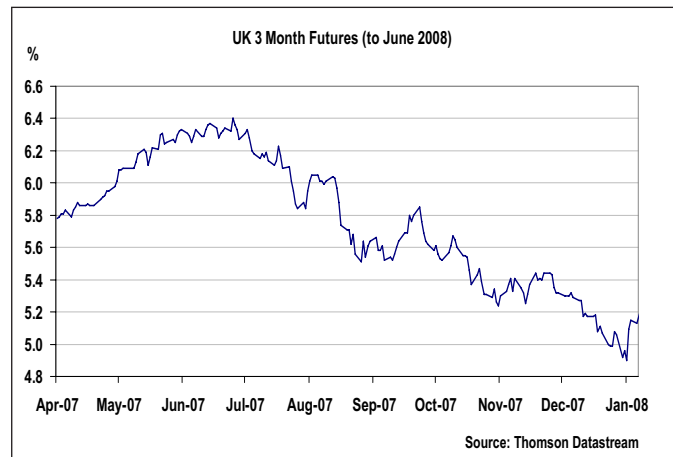




UK Rates on Gradual Downtrend - 0.25% Cut Likely in February

Having cut rates by 0.25% to 5.50% in December, the first time UK monetary policy had been eased in over two years, the Bank of England then left interest rates on hold at its January meeting. However, continuing weak UK economic data, the global economic downturn, the sharply lower trend to US interest rates and the ongoing financial market turmoil all argue for lower UK interest rates and a 0.25% cut in rates at the February meeting is quite likely. However, the Committee remains concerned about inflationary pressures and thus, while UK rates are likely to be cut again after this, the downtrend is likely to be gradual but sustained.

Just one member, arch-dove Blanchflower, voted for a rate cut in January. The minutes of the January meeting acknowledge the increased downside risks to the UK economy evident at that time. However, they also note that the short-run inflation outlook had worsened markedly, with sterling falling sharply. Furthermore, the Committee were concerned that, should it have lowered rates in January, at a second consecutive meeting, this might encourage observers to think that the MPC was more focused on stabilising demand rather than meeting the inflation target.



More recently, though, the BoE Governor, Mervyn King, hinted at an early move – saying that the current 5.5% level of rates is probably hurting demand - thus bolstering market expectations of a 0.25% rate cut at the February meeting. However, in the same speech, he dampened any expectations of a sharp downward trajectory to rates – warning also about price pressures. However, if current difficult financial market and economic conditions continue, rates may well be cut by up to a further 1.0% in total.

Economy Slightly Stronger Than Thought at end 2007

The most that can probably be expected in February is a 0.25% cut in rates. A more aggressive 0.50% move would seem unlikely, given that the economy appears to have been in slightly better shape than had been thought in the final quarter of last year. The initial estimate shows GDP growing at 0.6% in Q4. This is slightly stronger than the 0.5% rate that had been anticipated, though it still represents a mild slowdown from the 0.7% rate recorded in Q3 2007.

The 2007 growth rate at 3.1% is the best annual rate since 2004. However, while the UK economy would appear to have been in reasonably good shape in the final quarter of 2007, it is undoubtedly slowing. Recent economic data indicate that the pace of activity began weakening sharply at the end of last year and has continued to do so in early 2008.

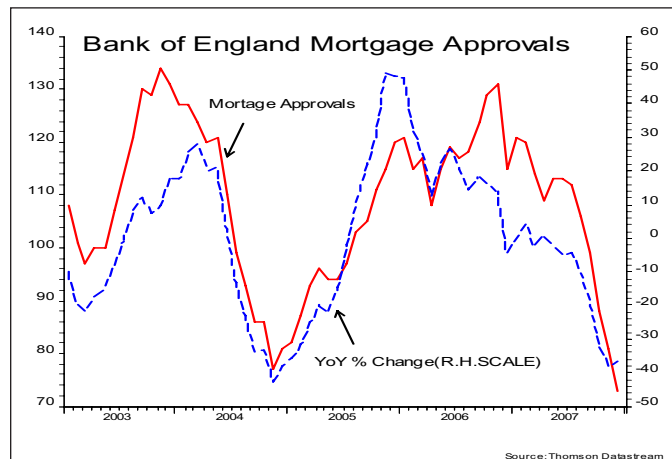
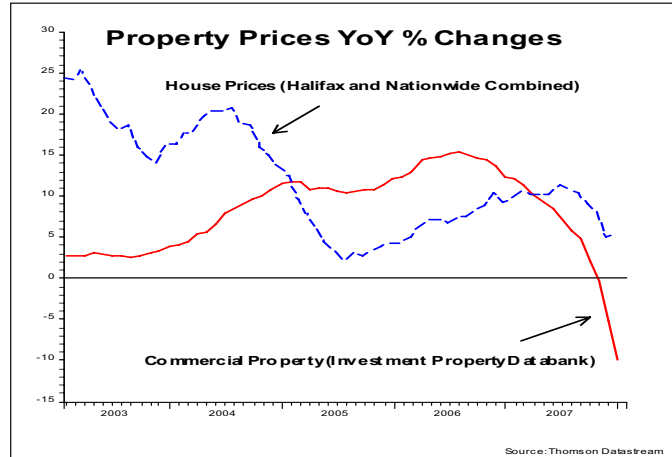
Tight Credit Conditions Weighing on Property Markets ...

The situation on money markets has eased somewhat, compared to the extremely tight conditions at the end of last year. However, as Mervyn King warned in his speech, conditions are not back to normal and remain fragile. Furthermore, the Bank of England's December survey of credit conditions showed that lenders intend to tighten conditions further this year and King believes that this tightening is unlikely to be short lived.

