

**The US External Deficit and Developing Countries**  
By William R. Cline

**Abstract**

In the absence of US fiscal adjustment and a further correction of the dollar, the current account deficit is headed to \$1.3 trillion by 2010 (8 to 8.5 percent of GDP) and net US foreign liabilities to over \$8 trillion (50 percent of GDP). According to CGD/IIE Senior Fellow William R. Cline, the rising trade deficit and associated borrowing from abroad are now financing a decline in personal saving and a rise in the government deficit. This imbalance will increasingly put the US economy—and the developing countries—at risk. This working paper focuses on the impact that the US external deficit and a possible “hard landing” for the US and world economies will have on developing countries. Cline finds that these countries are at risk since they have relied heavily on a continuing expansion of trade surpluses with the United States as a source of demand. Developing countries with high borrowing abroad are also doubly sensitive to a spike in world interest rates—once directly from higher US interest rates, and once indirectly through higher risk spreads—that might be associated with a hard landing. This Working Paper is based on *The United States as a Debtor Nation*, a book published in 2005 by the Center for Global Development and the Institute for International Economics.

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## **The US External Deficit and the Developing Countries**

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Working Paper<sup>1</sup>  
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The US economy now has its largest external imbalance on record, with a current account deficit of 6½ percent of GDP in 2005.<sup>2</sup> This is almost twice as large as the previous peak deficit (3.4 percent of GDP in 1987). This paper argues that this large and rising deficit poses serious risks to the US and world economies. It also argues that the developing countries not only have much at stake in a smooth adjustment of the US imbalance, but also that their own policies will be a key factor in achieving this outcome.

In particular, as set forth in my recent policy brief, the major developing countries should join with the leading industrial nations in a "Plaza II" agreement to appreciate a wide set of currencies against the dollar.<sup>3</sup> The degree of appreciation would depend on each country's circumstances. This would mean, for example, that Latin American currencies would tend to appreciate by less than East Asian currencies, thereby reversing some of the loss of Latin America's competitiveness relative to China and some other East Asian economies in recent years.

### ***Is There Really a Problem? The Sharpening Debate***

The proximate causes of the US external deficit are the impact of the overvalued dollar in making US exports uncompetitive and imports cheap, and the faster rate of growth of the economy and hence import demand in the United States in recent years

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<sup>1</sup> This Working Paper draws on my book *The United States as a Debtor Nation* (Washington: Institute for International Economics and Center for Global Development, 2005a).

<sup>2</sup> The current account is the balance on trade in goods and services, plus the balance on transfers and capital income. In 2005 the trade deficit accounted for about 90 percent of the overall current account deficit.

<sup>3</sup> William R. Cline, "The Case for a New Plaza Agreement," *Policy Briefs in International Economics* No. PB05-4 (Washington: Institute for International Economics, December, 2005b).

compared to Japan and Europe in particular. From the second quarter of 1995 to the first quarter of 2002 the real value of the dollar (adjusting for inflation) rose by 33.5 percent on a trade-weighted basis.<sup>4</sup> Since then it has moderated somewhat, falling by 11.9 percent from the first quarter of 2002 to the fourth quarter of 2005. But competitiveness has not been fully regained, and an even more competitive dollar than before is needed now in order to service today's higher stock of net external liabilities, the result of about \$4 trillion in cumulative trade deficits over the past decade. Underlying causes of the strong dollar included large inflows of private capital from abroad in response to investment opportunities in the "new economy" in the late 1990s and, more recently, inflows of foreign official capital as foreign central banks seek to keep their exchange rates from appreciating by intervening in exchange markets. In recent years the large inflows have shifted from financing rising private investment to financing rising government deficits and falling private saving.

Although most economists would agree with this outline of the sources of the large external deficit, an intensifying debate has emerged among them on whether the external deficit is a problem. Table 1 summarizes the arguments of some of the main participants in this debate.

Table 1  
Is the US External Deficit a Serious Problem?  
Alternative Diagnoses

Serious problem	Focus
Roubini and Setser	Crisis trajectory like Latin American episodes
Bergsten	Hard landing for dollar, US economy, world economy
Summers	Perilously low private saving rates
Cline	Growing crisis risk; future adjustment burden larger
Obstfeld and Rogoff	Huge adjustment for tradables sector
Blanchard, Giavazzi, Sa	Large depreciation likely to be required
Mann	Codependency postpones eventual crisis
Not a serious problem	
Cooper	Attractive US capital market induces ample foreign finance
Bernanke	Foreign saving glut is the cause
Gourinchas and Rey	With valuation effects the imbalance is smaller than in 1987
Dooley et al.	Bretton Woods II: Asia will finance US to sustain exports
Hausmann, Sturtzenegger	"Dark Matter" unaccounted US foreign assets

<sup>4</sup> Federal Reserve, "Price Adjusted Broad Dollar Index." ([www.federalreserve.gov/releases](http://www.federalreserve.gov/releases).)

Nouriel Roubini and Brad Setser are perhaps the most alarmist.<sup>5</sup> They point to Latin American crisis levels for the ratio of US external debt to exports, and warn of a surge in interest rates as the US risk premium rises, as well as a sharp spike in interest rates if China and other countries stop buying US government obligations. C. Fred Bergsten has warned of a hard landing and trade protection.<sup>6</sup> In the classic hard landing scenario (which dates from similar debates in the 1980s), there is a collapse in confidence in the dollar as markets shift their focus from the relatively high growth and interest rates in the United States to its large and widening current account deficit. A plunge in the dollar occurs along with a surge in interest rates that causes a US recession, and high interest rates along with the US downturn trigger global recession. If instead the dollar stays high, the growing trade deficit can trigger an outbreak of trade protection.

