



## The Economic Impact of a U.S. Slowdown on the Americas

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Imports are closely related to economic growth. When the economy grows rapidly, we buy more of everything, including goods and services imported from abroad. In recent years, the demand for imports created by a rapidly growing U.S. economy has provided an important boost to growth for many U.S. trading partners. Between 1994 and 2007, for example, as U.S. GDP grew by \$6.8 trillion, U.S. imports increased by more than \$1.5 trillion (on a U.S. dollar basis).

The link, however, also works in the other direction. If countries exporting to the United States benefit from the rapid growth of the U.S. economy, these same countries stand to be hurt by a period of slow growth or recession. A slower growing, or shrinking, U.S. economy implies less demand for the exports of our trading partners. This can lead, in turn, to slower growth or even a recession for our trading partners.

This paper examines the impact that a slower rate of growth in the United States due to the coming (or current) recession, in conjunction with an unavoidable longer-term adjustment in our trade deficit, is likely to have on the economies of U.S. trading partners in the Western Hemisphere. The slowdown in the United States is likely to contribute to a reduction in the size of the U.S. trade deficit to a level that is closer to what can be sustained over the long-run, leading, among other effects, to a reduction in U.S. imports. The trade deficits of recent years, which peaked at 5.8 percent of GDP in 2006, clearly cannot be sustained over the long-run, and the coming recession is likely to accelerate the inevitable adjustment process.

Deficits of this magnitude have led to the rapid growth in the net foreign indebtedness of the United States. The country's net indebtedness stood at \$2.6 trillion, or 19.7 percent of GDP, at the end of 2006.<sup>1</sup> The 2007 trade deficit will raise this figure substantially.<sup>2</sup> Persistent trade deficits of this magnitude would lead to an explosive foreign debt-to-GDP ratio. As this ratio starts to reach high levels, investors would likely demand an interest rate premium to invest in the United States in order to protect themselves against a depreciation of the dollar. Higher interest rates would then add to the current account deficit, which in turn would make the debt grow even faster, leading to an even higher interest rate premium.

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<sup>1</sup> See Box 1: U.S. Foreign Debt.

<sup>2</sup> Data on the net investment position of the United States were taken from the Bureau of Economic Analysis (BEA), New Release "U.S. International Investment Position, 2006," available at the BEA website: [<http://www.bea.gov/newsreleases/international/intinv/intinvnewsrelease.htm>].

Presumably, the trade deficit will fall back to a sustainable level before the United States starts approaching this debt-and-interest rate spiral. The calculations in this paper assume that the trade adjustment, which may have already begun, takes place by the year 2010. In a low-adjustment scenario, we assume that the trade deficit falls from 5.2 percent of GDP in 2007 to 3.0 percent of GDP in 2010. A trade deficit of this size would imply that the ratio of debt to GDP would still rise, but at a much slower pace than the increases in recent years. In a high adjustment scenario, we assume that the trade deficit falls back to 1.0 percent of GDP by 2010. Depending on the relative returns of U.S. investments abroad and foreign investments in the United States, this trade deficit could still be associated with a rising ratio of foreign debt to GDP; however the rate of increase would certainly be slow. (The appendix provides a full explanation for the calculations in the paper.)

### **Box 1: U.S. Foreign Debt**

As would be expected, persistent trade deficits led to a sharp increase in U.S. net foreign indebtedness as a percent of GDP through 2001. However, between 2001 and 2006, U.S. net foreign indebtedness as a percent of GDP barely increased, despite large and growing trade and current account deficits. The unchanged level of net foreign indebtedness mainly reflected changes in the valuation of U.S. assets held by foreigners relative to the foreign assets held by U.S. residents. A sharp decline in the value of the dollar since March 2002 (it has fallen about 25 percent in real terms against a trade-weighted basket of currencies and even more against currencies where the bulk of U.S. investment is located) has substantially raised the dollar value of US assets abroad, a large share of which is in equities denominated in foreign currencies; while foreigners hold a much greater proportion of their investment in the U.S. in bonds and dollar-denominated assets.

Furthermore, the return on foreign assets is higher than the return on U.S. assets. However, for a number of reasons, the trends that have kept U.S. net foreign indebtedness from increasing in step with U.S. current account deficits over the last five years cannot be expected to have this same impact going forward. (See, e.g., Cline, William R., "The United States As A Debtor Nation," (2005), Peterson Institute for International Economics: [<http://bookstore.petersoninstitute.org/book-store/3993.html>]).

