Group Economics

Ulster Bank

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We have further reduced our NI growth forecast as economic conditions deteriorate

- ***All the main economies are expected to contract by between 1.0% - 2.5% in 2009***
- ***The NI economy is expected to contract by 2.5% in 2009, this compares with our forecast of -1.5% in October***
- ***NI is set for a tentative recovery in 2010 as global economic conditions improve***

Slowdown is now widespread across all main sectors

- ***Manufacturing output remained flat in Q3 but is expected to decline sharply in Q4 08 and in 2009***
- ***House completions (new-builds) set for record low in 2009 and some 80% below 2006 peak***
- ***NI experienced a construction led downturn, the Executive should focus on stimulating a construction led recovery by accelerating social housing and capital investment plans***

Unemployment has been rising and this is set to rise by a further 20,000 in 2009

- ***NI experienced its sharpest drop in employee jobs in Q3 since 1981 with the service sector experiencing its sharpest quarterly fall on record***
- ***Unemployment is set to rise to 7% by the end of 2009***
- ***Unemployment benefit claimants set to hit 55,000 by the end of the year - currently 36,000***

Not all businesses will suffer

- ***The global response to the financial crisis has been unprecedented & will help to stabilise the world economies and sow the seeds of recovery***
- ***Not all businesses and sub-sectors will suffer with food producers, pharmaceuticals and aerospace expected to experience strong growth in 2009, while tourism could benefit from £ /€ exchange rate***
- ***Inflation concerns have receded and UK base rates are set to go to 0.75% if not lower***

NI ECONOMY NOW FEELING THE ECONOMIC CHILL FROM GLOBAL DOWNTURN

2008 proved to be a landmark year for all the wrong reasons following the near collapse of the global financial system. However, the global response to the threatened financial and economic meltdown has been unprecedented and this will help to stabilise the global financial system initially and ultimately help to sow the seeds of recovery. Nevertheless, economic growth prospects for the NI economy have deteriorated markedly since our October QER. Indeed, consensus forecasts for economic growth of all major economies have all been significantly revised downwards. Now every major advanced economy is expected to contract by 1.0 – 2.5%. The NI economy will prove to be no exception and we forecast the economy to contract by 2.5% in 2009 which is in line with the anticipated contraction for the UK. This compares with our October forecast of -1.5% (UK = -1.0%). We have also revised our NI growth figure for 2008 from 0% growth to -0.5% (UK=+0.7%). Our house price forecast has also been revised down, with a 45% peak to trough correction expected as opposed to 40% as highlighted in October.

The most significant development since our October QER has been the collapse in both global demand and inflationary pressures. Governments and forecasters alike have underestimated the scale of the downturn and the theory that the NI economy is recession proof, now appears to have been thrown out. Overall, the deterioration in the external economic environment, the persistence of the credit crunch and the expectation of even greater job losses has led us to revise our NI economic growth forecast down sharply.

While all sectors of the economy are expected to experience a marked decline in output in 2009, it is the weakening labour market, and particularly within the service sector that gives cause for the most concern. NI's employment growth over the last decade has been dominated by private sector services – notably business services and retail. These two sectors have experienced sharp declines in output over the last year and this is now feeding through into significant job losses. Indeed, Q3 2008 represented the largest quarterly fall in service sector employee jobs on record. Overall, the number of employee jobs in all sectors in Q3 fell by a hefty 7,000 from the Q2 peak. We anticipate at least five more quarters of employment decline with the number of employee jobs expected to go back towards levels last seen in late 2004. Meanwhile, in December 2008, the number of unemployed recorded its largest annual percentage increase since 1976. We expect the number of unemployed claimants, currently 36,000, to reach 55,000 by the end of the year. The wider ILO unemployment measure is set to hit 7% by the end of 2009.

These negative developments have outweighed some supports for the NI economy. These have included the marked easing of inflationary pressures *(notably energy & fuel costs)* and the added boost to the retail sector in border areas resulting from the favourable euro / sterling exchange rate. Clearly, the UK will not benefit as much as the NI on this latter point as NI is the only part of the UK to have a land border with the euro-zone.

World trade is expected to contract for the first time in 26 years and even the exporting superpowers, of China, Germany and the US have seen a collapse in export growth. NI is not immune to these developments and while the primary cause of NI's downturn until Q3 2008 was domestically generated *(i.e. construction sector)* the economy is now feeling the full force of the slump in global trade. While manufacturing output remained flat in Q3, job losses are now feeding through with 1,100 lost in the third quarter. This is set to intensify with some of NI's most prolific exporters and largest employers recently announcing extended Christmas shutdowns, reduced working weeks, wage cuts and redundancies. Given this outlook, heavy job losses are expected in 2009 and exports are set to experience a significant double-digit decrease.

Nevertheless, whilst the manufacturing sector as a whole is being hit hard there are some bright spots. The food and drink sector is one of the most recession proof sectors, alongside pharmaceuticals. While lack of global demand will limit growth in most sectors; the food & drink and retail (in border areas) are expected to benefit from increased trade with the RoI. These sectors, alongside tourism, will benefit from the favourable € / £ exchange rate. Unlike, the post 9/11 manufacturing downturn, NI's aerospace sector, and its sizeable supply chain, are better placed to weather the current downturn due to significant work in progress.

The property downturn continues to put pressure on both the construction and service sectors. The average house price in NI has fallen by between 24% - 34%, since the peak, depending on what surveys are used. We anticipate NI average house prices to end 2009 close to £140k or 45% below the August 2007 peak. Post-boom, there is the danger of *"irrational pessimism"*. A huge price correction has already occurred and prices will not keep falling indefinitely. Investors recognise this and given current prices and rising yields we expect the more seasoned investor to return to the market in 2009, but not to the same degree as in 2007. Ultimately, the market needs the first-time buyer to return, however, while concerns over affordability have receded, fears over job security have risen.

In 2008, housing starts fell by 60% and this will translate into a record low in house completions in 2009, some 80% below the 2006 peak. Meanwhile, mortgage repossessions and personal insolvencies have been on a rising trend and this is set to continue, particularly in light of the surge in unemployment. As a result, a further rise in demand for social housing is expected from already elevated levels and at a time when the expenditure dedicated to social housing (relative to demand) is set to fall. With the rate of house building at record lows, there is the potential for an even more severe social housing crisis in 2010 and beyond if the house building sector fails to return to more "normal" rates of house-building. The Executive has the opportunity to address this issue now before it gets much worse.

Against this backdrop, the local construction sector needs the Executive to deliver on its public infrastructure investment plans more than ever. However, these plans were reliant on capital receipts and asset disposals, which were largely linked to the property market. These will no longer be realised in the timescale or on the scale originally envisaged. It remains to be seen what flexibility the Executive has to fill this funding gap and bring forward future capital investment at a time when the industry needs it the most.

The NI economy is in the midst of a construction led downturn. The Executive should now focus on promoting a construction led recovery by accelerating social housing and capital investment plans. This is what other economies are now pursuing world-wide. While external challenges will largely define the NI economy in 2009, the Executive should focus on the internal challenges that lie within its remit. Making the planning and procurement processes more private sector friendly and fast tracking public sector reform are some of the key areas within which the Executive can make a notable difference.

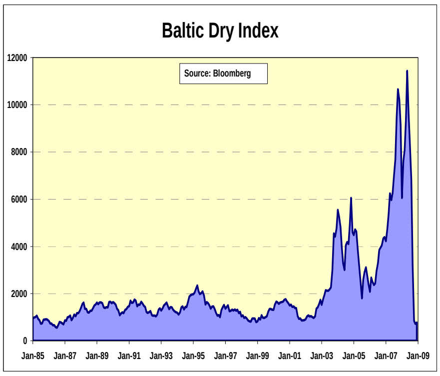
Summary Table

Economic Growth (real terms)			Forecasts		
	2006	2007	2008	2009	2010
NI – Gross Value Added (GVA)	3.6%	3.2%	-0.5%*	-2.5%	+1.0%
UK - GDP	2.9%	3.1%	0.7%	-2.5%	+0.5%
RoI - GNP	6.3%	4.1%	-2.5%	-4.5%	-1.0%
***** Estimate for NI					
Financial Market Forecasts (end period)	**Current Period**	**Mar-09**	**Jun-09**	**Sep-09**	**Dec-09**
Interest Rates					
- Fed Funds Rate	0-0.25%	0-0.25%	0-0.25%	0-0.25%	0-0.25%
- ECB refi rate	2.00%	1.50%	1.50%	1.50%	1.50%
- UK Base Rate	1.50%	0.75%	0.75%	0.75%	0.75%
Currencies					
- Eur/USD	1.28	1.15	1.20	1.25	1.30
- GBP/USD	1.42	1.32	1.41	1.52	1.63
- GBP/Eur	1.11	1.15	1.22	1.25	1.28
- Eur/GBP	90.1	0.87	0.85	0.82	0.80

I GLOBAL ECONOMIC OVERVIEW

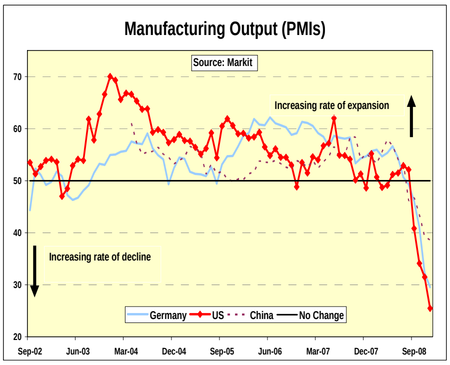
Global trade collapsed in Q4 2008

The last QER highlighted the sharp downturn in global economic activity, as measured by the Baltic Dry Index (BDI), that occurred in Q3 2008. The BDI measures the shipping rates for transporting materials on the world's main shipping routes and provides an indication of supply and demand for shipping capacity. The chart opposite highlights the boom that occurred between mid-2006 and mid-2008. During this period, the rapid global economic expansion, particularly in China, meant that the demand for shipping capacity to transport raw materials was outstripping supply. As a result, the BDI rose by 370% between May 2006 and May 2008 with the latter hitting a record high. Since then, the reversal of fortunes has been dramatic to say the least. The sharp decline in global economic activity has seen the BDI fall 66% in Q3 and a further 76% in Q4 and is now at levels not seen since 1986. The BDI will be closely watched as it will provide an early indicator of the global recovery, whenever it takes hold.



