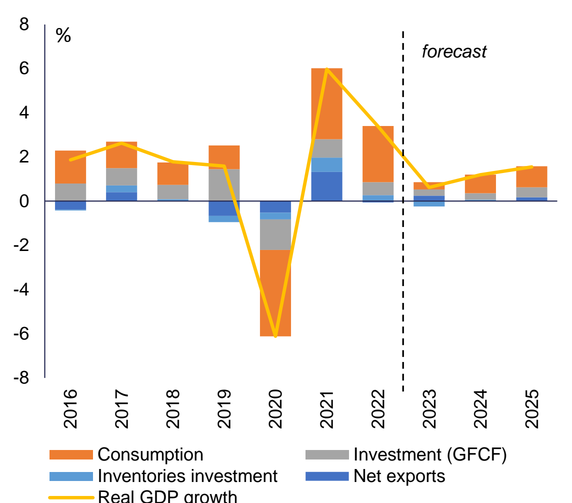
1. MACROECONOMIC OUTLOOK

Macroeconomic developments

After a continued rebound in 2022, the euro-area economy witnessed a strong deceleration this year. In 2022, the growth boost resulting from the post-COVID re-opening of the economy, together with policy support, led to a solid 3.4% economic expansion. Despite the rapid rise in energy prices in the winter of 2022, the euro area avoided a recession. The robust labour market has been and remains a key element of macroeconomic resilience and supportive of aggregate demand. Still, high consumer prices and tightening financing conditions have resulted in a loss of growth momentum over the course of 2023. For 2023, GDP for the euro area is expected to grow by 0.6%, with some Member States recording negative growth for the year as a whole.

Graph 1.1: **Real GDP growth and contributions, euro area**



(1) data for EA20 if not indicated otherwise
Source: European Commission

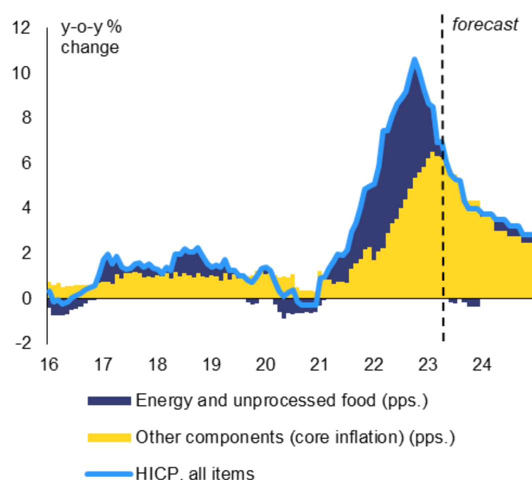
A mild rebound in growth is expected due to easing of inflation and a strong labour market. Entering 2024, the still high inflation and tighter financial conditions are set to weigh on economic activity. Rising nominal wages would only gradually lift real disposable incomes, in turn supporting a mild rebound in consumer spending. Recent survey results for the euro area point to weak economic activity, with continued weakness in industry and fading momentum in services, with, however, certain marginal improvements expected in the months ahead ([1]). With exports projected to grow at a moderate pace due to the more challenging global environment, the growth is set to be driven mostly by domestic demand. Overall, the GDP for the euro area is expected to grow by 1.2% in 2024 and by 1.6% in 2025 **(Graph 1.1)**.

Energy prices have gone down, while inflation excluding energy and food remains high though falling gradually. Euro area headline inflation fell sharply in October, to 2.9%. This is down from 4.3% in September, and as much as 7.7 pps from the peak recorded in October 2022. The decline was driven primarily by falling energy prices, but also by a gradual broad-based moderation in the other components. Lower energy and commodity prices, together with easing bottlenecks in the supply chains enabled non-energy prices to also fall. Yet, food inflation, although consistently declining, remains elevated. Services inflation also decelerated, but at a slower pace compared to other components (to 4.6% in October, after an increase to 5.6% in July), against the backdrop of wage growth, increasing unit profits **(see Box 3.1)** and persistently strong demand for contact-intensive services and tourism. The tightening monetary policy and contractionary fiscal policies helped ease inflationary pressures (see Section 2). Overall, headline inflation is projected to decline in the euro

