Constantinos Herodotou: The role of monetary policy in tackling inflationary pressures

Welcome address by Mr Constantinos Herodotou, Governor of the Central Bank of Cyprus, at the 1st Central Bank of Cyprus Annual Conference "The Role of Monetary Policy in Tackling Inflationary Pressures", Limassol, 4 October 2023.

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Dear Vice President of the ECB, Mr de Guindos, dear Luis, it is with great honour and pleasure that we welcome you to our conference today. Your presence, as the esteemed Vice President of the European Central Bank, highlights the importance of our discussions, and we look forward to your valuable insights.

I also extend a warm welcome to our esteemed speakers and express my gratitude for their participation and useful contributions. To all our distinguished guests, your presence is deeply appreciated.

Today's conference, on "The Role of Monetary Policy in Tackling Inflationary Pressures," marks the commencement of a series of Annual Conferences hosted by the Central Bank of Cyprus. These conferences will address contemporary economic issues and challenges. We aim to foster fruitful discussions and a collaborative environment for shared research and learning.

One of the most pressing challenges in our current economic landscape has been high inflation. Why is it so crucial to bring inflation down? The consequences of not acting and leaving inflation untamed would be dire. Inflation affects all of us, every individual, every family, every business and consequently the economy itself. When left unchecked, inflation erodes the purchasing power of our income. Imagine a world where the cost of basic necessities, such as food, housing, and healthcare, increases by 10% or 15% or even more every year. A number of Eurozone countries witnessed such levels of inflation last year. Households would suffer this cost, and the lower income households suffer the most.

Without an appropriate monetary policy response, we also risk entering a vicious inflationary cycle. If prices rise without control, people and businesses would expect higher prices in the future. This expectation usually leads to increased demand for higher wages, which drives up the costs for businesses. Businesses could then pass on these costs to consumers with further price increases. Monetary policy aims to keep such inflation expectations unchanged or anchored, otherwise a self-perpetuating cycle of rising prices could ensue, the well-known "wage-price" spiral.

Moreover, unchecked inflation can lead to economic uncertainty. Businesses, when uncertain of future costs and profits, tend to postpone decisions to invest in such a risky economic environment. This could stifle innovation, job creation and economic growth. For the average citizen also, long-term planning becomes a challenge. How does one save for a child's education or one's retirement when the future value of money could be so uncertain?

Furthermore, without tightening monetary policies, disparities between the wealthier and the more vulnerable segments of society are likely to widen in an inflationary environment. Those with assets, like property or stocks, might see the value of such assets rise with inflation. In contrast, those relying solely on fixed incomes or wages, could find themselves struggling to keep up with rising costs.

History has shown that periods of high inflation, for the reasons just explained, tend to create social unrest. In contrast, price stability maintains social cohesion and stability. So, the societal wellbeing is a crucial outcome of price stability. Under the Treaty on the Functioning of the European Union (TFEU) and the Statute of the European System of Central Banks and the European Central Bank ("Statute of the ESCB"), price stability is the primary objective of the ECB. Price stability ensures that individuals and businesses can maintain the value of their income and wealth, and plan for the future with confidence. This not only helps the economy to grow, but also pave the way for job creation and prosperity.

This brings me to another pivotal point: the symbiotic relationship between price stability and financial stability. The pursuit of price stability through monetary policy, and of financial stability through macroprudential policy, are to a large extend complementary. The primary objective of the ECB is price stability, namely a two per cent inflation rate over the medium term. However, 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. For example, the Central Bank of Cyprus, acting proactively, has recently increased the countercyclical buffer to 1% of risk weighted assets for all licensed banks incorporated in Cyprus. The Countercyclical Buffer can work concurrently with monetary policy as it increases the resilience of the banking sector. During periods of stress, when losses materialise, the Central Bank can release this buffer so that the banking sector can support the supply of credit to the economy, thus mitigating the impact of the downturn of the financial cycle. It is worth noting that the Central Bank of Cyprus is one of the five countries in the eurozone that have enacted a positive, cycle neutral countercyclical buffer. 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.

Turning now to another important question, is the ECB monetary policy setting bringing price stability? The recent data on inflation affirms that monetary policy transmission is effective and having an impact on inflation. In addition, the ECB has managed to keep inflation expectations anchored, as most measures of longer-term inflation expectations currently stand at around 2 per cent, which is the inflation target rate. As I mentioned earlier, this is important in order to avoid a wage-price spiral. Although inflation has been reduced relative to 2022, it's still above the 2% target, but some of the transmission of monetary policy decisions that have been made, still remains in progress. Based on the recent ECB macroeconomic projections of September, a continued inflation correction in the euro area is anticipated, with inflation decreasing from 8.4% in 2022, to 5.6% in 2023, and further decreasing to 3.2% in 2024 and 2.1% in 2025.

As regards the inflation outlook in Cyprus, according to the latest CBC projections, also of September 2023, a significant reduction in the inflation rate is expected from 8.1% in 2022 to 3.9% in 2023. This downward trend is anticipated to continue, with inflation decreasing to 2.7% in 2024 and 2.0% in 2025. According to the same projections, the Cyprus economy will continue to exhibit resilience, with the GDP growth rate expected to reach 2,4%, 2.7% and 3.1%, in each year from 2023 to 2025. Unemployment in Cyprus is expected to decrease to 6.3% in 2023 compared to 6.8% in 2022. In the years 2024-25 unemployment is expected at 5.9% and 5.6%, respectively.

Despite the lower inflation readings that I just mentioned, material uncertainty continues to persist for the eurozone. For instance, the recent spike in energy prices could transmit to the rest of the economy again, and have an upward pressure on prices. Furthermore, the elevated wages and profit margins observed in the euro area last year, need to be monitored closely, even though they are currently expected to normalize. Also the liquidity conditions in the euro area banking system can play an important role in the transmission of monetary policy and therefore inflation.

Let me conclude by noting that addressing successfully the current challenges would lower inflation, secure the benefits I referred to earlier, and set the stage for new opportunities in our economies. For instance, an economic environment characterized by stable price and financial conditions, can support the much-needed efforts and investments related to structural reforms. These reforms can be directed to preserve and enhance the competitiveness of our economies, through a transition to a more technologically advanced environment. This can be beneficial to all stakeholders of the economy and all members of society.

Thank you for your attention, and I look forward to the fruitful discussions that this conference will undoubtedly foster.