ECONOMIC SURVEY

1. THE EXTERNAL ENVIRONMENT AND THE EURO AREA

In the third quarter of 2023, real GDP expanded rapidly in the United States, whereas in the United Kingdom and in the euro area it contracted slightly. During the quarter under review, the unemployment rate rose marginally in both the United States and the United Kingdom but remained unchanged in the euro area.

Consumer price inflation rose in the United States but eased further in the United Kingdom and the euro area, amid still elevated inflationary pressures. In the United States, inflation increased to 3.7% in September, from 3.0% three months before. By contrast, in the United Kingdom, inflation fell to 6.7% in September, from 7.9% in June and, in the euro area, inflation declined to 4.3% in September, from 5.5% three months earlier. To address strong price pressures, during the quarter under review, the Federal Reserve, the Bank of England, and the ECB all raised their key interest rates further.

Brent oil prices rebounded in the review period, reflecting an upturn in demand and a substantial cut in crude oil supply. Also, the price of European natural gas rose in the context of supply disruptions, despite largely stable demand.

Key advanced economies

US economic activity grows at a faster pace

In the United States, real GDP grew at a quarterly rate of 1.2% in the third quarter of 2023, slightly more than twice the rate recorded in the preceding quarter (see Table 1.1). This growth was largely driven by personal consumption expenditure and gross private domestic investment. The latter mainly reflected a marked expansion in inventories and, to a lesser extent, an increase in residential and non-residential investment. Government consumption expenditures also contributed positively to growth. By contrast, the contribution of net exports to growth turned negative, albeit minimally, as an increase in imports outweighed a rise in exports.

Meanwhile, in the labour market, employment increased by around 0.3% in quarter-on-quarter terms, broadly in line with the growth rate recorded in the previous quarter. Non-farm payroll data indicate that the increase in employment was driven by private services and was most pronounced in the education and health services sectors followed by the leisure and hospitality sectors.

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

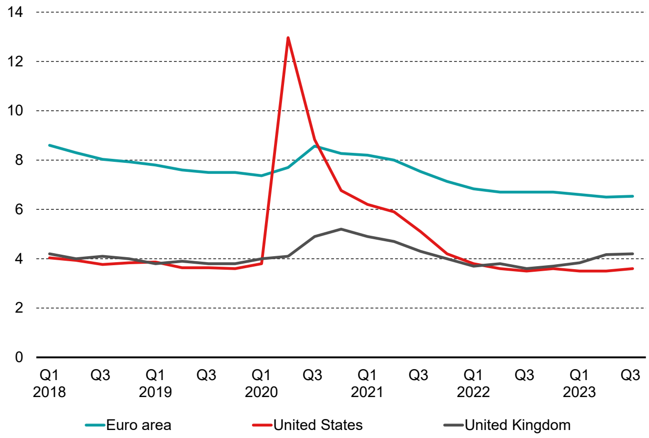
	2021		2022				2023		
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
United States	0.8	1.7	-0.5	-0.1	0.7	0.6	0.6	0.5	1.2
Euro area	2.1	0.5	0.7	0.8	0.5	-0.1	0.1	0.1	-0.1
United Kingdom	1.7	1.5	0.5	0.1	-0.1	0.1	0.3	0.0	-0.1

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

Government employment also increased. The participation rate edged up by 0.1 percentage point, to 62.7% during the review period. On average, the unemployment rate inched up to 3.7% in the third quarter, from 3.6% in the previous quarter (see Chart 1.1).

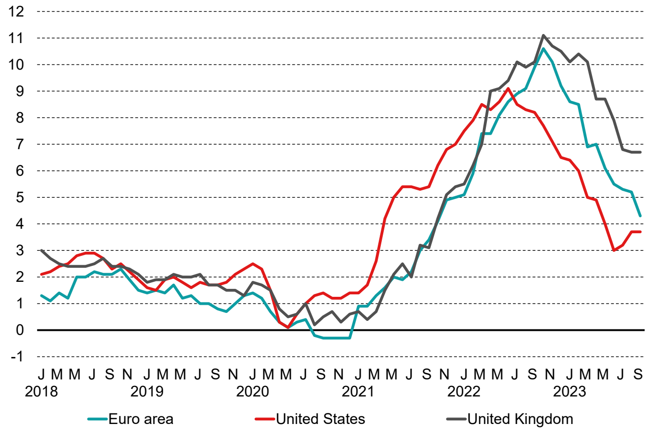
Inflation rebounded in the review period, mainly reflecting energy price dynamics, which camouflaged the continued easing in the other major inflation components. Thus, the annual inflation rate based on the consumer price index (CPI) stood at 3.7% in September, up from 3.0% three months earlier (see Chart 1.2). Although energy prices continued to fall compared to a year earlier, they did so at a much slower pace. Consequently, annual energy inflation rose to -0.5% in September as against -16.7% in June. Meanwhile, food inflation (including beverages) eased to 3.7% from 5.7% in June, while services inflation also moderated, falling to 5.2% in September. Inflation excluding food and energy eased to 4.1% in September, from 4.8% in June.