([1]) European Commission, Business and consumer survey results, October 2023

area from 8.4% in 2022 to 5.6% in 2023, and then further down to 3.2% in 2024 and 2.2% in 2025. Core inflation (2) is expected to be slightly more persistent, however, increasing to 5.1% in 2023 from 4.0% in 2022, and then subsequently falling to 3.2% in 2024 and 2.5% in 2025. **(Graph 1.2)**

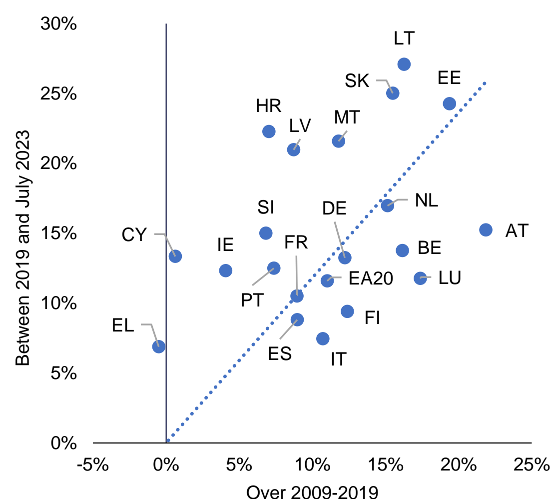
Graph 1.2: **Inflation breakdown, euro area**



Source: European Commission

The decrease in energy prices over 2023 has partly reduced the differences in inflation rates between the euro-area countries. In 2022, the inflation dispersion in the euro area was largely driven by differences in energy inflation, reflecting difference in the energy mix and in the sources of imported energy, as well as support measures implemented in the various Member States. Energy prices are expected to decrease in 2023 for most Member States, with the strongest decrease in the Member States that faced the sharpest increases in 2022, notably the Netherlands, Estonia and Belgium. However, the correction in energy prices remains far from complete, with some countries set to continue recording positive energy inflation. Moreover, inflation excluding food and energy remained high in most Member States in 2023, due in particular to the lagging effect of high energy prices. In the euro area, the core inflation recorded since 2019 is comparable to the cumulated increase in prices over the previous 10 years **(Graph 1.3)**. In a number of countries, including the Baltics, Croatia and Slovakia, the shock is even stronger.

Graph 1.3: **Convergence of underlying inflation, euro area**



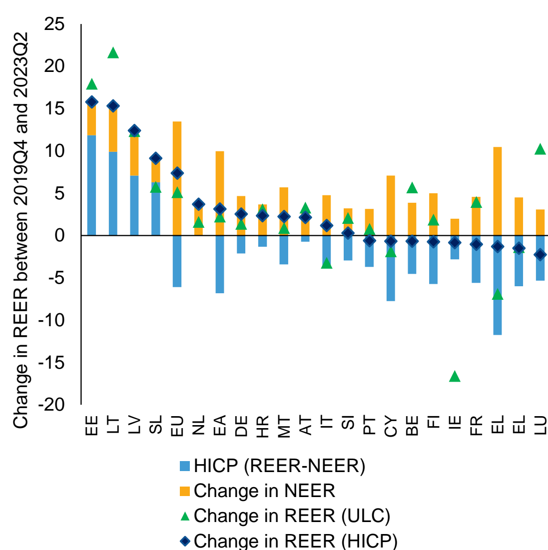
(1) HICP inflation excluding food and energy
(2) 2019 - 2023 cumulated inflation compared to 2009 - 2019 cumulated inflation
Source: Eurostat, own calculations

The labour market is close to full employment, and wage growth is gradually restoring purchasing power. Over the last two years, unemployment rates throughout the euro area have stabilised at record low levels, standing at 6.5% in September, down from 6.7% in the same period of the previous year. Meanwhile, employment continues to increase in almost of the Member States, except Italy, Latvia, Croatia and Estonia, recording from modest to moderate contraction of their employment rates in Q2 2023. Employment growth is particularly strong in low energy-dependent sectors, notably some services (See Section 3). Despite the slowdown in activity in the first part of 2023, the labour market remains very tight, with euro-area job vacancy rate remaining at elevated levels (3% in Q2 2023). In that context, wages have so far not kept pace with inflation, which is likely due to a lagged wage bargaining. In 2023, there are early signs of wage acceleration (see Section 2), although real wages are only expected to rebound as of the end of 2023 and recover moderately in the course of 2024.

