ECONOMIC SURVEY

1. THE EXTERNAL ENVIRONMENT AND THE EURO AREA

In the fourth quarter of 2022, real GDP grew at a slower pace in the United States, while in the United Kingdom a mild expansion followed the contraction recorded in the preceding quarter. In the euro area, real GDP growth stood at -0.1% on a quarter-on-quarter basis, down from 0.4% in the third quarter. During the quarter, the unemployment rate remained broadly unchanged in all three economies.

While still high from a historical perspective, consumer price inflation eased somewhat in the euro area and the United States, but rose further in the United Kingdom. Annual consumer price inflation in the euro area declined to 9.2% in December, from 9.9% in September. Meanwhile in the United States, inflation fell to 6.5%, from 8.2% in September. On the other hand, in the United Kingdom, inflation rose further to 10.5%, from 10.1% in September. To address the elevated price pressures, during the quarter under review, the Federal Reserve, the Bank of England and the ECB raised their key interest rates.

During the quarter, the Fed continued to reduce its holdings of Treasury securities and agency debt and agency mortgage-backed securities. Meanwhile, the Bank of England began to conduct sales of UK government bonds held for monetary policy purposes. It also continued to unwind the stock of sterling non-financial investment-grade corporate bonds. The ECB also raised its policy rates further. While it continued to reinvest securities maturing under the APP and the PEPP, in December, the ECB announced that from March 2023, the Eurosystem will not reinvest all of the principal payments from maturing securities under the APP. The ECB also changed the terms and conditions on TLTRO-III.

Brent oil prices ended the quarter at a lower level as the downward pressure on oil prices related to lower demand for oil, outweighed concerns around supplies.On the other hand, in the December quarter, non-energy commodity prices rose marginally compared with the previous quarter, as higher prices of metals and minerals offset falls in the prices of agriculture products and fertilisers.

Key advanced economies

US economic growth decelerates

In the United States, real GDP grew at a slower pace in the fourth quarter of 2022, rising at a quarterly rate of 0.6%, following an increase of 0.8% in the preceding quarter (see Table 1.1).

Table 1.1
REAL GDP GROWTH IN SELECTED ADVANCED ECONOMIES
Quarter-on-quarter percentage changes; seasonally and working day adjusted

	2020	2021				2022			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
United States	1.0	1.5	1.7	0.7	1.7	-0.4	-0.1	0.8	0.6
Euro area	-0.3	0.0	2.0	2.3	0.6	0.6	0.9	0.4	-0.1
United Kingdom	1.2	-1.1	6.5	1.7	1.5	0.5	0.1	-0.1	0.1

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

Personal consumption expenditure grew at a slower pace. Meanwhile, gross private domestic investment partly recovered from the declines recorded in the previous two quarters, while government expendture grew at the same rate as in the previous quarter. The trade deficit narrowed, as imports declined at a faster rate than exports.

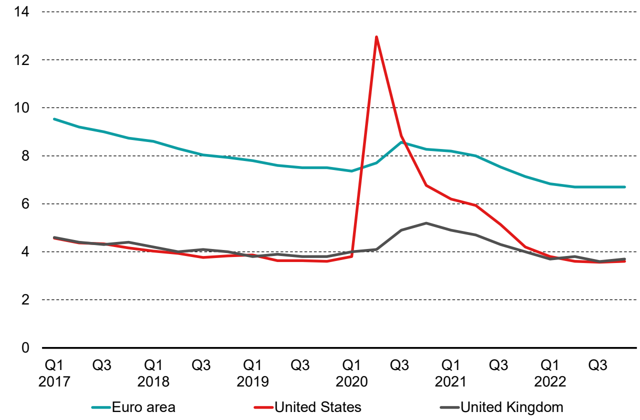
In the labour market, the participation rate averaged 62.2% in the fourth quarter, unchanged when compared with the two preceding quarters, but above the rate of 61.9% recorded in the final quarter of 2021. Meanwhile, employment increased by just 0.1% in quarter-on-quarter terms, after having risen by 0.3% in the third quarter.

Non-farm payroll data suggest that compared with the preceding quarter, the pace of job creation slowed down in most sectors, with the exception of the leisure and hospitality sector, and the financial sector. Employment growth in these two sectors was unchanged compared with the third quarter.

