1. THE EXTERNAL ENVIRONMENT AND THE EURO AREA

During 2023, economic activity in the United States (US) grew at a faster pace than the year before, whereas in the United Kingdom (UK) economic growth slowed down markedly. Unemployment remained practically unchanged both in the United States and in the United Kingdom. Price pressures, though remaining elevated, eased notably. By the end of the year, the annual rate of consumer price inflation fell to 3.4% in the United States and 4.0% in the United Kingdom.

During the year, both the Federal Reserve and the Bank of England raised their key policy rates further on several occasions to address still-high, albeit easing, inflation. Both central banks also continued to unwind the stock of assets held on their balance sheets.

In the euro area, real gross domestic product (GDP) growth slowed down to 0.4% in 2023. Employment continued to increase, though at a slower pace than in the previous year, while the unemployment rate declined slightly further, to 6.5%. Consumer price inflation, measured on the basis of the Harmonised Index of Consumer Prices (HICP), though still high, abated markedly during 2023, with the average for the year as a whole standing at 5.4%, compared to 8.4% in 2022.

During 2023, the ECB continued to tighten its monetary policy stance in the context of elevated, though moderating, inflation. The Governing Council raised the interest rates on the deposit facility, the main refinancing operations (MROs) and the marginal lending facility six times, such that by December these rates stood 200 basis points above their level at the end of 2022.

In February 2023, the Governing Council decided that the Eurosystem's holdings of securities under the APP would decline at an average monthly pace of €15 billion between March and the end of June 2023. APP reinvestments were discontinued as of July 2023. As regards the pandemic emergency purchase programme (PEPP), at its December meeting, the Governing Council expressed its intention to continue with full reinvestments during the first half of 2024. Over the second half of this year, the PEPP portfolio was expected to decline by €7.5 billion per month on average. The Governing Council intended to discontinue reinvestments under the PEPP at the end of 2024.

During 2023, the price of oil declined, amid some notable fluctuations, as supply outpaced subdued demand. Meanwhile, the price of European Natural Gas fell markedly, amid high volatility. Whereas gas supplies remained rather tight, mainly on account of disruptions and the replenishment of inventories, demand continued to decline.

Key advanced economies

US economic growth accelerates

During 2023, the US economy strengthened further, with economic growth expanding at an accelerated pace (see Table 1.1). Fiscal policy supported growth, with the Federal budget deficit widening from 5.3% of GDP in 2022 to 6.2% of GDP in 2023.

Real GDP increased by 2.5% in 2023, up from 1.9% in the previous year. This mainly reflected a notable rise in government expenditure, as against a contraction in 2022, and less negative net exports of goods and services. The latter reflected an increase in exports and a decrease in imports. These factors were partly offset by a slowdown in personal consumer expenditure, mainly reflecting slower growth in spending on services, and a decline in gross private domestic investment, largely on account of decreases in residential investment as

Table 1.1
REAL GDP GROWTH IN SELECTED ADVANCED ECONOMIES
Percentage changes over preceding period

	2018	2019	2020	2021	2022	2023
United States	3.0	2.5	-2.2	5.8	1.9	2.5
Euro area	1.8	1.6	-6.1	5.9	3.4	0.4
United Kingdom	1.4	1.6	-10.4	8.7	4.3	0.1

Sources: Bureau of Economic Analysis, US; Eurostat; Office for National Statistics, UK.

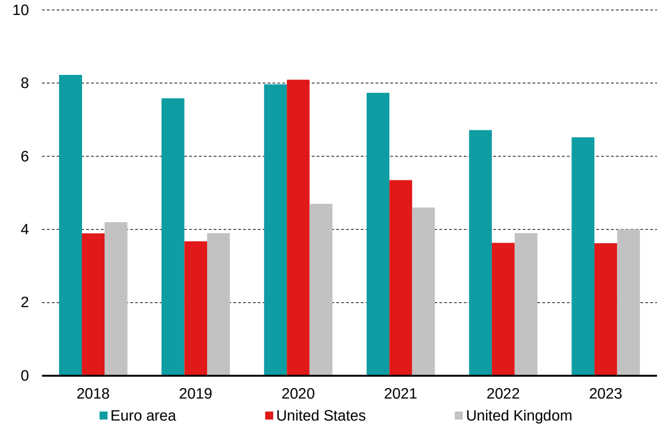
well as inventory investment. Fixed investment rose, but at a slower pace than in 2022.

Economic growth in the United States was underpinned by a robust labour market. Employment rose by 1.7% on average during the year, after having increased by 3.7% in 2022.

Non-farm payroll data suggest that during 2023 employment was higher across all main economic sectors, with the strongest level increases recorded in the education and health and leisure and hospitality sectors as well as government. The labour force participation rate edged up, averaging 62.6% in 2023, compared to 62.2% a year earlier. Meanwhile, the unemployment rate averaged 3.6% in 2023, unchanged from 2022 (see Chart 1.1).