(2) Core inflation is defined in this report as overall HICP inflation excluding energy, food, alcohol and tobacco.

The euro real effective exchange rate has appreciated in 2023 denting cost competitiveness. In 2019 - 2022, the depreciation in the value of euro compared to the currencies of the main trading partners supported the euro area cost-competitiveness. Since then, the increase in inflation, together with an appreciation in the euro against other currencies, has led to a deterioration in overall cost competitiveness. Within the euro area, divergences in price dynamics have led to a deterioration in the relative competitiveness of some Member States, notably the Baltics and Slovakia **(Graph 1.4)**, although some rebalancing could also be observed (see Section 5).

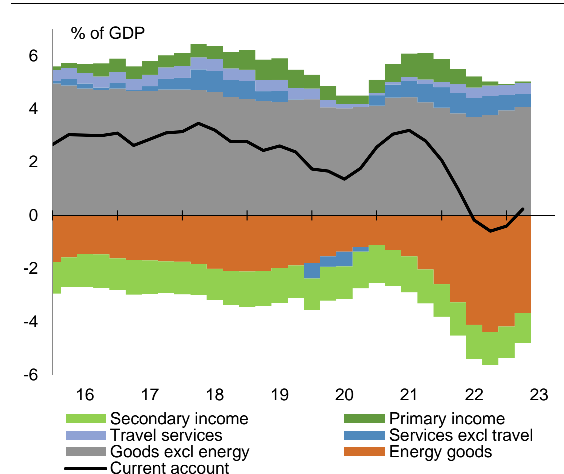
Graph 1.4: **Decomposition of the change in the real effective exchange rate (December 2019-June 2023)**



Source: Eurostat, own calculations

After a sharp fall in 2022, current account balances have rebounded, easing concerns about short term risks. The strong deterioration in the euro area's energy balance led to a sizeable negative terms of trade shock, which resulted in a sharp reduction in the euro area's current account surplus in 2022. In countries that had already recorded a deficit, the drop in current account balances created concerns about possible imbalances. As the energy shock gradually dissipates, the euro-area current account bottomed out in the first quarter of 2023 **(Graph 1.5)**, although with significant differences between Member States. In several countries, the deterioration in the energy balance was counterbalanced by a solid performance in services, particularly travel services (Spain and France). This helped somewhat reduce current account imbalances across the euro area. The euro-area current account balance is expected to increase in the next years, although it is set to remain below pre-pandemics levels. In addition, differences in cost competitiveness between Member States may be a cause for concern, as they may lead to emergence of new vulnerabilities (European Commission, 2023a).

Graph 1.5: **Current account composition, euro area**



(1) Four-quarter moving sum
Source: European Commission

The economic outlook continues to be marked by major risks linked in particular to geopolitical tensions. Measures to diversify energy sources and reduce energy demand are supporting higher resilience of the euro area. Still, geopolitical tensions will continue to keep energy prices high in the medium term. Persistence of high non-food and energy inflation is a key emerging risk. In particular, the euro area faces uncertainty, as to whether wages can be adjusted to recoup losses in the purchasing power without driving up inflation. The risks of higher-than-expected inflation therefore remain strong. This, in turn, would result in stronger monetary reaction that would adversely impact growth.

In the longer term, the euro area economy faces significant structural

challenges. The changing global geopolitical landscape entails long-term risks of persistent trade fragmentation and divergences in economic policies of global actors and key trade partners of the euro area **(see Box 5.1)**. In addition, the demographic outlook for the euro area is that of a shrinking and ageing population ([3]). This entails long-term limitations in potential growth and risks for the sustainability of public finances, in particular against the backdrop of persistently slow productivity growth and lack of innovation in the euro area. Moreover, the intensifying impact of climate change, as illustrated by the extreme weather conditions and unprecedented wildfires and floods in the summer, is set to weigh on economic growth. It also calls on decisive actions to accelerate the green transition and reach climate objectives.

