



BoE Resumes Its Easing Campaign

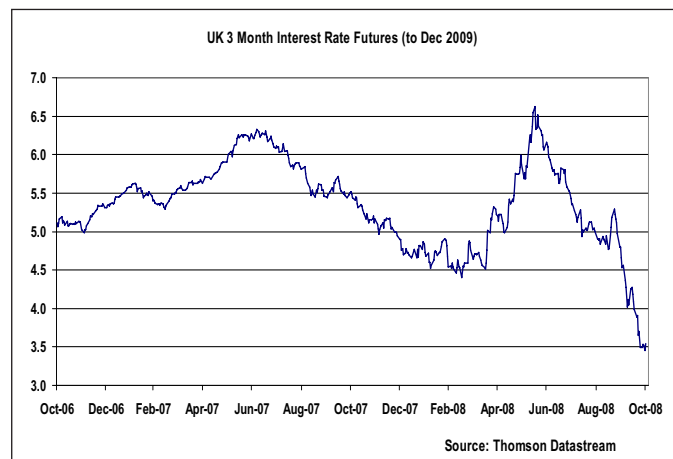
Responding to the deepening crisis on credit and financial markets, as well as a further deterioration in the prospects for the UK economy, the Bank of England cut interest rates by 0.50% on 8th October as part of a coordinated round of policy easing by leading central banks.

Official rates now stand at 4.50%, their lowest level since mid 2006. This, however, still represents a relatively restrictive stance and further rate reductions are expected in the months ahead. Indeed, as inflation risks quickly recede, markets anticipate that the Bank Rate could fall to levels not seen for over 50 years as the economy enters its first recession in nearly two decades. **Another cut of at least 0.50% is anticipated when this month's policy meeting concludes on Thursday.**

Dynamics of Growth/Inflation Debate Change

The pace of economic activity in the UK has been decelerating for some time now but lingering concerns about a well above target inflation rate left the MPC hamstrung in terms of following through on the policy easing witnessed at the beginning of the year.

However, given the dramatic events on financial markets over recent months and the rapid weakening in the pace of economic activity, the risk now is that a prolonged slowdown in domestic demand pulls inflation materially below target.



In the minutes of the October policy meeting the MPC commented that the outlook for UK economic activity "had deteriorated substantially, reflecting a sharp monetary contraction". Meanwhile, the balance of risks to inflation in the medium term was judged to have "shifted decisively to the downside".

CPI inflation rose to 5.2% in September, well above the MPC's 2.0% target level. This should be the peak and we expect inflation to fall back sharply over the medium term as the contribution from higher energy prices wanes and the margin of spare capacity in the economy increases.

Indeed, the headline CPI rate should fall well below 2% during 2009. In terms of the second round effects that the BoE was worried about, there is little sign that elevated inflation expectations have fed through to wage claims. Recent surveys report little evidence of employee resistance to below inflation wage settlements as the labour market weakens.

The Bank's significant shift downward in terms of its expectations for growth, as well as its revised outlook for inflation, suggests that the central bank is embarking on a steep rate cutting cycle that could see rates fall below 3% in H2-2009.

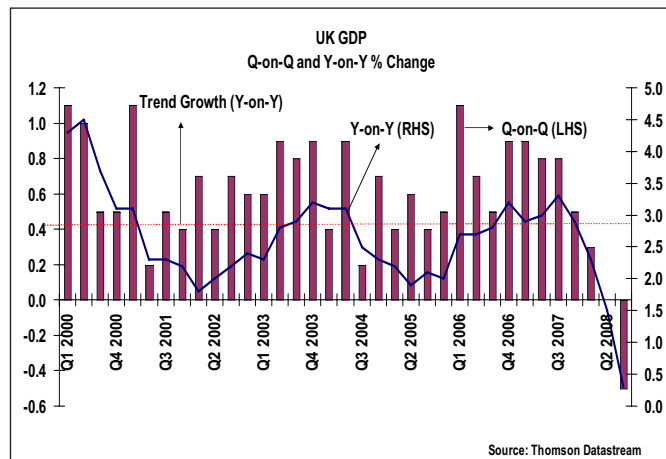
Economy Falls into Recession

Activity data released over the past month paint a very gloomy picture in terms of the outlook for the UK economy.

Provisional GDP data show that the economy contracted by 0.5% in Q3, the first fall in activity since Q2-1992. As a result, the year-on-year growth rate decelerated to 0.3% from 1.5% in Q2.

The downturn in the industrial sector intensified over the period, with output decreasing by 1.0%, compared with a fall of 0.7% in the previous quarter. Manufacturing production remained very weak, falling 1.0%, compared with a drop of 0.9% in the previous quarter. **Services output, meanwhile, decreased by 0.4%, compared with growth of 0.2% in the second quarter.**

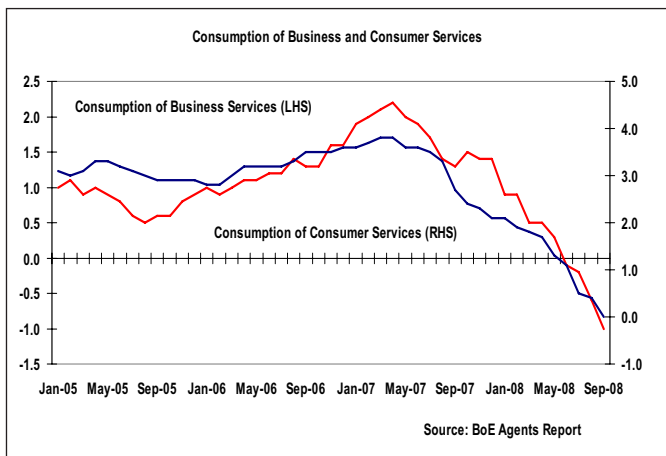
Particularly alarming was the news that there was a 1.7% drop in the demand for consumer related services.



