Constantinos Herodotou: Current economic dynamics in the euro area and Cyprus

Speech by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, at the London Business School Alumni Cyprus Club event, Nicosia, 12 September 2022.

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Introduction

I would like to thank the London Business School Alumni Club of Cyprus for arranging this event and for giving me the opportunity to participate in such an interesting, constructive, and open discussion. Today I will focus on the current economic challenges faced by the euro area and Cyprus. I will begin by providing a brief summary of recent economic developments in the euro area, followed by a discussion of monetary policy and how it responds to the new challenges of rising, persistent inflation and economic uncertainty. Then I will move on to cover the main developments in the Cyprus economy and its banking sector.

Euro area

Euro area economic developments

Starting from the euro area, a post-pandemic spending, fuelled by government expenditure, was expected to boost economic activity in 2022 and help households and businesses to rediscover stability after two difficult years. All of that changed when Russia invaded Ukraine.

As a result, GDP is growing at a much slower pace this year than previously expected. 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 is on the horizon. Nevertheless, a recovering tourism industry, decreasing unemployment, and EU funding payments all 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. Even though these growth rates are below the rates expected before the start of the war, the 0.8%, growth is still the strongest performance in three quarters, prompted by the easing of Covid restrictions and the good summer tourism season in southern countries. The 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 throughout 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. 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 was again 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 winter months of 2023, especially in countries with gas-intensive industrial sectors. In fact, the recent Purchasing Managers' Indices (PMIs) in the manufacturing sector have dropped notably. 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 feedthrough to consumer prices and are putting 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

Against this background, in our latest meeting last Thursday, 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.

Current challenges of monetary policy

Let me now elaborate a bit more on some of the most important challenges that Monetary Policy faces today. The crux of the matter is that the pandemic and the war in Ukraine have created significant macroeconomic uncertainty, associated with a high degree of output growth and inflation volatility. In such an environment of lasting output and inflation volatility and uncertainty, one of the main questions is how governments and central banks should formulate policy. Fiscal policy will be critical in improving the robustness of our economies. With debt ratios at record highs, expenditure should be targeted and prioritise social cohesion and productive green investments that will help assure long-term prosperity and develop fiscal flexibility needed to cushion future shocks. Non-targeted fiscal policy will counteract monetary policy efforts to contain inflation.

At the same time, central banks must safeguard price stability through, mainly, monetary policy. When the degree of inflation persistence is unclear, effective policy suggests a strong reaction to deviations from the target in order to limit the risks of inflation continuing to be high for an extended period. The risk of high and persistent prices, together with signals of tightening in the labour market, create an environment which makes it possible for higher inflation expectations and higher prices to become entrenched. These are strong signals that dictate forceful action to safeguard against inflation.

Medium to longer term challenges of monetary policy

Of course, it is normal to assume that when the extraordinary impact of the pandemic and the war fades away in the longer term, production and inflation levels and volatility are likely to fall. However, there are compelling reasons to suggest that policymakers will face a less favourable environment in the medium term, one in which shocks are likely to be stronger, more lasting, and more widespread.

1. Climate change & green transition

Climate change is one of the reasons. As we have seen, the frequency and intensity of extreme weather patterns are increasing dramatically, leaving the world economy vulnerable to higher volatility, in economic activity and inflation. The European Union, like many other regions of the world, has experienced droughts this summer. In addition, severe shortages of gas, especially in Europe, may necessitate severe changes to production and consumption in the coming months. In the long run, the move to greener technologies will alleviate such constraints, but it will also expand the types of energy shocks throughout the shift.

Unquestionably, such profound changes to our economies' structures provide new possibilities. For example, a committed battle against climate change strengthens the prospects of long-term growth sustainability. Nevertheless, the long and difficult transition period is expected to produce greater, more regular, and longer-lasting economic disruptions in the coming years. These will require a more delicate and effective monetary policy action.

2. New forms of protectionism

Another reason that makes monetary policy decisions more difficult is the rising trend of new forms of protectionism. When Russia invaded Ukraine, businesses throughout the world attempted to untangle their supply chains from the warring countries, and governments were hard-pressed to act as gas and food constraints became a reality. Many nations selected 'protectionism' measures to shore up their trade and economy, prioritizing domestic resources to meet domestic requirements, frequently through export restrictions. Temporary protectionism provides security during a crisis, but its widespread adoption, with no clear end point, can distort trade and shut off important suppliers from the global supply chain. As a trend, it is a cause for concern: Because, while food and oil are popular targets for protection programs, this list is expanding. As the pace of global economic integration slows, the downward pressure that globalisation has had on inflation diminishes. We can therefore expect higher inflationary pressures and volatility in the medium term and this situation will make the objectives of Monetary Policy even more complex to be achieved.

Developments in the Cyprus economy and the Cyprus banking sector

Let me now turn on the developments in Cyprus.

- **Domestic economy**

The Cyprus economy, continued to record noteworthy GDP growth despite the outbreak of the Russian-Ukrainian war. Real GDP growth in Cyprus expanded by about 6 percent over 2022H1, 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 2022H2 and 2023, primarily owing to the anticipated worsening in the international environment 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, in particular oil and wheat, as well as indirectly, via the impact on business and consumer confidence. Our exposure to Russia via the export of services side is the most significant vulnerability, with the most important exposure relating to financial and other business services and, to a lesser extent, tourism, transport as well as telecommunications, computer and information services. At the same time, it is important to mention significant adaptation effects for example in the area of tourism, losses from the Russian market have been covered to a large extent by other markets such as the UK, Poland, Germany, Israel and Scandinavian countries.

