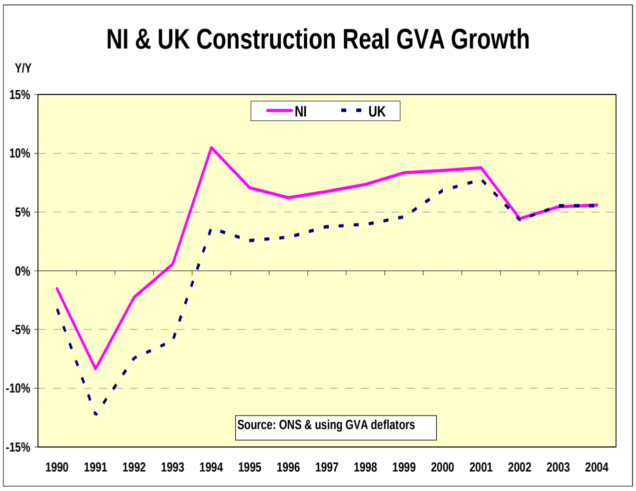








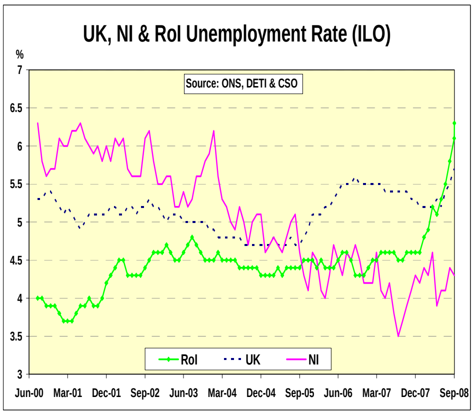




APPENDIX II - LABOUR MARKET PERFORMANCE

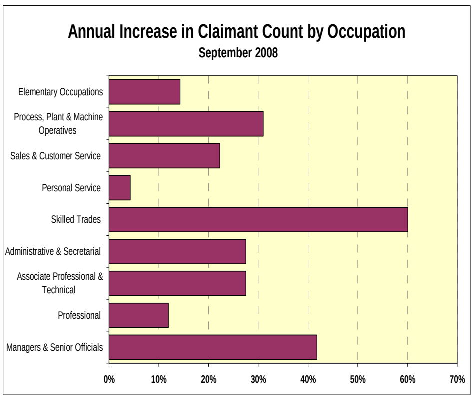
Unemployment low but rising

The LFS estimate for unemployment (Jun-Aug 2008) was 35,000 which represented a rise of 1,000 over the quarter and an increase of 5,000 over the year. The unemployment rate (ILO) now stands at 4.3%. This remains well below the UK average of 5.7 and compares favourably with the EU 27 rate of 6.8%. The latest unemployment rate for RoI is 6.3% in September. We still expect the unemployment rate to hit 5.0% by the end of the year. The global and NI economic outlook has deteriorated markedly since our July QER. As a result, we expect a significant rise in the unemployment rate to 6.2% by the end of 2009. This would take the unemployment rate back to levels last seen in Spring 2001 but would still compare favourably with the respective UK and RoI unemployment rates. While NI's level of unemployment is set to rise quite significantly it is important to keep this in perspective. The NI economy is not going to return to the double digit rates of unemployment that were experienced in the early 1990s.



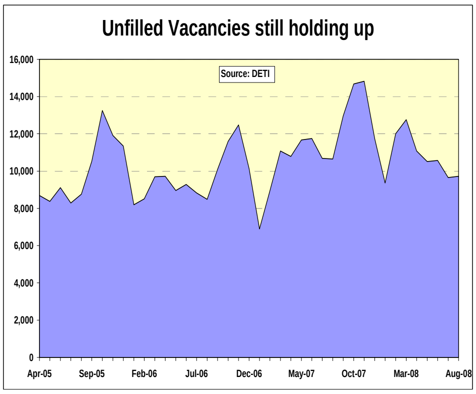
Rising unemployment - Where are they coming from?

All sectors of the NI economy are being affected by rising unemployment. According to DETI, almost 60% of the increase in the claimant count in September (1,200) was attributed to individuals previously working in construction activities. The top 3 occupations for unemployment are Elementary (9,805); Skilled Trades (5,090); and Process, Plant & Machine Operatives (3,845). Together these occupations account for 63% of claimants. Over the year to September 2008, the Skilled Trades category has experienced the sharpest rise in unemployment (60%) with an additional 1,910 added relative to September 2007. The Managers & Senior Official (+42%) category experienced a significant percentage gain but this amounted to an additional 165 people. Those in Elementary occupations and the Process, Plant & Machine Operatives category were the major net contributors to the claimant count with 1,225 and 910 individuals added over the year.