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



Sources: 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 third quarter of 2023, the Federal Open Market Committee (FOMC) increased the target range for the federal funds rate once. On 26 July 2023, the Committee decided to raise the target range for the federal funds rate by 25 basis points to between 5.25% and 5.50%. In September, the Committee kept the target range unchanged.

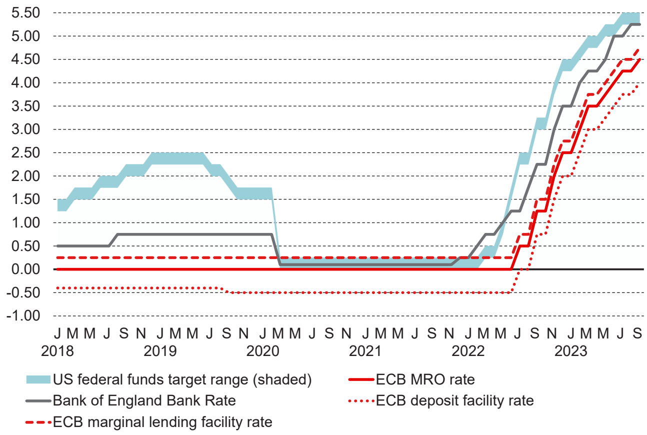
The Committee restated that it would continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities. The Committee reaffirmed its strong commitment to returning inflation to its 2% objective.[1]

1 In both November and December 2023, the Committee decided to keep the target range for the federal funds rate unchanged at 5.25%-5.50%.

UK economy contracts slightly

Real GDP in the United Kingdom shrank at a quarterly rate of 0.1% in the quarter under review, compared to no growth recorded in the previous quarter (see Table 1.1). Declines in investment and household consumption, outweighed increases in government expenditure, an increase in inventories as well as a less negative trade balance. The latter, however, reflected the fact that a drop in imports exceeded a fall in exports.

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



Sources: ECB; Federal Reserve; Bank of England.

Labour market conditions were broadly stable. The employment rate remained unchanged at 75.7% on a quarterly-average basis, while the unemployment rate averaged 4.2% during the review period, slightly up from 4.1% in the second quarter (see Chart 1.1).

Consumer price inflation in the United Kingdom continued to abate during the review period, although inflationary pressures remained elevated. The inflation rate decreased to 6.7% in September, compared to 7.9% in June (see Chart 1.2), with inflation easing across all major components. The deceleration reflected a notable decline in energy inflation, which turned negative in the third quarter, and a marked slowdown in food and non-energy industrial goods (NEIG) inflation. Meanwhile, services inflation also eased. The annual rate of inflation based on the CPI excluding energy, food, alcohol and tobacco fell to 6.1% in September, from 6.9% in June.

As inflation remained well above target and the risks around the inflation outlook continued to be skewed to the upside, the Bank of England's Monetary Policy Committee (MPC) increased the Bank Rate further by 25 basis points, to 5.25%, on 2 August 2023 (see Chart 1.3).

In the context of mixed developments in key indicators of inflation persistence, the MPC kept the Bank Rate unchanged on 20 September 2023. Also, 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.

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.[2]

The euro area

GDP in the euro area shrinks slightly

Economic activity in the euro area contracted marginally in the third quarter of 2023. In real terms, GDP shrank by 0.1% on a quarter-on-quarter basis, compared to a modest increase of 0.1%

[2] In its meetings held in November and December 2023, the MPC kept the Bank Rate unchanged at 5.25%. The MPC continued to judge that monetary policy was likely to need to be restrictive for an extended period of time.

