Geoeconomic tensions and Cyprus: Staying the course amid challenges ahead

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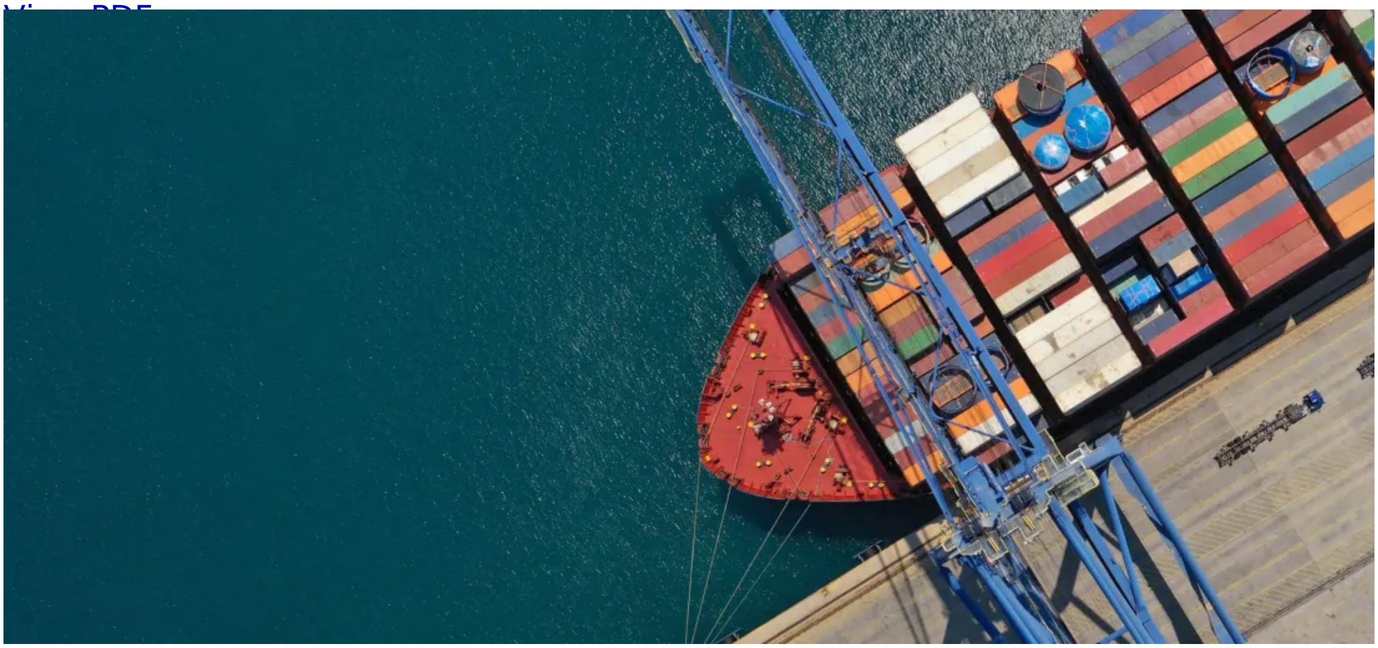

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“Geoeconomic tensions and Cyprus: Staying the course amid challenges ahead”
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Geoeconomic fragmentation, the reversal of progress towards global economic and financial integration due to political and military conflict and strategic policy decisions, is rising. Major shocks such as the global financial crisis and the Covid-19 pandemic exposed the vulnerabilities of an interconnected world.

Tensions between major economies, particularly between the United States (US) and China, have weighed on international trade and cross-border capital flows. Armed conflicts in Ukraine and the Middle East have caused tragic losses of human lives. Economic disruptions in trade routes, supply chains and allocation of resources have brought about higher uncertainty.

Cyprus has been particularly exposed to this uncertainty due to the impact of international sanctions, following the war in Ukraine and its proximity to the conflict in the Middle East.