But job opportunities remain

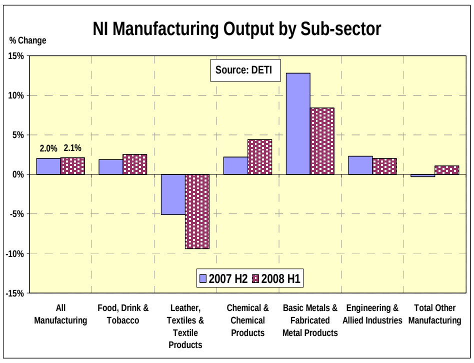
The recent upsurge in the level of unemployment is concerning particularly when there are still almost 10,000 unfilled vacancies in the labour market. This suggests that those individuals recently made unemployed do not have the skills or desire to avail of these opportunities. Clearly this level of job vacancies will provide an important buffer against rising unemployment in the year ahead. This highlights the importance of training to ensure that individuals are equipped with the necessary skills to take advantage of existing job opportunities.



APPENDIX III - MANUFACTURING SECTOR PERFORMANCE

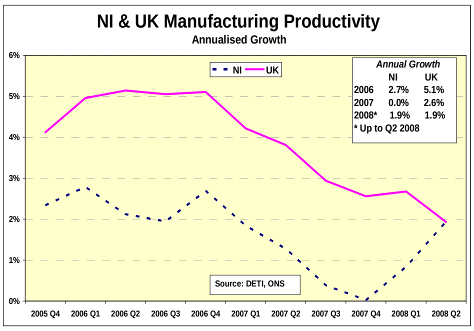
Strong performance for practically all sub-sectors in H1 2008

At a sub-sectoral level, NI's manufacturing output performance reveals differing degrees of performance. The *Textile & Textile Products* sector is the only manufacturing sector to record a decline in output during the first half of 2008 (-9.4%). Meanwhile, *Food, Drink & Tobacco (+2.5%); Other Manufacturing (+1.1%); and Chemicals & Chemical Products (+4.4%)* all recorded a stronger performance in the first half of 2008 relative to the previous six month period. The *Engineering* sector (+2.0%) and *Basic Metals & Fabricated Metal Products (+8.4%)* saw their rates of growth slip on H2 2007 but remain at healthy levels.



NI manufacturing productivity gap narrows in Q2 2008

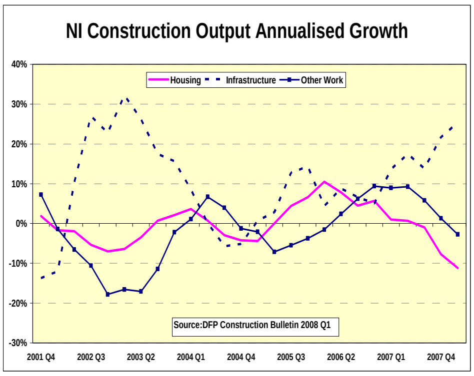
One of the targets of the Executive's Programme for Government is to halve the productivity gap with the UK (excluding the Greater South East area). While NI's manufacturing employment has held up a lot better than in the UK, one direct consequence of this is that NI's productivity performance has continued to lag that of the UK. In 2007, NI industry's productivity growth (in terms of output produced each man hour) was flat in 2007 which compared with a corresponding increase of 2.6% in the UK. More recently, the robust increase in manufacturing output in the second half for 2007 and the first half of 2008 has led to a pick-up in NI's annual productivity growth rise to 1.9% in Q2 2008. This is on a par with the rise recorded in the UK.