Former Treasury secretary Larry Summers judged the deficit benign in the late 1990s, but with the decline in private saving and swing to fiscal deficit, he now considers it a severe symptom of dangerously low saving.<sup>7</sup> Obstfeld and Rogoff do not see an imminent crisis, but emphasize that the dollar could fall a long way, because the size of the trade deficit is large relative to the tradables sector in GDP.<sup>8</sup> They emphasize that overshooting could shock the derivatives markets. Blanchard, Giavazzi and Sa incorporate favorable effects from higher dollar valuation of foreign assets as the dollar falls, but even so also arrive at a steep eventual correction of the dollar to correct the external deficit.<sup>9</sup> Catherine Mann notes that "codependency" of US consumers addicted

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<sup>5</sup> Nouriel Roubini and Brad Setser, "Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005-06," San Francisco Federal Reserve conference, February 4, 2005.

<sup>6</sup> C. Fred Bergsten, "A New Foreign Economic Policy for the United States," in Bergsten, ed., *The United States and the World Economy: Foreign Economic Policy for the Next Decade* (Washington: Institute for International Economics, 2005).

<sup>7</sup> Lawrence Summers, "The US Current Account Deficit and the Global Economy," Per Jacobsson Lecture, Washington, October 3, 2004.

<sup>8</sup> Maurice Obstfeld and Kenneth Rogoff, "The Unsustainable US Current Account Position Revisited," NBER Working Paper 10869, October 2004. Cambridge, MA: National Bureau of Economic Research.

<sup>9</sup> Olivier Blanchard, Francesco Giavazzi, and Filipa Sa, "The US Current Account and the Dollar," MIT Working Paper 05-02, May 2005.

to imports and foreign investors addicted to the US capital market keeps the imbalance going, but she worries about an eventual collapse.<sup>10</sup>

On the side of those not seriously concerned about the US external deficit, Richard Cooper argues that the deficit is "sustainable" because the rest of the world seeks the safety of the US capital market, so adequate capital inflows will continue to finance the deficit.<sup>11</sup> New Federal Reserve Chairman Ben Bernanke has argued that the large US external deficit is the consequence of a global "saving glut" that emerged as investment abroad fell while saving remained high.<sup>12</sup> Gourinchas and Rey emphasize the dollar asset valuation effect, and suggest that today's imbalance is actually smaller than that in 1987 because the foreign asset position on which dollar valuation gains can act is larger.<sup>13</sup> Dooley, Folkerts-Landau, and Garber argue that the US deficit could persist for a long time, because China, much of East Asia, and even Japan seek to keep exports growing as the source of growth for their economies and do so by keeping their exchange rates undervalued.<sup>14</sup> They buy up dollar reserves and maintain quasi-fixed exchange rates against the dollar, thereby creating a "Bretton Woods II" periphery of fixed-rate countries that coexists with the flexible-rate center (which includes Europe). Hausmann and Sturzenegger argue that the US current account deficit must be an accounting fiction, because despite years of deficit the United States still earns a net profit on its international assets and liabilities; there must thus be unobserved "dark matter" in US foreign assets that is not counted, and by implication there must be an understatement in annual exports of goods and services.<sup>15</sup>

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<sup>10</sup> Catherine L. Mann, "Managing Exchange Rates: Achievement of Global Re-Balancing or Evidence of Global Co-Dependency?" *Business Economics*, July 2004, pp. 20-29.

<sup>11</sup> Richard N. Cooper, "Living with Global Imbalances: A Contrarian View," *Policy Briefs in International Economics* No. PB05-3. (Washington: Institute for International Economics, 2005).

<sup>12</sup> Ben S. Bernanke, "The Global Saving Glut and the US Current Account Deficit," Speech, July 2005. [www.federalreserve.gov](http://www.federalreserve.gov).

<sup>13</sup> Pierre-Olivier Gourinchas and Hélène Rey, "International Financial Adjustment," CEPR Discussion Paper 4923, February 2005. London, Centre for Economic Policy Research.

<sup>14</sup> Michael Dooley, David Folkerts-Landau, and Peter Garber. "A Map to the Revived Bretton Woods end Game: Direct investment, Rising Real Wages, and the Absorption of Excess Labor in the Periphery," Deutsche Bank Global Markets Research, 2004.

<sup>15</sup> Ricardo Hausmann and Federico Sturzenegger, "'Dark Matter' Makes the US Deficit Disappear," *Financial Times*, December 7, 2005.

I agree with those who consider the US external deficit a serious problem. Some would argue that the hard landing scenario is unlikely because the Federal Reserve would be unlikely to boost interest rates if the dollar fell unless the economy were overheating, which would be the opposite of a recession. However, in a crisis the Fed could face a market-driven surge in the long-term interest rate, which it does not control, even if it did not raise the short-term federal funds rate. The United States already had close calls with the hard landing in 1979 and 1987. Although a hard landing remains less than likely, its chances will rise as the external deficit rises.

With respect to Richard Cooper's analysis, a close look at his numbers shows that he is talking about sustaining a current account deficit of only \$600 billion annually, rather than a deficit rising to \$1.2 trillion by 2010 (the baseline in my model projections). His long-term target for the current account deficit of 2.5 percent of GDP is no different from what most of those in the "concerned" camp would consider reasonable, but achieving a cutback to that level would require much greater adjustment than he seems to acknowledge. As for the Gourinchas and Rey diagnosis, they implicitly assume a seemingly perpetual downward slope for US net assets, raising questions about the sustainability of their trajectory. In a sense their analysis is disturbing rather than reassuring, because it says that in the absence of special policy efforts the foreign exchange market will allow the dollar to remain strong enough over time to plunge US net liabilities to depths previously not explored, suggesting an eventual wake-up collapse.

