

Pro-Growth Policies Boost U.S. Economic Recovery *Slower growth amid greater austerity in Europe*

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Key Takeaways

- One and a half years past the end of the most recent recession, the U.S. economy has rebounded more quickly than the typical pattern for countries following a financial crisis.
- In contrast, the European recovery is more muted, with growth hindered by fiscal austerity and weakness in the eurozone periphery.
- Part of the growth disparity lies in the United States' greater pursuit of more stimulative monetary and fiscal policies, and the sustainability of this growth advantage will depend on how successful the United States can transition to normalizing these policies.

A significant amount of academic work has indicated that economic recoveries following financial crises have tended to be more sluggish than typical recoveries that follow non-crisis recessions. One reason for this phenomenon is simply that the lingering impairment in the banking systems and credit markets—home to the excessive debt levels that generally triggered the crisis—need to be worked off and act as a constraint on the recovery. For example, a study by the International Monetary Fund that analyzed 83 developed-country recessions from 1970-2010 found that during post-crisis recoveries, average credit growth remained flat for two years after the end of the recession. As a result, economic recoveries after recessions caused by a financial crisis usually took longer (average length about five and a half quarters) to return to the previous peak in output, compared to all other recessions (about three quarters).ⁱ

This context can help explain why the current economic recoveries in both the United States and Europe have been sub-par when compared to historical averages—both were preceded by the financial crisis that began in 2008. However, the U.S. economic recovery has broadened and accelerated in recent months, placing its trajectory in a different light than that of Europe. With the solid 3.2% growth registered during the fourth quarter of 2010, U.S. economic output returned to pre-crisis levels (see Exhibit 1, page 3). The 3% average annualized U.S. economic growth during the six quarters since the recession ended in mid-2009 was slower than the historical average of normal recoveries, but faster than the average for post-crisis recoveries. In contrast, the euro region's economic pace remained well below the average of the typical post-crisis recovery, and its output level is still 3% below its pre-recession peak.



U.S. and Europe: Different policy choices

Part of the explanation for the growth disparity between the United States and Europe lies in the emphasis of their monetary and fiscal policies. Taking a look at monetary policies, not only has the U.S. Federal Reserve kept short-term interest rates near 0%, it embarked on a second round of quantitative easing in late 2010 that has resulted in a total \$1.5 trillion expansion of its balance sheet since August 2008. In contrast, the European Central Bank implemented a much less ambitious quantitative easing program in 2008, and its balance sheet is actually smaller today than it was in October 2008, despite continued sovereign debt and banking concerns in the Euro-zone periphery.ⁱⁱ

In terms of fiscal policy, troubled peripheral nations such as Greece and Ireland have begun to implement austere budget cuts. Larger countries, such as Germany, have maintained sizeable deficit spending this year, but at 4.5% of GDP the deficit is far smaller than the projected 11% U.S. deficit. In addition, Germany and other countries have proposed budget cuts, while the most significant budgetary action taken in the United States was the December 2010 legislation that extended the Bush-era personal tax cuts and added \$858 billion to the overall deficit.ⁱⁱⁱ Taken together, the tone of economic policy in the United States remains much more focused on promoting growth, while Europe has emphasized fiscal austerity and a general inclination to move more quickly toward normalizing policies in the post-crisis environment.

Post-recession scorecard

So far, both the United States and Europe have made only limited progress in improving their national balance sheets in the aftermath of their

financial crises (see Exhibit 2, page 3). During the past two years, U.S. financial firms and households have lowered the high levels of debt that spurred the 2008-09 financial crisis. The biggest progress occurred in the financial sector, where leverage ratios for major institutions declined significantly. While household (consumer) debt is lower, it remains at historically high levels relative to income. In contrast, the level of government debt has expanded dramatically during the past two years, and the increase in public debt has roughly offset the deleveraging that has occurred in the private sector. In Europe, government debt has not increased as much, but the size of household and financial liabilities has not fallen. In the aggregate, therefore, both the United States and Europe still have high levels of overall debt, despite solid economic growth and private-sector deleveraging in the United States, and a move toward tighter fiscal policies in Europe. The more rapid pace of economic recovery in the United States has benefited investors in U.S. assets. The U.S. stock market is up 107% from the trough level in early 2009, while stocks in the euro zone are up 88%. The dollar has risen 3% against the euro since the end of the recession. Meanwhile, U.S. government bond markets have remained relatively stable, while crisis-hit countries such as Greece and Ireland have seen long-term government bond yields double. Corporate bond yield spreads have declined further in the United States than in the euro region—a sign of renewed investor confidence in the corporate sector that has resulted in a 33% rally for investment-grade corporate bonds since early 2009 (versus 23% for euro-zone corporate bonds).^{iv}



EXHIBIT 1:

The post-financial-crisis recovery of the U.S. economy has been stronger than what transpired on average after other financial crises in history, but has been slower than recoveries that were not induced by a financial crisis. While the level of U.S. economic output has returned to the rate seen prior to the recent global financial crisis, the Euro-region's output remains about 3% below pre-crisis levels.

