



ECB TO CUT RATES TO 1.5%

The European Central Bank cut rates by 0.75% to 2.5% today, bringing the total reduction in official rates in the eurozone to 1.75% in the past two months. There has been a sea-change in ECB thinking on monetary policy since the summer, brought about by an abatement of inflationary pressures as oil prices collapsed, and the sharp weakening of activity with the eurozone now in the grip of a severe recession. Authorities everywhere have also now realised that the crisis in the financial system and associated credit crunch are having a very negative impact on economic growth. Thus, central banks across the globe are slashing interest rates.

The changed economic outlook is very evident in the latest quarterly economic forecasts published today by the ECB. In September, the ECB was forecasting that the eurozone economy would grow by 1.2% in 2009. Three months later it has slashed its growth forecast to -0.5%, with a range of -1 to zero per cent. It is also forecasting that growth will be sluggish in 2010 at 1%.

(%)	2007	2008	2009	2010
HICP	2.1	3.3	1.4	1.8
Real GDP	2.6	1.0	-0.5	1.0

Forecasts are mid-point of a range and based on assumption that oil prices will average \$67.3 per barrel in 2009 and \$76.6 per barrel in 2010. Source: European Central Bank

It has also made a big reduction to its inflation forecast. It is now predicting that the HICP rate will average 1.4% in 2009, compared to the forecast made in September of 2.6%. It sees inflation averaging 1.8% in 2010. Thus, the ECB is now forecasting a return to price stability in the eurozone. Key factors in this regard are the collapse in oil and other commodity prices and the recessionary economic conditions.

Indeed, even these revised economic forecasts may prove too high. The latest readings from key leading activity indicators, in particular the PMI surveys and EC's economic sentiment index, are truly awful and point to a very deep recession. GDP contracted by 0.2% in both Q2 and Q3 2008 but could be heading for a fall of 0.4-0.5% in Q4. Output is likely to continue declining in the first two or three quarters of next year. A 1% fall in eurozone GDP could be on the cards for 2009. Meanwhile, the continuing fall in oil prices and weakening demand and labour market conditions suggest that inflation could fall even more than forecast by the ECB. Indeed, at current oil prices, the HICP rate could be at 0% by next summer and average less than 1% in 2009.

With interbank rates still very high relative to official interest rates, it is quite clear that further significant policy easing is required. Three month interbank rates are still around 3.6% after today's cut, which is very high in the current economic environment. Official rates need to be cut to very low levels to help bring down interbank rates, as has happened in the US. Otherwise, the easing of monetary policy is going to be much less effective in this downturn.

In the last cycle, ECB rates were eventually cut to a low of 2%. On that occasion, the economy managed to avoid recession. With the economy now in deep recession, inflation falling sharply and elevated interbank rates meaning that monetary policy is less effective in this cycle, there is a strong case for cutting ECB rates to 1.5% if not lower in 2009. We see two further cuts in rates of 0.5% in the months ahead, taking ECB rates down to 1.5% by the spring.

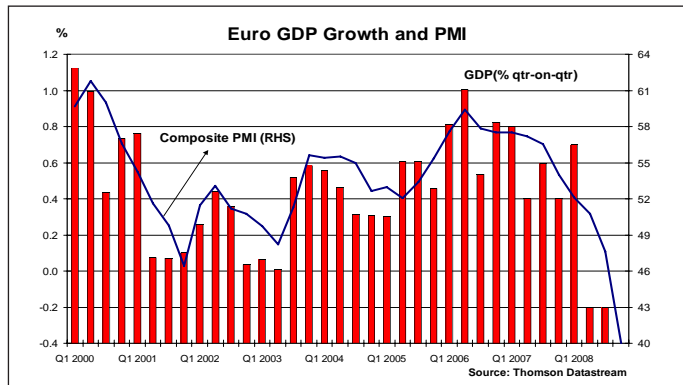
Eurozone Economy Faces A Deep Recession

Eurozone GDP contracted by 0.2% in Q2 and again in Q3 confirming that the economy is in recession. The GDP data for Q3 show flat consumer spending, declining fixed investment and weakening export growth. Both industrial production and construction output fell by 1.4% in the quarter, their second consecutive large quarterly declines. Overall, GDP growth in Q3 slowed to just 0.6% year-on-year, compared to 2.1% in Q1.

The data published to date for Q4 point to a deepening of the recession. The EC's economic sentiment index, a good leading indicator of economic growth, has collapsed in the past two months, falling to 74.9 in November from 80.0 in October and 87.5 in September. This leaves the index at a 15 year low, well down on its mid-2007 peak of 111.6.

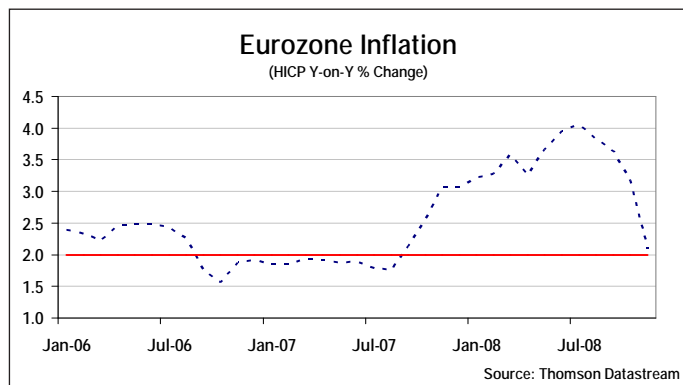
Meanwhile, the composite eurozone PMI has also collapsed, falling to a record low of 38.9 in November from 43.6 in October

and 46.9 in September, well below its peak of 57.8 in June 2007. The latest readings for both these indices point to a fall in GDP of around 0.4-0.5% in Q4. They also suggest that this will be a deep and prolonged recession as it will take some time for the indices to rise back up to levels consistent with economic growth.



A marked fall is also evident in national surveys of business and consumer confidence, notably the Ifo index in Germany, INSEE surveys in France and ISAE index in Italy. The sharp decline in leading indicators is also borne out by the recent steep falls in manufacturing output and retail sales and a marked slowdown in export growth. **The eurozone labour market has also weakened this year. The unemployment rate has been rising steadily in recent months, picking up to 7.7% in October compared to 7.4% in July and 7.2% earlier in the year.** Employment rose by 0.2% in Q2 2008 compared to 0.5% a year earlier in Q2 2007. Survey data point to a further slowdown in job growth in H2 2008.

Meanwhile, inflation has fallen sharply since the summer, declining to 2.1% in November from 3.2% in October, well below its peak in July of 4%. The fall in the CPI rate reflects the collapse in oil prices since the summer. Inflation is set to continue on its downward path given the further fall in oil prices over the past month. Other commodity prices have fallen sharply also, which will see food price inflation ease in particular. The recession and rising unemployment will also put downward pressure on core inflation. **The CPI rate could decline to zero by next summer** if the fall in oil prices in recent months proves sustained.



The growth in monetary aggregates is also decelerating. M3 grew by 8.7% yr-on-yr in October, down from 12% at end 2007. Growth in private sector credit slowed sharply in October to 8.6% yr-on-yr from 10.1% in September and close to 13% at end 2007. Loan growth to households has slowed to 3.5% yr-on-yr at this stage.

Overall, looking at the trend in the real economy, inflation and monetary aggregates, there seems little to stop the ECB from slashing interest rates to very low levels. Rates were cut to 2% in the last cycle. This is a much deeper downturn and, with inflation headed towards zero and sticky interbank rates, official rates could be cut to 1.5% by next spring.

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