

UK Rates Could Head Below 1%

The Bank of England cut official interest rates by a further 0.5% at its January policy meeting, bringing to 3.5% the total reduction in UK rates since early October 2008. Official rates now stand at 1.5%, an historical low for the UK. The move was widely anticipated and was underpinned by the ongoing evidence of a marked deterioration in economic conditions. We see another 0.50% cut at the February meeting.

Acknowledging the scale of the policy adjustment seen to date and the marked depreciation in sterling, the minutes of the January meeting note some caution on the part of the MPC with regard to further easing near term. Nonetheless, **we still expect rates to be cut to as low as 1% or possibly even below this year.**

Minutes Show Some Reservations About Further Easing

The minutes of the January meeting show MPC voted 8-1 to reduce interest rates by 0.5 percentage points to 1.50%.

External member and arch dove David Blanchflower called for a full 1.0%, expressing concern about the fact that there has been no real improvement in financial markets and conditions in the labour market were deterioration quickly.

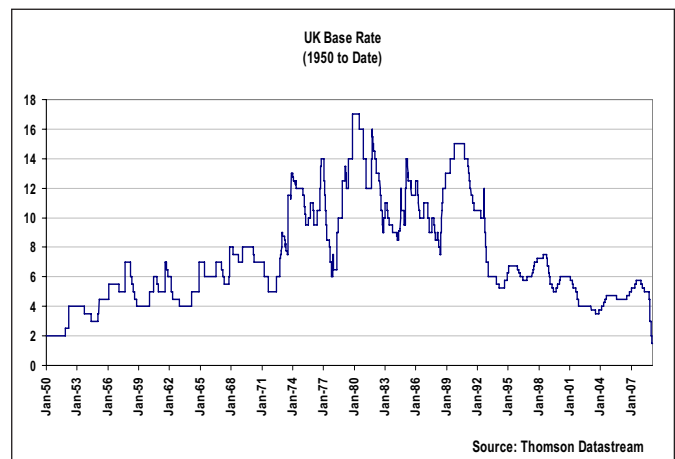
Some arguments were put forward for leaving rates on hold until February, when the

Quarterly Inflation Report would be released, including the very significant stimulus to demand seen to date. Waiting a month or so would give the Committee a chance to re-evaluate the medium-term inflation outlook in the light of all the news.

However, in the end, the committee ruled that a 0.50% cut was indeed appropriate as the news over the month had left the balance of risks to output and inflation, relative to the target, to the downside. Despite the ongoing dysfunctionality in credit markets, a cut of 0.50% could still have a "significant effect on the income of many businesses and households".

Despite January's reservations and a slowing in the pace of easing, there still appears a willingness on the part of the MPC to cut rates again, should the trend in data continue in the same vein as we have seen in the opening weeks of the year, supporting our view for a February move.

Although interest rates are now at ultra low levels, which should stimulate activity over time, the current disruption to the banking system has severely impaired the effectiveness of conventional



monetary policy instruments. Therefore, MPC members, including Governor Mervyn King, have also indicated a readiness to move towards employing additional quantitative easing tools, though as King outlined in his recent speech at a CBI Conference "I stress we are not there yet". He also pointed towards the need for the use of other "unconventional" measures, like the recent Asset Purchase Facility announced under the second bank rescue package. **Thus, there is a growing probability that the MPC will in fact cut interest rates to below 1% and engage in liquidity boosting measures, similar to what we have seen from the Federal Reserve in the US.**

UK Economy Enters 2009 In Deep Recession

The news from the UK continues to be very bleak. As 2009 gets underway the pace of economic output is contracting sharply, unemployment is rising steeply and there is little sign of any real improvement in financial market conditions.

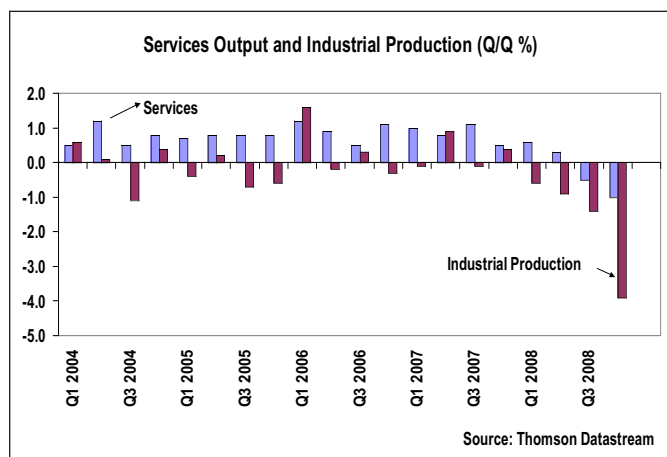
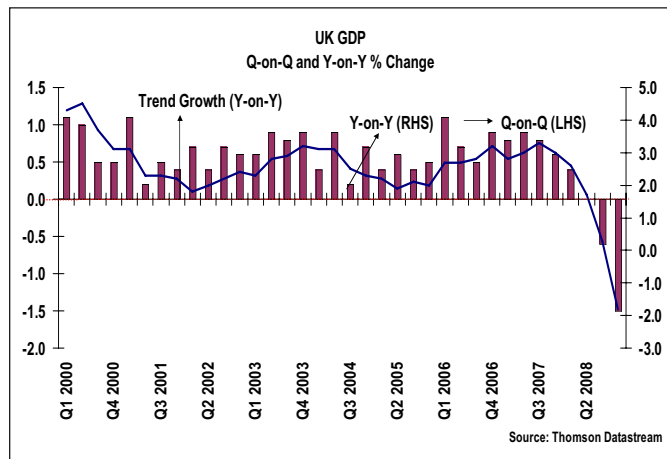
Provisional Q4 GDP data "officially" confirmed a recession, with the economy contracting by 1.5% in the final three months of last year, the biggest quarterly decline since Q2-1980. Activity in all the major sectors contracted sharply in Q4, with manufacturing output falling 4.6%, construction 1.1% and services 1.0%.

