Constantinos Herodotou: Developments in the European economy and the effect of monetary policy

Welcome speech by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, at the Conference at the Central Bank of Cyprus on the occasion of the official visit of the President of the Deutsche Bundesbank, Dr. Joachim Nagel, Nicosia, 28 November 2023.

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Esteemed Members of the Parliament,

Distinguished Guests,

I would like to start with expressing my sincere appreciation and thanks to my dear colleague at the ECB Governing Council, Governor Joachim Nagel, for being with us today to share his valuable insights and views on the euro area economy.

Recent economic dynamics indicate that we are witnessing a significant transition in the euro area in the post-pandemic era. In 2022, the euro area experienced a notable shift in demand, with a move away from goods and towards services. This shift led to a deceleration in the manufacturing sector. In 2023 this trend continued, resulting in contractionary quarter-over-quarter dynamics. The consequences of this shift were profound, influencing the overall GDP growth in the euro area.

Conversely, the services sector played a pivotal role in supporting GDP growth in 2022. Driven by robust demand for travel and leisure services, the sector registered significant growth. This resurgence was particularly pronounced in the contact-intensive services, which grew by an impressive 8.1% in 2022, compared to 3.5% in the non-contact-intensive services. However, the initial drive in the services sector has shown signs of abating in 2023. More specifically, the Purchasing Managers' Indices, known as PMIs, a monthly measure used to track the direction of economic conditions and trends in the manufacturing and services sectors, indicate a downturn in services activity from August 2023 onwards.

The resilience of the services sector that was reflected until summer 2023 in the PMI readings, are closely linked to the resilience exhibited in the labour market. Labour income has been a key factor in preserving the purchasing power of households and thus the growth dynamics. The Job Retention Schemes implemented during the pandemic, played a crucial role in safeguarding the productive capacity of the economy, thus moderating the negative economic impact. As a result, despite the significant GDP drop in 2020, as a consequence of the lockdowns, employment fell only by 1.4%. The strong and flexible labour market, safeguarded the resilience of domestic demand dynamics.

In the subsequent years, employment growth outpaced GDP growth, which, while positive in terms of job creation, signalled worrying trends in productivity. This may be attributed to several factors: such as the rebound in labour-intensive services, labour hoarding that is the decision of companies to keep staff employed as economies reopened even if they were not fully utilised combined with robust company profits that allowed firms to retain staff.

As of 2023, the euro area labour market's resilience appears to be changing. There are signs of a slow-down in job creation, particularly in the services sector. Business employment expectations are softening and vacancy rates are moderating. Notably, the slight increase in the unemployment rate in the euro area to 6.5% in October 2023, could be a further sign of the transition in economic dynamics. At the same time, wage growth remains strong, even though there are early signs of moderation, which could be fundamental in relieving inflationary pressures.

The short and medium term economic outlook is positive in the sense that our downside case scenarios have not materialised. The euro area's economic forecast points to a moderation in growth, but avoidance of a hard landing. The projections for 2023 predict a GDP growth of 0.7%, gradually increasing to 1.5% by 2025. Similarly in Cyprus, we see the same trends but at relatively higher levels of economic growth. Specifically, growth is expected to reach 2.4% in 2023, rising further to 2.7% in 2024, and 3.1% in 2025. The forecast for the euro area considers several factors such as the strength of the labour market, even though it is moderating; the challenging external environment; the impact of ongoing monetary policy tightening; and the gradual withdrawal of fiscal policy support.

Regarding price developments, inflation dynamics are on a strong corrective path. Recent months have witnessed a substantial turnaround in the inflation landscape of the euro area, with inflation dropping to 2.9% in October 2023, from the historical high of 10.6% in October 2022. This correction in inflation indicates that the ECB Governing Council's monetary policy efforts are bearing fruit. The projections indicate a continued disinflationary process, with energy inflation in negative territory and a moderation in food inflation, which is still at a high level in the euro area, specifically at 7.4% in October 2023. Headline inflation is expected to stabilize, reaching 2.1% on average by 2025. However, a key concern remains with services inflation, which, due to the staggered nature of wage agreements, is expected to moderate more gradually than headline inflation in the projections.

A crucial aspect of the ECB monetary policy against inflation lies in maintaining well-anchored inflation expectations, even in the face of significant inflation rates. This achievement, underscores the confidence of the markets and the public in the ECB's commitment and capability to maintain price stability. The anchoring of these expectations has been a cornerstone in preventing a self-fulfilling spiral of rising prices and wages, thereby contributing to the overall economic stability of the euro area. The ECB's actions have not only been effective in steering towards the price stability objective, during these turbulent times, but have also enhanced the credibility of our policy interventions. This credibility is fundamental in ensuring the continued effectiveness of our monetary policies and in maintaining the confidence of the markets and the public.

As regards the future, the current energy crisis has highlighted the importance of one of our key challenges, namely the need to speed up the green transition. To safeguard the long-term benefits of such a transition, policy makers need to be ready to address effectively any possible difficulties that may arise during the process.

According to the European Commission's impact assessment (2022), transition towards net zero emissions is expected to have a limited impact on aggregate output, but its composition will shift from consumption towards investment. This is because the green transition will require higher investments relative to historical averages at least for a few years, which will shift the relative dynamics of domestic demand towards investment. Further to this, it should also be expected that shifting consumption patterns towards net zero emissions may entail significant costs such as switching to electric or hydrogen vehicles and the energy needed to power them, thus increasing the prices of such goods while affecting negatively the purchasing power of consumers and reducing consumption in real terms. The worst-case scenario, according to the same study, suggests aggregate GDP by 2030 to be 0.4 % below the baseline, with the negative impact on GDP being explained by a decrease in private consumption as well as by a decrease in net exports as a consequence of the respective increase of prices of both input and final goods. On the other hand, the best-case scenario projects a 2030 GDP about 0.5 % above the baseline, resulting from an increase in private consumption due to an efficient use of carbon revenues.

The impact of the green transition on inflation is also of great importance, especially for central banks. If there are rising carbon prices and increases in the price of critical raw materials as a result of the roll-out of green technologies, this may lead to a period of high energy prices. According to an ECB survey of leading firms, more than 80% of respondents agreed that mitigating climate change, would make the raw materials and components they use for this purpose more expensive. Almost as many agreed that this would increase the price of the goods or services their company provides. If prospects of persistently rising energy prices contribute to the risk of de-anchoring inflation expectations, or if underlying price pressures boost rather than suppress growth, employment and aggregate demand over the medium term, then monetary policy cannot just look through energy price shifts, even if they are of structural nature. Therefore, it is important to monitor the transition and understand to what extent the green transition, which is undoubtedly necessary, may have a rising impact on prices.

In relation to this, policy makers, including central bankers need to be equally attentive to the broader challenge of climate change. The latest ECB monetary policy strategy review, incorporates climate considerations in its monetary policy framework. The monetary policy strategy review has laid out a roadmap with climate change-related measures for the next years. This includes the development of new macroeconomic models to monitor the implications of climate change for monetary policy, the introduction of new indicators for green financial instruments and the carbon footprint of financial institutions, and new climate stress tests for banks in the euro area.

In conclusion, the ECB's recent monetary policy actions stand as testament to our commitment to price stability. The path we have chosen has been both challenging and rewarding. As we look to the future, we need to remain dedicated to adapting our policies to meet the ever-changing economic environment, always with the aim of fostering price stability for a prosperous euro area. We should pursue our efforts, always having in mind that we cannot change the direction of the wind but we can adjust our sails to always reach our destination!