Table 1.2
CONTRIBUTIONS TO QUARTERLY REAL GDP GROWTH IN THE EURO AREA[1]
Percentage points; quarter-on-quarter percentage change

	2021		2022				2023		
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Private consumption	2.2	0.2	0.0	0.4	0.7	-0.4	0.0	0.0	0.2
Government consumption	0.2	0.1	0.1	0.0	0.0	0.1	-0.1	0.0	0.1
GFCF	-0.2	0.7	-0.1	0.1	0.3	-0.1	0.1	0.0	0.0
Changes in inventories[2]	-0.4	0.6	0.0	0.2	0.1	-0.1	-0.6	0.7	-0.3
Exports	0.8	1.3	0.8	1.0	0.6	-0.2	-0.1	-0.6	-0.6
Imports	-0.5	-2.4	-0.2	-0.9	-1.2	0.6	0.8	0.0	0.6
GDP	**2.1**	**0.5**	**0.7**	**0.8**	**0.5**	**-0.1**	**0.1**	**0.1**	**-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.

in the previous quarter (see Table 1.2). Economic activity during the quarter under review was mainly characterised by muted domestic consumption, as consumer confidence declined notably, while business sentiment remained largely subdued. Against this background, gross fixed capital formation (GFCF) was flat, as lower investment in construction largely offset increased spending on machinery and equipment. Firms depleted their inventories, which they had built up in the previous quarter. Exports also declined, reflecting sluggish global demand and exchange-rate developments. Reflecting weak aggregate demand, imports fell. These developments took place against the background of heightened, though easing, inflationary pressures and tighter financing and credit supply conditions.

In the third quarter of 2023, domestic demand deducted 0.1 percentage point from GDP. Private consumption and government consumption added around 0.2 and 0.1 percentage point to GDP, respectively, compared to zero in the previous quarter. By contrast, changes in inventories, which had contributed positively to growth in the previous quarter, reduced GDP growth by 0.3 percentage point. Net exports had a neutral impact on GDP, as both exports and imports declined in tandem.

Labour market remains resilient

The labour market in the euro area remained resilient during the third quarter despite the weakness in economic activity. The seasonally adjusted unemployment rate stood at 6.5% in September, compared to 6.4% in June. The three-month average rate stood at 6.5% in the quarter under review, the same as in the second quarter (see Chart 1.1).

Employment continued to expand, growing at a quarterly rate of 0.2% during the third quarter, compared to 0.1% in the preceding quarter.[3]

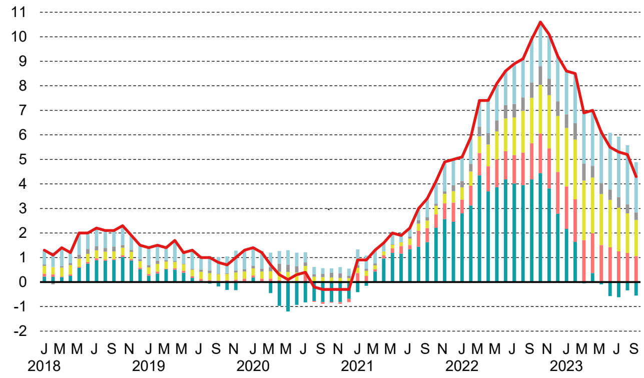
Inflation decelerates further

Although inflationary pressures in the euro area remained elevated, they eased further in the third quarter. The annual rate of inflation based on the HICP stood at 4.3% in September, down

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

from 5.5% three months before (see Chart 1.4). This deceleration reflected a slower growth in the prices of the non-energy inflation components. The contribution of past energy price increases and other supply shocks to overall inflation continued to fade out, while the tightening of the monetary policy stance dampened demand. However, domestic price pressures remained strong, partly reflecting rising wages.

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



Source: ECB.

Turning to the major HICP components, energy price inflation continued to exert a marked downward impact on headline inflation, as energy prices fell at an annual rate of 4.6% in September, following a drop of 5.6% in June. Unprocessed food inflation moderated to 6.6% in September, compared to 9.0% in June, while processed food inflation eased to 9.4%, from 12.4%, over the review period. Also, the annual rate of NEIG inflation slowed down to 4.1% in September, compared to 5.5% three months earlier. Finally, the annual rate of change of services prices eased to 4.7% in September from 5.4% in June.

