Constantinos Herodotou: Speech - 14th Limassol Economic Forum

Speech by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, at the 14th Limassol Economic Forum, Limassol, 6 October 2023.

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Honourable President of the House of Representatives,

fellow speakers, esteemed guests, Ladies and gentlemen.

I would like to thank the organisers for inviting me to the fourteenth Limassol Economic Forum, a prestigious and always successful event. I was asked to discuss today the economic outlook of one of the world's most significant economic regions, the euro area. Amidst the continuous waves of shocks and high uncertainty, the euro area remains a cornerstone of the global economy, exemplifying both the challenges and opportunities of integrated economies.

Over the years, the euro area has weathered numerous storms. From the impact of the great financial and sovereign debt crises, to the unprecedented shocks of the global pandemic, followed by the on-going consequences of the war in Ukraine, the euro area has encountered multifaceted challenges. Nevertheless, based on the combined strength and collective decision making of its member states, the euro area has shown resilience, ensuring that financial stability is preserved and economic recovery is steady and sustainable.

Having said that, the euro area is exhibiting a slow down in economic growth in 2023. The euro area economy grew by 0.1% on a quarter to quarter basis during the first half of 2023, and recent data suggests a similar performance for the third quarter. Decreased residential and business investments, as a result of tighter financing conditions, coupled with a reduced demand for exports from the euro area, are hindering economic growth. According to the Purchasing Managers' Index - the PMI, which is the index that summarises whether market conditions are expanding, staying the same or contracting, as viewed by purchasing managers surveyed monthly, the prevailing direction of economic trends in the manufacturing sector is contracting. According also to PMI data, the services sector had been growing until July 2023, albeit at a decelerated rate, but has since then moved also into contractionary territory. Based on the European Central Bank (ECB) September 2023 projections, which are the most recent projections available, the economic activity is expected to regain momentum at the beginning of 2024. This will be fuelled by projected increases in real income due to decreasing inflation, growing wages, a robust European labour market and recovering foreign demand. According to the September projections, the euro area economy is expected to grow by 0.7% in 2023, 1.0% in 2024 and 1.5% in 2025.

As regards inflation, a notable drop in headline inflation in the euro area was recorded from 5.2% in August to 4.3% in September. According to the ECB September projections, inflation is expected to drop from 8.4% in 2022 to 5.6% in 2023 and 3.2% in 2024. It is then forecast to continue its decline to 2.1% in 2025. So the numbers and trends indicate that the ECB monetary policy transmission is indeed taking place and it is working to tame inflation with the aim to bring it back to target.

Under the Treaty on the Functioning of the European Union and the Statute of the European System of Central Banks and the European Central Bank, price stability is the primary objective of the ECB and it is defined by the ECB as a 2% inflation target, over the medium term. Other major central banks, such as the Federal Reserve in the US, the Bank of England and the Bank of Japan, also consider 2% as the level of inflation compatible with price stability.

Keeping inflation in check by achieving price stability is essential for preserving the purchasing power of the euro area households and ensuring that the euro area economy remains stable and predictable for businesses and consumers, so that they can proceed with their financial planning and carry out investments, thus supporting economic growth. High levels of inflation create uncertainty, which discourages financial planning and investment.

The main tool that central banks have to combat inflation, is the adjustment of interest rates. To reinforce progress towards its 2% inflation target in the medium term, the ECB Governing Council, in which the central bank governors of the euro area participate, decided last month the 10th successive interest rate increase, amounting to a total increase of 450 basis points since July 2022. In its most recent assessment, the Governing Council considers that the key ECB interest rates have now reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to our target.

However, material uncertainty continues to persist in the euro area. For instance, the recent increase in energy prices could transmit again to the rest of the economy and have an upward pressure on prices. Furthermore, the elevated wages and profit margins, the profiteering, observed in the euro area last year and part of this year, need to be monitored closely, even though they are currently expected to normalise. The liquidity conditions in the euro area banking system is another area to monitor, since it plays a role for transmitting monetary policy and, consequently, affects inflation. These uncertainties are the reason why I believe the ECB Governing Council approach to be data-dependent in its interest rate decisions, is indeed the right one. In other words, determine the appropriate level and duration of its tightening policy stance, based on incoming economic and financial data and the consequent projections.

At this point, I would like to emphasise the complementary role of fiscal policy in supporting and not counteracting the effectiveness of monetary policy, in this currently challenging environment. It is important that governments employ only targeted fiscal measures, supporting the most vulnerable in society. Any horizontal measures should be avoided or rolled back to prevent an escalation in medium-term inflationary trends. Such horizontal measures risk extending the duration of high inflation, and consequently would force the extension of the duration of high interest rates in order to tame inflation and bring it back to the 2% target.

I would finally like to address another important aspect, which is the synergetic relationship between price stability and financial stability. The pursuit of price stability through monetary policy, as we just discussed, and of financial stability through macroprudential policy, are to a large extend complementary. Monetary policy needs to take financial stability and the stance of macroprudential policy into account. Monetary policy and macroprudential policy operate through common transmission channels, meaning that the scope for interaction between the two policy spheres is wide. The bottom line is that a stable price environment can foster economic growth and financial stability, while a stable financial system can make it easier for central banks to achieve their price stability objectives, through monetary policy.

There are a number of macroprudential measures in the toolkit of macroprudential authorities, which are typically the national central banks, that assist in preserving and safeguarding financial stability. These include capital-based measures, borrower based measures and liquidity-based instruments. Capital-based measures target the banks' capital to increase the overall resilience of the banking sector by mitigating the build-up of risk exposures. Borrower based measures, in other words for loan holders, impose quantitative restrictions, such as on the size of the loan, depending on the income and the ability of an individual to repay the loan. Liquidity-based instruments aim at containing banks' vulnerabilities stemming from over-exposure to short-term financing, maturity mismatches and lack of liquid assets. I should mention that the Central Bank of Cyprus has deployed a combination of these tools, to ensure financial stability in the Cypriot banking sector and economy.

To conclude, the euro area is at a pivotal juncture. Difficult times warrant difficult but necessary measures. The cost of leaving inflation untamed, is much higher to households, businesses and the entire economy, whereas tightening monetary policy should eventually revert down to neutral, when the 2% inflation target in the medium term is deemed sustainable. The decisions we make today about our economy will shape the economic trajectory for years to come. By working together with a common vision, remaining focused on the appropriate policies, the euro area, including of course Cyprus, can forge a future that is prosperous and sustainable.

Thank you for your attention.