At 3.6%, the average unemployment rate was still relatively low, and was 0.1 percentage point lower compared with the third quarter. It was also at par with pre-pandemic rates (see Chart 1.1).

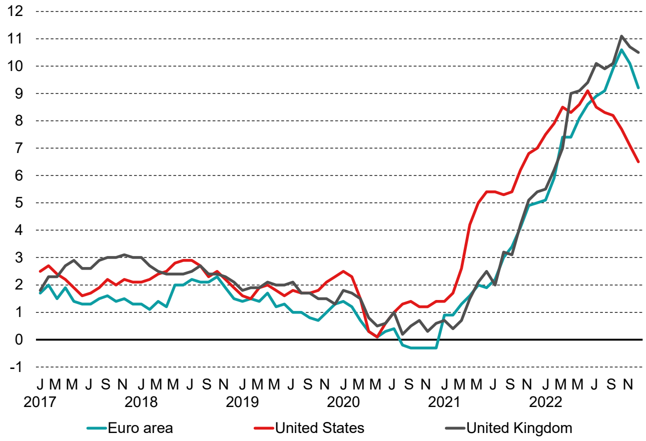
Inflationary pressures remained high from a historical perspective, but showed signs of moderation compared with the previous quarters. In fact, the annual inflation based on the consumer price index (CPI) stood at 6.5% in December, down from 8.2% three months earlier (see Chart 1.2). This decline was mainly driven by energy inflation, which fell to 7.3% in December from 19.8% in September. Meanwhile, food inflation eased to 10.4% from 11.2% in September. Prices of commodities, excluding food and energy, also rose less rapidly than in September, while services inflation was broadly unchanged. Inflation excluding food and energy declined to 5.7% in December, from the recent peak of 6.6% in September 2022.

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



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

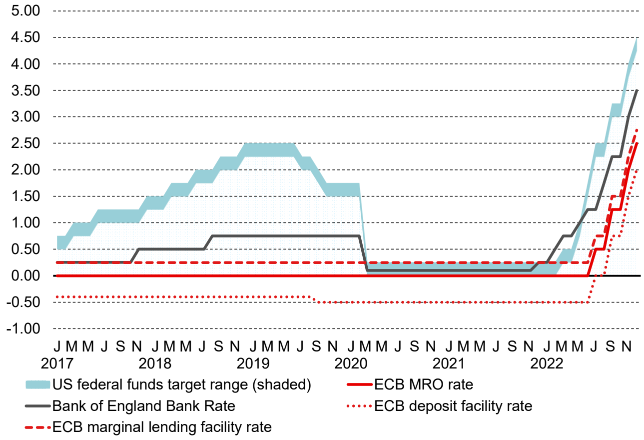
Chart 1.2
CONSUMER PRICE INFLATION
(annual percentage changes)



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

During the fourth quarter of 2022, the Federal Open Market Committee (FOMC) increased the target range for the federal funds rate on two occasions. In November, the target range was raised by 75 basis points. A further 50 basis points increase followed in December, bringing the rate to the highest level in 15 years. By the end of December, the target range stood between 4.25% and 4.50% (see Chart 1.3).

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



Sources: ECB; Federal Reserve; Bank of England.

The Committee remained committed in achieving its goals of maximum employment, and an inflation rate of 2.0% over the longer run. The Committee anticipated that further increases in the target range would be appropriate. In determining the pace of future increases, the Committee would consider the cumulative tightening of monetary policy, its lagged transmission to activity and inflation, and economic and financial developments.

In addition, the Committee said that it would continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, and reiterated that it remained strongly committed to returning inflation to its 2.0% objective.[1]

UK economy grows moderately

Real GDP in the United Kingdom increased at a quarterly rate of 0.1% in the fourth quarter, after recording a decline of 0.1% in the third (see Table 1.1). This mainly reflected an increase in the contribution of changes in inventories, although a recovery in household expenditure also contributed. On the other hand, government consumption and gross fixed capital formation (GFCF) grew at a slower pace. Meanwhile, the contribution of net exports turned negative. The GDP level stood broadly equal to its level at the end of 2019.