Underlying inflationary pressures continued to ease during the review period, as the effects of past energy price shocks receded further. Thus, the annual rate of HICP inflation excluding energy and food prices decelerated to 4.5% in September, compared to 5.5% in June.

Economic activity is expected to rebound modestly from 2024, inflation is set to fall further

According to the Eurosystem staff macroeconomic projections published in December 2023, real GDP growth in the euro area is estimated to slow down to 0.6% in 2023, from 3.4% in 2022. It is then expected to rebound to 0.8% in 2024 and stabilise at 1.5% in 2025 and 2026, broadly in line with the pre-pandemic average growth rates (see Table 1.3). In the near term, Eurosystem staff

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

	2022	2023	2024	2025	2026
GDP	**3.4**	**0.6**	**0.8**	**1.5**	**1.5**
Private consumption	4.2	0.5	1.4	1.6	1.4
Government consumption	1.5	0.1	1.1	1.3	1.2
GFCF	2.8	1.3	0.4	1.8	2.1
Exports	7.4	-0.4	1.1	2.9	3.0
Imports	8.1	-0.9	1.7	3.1	3.0
HICP	**8.4**	**5.4**	**2.7**	**2.1**	**1.9**
HICP excluding energy and food	3.9	5.0	2.7	2.3	2.1

Source: ECB.

[1] Eurosystem staff macroeconomic projections for the euro area, December 2023.

foresee weak economic activity, affected by the impact of monetary policy tightening and restrictive credit supply conditions. As from the early months of 2024, however, real GDP growth is expected to recover gradually, as rising real disposable income supports private consumption and increasing foreign demand raises exports. Meanwhile, relatively weak economic activity and tight financing conditions are expected to act as a drag on business investment. The latter should, however, recover in the medium term, supported by the Next Generation EU programme and the pick-up in economic activity.

Compared to the September 2023 projections, the baseline projections are built on assumptions that include lower short-term euro area interest rates, lower energy prices and a depreciation of the euro. Real GDP growth is revised downwards by 0.1 percentage point for 2023 and 0.2 percentage point for 2024. Real GDP growth for 2025 is unrevised. The revisions to the 2023 and 2024 forecasts mainly reflect a weaker than expected outcome for the third quarter of 2023. Furthermore, the outlook for net exports has been downgraded largely on the back of weaker-than-expected foreign demand.

Turning to the outlook for prices, according to the December 2023 projections, HICP inflation is foreseen to moderate to an average of 5.4% in 2023 and ease further to 2.7% and 2.1% in 2024 and 2025, respectively. HICP inflation is expected to fall to slightly below the ECB's 2% target in 2026. A temporary rebound in inflation is expected to occur early in 2024, mainly related to upward base effects in the energy component, the reversal of some fiscal support measures, higher labour cost pressures, and the assumed depreciation of the euro. From the end of 2024, however, all the main inflation components are expected to continue to ease. Food inflation is projected to decline sharply throughout 2024, largely on account of easing pipeline price pressures, and to decrease more gradually thereafter.

HICP inflation excluding energy and food is expected to continue to moderate from an average of 5.0% in 2023 to 2.7% in 2024 and further to 2.3% and 2.1% in 2025 and 2026, respectively. Underlying inflation is expected to gradually decline over the projection horizon, mainly reflecting fading impacts from earlier pipeline pressures and supply bottlenecks, the normalisation of demand and the ECB's monetary policy tightening.

Compared to the September 2023 projections, HICP inflation has been revised downwards by 0.2 and 0.5 percentage point for 2023 and 2024, respectively, while the inflation projection for 2025 remained unchanged. The downward revision for 2024 mainly reflects lower-than-expected data outcomes and lower futures for energy commodity prices. Underlying inflation projections are revised downwards by 0.1 and 0.2 percentage point for 2023 and 2024, respectively. In contrast, the projection for HICP energy excluding energy and food is revised upwards by 0.1 percentage point for 2025, reflecting higher domestic cost pressures and import prices in 2024.

ECB raises interest rates further

In July 2023, the Governing Council raised the three key ECB interest rates by 25 basis points, bringing the interest rates on the deposit facility, the MROs and the marginal lending facility up to 3.75%, 4.25% and 4.50%, respectively. The 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.