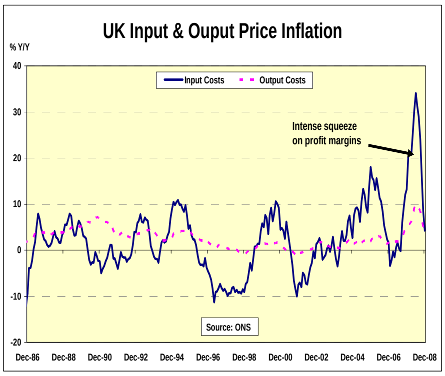
Export superpowers are not exporting

The BDI highlights the collapse in world trade that has occurred in Q4 2008. The speed and scale of the downturn has surprised forecasters including ourselves. Exporters the world over are being hit by falling demand and this year global trade is expected to contract for the first time in 26 years. The chart opposite shows that the export super powers of Germany, the US and China have witnessed a marked deterioration in manufacturing activity. These economies are not alone, and indeed the UK GDP figures for the final quarter of last year indicated that the manufacturing sector experienced a hefty 4.6% quarterly decline. Clearly, NI's manufacturing industry is not immune from these developments. These figures provide an early warning of what NI can expect to see when manufacturing output figures are released in three months time.



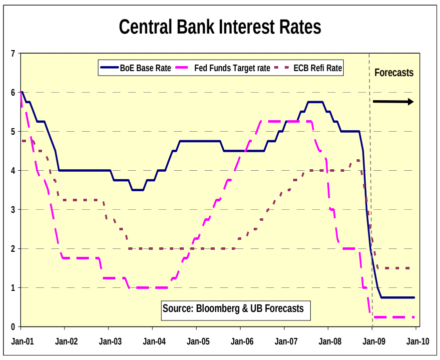
Falling demand is leading to falling inflation

During 2008, rising input costs, particularly raw materials was a key problem for many firms. The chart opposite highlights the input cost price inflation for the raw materials for UK manufacturing firms. In June 2008, the rate of inflation increased at a record rate of 34% y/y. At this time, global demand remained buoyant and UK firms retained a strong degree of pricing power and were able to increase the price of their manufacturing products by 10% y/y. However, given that input costs were rising at a faster rate than output prices profit margins were under intense pressure. The key benefit of the sharp global downturn is that commodity prices have fallen sharply. Indeed, oil prices (in Brent crude terms) are currently more than $100 below the July peak of $147 per barrel. The flipside of falling demand is reduced pricing power, which has also fallen significantly since its July 2008 peak.



Inflation is no longer a concern, but deflation is

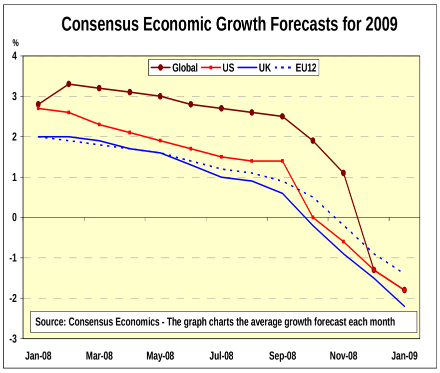
The inflation outlook for the major economies has changed dramatically since our last QER. The Federal Reserve, the BoE and the ECB have all acted aggressively and slashed their respective policy interest rates accordingly. The Fed now has its policy rate effectively at zero. The BoE has lowered its Bank Rate by 3.5% in just over 3 months which has taken official rates to 1.5% - a record low since the BoE was formed in 1694. With UK CPI inflation, set to flirt in negative territory in mid-2009, there is scope for the MPC to lower rates further. We expect a 50bp cut at the next meeting in February and a further quarter point cut in March, bringing the base rate to 0.75%. Clearly, the risks are that rates may go even lower. Meanwhile, the ECB has lowered rates by a cumulative 2.25%, so far in this interest rate cycle, to 2.0%. We anticipate a new record low of 1.5% to be reached in the coming months.



II ECONOMIC GROWTH – PAST, PRESENT, & FUTURE

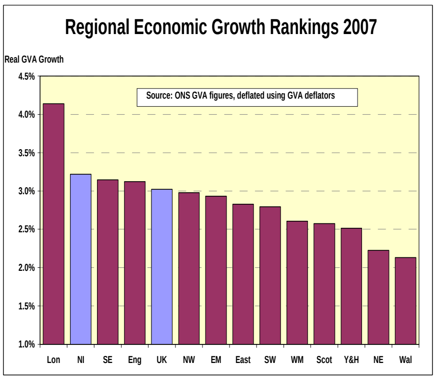
Economic growth forecasts continue to be slashed

The global response to the rapid deterioration in the global economic and financial system has been unprecedented. The slashing of interest rates, the 'mexican wave' of bank recapitalisations alongside the various fiscal injections that are taking place will all help sow the seeds for recovery. Nevertheless, in view of the weakening economic activity, consensus forecasts for economic growth of all major economies have been significantly revised. Back in September 2008, just before the collapse of Lehman Brothers, all of the major economies were expected to record positive economic growth in 2009. The latest Consensus Forecasts for economic growth in 2009 are: Global (-1.8%), US (-1.8%), UK (-2.2%), EU 12 (-1.4%) and the RoI (-4.0%). The two most important economies determining NI's overall economic health are the UK and the RoI. Our forecasts for these two economies are now (UK = -2.5% & RoI = -4.5%).



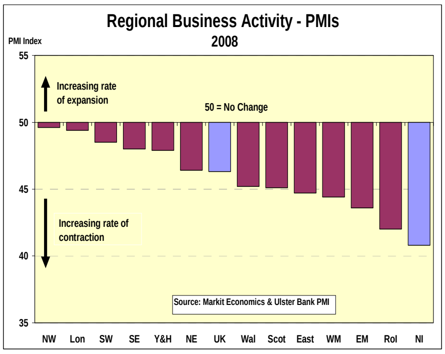
NI outperformed the UK in 2007

Gross Value Added (GVA) is the measure used for regional economic growth and the latest available statistics are for 2007. Over the last 5 years, 2002-2007, NI has experienced a faster rate of economic growth than the UK as a whole. After London, NI has been the fastest growing UK region over the same period. The latest figures included revisions to the 2006 growth figures. Indeed, NI's growth performance was even stronger than previously stated at 3.6% as opposed to 3.0% and just marginally behind London 3.7%. We had forecast growth in 2007 to ease by at least 0.5% (to 2.5%) on the 2006 figure. The 2007 outturn did indeed mark a slightly weaker growth rate, easing back by 0.4% from the revised 2006 figure to 3.2%. Once again, NI was second only to London. Despite this above UK growth performance in recent years, NI's relative economic prosperity, which is GVA per capita, remains almost 20% below the UK average where it has remained for the last decade.



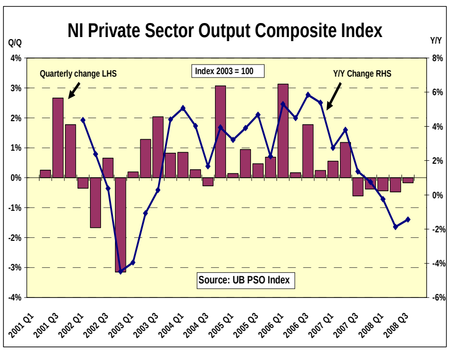
But under-performed in 2008

A consistent theme in our previous QERs was our expectation that the NI economy would record much weaker growth in 2008 than the UK. The reason for this is linked to the fact that NI's housing market crash triggered a downturn in the wider economy ahead of the credit crunch that hit the UK economy 3-6 months later. The Official GVA statistics for UK regions will not be available until December 2009, therefore we have to estimate growth using a range of economic data. One of the most timeliest indicators of economic activity are the internationally renowned Purchasing Managers Indices (PMIs). These are undertaken for most economies including NI. According to the regional PMIs, NI recorded the most pronounced slowdown in 2008 of all the UK regions with a reading of 40.8 which compares to 46.3 for the UK. These are broadly consistent with GVA / GDP economic growth rates of -0.5% and +0.9% respectively.



