## Box 3: Economic developments in the euro area

Wider euro area economic conditions impact on the Irish economy through a number of channels, the most important being the shared monetary policy channel. It is important, therefore, that the evolution of the euro area economy is monitored and understood.

Economic activity in the euro area has effectively stagnated in the first half of this year, and higher frequency data point to continued softness over the summer. The European Commission, in its most recent forecasts, revised its projections for euro area GDP growth downwards to 0.8 per cent in 2023 (**figure 8A**).

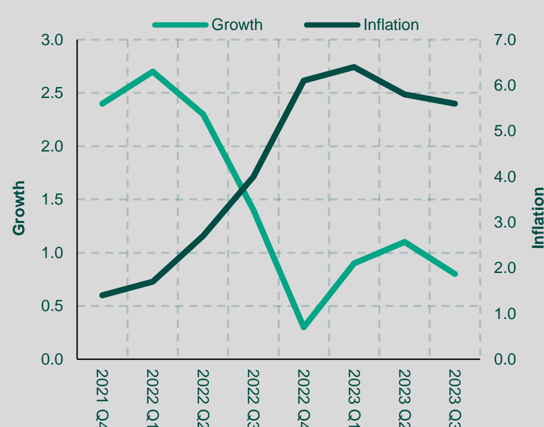
Several factors are weighing on activity in the euro area. First, the impact of high inflation is continuing to work through the economy, via demand and supply channels. Second, and related to the first, the macroeconomic policy mix has pivoted towards a more restrictive stance with a significant tightening of monetary policy over the past year and the gradual phasing out of fiscal supports related to the energy price shock. Third, the external environment has become more challenging, with weaker growth prospects in several key trading partners.

Notwithstanding the softening of activity, the euro area labour market has proven remarkably resilient. As of July, the unemployment rate across the region was 6.4 per cent, a record low. Moreover, activity rates – both in terms of employment and participation - are either at, or close to, all-time highs. One exception relates to average hours of work, which still remain below pre-pandemic levels. The combination of high employment at lower average hours may point to some element of labour hoarding by employers in response to the difficulties in re-hiring skilled staff following the pandemic lockdowns.

On the inflation front, the latest data confirm the downward trajectory in headline inflation across the euro area, with the inflation rate estimated (i.e. 'flash' estimate) at 4.3 per cent in September – this is more than half its rate of little over a year ago. This trend is expected to persist, with all of the major institutions anticipating a further moderation in inflation over the next few years. However, the dynamics of 'core' inflation have been somewhat less favourable, with an estimated rate of 5.5 per cent in September.**^** Persistence in this series suggests that the original supply shock has morphed into a demand shock.

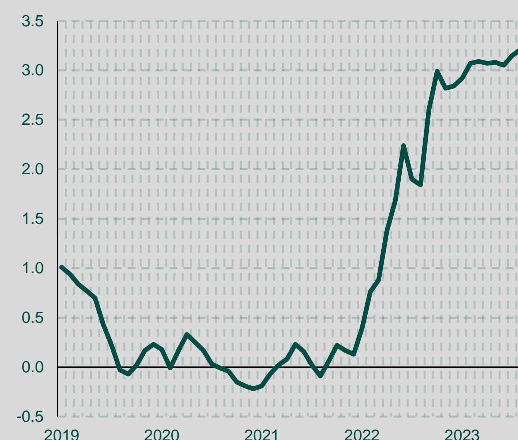
### Figure 8: Key macro developments in the euro area economy

A: forecasts vintages for growth and inflation for 2023




Source: European Commission.

B: euro area sovereign borrowing costs (long-term yields)




Source: Eurostat.

To rebalance demand and supply, policy rates were increased by a further 25 basis points (bps) in September, bringing the cumulative increase to 450 bps since July 2022. Ancillary instruments are also being used to tighten the stance of monetary policy – such as the scaling bank of the *eurosystem's* balance sheet. Partly as a result, there has been a marked increase in sovereign borrowing costs in the euro area with an 8-fold rise in just over 2-years (**figure 8B**). Banks in the euro area banks are also repaying borrowings under the ECB's targeted longer-term refinancing operations.

On the budgetary side, headline fiscal ratios are expected to improve further this year with the general government deficit averaging 3.2 per cent of GDP in the euro area, with a further decline in prospect for next year. However, the debt ratio across the euro area is expected to average c.90 per cent of GDP this year and next, with much heterogeneity across the Member States (6 countries had debt-income ratios in excess of 100 per cent last year).

Last April, the European Commission tabled legislative proposals on reforms to the economic governance framework with the hope for an agreement by end-year. The outcome of these discussions will have a significant bearing on euro area budgetary policy in the years ahead.

**^** core inflation here is defined as excluding unprocessed food and energy in line with the European Commission approach.