Risks to our economies and financial stability

The economic costs stemming from geopolitical tensions and geoeconomic fragmentation are evident. Global growth suffers and price pressures emerge. US-China tensions, the predominant global friction, significantly impact global trade, including trade with Europe. As a key player in international trade, this fragmentation has a higher impact on Europe than other regions in the world.

The European Union (EU), the most open among the advanced economies, stands to lose more than others if globalisation reverses and the world economy becomes more fragmented. The losses would stem from higher and more volatile energy costs and changes in supply chains and commercial relationships that disrupt production structures, requiring diversification among enterprises as geopolitical tensions diminish the resilience of supply chains.

This also applies to Cyprus, which as a small open-island economy tends to be more vulnerable to external shocks from geopolitical tensions and geoeconomic fragmentation. Energy and commodity prices in Cyprus have been higher, and trade frictions have lowered global risk appetite, and if risks from geoeconomic fragmentation materialise, they may impact borrowing costs.

Tourism, a key sector of the Cypriot economy, remains subject to risks of sudden reversals due to geopolitical developments. The same can be said about the adverse impact of ongoing geopolitical tensions on foreign investment flows.

Another channel is migration. For Cyprus, a leading asylum-receiving country per capita, further escalation of geopolitical conflicts could raise the cost of an increased influx of migrants and strain the resources of the immigration system.

For Europe and for Cyprus, this increases the importance of European integration and the EU single market, which helps offset external pressures. European solidarity and common responses in the past three crises – the financial crisis, the pandemic, and the energy crisis – have mitigated their impact and made our economies more resilient.

During this period, the single market, the cornerstone of European integration, continued to ensure access to goods and services for close to 450 million consumers and over 30 million firms. As an EU Member State, Cyprus contributed to and benefitted from European integration, European solidarity, and the EU single market.

In view of the new geopolitical and geoeconomic risk, the single market remains too fragmented and should be deepened further. Completing the single market would strengthen Europe's competitiveness as Enrico Letta and Mario Draghi convincingly argued.[1] It would allow Europe overall and Cyprus itself to keep up with global developments in the areas of the green and digital transitions and reinforce their capacity to absorb shocks in the face of growing uncertainty.[2]

Navigating uncertainty: Cyprus's economy and challenges ahead

Cyprus has a good starting position to face the challenges of rising geopolitical tensions and geoeconomic fragmentation. The strong reform efforts over the last decade have benefitted the economy. Cyprus has undertaken crucial reforms to address macroeconomic vulnerabilities and enjoyed a strong economic performance and favourable economic projections.

The country has also been fiscally prudent with public debt expected to decline further, reaching 60% of GDP by the end of 2026. Cypriot banks have substantially de-risked their balance sheets, and so far, asset quality has remained resilient. The banking sector is in its strongest position in a decade with higher interest rates boosting earnings and driving solvency ratios above the euro area average.

Harnessing European integration and solidarity

Despite this favourable economic outlook, Cyprus remains vulnerable in several areas. It would do well to maintain the ongoing reform momentum, address remaining vulnerabilities, and harness the full benefits of European Integration.

This includes accelerating the implementation of the reforms and investments in the green and digital transitions set out in Cyprus's Recovery and Resilience Plan. Cyprus would also benefit from further diversification of its export and energy markets making its economy more agile in view of geoeconomic fragmentation.

Cases in point are the ongoing diversification of tourist markets and products, efforts to introduce a diverse and greener energy mix from different and greener energy sources, further internationalisation of higher education and healthcare services and export manufacturing such as pharmaceuticals.

Our work is not finished. We need to strengthen European integration and the single market, for Cyprus and Europe in general, in view of today's challenges. I have no doubt that Cyprus stands to benefit and can contribute, including when it holds the EU Presidency in 2026.

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[1] Letta, E., Much more than a market, April 2024; Draghi, M., The future of European competitiveness – A competitiveness strategy for Europe, September 2024.

[2] Advancing capital markets union and banking union are part of that and reducing the EU's dependence on external sources of financing needed for defence, welfare, and the transition towards a greener and more digital economy.

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