Constantinos Herodotou: Current economic developments in euro area and Cyprus - the balancing act of monetary policy

Speech by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, at the Distinguished Speakers Seminar of the European Economics & Financial Centre (EEFC), London, 19 October 2022.

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Introduction

Dear guests, ladies and gentlemen.

Thank you for inviting me to this seminar. It is a pleasure to have this opportunity to speak to you today.

I will begin by providing an overall assessment of recent economic developments in the euro area, as well as the monetary policy decisions taken by the Governing Council of the European Central Bank in response to the new challenges of persistently high inflation and rising economic uncertainty. I will continue with the developments in the Cyprus economy and its banking sector, and how it responds to the challenges in this rapidly changing economic environment.

Euro area economic developments

In the euro area, GDP is growing at a slower pace this year than previously expected due to the negative geopolitical developments, caused by the war in Ukraine. Growth is hampered by soaring energy and commodity costs, low confidence and supply chain disruptions. At the same time, inflation has approached double digits, and a winter with possible energy shortages and high energy prices is on the horizon. Nevertheless, a recovering tourism industry, decreasing unemployment, and EU funding payments helped to boost activity and limit, to some extent, output loss.

More specifically, the Euro area quarterly economic growth reached 4.8 percent in the first half of 2022. However, the biggest impact from war developments is expected to be shown in the data of the fourth quarter of 2022 and the first half of 2023. This outlook is reflected in the latest ECB projections for economic growth, which have been revised down markedly for the remainder of the current year and for 2023. At the September 2022 ECB forecast round the euro area real GDP growth is expected to reach 3.1% for 2022, 0.9% for 2023 and 1.9% for 2024. The euro area economy is now expected to grow by less than projected, with the possibility of a recession taking place in 2023 being more likely.

Inflation started rising in 2021, due to demand and supply imbalances following the reopening of economies after covid-related restrictions were lifted and due to supply chain bottlenecks. But there was another unpredictable and bigger inflation shock from the Russian war in Ukraine that catapulted energy prices. Harmonized inflation in the euro-area rose to a high of 10 percent in September, up from 9.1 percent in August, indicating a continuing rising trend. Based on the September Eurosystem staff Broad

Macroeconomic Projection Exercise, both headline and core inflation are expected to be higher in 2022, at 8.1 per cent and 3.9 per cent, respectively. In fact core inflation is expected to be slightly above our inflation target by the end of the forecast horizon at 2.3 per cent. Energy price inflation remained extremely elevated at 40.8 per cent in September and it continues to be the dominant component of overall inflation. Market-based indicators suggest that, in the near term, oil prices are likely to moderate, while wholesale gas prices will stay extraordinarily high. The relatively high import share of gas needed for the EU27 energy consumption, will create extensive challenges in the coming winter months, especially, in countries with gas-intensive industrial sectors. Food price inflation also rose in September (to 11.8 per cent), reflecting higher input costs related to energy, disruptions of trade in food commodities, and adverse weather conditions.

While supply bottlenecks have been easing, these continue to gradually feed through to consumer prices and are putting further upward pressure on inflation, as is recovering demand in the services sector. The depreciation of the euro has also contributed to the rising inflationary pressures, together with the aforementioned supply and demand factors.

Monetary policy

The ECB's primary objective is price stability, which is defined as keeping inflation at 2% over the medium term. In response to these developments, in our September monetary policy meeting, the Governing Council of the ECB decided to raise policy rates by 75 basis points. This significant step frontloads the transition to normalise monetary policy towards levels that will enable the timely return of inflation to our two per cent medium-term target.

Unquestionably, the key current challenge, is to put under control excessive and persistent inflationary dynamics. Monetary policy decisions, however, have to be considered and made within the following context:

Monetary policy takes roughly 18 months to affect the real economy as it is channelled through banks, households and firms and consequently impacts their decisions on credit, consumption and investment, respectively. Therefore, monetary policy does not target current inflation but the medium term inflation outlook. At the current juncture that most of inflation is cost push, stemming from energy and food prices, monetary policy attempts to re-align aggregate demand and aggregate supply so as to contain inflationary pressures. So, monetary policy has a more difficult job than when dealing with the typical demand driven inflationary pressures. Therefore, it requires a balanced approach to contain cost-push inflation but avoid having an exacerbated negative effect on output and unemployment. In addition to the balance I mentioned before, monetary policy decisions have to deal with a lot of uncertainty. The risk of a wage-price increases spiral, even though not yet evidenced in the Eurozone, would exacerbate inflationary pressures. If inflation expectations get de-anchored then inflation will persist for much longer. In such a case the pace of interest rate adjustment as well as the final rate level may have to increase. Currently no material de-anchoring has been observed even though some measures indicate inflation expectations to be slightly above 2 per cent in medium term.