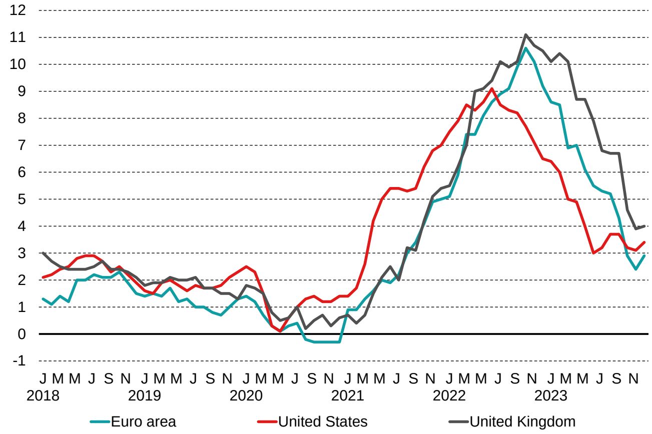
Inflationary pressures declined significantly during 2023, with the annual inflation rate based on the consumer price index (CPI) broadly halving to 4.1% from 8.0% in 2022. Inflation fell to 3.4% in December, from 6.5% a year earlier (see Chart 1.2). US inflation fell consistently to 3.0% in June and subsequently it fluctuated in a relatively narrow range.

Chart 1.1
UNEMPLOYMENT RATE
(percentage of the labour force; seasonally adjusted)



Sources: Eurostat; US Bureau of Labor Statistics; Office for National Statistics, UK.

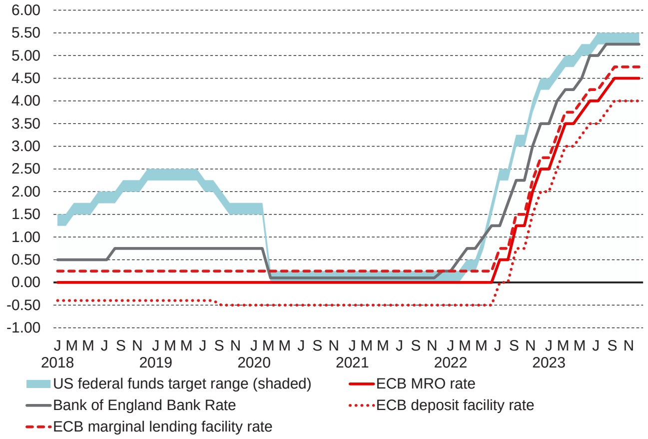
Chart 1.2
CONSUMER PRICE INFLATION
(annual percentage changes)



Sources: Bureau of Labor Statistics, US; Eurostat; Office for National Statistics, UK.

The decline in inflation reflected mainly lower energy prices, coupled with lower increases in the other major components. Annual energy price inflation turned negative in March and continued to follow a negative trend through the remainder of the year, with the decline being especially pronounced between May and July. Energy price inflation ended the year at -2.0%, in contrast with 7.3% in December 2022. Food price inflation rose at a substantially slower pace during the year when compared to the previous year. It eased to 2.7% in December 2023 from 10.1% a year earlier. The rest of the components of inflation also rose at slower rates. Services inflation decreased to 5.0% in December 2023, while prices of commodities excluding food and energy grew at an annual rate of 0.2%, as against 7.5% and 2.1%, respectively a year earlier. As a result, inflation excluding food and energy slowed down to 3.9% at the end of 2023, from 5.7% in December 2022.

Chart 1.3
OFFICIAL INTEREST RATES
(percentages per annum; end of month)



Sources: ECB; Federal Reserve; Bank of England.

As regards monetary policy, the Federal Open Market Committee (FOMC) continued to raise the target range for the federal funds rate during 2023 to attain a stance of monetary policy that would be sufficiently restrictive to return inflation to 2.0% over time (see Chart 1.3). To this effect, the FOMC increased the target range four times between February and July so that, by the end of 2023, it stood between 5.25-5.50%, up from 4.25-4.50% at the end of 2022. The FOMC expressed its preparedness to adjust the stance of monetary policy as appropriate if risks emerged that could impede the attainment of its dual inflation and employment mandate.[1] Moreover, throughout the year, the Committee continued to reduce its holdings of Treasury securities and agency debt and agency mortgage-backed securities.

UK economic growth slows down markedly

During 2023, the UK economy stagnated, with real GDP growing by just 0.1%, down from 4.3% in 2022 (see Table 1.1). Growth recorded in the first quarter of the year was almost offset by contractions in economic activity registered consecutively in the third and fourth quarters. The rate of expansion in 2023 was the weakest since 2020, which was affected by the COVID-19 pandemic. Expenditures by households and non-profit institutions increased at a markedly slower pace as elevated price pressures and tight financial conditions weighed on consumption. Government consumption also grew less rapidly than in the year before. Nevertheless, UK general government net borrowing is estimated to have increased in 2023. Similarly, business investment, including inventories, increased at a much slower pace. On the other hand, the trade deficit narrowed, as the decline in imports exceeded that in exports.

In 2023, payrolled employees in the United Kingdom rose by 0.7%, a slower rate of increase than the 1.3% recorded a year earlier. The employment rate stood at 75.1%, on average, same as in 2022. The unemployment rate averaged 4.0%, slightly up from 3.9% a year earlier (see Chart 1.1).

