Irish ‘boom’ disguises eurozone weakness

The strong GDP growth reading in the eurozone for the first quarter was largely due to special factors, which are expected to balance out in the second and third quarters. Meanwhile, inflation is now projected to remain below 2% for several quarters. That said, the ECB is nearing the end of its easing cycle

Inflated Irish GDP figures are masking eurozone weakness

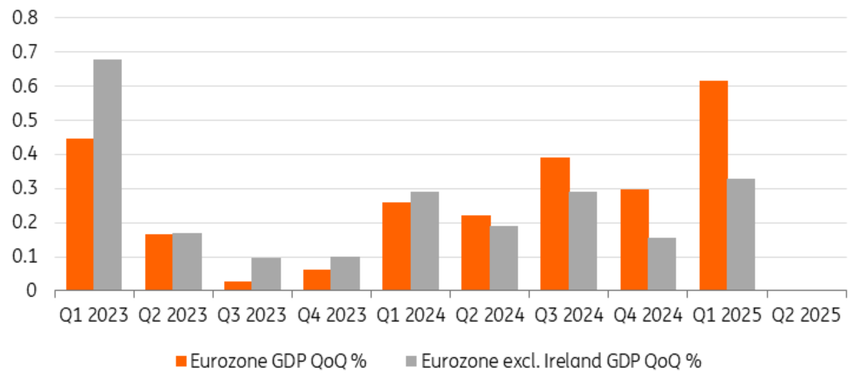
The Irish distortion

The trade war, much like the Covid-19 pandemic, has strongly influenced economic data. Eurozone exports to the US surged in the first quarter as US importers sought to increase their inventories before import tariffs were imposed. Additionally, growth in the fourth quarter of 2024 and the first quarter of 2025 was revised higher, mainly due to Irish GDP figures.

Despite Ireland representing only around 4% of eurozone GDP, it contributed about half of the 0.6% GDP growth in the eurozone for the first quarter. This was driven by the strong performance in the pharmaceutical sector and distorted GDP figures resulting from tax-induced accounting practices by foreign multinationals. The presence of intellectual property rights in Ireland leads to licensing revenues being recorded there, inflating Irish GDP – even though much of this income is ultimately channelled away.

This part of GDP does not represent any real economic activity in Ireland but still affects eurozone growth numbers. Some payback is expected in the second and/or third quarter, as Irish manufacturing production fell by 13.7% month-on-month in April. One thing looks certain: growth figures are likely to remain volatile.

Eurozone GDP growth with and without Ireland



Source: LSEG Datastream

Unemployment expectations rise

Looking past the distorted figures, the eurozone economy appears rather weak. While sentiment in the manufacturing sector has improved from very low levels, the sector remains vulnerable to further tariff actions, with the impact of increased US import tariffs on steel and aluminium (now at 50%) expected to show in June sentiment surveys. Meanwhile, the services sector is losing momentum, possibly reflecting weakening domestic demand.

Unemployment expectations rose in May to the highest level in five months, which will likely increase the savings ratio and reduce consumer expenditure. The current high-uncertainty environment is also likely to weigh on business investment in the short term.

After weak or negative growth in the second and third quarters, we anticipate a gradual improvement in the growth profile, supported by expansionary fiscal policy in Germany and lower interest rates. We have adjusted our GDP growth forecast to 1.0% for 2025 and 0.9% for 2026, due to carry-over effects.

Inflation on a downward path

Inflation is finally evolving favourably, with the May headline harmonised inflation rate falling to 1.9%, while underlying inflation dipped to 2.3%.

Energy prices are likely to continue exerting downward pressure on headline inflation in the coming quarters. Wage growth is decelerating, and the slowdown in services is now capping selling price expectations. Food prices still exert upward pressure on inflation but not enough to reverse the downward trend.

We now expect headline inflation to remain below 2% until the middle of next year, resulting in an inflation forecast of 2% for both 2025 and 2026.

The end of the easing cycle approaches

As expected, the ECB cut its key interest rates by another 25 basis points in June. However, during the press conference, ECB President Christine Lagarde stated that the central bank has "nearly concluded a monetary policy cycle," indicating limited further downward room for interest rates.

We believe the ECB will pause its easing cycle in July, but another rate cut is likely in September due to a weak economy and inflation below 2%. Afterwards, rates are expected to remain stable for an extended period.

Author

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com