As for the global saving glut, it is true that from 1997 to 2004 following the financial crises of the late 1990s, the newly industrialized East Asian economies, other ASEAN countries, and Latin America together experienced a drop of about 6 percent of GDP in investment while their saving remained broadly unchanged. But when this shock is applied to the size of their combined GDP, the resulting measured impact amounts to only 0.7 percent of rest of world GDP. So the fair share for the United States of the global saving glut might be a 0.7 percent of GDP shock. This is far smaller than the 4 percent of GDP downswing in the US external balance in this period. The "smoking gun" of a 6 percent of GDP collapse in US fiscal accounts, and a 2.6 percent of GDP

structural fiscal deterioration from the tax cuts alone, is a far more plausible cause of the US trade deterioration. Blaming the rising trade deficit on a glut in foreign saving distracts attention from the need for fiscal correction at home.

Nor is the Bretton Woods II argument convincing. Japan is not a plausible "periphery" country, as it has no surplus labor that must be absorbed in export activity. The surplus of the other Asian economies (including China) is too small by itself to finance the large and growing US deficit; and even if it could do so, rising US protectionist pressures could cause the model to crack. As for the new discovery of "dark matter," my own earlier work already pointed out the fact that the United States is still a net creditor nation when judged by Capitalized Net Capital Income (CNCI) because it has a persistently higher return on direct investment assets abroad than foreigners earn on direct investment in the United States.<sup>16</sup> However, I also emphasized that the trend is seriously negative even by this measure. In my projection baseline, on the standard accounting basis by 2010 the US net international investment position (NIIP) is -50 percent of GDP, compared to -22 percent in 2004. The CNCI, arguably a better measure of economic burden, similarly deteriorates from +7 percent of GDP in 2004 to -22 percent by 2010. As the *Economist* puts it, this is "A dark matter indeed."<sup>17</sup>

After considering the various indicators, I arrive at a 50 percent of GDP ceiling as what I would consider safe for accounting-based net international liabilities for the US economy. I therefore argue for dollar adjustment and fiscal adjustment that will bring the current account deficit down from a baseline of 8 - 8½ percent of GDP in 2010 to about 3½ percent. I judge that even if the markets would permit a much larger debt buildup, the result would be to impose a severe burden on US households about a decade from now. Extrapolation of the baseline shows net external liabilities reaching 135 percent of GDP and the current account deficit reaching 14 percent of GDP by 2024 (figure 1).<sup>18</sup> Because that trajectory is patently unsustainable, the real question is whether adjustment occurs

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<sup>16</sup> The CNCI is an estimate of foreign assets based on actual capital income flows rather than stock measures of assets and liabilities. See Cline, 2005a.

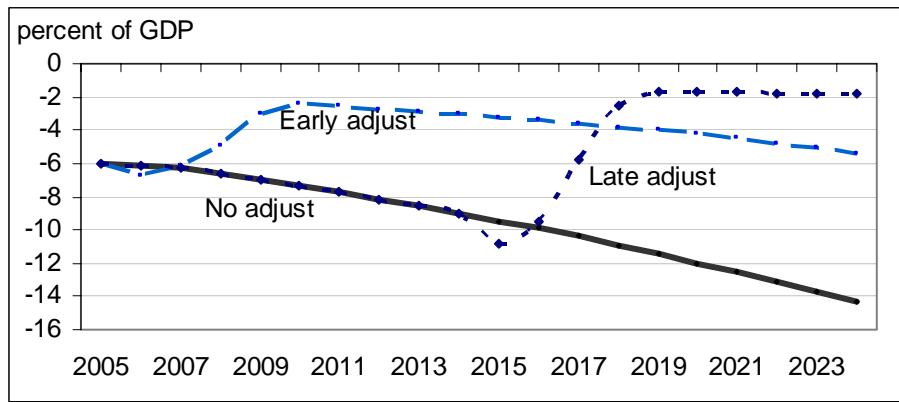
<sup>17</sup> "America's Dark Materials," *The Economist*, January 19, 2006.

<sup>18</sup> Author's calculations; see Cline, 2005a.

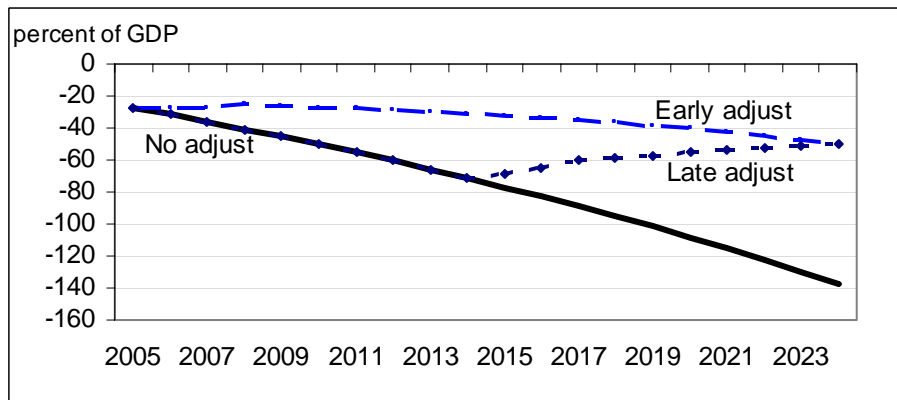
earlier or later. If adjustment is early, then the cutback in consumption can be evenly spread between households today and households in the future. If instead the United States delays adjustment for another decade, then a much more severe consumption cutback will be forced on households at that time, as shown by the contrast between the dashed line and the dotted line in the top graph.