In September, the Governing Council hiked 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 reached 4.00%, 4.50% and 4.75%, respectively (see Chart 1.3). The Council considered that the key ECB interest rates had reached levels that, maintained for a sufficiently long duration, would make a substantial contribution to the timely return of inflation to the target. The Council reiterated that it would continue to follow a data-dependent approach to determining the appropriate level and duration of restriction of the policy interest rates. In particular, future policy rate decisions would continue to be based on an assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary transmission.

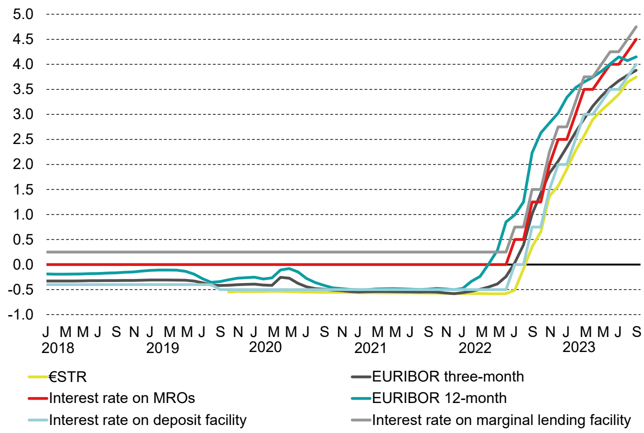
The Governing Council reiterated that bond holdings under the APP were declining at a measured pace, as the Eurosystem no longer reinvested the principal payments from maturing securities. As to the PEPP, the Council restated its intention to reinvest the principal payments from maturing securities purchased 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 would continue to be reinvested flexibly, to counter risks to the monetary policy transmission mechanism related to the pandemic.

Turning to refinancing operations, the Governing Council reiterated 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.[4]

Money market rates rise further

Money market interest rates in the euro area continued to rise during the review period, reflecting the tightening of the monetary policy stance and expectations that key policy rates could edge up more. The euro short-term rate (€STR) increased further, though it remained below the interest rate on the ECB's deposit facility (see Chart 1.5).[5] It averaged 3.75% in September, compared to 3.24% in June. The three-month euro interbank offered rate (EURIBOR) averaged 3.88% in September, as against 3.54% three months earlier. Meanwhile, the 12-month EURIBOR also rose further, with its average reaching 4.15% in September from 4.01% in June.[6]

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



Source: ECB.

Euro area government bond yields rebound

The euro area ten-year benchmark government bond yield

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[4] The Governing Council kept the three key ECB interest rates unchanged in both October and December 2023. In December, the Council announced its intention 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 the year, it intended to reduce the PEPP portfolio by €7.5 billion per month on average. The Governing Council intended to discontinue reinvestments under the PEPP at the end of 2024.

[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 the €STR on 2 October 2019.

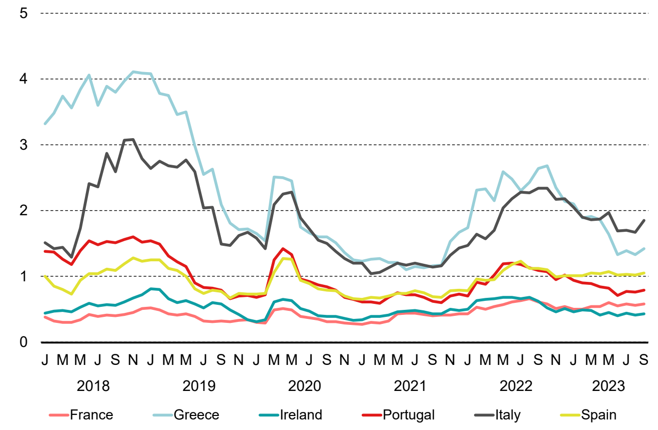
[6] The EURIBOR is an interest rate benchmark indicating the average rate at which principal European banks lend unsecured funds on the interbank market in euro for a given period.

rebounded slightly during the third quarter, resuming a generally rising trend established since late 2021 as monetary policy tightened. It averaged 3.51% in September, compared to 3.16% three months earlier. The increase in yields occurred against continued issuance of sovereign bonds in the euro area this year. It could also reflect declining central-bank bond purchases and potential spillover effects amid a reappraisal in global investor risk sentiment. The latter may have supported riskier assets, on expectations that the US economy would avoid a recession.