Tight credit conditions are undoubtedly already seriously impacting on property markets. International Property Bank data indicate that commercial property prices have fallen by some 12% since the middle of last year.

Meanwhile, both Halifax and Nationwide are starting to report monthly falls in house prices with the year-on-year growth rate in house prices beginning to drop sharply.

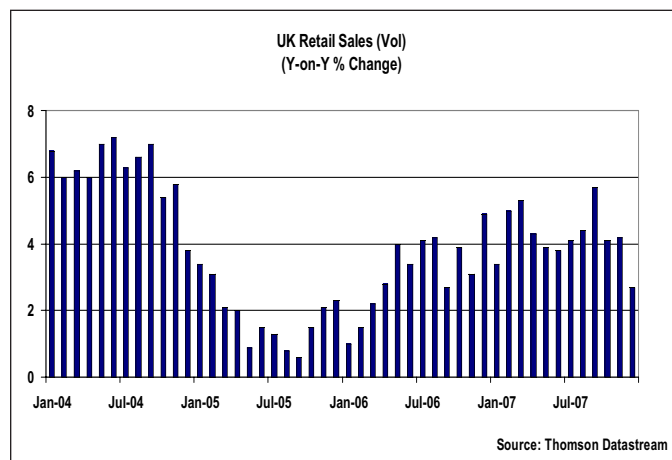
Furthermore, the latest data from the Bank of England show mortgage approvals at a record low in December, down by over 36% year-on-year in the month. These **less buoyant housing market conditions will undoubtedly depress consumer demand.**



.. Adding to Pressures on Already Faltering Consumer Demand

Domestic demand conditions are already subdued. Retail sales fell of 0.4% in December, despite some heavy discounting by retailers, bringing the year-on-year growth rate down to just 2.7%, the weakest annual growth rate since September 2006.

Furthermore, according to the Bank of England's Agents survey, retailers are nervous about the outlook for 2008. The Agents report that tighter credit conditions had become a factor in some spending decisions. They also found evidence of weakness in housing-related expenditure and weaker spending by those age-groups most exposed to mortgage debt.



Meanwhile, spending on consumer services was reported by the Agents to be more resilient than for consumer goods, though also growing at a slower pace than in the first half of last year.



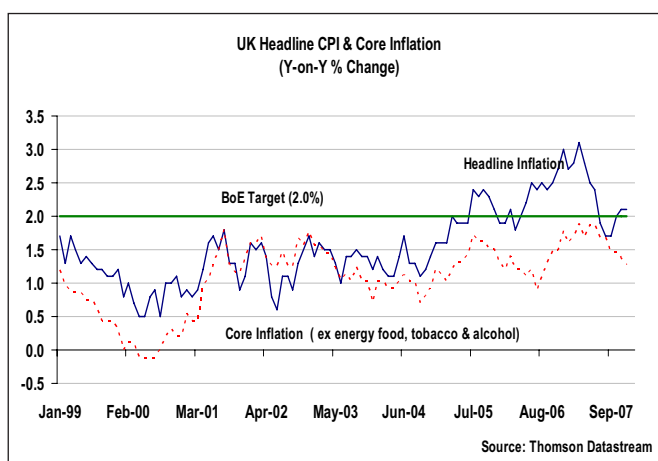
External Demand Supporting Manufacturing Sector

On a somewhat more positive note, the Bank of England Agents report that growth in the manufacturing sector remained solid at the end of last year, supported by external demand, despite difficulties for those exporting to the US. Orders data point to continued support from high levels of export orders. However, they also indicate continuing difficulties for those in the domestic sector, particularly manufacturers of building materials.

Inflationary Pressures Remain a Concern - But Unlikely to Prevent Lower Interest Rates

Indeed, given the obvious signs of slowing domestic demand, the BoE Governor's comment, that interest rates at 5.5% are probably bearing down on demand, was hardly surprising.

King also reiterated the need to keep inflation close to target in the medium term. However, the headline CPI remained steady at 2.1% in December, which is only just above the BoE's 2.0% target and well below the March peak of 3.1%. Meanwhile, the annual rate of core inflation (ex volatile food, energy, alcohol and tobacco) continues to decline, falling from 1.9% in mid 2007 to 1.3% in December.



The concern, though, is that the headline inflation rate is expected to move higher over the coming months as higher prices for food and utilities impact. As yet, there would appear to be little sign of second round inflationary pressures with earnings growth remaining subdued despite the firm labour market conditions. Hence, if the domestic economy continues to struggle, higher headline inflation will probably not provide an unsurmountable constraint to a gradual lowering of interest rates. **The February Inflation Report will provide a good indicator of how the Bank views the inflation outlook.**

On balance it seems likely that concerns about the growth outlook will dominate and the risk of a potential build up of inflation pressures will be insufficient to prevent the majority of the MPC for voting for further interest rate cuts over the coming months.

At 5.50%, official rates in the UK are relatively high which possibly gives the BoE more scope to act than other central banks as they struggle with the inflation versus growth debate. Thus, if financial market and economic conditions remain difficult, rates could be cut by up to 1.0% in total, bringing the repo rate down to 4.50%. A 0.25% cut at the February meeting is anticipated, especially after the recent gains by sterling. After that, rates are likely to come down in modest 0.25% stages, reaching 4.5% by the summer.

UK Interest Rate Forecasts					
	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.50	5.50	5.28	5.00	5.00
Mar '08	5.25	5.35	5.20	5.00	4.95
June '08	4.75	5.00	4.90	4.90	4.90
Sept '08	4.50	4.70	4.90	4.90	4.90

* Swap Forecasts Beyond 1 Year.
Current Rates Sourced From Reuters, Forecats AIB ERU

29th January 2008

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