Figure 1  
Long-term Current Account and NIIP, 2005-2024

A. Current Account



B. Net International Investment Position



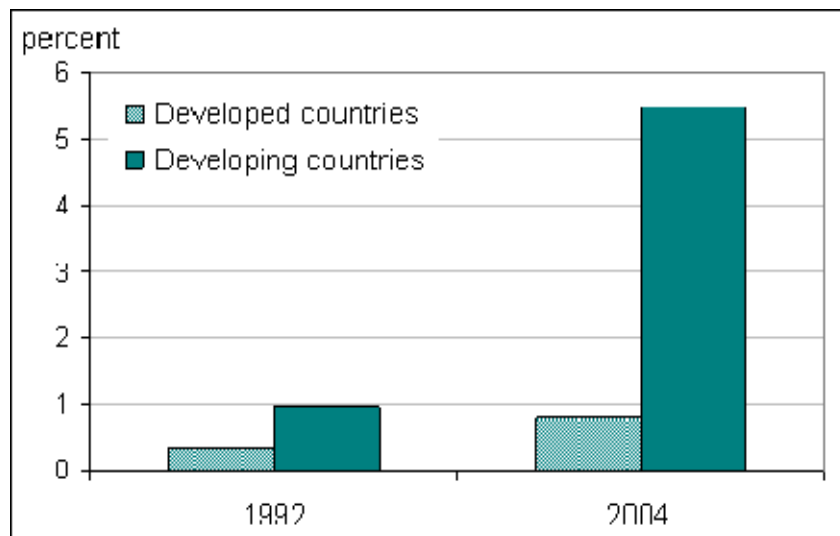
*Stakes of the Developing Countries in a Smooth US External Adjustment*

The developing countries have experienced a large source of increased net demand from the widening US trade deficit in recent years, and they will need to shift toward other sources of demand — primarily domestic — if the United States is to begin



to reduce its external imbalance toward more sustainable levels. As shown in figure 2, the positive demand shock from the widening US trade deficit in recent years was much more powerful for the developing countries than for the industrial countries. The trade surplus of developing countries with the United States rose from 1 percent of their combined GDP in 1992 to 5.5 percent in 2004, a demand boost equivalent to 4.5 percent of developing-country GDP.<sup>19</sup>

Figure 2  
Developed and Developing Countries' Aggregate Trade Balances  
with the United States (percent of their aggregate GDP)



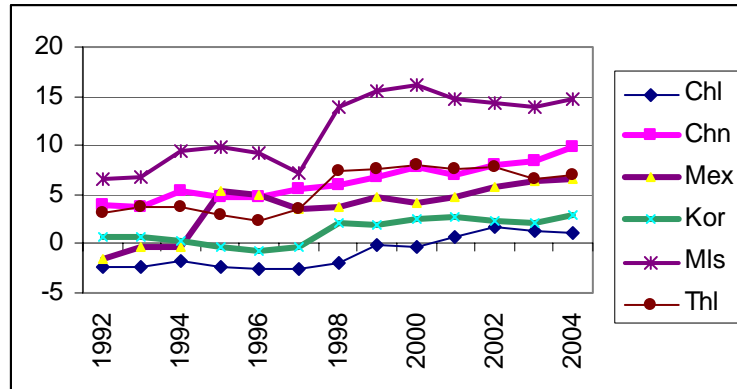
For some key developing-country trading partners, the increase in demand from a rising trade balance with the United States was especially large. As shown in figure 3, Mexico's trade balance with the United States swung from -1.5 percent of GDP in 1992 to +6.7 percent in 2004.<sup>20</sup> For China, the upswing was from a surplus of 3.9 percent of its GDP to 9.8 percent. Although it gives pause that any nation would rely on the market of any other nation to provide net demand amounting to 10 percent of GDP, Malaysia trumped even China, with a trade surplus with the United States rising to 15 percent of its

<sup>19</sup> International Monetary Fund, Direction of Trade Statistics, CD-Rom, August 2005; World Bank, Quick Reference Tables, 2006. For details on data underlying figures 2-4, see Cline, 2005a, pp. 220-21.

<sup>20</sup> International Monetary Fund, International Financial Statistics, January 2006; United States International Trade Commission, Interactive Tariff and Trade DataWeb.

GDP.<sup>21</sup> Among other developing countries, major increases in bilateral trade balances with the United States were also sizable (in the range of 3 percent of GDP) for Chile, Korea, and Thailand.

Figure 3  
Trade Balances with the United States Relative to Partner Country GDP:  
Six Developing Countries (percent)



In contrast, the size of the trade surplus with the United States relative to partner GDP remained much more modest for the European Union, rising from near zero in 1992 to 0.9 percent in 2004, and in Japan, where the level was somewhat higher but the increase was smaller (from 1.3 percent of GDP in 1992 to 1.6 percent in 2004). Among the industrial countries, only Canada experienced a surge in its trade surplus with the United States comparable to those of several major developing economies (by 5.4 percent of GDP).<sup>22</sup>

Looking forward, a central question is whether and how the United States can achieve external adjustment without causing contractionary pressure on the world economy. It is useful to review what happened to the world economy the last time the United States went through a major balance of payments adjustment cycle, in the late 1980s.