Individual sovereign bond yields rose to varying extents in almost all euro area countries. In Germany, ten-year sovereign bond yields went up by 28 basis points to 2.66%. Yields went up by 44 basis points in Italy and by 37 basis points and 36 basis points in Greece and Portugal, respectively. Yields rose by 31 basis points in France, Spain and Ireland. The increase in sovereign bond yields was somewhat less pronounced in most of the smaller euro area jurisdictions.

As a result, spreads between yields on the ten-year German bonds and those on the bonds issued by France, Italy and Spain, tended to widen marginally during the quarter under review (see Chart 1.6). By contrast, the spreads on the bonds issued by a considerable number of the smaller euro area jurisdictions narrowed marginally.

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



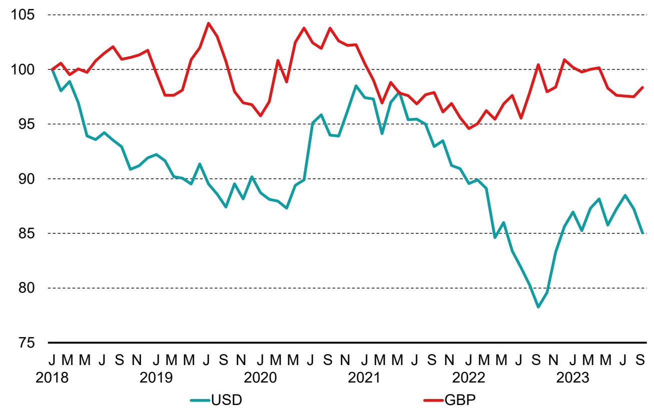
Source: ECB.

The euro depreciates further versus the US dollar and weakens in effective terms

The nominal effective exchange rate (EER) of the euro against the EER-18 group of countries depreciated by 0.7% in the quarter under review.[7]

In the three months to end-September, the euro fell by a further 2.5% against the US dollar (see Chart 1.7). This was probably triggered by the relatively strong economic growth prospects for the United States as well as interest rate differentials between the United States and the euro area.

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: ECB.

[7] The EER-18 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.

Besides the US dollar, the euro also weakened against other currencies including the Norwegian krone, the Swiss franc and the Hong Kong dollar.

By contrast, the euro appreciated by 0.7% versus the British pound, which was undermined by renewed signs of weakness in the UK economy. It also gained ground on the Japanese yen, where monetary policy remained accommodative and the Chinese renminbi, probably reflecting investors' concerns regarding an uneven trajectory in China's economic recovery. The single currency also strengthened against the currencies of several other non-euro area EU countries, as well as the Australian dollar, the Korean won and the Canadian dollar.

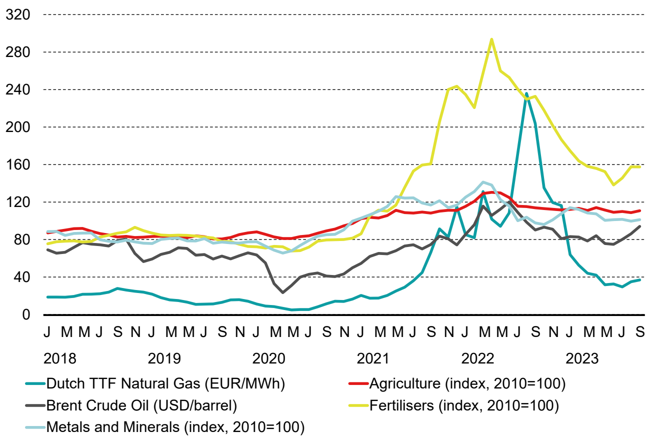
Commodities

Commodity prices rise during the quarter

Oil prices rebounded in the review period, reflecting an upswing in demand and a marked reduction in crude oil supply particularly by OPEC+. The price of Brent crude oil averaged USD 94.00 per barrel in September, 25.5% above the level prevailing in June. Meanwhile, the price of European natural gas remained highly volatile amid supply disruptions and broadly flat demand. The average price of Dutch TTF natural gas in September 2023 was 13.4% higher than three months earlier (see Chart 1.8).

World Bank data show that the prices of fertilizers and, to a lower extent, agricultural products increased, whereas there was a marginal decline in the prices of metals and minerals.

Chart 1.8
COMMODITY PRICES
(monthly averages)



Sources: World Bank; Central Bank of Malta estimates.