ECONOMIC BULLETIN

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DEVELOPMENTS IN THE WORLD ECONOMY

While the global economy maintained a steady pace in the first half of 2018, momentum is expected to moderate amid mounting risks and uncertainties related to rising protectionism, vulnerabilities in emerging markets and financial market volatility. Advanced economies continue to benefit from accommodative monetary policies and the US fiscal stimulus, while activity among commodity exporters has also been bolstered by the recovery in commodity prices over the past year. However, financial conditions have tightened, particularly for some emerging markets. Moreover, global trade growth has slowed and uncertainties about future trading relations have risen. Over the medium term, global economic activity is expected to expand at a pace close to potential growth. Output gaps are already closed or closing in most advanced economies, policy support will gradually diminish and China is transitioning to a lower growth path. Global inflationary pressures are expected to rise slowly as spare capacity diminishes. Risks to global activity are skewed to the downside.

Europe: At its monetary policy meeting on 13 September 2018, the Governing Council concluded that the incoming information broadly confirms the Governing Council's previous assessment of an ongoing broad-based expansion of the euro area economy and gradually rising inflation. Based on the regular economic and monetary analyses, the Governing Council made the following decisions. First, the Governing Council decided to keep the key ECB interest rates unchanged and continues to expect them to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2.0% over the medium term. Second, the Governing Council will continue to make net purchases under the Asset Purchase Program (APP) at the current monthly pace of €30 billion until the end of September. After September 2018, the monthly pace of the net asset purchases will be reduced to €15 billion until the end of December 2018. The Governing Council anticipates that, subject to incoming data confirming its medium-term inflation outlook, net purchases will then end. Third, the Governing Council intends to reinvest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of the net asset purchases, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. Real GDP growth increased by 0.4%, quarter on quarter, in the second quarter of 2018, the same rate as in the previous quarter. The ECB's monetary policy measures continue to underpin domestic demand. Private consumption is supported by ongoing employment gains, which, in turn, partly reflect past labour market reforms, and by rising wages. Business investment is fostered by the favourable financing conditions, rising corporate profitability and solid demand. Housing investment remains robust. In addition, the expansion in global activity is expected to continue, supporting euro area exports. The euro area foresees annual real GDP increasing by 2.0% in 2018, 1.8% in 2019 and 1.7% in 2020. Euro area flash estimate annual HICP inflation was 2.0% in August 2018, down from 2.1% in July. Looking ahead, on the basis of current futures prices for oil, annual rates of headline inflation are likely to hover around current levels for the remainder of the year. While measures of underlying inflation remain generally muted, they have been increasing from earlier lows. Domestic cost pressures are strengthening and broadening amid high levels of capacity utilisation and tightening labour markets, which is pushing up wage growth. Underlying inflation is expected to pick up towards the end of the year and thereafter to increase gradually over the medium term, supported by the ECB's monetary policy measures, the continuing economic expansion and rising wage growth. The euro area foresees annual HICP inflation at 1.7% in 2018, 2019 and 2020. HICP inflation excluding energy and food is projected to rise gradually from 1.1% in 2018 to 1.5% in 2019 and 1.8% in 2020. The euro area unemployment rate stood at 8.2% in July – the lowest level seen since November 2008. Survey indicators have moderated somewhat from very high levels, but still point to continued employment growth in the third quarter of 2018. While indicators of labour shortages have moderated slightly in some sectors and countries, they remain at historically very high levels. Private consumption rose by 0.2%, quarter on quarter, in the second quarter of 2018, following somewhat stronger growth in the first quarter. The latest developments in retail trade and passenger car registrations are broadly in line with steady consumption growth in the near future. From a longer-term perspective, increasing labour income is supporting the solid underlying momentum in consumer spending, which is also reflected in elevated consumer confidence. In addition, the strengthening of households' balance sheets remains an important factor behind steady consumption growth, since households' creditworthiness is a key determinant of their access to credit.