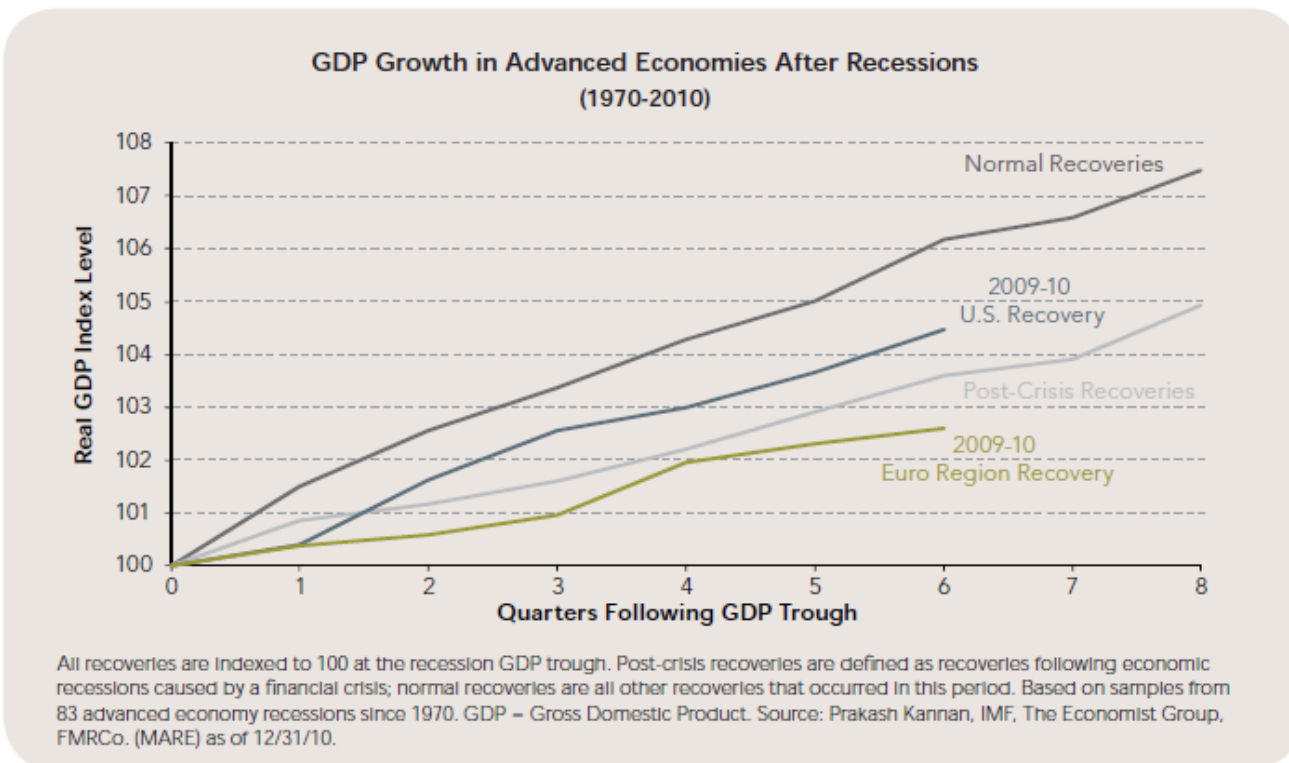
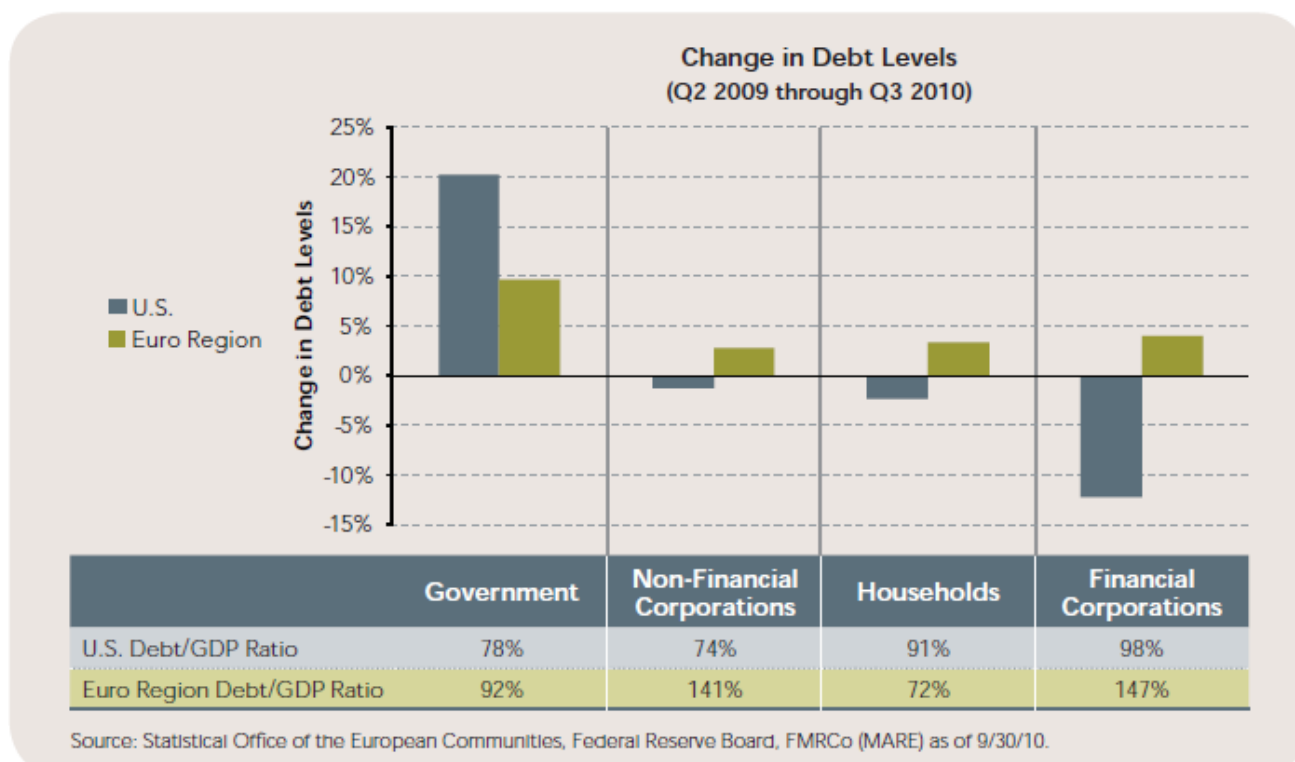