After having fallen in the preceding quarter, employment rose by 0.2% on a quarterly basis. Meanwhile, the unemployment rate averaged 3.7% in the fourth quarter, up slightly from 3.6% in the third quarter. The unemployment rate was 0.1 percentage point below that prevailing in the last quarter of 2019 (see Chart 1.1).

Consumer price inflation in the United Kingdom increased further. It rose from 10.1% in September, to a new high of 11.1% in October (see Chart 1.2). The rate decreased to 10.5% in December. Prices of energy, food and services all grew at a faster pace compared to September, while NEIG inflation eased. The annual rate of inflation based on the CPI excluding energy, food, alcohol and

[1] In the first quarter of 2023, the Committee decided to raise the target range for the federal funds rate to between 4.75% and 5.00% and anticipated that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2.0% over time.

tobacco decelerated to 6.3% in December, from 6.5% in September, but remained high from a historical perspective.

As the labour market remained tight and against evidence of inflationary pressures in domestic prices and wages, the Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate by 75 basis points, to 3.00% in November, and a further 50 basis points to 3.50% in December (see Chart 1.3). The Committee also signalled that further increases in Bank Rate might be required for a sustainable return of inflation to target.

The MPC said that the inflation target applies at all times, reflecting the primacy of price stability in the UK monetary policy framework. The framework recognises that there will be occasions when inflation will depart from the target as a result of shocks and disturbances. Monetary policy will ensure that, as the adjustment to economic shocks continues, CPI inflation will return to its target sustainably in the medium term, and also ensure that longer-term inflation expectations are anchored at the 2% target.

At the end of the third quarter, the Bank of England had announced that gilt sales would be postponed, in light of a significant repricing of UK and global financial assets, which could undermine financial stability and the flow of credit to the economy. As financial market conditions stabilised, the Bank of England began to sell of UK government bonds held for monetary policy purposes, with the first operation carried out on 1 November. Furthermore, it continued to sell non-investment grade corporate bonds.[2]

The euro area

GDP in the euro area contracts slightly

Economic activity in the euro area stagnated in the fourth quarter of 2022. In real terms, GDP growth stood at -0.1% on a quarter-on-quarter basis, down from 0.4% in the third quarter (see Table 1.2). Economic activity during the quarter under review was mainly characterised by a sharp drop in private domestic demand, weak exports, and a contraction in imports. These developments mainly reflected subdued, though improving, consumer and business confidence amid persistently elevated inflationary pressures, tighter financing conditions and an external environment marked by protracted geopolitical uncertainty.

In the fourth quarter of 2022, final domestic demand deducted 1.1 percentage points from GDP growth, of which 0.8 percentage point represented lower investment. In part, this drop reflected a reduction in intellectual property investment in Ireland that had boosted investment in the previous quarter, together with lower investment in construction as well as machinery and equipment. In addition, rising inflation lowered real disposable income, leading to a fall in private consumption that lowered GDP growth by 0.5 percentage point. By contrast, government consumption contributed 0.2 percentage point while changes in inventories contributed a further 0.1 percentage point to economic activity. Net exports contributed 0.9 percentage point to GDP, which mainly reflected a decrease in imports, partly driven by a correction in energy imports, while exports were broadly unchanged.

[2] In its meetings held in February and March 2023, the MPC increased the Bank Rate to 4.25%. The MPC said that the labour market remains tight, and the near-term paths of GDP and employment are likely to be somewhat stronger than expected previously, and although nominal wage growth has been weaker than expected, cost and price pressures have remained elevated.

Table 1.2

CONTRIBUTIONS TO QUARTERLY REAL GDP GROWTH IN THE EURO AREA[(1)]

Percentage points; quarter-on-quarter percentage change

	2020	2021				2022			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Private consumption	-1.5	-1.0	1.6	2.2	0.1	0.1	0.5	0.5	-0.5
Government consumption	0.1	-0.1	0.5	0.1	0.1	0.0	0.0	0.0	0.2
GFCF	0.8	-0.5	0.4	-0.1	0.7	-0.2	0.2	0.9	-0.8
Changes in inventories[(2)]	0.8	0.7	-0.6	0.0	0.6	-0.3	0.2	0.2	0.1
Exports	2.1	0.5	1.2	0.8	1.2	0.7	0.9	0.9	0.0
Imports	-2.6	0.4	-1.2	-0.7	-2.2	0.2	-0.9	-2.0	0.9
GDP	**-0.3**	**0.0**	**2.0**	**2.3**	**0.6**	**0.6**	**0.9**	**0.4**	**-0.1**

Source: Eurostat.