After having reached new highs towards the end of 2022, consumer price inflation in the United Kingdom abated steadily during 2023, driven by the energy component, although inflationary pressures remained elevated. Thus, annual inflation, based on the CPI averaged 7.2%, from 9.1% in 2022. It declined to 4.0% in December 2023, from 10.5% in December 2022 (see Chart 1.2). Annual energy inflation fell consistently from a historical high of 59.0% in October 2022, turning negative in July 2023 and ending the year at -17.3%. Inflation eased across all the other major components during 2023, albeit to various extents, but remained positive. The annual rate of change of prices for food, alcoholic beverages and tobacco declined in December, though, it remained high at 9.3%. Services inflation eased marginally, ending the year at 6.4%, while non-energy industrial goods (NEIG) inflation dropped to 3.1%. The annual rate of inflation

[1] In its meeting held on 30-31January 2024, the Committee kept both the target range for the federal funds rate and the pace of quantitative tightening unchanged. The FOMC dropped its tightening bias in favour of a more neutral stance, as it stated the risks to achieving its goals were "moving into better balance". However, the Committee added it needed to gain "greater confidence" that inflation was moving sustainably towards 2% before it could cut rates.

based on the CPI excluding energy, food, alcoholic beverages and tobacco, declined to 5.1% in December 2023 from 6.3% a year earlier.

In the context of a persistently tight labour market, stronger-than-expected employment growth and evidence of heightened domestic inflationary pressures, the Bank of England's Monetary Policy Committee (MPC) continued to increase its Bank Rate, and did so five times during the year, with the last rise coming in August. Against the background of mixed developments in key indicators of inflation persistence, the MPC kept the Bank Rate unchanged in the later months of the year. Hence, the Bank Rate ended 2023 at 5.25% (see Chart 1.3). However, the MPC stated that monetary policy would need to be sufficiently restrictive for sufficiently long to return CPI inflation to the 2% target sustainably in the medium term.

In September, the Committee agreed that the Bank of England should reduce the stock of UK government bond purchases held for monetary policy purposes, and financed by the issuance of central bank reserves, by GBP 100 billion over the period from October 2023 to September 2024, to a total of GBP 658 billion.[2]

Economic and financial developments in the euro area

Euro area GDP growth slows down sharply[3]

Real GDP growth in the euro area slowed down to 0.4% in 2023, compared to 3.4% in 2022 (see Table 1.2). After having expanded marginally in quarter-on-quarter terms during the first half of 2023, economic activity contracted slightly in the second half of the year. The slowdown in economic growth over the year as a whole occurred mainly on the back of muted domestic demand, largely reflecting subdued consumer and business confidence, elevated inflationary pressures that lowered real disposable income, and tighter financing and credit supply conditions. Both imports and exports declined, with the latter reflecting sluggish global demand and exchange-rate developments.

Table 1.2
REAL GDP GROWTH IN THE EURO AREA
Chain-linked volumes

	2018	2019	2020	2021	2022	2023
			Annual percentage changes			
Private consumption	1.5	1.4	-7.7	4.4	4.2	0.5
Government consumption	1.0	1.8	1.0	4.2	1.6	0.7
Gross fixed capital formation	3.1	6.9	-5.9	3.5	2.5	1.1
Exports	3.6	3.2	-9.1	11.5	7.2	-1.1
Imports	3.9	5.0	-8.5	9.2	7.9	-1.6
GDP	**1.8**	**1.6**	**-6.1**	**5.9**	**3.4**	**0.4**
			Percentage point contributions			
Private consumption	0.8	0.7	-4.1	2.3	2.1	0.3
Government consumption	0.2	0.4	0.2	0.9	0.3	0.2
Gross fixed capital formation	0.7	1.4	-1.3	0.8	0.5	0.3
Changes in inventories(1)	0.1	-0.3	-0.3	0.6	0.4	-0.5
Exports	1.7	1.5	-4.4	5.2	3.6	-0.6
Imports	-1.7	-2.2	3.8	-3.9	-3.6	0.9
GDP	**1.8**	**1.6**	**-6.1**	**5.9**	**3.4**	**0.4**

Source: Eurostat.

[2] In its meeting ending on 31 January 2024, the MPC kept the Bank Rate unchanged. The MPC removed its tightening bias, due to positive news on inflation, and now it stated that it would "keep under review" how long the Bank Rate should be held at the current level. The MPC added it needed to see more evidence that inflation would return sustainably to 2% before it could cut rates.
[3] The cut-off date for data on euro area GDP and the labour market in this chapter is 8 March 2024.

The marginal growth in real GDP largely reflected a modest rise in domestic demand and net exports of goods and services, which turned positive in 2023. As regards domestic demand components, gross fixed capital formation (GFCF) and private consumption rose by 1.1% and 0.5%, respectively, over the previous year and contributed 0.3 percentage point each to GDP growth. Also, government consumption expenditure increased by 0.7% and contributed 0.2 percentage point to economic growth. Meanwhile, net exports added 0.3 percentage point to GDP growth, as a 1.1% drop in exports was outweighed by a 1.6% decline in imports. By contrast, a drawdown in inventories exerted a negative impact on GDP growth during 2023.