APPENDIX IV – CONSTRUCTION SECTOR PERFORMANCE

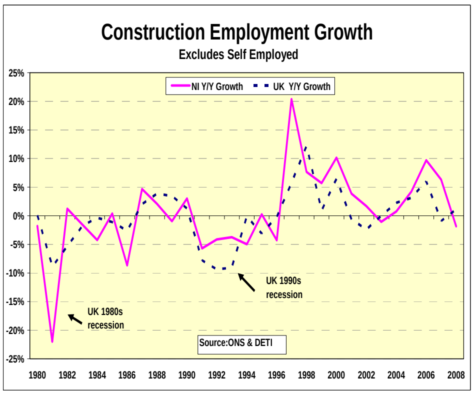
Capital investment at record highs but contruction is still contracting

The construction downturn has been largely driven by its largest component – housing. Housing output, which accounts for 35% of construction output, has fallen for 5 quarters in a row. NI's housing output has recorded an annualised decline of 11% to Q1 2008. The latest quarter, Q1 2008 also reported a fall in output of 16.6% on the corresponding quarter in 2007. Outside of housing, capital investment is at record high and this is buoying up infrastructure investment. Infrastructure output, which is half the size of the house building sector, recorded a 25% increase over the year to 2008 Q1, while Repair & Maintenance (*20% of construction output*) witnessed a 9.4% rise over the same period. The Index of Other Work, which includes the commercial, industrial, health & education sectors, also recorded its second consecutive quarterly decline. This sector accounts for around 30% of construction output and recorded a 2.7% fall over the year to Q1 2008.



Slowdown in housebuilding is leading to falling levels of employment

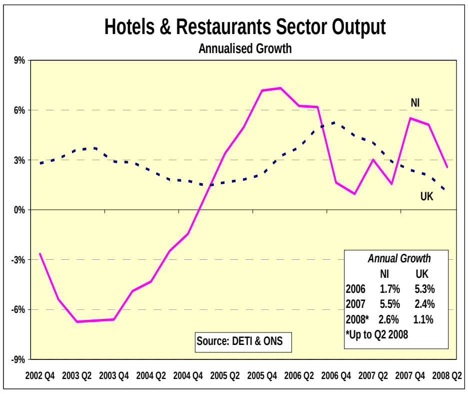
Over the last 5 years, 7,300 jobs have been created in the construction industry (*excluding the self-employed)* - an increase of 20%. The sector has also consistently outperformed the UK with employment growth, over the last 5 years, well above the UK rate (+12%). However, over the latest 12 month period, the UK still managed to increase employment by 1.2% in contrast with NI's 1.8% decline (-810 jobs). This is the first time since 2004 that the UK has outperformed NI in annual construction employment growth. Indeed, NI's annual fall in construction employment has proved to be the sharpest fall in construction employment since 1997. NI construction employment peaked last September and has since fallen back by 1,330 jobs (3%) up to Q2 2008. This does not include the construction sector's self employed who have been bearing the brunt of the downturn and swelling the ranks of the unemployed. In the last recession, NI experienced declining levels of employment each year over the period 1991-1994. Significantly, it fared much better than the UK – due to the latter's housing market crash.



APPENDIX V – CONSTRUCTION SECTOR PERFORMANCE

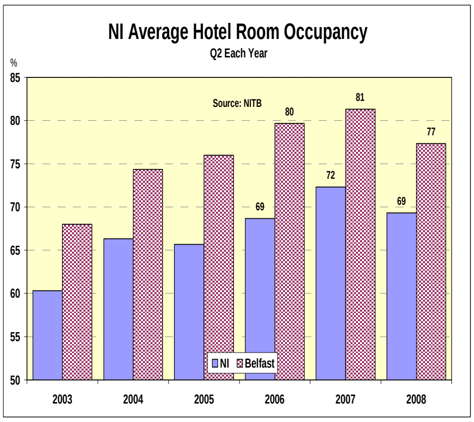
Hotels & Restaurant sector witnesses slowdown from a high level

During 2007, NI's *Hotels & Restaurants* sector recorded a robust increase of 5.5%, which was more than twice the growth rate for the UK (+2.4%). This was strongly influenced by the record year for the NI tourism industry. However, the sector has subsequently experienced much slower activity with the latest annualised growth rate falling to 2.6% (UK = +1.1%). Output in NI's *Hotels & Restaurants* sector was flat in Q2 and this represented a fall of 0.6% on the same period a year ago. The UK by contrast experienced a fall in output of 0.6% in Q2 which was 1.0% lower than the corresponding quarter in 2007. The *Hotels & Restaurants* sector is going to be vulnerable to the continued slowdown in consumer demand and the deteriorating economic environment. Higher food & energy prices alongside the credit crunch – increased cost and reduced availability of credit – will reduce disposable incomes and consumer demand. The *Hotels & Restaurants* sector will also be vulnerable to a rising cost base, energy & food, and falling tourist numbers.