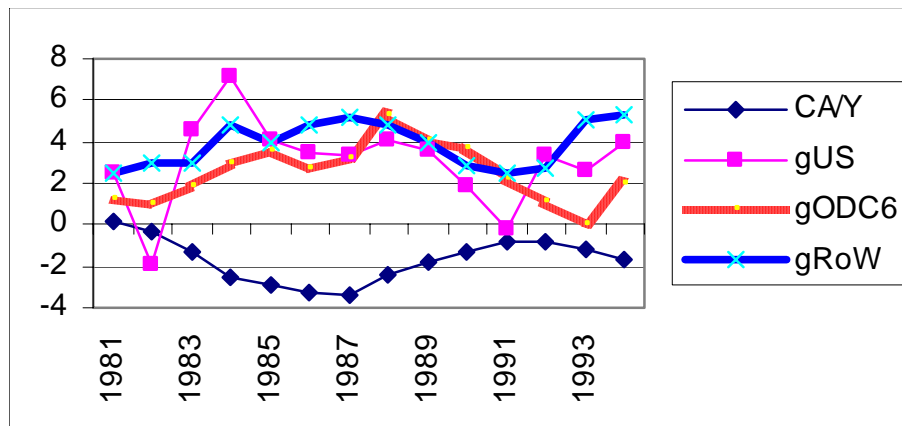
<sup>21</sup> The largest increase of all was for Venezuela, as its bilateral trade surplus rose from 4.5 percent of GDP in 1992 to 18.5 percent in 2004 on the strength of high oil prices.

<sup>22</sup> Canada's bilateral surplus rose from 1.4 percent of Canada's GDP in 1992 to 6.9 percent in 2004.

In the mid-1980s the United States swung into large current account deficit as a consequence of a strong dollar, high domestic growth, and a move into large fiscal deficits. The adjustment process in the 1980s episode included a coordinated effort of exchange rate intervention in the September 1985 Plaza Agreement of G7 finance ministers to correct the overvaluation of the dollar. After the usual two-year lag from exchange rate signal to trade performance, the US current account deficit peaked in 1987 and then experienced a significant narrowing by 1989. Even so, it was not until the US economy slowed in 1990 and went into recession in 1991 that the current account deficit largely disappeared, suggesting that although the external adjustment process “worked” for the United States in the 1980s episode, it was less than fully satisfactory.

Figure 4 shows the course of the US current account deficit during this episode. The cycle lasted a decade, with the initial period of wider deficits spread over six years and the reversal accomplished during the subsequent four years.

Figure 4  
US Current Account Deficit (percent GDP) and  
Growth in the United States, Six Other Major Industrial Countries,  
and Rest of World (percent)



The figure also shows growth in the six other major industrial countries (ODC6) as well as the rest of the world. There is an uncanny mirror image between the growth rate for the Rest of World and the size of the US current account deficit in this period. As the US current account deficit narrowed from 3.4 percent of GDP in 1987 to 0.8 percent

in 1991-92, rest of world growth (excluding ODC6) eased from 5.2 percent to 2.5 percent. Average growth in the ODC6 fell from 5.3 percent in 1988 to 2.2 percent in 1991. As reunification in Germany spurred higher interest rates and spillover recession in Europe, and as Japan entered the post-bubble period of the early 1990s, ODC6 growth fell to zero by 1993 before recovering moderately.

Even though the US adjustment of its external imbalance in the 1980s avoided a "hard landing," the correction was helped by a mild US recession. For the rest of the world, moreover, the experience was hardly reassuring. A 2.6 percent of GDP reduction in the US current account deficit was associated with a 2.7 percentage point slowdown in the growth rate of the Rest of World (which includes the developing countries). Even without demonstration of a causal relationship, this experience must surely be seen as a warning about adverse effects if an even greater US external adjustment is needed in the future. The developing countries in particular may need to take heed considering that they have experienced especially large increases in net demand from the rising US trade deficit in recent years.

Achieving a smooth external adjustment instead of a hard landing for the US economy is of great importance for the developing countries. Their export growth will of course tend to be curbed by a deceleration in the growth of US imports and acceleration in growth of US exports. But their cumulative export growth over the medium term would likely be even lower if an additional few years of unsustainably high growth of exports to the US market were to be followed by a sharp fall in these exports because of a plunge in the dollar and recession in the US economy.

US external adjustment implies some shift in developing country demand from exports toward domestic investment and consumption. Such a shift would be desirable in terms of global development patterns. At present there is a distorted pattern of global trade and payments in which a many developing countries are running current account surpluses rather than deficits. These include the oil exporting developing countries, the East Asian developing countries, India, and the major Latin American countries

excluding Colombia and Mexico. This is a pattern of perverse resource flows from developing countries to the largest rich country in the world.

The developing countries will also stand to gain from a smooth US external adjustment because it is more likely to keep global interest rates moderate than would be the case with a hard landing. A severe break in confidence in the dollar after additional years of ever-widening external deficits would exert upward pressure on US interest rates as foreign capital inflows began to decline, and interest rates could also rise from a decision by the Federal Reserve that tighter monetary policy was required to weigh against the inflationary impact of a sharp decline in the dollar. Inflationary pressure would arise from the pass-through of the exchange rate change to imports, which account for 15 percent of GDP (goods and services), even with incomplete pass-through from exchange rates to import prices. Thus, suppose that as a consequence of delay in adjustment the eventual exchange rate correction required an extremely large correction of the dollar, such as a real depreciation of some 40 percent, with corresponding price pressures. For example, a depreciation of 37.5 percent would mean a 60 percent rise in the price of foreign exchange which, combined with a pass-through ratio of 0.5, would raise import prices by 30 percent. This would contribute a 4.5 percentage point increase ( $30 \times 0.15$ ) to the consumer price index, which would mean a substantial inflationary shock if concentrated within a year or two. Inflationary pressure would be further aggravated as US supply began to be channeled toward exports and as the supply of foreign goods began to decline in response to the exchange rate change.