From a sectoral perspective, activity expanded in most economic sectors during 2023, although contributions to overall growth were smaller than the year before. This applies particularly to wholesale and retail trade, transport, accommodation and food service activities. Meanwhile, the industrial sector registered a contraction in activity.

Labour market conditions remain strong

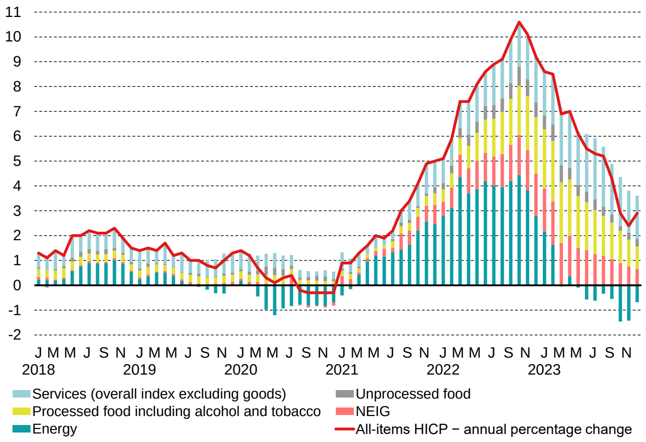
Labour market conditions in the euro area remained robust during the year under review, with employment increasing by 1.4% in 2023, compared to 2.3% in 2022. Meanwhile, unemployment declined slightly further throughout 2023, with the seasonally-adjusted unemployment rate averaging 6.5% during the year, down from 6.7% in 2022 (see Chart 1.1). In December 2023, the unemployment rate stood at 6.5% as against 6.7% a year earlier. Buoyant labour market conditions attracted a strong inflow of persons, including migrants and those previously inactive, to joining the labour force. The drop in the unemployment rate also partly reflected labour hoarding as economic activity was subdued.

HICP inflation, though still elevated, eases notably

The annual rate of HICP inflation in the euro area, though still high, abated markedly during 2023, with the average for the year as a whole standing at 5.4%, compared to 8.4% in 2022. This decrease mainly reflected a sustained decline in energy inflation, which fell to an average of -2.0% as against a rise of 36.9% in 2022, partly reflecting developments in commodity markets, as well as downward base effects. As a result, the contribution of energy to overall inflation fell to -0.1 percentage point in contrast to a rise of 3.8 percentage points in the previous year. Unprocessed food inflation decelerated to 9.1% on average in 2023, from 10.4% the year before, with its contribution to overall inflation easing slightly. On the other hand, the other major components of inflation rose further and at slightly faster rates, during 2023. Processed food (including alcohol and tobacco) inflation rose to 11.6%, on average, while NEIG inflation went up to 5.0% and services inflation rose to 4.9%, on average. Consequently, the processed food contribution to overall inflation increased to 1.8 percentage points, from 1.4 percentage points a year before, while services contributed 2.1 percentage points to overall inflation, up from 1.5 percentage points in 2022. The contribution of NEIG to overall inflation went up marginally to 1.3 percentage points.

However, inflationary pressures eased almost consistently as the year progressed, with the annual rate of HICP inflation falling to 2.9% in December 2023 from 9.2% a year earlier (see Chart 1.4). In the early months of the year, the gradual pass-through of past cost increases continued to exert an upward impact on inflation, but thereafter this factor faded out partly also as the sustained tightening of the monetary policy stance

Chart 1.4
CONTRIBUTIONS TO HICP INFLATION IN THE EURO AREA
(percentage points; annual percentage change)



Source: ECB.

dampened demand. Nonetheless, domestic price pressures remained considerable, also reflecting rising wages, though these were to an extent absorbed by previous increases in profit margins, thus averting a wage-price spiral.

HICP inflation excluding energy and food averaged 5.0% during 2023, 1.0 percentage point higher than that recorded in 2022, though this measure of inflation moderated as the year progressed. It peaked at 5.7% in March and then embarked on a general downward trend, falling to 3.4% in December.

ECB projects a gradual recovery in economic activity, while inflation is set to decline further

According to the ECB staff macroeconomic projections published in March 2024, real GDP growth in the euro area is expected to increase marginally to 0.6% in 2024, before rising further to 1.5% and 1.6% in 2025 and 2026, respectively (see Table 1.3).[4] Economic activity is expected to remain sluggish in early 2024 as tight financing conditions and high consumer uncertainty continue to exert an adverse impact on growth. Nevertheless, in the first half of this year, falling inflation and strong wage growth are expected to bolster households' purchasing power, boosting private consumption. This, together with higher government consumption, is expected to bring about slightly higher economic growth in the second half of 2024. Over the medium term, real economic growth is expected to stabilise at rates that modestly exceed potential growth as inflation slows down and income growth remains strong. Although the negative impact of tight monetary policy on financing conditions and on economic growth is initially strong, it is expected to begin to gradually fade in 2024. ECB staff estimate that the fiscal stance tightened during 2023, with the general government budget deficit narrowing to 3.2% of GDP. The deficit is expected to narrow further, and the withdrawal of energy and inflation compensatory fiscal support measures should have a small negative impact on economic growth over the projection horizon.

