Eurozone economy braces itself for prolonged sluggishness

Economic sentiment dropped in October as the first countries reported somewhat better-than-expected GDP growth in the third quarter, making a technical recession in the second half of the year unlikely – but a decline in 4Q is a realistic prospect. Businesses report a slight tick-up in selling price expectations, but hard data still looks benign

A technical recession in the second half of the year appears unlikely, but a decline in the fourth quarter remains a realistic prospect

The decline in the Economic Sentiment Indicator (ESI) in October came as no surprise after the PMI had already dropped further into contraction territory. Still, the drop was relatively mild – from 93.4 to 93.3. This essentially means that sentiment was relatively stable at a low level. Coming from 99.5 in January, the ESI has been indicating that conditions have weakened more or less throughout 2023. With GDP growth already in broad stagnation, we expect that trend to continue in the fourth quarter. The third-quarter GDP data is a mixed bag so far, with Germany and Austria at -0.1% and -0.6% respectively, but Belgium and Spain growing strongly at 0.5% and 0.3%. This makes it likely that eurozone GDP did not contract in the third quarter – but a small decline in the fourth quarter is a realistic prospect.

The ESI does not show any marked deterioration though. Industry saw sentiment weaken slightly, while services sentiment ticked up a bit. Overall, movements aren't too significant at the moment, with a slightly more negative consumer. Retail trade did see a marked deterioration of sentiment, mainly related to weaker recent activity, slowing expected output ahead and higher inventories.

The underlying picture is still quite negative. The service sector increase is only based on expectations, while recent production was still weaker in October. New orders in manufacturing continue to drop, and so does capacity utilisation. Employment demand from manufacturing is outright negative, and in services, it has now dropped below the historic average. This paints a picture of a slight contraction in activity, while increased service sector optimism adds a bit of hope for the coming winter months.

The inflation picture showed two small increases in selling price expectations for both goods and services. This is a warning sign that higher oil prices and elevated wage growth could keep core inflation somewhat elevated, but at the same time, we see retail selling price expectations still falling. With manufacturing companies producing more B2B, the picture is still quite benign for consumer core inflation in the coming months, although stubborn pipeline inflation serves as a warning signal for 2024. The downward momentum for core inflation is confirmed by the weak German regional and Spanish inflation data already out for October this morning.

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