

Constantinos Herodotou: Speech - visit Ms Lagarde

Speech by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, during Ms Lagarde visit to Cyprus, Nicosia, 30 March 2022.

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It is such an honour for me to welcome to Cyprus a prominent European citizen. A reputable lawyer, a successful policy maker both during her term as a finance minister, as well as while being head of the IMF and the ECB. A great leader who during a turbulent time of serious and consecutive crises is steering us towards a better European Union, a more prosperous Eurozone and a more stable Eurosystem. We welcome today the President of the European Central Bank, Christine Lagarde.

I would like to express to you, dear President my sincere gratitude for accepting my invitation to visit Cyprus. Your visit to our island as the head of the European Central Bank, is something that bears a twofold significance.

Firstly, it emphasizes that in the effort to overcome the common challenges we face, all European countries stand together and united. We are working in a coordinated manner, in close collaboration and aware of the difficulties we encounter, both large and small countries, as one European family.

Secondly, it is a recognition of the active role of Cyprus - and allow me to say the Central Bank of Cyprus in particular – in contributing to the shaping of the common European monetary strategy. And this is an acknowledgment that fills us with great satisfaction.

When I addressed the invitation to Madame Lagarde to visit Cyprus a few months ago, I could not have imagined how much more complicated the situation would be today. At the beginning of the year, the economic confidence was improving and the GDP growth rate was recovering fast. The war in Ukraine however changed everything. It has first and foremost caused a humanitarian tragedy, which we, as Cypriots, can relate to since we have gone through a similar situation with the Turkish invasion back in 1974. It has also shaped an economic landscape of higher risks and uncertainties. The situation calls for a strategy that goes far beyond the financial technical sphere, reaching to the core of our European values. I am confident that once again, as we did recently with the pandemic, the Eurozone will manage to address the challenges and come stronger out of this crisis.

The most recent ECB policies have successfully guided the euro area economies out of the pandemic shock with the minimum possible scarring. Both the euro area as well as Cyprus have reached the pre-pandemic real GDP level within 2021, while a similar path has been recorded in the labour dynamics with the labour force participation having reached pre-pandemic levels. This has been achieved by the formulation of ample policy support. The ECB took a series of policy decisions aimed at achieving favourable financing conditions and alleviating the economic hit on households and businesses. More specifically, the ECB enhanced its Asset Purchase Programme (APP) with the introduction of the Pandemic Emergency Purchase Programme known as PEPP, the size of which was 1.85 trillion Euros, in order to lower borrowing costs and re-establish

favourable financing conditions within the Eurozone. Focusing on Cyprus, the total amount of net asset purchases in government bonds reached €6,86 billion Euros at the end of February, 90% of which was purchased by the CBC. At the PEPP announcement, amid severe market fragmentation, the Cyprus 10 year sovereign bond yield increased to 2,21% while within a quarter of these Eurosystem bond purchases dropped by 1,25% (reaching 0,96% in June), exemplifying the benefits of these purchase programmes. Furthermore, the Cypriot banking system benefited from the use of TLTRO III, as well as from the easing of macro prudential measures, in order to support access to credit. It should also be noted that through the explicit assurance to maintain supportive monetary policy for as long as needed, through our Monetary Policy Forward Guidance, the ECB is decisively strengthening the efforts to boost economic activity.

Turning to the current challenge that we are faced with, the Russian invasion of Ukraine has moderated expectations of a continued strong GDP expansion in the Eurozone and Cyprus, at least in the short-term. There is increased uncertainty about the economic impact, owing to the length and breadth of the conflict, the degree of severity of currently enacted sanctions and the extent of possible economic retaliation by Russia. Against this background, the world economy is experiencing a double hit by complex supply and demand shocks. Economic impact in Cyprus is expected to be channelled through the foreseen surge in oil prices, the trade in goods and services, such as minerals of oil and fuel, cereals, tourism, transportation and IT services, and a negative impact on a specific part of professional services (lawyers and accountants), while significant confidence effects cannot be ruled out.

A set of internal scenarios analysed by the CBC point to a downward impact on GDP growth and an upward impact on inflation in 2022. Under a baseline scenario, assuming that the conflict is not protracted, that is, a normalisation of the situation by end-2022, GDP growth is expected to decelerate to 2,7% in 2022 (compared with 3,6% before the outbreak of the war), with a strong recovery in the medium term of around 3,7%.

In 2021, domestic HICP inflation registered a substantial rise, similar to the euro area inflation developments, reaching, on average, 2,3%. In general, this development was largely due to the surge in oil prices, upward base effects and other pandemic-related factors, as well as the recovery in economic activity. The recent developments following the war will push inflation higher in 2022, with negative consequences on the purchasing power of households and investment decisions of firms. We have, for this reason, begun adjusting monetary policy accordingly. When the necessary conditions, as set out during our recent monetary policy strategy review, are satisfied, we can take additional steps towards policy normalisation, always taking into account the high uncertainty and the underlying risks caused by the war. Hence preserving flexibility is of paramount importance.

A fundamental difference of the current crisis with the one faced a decade ago is that the Cyprus banking system is not part of the problem now but it can and must be part of the solution. The Cyprus banking sector has the buffers to absorb unexpected shocks, both from a solvency and a liquidity perspective. The core regulatory ratios of Cyprus Banks compare well with our European peers, providing our banks with the capability to

absorb losses and to fund the real economy through lines of credit to both viable businesses and households and be accommodative for the transmission of monetary policy.

In this ever changing global terrain, we shall be neither optimistic nor pessimistic. Instead, we shall act; and we shall act in a responsible manner with realism and honesty. The citizens of Europe need to be aware of the challenges and difficulties. A well-informed citizen acts more responsibly. And that's the best answer to any challenge. We, here in Cyprus, know what a challenge is and how to overcome it. A country at the edge of the Mediterranean sea, has managed to place itself to the political and economic core of the European continent. A small island with a part of it under occupation, thrives thanks to its extroversion and its people, who despite having been put to the test so many times in the past, have never stopped creating, evolving and moving forward. I have no doubt that together with our European partners we will take all the necessary actions to overcome this challenge as well, guided by our common core values and principles. As the great French novelist Victor Hugo said,

"Changez vos opinions, gardez vos principes; changez vos feuilles, gardez intactes vos racines"

"Change your opinions, keep to your principles; change your leaves, keep intact your roots".

Here in Cyprus we often say that "a captain is proven capable when she is in a storm". And hence, I consider ourselves lucky since our ECB captain steering us through both the Covid and geopolitical storms is Christine Lagarde, a leader of undoubted capacity and experience, whom I thank again for being with us today and would like to invite her to the podium to share her thoughts with us.