Compared to the December 2023 projections, real GDP growth has been revised downwards by 0.2 percentage point for 2024. Growth projections remained unchanged for 2025 and were revised upwards by 0.1 percentage point for 2026. The revision for 2024 mainly reflects downward revisions to investment and private consumption, which outweighed a positive revision to the external trade balance and an upward revision to government consumption. By contrast, small upward revisions to private consumption and investment led to an upward revision to GDP growth outlook for 2026.

Turning to the outlook for prices, according to the March 2024 projections, headline HICP inflation is envisaged to decline to 2.3% in 2024, and ease further to 2.0% and 1.9% in 2025 and 2026, respectively. Energy

Table 1.3
MACROECONOMIC PROJECTIONS FOR THE EURO AREA[(1)]
Annual percentage changes

	2022	2023	2024	2025	2026
GDP	**3.4**	**0.5**	**0.6**	**1.5**	**1.6**
Private consumption	4.2	0.5	1.2	1.6	1.5
Government consumption	1.6	0.2	1.3	1.4	1.2
GFCF	2.8	0.8	-0.6	1.6	2.3
Exports	7.4	-0.7	1.0	2.9	3.2
Imports	8.1	-1.3	1.0	3.1	3.2
HICP	**8.4**	**5.4**	**2.3**	**2.0**	**1.9**
HICP excluding energy and food	3.9	4.9	2.6	2.1	2.0

Source: ECB.

[(1)] ECB staff macroeconomic projections (March 2024).

[4] Figures for 2022 and 2023 may differ from those reported in Table 1.2 due to an earlier cut-off date for the ECB staff projections.

inflation is expected to rebound by end 2024 mainly on account of three factors: upward base effects, the unwinding of government energy compensation schemes and measures related to climate change. Subsequently, however, HICP energy inflation is expected to ease to around 0.5% in 2025 and 2026 in a context characterised by modestly downward sloping energy commodity futures prices. Food inflation is expected to fall markedly in 2024, as the impact from earlier input cost increases will likely ease and stabilise at a somewhat slightly elevated level in 2025 and 2026. Similarly to headline inflation, HICP inflation excluding energy and food is expected to decline further over the projection horizon albeit at a more measured pace than in the recent past. Whereas pipeline pressures continue to decline, high labour cost pressures are expected to gradually impact underlying inflation.

Compared to the December 2023 projections, HICP inflation has been revised downwards by 0.4 percentage point for 2024 and 0.1 percentage point for 2025 but was unrevised for 2026. The downward revision for 2024 largely reflects developments in energy prices. As regards 2026, upward revisions to energy inflation offset downward revisions to food and HICP inflation excluding food and energy, resulting in an unrevised headline inflation projection. Meanwhile, HICP inflation excluding food and energy was revised downwards across the horizon. This mainly reflects indirect effects from lower energy prices as well as the weaker growth outlook and lower growth in unit labour costs (ULCs).

ECB raises key interest rates further

The ECB's Governing Council tightened further its monetary policy stance in 2023 amid heightened inflationary pressures. Thus, the Council raised policy rates six times during the year, so that the interest rates on the deposit facility, the MRO and the MLF ended 2023 at 4.00%, 4.50% and 4.75%, respectively, compared to 2.00%, 2.50% and 2.75% at the end of 2022 (see Chart 1.3 and Box 1). The Council continued to follow a data-dependent approach in determining the appropriate level and duration of a restrictive monetary policy.[5]

[5] On 25 January 2024, the Governing Council kept the three key ECB interest rates unchanged. The Council expressed its determination to ensure that inflation would return to its 2% medium-term target in a timely manner. The Council reiterated it would continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. Regarding refinancing operations, as banks were repaying the amounts borrowed under the targeted longer-term refinancing operations (TLTRO III), the Governing Council would regularly assess how these operations and their ongoing repayment were contributing to its monetary policy stance.

BOX 1: CHRONOLOGY OF ECB MONETARY POLICY DECISIONS IN 2023

2 February

Against the background of persistently elevated inflationary pressures, the Governing Council of the ECB decided to raise the three key interest rates further, by 50 basis points. Accordingly, the interest rate on the deposit facility was raised to 2.50%, while the interest rates on the MROs and the marginal lending facility were raised to 3.00% and 3.25%, respectively. In view of underlying inflationary pressures, the Governing Council announced its intention to raise rates further in March 2023, but reiterated that its future policy rate decisions would continue to be data-dependent and follow a meeting-by-meeting approach.

The Governing Council also decided on the modalities for reducing the Eurosystem's holdings of securities under the APP. More specifically, the Governing Council restated that these holdings would decline at an average monthly pace of €15 billion between March and the end of June 2023. The subsequent pace of portfolio reduction will be determined over time.

As regards the PEPP, the Governing Council reiterated its intention to reinvest the principal payments from maturing securities purchased under the programme until at least the end of 2024. The future roll-off of the PEPP portfolio would be managed to avoid interference with the appropriate monetary policy stance. Redemptions coming due in the PEPP portfolio were being reinvested flexibly, to counter risks of fragmentation in the monetary policy transmission mechanism.

