Christodoulos Patsalides: Cyprus and the euro area - navigating growth, stability, and opportunities

Keynote address by Mr Christodoulos Patsalides, Governor of the Central Bank of Cyprus, at the Cyprus Shipping Chamber (CSC) Monthly Members Meeting, Nicosia, 6 February 2025.

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I would like to thank the Cyprus Shipping Chamber for giving me the opportunity to address this meeting today and discuss key economic developments. My remarks will begin with an overview of Cyprus' economic performance. I will then discuss the notable progress achieved in the banking sector and underscore the critical role of the shipping industry in driving export revenues. Following this, I will turn to the broader economic outlook for the Euro Area, concluding with insights into the European Central Bank's latest monetary policy decision on achieving price stability.

Domestic economic outlook

The Cypriot economy continues to exhibit robust growth, despite facing persistent external challenges in a turbulent and uncertain global environment. Geopolitical risks, such as the ongoing war in Ukraine, conflicts in the Middle East, and rising international tensions, have elevated economic uncertainty.

Amidst these conditions, the Cypriot economy has consistently demonstrated remarkable resilience and flexibility. This is clearly reflected in its recent upgrades by credit rating agencies to the "A" category, further cementing its reputation in international financial markets. These upgrades underscore the growing confidence in Cyprus's fiscal policies and the solid outlook for its economic and banking systems.

Improved fiscal performance has been a cornerstone of these positive developments. Public debt has been reduced significantly, declining from 114% of GDP in 2020 to 74% in 2023, highlighting disciplined financial management. Projections from the Ministry of Finance indicate that this downward trajectory will continue, with public debt expected to fall below 50% of GDP by 2028. This progress strengthens fiscal sustainability and enhances the country's ability to respond to future challenges, reflecting a strong commitment to long-term economic stability.

According to the December 2024 projections of the Central Bank of Cyprus (CBC), economic growth for 2024 is expected to reach 3.7%, significantly higher than the projected Eurozone average of 0.7%. The expansion of productive sectors such as technology, trade, tourism, financial and professional services, shipping, and construction-particularly large private sector infrastructure projects-has been a key driver of growth.

For the period 2025-2027, GDP is expected to grow by approximately 3% annually, driven primarily by a projected increase in domestic demand and, to a lesser extent, external demand. Domestic demand is expected to be supported by a rise in private consumption due to the increase in real disposable household income and the continued resilience of the labour market. Additionally, domestic demand will benefit from ongoing large-scale private non-residential investments, infrastructure projects aimed at supporting digital and green development, and other reform projects under the Recovery and Resilience Plan.

Regarding the shipping sector in particular, our small island has a maritime history spanning hundreds of years, and it is rightly is considered as one of the main pillars of the Cypriot economy. The country's maritime industry considerably contributes directly and indirectly to the country's GDP. Based on 2023 data, the shipping sector ranks third with a share of 17.2% to the total value of exports of services, after the Information and Communication Technology sector, the financial services and the tourism sectors, with shares of 30.2%, 20.3% and 11,5% respectively. In view of the aforementioned figures, it is evident that the sector managed to stay focused and strong despite the unprecedented challenges faced in the last few years, namely the covid pandemic, the wars in Ukraine and Gaza as well as the tensions in the Red Sea.

The strength of the labour market further reinforces this positive narrative. Unemployment has declined to 5% in the first nine months of 2024, compared to 5.8% in 2023. It is projected to remain at 5% for the full year and to fall further to 4.6% by 2027, approaching levels indicative of full employment. These figures compare favourably to the euro area, where unemployment is forecast to stabilize at 6.1% by 2027.

On the prices front, inflationary pressures have eased significantly, with inflation dropping to 2.2% in the first eleven months of 2024, compared to 4.1% in the same period of 2023. According to the CBC's December 2024 projections, inflation is expected to stabilize near the 2% medium-term target, reaching 1.9% in 2025, 2.1% in 2026, and 2.0% in 2027.

The Cyprus banking sector

The Cyprus banking sector has demonstrated tangible progress and resilience, with key financial metrics reflecting a strong and sound performance. A primary indicator of this strength is the solid improvement in terms of solvency, with the Common Equity Tier 1 (CET1) ratio increasing from 21.5% in December 2023 to 23.5% in September 2024. This increase marks the highest CET1 ratio in the Union, surpassing the EU average of 16.0%.

Despite the challenges posed by consecutive crises, no tangible signs of credit quality deterioration are observed up to this point. In fact, the Non-Performing Loans (NPL) ratio has continued its positive downward trend. As of September 2024, the NPL ratio stands at 6.5%, a marked improvement from 7.9% in December 2023. This reduction reflects the sector's ongoing commitment to addressing legacy issues, bolstering the financial health of the asset side of its balance sheet, and reinforcing its capacity to support economic recovery. Yet, there is still some way to go, particularly considering that the average NPL ratio of the EU sector stands as of September 2024 at 1.9%. Furthermore, the improvement within the Cyprus banking sector has not been homogeneous across all institutions, with certain banks lagging behind. These institutions must therefore accelerate their efforts to align with the sector-wide advancements.