[(1)] Data are seasonally and working day adjusted. Figures may not add up due to rounding.

[(2)] Including acquisitions less disposals of valuables.

Labour market conditions remain strong

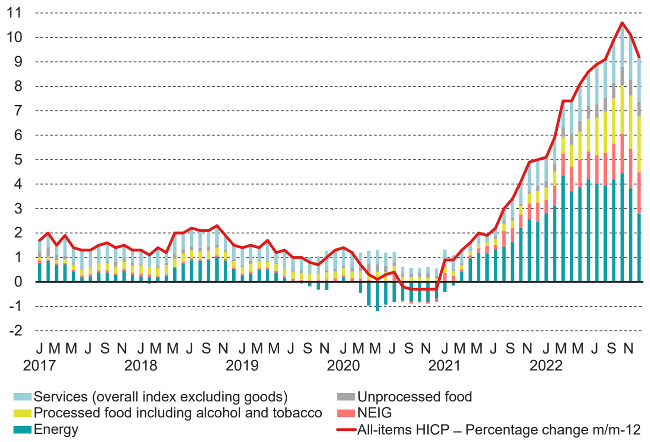
The labour market in the euro area continued to perform well in the fourth quarter despite the slowdown in economic activity. The seasonally adjusted unemployment rate stood at 6.7% in December, unchanged when compared to September. Meanwhile, the three-month average rate was also unchanged at 6.7% (see Chart 1.1).

Employment continued to expand, growing at an unchanged rate of 0.3% in quarterly terms.[3] This implies that the number of employed persons stood at 2.3% above the level recorded in the final quarter of 2019, just before the onset of the pandemic.

Inflation eases slightly but remains notably high

Elevated inflationary pressures in the euro area persisted, though they eased slightly in the fourth quarter. The annual rate of inflation based on the HICP stood at 9.2% in December, compared to 9.9% three months before (see Chart 1.4). This deceleration mainly reflected a marked decline in energy inflation and, to a lesser extent, slower growth in the prices of unprocessed food. These developments outweighed faster growth in the prices of processed food, NEIG as well as services. The past surge in the cost of energy and of other inputs for food production was still feeding through to consumer prices. Meanwhile, although supply bottlenecks

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



Sources: SDW; ECB.

[3] Employment data refer to the national accounts, total employment domestic concept. Data are seasonally and calendar adjusted.

were gradually easing, their delayed effects were still pushing up goods price inflation. Similarly, the effect of pent-up demand, following the lifting of pandemic-containment measures, was still exerting upward pressure on prices, particularly in the services sector.

Turning to the major HICP components, although energy continued to account for a substantial part of euro area inflation, the yearly growth in energy prices eased to 25.5% in December, compared to 40.7% three months before, due largely to the drop in energy commodity prices. Meanwhile, unprocessed food prices rose at a slightly subdued pace, with the annual growth rate standing at 12.0% in December, compared to 12.7% in September. Processed food prices rose by 14.3% year-on-year in December, compared to 11.5% in September. Also, the annual rate of NEIG inflation rose to 6.4% in December, compared to 5.5% in September. Lastly, the annual rate of change of services prices inched up to 4.4% in December, from 4.3% in September.

Underlying inflationary pressures continued to build up and did so at a faster pace. The annual rate of HICP inflation excluding energy and food prices rose from 4.8% in September to 5.2% in December.

ECB projects weaker economic activity, while inflation is set to ease

According to the Eurosystem staff macroeconomic projections published in March 2023, real GDP in the euro area is estimated to have expanded by 3.6% in 2022. Real GDP growth in the euro area is expected to slow down to 1.0% in 2023, but pick up in 2024 and 2025, with economic activity expanding by 1.6% in both years (see Table 1.3). Following zero real GDP growth at the turn of the year, economic activity in the euro area is expected to improve in the short term, as a result of lower energy prices, dissipation of global supply bottlenecks, improving real incomes and lower uncertainty related to energy bills. However, the ECB's tightening policy stance and further expected interest rate hikes are likely to increasingly feed through to the real economy, with some additional dampening effects stemming from the recent tightening in credit supply conditions. These factors, together with the expected gradual withdrawal of fiscal stimulus measures and persisting concerns about the energy supply-demand balance, are likely to weigh on economic growth in the medium term.