As to refinancing operations, the Governing Council stated that since banks were repaying the amounts borrowed under TLTRO III, it would regularly assess how targeted lending operations were contributing to its monetary policy stance.

The Governing Council reaffirmed that it stood ready to adjust all of its instruments within its mandate to ensure that inflation returned to its 2% target over the medium term. It recalled that the Transmission Protection Instrument was available to ensure that the monetary policy stance was transmitted smoothly across all euro area countries. This would allow the Governing Council to more effectively deliver on its price stability mandate.

16 March

The Governing Council decided to raise the three policy interest rates by an additional 50 basis points so that the interest rates on the deposit facility, the MROs and the marginal lending facility reached 3.00%, 3.50% and 3.75%, respectively.

In view of the recent emergence of market tensions triggered by bank failures in the United States, the Governing Council stated that it was monitoring the situation closely and stood ready to respond as necessary to preserve price stability and financial stability in the euro area.

4 May

In light of the ongoing high inflation pressures, the Governing Council decided to raise the three key ECB interest rates by 25 basis points. Thus, the interest rates on the deposit facility, the MROs and the marginal lending facility went up to 3.25%, 3.75% and 4.00%, respectively.

Regarding the APP portfolio, the Governing Council said that it expected to discontinue the reinvestments as of July 2023.

15 June

The Governing Council considered that although inflation was declining, it was projected to remain too high for too long. Accordingly, the Governing Council decided to hike the three policy interest rates by an additional 25 basis points. Hence, the interest rates on the deposit facility, the MROs and the marginal lending facility were raised to 3.50%, 4.00% and 4.25%, respectively.

The rate increase reflected the Governing Council's updated assessment of the inflation outlook, the dynamics of underlying inflation, and the strength of monetary policy transmission.

The Governing Council observed that its past rate increases were being transmitted forcefully to financing conditions and were gradually having an impact across the economy.

Regarding the APP, the Governing Council reiterated that it would discontinue reinvestments under this programme as of July 2023.

27 July

The Governing Council decided to raise the three key ECB interest rates by 25 basis points. Thus, the interest rates on the deposit facility, the MROs and the marginal lending facility reached 3.75%, 4.25% and 4.50%, respectively.

The Governing Council also decided to set the remuneration of minimum reserves at 0% with effect from the beginning of the reserve maintenance period starting on 20 September 2023.

14 September

Although inflation continued to decline, it was still expected to remain too high for too long. Accordingly, the Governing Council decided to hike the three policy interest rates by an additional 25 basis points so that the interest rates on the deposit facility, the MROs and the marginal lending facility were increased to 4.00%, 4.50% and 4.75%, respectively.

The Governing Council considered that the key ECB interest rates reached levels that, maintained for a sufficiently long duration, would make a substantial contribution to the timely return of inflation to the target.

26 October

The Governing Council decided to keep the three key ECB interest rates unchanged and stated that its future decisions would ensure that policy rates would be set at sufficiently restrictive levels for as long as necessary.

Inflation was still expected to stay too high for too long, and domestic price pressures remained strong. Meanwhile, inflation fell notably in September, and most measures of underlying inflation had continued to ease. The Governing Council's past interest rate increases continued to be transmitted forcefully into financing conditions. This was increasingly dampening credit demand and thereby helping to push down inflation.

14 December

The Governing Council decided to keep the three key ECB interest rates unchanged. While inflation had dropped in recent months, it was likely to pick up again temporarily in the near term. Although underlying inflation had eased further, domestic price pressures remained elevated, primarily owing to strong growth in ULCs.

The Governing Council said that it would continue to follow a data-dependent approach in determining the appropriate level and duration of a restrictive monetary policy stance.

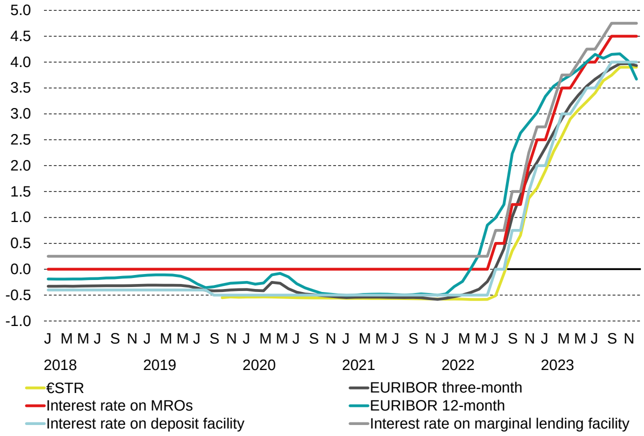
The Governing Council also announced further steps in the normalisation of the Eurosystem balance sheet. It stated that it intended to continue to reinvest, in full, the principal payments from maturing securities purchased under the PEPP during the first half of 2024. Over the second half of that year, the PEPP portfolio was expected to decline by €7.5 billion per month on average. The Governing Council intended to discontinue reinvestments under the PEPP at the end of 2024.

