

Eurozone economy slows as inflation increases to 7.5%

The 0.2% increase in GDP masks deteriorating economic circumstances and inflation is still trending up. Core inflation jumped to 3.5%, indicating that second-round effects are coming in more quickly than expected. This adds to pressure on the European Central Bank to act sooner rather than later



GDP slows rapidly for a hodgepodge of reasons

Eurozone growth has been a mixed bag over the first quarter with strong growth in Austria, [modest growth in Germany](#) and Spain, [stagnation in France](#) and a [contraction in Italy](#). The reasons behind this were also very different depending on the country though the early GDP releases have come with limited information and a full picture remains difficult to paint. The reopening of the economy has boosted growth to a degree, probably postponing the pain that high prices will bring to household consumption. But France already experienced a marked decline in household consumption in 1Q, while Belgium suffered from manufacturing weakness. Germany reported strong investment and weak net trade.

Zooming out, we see a eurozone economy undergoing a turbulent quarter though managing to eke out a small positive growth number, with the Omicron impact milder than expected and the

war in Ukraine having an increasing impact from early March onwards. Supply chain problems flared up again in March, causing production shutdowns across the eurozone, which has added to the slowing growth figure in 1Q.

Core inflation at 3.5% is the key figure from today's batch of data

The inflation rate did not continue its rapid ascent of recent months, thanks to energy prices taking a breather. The spike in fuel, electricity and gas prices from early March at the start of the war in Ukraine was followed by cautious retreats and governments reducing taxes on energy. This has resulted in a slight moderation of energy inflation, but concerns remain for the months ahead. The recent jump in market gas prices on the back of Russia cutting off Poland and Bulgaria from gas supply illustrates that it is very possible energy prices spike once again as the war continues.

The impact on core inflation remains key and poses a concern for the ECB. Second-round effects and supply chain problems add to faster price increases in goods and services as well, which has caused core prices to jump from 2.9% in March to 3.5% in April. With supply chain problems set to last longer and become more severe again due to Chinese lockdowns and the war, expect core inflation to trend higher for most of 2022 at least. This broadening of high inflation is a key concern for the ECB and adds to pressure to act quickly, despite the fact that this inflation continues to be rooted in supply-side issues beyond the control of the central bank.

A muddied outlook awaits, also for the ECB...

The outlook for 2Q is pretty tough to read at the moment. Early data from the PMIs signal a positive start to the quarter. At the same time, we see soaring prices, weak consumer confidence and tightening financing conditions, which means that we can expect significant pain ahead. It looks like some reopening of the economy still boosted service sector activity in April, but the question is how long this effect can last. We expect the economy to shrink in 2Q. Still, employment demand remains strong and businesses continue to expect significant price increases in the months ahead.

For the ECB, the continued – albeit slowing – economic growth means that it is likely to act sooner rather than later. The central bank seems keen to battle second-round effects and keep inflation expectations anchored around 2%. While the economy remains weak and this definitely is not an environment in which the ECB can hike as much as the Federal Reserve, don't expect the ECB to wait much longer. A first hike should come in September though July could come into the frame if the economic outlook doesn't worsen materially from here on. That is a big 'if', of course, because the war adds enormous uncertainty to the outlook for the eurozone economy.

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