Eurozone economy sees a small contraction as inflation plunges

A drop in eurozone GDP keeps a small technical recession in the second half of 2023 a realistic prospect. With inflation falling faster than expected, the debate within the European Central Bank's governing council is set to turn more dovish, but don’t expect rate cuts anytime soon

GDP decline is not meaningful, broad stagnation continues

The drop of 0.1% quarter-on-quarter in eurozone GDP is not very dramatic. It was led by Irish GDP falling by 1.8% – a figure which is often subject to dramatic revisions. Germany experienced a small decline of 0.1%, while Italy stagnated over the quarter. Growth in France and Spain remained positive but still lower than last quarter. All in all, growth continued to trend around zero in the third quarter.

While a technical recession is certainly possible in the second half of this year on the back of the third-quarter GDP reading and a weak start to the quarter according to first business surveys, we don’t see too much reason for real alarm so far. It does look like the economic environment is weakening at the moment, but no sharp recession is in sight either. Still, continued economic and geopolitical uncertainty alongside the impact of higher rates on the economy will weigh on economic activity in the coming quarters.

Inflation surprises should make ECB debate more dovish at coming meetings

Inflation is really looking more benign at the moment. It has been falling for some time, but the pace of declines disappointed up until summer. September and October surprised positively despite high oil prices and still stubborn wage growth, which adds to confidence that inflation is slowly getting under control.

The October decline from 4.3 to 2.9% was mainly driven by base effects from last year's high energy prices, but core inflation also continues to come down. Month-on-month price growth does not get reported on but a quick calculation suggests that goods prices rose well under 2% annualised in October, while services prices remained more sticky around 3.5% annualised. While high services inflation remains a concern, these figures do mean that annual core inflation – currently at 4.2% – will likely trend lower over the coming months. Especially as businesses are not indicating a new surge in prices is expected.

The numbers start to point to a much better inflation environment, especially now that the economy is clearly performing much weaker than last year and most of the impact of recent hikes is still in the pipeline. While the European Central Bank (ECB) will be very keen to avoid making the mistake of the 1970s by easing too soon and allowing another spell of high inflation later, debates over whether current restrictive levels of interest rates are not too strict are set to grow louder in the months ahead. Don’t expect the ECB to lower rates anytime soon though; upside risks to inflation will weigh heavily in the central bank's decision-making at the coming meetings.

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