With GDP growth down a cumulative 2.1% since the middle of last year, this is shaping up to be one of the worst post war recessions. The severity of the situation facing the UK was underpinned by the recent IMF comments that the UK faces the deepest downturn of any of the industrialised economies.

Survey and activity data released over recent weeks have been broadly consistent with a continued sharp contraction in activity going forward. **The CIPS/Markit manufacturing and service surveys for December showed a modest improvement but remain at very weak levels. Marked weakness also continues to be evident in the CBI industrial and distributive trades surveys,** with export orders falling sharply despite the weakness of sterling. **The latest BoE agents report also provides more evidence that the downturn in activity is now pronounced and widespread.**

Agents reported widespread evidence of **substantial reductions in investment intentions in December** as expectations of future demand weakened further. **Employment intentions fell with reported redundancies also rising, particularly in the manufacturing sector.**

The downturn in manufacturing output certainly appears to be gathering momentum with the slowdown in world growth, so far, more than offsetting any improvement in competitiveness arising from the marked depreciation in sterling. **November's trade data showed that exports collapsed towards the end of last year, falling 5.5% over the month, helping to push the trade deficit to a record high of Stg8.3bn, adding further to the pressures facing the UK.**

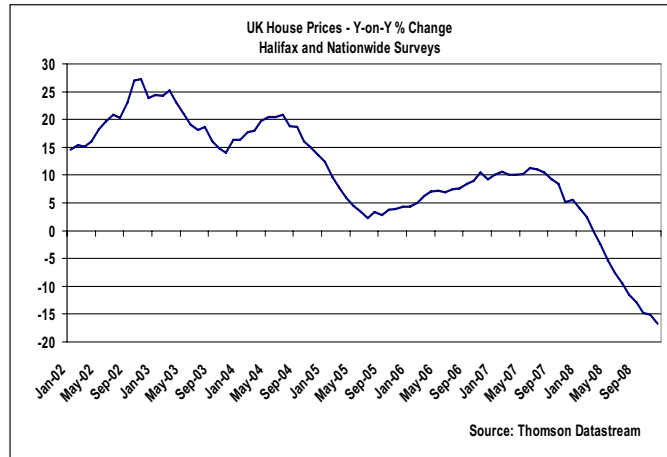




Evidence from the Retail Sector Outweigh Official Data

Official data from the retail sector would seem to suggest that consumer expenditure is holding up reasonably well, with sales volumes up 1.6% in December. However, sales values were down -0.8% as many retailers offered huge discounts in the run up to the Christmas period and official data remain at odds with all other retail sector indicators.

Meanwhile, demand for a wide range of consumer services continues to shrink, with new and used car sales particularly weak. **We expect consumption activity to weaken further in the coming months, with confidence at ultra low levels and unemployment now rising at a pretty alarming rate.**



The claimant count rose by a further 78,000 to 1.15million in December, bringing to 347,000 the cumulative rise for 2008. The unemployment rate, meanwhile, (ILO measure in the three months to November) has risen to 6.1% from 5.5% at mid year and 5.2% at end 2007. This marks the highest jobless rate since September 1997.

Housing Sector Remains Under Pressure

Conditions in the construction sector also remain difficult, with the construction PMI shrinking at its fastest pace ever in December. Meanwhile, average house prices are close to 20% off their peaks. Widespread expectations of further price falls, tightened credit conditions and falling consumer confidence are all reported to be curtailing transaction activity in the housing market. The gap between official and wholesale rates has narrowed in recent weeks but liquidity conditions remain difficult.

Interest Rates Set to Fall to Very Low Levels

The scale of monetary adjustment introduced to date by the Bank, as well as fiscal stimulus measures, should be positive in terms of providing support to the economy over the medium term.

However, given the severity of the situation, this does not preclude the need for further action from the BoE. Thus, we would not be at all surprised if the MPC cut rates to 1% at this month's meeting and possibly to 0.50% before the end of the year. This month's policy meeting will be followed by the release of the Quarterly Inflation Report on 11 February, which will provide updates on growth and inflation forecasts as well as the medium term policy outlook.

UK Interest Rate Forecasts (to end quarter)					
	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	1.50	2.17	2.48	2.60	3.01
Mar '09	1.00	2.00	2.50	2.50	2.90
June '09	1.00	1.95	2.45	2.45	2.90
Sept '09	1.00	1.90	2.45	2.45	2.90

* Swap Forecasts Beyond 1 Year

30th January 2009

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