The recent increases in oil prices are unlikely to significantly dent the growth of real disposable income and private consumption.

United States: At its meeting on September 26, 2018, the Federal Open Market Committee (FOMC) decided to raise the target range for the federal funds rate by 25 basis points, bringing it at 2.0% to 2.25%. Both household spending and business investment are expanding briskly, and the overall growth outlook remains favorable. And several factors support this assessment: Fiscal policy is boosting the economy, ongoing job gains are raising incomes and confidence, and overall financial conditions remain accommodative. The median of Committee participants' projections for the growth of real GDP is 3.1% this year and 2.5% next year. Job gains averaged 185,000 per month over the last three months, well above the pace needed in the longer run to provide jobs for new entrants to the labor force. The unemployment rate stood at 3.9% in August and has been near that level since April. Smoothing through month-to-month variations, the labor force participation rate remains about where it was in late 2013—a positive sign, given that the aging of our population is putting downward pressure on participation. The job market is expected to remain strong. And the median of Committee participants' projections for the unemployment rate later this year is 3.7% and a bit lower than that in 2019. Overall consumer prices, as measured by the price index for personal consumption expenditures (PCE inflation), increased 2.3% over the 12 months ending in July. The core price index, which excludes the prices of energy and food and tends to be a better indicator of future inflation, rose 2.0 % over the same period. The FOMC seeks, and expects to see, inflation remaining near our 2.0% longer-run objective on a sustained basis. At any given time, inflation may be somewhat above or below 2.0 %. The recent rise in oil prices has pushed inflation a little above 2.0%, and this is expected to be transitory, as is reflected in the projections. The median projections for both the overall and core inflation measures remain very close to 2.0% across the whole projection horizon. Looking ahead, the projections show gradual interest rate increases continuing roughly as foreseen in June. The median of participants' views on appropriate policy through 2020 are unchanged since the June meeting. The committee is aware that the economy regularly surprises, and that even the most carefully constructed projections are highly uncertain. The projections about the appropriate path of policy assume that the economy evolves broadly in line with the projections for growth, employment, unemployment, and inflation. If the economy were instead to falter, lower interest rates would be appropriate. Conversely, if inflationary pressures were to rise more than expected, higher interest rates would be appropriate. Right now the economic outlook appear roughly balanced.

United Kingdom: At its meeting ending on 12 September 2018, the Monetary Policy Committee (MPC) voted unanimously to maintain Bank Rate at 0.75%. The committee set monetary policy to meet the 2.0% inflation target, and in a way that helps to sustain growth and employment. The Committee voted unanimously to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10.0 billion. The Committee also voted unanimously to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435.0 billion. In the MPC's most recent economic projections, set out in the August *Inflation Report*, GDP was expected to grow by around 1.75% per year on average over the forecast period, conditioned on the gently rising path of Bank Rate implied by market yields at that time. Although modest by historical standards, the projected pace of GDP growth was slightly faster than the diminished rate of supply growth, which averaged around 1.5% per year. With a very limited degree of slack remaining, a small margin of excess demand was therefore projected to emerge by late 2019 and build thereafter, feeding through into higher growth in domestic costs than has been seen over recent years. The contribution of external cost pressures, which has accounted for above-target inflation since the beginning of 2017, was projected to ease over the forecast period. Taking these influences together, and conditioned on the gently rising path of Bank Rate, CPI inflation remained slightly above 2.0% through most of the forecast period, reaching the target in the third year. CPI inflation was 2.5% in July. That was 0.1 percentage points lower than projected in the August Inflation Report, however, continuing a series of small downside errors since the beginning of 2018. UK GDP grew by 0.4% in 2018 Q2 and by 0.6% in the three months to July and is expected to grow by around 1.75% per year on average over the forecast period, conditioned on the gently rising path of Bank Rate implied by market yields at that time. The UK labour market has continued to tighten, with the unemployment rate falling to 4.0% and the number of vacancies rising further. Regular pay growth has risen further to around 3% on a year earlier. The MPC sets monetary policy to meet the 2.0% inflation target, and in a way that helps to sustain growth and employment. In pursuing that objective, the main challenges for the Committee had continued to be to assess the economic implications of the United Kingdom withdrawing from the European Union and to identify the appropriate policy response to that changing outlook. During the negotiation period, those economic implications would be influenced significantly by the expectations of households, firms and financial markets about the United Kingdom's eventual economic relationships with the European Union and other countries, and the transition to them. Since the Committee's previous meeting, there had been indications, most prominently in financial markets, of greater uncertainty about future developments in the withdrawal process.

