Eurozone economy stronger than expected, but inflation beats 10%

The eurozone contraction hasn't started yet as GDP growth for the third quarter came in at 0.2%. Inflation continues to increase though, which sets the eurozone economy up for a tough winter as a recession is looming

Inflation continues to be a problem across the eurozone. Pictured: shoppers in Madrid

GDP growth of 0.2% is better than expected

A positive surprise for eurozone GDP. In fairness, this has happened often during the pandemic recovery as the rebound effect has been stronger and lasted longer than expected. While cracks in the eurozone economy are clearly showing, the economy continued to expand in the third quarter. In Germany, it looks like this was mainly due to the last legs of the consumer rebound, while in France consumption growth had already stalled. Investment was the positive surprise in France. Spain experienced fast slowing growth but the tourism recovery prevented the economy from going into the red in the third quarter.

Overall, the picture remains bleak though. Consumer confidence is near historical lows as real wage growth is at a multiple-decade low at the moment. This weighs substantially on the consumption outlook, as retail sales have already been trending down over recent quarters. The reopening of economies boosted services, but that effect is now fading. With interest rates up and the economic outlook uncertain, investment expectations are weakening too. We therefore still expect the economy to contract over the coming quarters.

Inflation into double digits

The inflation rate jumped once again in October, to a whopping 10.7%. This was partly on higher consumer energy prices. The low prices on the wholesale market in recent weeks are clearly not yet translating into declining prices for households. In fact, it's likely that this will only happen in a few months' time and even that is a big 'if' because it depends on uncertain factors such as energy supply and the weather of course.

Other components saw little bright spots in this October release. Food inflation continues to trend up fast despite commodity prices moderating, and goods inflation is also still showing large monthly gains which that's pushed core inflation up to 5%. Services inflation trended just mildly higher to 4.4% in October.

Overall there is still clear evidence that the second round effects of the supply-side shocks to the economy keep pushing up inflation despite moderating demand.

Tough time for a pivot?

The slightly more dovish tone at the ECB press conference on Thursday indicates we shouldn't come to expect such extensive rate hikes, such as the 75bp rise they gave us last week, to be a feature of forthcoming meetings, especially since a recession is drawing closer. Today's data will provide more ammunition for the hawks to show that there is no need to make a sudden pivot yet. Overall though, we keep reiterating that current inflation cannot be fought effectively by monetary policy that has the most effect with a big lag. And hawks cannot expect GDP to keep surprising on the upside forever.

With economic conditions weakening and a recession in the making for the winter, we think the ECB is going make its next hike somewhat smaller at 50 basis points. Given the historic total size of the hikes the ECB is delivering, that will have quite the slowing impact on the economy next year.

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