Tourism – Hotel Occupancy rates fall in Q2 2008 but remain strong

Last year proved to be a record year for NI's tourism industry with the average hotel occupancy at record highs. However, in the first quarter of 2008 the average hotel occupancy rate fell from 59% in 2007 to 54%. This represented the lowest Q1 figure since 2005. A similar trend in occupancy figures has been repeated in Q2 2008. NI hotels recorded an average hotel occupancy rate of 69% which compares with 72% in 2007. This figure still compares favourably with the occupancy levels prior to 2006. Belfast hoteliers also witnessed a decline in occupancy rates from 81% in Q2 last year to 77% during the same quarter this year. Nevertheless, these figures still remain reasonably robust and are still in excess of the occupancy rates achieved before 2006. While NI is likely to suffer from a fall in demand from overseas tourists, like other economies, the continued weakness of sterling is making NI's tourism product more competitively priced than last year in both North American and Eurozone markets. During Q3 2008 the number of NI air routes has been scaled back further as we flagged in the July QER. Clearly this will have a negative impact on NI's tourism performance in the years ahead.



APPENDIX VI – CORPORATION TAX DEBATE CONTINUES

The story so far

Tax has become a key cost issue for businesses, with lower corporation tax (*namely a 12.5% rate in line with the RoI*) becoming the cause celebre for the local business community and political leaders. The need to attract high waged foreign direct investment (FDI) has received considerable attention over the last 18 months and has formed the backbone of the lower corporation tax debate. Attracting additional FDI into Northern Ireland is viewed as the quickest route to enhanced export performance and raising the economic growth trajectory. Foreign-owned companies have had, and will continue to have, an important influence on the local economy. A lower corporation tax rate has been viewed by many as a necessary pre-requisite to provide potential FDI with a selfish and strategic economic reason to locate here. Given that Northern Ireland is the only part of the UK to share a land-border with a low tax economy, the RoI, it is deemed to be an unfavourable location for FDI.

On 22 March 2007, following representations from local political parties, the Chancellor announced a review to report on *"How current and future tax policy, including the tax changes announced in the Budget 2007, can support the sustainable growth of businesses and long-term investments in Northern Ireland."* This review was led by Sir David Varney and became known as the *'Varney Review'*.

Budget 2007 announced a lowering of the main UK corporation tax rate from 30% to 28% in April 2008. Furthermore, Budget 2007 announced the small company rate will rise incrementally from 19% to 22% in April 2009. The current small companies' corporation tax rate is 21%. Further submissions were made to the Varney Review by the Northern Ireland Executive, local businesses and key stakeholders, with the former setting out the case for a lower rate of corporation tax here.

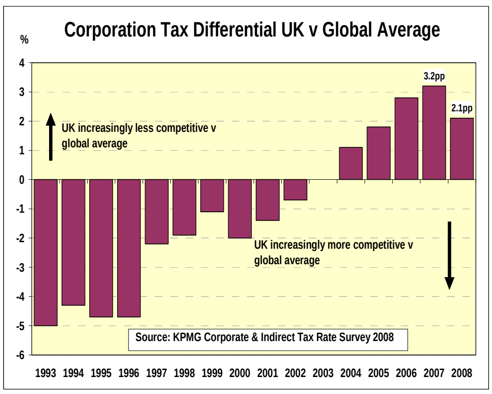
The Varney Review's findings, released on 17 December 2007, ruled against a lower corporation tax rate for Northern Ireland. "*While there is not a clear and unambiguous case for changing corporation tax in Northern Ireland beyond the UK-wide measures announced in the 2007 Budget, I am convinced that, in light of the successful peace process, Northern Ireland can potentially emulate the economic success of the Republic".* The Executive expressed its disappointment at the Varney I conclusions which triggered a second review, '*Review of the Competitiveness of Northern Ireland',* which became known as *'Varney II'.* Varney II also failed to recommend any additional fiscal incentives for Northern Ireland.

Corporation tax debate is gathering momentum at the UK level

The Executive has been unable to secure a 12.5% corporation tax rate for NI. However, continuity corporation tax campaigners may take some heart that the issue of lower corporation tax is gathering momentum at the UK level. For example, in March this year, Richard Lambert the Director-General of the CBI, called for the main rate UK corporation tax rate to be lowered to 18% over the next eight years. Meanwhile, the Shadow Chancellor, George Osborne, recently called for the rate to be lowered to 25% which *"would go some way towards undoing the damage the government has done by failing to keep pace with European tax rates".* Despite the UK's recent cut in its headline corporation tax rate (*to 28%*), *the latest KPMG Corporate and Indirect Tax Survey for 2008*, confirms that this main rate still remains uncompetitive relative to the EU and global average rates.