Japan: The economic expansion is projected to decelerate gradually. While activity should benefit from accommodative monetary policy, waning fiscal support and increasingly binding capacity constraints are expected to weigh on growth. Wages are rising moderately amid a tightening labour market, which should support household spending. However, inflation is projected to remain below the Bank of Japan's 2.0% inflation target.

China: Recent data suggest that activity in China is decelerating in the near term. A slowing housing market and the lagged effects of earlier financial tightening may weigh on growth, while higher tariffs imposed by the United States are expected to weigh on trade. However, monetary accommodation and some fiscal support should help to sustain activity growth in the near term. Over the medium term, it is assumed that continued progress on structural reforms would lead to an orderly slowdown and some rebalancing of the Chinese economy.

Energy News: Oil prices have been volatile in recent weeks. During the early summer months, oil prices declined as supply prospects improved with the cessation of disruptions in Libya and the prospect of increased supplies from OPEC and Russia. That meant that the oil price assumption underpinning the September ECB staff macroeconomic projections was about 7.5% lower in the short term than it had been in the previous projection. Since the cut-off date for the projections, however, the price of oil has risen again, reaching USD 80 per barrel on 12 September. The latest increase reflected market reaction to lower-than-expected crude oil inventories in the United States, which suggested a faster tightening of the market than had been expected.

CYPRUS ECONOMY AND MAJOR DEVELOPMENTS

- In the 2nd quarter of 2018, Cyprus' Real GDP (seasonally adjusted) recorded a positive rate of growth of 3.9% compared to 4.1% in the 1st quarter of 2018 on an annual basis. Growth is expected to reach 4.0% in 2018 and 4.2% in 2019 (IMF's June projections). Inflation (HICP) for August 2018 increased by 1.7% when compared to August 2017, while compared to July of 2018 increased by 1.2%. For the period January - August 2018, the HICP recorded an increase of 0.4% compared to the corresponding period of the previous year. It is expected to be in the area of 0.2% in 2018 and 1.0% in 2019 (IMF's June projections). In August 2018, deposits amounted to €51.1 billion, compared to €50.9 billion in July 2018 and at €49.4 billion the end of 2017.

Main Economic Indicators

	Eurozone	*United States*	*United Kingdom*	*Japan*	*China*	*Cyprus*
Real GDP (year-on-year 2017-2016 %)	2.4	2.3	1.7	1.7	6.9	3.9
Forecasted Real GDP (year-on-year 2018-2017 %)	2.0	2.8	1.3	1.1	6.6	4.0
Forecasted Real GDP (year-on-year 2019-2018 %)	1.8	2.4	1.5	1.1	6.3	4.2
Forecasted Unemployment 2018 (%)	8.3	3.6	4.1	2.4	4.0	9.5
Forecasted Inflation 2018 (%)	1.7	2.1	2.5	0.9	2.1	0.2

Sources:

1) *European Central Bank 2) Bank of England 3) Federal Reserve 4) Statistical Service of Cyprus (CYSTAT) 5) Bloomberg Statistics, 6) IMF*

USB BANK PLC

Treasury & Correspondent Banking | P.O. Box 28510, 2080 Nicosia, Cyprus | Telephone 22883417