EXHIBIT 2:

Despite solid economic growth and private-sector deleveraging in the United States, and a move toward tighter fiscal policies in Europe, both the United States and the euro region still have high levels of overall debt.





Investment implications

There are many differences between the U.S. and European economies, including the degree of labor market regulation, importance of exports to economic output, and demographics. However, the manner in which each is choosing to navigate the aftermath of the financial crisis offers a particularly interesting contrast to the following question: Should growth or austerity be the first emphasis when attempting to pare down debt levels in a post-crisis environment? Ultimately, fiscal sustainability and deleveraging will only be

achieved through both economic growth and greater fiscal rectitude. In the meantime, Europe will need to convince investors it can still grow its economy while paring government budgets and implementing austerity measures. The United States has undeniably recovered more quickly and offered greater returns to investors over the past year and half. The challenge ahead will be whether it can take advantage of an increasingly solid economic environment to transition to more normalized and sustainable monetary and fiscal policies.

Footnotes:

[i] Post-crisis recoveries are defined as recoveries following economic recessions caused by a financial crisis; normal recoveries are all other recoveries that occurred during this period. Based on samples from 83 advanced economy recessions since 1970. Source: Prakash Kannan, IMF, The Economist Group, FMRCo. (MARE) as of 12/31/10.

[ii] From August 2008 to January 2011, Federal Reserve total assets rose from \$911 billion to \$2.5 trillion. The European Central Bank's total assets rose €500 billion to €2.03 trillion in October 2008, and most recently stood at €1.96 trillion in January 2011. Source: European Central Bank, Federal Reserve Board, Haver Analytics, FMRCo. (MARE) as of 1/31/11.

[iii] Budget deficits for Germany and the United States are 2010 OECD (Organisation for Economic Co-operation and Development) estimates. The U.S. government's "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" extended the Bush-era tax cuts and other programs, with an estimated monetary impact of \$858 billion over two years. Source: OECD, Internal Revenue Service, The Library of Congress, FMRCo. (MARE) as of 1/31/11.

[iv] U.S. stocks and European stocks are represented by the S&P 500 Index and the MSCI Euro Index, respectively. U.S. and European investment-grade bonds are represented by the Barclays Capital (BC) U.S. Aggregate Bond Index and the BC Euro-Aggregate Bond Index, respectively. Performance for U.S. and European stocks and bonds from 3/9/09 through 2/18/11. Source: Barclays Capital, FactSet, FMRCo. (MARE) as of 2/18/11.

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