

Constantinos Herodotou: Developments in the monetary policy of the European Central Bank and the Cyprus banking sector

Speech by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, at the 2nd Mediterranean Finance Summit, Limassol, 18 May 2023.

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Cyprus, and the euro area at large, have been hit by successive and persistent global shocks over the past three years, that have caused an exceptionally high level of uncertainty, an economic slowdown and immense inflationary pressures. Our exit from the first shock of the pandemic-related supply chain disruptions, was abruptly interrupted by Russia's war in Ukraine and the subsequent energy crisis it caused, that fueled significant inflation pressures globally. Despite the current disinflation path in headline inflation, price increases have now become broader and more persistent in the underlying inflation dynamics, that is, inflation excluding energy and food. This is due to the continuous pass-through of past energy cost pressures to other sectors of the economy, such as manufacturing and services.

In my speech today, I will briefly explain the current European Central Bank (ECB) Monetary Policy, analyse the economic activity in Cyprus, and then focus on the developments as well as other major challenges in the Cyprus banking sector.

The ECB Monetary Policy

Inflation rose sharply and became persistent in the Eurozone. Therefore a substantial rise in interest rates was initiated by the ECB in order to ensure the timely return of inflation to the 2% medium-term target. For the most recent interest rate rise, the Governing Council of the ECB decided in early May to raise the three ECB key interest rates by a further 25 basis points. This was the seventh consecutive rate hike since last July, comprising a total increase of 375 basis points from -0.50% to 3.25%. It was also decided last May that bond reinvestments under the Asset Purchase Programme are expected to be discontinued as of July 2023, thus further aligning all of ECB's monetary instruments in fighting against persistent inflation.

Currently, monetary policy is in the restrictive territory, as reflected in the significant tightening of the financing conditions. Even though headline inflation is declining, and financing conditions are tighter, there is still a lot of uncertainty. This is the main reason that a data-dependent approach on future policy rate decisions is required - in order to assess the headline and core inflation outlook on the basis of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission. Policy rates need to be brought to and maintained at the necessary restrictive levels to achieve a timely return of inflation to the 2% medium-term target, while the same data-dependent approach will determine the potency and duration of this restriction.

The real economy in Cyprus

The Cypriot economy has shown significant resilience to the external shocks of recent years, such as the pandemic, the recent energy crisis, and the ongoing war in Ukraine, with its consequent impact on the international economy through de-globalisation.

GDP

Specifically, Cyprus' real Gross Domestic Product (GDP) registered an annual increase of 5.6% in 2022. This increase reflects the robustness of private consumption, the better-than-expected performance of tourism and the continued implementation of important investment projects. Investment was also boosted by the continued inflow of foreign companies into Cyprus, also known as "International Headquartering".

According to the latest macroeconomic forecasts of the Central Bank of Cyprus (CBC), of March 2023, economic growth of 2.6% is expected in 2023. This rate of growth compares positively with the euro area expected average growth of 1%. The lower GDP growth compared to 2022 is expected to stem mainly from reduced demand for loans due to higher interest rates and a decline in private consumption and investment. However, investments in the context of the implementation of the Recovery and Resilience Plan, estimated at around €700 million over the next three years, are expected to contribute significantly to GDP growth (around 0.7% of GDP per year for the period 2023-2025). For the period 2024-2025, economic growth is expected to be around 3.1% per year.

Inflation

In 2022, inflation (Harmonised Index of Consumer Prices) in Cyprus recorded an annual increase of 8.1% compared to an average of 8.4% in the euro area. High inflation was initially driven by large increases in energy prices and supply chain disruptions. These increases later penetrated other categories of the economy such as the prices of food, manufactured goods and services.

Inflation is forecast to decline significantly to 3.3% in 2023, while a further easing of inflationary pressures is expected in 2024 and 2025, to 2.3% and 1.9%, respectively.

Overview of the Cyprus Banking sector developments in 2022 and the implications of the ECB monetary policy

The banking sector of Cyprus has enhanced its resilience further and retained a solid financial standing throughout 2022. The liquidity of the banking system stands at high levels compared to other EU countries, with the Liquidity Coverage Ratio at 310% as at December 2022, almost double the EU average of 161%. Its loss absorption capacity, the Common Equity Tier 1 ratio, stood at 17.7% as at December 2022, which is also above the EU average of 14.96%. Moreover, the banking sector's profitability reported significant profits in 2022, with the increasing interest rate environment being the key contributor to this.

