Constantinos Herodotou: Central Bank Challenges in a world of growing uncertainties - the conduct of monetary policy and the evolution of traditional banking

Speech by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, at the ICPAC Mediterranean Finance Summit, Limassol, 5 May 2022.

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Dear guests, dear co-speakers, it is a pleasure to have the opportunity to speak to you here today.

These days our thoughts are with those affected by the tragic events of the Russian invasion in Ukraine. Beyond the human loss, Russia's war against Ukraine has disrupted further the global supply chains and in effect growth and inflation patterns around the world and the euro area economy. Europe faces both supply disruptions and surging prices for commodities and raw materials, problems exacerbated by the region's dependency on Russian oil and gas. How the euro area economy performs will greatly depend on the magnitude and time length of the conflict, the side effects of current sanctions on the euro area and on possible further measures.

I will first describe the current economic developments in the euro area as regards growth and inflation outlook and the ECB's monetary policy stance and challenges under the prevailing uncertain geopolitical situation.

As the supply disruptions from the acute phase of the pandemic were easing, the war and the consequent sanctions imposed on Russia are causing a new negative shock that is weakening the pace of the post pandemic recovery, creating new supply-side bottlenecks and increasing inflationary pressures for longer.

Overall, the war in Ukraine has a strong effect on economic sentiment and increased considerably the risks to the economic growth outlook which are now skewed to the downside. According to the April IMF forecasts, euro area GDP growth in 2022 is revised down to 2,8 per cent, from the previous projection for growth of 3,9%. A 1.1 percentage points reduction in expected GDP growth.

However, there are still factors supporting economic activity and recovery, such as the reopening of the economies after the crisis phase of the pandemic, strong labour market underpinning incomes, and households' accumulated savings from the pandemic period which support consumption. The labour market in particular, has sustained its recovery momentum, with unemployment falling to a historical low of 6,8 per cent in February 2022. Job postings across many sectors still reflect strong labour demand.

Whereas the war caused GDP growth to be revised downwards, a parallel impact is that it has also intensified the upside risks surrounding the inflation outlook, especially in the near term. Based on the same IMF forecasts, euro area inflation in 2022 is expected to reach 5,3 per cent, compared to 1,7 per cent projected by the IMF back in October 2021. Core euro area inflation, as measured by HICP excluding energy and food rose from 2,7 per cent in February to 3 per cent in March 2022 with an increase in the sectoral inflation rates for both non energy industrial goods and services. All-items HICP reached 7,5 per cent in March from 5,9 per cent in February. The rising inflation, is increasing the production costs of firms and is eroding disposable income.

The war has heightened the uncertainty of future price developments and the pace with which supply bottlenecks will recede. In parallel, new pandemic restrictive measures in China, for example the closing of the city of Shanghai and its port, which is considered the busiest port in the world, also accentuate supply chain difficulties. Energy prices, which were driven even higher after the outbreak of the war, now stand 45 per cent above their level one year ago and continue to constitute the main reason for the high level of inflation. Overall, inflation pressures are projected to remain strong in the short-term undermining business and consumer confidence.

The main challenge for monetary policy now is to control inflation without jeopardising economic recovery. This requires careful attention of all these elevated uncertainties and their implications on the evolving economic outlook. The complication is that the inflation pressures result mainly from the supply side shocks which cannot be remedied via monetary policy. Higher interest rates will neither restore supply chains nor reduce energy prices. For this reason, at the ECB Governing Council, we have already began adjusting certain monetary policy instruments such as the Pandemic Emergency Purchasing Programme and the Asset Purchasing Programme, reducing significantly the bonds bought by the national central banks of the euro area members states. In other words monetary tightening has already begun. There is a clear sequencing of monetary policy actions that has been set and is being followed by the Governing Council. We closely monitor all incoming data and adjustment of the ECB monetary policy instruments will be done gradually and flexibly to target any demand side or second-round inflationary effects or de-anchoring of inflation expectations. The volatility and high uncertainty force a need for optionality in the conduct of monetary policy to ensure price stability over the medium term.

It is both interesting and important here to briefly explain the difference in the monetary policy actions employed so far by the ECB and the Federal Reserve in response to the inflationary shocks. The policy actions of the ECB and the Federal Reserve, diverge since they face very different economic environments and data. In the U.S., where the Federal Reserve has already raised rates and delivered today the biggest rate hike since 2000, the inflationary pressure has been made more acute by a tight labour market. In the euro area the labour market is not tight. Also, domestic demand in the euro area is back to pre-Covid levels. In the U.S., it is higher. Therefore, the US is facing demand-side inflationary pressure that monetary policy can deal with.

In Cyprus, the rise in oil prices has a direct impact on the households' cost of living and firms' production costs while the sanctions imposed on Russia mainly affect the tourism and professional services sectors of the country and are expected to weigh on economic activity. Specifically, they are expected to reduce the level of GDP growth in 2022, as currently estimated, by around 1,3 percentage points, from 3,6 per cent as per the Central Bank of Cyprus December projections, to around 2,3 per cent. Inflation is currently expected to hover around 6,8 per cent in 2022, compared to the December projection of 2,5 per cent. This impact is associated with the rise in oil and other commodity prices, as well as the disruption in exports of goods and services to Russia, which on average constitute about 16 per cent of overall exports of goods and services. Important such services exports to Russia include tourism, transportation, financial, professional and computer services. In addition, indirect consequences are expected via the impact on consumer and business confidence. Nevertheless, the medium-term economic outlook remains positive, supported by disbursements from the European Recovery and Resilience Fund. The allocation for Cyprus for the period 2021-2026 is €1,2bn, of which €1bn in grants and €200 million in loans. The total grants allocation for the EU is €338bn, which implies 0,3 per cent of the total grants package is allocated to Cyprus.

