Eurozone economy returns to positive growth but underlying weakness remains

GDP growth beat expectations at 0.3% quarter-on-quarter in 2Q, but underlying weakness remains significant. For the data-dependent European Central Bank, this GDP reading will not be a dovish argument at the September meeting, leaving a further hike on the table

Eurozone GDP was boosted by very strong Irish activity, which is known to be volatile

After GDP declined in the fourth quarter and stagnated in the first, it increased by 0.3% quarter-on-quarter in the second quarter. This was better than expected but also boosted by very strong Irish activity, which is known to be volatile on the back of multinational accounting activity. Without Ireland, growth would have been halved. Looking through the most volatile components, we argue that the economy has remained broadly stagnant. Still, for the ECB this will not be the main argument to pause in September.

The buoyant reopening phase is behind us and the effects of high inflation, weak global demand and monetary tightening are resulting in a phase of sluggish economic activity. While the labour market continues to perform very well, a recession is never far away in this type of environment and remains a clear downside risk for the quarters ahead.

The differences between countries are large in terms of performance. The German and Italian economies continue to suffer, in part because their manufacturing sectors are larger and demand for goods remains in contraction. Germany saw flat GDP growth quarter-on-quarter after two quarters of negative growth, while Italy dipped back to -0.3%. On the other hand, France and Spain continued to perform well. French GDP growth accelerated from 0.1 to 0.5%. Spain saw growth decelerate from 0.5 to 0.4%.

Judging by the survey data we have so far on the third quarter, the risks are to the downside for the coming quarters. Manufacturing performance continues to slump as new orders continue to weaken and strong services performance is waning as reopening effects from the pandemic fade. With monetary tightening still expected to have its most dampening effect on growth later, continued broad stagnation of economic activity remains the most likely outcome for the coming quarters.

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