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

	2022	2023	2024	2025
GDP	**3.6**	**1.0**	**1.6**	**1.6**
Private consumption	4.3	0.7	1.3	1.4
Government consumption	1.4	-0.2	1.4	1.4
GFCF	3.7	0.3	1.4	1.8
Exports	7.5	3.4	3.5	3.3
Imports	8.3	3.0	3.0	3.2
HICP	**8.4**	**5.3**	**2.9**	**2.1**
HICP excluding energy and food	3.9	4.6	2.5	2.2

Source: ECB.
(1) ECB staff macroeconomic projections (March 2023).

Compared to the December 2022 projections, the baseline projections are built on assumptions that include tighter financing conditions, lower oil prices, significantly lower wholesale gas and electricity prices and an appreciation of the euro.

Compared to the previous projection exercise, real GDP growth has been revised upwards by 0.5 percentage point for 2023. By contrast, growth projections were revised downwards by 0.3 and 0.2 percentage points for 2024 and 2025, respectively. The revision for 2023 reflects a better than expected performance in the second half of 2022 and significantly lower energy prices. On the other hand, the tightening of financing conditions and the appreciation of the euro are expected to outweigh the positive effects of lower inflation and act as a drag on economic growth in 2024 and in 2025.

Turning to the outlook for prices, according to the March 2023 projections, HICP inflation is envisaged to moderate to 5.3% in 2023, and ease further to 2.9% and 2.1% in 2024 and 2025, respectively. These developments are expected to take place on the back of the sharp adjustment in energy markets, strong base effects, and the appreciation of the euro. Since high costs continue to have an impact, food inflation is expected to start declining later. The expected decline of headline inflation in the medium-term also reflects the gradual impact of monetary policy normalisation. In contrast to headline inflation, HICP inflation excluding energy and food is expected to increase in 2023 compared to 2022, reflecting lagged effects related to past high energy prices and from the past strong depreciation of the euro. The effects of the recent energy price declines and euro appreciation on core inflation will be felt only later in the horizon. In addition, the tight labour markets and inflation compensation effects imply that wages are likely to grow at rates well above historical averages, putting upward pressure on inflation.

Compared to the December 2022 projections, HICP inflation has been revised downwards by 1.0 percentage point for 2023, and by 0.5 and 0.2 percentage points for 2024 and 2025, respectively. The notable downward revision in 2023 is driven by the energy component, partially offset by upward surprises in HICP inflation excluding energy and food. As to 2024 and 2025, the HICP inflation rate projections were revised downwards on account of a lower impact from the reversal of fiscal measures on energy inflation, weakening indirect inflationary effects and an increasing pass-through of the recent appreciation in the euro exchange rate.

ECB raises interest rates steadily further

On 27 October 2022, the Governing Council decided to raise the three key ECB interest rates by 75 basis points against a backdrop of rising inflation and broad price pressures. It also adjusted the interest rates applicable to the TLTRO III from 23 November 2022 to ensure consistency with the monetary policy stance and offered banks additional voluntary early repayment dates. Finally, it decided to set the remuneration of minimum reserves at the ECB's deposit facility rate, thus aligning it more closely to money market conditions.

Subsequently, on 15 December 2022, the Governing Council raised key interest rates by a further 50 basis points because inflation was too high and was foreseen to remain above the target for too long. Accordingly, the interest rates on the deposit facility, the MROs and the marginal lending facility were increased to 2.00%, 2.50% and 2.75%, respectively (see Chart 1.3). The Council stated that it anticipated further significant increases in interest rates given still very high inflation.

Whereas net asset purchases under the APP ended as of 1 July 2022, the Governing Council reaffirmed its intention to continue fully reinvesting the principal payments from maturing securities purchased under the APP until the end of February 2023. It decided that from the beginning of March, the APP portfolio will decline at a measured and predictable pace, as the Eurosystem will not reinvest all of the principal payments from maturing securities. The decline will amount to €15 billion per month on average until the end of the second quarter of 2023 and its subsequent pace will be determined over time.