Delayed adjustment and an eventual hard landing would likely mean that a US recession would be part of the adjustment process. A recession would cause an even more severe reduction in developing country exports to the United States than would a smoother, earlier US adjustment. As for interest rate effects, many developing countries have large outstanding debt that is sensitive to dollar interest rates. A scenario in which interest rates were to soar would increase the cash-flow burden of their external debt and make it more costly for them to issue new debt.

Whereas a hard landing for the US economy would thus tend to cause spillover damage for developing countries, a smooth landing involving some upward exchange rate realignment for these economies against the dollar would provide some benefit to them in the form of a reduction in the real burden of their existing dollar-denominated debt. Ratios of external debt to GDP for countries such as Brazil would ease substantially as their currencies appreciated relative to the dollar as part of an overall adjustment process.

The World Bank has considered a scenario in which there is a loss of investor confidence in the dollar.<sup>23</sup> After considering as well possible rising concerns about debt and pension obligations in industrial countries, and return to a more normal yield curve, it postulates as an illustration of global interest rate risk an increase of 200 basis points (2 percent) in interest rates in industrial countries. It suggests that under these circumstances there would be a rise by 200 basis points in the risk premium for developing countries, meaning that long term interest rates facing them would rise by 400 basis points. Simulations of the Bank's global macroeconomic model indicate that by the third year after such a shock, GDP would be 2.7 percent below the baseline level in high income countries, and 3.5 percent below baseline in low- and middle-income countries. On this basis, what might be called the "center-periphery growth elasticity" relating the change in periphery growth to change in growth in the center appears to be particularly high ( $3.5/2.7 = 1.3$ ) when the source of the shock is interest rates. This reflects the fact that for a given shock to the base interest rate in the center, the emerging market economies face a larger rise in the interest rate because of the additional tranche of higher interest rates from the rise in the risk spread.

In a parallel modeling exercise on growth spillover but strictly from the side of trade, the Asian Development Bank has estimated that a growth downswing by 2.75 percentage points in the United States and 1.75 percentage points in Japan would induce a reduction in growth rates by about 0.9 percent for Latin America, 0.7 percent for the four newly-industrialized economies and the ASEAN economies, 0.3 percent point for

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<sup>23</sup> World Bank, *Global Economic Prospects 2006: Economic Implications of Remittances and Migration* (Washington: World Bank, 2006), p. 20.

South Asia, and 0.6 percent the rest of the developing world including Africa.<sup>24</sup> These estimates imply that the center-periphery growth elasticity is considerably lower, only in the range of about say 0.5, when the shock is solely from output and trade slowdown unaccompanied by interest rate shock.<sup>25</sup>

Goldstein has reviewed prospective effects of a US hard landing for emerging market economies.<sup>26</sup> He suggests that in the event of a confidence shock from the rising US external deficit, long-term US interest rates could rise by 200 to 300 basis points to reach 7 to 8 percent, which in turn would prompt a surge in emerging market risk spreads and run the risk of a "sudden stop" in capital flows to emerging markets. In addition to citing growth spillover along the lines of the World Bank simulations, he notes that commodity prices could suffer. He cites a survey by Reinhart and Reinhart, who find that a one percentage point drop in growth of industrial output in industrial countries has been associated with a drop of 0.77 to 2 percent in commodity prices.<sup>27</sup> However, in a context in which slower world growth is accompanied by a sharp decline in the dollar, there would be some amelioration in the downward pressure on dollar commodity prices. In the past, there has tended to be an inverse relationship between the level of commodity prices in dollar terms and the international strength of the dollar, as would be expected if the real value of commodities is to remain unchanged by exchange rate realignments.

It is beyond the scope of this paper to set forth a quantitative analysis of the impact of a US hard landing on the developing economies. It is clear, however, that especially because of the likelihood of a surge in interest rates and, additionally, in emerging market risk spreads, the adverse spillover to developing countries could be

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<sup>24</sup> Asian Development Bank, "Asian Development Outlook 2004 Update: III. Economic Scenarios for Asia," p. 7. The calculation here takes the difference between the above-baseline and below-baseline cases for US and Japanese growth.

<sup>25</sup> That is, the simple average of the US and Japan growth reduction in the ADB exercise is 2.25 whereas the induced periphery slowdown is centered around 0.7 percent. The implied spillover elasticity is 0.3, but the "center" in this exercise excludes Europe and other industrial countries so a parallel estimate for the center as a whole would be larger.

<sup>26</sup> Morris Goldstein, "What Might the Next Emerging-Market Financial Crisis Look Like?" Working Paper No. WP 05-7 (Washington: Institute for International Economics, July 2005).