The labour market has also been exhibiting continued resilience. Over 2022H1, the unemployment rate reached 6,7 percent, well below the 7,5 percent rate recorded in 2021. The resilience of the Cyprus labour market is in line with business views about expecting a relatively small impact from the war. Going forward, and despite an impact from the war on the sectors previously mentioned, a continued downward trend in the overall unemployment rate is projected over the following years, converging closer towards full-time employment conditions in 2024, owing to the projected ongoing economic expansion and the expected manageable impact from the war. The latter is supported by survey data from the European Commission, where employment expectations by businesses across services and industry remained broadly unchanged since the outbreak of war.

Turning now to inflation, the Harmonised Index of Consumer Prices (HICP) increased by 7,7% during the period January-July 2022 compared with 0,9% in the corresponding period of 2021. During the period under review, the surge in the domestic HICP, is mainly attributed to the sizeable adverse consequences of the Russian invasion of Ukraine and also due to the ongoing consequences of the pandemic.

More specifically, the energy component of HICP is the largest contributor to the surging trend of domestic headline inflation (with around 45% share on HICP) during the period under review mainly due to the developments related to the Russian invasion of Ukraine which resulted to the exceptional soaring in the prices of oil and gas in international markets.

Food prices also registered sizeable yearly increases (7,1% during Jan-July 2022 Vs -1,3% in the corresponding period of 2021) in the aftermath of the latest ongoing geopolitical tensions. At the same time, the remaining components of the HICP such as services, non-energy industrial goods also recorded significant yearly price increases.

Latest Eurostat's flash estimate data revealed that Cyprus HICP is expected to reach 9,6% in August 2022 compared with 3,3% in August 2021.

Taking into consideration the said inflation developments, 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 Russian-Ukraine war. More specifically, Cyprus HICP inflation for 2022 has been revised upwards in our most recent projections, reaching 8,4% compared with 7,0% in the CBC June 2022 economic bulletin.

- **Banking sector**

Now let's consider the developments in the Cyprus banking sector. Data from the sector demonstrates that despite the negative international economic environment, the 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 the inflationary pressures 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 European Union.

This significant asset side de-risking is attributed to both organic solutions such as restructurings as well as non organic through securitisations and sales. Therefore a large portion of the NPL reduction still remains in the economy through the credit acquiring companies. Indeed, the total amount of NPLs currently managed by these entities amount to €18,5b which is more than six times larger than the €2,9b NPL volume in banks' balance sheets. It must be pointed out though that the derisking process and progress has not been homogeneous across the system with the smaller Banks lacking significantly behind. Therefore, the close monitoring of asset quality enhancement of less significant institutions is high on our supervisory agenda The Central Bank of Cyprus, acted decisively in this regard by urging both the Banks and credit acquiring companies to proceed with viable restructurings with cooperative troubled borrowers, in line with the related directives and guidelines. In particular, since the expiry of the initial moratorium period (i.e. freezing of bank loan instalments) in December 2020, restructuring activity within 2021 increased significantly (by 251,5 percent) to €1,7bn compared to €480mn in 2020, indicating the effort made by banks to help distressed borrowers settle their obligations. In addition, thanks to the solid solvency buffers and the support of the Central Bank of Cyprus that relaxed temporally the capital and loan origination requirements, the banking system has supported the domestic economy by providing fresh lines of credit from January 2020 to June 2022 of 8,1 billion Euros. 2,6b euros have been granted to households for mortgages, whilst 1,6 billions and 0,6 billions have been granted to the Wholesale and Hotel Industries which have been affected severely by the pandemic.

Nevertheless, all the banks need to remain cautious, prudent and active in order to confront a challenging period that lies ahead us. Whilst the first round effects from the geopolitical crisis has been up until now manageable, the second round effects have not yet materialised and uncertainty in an environment with high inflation and weakened growth prospects is elevated. Adverse macroeconomic developments may deteriorate banks' profitability and asset quality, causing delinquencies and an upward trend in impairments and provisions. Interest rate normalisation policies may support the banks' revenue capacity through higher yields. However, they might fall short to balance out the structural deficiencies that would be magnified if the economic prospects follow an adverse route. It is therefore of pivotal importance for banks to adapt their business strategies to the new realities forged by the consecutive crises. And this would not be an easy ride as challenges emerge, often in unpredictable ways. I will today refer to two which I consider to be amongst the most important ones.

The first one relates to business model and structural weaknesses. Despite the low profitability being a wider structural European issue, 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, signalling serious cost inefficiencies relative to peers. Investment in technology is key in the efforts to unlock efficiency and bridge this gap by addressing chronic issues that dent profitability such as cost inefficiencies, limited avenues of income generation, competitive pressure from entities operating outside the traditional banking spectrum and changing customer demands and needs.

The second one relates to the risks of climate change. The ongoing effort to reduce the dependence from Russian energy may increase the transition risks and as such banks shall enhance and adapt their climate risk mitigation strategies. The fact that some of the banks have started making tangible steps on this regard is a positive development, but they are still early on the learning curve. They must act more aggressively and more decisively to meet our expectations of incorporating climate-related and environmental risks into their overall risk management frameworks.

Conclusion

Let me now briefly summarise the main points of my remarks and conclude: The adverse geopolitical developments led to a significant and persistent increase in inflation, associated with output loss and elevated economic uncertainty. This situation, combined with pre-existing challenges, such as the climate change and the new protectionism trend, requires a new approach in Monetary Policy and constitutes a major test for policymakers in the euro area and around the world. In Cyprus, the consequences of the adverse geopolitical events to the economy and the banking sector are so far contained, but the second round effects have not yet materialised and uncertainty in an environment with high inflation and weakened growth prospects might lead to unpredictable new challenges. Therefore, close monitoring is of utmost importance for a timely and decisive reaction.

Thank you for your attention.