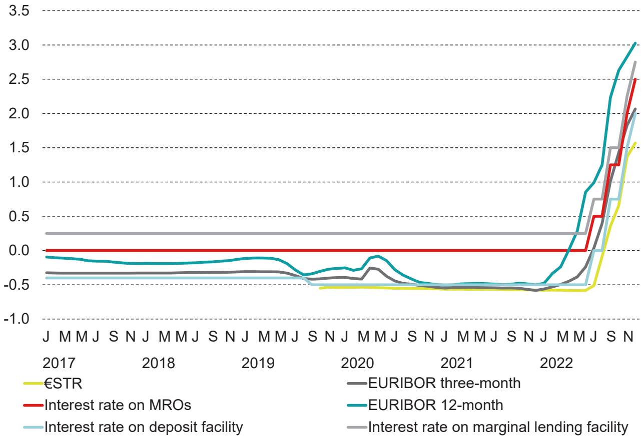
Regarding the PEPP, the Governing Council reiterated its intention to continue reinvesting the principal payments from maturing securities purchased under the programme until at least the end of 2024. The future roll-off of the PEPP portfolio would be managed to avoid interference with the appropriate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

As to refinancing operations, the Governing Council stated that since banks were repaying the amounts borrowed under TLTRO III, the Council would regularly assess how targeted lending operations were contributing to its monetary policy stance.[4]

Money market rates rise further

Money market interest rates in the euro area continued to increase during the quarter under review, reflecting the tightening of the monetary policy stance and expectations of higher key policy rates. The euro short-term rate (€STR) rose markedly further, though it remained below the interest rate on the ECB's deposit facility (see Chart 1.5).[5] It averaged 1.57% in December, compared to 0.36% in September. The three-month euro interbank offered rate (EURIBOR) went up by more than a full percentage point, averaging 2.07% in December, compared to 1.01% three months earlier. Meanwhile, the 12-month EURIBOR continued to increase, with its average reaching 3.03% in December from 2.23% in September.[6]

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



Source: ECB.

[4] In February 2023, the Governing Council raised the three key ECB interest rates by 50 basis points and stated that it expected to raise them further. The Governing Council also decided on the modalities for reducing the Eurosystem's holdings of securities under the APP. In March 2023, the Governing Council hiked the three policy interest rates by 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.

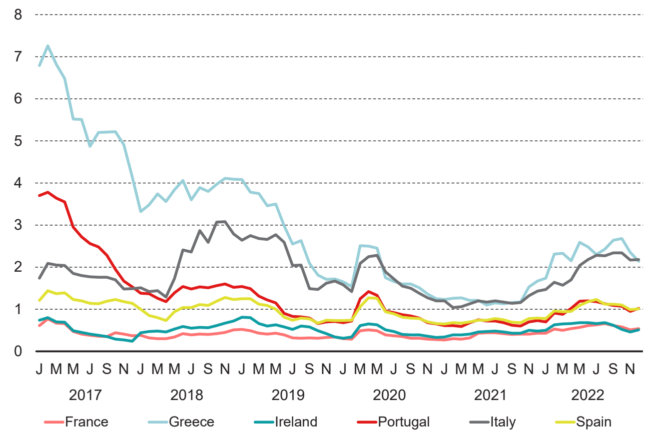
[5] The €STR reflects the wholesale euro unsecured overnight borrowing costs of banks located in the euro area. The €STR is published on each TARGET2 business day based on transactions conducted and settled on the previous TARGET2 business day. The ECB first published €STR on 2 October 2019.

[6] 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.

Euro area government bond yields generally increase further

The euro area ten-year benchmark government bond yield rose further during the fourth quarter, albeit at a slower pace than in the previous quarter. It stood at 3.00% at end-December, compared to 2.81% three months earlier. The increase reflects higher inflation and expectations regarding further tightening of monetary policy in the euro area and in other major economies.

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.