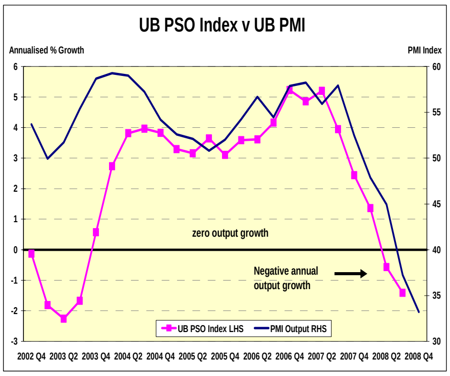
Private sector output falls for 5th consecutive quarter

The composite index of private sector output, derived by Ulster Bank Group Economics (UB PSO Index) using official private sector output data, peaked in Q2 2007. However, the index has subsequently fallen in the five consecutive quarters to Q3 2008. As a result, the UB PSO index signals that output has declined by 2.1% since Q2 2007's peak. This confirms our view that NI's slowdown occurred before the credit crunch. In Q3 2008, private sector output was only marginally lower (0.2%) than the previous quarter and 2.2% lower than the corresponding quarter in 2007. With the exception of 2002/03, when the Index of Services survey was in its infancy and is deemed more reliable now, the PSO index should broadly mirror changes in GVA. Although, whether input costs are rising or falling will influence how output changes translate into GVA.



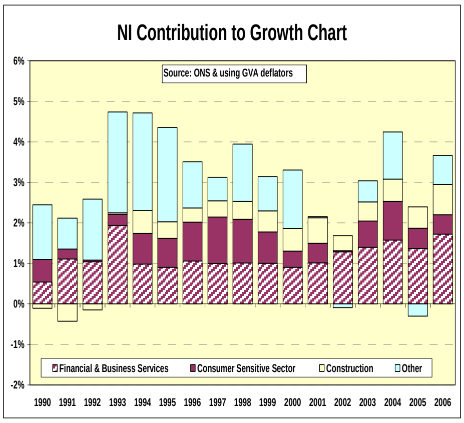
PMI has been closely correlated with official Private Sector Output data

We know that the official UK GDP growth figure for 2008 has been confirmed at +0.7% which was close to the PMI estimate of 0.9%. The UB PMI has been particularly gloomy in 2008 and has signalled private sector contraction, *(i.e. below the 50 threshold)* for the last 13 months. The chart opposite highlights that the PMI has a reasonably strong correlation with the PSO index *(excluding the "Other services" category to ensure comparability)*. The PMI peaked in Q3 2007 but has slowed down rapidly since and has been in outright contraction since Q1 2008. Meanwhile, the PSO index has mirrored this decline in the PMI. With the PMI signalling contraction, at an accelerating rate in Q4, viewed alongside our wider forecasts for the economy to deteriorate further, we expect the UB PSO index to contract sharply in the coming quarters.



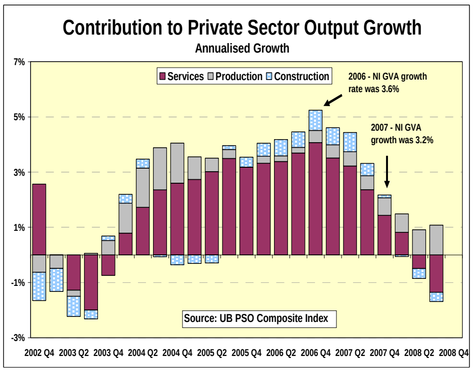
Sectoral contribution to Economic Growth

The latest official economic growth (GVA) data by sector are for 2006. The 2006 figures provide some detail on the key drivers of economic growth at the start of the property boom. Property-related sectors such as construction (+0.75%) and financial intermediation & business services (+1.9%) or FIBS, accounted for 68% of NI's total increase in economic growth (+3.6%). Indeed, the only time that the financial intermediation and business services sectors made a larger contribution to NI's economic growth rate was in 1993, which was when growth was rebounding from the UK recession. The FIBS has doubled its share of GVA since the early 1990s and now accounts for more than 20% of total GVA. Meanwhile, the construction sector's share of GVA has risen from a low of 5% after the early 1990s recession in 1993 to 8.5% in 2006 and 2006 represented its greatest contribution to NI economic growth to date. Appendix I highlights the annual rate of growth for each sector in 2006.



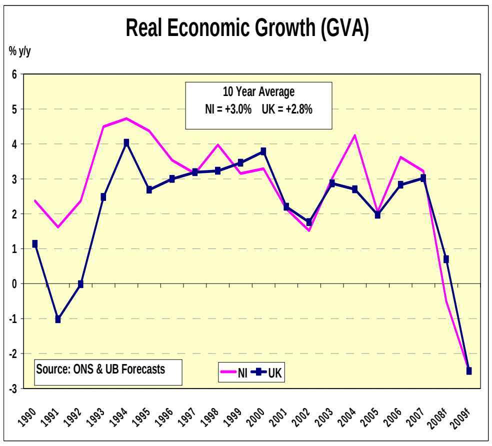
In 2008 manufacturing has been the only main sector growing

The latest GVA figures for NI overall (*sector breakdown is not available*) showed that real economic growth eased to 3.2% in 2007. The main contributors to growth are expected to be broadly similar in 2007 to the 2006 profile. However, the contribution to growth of the construction sector will have eased due to the beginning of the slowdown in the housing market. The FIBS component is also expected to have eased for the same reason. Throughout 2007, all three sectors contributed to NI's private sector output growth of 2.7% using the UB PSO index. However, since the second half of 2007, the construction and services sectors have seen output decline and NI's private sector output has signalled contraction, on an annualised basis, since Q3 2008.



Both NI & UK will both experience deep recessions in 2009

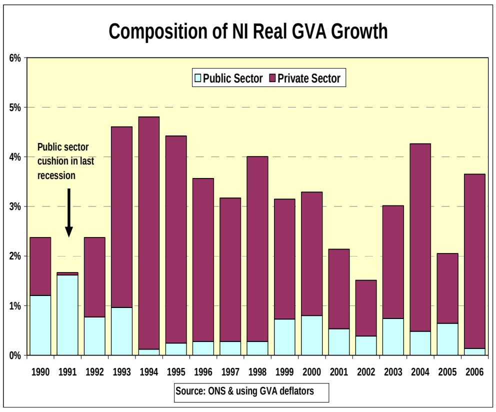
With the exception of the early 1990s recession, the NI economy has traditionally followed the UK economic cycle. The October QER examined the factors that contributed to NI's recession proof status in the 1990s. These were quite unique and are either no longer applicable in the current downturn or will no longer insulate the economy to the same extent. These factors included: a large public sector; extremely high levels of financial assistance to manufacturing firms; the absence of a housing market crash; an underdeveloped private sector, particularly in consumer demand sensitive sectors such as retail; continuous employment growth with only a very modest rise in unemployment. However, the theory that the NI economy is recession proof has now been thrown out by commentators and Government alike. As a result, the NI economy will more closely follow the performance of the UK economy, in a downturn, than has previously been the case. We expect the NI economy to contract by 2.5% in 2009 (UK= -2.5%) with a tentative recovery of +1.0% in 2010 (UK = +0.5%).



III KEY TRENDS IN NI's HISTORICAL ECONOMIC GROWTH PERFORMANCE

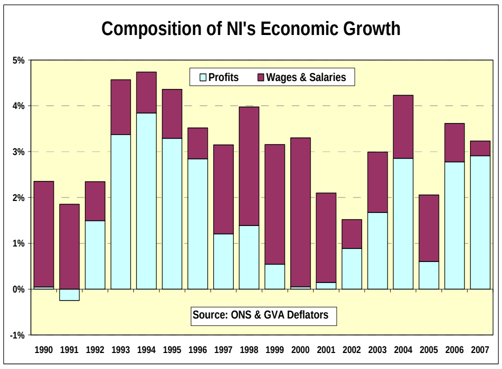
NI's changing economic growth picture

Looking at NI's economic growth performance in more detail reveals a number of significant changes. First, in terms of public v private sector economic growth. Second, in terms of the source of growth, namely, wages or profits. In 1991, the public sector was a direct source of real economic growth and the private sector narrowly escaped recession with real growth of just 0.1% vs 1.6% for the public sector. This contrasts with the latest data for 2006 which shows that the public sector only ***directly*** accounted for 0.1% of growth as opposed to 3.5% for the private sector. In 2008, public sector employment fell for the first time in more than a decade, further falls are expected in 2009. Therefore the ***direct*** contrbution to economic growth is expected to be neutral at best for 2008 & 2009. It is important to appreciate that what this is measuring is the direct impact namely wages and salaries. The ***indirect*** impact is highly significant in driving business growth through procurement, capital investment etc.



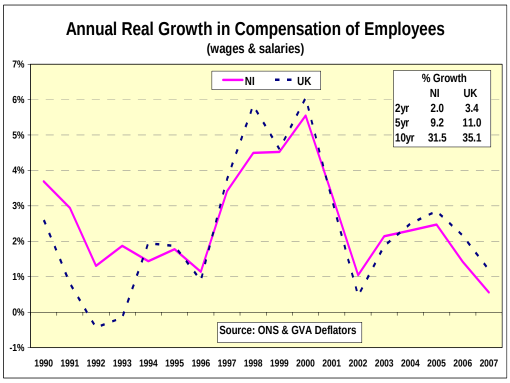
Rising profits were the key driver of economic growth in 2006 & 2007

Regional GVA *(economic growth)* is split into two categories: operating surpluses, which is essentially profits; and compensation of employees, which is wages & salaries. Clearly, the greater the increase in employment and / or real wages, the larger the real growth in the compensation of employees component *(wages & salaries)* of GVA. Similarly, the operating surplus component of GVA will rise if business profits rises at a faster rate than inflation. The chart opposite highlights that in 2006 & 2007 *(during the property & credit boom),* increased profits accounted for the vast majority (2.9%) of NI's overall economic growth rate of 3.2%. Indeed, apart from London, NI recorded the strongest rise in profits of any UK region (+6.8%). Conversely, NI's wages & salaries component increased by only 0.6% in real terms, half the UK rate, and the weakest of all UK regions bar Wales.