Money market rates continue to rise

In the context of the ECB's further tightening of its monetary policy stance and indications that future decisions on policy rates would continue to follow a data-dependent approach, money market rates in the euro area rose further in 2023. Nevertheless, most rates increased at a slower pace when compared to 2022. The euro short-term rate (€STR) stood at 1.57%, on average, in December 2022 and continued to increase consistently until October 2023, reflecting changes in the key ECB interest rates. Subsequently, it remained largely unchanged, and averaged 3.90% in December.[6] It remained slightly below the interest rate on the ECB's deposit facility throughout the year.

The three-month Euro Interbank Offered Rate (EURIBOR) averaged 2.07% in December 2022 and continued to rise incrementally until November, when it reached 3.97%. Subsequently, it fell marginally and averaged 3.93% in December. The 12-month EURIBOR rose from 3.03% to 4.15% between December 2022 and July 2023. It declined towards the end of the year, possibly because market players considered that the interest rate hiking cycle had peaked, and it averaged 3.67% in December (see Chart 1.5).[7]

Chart 1.5
KEY MONEY MARKET INTEREST RATES
(percentages per annum; market rates − monthly averages; ECB rates − end of month)

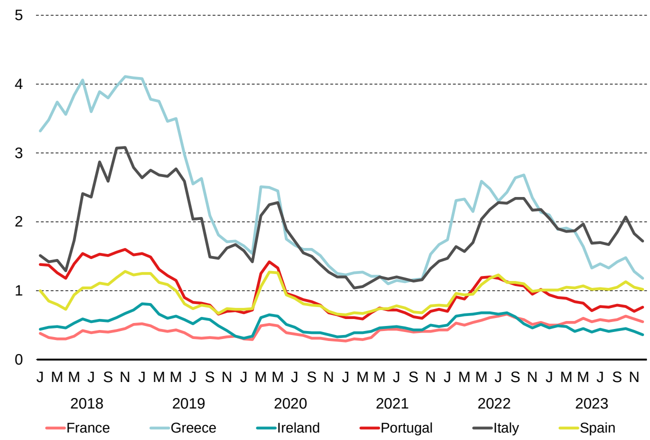


Source: ECB.

Euro area bond yields fall slightly

After having risen notably in 2022, the ten-year benchmark government bond yield in the euro area increased further during 2023, peaking in October. This occurred against the background of still high inflationary pressures. However, the ten-year benchmark government bond yield subsequently decreased amid market sentiment that the tightening phase of the monetary policy cycle had probably reached an end. Overall, the euro area ten-year benchmark government bond yield fell from 3.00% at end-December 2022 to 2.87% one year later.

Chart 1.6
SELECTED EURO AREA GOVERNMENT BOND YIELD SPREADS
(difference vis-à-vis German ten-year government bond yields in percentage points)



Source: ECB.

Whereas some government bond yields in the euro area rose modestly during 2023, most sovereign bond yields fell. German ten-year bond yields rose incrementally until October 2023 but fell in the last two months of the year. Thus, they stood at 2.10% in December or just 2 basis points higher than twelve months before. French and Spanish bond yields went up by 3 basis points to average 2.65% and

[6] The €STR is a reference rate based on money market data collected by the Eurosystem, reflecting the wholesale euro unsecured overnight borrowing costs of banks located in the euro area.

[7] The EURIBOR is an interest rate benchmark indicating the average rate at which principal European banks lend unsecured funds on the interbank market in euro for a given period.

3.12%, respectively, in December. Slovak yields recorded the highest increase among the sovereign bonds in the euro area, as they rose by 11 basis points to 3.31%. Most other euro-area government bond yields fell, the most prominent of which being those on Cypriot, Greek and Italian bonds, which went down by 97 basis points, 94 basis points and 44 basis points, averaging 3.23%, 3.28% and 3.82%, respectively, in December.

Consequently, spreads between yields on ten-year German bonds and those on similar bonds issued by most other euro area sovereigns narrowed over the year (see Chart 1.6). By the end of 2023, spreads on Cyprus and Greek bonds narrowed by nearly 100 basis points while those on Italian bonds declined by 46 basis points. The narrowing of spreads was more contained in Portugal and Ireland. By contrast, yield spreads of Slovak sovereign bonds widened, as did those of French and Spanish bonds, albeit marginally.

The euro appreciates versus the US dollar but weakens against the British pound

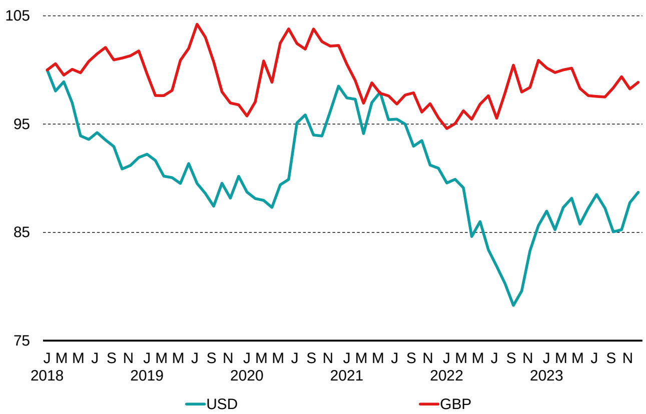
The euro exchange rate appreciated in nominal effective terms during 2023, with the NEER-18 gaining 1.7% from its end-2022 level.[8] This exceeded an appreciation of 0.2% in 2022. The increase in the external value of the euro during 2023 mainly reflected the tightening of the monetary policy stance in the euro area and indications that the ECB was not about to cut policy rates soon.