<sup>27</sup> Carmen Reinhart and Vincent Reinhart, "What Hurts Most? G-3 Exchange Rate or Interest Rate Volatility?" NBER Working Paper 8535. (Cambridge, MA: National Bureau of Economic Research, October 2001).

severe. That is why it is in the developing countries' interests that the US external adjustment occur earlier and more smoothly rather than later and in a more disruptive fashion.<sup>28</sup>

### ***The Role of Developing Countries in Achieving Global Adjustment***

Fortunately many of the developing countries can take an active role in helping assure a smooth US external adjustment by adopting more flexible exchange rate policies of their own. By now, the East Asian economies in particular are arguably an important part of the cause of global imbalances. For most, their exchange rates have remained almost unchanged against the US dollar at a time when major currencies of industrial countries as well as a number of developing-country currencies have appreciated significantly against the dollar in what amounts to the beginning of a much needed process of adjustment in the US external imbalance. China, Hong Kong, and Malaysia all maintained exchange rate pegs against the dollar for the past several years until mid-2005 when China and Malaysia adopted a float but even then allowed only minimal change.

Figure 5 shows the extent of real appreciation of major developing country currencies against the dollar from the 2002 annual average to the end of 2005. Figure 6 shows the corresponding changes in real exchange rates for the major industrial country currencies against the dollar.<sup>29</sup> The euro rose 22 percent and the Australian and Canadian dollars more than 30 percent against the US dollar during this period (after having risen even more sharply through end-2004 but then fallen back during 2005). The currencies of Sweden, Switzerland, and the United Kingdom rose only about 10-15 percent against the dollar in the same period, and the Japanese yen actually fell against the dollar in real terms by 4 percent. Even for the industrial countries, then, the average real appreciation against the dollar fell well short of the 39 percent from the 2002 base (equivalent to a 28

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<sup>28</sup> For an eloquent essay on this issue, see Richard Sabot, *The Dollar and Development*, Working Paper no. 64 (Washington: Center for Global Development, August 2005).

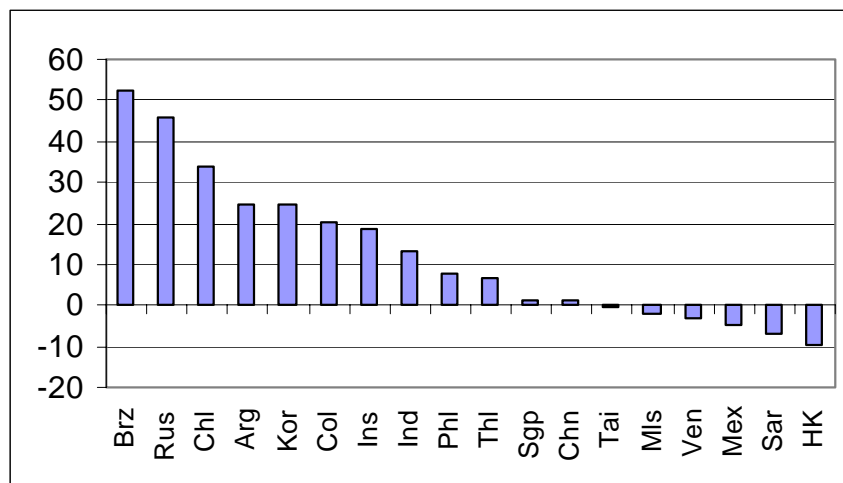
<sup>29</sup> Data is from International Monetary Fund, Federal Reserve, and JP Morgan databases.



percent real depreciation of the dollar) that I have calculated is needed to bring the US current account deficit back down to about 3 percent of GDP.<sup>30</sup>

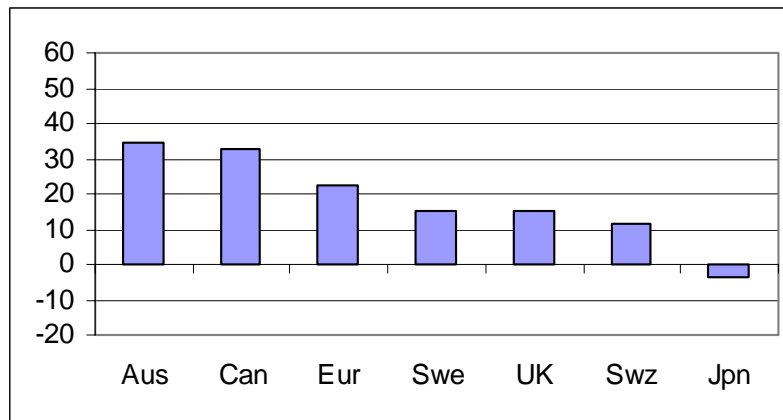
Among developing countries there has been even less appreciation against the dollar. The United States' two largest developing country trading partners have shown minimal real exchange rate change (China) or outright depreciation against the dollar (Mexico). With low inflation and a fixed exchange rate, Hong Kong has depreciated in real terms by about 10 percent against the dollar. Taiwan, Singapore, and Malaysia have had almost no change; and the Philippines and Thailand have experienced only minor real appreciation against the dollar. Korea is an important exception to the Asian pattern, with real appreciation against the dollar by about 25 percent in this period. Some major Latin American countries have also had significant real appreciations against the dollar (especially Brazil but also Chile, Argentina, and Colombia) but nonetheless by amounts smaller than the overall amount needed for US external adjustment.

Figure 5  
Real Appreciation against the Dollar: Selected Developing Countries  
(2002 average to end-2005; percent)



<sup>30</sup> Cline, 2005a, chapter 6.