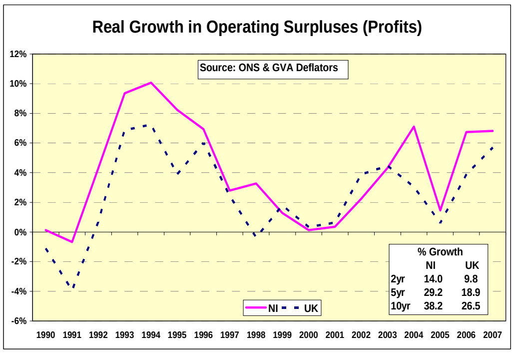
Contribution of wages & salaries to growth is set to go negative

In 2007, NI recorded its weakest increase in wages & salaries GVA since records began in 1989. However, this was against a background of rising employment growth and relatively low inflation. The October QER highlighted that NI's employment growth is increasingly dominated by part-time employment which means proportionately lower regional income growth in GVA terms. This is why the annual rate of growth of wages & salaries (see opposite) is declining. If this was declining, but remaining positive during a period of employment growth and low inflation, it is destined to go into contraction territory in 2008 when inflation was eroding real wage growth and when employment is falling. During the last UK recession it is noted that the UK's wages & salaries decreased in real terms in 1991. NI will see this for the first time in 2008 with an even steeper decline in 2009 due to significant job losses. Wages & salaries account for 56% of NI's total GVA (UK = 60%).



Profits are also set for a sharp decline in 2008 & 2009

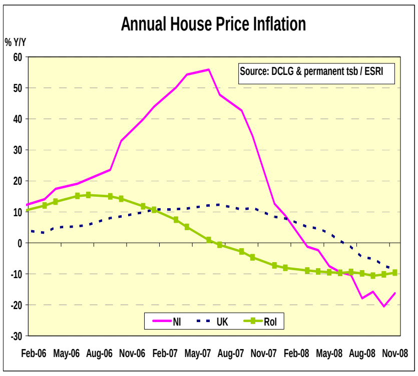
In our view, the property boom, which benefitted not just the construction sector but business & financial services alongside the wholesale / retail sectors was a key factor behind the sharp rise in real operating surpluses or profits in 2006 & 2007. However, the housing downturn, that has been more pronounced in NI than any other UK region to date, will see this growth go into reverse in 2008 and negative territory in 2009. According to the Index of Services, these sectors have experienced a sharp contraction in output for the last 6 consecutive quarters and have fallen at a faster pace than the UK as a whole.The manufacturing sector's strong performance in the first half of 2008 will limit the overall fall, but it will experience the sharpest decline of any sector in 2009.



IV PROPERTY DOWNTURN TRIGGERED THE DECLINE IN PRIVATE SECTOR OUTPUT

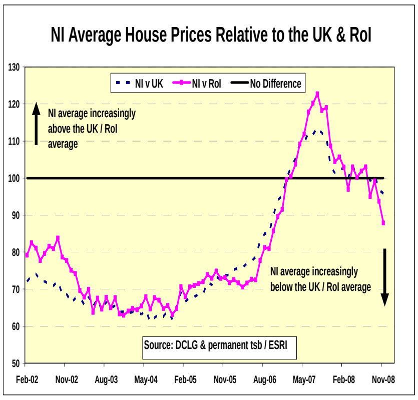
House price falls continue

According to the DCLG, the average NI house price fell to £191k in November 2008, a 16% y/y fall which was the steepest annual decline of all the UK regions (UK = -8.6%). This represents a £58k or 24% drop relative to the peak in August 2007 of £249k. Meanwhile, other house price surveys have highlighted even sharper annual house price falls, the latest Nationwide survey recorded a 34% y/y drop for Q4 2008. Our April 2008 QER forecast the average house prices in NI to fall below the respective UK & RoI averages and would end the year at £175k. The former has occurred but the low level of housing transactions is disguising the true extent of the house price falls. While the house price correction has taken place for new builds, the second hand market will see more price adjustment. We anticipate NI average house prices to end 2009 close to £140k or 45% below the August 2007 peak. It is still premature to be talking about house price growth but house prices should stabilise in 2010.



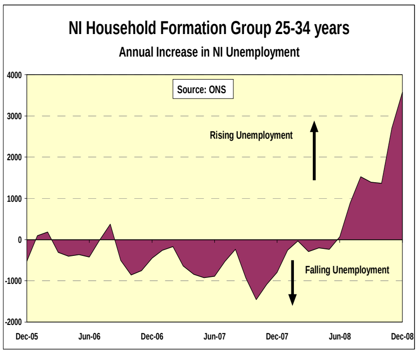
NI house prices back below the UK and RoI averages

While both the NI and RoI continue to experience house price falls, there has been significant movement in the relative average house prices due to the depreciation of sterling. At the peak of the house price boom NI's average house price (£249k) was some 23% above the RoI average (£202k) and 14% above the UK average (£219k). The latest figures for November 2008 confirm that this position has reversed dramatically with the NI average house price (£191k) now 12% below the corresponding RoI figure of £218k. Meanwhile, the average NI house price is now 4% below the UK average. With the euro rising further against sterling since November 2008, the house price differential will be even wider. It will be interesting to see whether estate agents, particularly in the border areas, start reporting a pick up in enquiries from RoI customers, as is currently the case with new car sales.



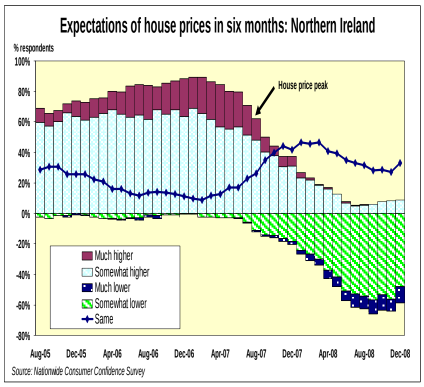
Household formation group is growing but so too is unemployment

A key driver of housing demand is the household formation category, 25-34 years of age. This is the age bracket that contains first-time buyers (FTB) and the housing market recovery is dependent upon their return. The number of individuals in this grouping are set to rise over the next few years and this will support housing demand. These favourable demographics have been accompanied by a marked improvement in affordability. Indeed, the average house price of a FTB property is now £135k which is down 29% on the peak recorded in August 2007 (£189k) and back to levels not seen since 2006. However, while concerns over affordability have receded, fears over job security have risen. Unemployment has been rising rapidly in the 25-34 age group, up 66% (+3,575) over the year to December 2008 and up almost 50% (+2,900) over the last 6 months. This will limit the return of the FTB.



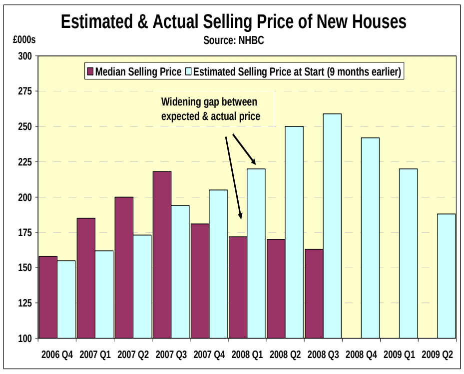
Danger of excessive house price pessimism

As a general rule, confidence surveys tend to be treated with a degree of caution. In the housing market, however, while economic fundamentals are critical, consumer confidence is also important. Property bubbles are preceded by excessive optimism amongst potential house buyers. This optimism, which Alan Greenspan referred to as *"irrational exuberance"* is contagious with individuals inclined to follow the herd. It is noted opposite, that even at the house price peak in August 2007, 62% of individuals surveyed thought that prices would go even higher. They were proved wrong. Post-boom, there is the danger of *"irrational pessimism"*, which is equally as contagious. NI has already experienced a huge price correction and prices will not keep falling indefinitely. Investors recognise this and given current prices and rising yields we expect the more seasoned investor to return to the market in 2009, but not to the same degree as in 2007.



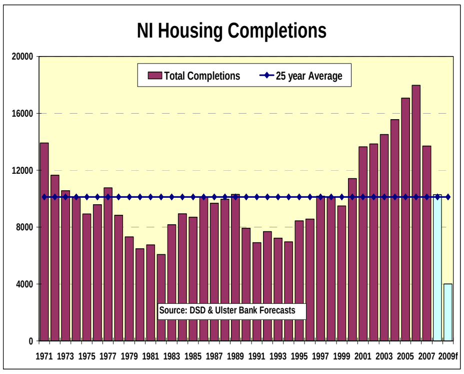
Builders also underestimated & over-estimated house price growth

Builders, like investors and house purchasers, also suffered from "*irrational exuberance"* during NI's property bubble. According to the NHBC, New House Building Statistics, builders underestimated the house price growth during the initial phase of the housing boom, with actual selling prices exceeding the builder's expectations at the start phase 9 months earlier. However, once house prices peaked, they began to over-estimate the eventual selling prices. For example, in Q4 2007, at the start phase of a house build, builders estimated they would sell a house for £259k on average. However, 9 months later in Q3 2008 the average house was selling for just £163k. This represents a fall of some 37% or £96k on what was originally anticipated. Clearly, these developments will have had a negative impact on the profitability of many building firms, particularly those firms that bought land at the height of the property boom. This will become more transparent in 2009.



