Constantinos Herodotou: A resilient banking sector in an ever-changing economic environment

Speech by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, at the Deloitte Annual Conference, Nicosia, 28 September 2022.

* * *

Introduction

Distinguished co-speakers and guests, ladies and gentlemen.

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

I will start with a brief overview of recent euro area and Cyprus economic developments and the monetary policy decisions taken in response to the new challenges of persistently high inflation and elevated economic uncertainty. I will continue with the developments in the Cyprus banking sector which needs to address a number of challenges in this fast evolving economic environment.

Euro area

Euro area economic developments

In the euro area in general, GDP is growing at a slower pace this year than previously expected due to the negative geopolitical developments, mainly 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 is approaching 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 help to boost activity and limit, to some extent, output loss.

More specifically, the Euro area quarterly economic growth reached 0.8 percent in the second quarter, following a 0.7 percent rise in the first quarter. 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. The euro area economy is now expected to grow by 3.1 percent in 2022, 0.9 percent in 2023 and 1.9 percent in 2024, compared to the December 2021 projections of 4,2 percent, 2,9 percent and 1,6 percent respectively.

Harmonized inflation rose to a high of 9.1 percent in August, up from 8.9 percent in July, indicating a continuing rising trend. For the period January-August as a whole, inflation stood at 7,6 percent. Compared with the June 2022 Eurosystem staff Broad Macroeconomic Projection Exercise, headline inflation has been substantially revised up in September by 1,3 percentage points to 8,1 percent for 2022, by 2 percentage points to 5,5 percent for 2023 and by 0,2 percentage points to 2,3 percent for 2024. Energy price inflation remained extremely elevated, (at 38.3 per cent), 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 August, (to 10.6 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.

Governing Council latest meeting decision

In response to these developments, in our latest meeting, the Governing Council of the ECB decided to raise the three key ECB interest rates by 75 basis points. This significant step frontloads the transition from the prevailing accommodative level of policy rates towards levels that will enable the timely return of inflation to our two per cent medium-term target.

Undeniably, the key current challenge for the ECB as well as other major central banks is raising interest rates to deal with inflation while recession risk is high. However, the risk of high inflation becoming entrenched in inflation expectations is a greater threat. The longer inflation remains elevated, the more harm it will cause to individuals and companies.

While monetary policy will act decisively to restore inflation to our target, fiscal policy must be targeted in order not to counteract monetary policy and safeguard the most vulnerable people's incomes.

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 over the second half of 2022 and early 2023, primarily owing to the anticipated worsening in the international economic outlook. More specifically, the impact of the war is expected to be channelled directly, via the disruption in trade of services and the rise in commodity prices, as well as indirectly, via the impact on business and consumer confidence. Our exposure to Russia via the export of services is the most significant vulnerability, with the most important exposure relating to financial and other business services and, to a lesser extent, tourism and transport.

In terms of inflation, the Harmonised Index of Consumer Prices (HICP) reached 9,6 percent in August 2022 compared with 3,3 percent in August 2021. For the period January-August 2022, inflation climbed to 8 percent, compared to 1,2 percent in the same period in 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.

Banking sector

n this ever changing and uncertain economic environment, the Cyprus Banking Sector is proving resilient, exhibiting a solid and healthy financial standing. The solvency position, as measured by the Common Equity Tier 1 ratio was edging up 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 July 2022 which is more than 3 times higher than the minimum requirement of 100 percent, placing Cyprus amongst the most liquid banking sectors in the Union, where the average LCR amounts to 168 percent. The non-performing loan ratio has continued its downward trend despite the supply and demand shocks caused by the pandemic and stands at 11,2 percent as at June 2022, with total non-performing loans amounting to €2,9b, which is the lowest level observed since 2014 when the definition was harmonised across the European Union.

The current situation is therefore encouraging. But we should not fall into a complacency trap. Even though the banking sector exhibits significant reduction in NPLs, the progress has not been similar across the banking system with the smaller Banks lacking behind. Moreover, the risk of new defaults is increased in the current economic outlook. The elevated levels of inflation, in combination with the increasing interest rates, are expected to reduce net household income, which might ultimately hamper borrowers' repayment ability.

The banking sector should continue to practice prudent policies and sensible risk management while being flexible to address the challenges that will arise. In a rather volatile period following two consecutive crises, it is vital that the banking sector adapt its business strategies to the new realities. This will be a challenging task as, it requires significant investment, cultural change and contribution of different stakeholders. Being mindful of time, I will focus on only three factors, which encompass the above challenges.

The first is transforming the banking business model towards technologically advanced services with digitization being the focus of this effort. The cost to income ratio of the Cyprus Banking Sector, which amounts to 76 percent as at June 2022, is significantly higher than the respective EU average of 63 percent. Investment in technology can become the catalyst in the effort to strengthen efficiency and build sustained profitability, which will ultimately bridge the gap with the rest of the EU area banks.

The second challenge relates to the risks of climate change. The ongoing effort to reduce the dependence on Russian energy may increase the transition risks and as such banks must enhance and adapt their climate risk mitigation strategies. The fact that certain banks have started making tangible steps in this regard is a positive development, but they are still early on the learning curve and behind their European peers. They must act faster and more decisively to meet our expectations of incorporating climate-related risks into their overall risk management frameworks, which will ultimately also target their clientele and the submission of detailed climate related information in order to feed the banks' risk management processes. Professional accountants also have an important role to play in this overall transformation of the economy by providing relevant advice to their customers to set up the appropriate management information systems that could enhance the relevant disclosures.

And this takes me to the third challenge which is the overall interaction of credit institutions with their clientele. It is in the interest of both clients and banks to cultivate a relationship of mutual respect and trust. To this point, the recently introduced alternative procedure for the simplification of the auditing of the financial statements of very small businesses should support these efforts and facilitate the timely transmission of the financial statements to the credit institutions. It is of utmost importance that a timely flow of up-to-date customers' financials is maintained by banks at all times. Unquestionably, this will be beneficial for both parties, banks and clients, as any events signalling a deterioration of the client's financial standing will be captured early on. Consequently the most suitable restructuring solution may be sought, which could ensure the continuation of a healthy and economically viable business relationship.

Conclusion

To sum up, the world's economies have been through a lot in recent years, from the challenge of the pandemic, to the impact of the war in Ukraine. It is up to us to come through these challenges unscathed or even stronger, wiser and better prepared for a brighter future. We have done it before, we can do it again. After all, to quote Gever Tulley (*an American writer, speaker, educator, and entrepreneur*) - persistence and resilience only come from having been given the chance to work through difficult problems.

Thank you for your attention.