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SEPTEMBER 25, 2009

# Leaders Face Dilemma on When to Unwind

*Uncertain Pace of Upturn Complicates Decisions on Withdrawing Stimulus*

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By JUSTIN LAHART

The global economy appears to be growing, after weathering the worst world-wide recession since the 1930s. But the severity and scope of the crisis and the downturn it provoked make the recovery's pace highly uncertain -- posing a dilemma for leaders at the Group of 20 summit.

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The stimulus efforts and other programs governments have put in place to revive their economies are incredibly costly, saddling countries around the world with budget deficits that could weigh on future growth. The International Monetary Fund forecasts that in the next few years debt levels for the Group of 20 leading and

developing nations will average more than 100% of gross domestic product -- the value of all goods and services produced by an economy.

The unpredictability of the recovery is complicating decisions that governments must consider. If they keep support high -- especially through fiscal stimulus programs -- that could spur inflation. Withdrawing support too soon could derail a recovery.



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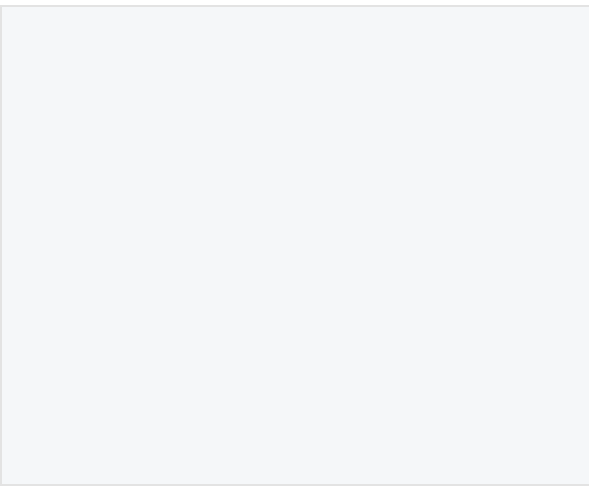
Residents sit atop Mount Washington at dusk while overlooking downtown.

A number of central banks are beginning to unwind some programs. On Thursday, the Federal Reserve said it would shorten the maturity on loans it makes to banks under its Term Auction Facility, a program set up in December 2007 to flood banks with needed cash as the credit crunch worsened. Instead, it will shift the program toward its shorter-term loans of 28 days. The sizes of the 28-day loans will shrink early next year.

The Fed said the move was part of its plan "to gradually scale back these facilities in response to continued improvements in financial market conditions."

### The G-20 Summit

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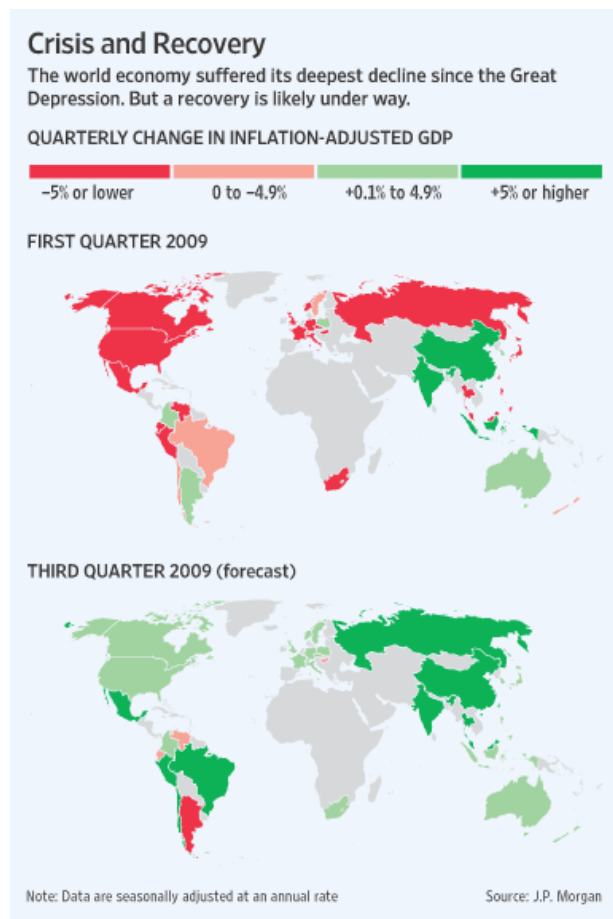
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Many such programs were launched as the world economy began to falter. By the time the G-20 met in April, it was reeling. Economists at Barclays Capital calculate that global GDP fell at a 5.9% annual rate in the first quarter, after a similar decline in the fourth quarter of 2008. Barclays estimates that global GDP grew by 3% in the second quarter, and that it will grow by 3.9% in the soon-to-be-finished third quarter. For the

year, Barclays sees GDP falling by 1.2%, which is in line with most other forecasts.

IMF Managing Director Dominique Strauss-Kahn warned Thursday it is too early to begin "mopping up" the effects of stimulus.

For 2010, however, forecasts vary. The IMF, which will update its estimate next month, said in July it expects global economic output to grow by 2.5% in 2010. Michael Mussa, a former IMF chief economist who is with the Peterson Institute for International Economics, is looking for 4.2% growth. In a recent research report, Mr. Mussa invoked the "Zarnowitz rule," named after the late economist Victor Zarnowitz: Deep recessions tend to be followed by abrupt recoveries.



While it is typical for an economy to grow much faster than normal after a downturn, quickly returning GDP to its pre-recession level, some economists worry that the fallout from the global financial crisis will stymie a fast recovery.

"One thing we have to be careful of is that we don't go into premature victory here," said University of Maryland economist Carmen Reinhart, who examines the history of financial crises' fallout in a coming book with Harvard University's Kenneth Rogoff, another former IMF chief economist. "The message to the G-20 is that the situation, while encouraging, is still tenuous."

In the post-World War II period it has taken, on average, two years for a

country's GDP to recapture its prior level, Ms. Reinhart and Mr. Rogoff find. The main reason is the shrinking of available credit caused by hits to banks and other lenders.

A second factor is the global nature of the downturn. Rising exports tend to drive recoveries in crisis-hit economies. But the crisis has hit so many countries at once that they can't all export their way to recovery. That could weigh on growth, and intensify frictions over trade.

In China, much of the stimulus money the government has spent has gone into investments in plants and equipment that are boosting the country's productive capacity, rather than boosting domestic demand.

That will exacerbate China's need to increase its exports, said Cornell University economist

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Eswar Prasad. He worries that Japan and Europe, too, will remain too reliant on exports for growth, placing U.S. households back in the role of consumer of last resort. After heavy real-estate and stock-market losses, U.S. households may not have the wherewithal to play that role again -- at least not for long.

Write to Justin Lahart at [justin.lahart@wsj.com](mailto:justin.lahart@wsj.com)

Printed in The Wall Street Journal, page A6

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