## **The Relative Importance of Exports to the U.S. Market**

Table 1 shows the GDP of the countries in the Western Hemisphere, including the United States, as well as their overall exports and exports to the United States,<sup>3</sup> with both expressed as a percent of GDP. Some countries are much more dependent on the U.S. market than others. For example, 77 percent of Mexico's exports go to the U.S. market, and these exports to the United States accounted for approximately 21 percent of the country's GDP in 2007. Other countries where exports to the U.S. constitute a significant percentage of GDP include Honduras (37 percent), Nicaragua (26 percent), Canada (23 percent), and several other countries in Central America and the Caribbean.

Most of South America is much less dependent on exports to the United States, partly because these countries have less open economies (that is, the sum of imports and exports is a smaller share of these

<sup>3</sup> The U.S. export and import data in the table refer to total U.S. imports from and exports to the rest of the world.

countries' GDP) and partly because these countries export more to countries other than the United States. For example, exports to the United States are only 1.6 percent of Argentina's GDP and 2.9 percent of Brazil's GDP. Venezuela's exports to the US are 15 percent of GDP, but 95 percent of that is oil. In the calculations that follow, we assume that oil, oil-related and natural gas exports are not reduced as a result of the U.S. slowdown. This significantly mitigates the effect of the U.S. slowdown for Canada, Colombia, Ecuador, and Venezuela.

**TABLE 1**  
**Western Hemisphere: Nominal GDP, Total Exports to the World and to the U.S. in 2007**

	<b>Nominal GDP</b> <i>(In US\$ millions)</i>	<b>Exports to the U.S.</b> <i>(In % of GDP)</i>	<b>Total Exports</b> <i>(In % of GDP)</i>
Argentina	248,332	1.6	21.4
Bahamas, The	6,586	6.8	30.3
Barbados	3,739	0.9	8.4
Belize	1,304	7.8	29.0
Bolivia	12,710	2.4	28.2
Brazil	1,295,355	1.9	12.7
Canada	1,406,430	23.3	29.4
Chile	160,784	5.5	41.8
Colombia	171,738	5.1	16.3
Costa Rica	22,842	17.0	66.5
Dominica	268	0.6	40.5
Dominican Republic	35,494	11.1	16.6
Ecuador	44,528	13.1	30.7
El Salvador	20,234	9.6	20.1
Grenada	553	1.7	9.1
Guatemala	33,320	9.2	22.8
Guyana	978	12.5	78.6
Haiti	5,295	8.6	11.5
Honduras	10,059	37.0	53.8
Jamaica	10,737	6.7	19.9
Mexico	886,441	21.4	27.8
Nicaragua	5,675	25.7	42.7
Panama	19,280	1.7	8.9
Paraguay	10,347	0.6	25.2
Peru	101,504	4.8	26.0
St. Kitts and Nevis	520	10.7	18.7
St. Lucia	958	1.7	13.1
St. Vincent and the Grenadines	528	0.3	32.6
Suriname	2,234	5.6	65.1
Trinidad and Tobago	20,703	41.3	68.5
Uruguay	21,171	2.5	22.5
Venezuela	226,922	15.0	34.9
	<b>Nominal GDP</b> <i>(In US\$ millions)</i>	<b>Total U.S. imports</b> <i>(In % of GDP)</i>	<b>Total U.S. exports</b> <i>(In % of GDP)</i>
United States	13,843,000	17.0	11.9

**Sources:** International Monetary Fund (IMF), World Economic Outlook (WEO), October 2007; IMF, Direction of Trade Statistics (DOTS); Bureau of Economic Analysis, National Economic Accounts.

## Small Adjustment Scenario

Table 2 shows the projected changes in non-oil exports (that is, excluding oil, oil-related and natural gas exports, as described earlier) to the United States associated with a reduction in the size of the U.S. trade deficit to 3.0 percent of GDP by 2010. The table presents the impact as both a share of each country's total exports and as a share of each country's total GDP, under the assumption that the decline in exports to the United States is shared equally across the countries in proportion to their current shares of total U.S. non-oil and non-gas imports.

**TABLE 2**  
**Small Decline In U.S. Trade Deficit**

	<i>Projected Reduction in Exports to the United States</i>	
	<i>(% of GDP)</i>	<i>(% of Exports)</i>
Argentina	0.2	0.8
Bahamas, The	0.7	2.4
Barbados	0.1	1.8
Belize	1.1	3.8
Bolivia	0.3	1.1
Brazil	0.2	2.0
Canada	2.8	9.5
Chile	0.9	2.1
Colombia	0.4	2.3
Costa Rica	2.7	4.1
Dominica	0.1	0.2
Dominican Republic	1.8	10.7
Ecuador	0.6	1.9
El Salvador	1.5	7.6
Grenada	0.3	3.0
Guatemala	1.4	6.0
Guyana	2.0	2.5
Haiti	1.4	11.9
Honduras	5.9	11.0
Jamaica	1.1	5.4
Mexico	2.9	10.4
Nicaragua	4.1	9.6
Panama	0.3	3.1
Paraguay	0.1	0.4
Peru	0.6	2.5
St. Kitts and Nevis	1.7	9.1
St. Lucia	0.3	2.1
St. Vincent and the Grenadines	0.0	0.1
Suriname	0.9	1.4
Trinidad and Tobago	2.3	3.3
Uruguay	0.4	1.7
Venezuela	0.1	0.3

**Sources:** International Monetary Fund (IMF), World Economic Outlook (WEO), October 2007; IMF, Direction of Trade Statistics (DOTS); U.S. International Trade Commission (USITC), Interactive Tariff and Trade Dataweb; and authors' calculations.