The recent episodes with a number of failing regional American Banks and Credit Suisse have reminded us that we should all remain vigilant. Our banking sector has successfully weathered the shocks of these recent events so far. However, contagion

risks have been elevated globally as a crisis event in a non-systemic bank in the US, such as SVB, caused market volatility and ripple effects in other continents. The Eurozone mandatory supervisory restrictions with regards to the banks' continuous management of concentration risks on assets as well as financing, has proved to be once again best practice for risk management purposes. The ample liquidity of Cyprus banks in conjunction with CBC's preventive measures in 2021 to manage concentration risks, reinforced the banks' actions towards diversification making them stronger and capable to face any similar events.

However, there is no room for complacency. The elevated levels of inflation, in combination with the increasing interest rates, are expected to reduce net household income, hampering borrowers' repayment ability. Consequently, loan portfolios bear elevated risks that need to be properly managed.

In this respect, the CBC has mandated a consortium of experts, comprised of international, well reputable companies, to carry out a project with the ultimate goal of maintaining and further strengthening the economy's financial stability. The scope of the project is the formulation of a national systemic solution that could contribute to a further reduction of existing and new non performing loans in the Cyprus banking system. This effort is of prime importance for an additional reason; the progress achieved in de-risking the banks' balance sheets by reducing the amount of non-performing loans in each bank, has been heterogeneous across banks. Most of the progress has been achieved only by the big banks, while the smaller banks are still lagging far behind. So the project aims to provide a possible solution also for the long-standing problem of the non-resolved non-performing loans that are still present at a number of banks. The aim is to make them more resilient for future shocks but also free the time of banks' management and enable them to focus on their core banking business and improve their banking offer and service to their clients.

It is therefore of equal importance that the banking sector steps up its efforts to address its structural weaknesses in order to build a sustainable business model. In doing so, banks need to elevate their service levels. In the changing business environment, banks must utilise the opportunities that technology offers in order to enhance their service channels, train their employees in this direction and reduce response times. I have made this point a number of times to the banking sector leadership and stressed the importance for Cyprus banks to promote and facilitate more efficient ways of doing business.

In this respect, banks are currently engaged in transforming their business models towards technologically more advanced services, with digitization being the focus of this effort. Investment in technology can become the catalyst in the effort to strengthen efficiency and build sustained profitability. This should ultimately bridge the current gap that exists with the rest of the EU area banks.

In order to further encourage, promote and support domestic financial innovation, the CBC announced last December the operation of its Innovation Hub. The Innovation Hub aims to become an official platform for communication between the CBC, as a supervisory and regulatory authority, and businesses or start-ups active in Financial Technology sectors, in other words Fintech, that is, combining innovative technology with financial services.

Thus, the Innovation Hub is a crucial step in the broader context of the supervisory objectives and priorities that we have set at the CBC, which include innovation, digital operational resilience, digital transformation and cybersecurity.

Additionally, as I announced in my last year's speech here, the CBC took the initiative to formulate and implement the 'digital onboarding' project. As a reminder, this project's goal is to establish faster, more flexible and efficient banking services by developing the technological platform to allow the digital onboarding of clients and the digital monitoring and renewal of information of clients. We undertook this initiative despite the fact that it is not the responsibility of the CBC. We have nevertheless recognized the multiple benefits that such a project would bring to the banking sector, as well as to households and businesses in Cyprus. The tender process is now in its final stages of completion and the successful tendering company that will implement the technological platform should be announced soon.

Finally, and without repeating myself, another challenge that our banks face relates to the risks associated with climate change. As I mentioned in a speech on ESG (Environmental, Social and Governance) earlier this week, banks must accelerate, 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. We acknowledge the challenge that this poses, especially for smaller banks. However, they must act faster and more decisively to meet our supervisory 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 inform the banks' risk management processes.

Concluding remarks

So with this in mind, when it comes to challenges, it is important to note that these emerge through various channels. The challenges I mentioned, require significant upfront investment, cultural change and contribution from different stakeholders before reaping the benefits. And the time for Cyprus banks is now. Their strong capital position, ample liquidity and materially increased profitability can and must drive, without delay, their transformation towards a sustainable and competitive business model to address the challenges ahead. Complacency emanating from short term profits is not a viable option. Sustainability through transformation is the way forward. The CBC will continue pushing for this and will support this effort.