On a bilateral basis, the euro gained 3.6% against the US dollar in 2023, which contrasts with a 5.8% loss recorded the previous year (see Chart 1.7). The euro appreciated further versus the US currency during the first half of the year, peaking in July. This mainly occurred in the context of narrowing interest-rate differentials between the euro area and the United States. Subsequently, however, the euro fell versus the US currency mainly on indications of a global economic downturn and the strong economic growth prospects for the United States relative to the weak outlook for the euro area. Nevertheless, in the later months of the year, the single currency rebounded against the US dollar largely on the back of ongoing Fed rate cut expectations as inflation pressures abated, positive risk appetite, and signs that the ECB would keep its tight monetary policy stance for longer.

Over the year as a whole, the euro recorded gains against several other currencies, including the Japanese yen, the Chinese renminbi, the Australian dollar, the Canadian dollar, the Swedish krona and, to a lesser extent, the Romanian leu, the Czech koruna and the Danish krone.

By contrast, the euro fell by 2.0% against the pound sterling in 2023, as against an appreciation of 5.6% the year before. The euro fell slightly versus the pound sterling during the first quarter, as the pound benefitted from indications that UK's political outlook had stabilised and weakened noticeably in the second quarter. However, in the second half of the year, the euro partly reversed its losses against the pound, which was undermined by renewed signs of weakness in the UK economy. In 2023, the single currency also weakened versus the Polish zloty, the Hungarian forint, and the Swiss franc.

Chart 1.7
EXCHANGE RATE MOVEMENTS OF THE EURO AGAINST OTHER MAJOR CURRENCIES
(index of end of month rates; Jan. 2018=100; an increase in the index implies euro appreciation)



Source: Eurostat.

8 The nominal effective exchange rate (NEER) is based on the weighted averages of the euro exchange rate against the currencies of Australia, Bulgaria, Canada, China, Czech Republic, Denmark, Hong Kong, Hungary, Japan, Norway, Poland, Romania, Singapore, South Korea, Sweden, Switzerland, the United Kingdom and the United States.

Commodities

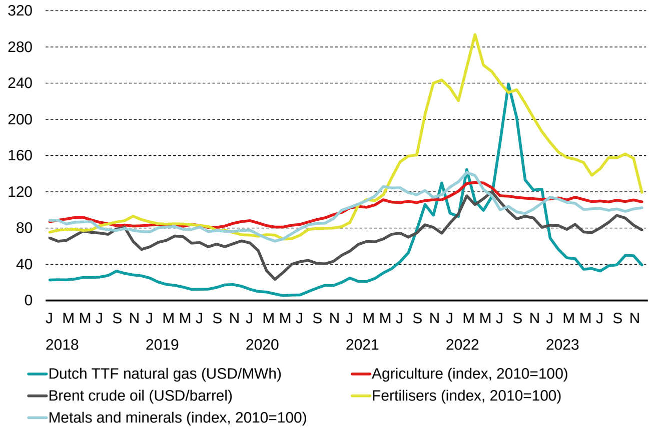
Commodity prices end the year lower

At the beginning of 2023, oil prices continued to follow a downward path, as supply increased markedly whereas global demand remained muted. This dynamic was reinforced in the second quarter, as low demand, especially in advanced economies, outpaced supply cuts from some OPEC+ countries. Subsequently, however, oil prices rebounded, reflecting an upswing in demand and a marked reduction in supply particularly by OPEC+ countries. Nevertheless, oil prices resumed their declining trend in the later months of the year as an increase in non-OPEC+ supply coincided with slowing growth in global oil demand. The announcement that OPEC+ output cuts would be extended into the first quarter of 2024 failed to halt the decline in oil prices. The price of Brent crude oil ended 2023 at USD 77.9 per barrel, 3.8% below the level prevailing at the end of 2022 (see Chart 1.8).

The price of European natural gas started 2023 on a marked downward trend, which continued almost uninterruptedly until around mid-year. A milder-than-normal winter, gas savings measures, a reinforced shift towards liquefied natural gas imports and healthy inventory levels in the European Union exerted downward pressure on the price of European natural gas. Following some fluctuations, reflecting high volatility amid supply disruptions and broadly flat demand, the price of European natural gas resumed its decline towards the end of the year, mainly in the context of high storage levels in the European Union. The price of Dutch TTF natural gas averaged USD 39.3 per megawatt hour in December 2023, 68.1% lower than the year before.

Non-energy commodity prices fell during 2023, with World Bank data showing a decrease of 5.1%. The drop mainly reflected lower prices for fertilisers, which were down by over a third, and, to a lesser extent, agricultural products, metals and minerals.

Chart 1.8
COMMODITY PRICES
(monthly averages)



Source: World Bank.