

# THE ECONOMIC OUTLOOK GROUP



475 Wall Street  
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300  
[www.economicoutlookgroup.com](http://www.economicoutlookgroup.com)

## ECONOMIC TALKING POINTS

Bernard Baumohl  
Chief Global Economist

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### **Growth Recession in the US, and Comic Relief from Europe**

Two big events occurred this morning and both raise more questions than they answer.

Let's start with the initial GDP report for the third quarter, which said the economy grew at a 2.5% rate during the summer. The number drew a sigh of relief on Wall Street because that was in line expectations. It also meant for some that the odds of recession had diminished. Perhaps so. But it also means that this wretched crawl we have proclaimed an economic recovery merely continues. Frankly, to call this a "recovery" at all is hyperbole. Most Americans are unable to discern the difference between a recession and a growth recession, which is what we have had all year.

Though the Dow shot up by more than 300 points this morning, it is time for a reality check. First, the third quarter GDP pace will not make much of a dent in bringing down the jobless rate. For that you have to achieve rates of growth in excess of 3.5% for more than a year.

Second, we don't see the economy even sustaining this mild 2.5% pace the next two quarters. While personal consumption expenditures did "pop" up 2.4% last

quarter, let's keep this increase in perspective. With real wages plummeting and consumer confidence in free fall, household spending will very likely slow in the coming months. Indeed, the gap between real income and consumption is now so wide, consumers are digging deeper into savings to finance consumption. We saw in today's GDP report how the savings rate has fallen to 4.1% in the third quarter, from 5.6% a year ago. In addition, the Federal Reserve's latest figures on consumer debt in the third quarter show that Americans are under such financial stress, they have resumed borrowing again for the first time since 2009. Total consumer loans rose at a 2.2% annual rate in the third quarter.

Does this signal the end of deleveraging? No, not in this environment of poor job growth, declining household wealth and lagging confidence. Third, with Europe in or near recession and both China and India's economies slowing, the growth in US exports will ease too and contribute less to GDP in the coming quarters.

Finally, we see evidence in this report of companies being very cautious in adding to their stockpiles. Inventories were rebuilt at a \$5.4 billion annual pace, the smallest in nearly two years. Keeping inventories lean may be a positive development in the future once demand picks up and the restocking begins. But we see no significant increase in demand for at least the next two quarters.

So while the advance report on third quarter GDP did show the economy growing at the fastest pace in a year, economic activity is still stuck in first gear with a 1.4% pace so far in 2011. When you combine this lackluster performance with the looming geopolitical threats from Europe, North Africa, the Middle East, not to mention the political paralysis in Washington, it is easy to understand why employers have no desire to ramp up hiring. That sentiment came through in the latest jobless claims report, which saw new applications for unemployment benefits, once again, stuck at around 400,000.

Our forecast calls for GDP growth to slip back to less than 2% in the final quarter of the year, and a small contraction in the first quarter of 2012. Putting the breaks on growth will be less consumer spending, a cutback in business capital expenditures, fewer exports, and little new fiscal stimulus coming out of Washington.

### **How about that 15-page report to save Europe and the world from a financial meltdown?**

The second major piece of news this morning is the agreement announced in

Europe to defuse, if not end, the sovereign debt crisis. The plan, in short, requires holders of Greek debt to accept a 50% discount on the bonds they hold and orders banks recapitalize by raising euro 106 billion euros in fresh funds to cushion against future losses. The goal is to bring European bank Tier 1 capital reserves up to 9% by next June. It also turns the 440 billion euros in the EFSF into a 1 trillion euro plus war chest (primarily by issuing bonds and through special purpose investment vehicles) to prevent countries like Spain, Italy and France from being sucked into the crisis. Both Greece and Italy also promised to take even more austerity measures.

Financial markets reacted positively now that European leaders, after weeks of dithering and haggling, came through with a new bailout strategy.

Our assessment of the plan, however, is that it is woefully short on detail, and in some areas so vague to the point of being humorous. The 15-page report itself came across as one large throat clearing exercise. At a press conference, French president Sarkozy said the new plan “will be a source of huge relief worldwide.” If he meant comic relief, he may have a point.

What European leaders really needed was a massive, comprehensive, and credible bazooka of a plan to illustrate it has the resources and resolve to end this crisis once and for all. Instead, after 14 summit conferences and 10 hours of negotiations last night, the bazooka ends up popping out a small flag that says “Bang!”

Here are a couple of observations.

- For banks and other private investors, there was little that was “voluntary” about agreeing to 50% haircut on Greek debt. It was either that or face financial ruin under a complete Greek default. The banks had NO choice. Here’s the sentence of the week in the official report: “We invite Greece, private investors and all parties concerned to develop a voluntary bond exchange with a nominal discount of 50% on notional Greek debt held by private investors.” Don’t you just love that semantic touch by adding...*Invite!!*
- After much parliamentary infighting, Italy has agreed to take the extraordinary challenging!! step of increasing the retirement age from 65 to 67 by the year 2026. We’re talking about fifteen years from now. (Our sources tell us there was even some last minute backroom fighting over whether the year should be 2026 or 2027.)
- There are so many details still to be worked out on how Italy will cut government spending that another sentence in the report simply notes that it will

“call on Italy to present as a matter of urgency an ambitious timetable for these reforms.”

- Another favorite passage calls on Italy to have a balanced budget amendment in its constitution by the middle of next year.
- Just how Europe would leverage the 440 billion euros into a war chest four or five times that size was described in less than 10 lines. But then European leaders probably are certain how to pull this off yet. Alas this statement: “We call on the Eurogroup to finalise the terms and conditions for the implementation of these modalities in November.” As for the final, final, final detailed plan, there is this final note: “A report on how to implement the agreed measures will be finalised by March 2012.”
- As for the role of the IMF? “We call on the IMF to continue to contribute to the financing of the new Greek programme.”

Well, you get the idea.

As tough as it was for Europe to draft this 15-page report, the real hard work comes next. The success or failure in arresting the European financial crisis rests in the hands – or shall we say cup --- of France’s Sarkozy. He is flying off to China to grovel in fine diplomatic form for funds. The Asian giant has amassed \$3.2 trillion in foreign reserves and it may be that the success of Europe’s bail out plan ultimately rests with the generosity of China’s politicians, investors and companies. Europe has now kicked the can down the road for two years. Ironically, that road has now come to an end, right in front of China’s door.

**Bottom line:**

Is the systemic risk over in Europe. Not by any means. The region is in recession. State revenues will fall further. Unemployment will worsen. It means that national leaders will be under increasing pressure to back away from the reforms they promised at the latest European summit. Thus the odds are better than even that Europe will lurch to another crisis before the year is out.