Figure 6  
 Real Appreciation against the Dollar: Major Industrial Countries  
 (2002 average to end-2005; percent)



The best way to achieve a smooth US external adjustment is to pursue a program of coordinated policies among the large industrial and developing economies designed to do three things: a) bring about a trade-weighted decline in the value of the dollar by about 20 percent; b) commit the United States to a clear path of elimination of the fiscal deficit over 4-5 years; c) enlist other countries in efforts to shift demand from exports to domestic sources. I have suggested a "Plaza II" international agreement toward this end.<sup>31</sup>

A well-balanced realignment of exchange rates will necessarily involve substantial appreciations of currencies of a number of developing countries, especially in Asia, because it is these currencies that have not adjusted much at all so far. Table 2 reports my estimates of appropriate magnitudes of appreciation against the dollar (in real terms) from mid-November 2005 levels.<sup>32</sup> This set of realignments results from an "optimizing" calculation that sets a target real depreciation of the dollar by 28 percent from the 2002 yearly average and then allocates the amount of exchange rate change across US trading partners taking into account the size of their current account surpluses.

<sup>31</sup> Cline, 2005b.

<sup>32</sup> Data from Cline, 2005b.

Because some countries have especially large current account balances, they are assigned greater real appreciations.<sup>33</sup>

Table 2  
Further Real Exchange Rate Appreciation against the Dollar  
Needed for US External Adjustment (percent)<sup>a</sup>

Country/ region	appreciation	Country/ region	appreciation
Argentina	13	Korea	19
Australia	9	Malaysia	61
Brazil	-13	Mexico	19
Canada	-8	Philippines	42
Chile	9	Russia	6
China	43	Saudi Arabia	74
Colombia	4	Singapore	92
Euro area	21	Sweden	36
Hong Kong	74	Switzerland	42
India	32	Taiwan	51
Indonesia	41	Thailand	43
Israel	45	United Kingdom	25
Japan	62	Venezuela	73

a. From November 15, 2005 level.

The major developing countries are not in a position to inaugurate a coordinated Plaza II, but it will be crucial that they participate when and if such an effort is mounted by the United States and other major industrial countries. The Group of 20, which includes both the main industrial countries and the larger developing countries, would seem the appropriate venue for a coordinated policy effort along these lines. The key policy commitments would be as follows. Developing countries and Japan would pledge to desist from intervening in foreign exchange markets, as they have done in recent years to keep their currencies from rising against the dollar. This would mean that they would stop building up massive foreign exchange reserves, as China and Korea in particular have done. Industrial countries would stand ready to intervene in exchange markets to help guide the dollar to a lower level, with the European Central Bank and the Bank of Japan (for example) selling dollars out of reserves. For its part, the United States would

<sup>33</sup> For example, whereas the weighted average target real appreciation against the dollar is 39 percent from the 2002 base, the "optimal" appreciation for the Malaysian ringgit against the dollar is 55.7 percent against that base, in light of Malaysia's enormous current account surplus (13.3 percent of GDP in 2004). See Cline, 2005a, Appendix 6A.

set forth a credible commitment to eliminate its fiscal deficit over the next four years or so. Finally, to offset demand contraction from the reduction in trade surpluses with the United States, developing and industrial countries would lean toward spurring domestic demand in their fiscal and structural policies.

A central dynamic in a coordinated approach of this type is that the overall trade-weighted exchange rates of most countries would not appreciate by nearly as much as their bilateral exchange rates against the dollar, because most of the trading partners of any individual country would also be appreciating against the dollar.<sup>34</sup> Thus, whereas a particular developing country might reasonably fear loss of international competitiveness if it allowed its currency to appreciate substantially against the dollar in isolation, it would not need to have nearly the same degree of concern about loss of competitiveness in the context of a program of coordinated currency realignments against the dollar.

### *Conclusion*

The United States has a serious problem in its large and growing external deficit. The deficit is already nearly twice its previous peak relative to GDP, and unless it is cut by about half to a more sustainable level of some 3 percent of GDP it will increasingly pose the risk of a hard landing for the US and world economies. The developing countries especially are at risk, because they have been relying heavily on expansion of trade surpluses with the United States as a source of demand, and because they are doubly sensitive to a spike in world interest rates – once directly, once indirectly through higher risk spreads – that might be associated with the hard landing.

The Group of 20 major industrial and developing nations should take the lead in coordinating a program of global exchange rate realignments that can foster US external adjustment, in a “Plaza II” initiative. The United States should make a credible commitment to eliminate its fiscal deficit over four or five years. Those developing countries that have been intervening in exchange markets to keep their currencies from

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<sup>34</sup> For specific estimates see Cline, 2005a, p. 242.

appreciating against the dollar should stop doing so, especially China and several other East Asian economies. The European Central Bank, Bank of Japan, and Bank of England should begin selling off some of their holdings of dollar reserves as part of a process of guiding the dollar downwards, towards a goal of a real depreciation of about 20 percent for the dollar from its current level, thereby renewing the process of dollar adjustment that began in 2002-04 but partially reversed in 2005. Most industrial countries as well as the developing countries should also pursue domestic demand and structural policies designed to ensure the maintenance of growth as demand from exports to the US market begins to be scaled back, and imports from the United States are scaled up, to more sustainable levels.

In a coordinated program of this nature, the overall trade-weighted real exchange rates of most developing countries would not appreciate dramatically even though there would be sizable real appreciations bilaterally against the dollar, because each country's main competitors would also be appreciating against the US currency. A smooth US external adjustment facilitated by a coordinated international effort along these lines is greatly preferable to a much more wrenching adjustment from much larger imbalances if the process of adjustment is long delayed. It is strongly in the developing countries' interests to cooperate fully in the international adjustment process, especially through the exchange rate policies they pursue, to help ensure that the US adjustment comes sooner and more smoothly rather than later and in a fashion more disruptive to the world economy.