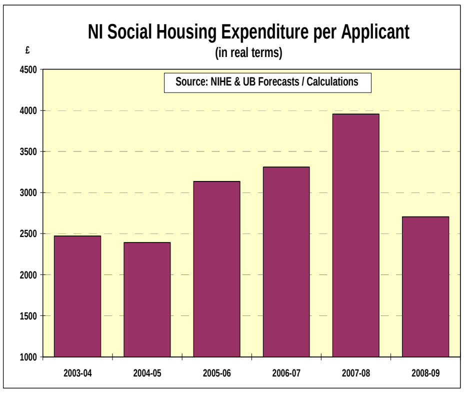
House building sector is in the midst of its worst downturn

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 2008 some 60% lower than in 2007 according to the latest NHBC figures. This compares with a decline in the UK of over 47%. The decline in starts last year will translate into fewer completions this year and we anticipate this falling to 4,000 if not lower. This would represent a reduction in completions of close to 80% or 14,000 fewer from the 2006 peak. This would be well below the previous low of 6,100 in 1983.



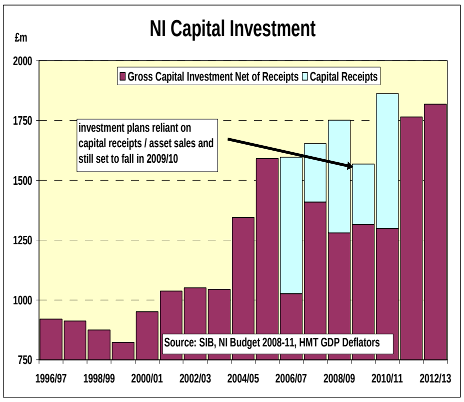
Demand for social housing is set to rise but funding is set to fall

Mortgage repossessions and personal insolvencies have been on a rising trend over the last year and are set to increase, particularly given the rapid rise in unemployment. As a result, a further rise in demand for social housing is expected. A key feature of the NI housing market to date has been the shortage of social housing. The number of individuals on the social housing waiting list has risen by 10% on average over the last 4 years to March 2008. There are currently almost 40,000 on the waiting list. A conservative estimate for the likely increase in the waiting list would be a further 10% rise. However, as the Chart opposite shows, the expenditure dedicated to social housing *(in real terms)* relative to demand *(social housing applicants)* is set to fall by over 30%. With the rate of house building at record lows, there is the potential for an even more severe social housing crisis in 2010. The Executive has the opportunity to address this issue *(through more funding)* now before it gets much worse.



Capital investment to contract when it is most needed in 2009/10

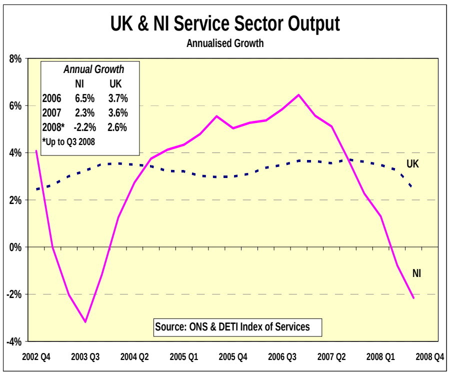
The downturn in the NI housing market has dragged the construction sector into recession. As a result, the local construction sector needs the Executive to deliver on its public infrastructure investment plans more than ever. However, these plans were reliant on capital receipts and asset disposals, which in turn were largely linked to property related sales or receipts. These will no longer be realised in the timescale or on the scale originally envisaged. Even if the capital receipts were all realised for 2009/10 it would still represent a fall in real terms of more than 10% on the planned expenditure for 2008/09. This slowdown in public investment will put even more construction jobs in the civil engineering trades at risk. The Construction Employers Federation has warned of the potential of 30,000 construction redundancies.



V THE CONSTRUCTION LED DOWNTURN CONTINUES TO SQUEEZE THE SERVICES SECTOR

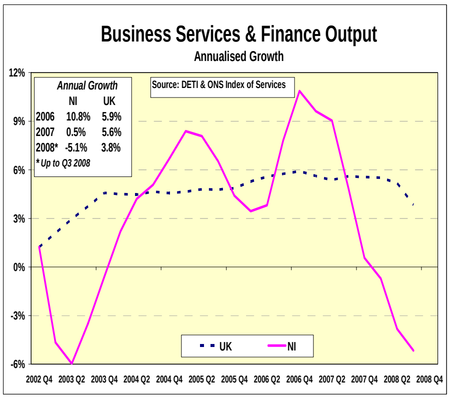
Services output is slowing at a much faster rate than the UK

The current NI downturn has exposed the reliance of sectors outside of construction to the property market. NI's property downturn has had a 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 fifth consecutive quarter although the latest quarterly contraction (-0.3%) was much smaller than the previous declines. Meanwhile, the UK services sector experienced its first quarterly decline which was above the NI (-0.5%). However, over the year to Q3 2008, the UK has seen its services sector expand by 2.5% which compares with a 2.2% decline in NI.



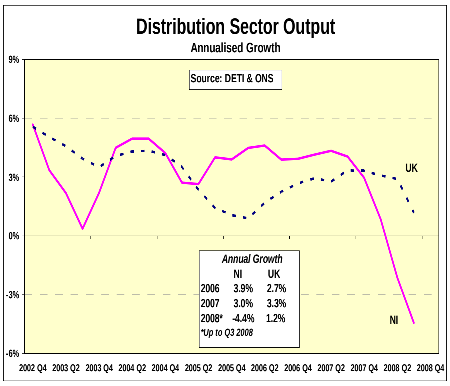
Output continues to plummet in the Executive's priority area

The service sector slowdown 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 such as banking. Relative to the UK this sector is about half the size in the NI and therefore NI will be less exposed from the fall-out of the credit crunch than other regions, primarily the South East & London. Nevertheless, NI's business and services sector is arguably more exposed to property and NI's boom and bust will be more pronounced than in the UK. To date, the sharp fall in output in the *Business Services & Finance* has mirrored the downturn in the NI property market with the sector contracting for the last 5 quarters. In Q3 2008, NI output fell by 3.8% (UK= -0.6%) and decreased by 5.1% over the year as a whole. Meanwhile, Q3 marked the first quarterly contraction for the UK and it has enjoyed robust growth of 3.8% over the year to Q3 2008.



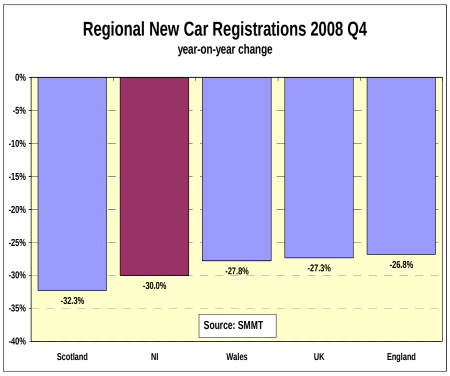
Wholesale and retail output experiences sharpest annual decline

The NI economy is more exposed to a consumer downturn now than it was during the 1990s UK recession. This is particularly apparent in the *Distribution* sector which includes retail, wholesale and car sales. This sector has experienced five consecutive quarters of contraction to date. NI's *Distribution* sector recorded a quarterly decline of 1.6% in Q3 2008 which compared favourably with the UK (-2.7%). However, this marked the first quarterly decline for the UK and suggests that the UK downturn is catching up with NI. Over the year to Q3 2008, the UK has still achieved output growth of 1.2% against a 4.4% contraction for NI. However, NI's retail sector has received a much needed boost in recent months due to the weakness of sterling against the euro. This has led to a flood of shoppers from the RoI to NI's border towns.



Consumer demand weak for big ticket items e.g. new cars

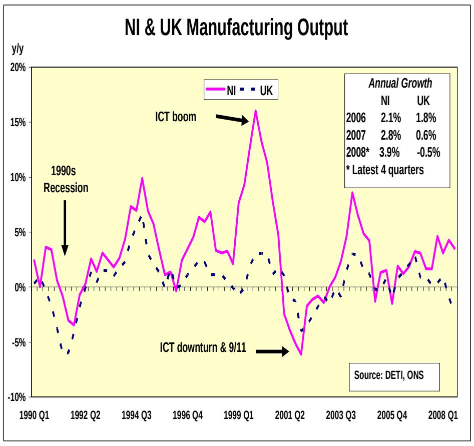
According to the latest car sales data Q4 2008 from the motor industry group SMMT, new car sales continued to fall. NI experienced a 30% quarterly decline relative to the same period in 2007. This was a steeper decline than the UK but below that of Scotland. NI's Q4 figures were boosted by increased interest from the RoI. Indeed, it was reported that 30% of car sales in NI were to RoI customers in November & December. The significant savings from the exchange rate more than compensated for the import tax that RoI customers incur. Aggressive marketing of RoI customers could reap further rewards this year given the exchange rate. Overall in 2008, NI experienced the sharpest annual fall in car sales of the UK regions with 12,000 fewer cars sold (NI -17.5% v UK -11.4%).