In terms of the banking sector of Cyprus, it faces the effects of the Russian invasion in Ukraine from a financially sound position. The Liquidity Coverage Ratio amounts to 344 per cent as at February 2022 which is almost double than the respective EU average of 175 per cent. Its loss absorption capacity, as measured by the CET1 ratio, amounts to 17,6 per cent as at December 2021, which is also above the EU average of 15,7 per cent. But more importantly, the first round effects of the war to the Cyprus banking system do not appear to pose any material threat to the banking sector since the direct links of Cyprus' banking sector with Russia and Ukraine are limited and not material. As at December 2021, the total assets that is loans and deposits from the two countries amounted to just 0,8 per cent of total loans and 4,7 per cent of total deposits respectively.

The only bank whose business model was affected by the war and the sanctions on Russia was RCB Bank. The Central Bank of Cyprus acted proactively and timely. Our objective was to safeguard depositors and financial stability of the country. Through our actions and the cooperation of RCB Bank itself, a transaction structure was successfully implemented that safeguarded all depositors without any impact on the public finances or any negative spill over effects to the rest of the banking sector, thereby preserving financial stability. It is our opinion, which is also shared by the ECB, that the decisions and actions taken were the best possible under the prevailing circumstances.

The Cyprus banking sector is providing credit to viable businesses and households. Total new lending to households in 2021 amounted to €1,4b, which is higher than the €1,2b credit that was granted during the pre-pandemic year of 2019 and well above the €1,1b granted during 2020. The momentum has been maintained in the first two months of 2022 as well, since the new lines of credit amounted to €277m against €180m last year. Total new lending to businesses in 2021 accumulated to €1,5b which is higher than the €1,3b granted in 2020 but subdued when compared with the €2,0b granted in 2019. It is evident that the banks' financial position, the regulatory measures and initiatives taken by both the European Central Bank and Central Bank of Cyprus are the factors that contributed to this positive post-Covid development of the banking sector providing support to the economy.

However, banks must, for their own good and profitability as well as for the good of the Cypriot economy, become better and more efficient at serving their clients. I have made this point to the CEO's and Chairmen of the banks a number of times and I also called a meeting between the CBC, economy stakeholders like KEBE, Institute of Certified Public Accountants of Cyprus, the Cyprus Bar Association and the Cyprus banks to promote and facilitate better and more efficient ways of doing business with the banking sector. Whereas as agreed, follow-on meetings have subsequently taken place between the stakeholders, I'm forced to say that I have not seen practical progress. I call on all parties to continue the discussions but more importantly to move from talking to doing.

In order to help this situation as well as the economy, at the CBC we also initiated a project to digitise the banking sector's client onboarding process as well as the exchange of customer information between banks. Let me be clear: this is not the responsibility or remit of the central bank. However, I decided for this to happen in order to push this technological change in the banking sector. We set this project as a priority and obtained the commitment of Cyprus banks to embrace and participate in the project. We are now at an advanced stage of formulating the technical and legal requirements for the project. The project, as envisioned by the CBC, will be a flexible and scalable solution to be implemented in phases.

Phase one, will be the remote digital onboarding of new customers through a seamless digitalised process and an optimised customer on-boarding experience, thereafter expediting the remote updating of customer data and information.

Digitalisation of the onboarding process will initially focus on Cyprus citizens, allowing for expansion to include EU and non-EU citizens as well as legal entities and, to the extent possible, similar structures. In other words it will learn to walk before it will run.

Phase two will roll out an interoperability solution with utility service providers and governmental services, allowing for possible incorporation of electronic IDs as provided for in the European Regulation.

Phase three will see the information sharing between participating banks when there is an update of customers' data for AML/Know Your Customer compliance purposes or when a new customer is onboarded and such person is already a customer of a participating bank.

Finally, Phase four will deal with information sharing between participating banks for the purpose of account switching.

The CBC is committed to make the project work as the benefits to all stakeholders and especially bank customers will be tangible in terms of cost and time savings. This will benefit the entire Cypriot economy including the banks themselves.

Having said this, I wish to emphasise that digitisation on its own does not bring full efficiencies or solve the issues I mentioned earlier. The Association of Cyprus Banks and the CEOs and Chairmen of banks must make the necessary internal changes and training to make servicing of clients more efficient. Let me be clear, European banking regulations are the same across Europe. That's why they are called European. Hence differences on banking practices and efficiencies are because of banks' management and their practices. The Cyprus banking sector practice is less efficient than European counterparties. As I mentioned before, it's time for banks and stakeholders to act.

In conclusion,

The world's economic system has been through a lot in recent years, from the challenge of the pandemic to the impact of the war in Ukraine. Policymakers around the world should focus their actions on dealing with elevated uncertainty and rising inflation, while safeguarding growth prospects. The CBC remains alert in gauging these challenges, as proven by our actions that safeguarded depositors and public finances with the controlled transaction relating to RCB and also on the client onboarding digitisation project we are close to launching on our own initiative for the benefit of the economy,

It is up to us to come through these challenges unscathed or even stronger, wiser and better prepared for the future because the world geopolitically, economically and financially is changing fast in fundamental and lasting ways. We have done it before, we can do it again.