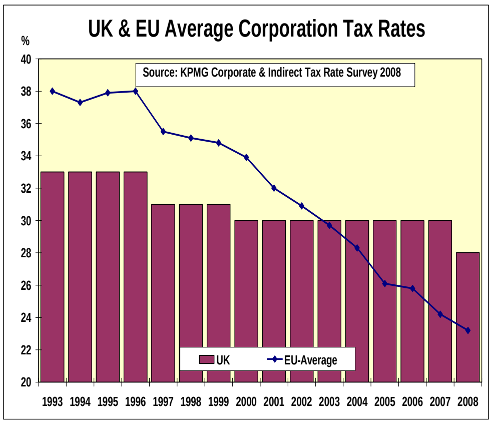
UK Corporation Tax – the Global Context

A key feature of the move towards an increasingly globalised economy has been greater competition. Globalisation also represents a serious challenge to tax system as companies are now more mobile & tax regimes around the world are starting to matter more than before. Comparisons of the UK's main corporate tax rate versus the global average rate, reveal a significant erosion in the UK's corporate tax competitiveness. During the 1990s the UK industry enjoyed lower rates of corporation tax relative to its global counterparts. However, the average global corporate tax rate has fallen for the 12th year in succession from 37.7% in 1996 to 25.9% in 2008. Indeed, the UK has being playing catch-up with the global average corporate rate since 2004. However, the UK's latest reduction in the headline corporate tax rate to 28%, which came into effect in April this year, has reduced the tax differential to 2.1 percentage points (pp) from the 3.2pp gap in 2007.



UK Corporation Tax – the EU Context

The rapid decline in average corporation tax rates has been particularly apparent in the UK's backyard – the EU. The average EU corporate tax rate has fallen for the 12th year in a row from 38% in 1996 to 23.2% in 2008. Back in 1996 the UK's corporate sector enjoyed a tax rate of 33% which was some 5 pp lower than the equivalent EU rate. However, since 2003, the EU's average rate has been lower than the UK rate with the gap currently some 4.8 pp.In recent years, many of the new entrants to the EU have sought to replicate the RoI's low corporation tax success story. Bulgaria and Cyprus currently have the lowest headline rates of corporation tax at 10%, which is below the RoI's main rate of 12.5%. The most significant move in the corporation tax rate has been with the EU's largest economy. In 2008, Germany slashed its headline rate from 38.4% to 29.5% in just one year Nevertheless, this is still above the current UK rate of 28% and the UK Government can still claim to have the lowest rate of the G7 economies.



Viewpoint

While the Varney reviews have ruled out the prospect of Northern Ireland achieving a 12.5% corporation tax rate, the debate has not gone away. Instead, the debate has widened with the latest *KPMG Corporate and Indirect Tax Rate Survey 2008* reaffirming concerns over corporation tax competitiveness at a UK level. Clearly, lowering the UK corporation tax rate is moving up the UK's political and economic agenda. However, given the current state of the public finances, which are set to deteriorate further during the current downturn, the ability of the UK government to deliver such a move in the short-term is extremely doubtful.

In the meantime, the local Executive needs to develop 'Plan B' and focus on the policies and interventions that lie within its remit. Without a lower corporation tax rate, Northern Ireland will become increasingly reliant on wooing investors with its skills and infrastructure base. Clearly, attracting new FDI remains one important strand of Northern Ireland's economic development strategy but we must not lose sight of the importance of the firms already here. Encouraging enterprise and entrepreneurship within Northern Ireland's existing business base is arguably more important than attracting new FDI. Almost 90% of Northern Ireland's 73,000 firms are locally owned and it is these enterprises who have consistently demonstrated a selfish strategic and economic interest in doing business here. It is therefore vital that we improve the skills base and enhance the economic infrastructure for these firms. The business community will be eager to see the Executive's response to Varney II and what measures it plans to adopt. Will the Executive *"deepen and intensify public sector reform"* along the lines suggested by Varney for the benefit of the private sector? These options need to be explored.

Northern Ireland's overall economic prosperity will be dependent upon its success in international markets. Irrespective of the amount of FDI that we can or cannot attract in the years ahead it is crucial that we maximise the potential of our existing business base for the long-term. While recognising the short-term difficulties facing the local economy, it is important that the Executive and local businesses position themselves to take advantage of the economic upturn whenever it comes.