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The Hard Work in Europe Starts Now

The success or failure rests in the hands of France's Sarkozy.

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

Let's begin with the initial gross-domestic-product 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 with 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 as an economic recovery merely continues. Frankly, to call this a "recovery" at all is hyperbole.

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 freefall, 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 Thursday'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.

Third, with Europe in or near recession and both China and India's economy slowing, the growth in U.S. 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.

The second major piece of news was 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 106 billion euros in fresh funds to cushion against future losses. The goal is to bring European bank capital reserves up to 9% by next June.

It also turns the 440 billion euros in the European Financial Stability Facility into a one 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.

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 summits conferences and 10 hours of negotiations last night, the bazooka ends up popping out a small flag that says "Bang!"

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 Nicolas 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 bailout 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. That road has now come to an end, right in front of China's door.