Individual sovereign bond yields continued to rise in almost all euro area countries. In Germany, ten-year sovereign bond yields went up by 28 basis points to 2.08%. Similarly, yields increased by 21 basis points in France and by 17 basis points in Spain and Ireland. In Italy yields rose by 12 basis points. The increase in sovereign bond yields was especially pronounced in several smaller euro area jurisdictions. By contrast, Greek ten-year sovereign bond yields fell by 22 basis points, to 4.22%, likely reflecting a narrowing of Greece's fiscal imbalances and progress registered in the country's reform agenda.

Spreads between yields on the ten-year German bonds and those on the bonds issued by other euro area sovereigns generally narrowed during the quarter under review. Most notably, the spread on Greek bonds narrowed by 50 basis points (see Chart 1.6). By contrast, the spreads on the bonds issued by a number of smaller jurisdictions, including the Baltic states, Cyprus and Slovenia, widened to varying extents.

Euro exchange rate appreciates in effective terms

By the end of December, the nominal effective exchange rate of the euro against the Effective Exchange Rate group of countries (EER-19) appreciated by 3.0%, compared to end-September.[7]

In the three months to December, the euro rose by 9.4% versus the US dollar, extending the recovery which started in September (see Chart 1.7). This mainly occurred in the context of the ECB's rapid normalisation of its monetary policy stance and as risk aversion abated.

Meanwhile, the euro rose by 0.4% against the British pound, as the latter continued to be negatively affected by political developments in the United Kingdom and persistent economic weakness that was also related to Brexit. During the review period, the euro recorded gains against other currencies including the Canadian, Hong Kong and Australian dollars, the Chinese renminbi, the Norwegian krone, the Swiss franc and a number of currencies of non-euro area EU member states.

[7] The EER-19 is based on the weighted averages of the euro exchange rate against the currencies of Australia, Bulgaria, Canada, China, Croatia, Czech Republic, Denmark, Hong Kong, Hungary, Japan, Norway, Poland, Romania, Singapore, South Korea, Sweden, Switzerland, the United Kingdom, and the United States.

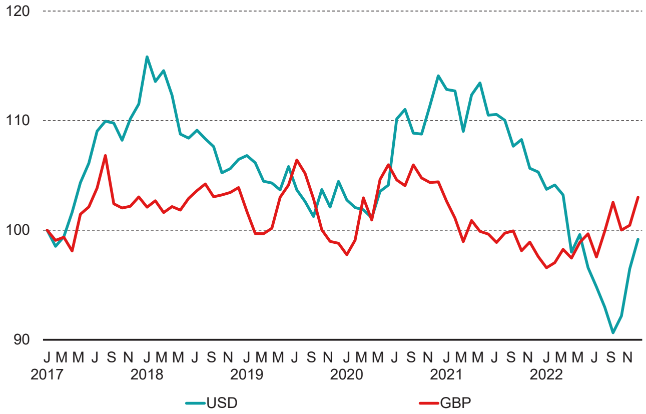
By contrast, the single currency lost ground against the Polish zloty, the Czech koruna and the Japanese yen.

Commodities

Oil prices end the quarter at a lower level

Oil prices were relatively stable during October and most of November, as the decision of OPEC+ to reduce its oil supply offset the negative effect on oil prices associated with lower demand as a result of the moderation in global economic growth. However, as the quarter progressed, downward pressures on oil prices related to lower demand for oil, outweighed concerns about supply. Moreover, there was still considerable uncertainty regarding the effects of the EU's embargo and the G7's price cap on Russian crude oil implemented in the beginning of December. The price of Brent crude oil ended 2022 at USD 83.3 per barrel, 10.8% below the level prevailing at the end of September (see Chart 1.8).

Chart 1.7
EXCHANGE RATE MOVEMENTS OF THE EURO AGAINST OTHER MAJOR CURRENCIES
(index of end of month rates; Jan. 2017=100; an increase in the index implies euro appreciation)



Source: Eurostat.

Chart 1.8
PRICE OF BRENT CRUDE OIL
(end of week; US dollars per barrel)

Source: Reuters.

World Bank data show that non-energy commodity prices rose marginally during the fourth quarter of 2022, adding 0.2%. This was attributable to prices of metals and minerals. By contrast, prices of agricultural products and in paritcular fertilisers fell compared with September.