There is also uncertainty surrounding geopolitical developments and the impact on the supply side if events on the ground worsen and they create further energy and commodity price shocks and disruptions. In such case, inflation and output would be worse than projected in 2023 and 2024. On the other hand, if there is an improvement in geopolitics, energy prices may fall as rapidly as they rose. Therefore monetary policy has to act in the middle of a lot of uncertainty in a number of areas, hence monitoring and pacing is still very important.

Domestic economic developments

Let me now turn to domestic economic developments.

The Cyprus economy, continued to record noteworthy GDP growth, despite the outbreak of the war. Real GDP growth in Cyprus expanded by about 6 percent during the first half of 2022, mainly driven by a faster than expected recovery in tourism-related activities and, to a lesser extent, by growth in information and communication activities and in professional services. At the same time, weakness in the Cyprus GDP performance could be expected to become visible towards the end of 2022 and the first half of 2023, primarily owing to the anticipated worsening in the international economic outlook, which also has an impact on the domestic developments. For 2023, GDP growth is expected to reach 2.5 per cent.

In terms of inflation, the Harmonised Index of Consumer Prices (HICP) reached 9 percent in September 2022 compared with 3.6 percent in September 2021. The spike in the domestic inflation is mostly attributed to the significant negative impact of the war, as well as the continued consequences of the pandemic.

More specifically, the energy component is the largest contributor to the surging trend of domestic headline inflation (with around 45% share of HICP).

We expect that our domestic short-term inflation outlook will continue to remain, overall, at very elevated levels, similar to the euro area inflation developments, amid the ongoing significant uncertainty and volatility resulting from the war. More specifically, Cyprus HICP inflation for 2022 has been revised upwards in our most recent projections, now reaching 8,4 percent compared with 7,0 percent in the CBC June 2022 projections.

The Cyprus banking sector

Let me now give you a brief overview of the banking sector developments in Cyprus.

The Banking sector exhibits a healthy financial standing, with solid solvency and liquidity buffers. The solvency position, as measured by the Common Equity Tier 1 ratio amounts to 17.5 percent in the second quarter of 2022, a level higher than the respective European average of 15.2 percent. The Liquidity Coverage Ratio, indicating the availability of liquid funds against deposit outflows over a 30 day stressed period, stood at the level of 320 percent in August 2022 which is more than 3 times higher than the minimum regulatory requirement of 100 percent, placing Cyprus amongst the most liquid banking sectors in the Union, where the average LCR amounts to 165 percent. The non-performing loan ratio has continued its downward trend and stands at 11.2

percent as at June 2022, with total non-performing loans amounting to €2.9 billion, which is the lowest level observed since 2014 when the definition was harmonised across the European Union.

So far the first round effects from the geopolitical crisis have been manageable and of limited direct extend. Nevertheless, the second round effects are yet to be materialised. Adverse macroeconomic developments may weaken banks' profitability and deteriorate asset quality, causing delinquencies and an upward pressure on impairments and provisions. It is therefore important for banks to adapt their business models to the new realities as shaped by the consecutive crises. Challenges emerge through various channels. Intense competition, from entities not falling in the traditional banking spectrum, threat of additional provisions due to increased credit risk, the need to invest in digitalisation to streamline operations, and the costs of managing climate change and the transition towards a sustainable greener economy are among the challenges that the Cyprus banking sector faces.

It is important to say that these challenges are not country specific to the banking system of Cyprus. They are challenges that are commonly faced by European banks. Especially the issues of digital transformation together with the management of climate risks and the transition to a green economy are key issues that should be on top of the agendas' of European economies and banks. They surely are on the top of the supervisory agenda.

Conclusion

Let me now conclude. The world's economy has gone through the various problems caused by the pandemic to the consequences of the Ukraine war. For the first time in many years, inflation has become a threat for many countries around the world. Growth is down and inflation is up. This is a big setback for the global recovery. The decisions we make now will have far-reaching consequences for our future. We need to be determined to make difficult choices. But if these choices are based on data, on what we learned from the past and on a clear understanding of the evolving challenges, then I am sure we will come out from this crisis stronger and better equipped for a more sustainable and resilient economic future.