Profitability metrics have been robust, with the Return on Equity (RoE) reaching 23.2% in September 2024 as opposed of 11,1% of the EU average. Operational efficiency has improved as the cost-to-income ratio declined to 35.5%, a notable reduction from previous years and lower than the EU average of 53%.

Cyprus banks also exhibit some of the highest liquidity standings in the EU, reinforcing their ability to meet potential liquidity demands. The Liquidity Coverage Ratio (LCR), a measure of a bank's ability to withstand large liquidity outflows under a stressed period, stands as of September 2024 at 336%, compared to the EU average of 161% and minimum requirement of 100%. Furthermore, the Net Stable Funding Ratio (NSFR), which assesses the stability of a bank's funding base, stands also high at 187%, surpassing both the EU average of 127% and the minimum regulatory requirement of 100%. The Cypriot banking sector is thus well-positioned to face potential market disruptions and continue driving economic stability.

Through the first 11 months of 2024, Cypriot banks granted €3.3 billion in new loans to households and non-financial corporations (NFCs), surpassing the already high €2.9 billion provided during the same period in 2023. A negative side effect of a strongly liquid banking sector in a small country is the slow adjustment of interest rates in response to ECB monetary policy actions. Banks must exhibit responsible pricing policies in the face of reputation risk and the need to support the competitiveness of the economy.

Looking to the future, the banking sector faces challenges such as adapting to AI, mitigating cyber risks, addressing geopolitical uncertainties, and transitioning to a greener economy. Tackling these priorities is essential for sustaining the sector's positive trajectory and remains central to our supervisory agenda.

Economic Developments in the Euro Area

The risks to economic growth continue to lean towards the downside. Increased disruptions in global trade may hinder euro area growth by suppressing exports and slowing the global economy. Additionally, reduced confidence could delay the recovery of consumption and investment beyond current expectations. The ECB's December projections estimate economic growth of 0.7% in 2024, 1.1% in 2025, 1.4% in 2026, and 1.3% in 2027. This recovery is expected to be driven primarily by rising real incomes, which should enable households to boost consumption, alongside increased investment by firms.

On the price front, euro area inflation rose to 2.4%, in December 2024, up from 2.2% in November, primarily driven by increased energy costs but this was expected due to energy-related upward base effects.

Despite the upticks in recent months, the disinflation process is well on track. ECB Staff see headline inflation averaging 2.4 per cent in 2024, 2.1 per cent in 2025, 1.9 per cent in 2026 and 2.1 per cent in 2027 when the expanded EU Emissions Trading System becomes operational. Services inflation continues to be sticky at around 4%, largely stemming from the delayed catch-up adjustment of certain services prices to past inflation surges and ongoing wage pressures. At the same time, recent signals point to continued moderation in wage pressures and to the buffering role of profits.

Inflation is expected to fluctuate around its current level in the near term. It should then settle sustainably at around the two per cent medium-term target. Easing labour cost pressures and the continuing impact of past monetary policy tightening on consumer prices should help this process. Most measures of longer-term inflation expectations continue to stand at around 2 per cent.

ECB Monetary Policy

Based on our updated assessment of the inflation outlook, underlying inflation dynamics, and the effectiveness of monetary policy transmission, we decided at our January Governing Council meeting to further reduce the three key ECB interest rates by 25 basis points. This adjustment brought the deposit facility rate-the primary tool for steering our monetary policy stance-to 2.75%

Overall, the euro area's economic environment remains intricate, with the risks to economic growth tilted to the downside and with both upside and downside risks to inflation present. The ECB continues to navigate these challenges through measured, careful adjustments in its monetary policy stance. Growth is a factor influencing inflation dynamics. It is crucial to ensure that the economy does not grow too slowly, as this could lead to inflation stabilizing below the target. As we move forward, in the current environment of elevated uncertainty stemming from potential global trade frictions and geopolitical tensions, the ECB's prudent data-dependent meeting by meeting approach shall continue to be important in addressing the evolving economic conditions within the euro area to ensure the timely return to the inflation target in a sustainable manner. The ECB is not pre-committing to a particular rate path.

Conclusion

Let me now conclude: the Cypriot economy has shown resilience and adaptability, supported by strong performance, prudent fiscal policies, and a stable financial system, with key contributions from banking and shipping. As one of the pillars of our economy, the shipping sector continues to demonstrate global competitiveness and innovation, further strengthening Cyprus's position as a leading maritime hub. Looking ahead, challenges like climate change and geopolitical risks demand strategic foresight, but Cyprus is well-prepared to sustain growth.

At the Euro Area level, the economic outlook balances risks and opportunities, with the ECB ensuring price stability and sustainable growth through proactive, data-driven policies. By remaining data-driven and proactive, we can ensure that the monetary framework across the region remains resilient and responsive to evolving global dynamics.

Thank you.