The most affected countries are those where exports constitute a higher share of national GDP and where exports to the United States represent a larger share of total national exports. As a result, our calculations suggest that Mexico, the Caribbean, Central America, and Canada will suffer most as a result of any recession-induced downturn in U.S. imports. Mexico would see a 10.4 percent decline in its total exports, which implies a 2.9 percent decline in its GDP relative to a scenario where U.S. imports remained unchanged. Canadian exports would fall 9.5 percentage points, translating to a 2.8 percent decline in GDP. The proportional impact on Honduras and Nicaragua would be even larger, with exports dropping 11.0 percent in Honduras and 9.6 percent in Nicaragua. These correspond to a 5.9 percent decline in GDP in the case of Honduras and 4.1 percent of GDP fall in the case of Nicaragua.

By comparison, the average annual rate of real GDP growth for Latin America from 1980-2007 was 2.5 percent. These projections imply that, even in a low-adjustment scenario where the U.S. trade deficit only falls to 3.0 percent of GDP, the loss of demand from exports to the United States would be proportionately 1.2 times as large in Mexico and nearly 2.4 times as large in Honduras as this average annual growth rate for the region. Declines in exports of this magnitude would undoubtedly lead to substantial economic disruptions.

A decline in U.S. imports would have much less impact on the countries in South America. In this region, Chile would feel the biggest effect, with a drop in exports of 2.1 percent or about 0.9 percent of GDP. The drop in exports for both Brazil (down 2.0 percent) and Argentina (down 0.8 percent) would be equal to just 0.2 percent of each country's GDP.

### **Large Adjustment Scenario**

Table 3 shows the projected changes in non-oil and non-gas exports to the United States in the case of a large trade adjustment associated with a reduction in the size of the U.S. trade deficit to 1.0 percent of GDP by 2010.

Since all of the adjustments are assumed to be proportionate, the relative impacts across countries do not change. In the large adjustment scenario, the decline in Mexico's exports would be equal to 14.6 percent of total exports or about 4.1 percent of its GDP. For Canada, exports would shrink by 13.5 percent, for a 4.0 percent decline in overall GDP. The reduction in exports to the United States would be 15.5 percent in the case of Honduras and 13.5 percent for Nicaragua, or 8.3 percent of Honduras's total GDP and 5.8 percent of Nicaragua's total GDP.

Using the average annual growth rate in Latin America and the Caribbean as a metric once again, in this large-adjustment scenario, the reduction in Mexico's exports to the United States is nearly 1.6 times as large relative to Mexico's GDP as the average annual growth rate for Latin America and the Caribbean over the years from 1980-2007. The loss of exports for Nicaragua would be nearly 2.3 times as large, relative to the size of its economy and for Honduras, more than 3.3 times as large. A reduction in exports of this magnitude will clearly have a substantial impact on these economies.

In this large-adjustment scenario, the decline in exports to the United States would be equal to 2.9 percent of Chile's total exports or about 1.2 percent of the country's GDP. As a share of total exports, the calculations suggest that exports would fall about 1.1 percent in Argentina (or about 0.2 percent of the country's GDP) and about 2.8 percent in Brazil (or about 0.4 percent of the country's GDP).

**TABLE 3**  
**Large Decline In U.S. Trade Deficit**

	<i>Projected Reduction in Exports to the United States</i>	
	<i>(% of GDP)</i>	<i>(% of Exports)</i>
Argentina	0.2	1.1
Bahamas, The	1.0	3.4
Barbados	0.2	2.5
Belize	1.5	5.3
Bolivia	0.5	1.6
Brazil	0.4	2.8
Canada	4.0	13.5
Chile	1.2	2.9
Colombia	0.5	3.2
Costa Rica	3.8	5.7
Dominica	0.1	0.4
Dominican Republic	2.5	15.1
Ecuador	0.8	2.7
El Salvador	2.2	10.7
Grenada	0.4	4.3
Guatemala	1.9	8.5
Guyana	2.8	3.6
Haiti	1.9	16.8
Honduras	8.3	15.5
Jamaica	1.5	7.7
Mexico	4.1	14.6
Nicaragua	5.8	13.5
Panama	0.4	4.4
Paraguay	0.1	0.6
Peru	0.9	3.5
St. Kitts and Nevis	2.4	12.9
St. Lucia	0.4	2.9
St. Vincent and the Grenadines	0.1	0.2
Suriname	1.3	1.9
Trinidad and Tobago	3.2	4.7
Uruguay	0.5	2.4
Venezuela	0.2	0.5

**Sources:** International Monetary Fund (IMF), World Economic Outlook (WEO), October 2007; IMF, Direction of Trade Statistics (DOTS); U.S. International Trade Commission (USITC), Interactive Tariff and Trade Dataweb; and authors' calculations.