VI NI'S OUTPUT NOW SET TO FALL FROM SLUMP IN GLOBAL TRADE

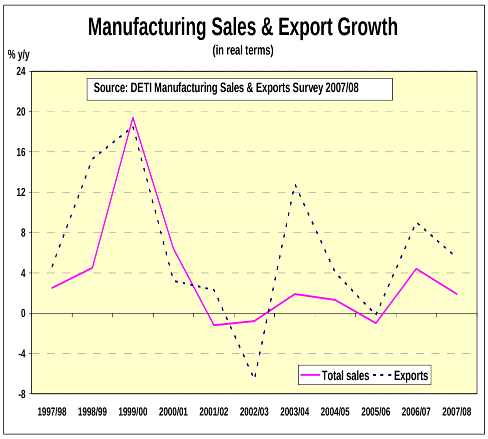
NI's Manufacturing sector continues to outperform the UK

The latest Index of Production survey for Q3 2008 highlights that NI's manufacturing industry continued to outperform its UK counterpart. However, it is clear from more recent job losses within the sector that a marked slowdown is now in train with a steep contraction expected for Q4 2008. The UK manufacturing sector saw output fall for the second consecutive quarter in Q3 2008 with the 1.5% contraction following on from the 1.1% drop in Q2. Meanwhile, NI industry fared relatively better with output growth remaining flat in Q3. Over the previous four quarters NI manufacturing output has increased by a robust 3.9% which compares to a decline of 0.5% for the UK. It is also noted that the 2007 output figures were revised significantly upwards from a decline of -0.3% to a rise of 2.8%. This is another factor explaining why NI GVA growth came in stronger than we had expected. The latest UK GDP figures recorded a quarterly decline in manufacturing output of 4.6% in Q4. In Q4 2001, after 9/11 NI manufacturing output contracted by 6.1% over the quarter. Given the scale of the downturn in Q4 2008, it would not come as a surprise if NI manufacturing output dropped by an even larger amount.



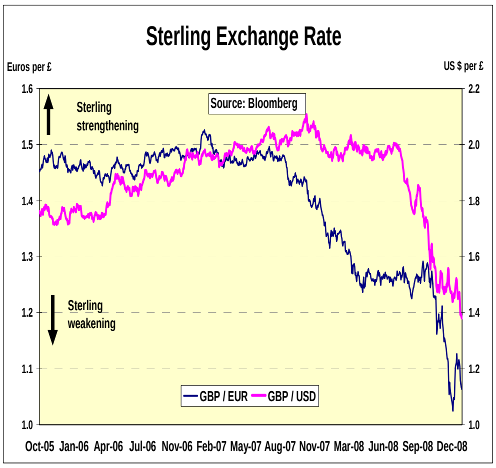
Exports set to fall but some sectors will prosper

In 2007/08, total manufacturing sales increased by 1.9% in real terms, while exports increased by 5.5%. In NI, businesses that do achieve export growth in 2009 will clearly be the exception and not the rule and NI's overall export performance will be sensitive to the fortunes of a number of key exporters. NI's top 10 exporters account for 43% of total exports and some of these largest exporters have either recently closed (Seagate Limavady), or have witnessed significant declines in demand and therefore output (e.g. FG Wilson, Seagate Springtown). NI's exporters last experienced a significant demand shock in 2001. Firstly, the internet / ICT bubble burst and this hit suppliers of products in this industry, notably Seagate & Nortel. This was followed by the events of 9/11 which had a notable impact on the global aerospace industry including Bombardier. Following these two events exports fell by 6.6% the following year. In this downturn, the ICT sector will be hit hard again but Bombardier is well placed to weather the storm with significant work in progress. This will buoy up activity in Bombardier's extensive NI supply chain. Other recession proof sectors include food producers and pharmaceuticals.



Sterling weakness good for exporters but bad news for importers

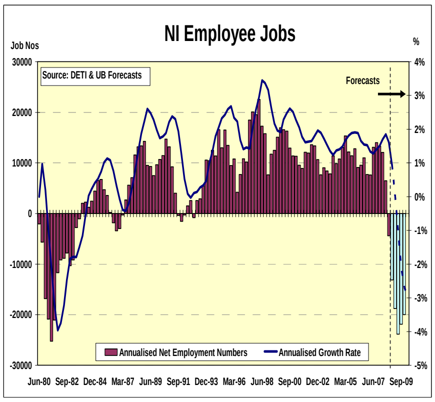
One of the most significant economic developments over the last quarter has been on the exchange rate front. A sharply deteriorating UK economy combined with an aggressive rate cutting Bank of England encouraged currency traders to sell sterling. Conversely, the ECB has been more cautious on the rate cutting front and this helped propel euro / sterling to successive record highs towards the end of 2008. However, the single currency failed to reach parity with sterling falling short at 98p, or £ = €1.02. Against the dollar, GBP has recently plunged below $1.40 touching $1.38. Clearly, sterling weakness will benefit NI exporters as NI goods and services are now much more competitive. However, lack of demand, irrespective of price remains a key concern for some of NI's largest exporters. Furthermore, the depreciation in sterling pushes up the price of imports and manufacturing input costs. The net result is the pricing power of many NI firms has been eroded. Those firms that require limited inputs from outside of NI, e.g. food manufacturers, will arguably benefit the most. We expect sterling to regain a firmer tone against both the dollar and euro in the months ahead with our currency forecasts highlighted on page 3.



VII FALLING OUTPUT IS TAKING ITS TOLL ON THE NI LABOUR MARKET

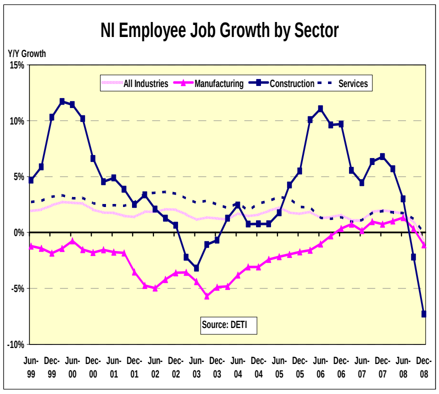
NI records largest fall in quarterly employment since March 1981

Earlier in 2008, this publication flagged that the record levels of employment in Q2 would represent the peak in employment for quite some time, as the deterioration in economic activity would inevitably lead to job losses. According to the latest Quarterly Employment Survey for September (Q3), the number of jobs fell by a hefty 6,990 or -1.0% over he quarter (UK= -0.3%) to 718,370. This marked the largest drop in employment in a single quarter since March 1981. Furthermore, NI's employment growth was weaker than the UK for the first 3 quarters of 2008. We anticipate at least a further five quarters of employment decline. In our view, 2008 is going to record a marginal decline in overall employment and would represent the first annual decline since 1986. However, our forecast for 2009 is for a much steeper fall in employment of around 3%, which would signal the sharpest annual contraction in employment since 1981 (-3.7%). This would take the employee jobs figure closer towards 690,000, a level not seen since 2004.



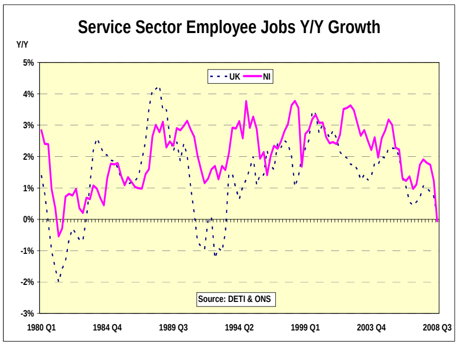
All sectors will experience heavy job losses in 2009

The construction sector continues to bear the brunt of the job losses in percentage terms and recorded a quarterly decline of 1,600 jobs or -3.7% in Q3 2008. This represents a fall of 3,270 or 7.3% y/y. The job losses are particularly apparent in the house–building sector which is in the midst of its worst downturn on record. Meanwhile, manufacturing has been defying gravity in employment terms in recent years unlike the UK which has experienced 42 consecutive quarters of employment decline. However, since Q3 2008, NI manufacturing has experienced a dramatic reversal of fortunes as global trade collapsed towards the end of last year. In Q3 2008, NI manufacturing recorded a quarterly decline of 1,110 jobs or -1.3% (UK = -1.2% q/q). This is set to intensify with some of NI's most prolific exporters and largest employers (e.g. Seagate & FG Wilson) have announced extended Christmas shutdowns, reduced working weeks, cut wages or shed employment. Given this outlook, heavy job losses are expected in 2009.



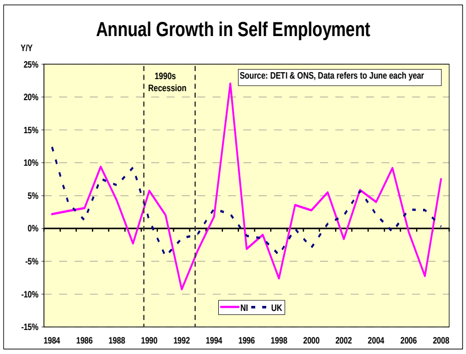
NI service sector experiences record decline in jobs

The NI service sector recorded its largest quarterly fall in employment on record in Q3 2008, with the total number of employee jobs falling by 4,280. This represented a fall of 0.1% on the same period in 2007, which marked the first year-on-year decline since June 1981. The UK experienced a larger quarterly decline of 0.3% in Q3 2008 but still managed to eke out a marginal increase in employment relative to Q3 2007. The service sector has never experienced a contraction over a full four quarters and the latest figures to Q3 2008 highlight employment growth of 1.2% (UK = +0.7%). However, this is likely to change this year and NI's service sector will not prevent the NI economy from falling deeper into recession as it did in the early 1990s.