Policy implications

Weaker growth in 2023 combined with persistent inflationary pressures underscore the importance of continued consistency between monetary and fiscal policy. To bring down inflation, the European Central Bank (ECB) has decided on a series of hikes bringing policy interest rates to high levels. While the ECB has decided to pause the increase in policy rates in October, it has repeatedly committed to setting them as high as needed for "as long as necessary". Meanwhile, fiscal policy coordination is key to helping monetary policy bring inflation back to its medium-term target in a timely manner. Member States should adopt coordinated and prudent fiscal policies to keep debt at prudent levels or put debt ratios on a plausibly downward path. While remaining agile in view of the high uncertainty, achieving a contractionary fiscal stance, as expected in 2023 and 2024, will contribute to restoring fiscal buffers over time and thus to improving the sustainability of public debt in some Member States. Besides the need to maintain a prudent fiscal strategy, public investment needs to be maintained and, where needed increased, to support long-term growth and the green transition.

([3]) The euro area population is expected to decrease by 4.5% between 2022 and 2100.

The labour market has proven resilient so far and wages have reacted moderately to the inflation surge but are expected to accelerate. The post-COVID 19 period has been marked by very high employment and decreasing unemployment. The strong labour demand, together with factors limiting labour supply, have resulted into labour shortages that are widespread across occupations and skill levels. Measures to increase the labour force, in particular through active labour market policies, are helpful in that respect. Despite the tight labour market, wages increased less than inflation in 2022 and 2023, leading to an increase in unit profits and to decreasing purchasing power for workers. In countries with indexation mechanisms, in particular for minimum wages, social consequences on low-paid workers have been more limited. Going forward, real wages are expected to recover part of the past losses and a fine balance needs to be struck between regaining the lost purchasing power for workers, limiting second-round effects of wages on inflation, and avoiding sustained competitiveness losses in some countries.

The tightening of monetary policy calls for a careful monitoring of risks in the financial sector. The rapid increase in interest rates and the accompanying tightening of financial conditions throughout the euro area have put a lid on credit growth. Slower economic growth and higher interest rates have affected the housing market, especially in countries where prices were over-valued and where household debt is high (European Commission, 2023a). Several Member States recorded a fall in real estate prices in 2023, with impact on households' wealth and commercial real estate companies. Progress made by euro-area banks in strengthening their balance sheet has increased their resilience and generally equipped them well to respond to a potential deterioration in asset quality. Meanwhile, the risks may emerge regarding non-bank financial intermediaries (e.g., insurers and

investment funds), which are less regulated, and on which less information is available. Risk may also build up due to potential further asset price corrections, volatile markets, and a turning real estate cycle.

High energy costs and inflation, together with geopolitical developments, underline the need to support the euro area's competitiveness. The durably higher energy costs in the euro area compared to global partners together with the increasing labour costs risks leading to a deterioration in the cost competitiveness of euro-area economies. These shocks have already undermined the trade performance of energy-intensive sectors. Differences in price levels between euro-area countries, including for non-energy goods, have so far not been alleviated by the decrease in energy prices. This is leading to a deterioration of the relative competitiveness of some countries vis-à-vis euro area peers. Such an uneven impact across the euro area, if sustained, may also feed macroeconomic imbalances (European Commission 2023a). In the long-term, the euro area's competitiveness will be determined by its ability to increase productivity, in particular through increasing skills and innovation. Supporting investment, both public and private, also remains a policy priority. Accordingly, the timely implementation of the investment and reforms set out in the national recovery and resilience plans and cohesion policy programmes can spur productivity and growth. Improving the business environment is also critical to boost investment and competitiveness in the private sector. Specifically, making further progress in the Capital Market Union would help innovative companies access to the different forms of finance for their investments.