Leading indicators point to a continued contraction in activity in Q4 as the tightening in credit conditions continues to weigh on domestic demand. After a sharp fall in September, the manufacturing PMI recovered a little in October but, in line with the services PMI survey, remains at levels consistent with an economy that is in the midst of a recession.

Marked falls have also been evident in the CBI industrial and distributive trades survey, with export orders falling despite the depreciation in sterling. **Meanwhile, the latest BoE agents report, which is considered carefully by the MPC when it meets to discuss interest rates, showed a fall off in activity in all main sectors of the economy in September.**

There was evidence of a widespread slowdown in capital spending, with business confidence badly hit by the rapid pace of weakening in economic activity. Employment intentions have fallen sharply and household consumption was reported to be at its weakest level since the survey began in 1997. Retail spending on a wide range of items fell sharply over the month, with households also switching to unbranded products and discount outlets as they search for value for money.



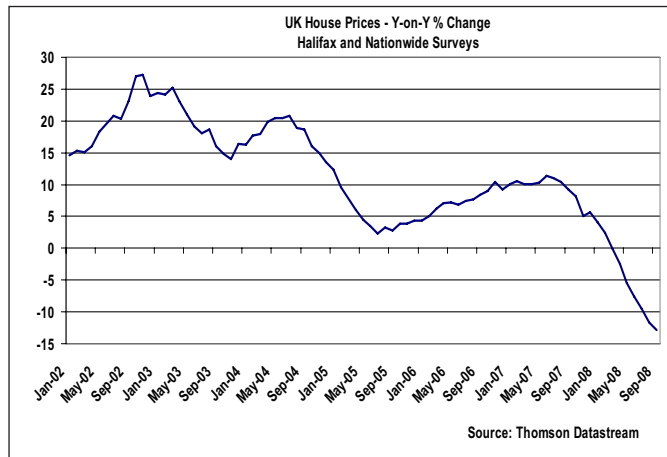
Official retail sales data show that the high street is still looking fairly resilient. However, the year-on-year growth rate in the volume of retail sales fell back to 1.8% in September, compared to a growth rate of 6.0% in the same month last year.



Consumer Spending to Slow Further

We anticipate a further slowdown in the pace of household spending in the months ahead, as labour market conditions deteriorate and credit conditions remain tight. Rising by a cumulative 145,000 since the beginning of the year, the claimant count is pushing towards the 1 million mark for the first time since early 2001. **Real income growth is already weak, personal savings are low and household asset wealth is falling.**

House prices are still falling as conditions in residential construction remain difficult. **All key house price surveys are now showing prices falling sharply on a year-on-year basis, with average house prices reported to be 12/13% off their peaks.** Banking data indicate further weakness ahead as households face tighter credit conditions, with mortgage approvals now down over 70% in year-on-year terms.



Lending conditions are set to remain difficult, as outlined in the BoE's recent Financial Stability Survey. Despite the announcement of a range of initiatives aimed at supporting the financial sector, including October's 0.50% cut in official rates, **inter bank markets continue to operate at dysfunctional levels.** 3 month rates are currently trading 1.35% above the Bank Rate of 4.50%. While this represents some improvement from the gap of 1.85% seen in early October, it is still an exceptionally wide spread. Furthermore, over the medium term, banks will have to continue to adjust their balance sheets, reining in growth in lending.

Meanwhile, the government may be limited in the support it can offer the economy. There are already growing concerns about the state of the public finances, with recent data intensifying fears about the impact of the general economic slowdown and cost of banking rescue packages on the fiscal balances.

Interest Rates Set to Fall Sharply

A sharp economic slowdown is thus well underway, with the downside risks to growth, not concerns about price pressures, set to be the main focus of the Bank of England's forthcoming inflation report, which is due for release on 12th November.

	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	4.50	5.78	5.96	4.16	4.55
Dec '08	4.00	5.30	5.50	4.00	4.35
Mar'09	3.50	4.60	4.80	3.85	4.20
Jun '09	3.00	4.00	4.15	3.70	4.05

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

Recent developments pave the way for significant easing from the MPC over the coming quarters and, given the very poor economic outlook, we anticipate that the Bank Rate will reach 3% by next summer, and possibly even lower in H2-2009.

4th November 2008

The publication is for information purposes and is not an invitation to deal. The information is believed to be reliable but is not guaranteed. Any expression of opinions are subject to change without notice. This publication is not to be reproduced in whole or in part without prior permission. Allied Irish Banks p.l.c. is regulated by the Financial Regulator.