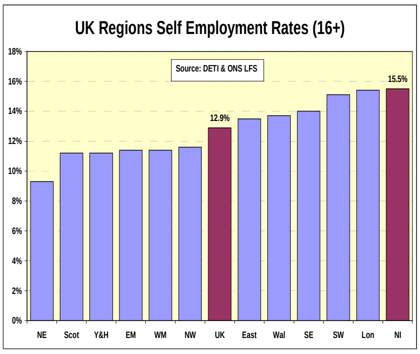
Traditionally the self employed are also hit hard during recessions

The employee jobs figures exclude the self-employed. This cohort traditionally experiences significant job losses and under-employment during economic downturns. During the last UK recession in the early 1990s, NI fared much better than the UK in terms of employee jobs growth. That is, NI experienced continued jobs growth over this period, whereas the UK experienced a sharp decline. Conversely, with the self-employed, NI experienced a deeper contraction than the UK with a sizeable annual decrease of over 9% in 1992. The latest annual growth figures up to June 2008 signalled a robust 7.5% increase. This compared to a marginal rise of 0.3% for the UK. However, the economic downturn, will lead to a steep decline (>10%) in the number of self-employed in the second half of 2008 and 2009. Indeed, the rapid rise in the number of individuals claiming unemployment benefit in 2008 H2 would support this view.



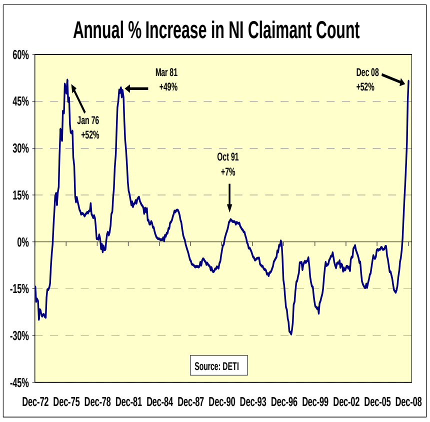
The self employed are more important in NI than any other UK region

In June 2008, there were over 122,000 self-employed with some 44% of this figure employed in either Wholesale & Retail trade or Construction activities. These are the sectors that will be affected the most by the current downturn. However, NI also has a sizeable proportion of its self employed engaged in agriculture (16%), and this sector continues to perform relatively well. It is noted that NI has the highest proportion of its workforce classed as self employed of all the UK regions (NI=15.5% v UK 12.9%) due to its relatively large agriculture and construction sectors. In NI, almost one half of those classified as self-employed were employed in Skilled Trade occupations. It has been this grouping that has been hit hard by the construction downturn and is swelling the ranks of the unemployed.



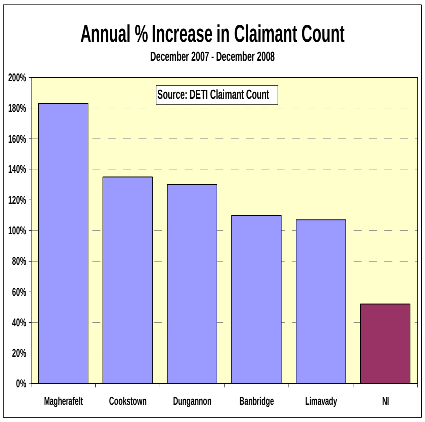
NI unemployment is rising at its fastest rate since 1976

The claimant count measure of unemployment rose by a further 6,700 in Q4 2008 bringing the number claiming unemployment benefit to 35,900 in December 2008. This represents an annual cumulative increase of 12,200. NI has not seen an annual increase of this scale since 1982. In percentage terms, this represents an annual increase of 52% (UK=+43%) which is the sharpest rise in the number of unemployed since January 1976. We expect the number of unemployed to accelerate in the coming months with the monthly claiming count rising by more than 1,500 per month and ending 2009 close to 55,000. Meanwhile, NI's ILO unemployment rate for Sep-Nov 2008 has fallen over both the quarter and the year by 0.1 percentage points to 4.2%. This rate compares favourably with the UK (6.1%). Clearly, this measure needs to be treated with caution given the significant sampling error associated with the survey. The claimant count measure provides a more accurate picture of unemployment. The unemployment rate using this measure is 4.1% which compares unfavourably with the UK rate of 3.6%. NI's unemployment rate has not been at this rate since December 2003.



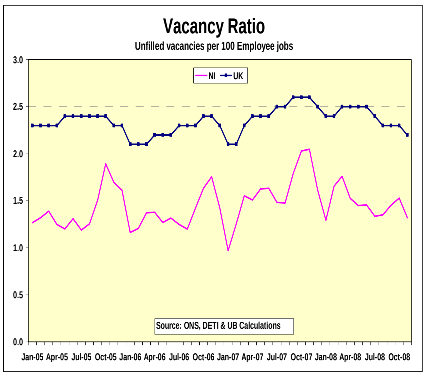
Mid-Ulster experiences the sharpest rise in unemployment

At a local level the area which has experienced the sharpest rise in unemployment is Mid-Ulster. Magherafelt (+183%), Cookstown (+135%) and Dungannon (+130%) have recorded the highest percentage increases in unemployment of all the NI district council areas over the last 12 months. Banbridge (+110%) and Limavady (+107%) have also seen the numbers of unemployed more than double over the last year. Magherafelt & Cookstown have seen a surge in unemployment due to their exposure to the construction industry. Meanwhile, County Tyrone contains a number of manufacturing firms (e.g. Powerscreen) which make NI one of the leading exporters of quarrying equipment in the world. The slump in global demand has seen these firms cut wages, staff and the length of their working week. This is also widespread throughout the manufacturing sector elsewhere in NI. The North West has been hit by the high profile closure of Seagate Limavady (900 jobs) last year.



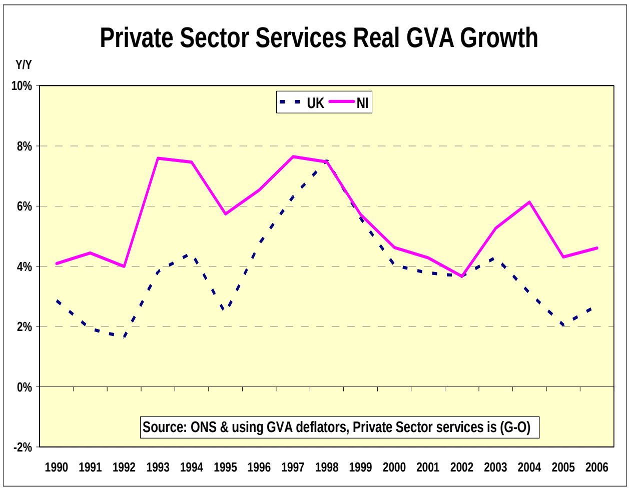
The number of job vacancies starts to ease

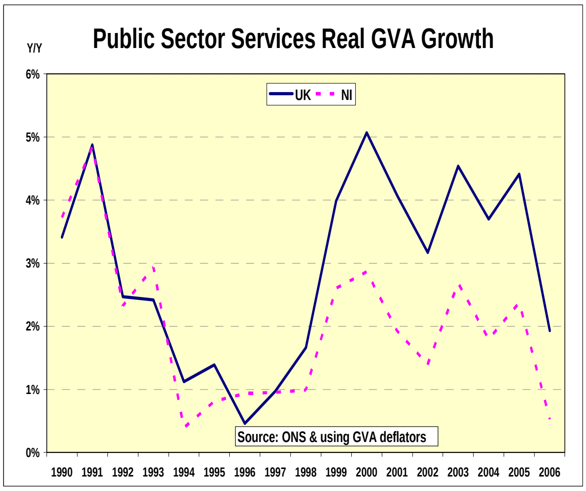
Despite the recent upsurge in the level of unemployment there are still some 9,300 unfilled job vacancies in NI. However, the latest figures for November 2008 represented a marked easing of some 1,500 vacancies over the previous month. The UK has also been experiencing a decline in job vacancies. However, it is noted that the UK has relatively more vacancies as a proportion of employment *(a higher vacancy ratio)* than NI. In November 2008 there were 2.2 job vacancies per 100 employee jobs in the UK, as compared to an estimate of 1.3 for NI. The number of unfilled vacancies is expected to ease back further in 2009 as firms are less likely to be hiring in the current economic environment. From a policy perspective, it is important that those individuals who have recently lost their jobs have the basic skills and receive the necessary training to return to the labour market when the economy recovers.

