Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Box A: QB 1 – March 2023

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The International Economic Outlook

By the Monetary Policy Division

Inflation has dominated developments in the global economy in recent months, arising from a surge in energy prices as a result of the Russian war in Ukraine, as well as post-pandemic reopening of major economies. The strong responses of central banks to the steep rises in inflation, as well as the recent reopening of China's economy, are set to be the main drivers of developments in the global economy in 2023. Inflation appears to have peaked in most major advanced economies, having fallen significantly from its peak notably in the United States, as well as the euro area and UK in more recent months. Nevertheless, it still remains well above the targets of these economies' respective central banks, with the high levels of core inflation and stronger-than-expected economic activity and labour markets in particular eliciting a continued strong response of monetary policy.

In its January 2023 update to the World Economic Outlook, the IMF predicts growth in the global economy to slow in 2023, albeit less markedly than previously anticipated. It forecast global GDP growth to have been 3.4 per cent in 2022, falling to 2.9 per cent in 2023 (an upward revision compared with the previous forecast). Growth in 2023 according to the IMF will be driven by emerging markets (+4.0 per cent, with the reopening of China driving a significant part of this) rather than advanced economies (+1.2 per cent, with 0.7 per cent for the euro area). Global inflation is projected to fall through 2024 to a level of 4.3 per cent, which however remains higher than pre-2020.

For the euro area, the Eurosystem staff projections of December 2022 forecast GDP growth of 3.4 per cent in 2022, followed by 0.5 per cent in 2023 (lower than the 0.9 per cent forecast in September), recovering to 1.9 per cent in 2024. Employment is expected to grow throughout the forecast horizon, with the unemployment rate rising only marginally to 6.9 per cent in 2023, declining again afterwards. HICP inflation, reaching 8.4 per cent in 2022 overall, was predicted to remain high, but on a declining

trend, in 2023 (6.3 per cent) and 2024 (3.4 per cent; both were strong upward revisions from 5.5 per cent and 2.3 per cent, respectively, in the September projection exercise). By 2025 inflation was forecast to be approaching the ECB target, at 2.3 per cent.

Since the Eurosystem staff projections in December 2022, incoming data has shown that the euro area economy has so far weathered the energy price shock better than previously expected. Economic activity expanded marginally in the last quarter of 2022, as opposed to a previously forecasted slight contraction. GDP grew by 0.1 per cent in Q4 2022 (+1.9 per cent in year-on-year terms) after 0.3 per cent in Q3 (+2.3 per cent YoY). Over the whole of 2022, euro area GDP grew by 3.5 per cent compared with 2021. The continued growth was in part due to the effects of fiscal stimulus to shield households from higher energy prices. Wholesale prices for oil and gas have subsequently fallen, and a relatively mild winter contributed to lower demand in Europe. Meanwhile, the effects of more restrictive monetary policy by the ECB, while showing strongly in the tightening of financing conditions and rises in retail interest rates, have yet to filter through to economic activity and employment fully, as the transmission of monetary policy to the real economy operates with a significant lag.

The euro area labour market remained very strong in spite of inflation, a slowdown in growth, and more restrictive monetary policy. The euro area seasonally-adjusted unemployment rate stood at 6.6 per cent in December, stable at that level (the lowest recorded for the euro area) since October. In Q4 2022, the annual growth rate of employment for the euro area was 1.5 per cent (down from 1.8 per cent in Q3), following a quarterly growth in employed persons of 0.4 per cent compared with Q3 2022.

Euro area annual HICP inflation, after reaching a peak of 10.6 per cent in October 2022, was estimated to have fallen to 8.5 per cent in February 2023. Food has became the largest contributor to overall inflation, replacing energy. Energy inflation, which drove the rise in HICP in 2022, declined the most strongly, falling from 25.5 per cent in December to 13.7 per cent in February 2023; it had reached over 40 per cent in September and October 2022. Core inflation (i.e. HICP excluding energy, food, alcohol and tobacco) was at 5.6 per cent, or more than twice the ECB's medium term inflation target. Services inflation, the largest component of the HICP basket, rose from 4.4 per cent to 4.8 per cent between January and February.

As a result of its assessment that inflation in the euro area remains excessively high, the ECB Governing Council decided to raise all three key ECB interest rates by 50 basis points at its February 2023 meeting. This brought the consecutive rate rises since July 2022 to 300 basis points, with the deposit facility rate, the main refinancing operations rate and the rate on the marginal lending facility now at a level of 2.50, 3.00 and 3.25 per cent, respectively. The Governing Council also expressed its intention to raise interest rates by a further 50 basis points at its March meeting, and to continue following a meeting-by-meeting approach for future decisions, in order to ensure the return of inflation towards the ECB's 2 per cent target in the medium term. The Governing Council further

decided on the modalities for reducing the ESCB's holdings of assets under the APP programme. These holdings will decline by an average of €15bn per month from March to the end of June 2023, after which the pace of reductions will be reassessed. The reduction in the stock of holdings will be done by only partially reinvesting maturing securities under the APP.

In the United States, quarterly GDP increased by 0.7 per cent in the fourth quarter of 2022, after another 0.8 per cent increase in the third quarter. In annual terms, GDP growth slowed down to +1.0 per cent in Q4 from +1.9 per cent in Q3. The labour market remains particularly strong, with the unemployment rate standing at 3.5 per cent. US inflation marginally declined to 6.4 per cent in January 2023 from 6.5 the previous month, having fallen consistently from its recent peak of 9.1 per cent in June 2022. However, the month-on-month increase in prices was 0.5 per cent, and core inflation remained significantly high at 5.6 per cent. After a number of consecutive and large interest rate rises at previous meetings, in February the Federal Open Market Committee (FOMC) of the US Federal Reserve further increased the target range for the Federal Funds Rate by 25 basis points to 4.5 to 4.75 per cent and anticipates further increases will be needed to ensure the inflation target of 2 per cent is reached. The FOMC is continuing to reduce the size of the Federal Reserve balance sheet as previously announced.

In the United Kingdom, quarterly GDP remained unchanged in the last quarter of 2022, after a decline of 0.2 per cent in Q3. Over the whole of 2022, GDP grew by 4.0 per cent. Between October and December 2022, unemployment stood at 3.7 per cent. Inflation in January 2023 declined to 10.1 per cent from 11.1 per cent in December 2022. At its February meeting, the Bank of England's Monetary Policy Committee voted to increase the Bank Rate by a further 50 basis points, to 4.0 per cent.

In December 2023, the Policy board of the Bank of Japan, one of the few central banks that have so far refrained from raising interest rates (also on account of lower inflation rates in Japan, and particularly so for core inflation), increased the range around which it allows yields on the 10-year JGBs to fluctuate, from a range of -0.25 to 0.25 per cent, to a range of -0.5 to 0.5 per cent.