## Conclusion

The United States is currently running a trade deficit that virtually all economists recognize to be unsustainable. At some point, the United States will have to move towards a more sustainable situation, which implies increased exports and reduced imports. An economic recession such as the one that the U.S. economy appears to be entering now is likely to play a role in that adjustment process. Plausible estimates suggest that any such adjustment process is likely to have a substantial impact on the economies of the U.S. trading partners, especially Canada, Mexico, and the countries in the Caribbean and Central America. The reduction in exports from these countries to the United States will be large relative to the size of their economies. Unless declines in these exports are offset by some other source of demand, in the worst case, the falloff in exports to the United States could be sufficient to push some economies into recessions of their own. Growth in both Canada and Mexico, for example, slowed sharply in 2001, during the last U.S. recession, with real GDP growth in Mexico slipping to zero for that year. The last U.S. recession was relatively short (March to November 2001) and mild in terms of lost output. The next (possibly current) recession in the United States will likely be worse.<sup>4</sup>

The countries that will likely suffer most as the result of a reduction in U.S. imports are the same countries with which the United States has implemented “free trade” agreements in recent decades, including the North American Free Trade Agreement (NAFTA) between the United States, Canada, and Mexico, and the Dominican Republic-Central America Free Trade Agreement, DR-CAFTA, which includes the United States along with Guatemala, El Salvador, Costa Rica, Nicaragua, Honduras, and the Dominican Republic. Meanwhile, countries that are less dependent on the United States, or more reliant on domestic demand, will see smaller impacts of the U.S. recession on their exports and national GDP.

Our estimates do not address other important channels through which a U.S. recession would affect the rest of the hemisphere. One of these channels is remittances sent home by foreign nationals working in the United States. Remittances form a large part of a number of economies: Haiti (31 percent), Nicaragua (17 percent), El Salvador (16 percent), Jamaica (16 percent), and Guatemala (11 percent).<sup>5</sup> Although not all of this money comes from the United States, most of it does. A second possible transmission channel that we do not consider in this report is that this particular economic slowdown in the United States is connected to a credit crunch brought on by the collapse of the market for mortgage-backed securities. The extent and duration of the resulting problems in the international financial system, and their impact on other countries in this hemisphere, are not yet clear, but further negative impacts are likely.

However, these other effects are difficult to predict. The impact of a U.S. recession on its import market, and the resulting impact on the rest of the hemisphere, is much more straightforward, although the timing and pace of such an adjustment are still uncertain.

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<sup>4</sup> See John Schmitt and Dean Baker (2008), “What We’re In For: Projected Economic Impact of the Next Recession,” Center for Economic and Policy Research: [[http://www.cepr.net/documents/publications/JSDB\\_08recession.pdf](http://www.cepr.net/documents/publications/JSDB_08recession.pdf)].

<sup>5</sup> Multilateral Investment Fund, “Remittances to Latin America and the Caribbean (2006),” online at: [<http://www.iadb.org/mif/remittances>].

## Appendix

The calculations in Tables 2 and 3 assume a trend rate of real growth of 2 percent annually for US GDP and imports, and 4 percent annual real growth for GDP and overall exports in other countries for the three years 2008-2010. To the extent that the recession reflects a decline in consumption associated with declines in U.S. house prices, the 2 percent growth rate for U.S. imports may well be optimistic. The narrowing of the U.S trade deficit is assumed to take place equally through an increase in exports and decrease in imports. For example, in the low adjustment scenario, the U.S. trade deficit shrinks from 5.2 percent of GDP to 3.0 percent of GDP, which implies a 1.1 percent of GDP (half of 2.2 percent) reduction of U.S. imports against the level implied by the (2 percent annual) trend rate of growth. The data for U.S. GDP and export and imports are taken from the U.S. Commerce Department's National Income and Product Accounts, Table 1.1.5.

This reduction of U.S. imports is assumed to take place only in non-oil and non-gas imports. For the countries exporting to the United States, their non-oil (and for Canada, also non-gas) exports to the United States are assumed to be reduced by the same proportion in all countries. This reduction in exports to the United States is, as above, a reduction from a baseline of 2 percent annual growth.