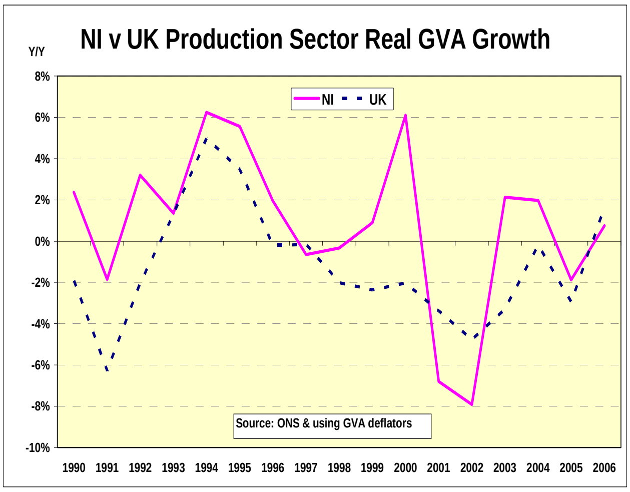


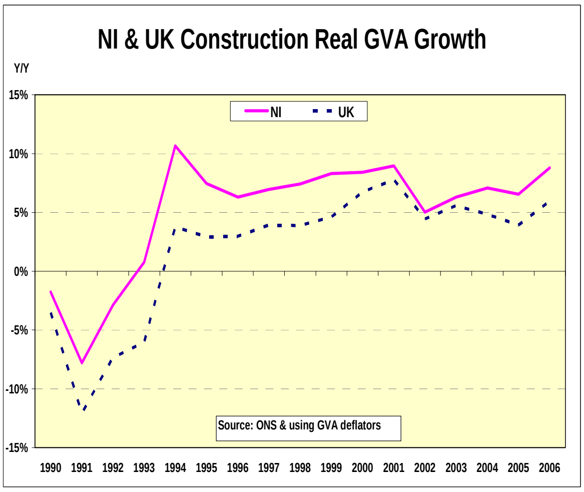
APPENDIX I – GVA Performance by Sector

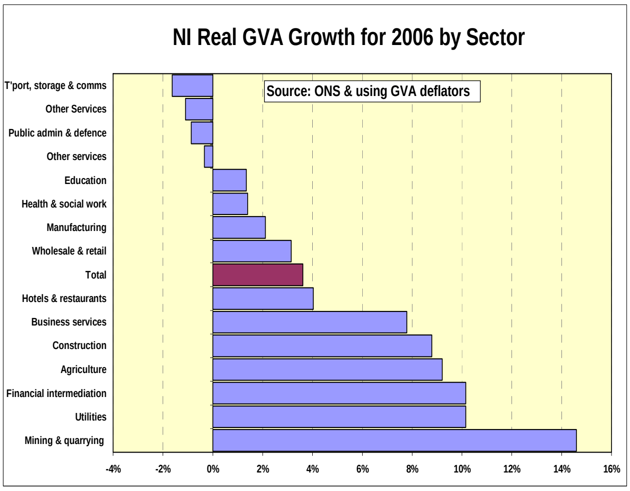
(Data for 2005 & 2006 released December 2008)

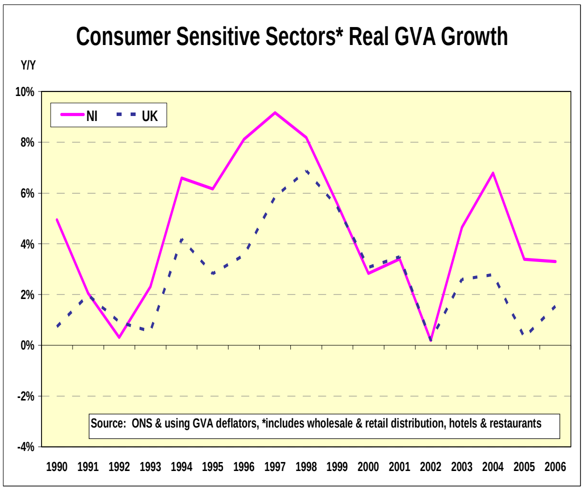






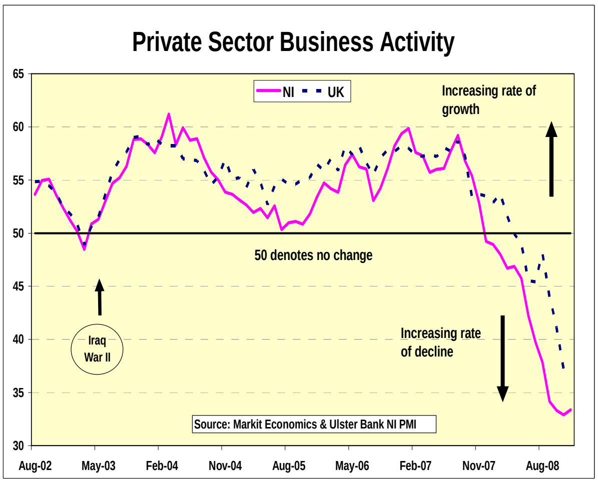


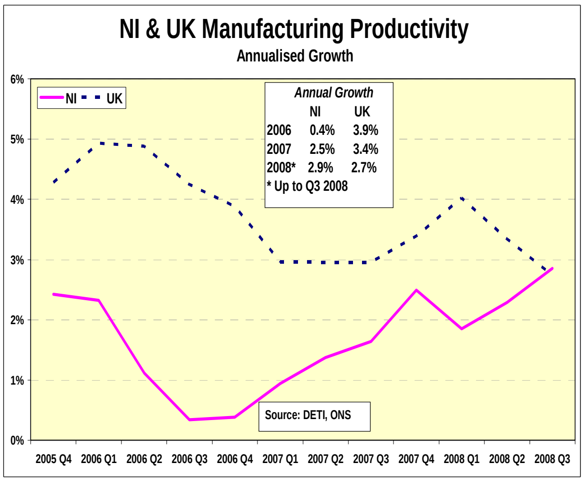


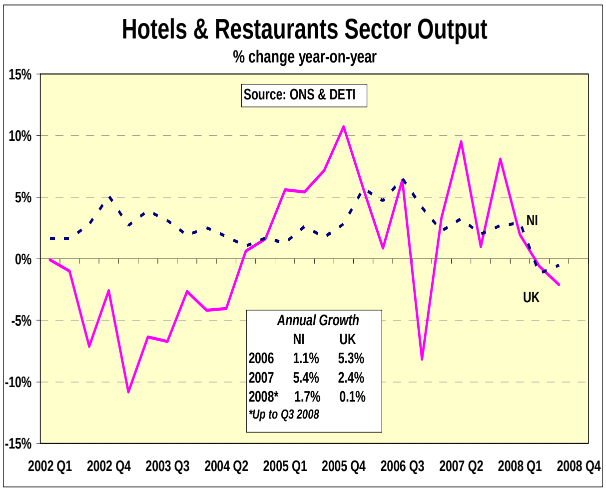


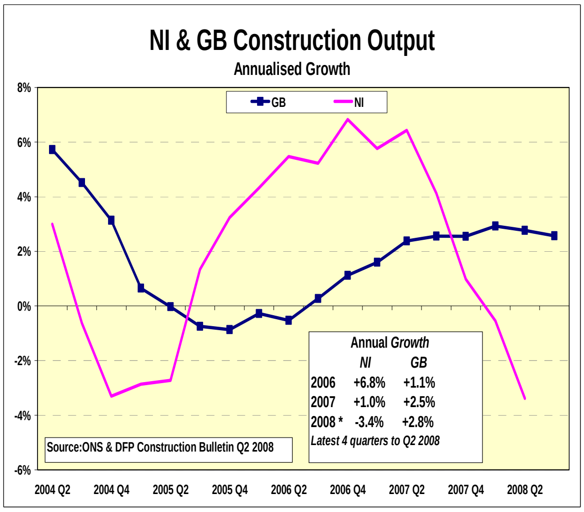
APPENDIX II – Output Performance

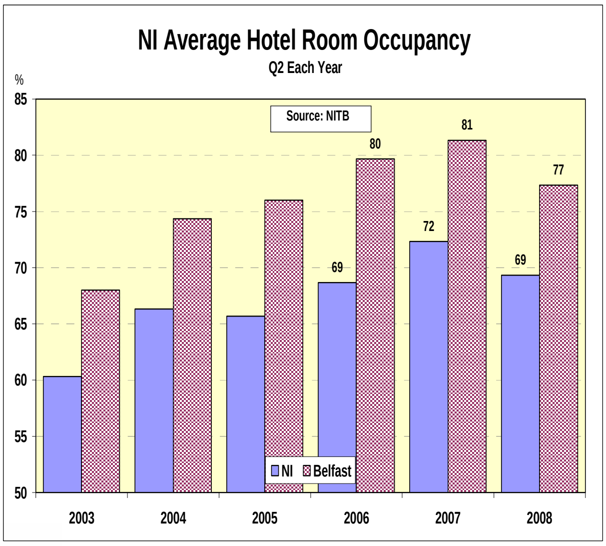
(Using latest surveys PMI, NITB, Indices of Construction Services & Production)

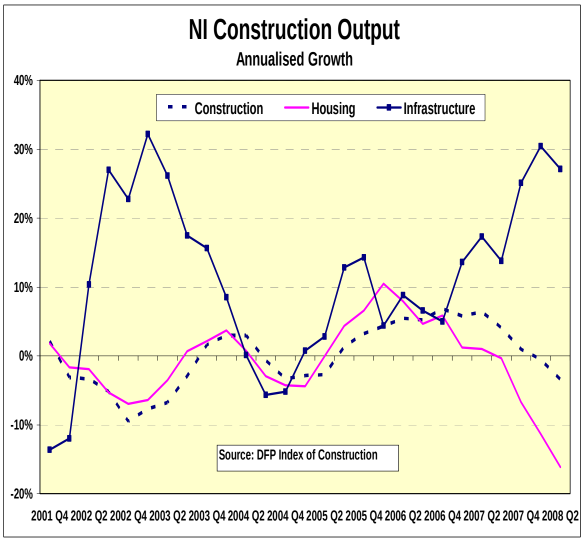












APPENDIX III - LABOUR MARKET PERFORMANCE