McKinsey&Company

# Keeping the American Dream Alive

## *Will the United States make the investments it needs to compete?*

Lowell Bryan and Alan FitzGerald

# Introduction

Despite the improving economy and the current buoyancy of the stock market, the United States faces dramatic structural changes in the global economy that in the medium term (2013 to 2020) threaten sharply to erode and potentially eliminate its ability to remain competitive and prosperous. These changes include the increasing strength of emerging economies and their labor forces and the simultaneous aging and decline in the skills and education level of American workers. They also include widely acknowledged dangers posed by relentless national and state fiscal deficits, stubborn trade deficits, and sluggish job creation. Even the status of the dollar as the world's "safe haven" reserve currency, historically a source of competitive strength, has become a source of competitive disadvantage for American workers. At risk of being lost is the American dream: the societal belief that America is the land of opportunity and that if you want to improve yourself, and are willing to work hard, you will succeed. Nearly 25 million Americans today want to work but cannot find a job.

Recent domestic economic growth and employment figures offer some hope that the U.S. economy is beginning to accelerate its recovery. But even the end of the Great Recession will not solve what are becoming structural problems. The U.S. needs to make a fundamental shift towards building its economy on savings and investment, rather than on consumption and borrowing, if it wants to remain prosperous and keep the American dream alive. To make this shift it needs to dedicate energy and money, in a sustained way, to making its workforce and its corporations more globally competitive in the face of these structural changes. As the U.S. population ages and emerging-market nations continue to grow in size and productivity, the U.S. finds itself, for the foreseeable future, without either the disposable income or the debt capacity needed to remain the world's consumption engine. Labor Department statistics show that real wages, for example, have remained relatively flat on a per capita basis over the last decade. At the same time the U.S. personal savings rate as a percentage of GDP did manage to hit 6 percent in the third quarter of 2010. That was up from a meager 2 percent in the fourth quarter of 2007, but still modest compared with the 10 to 11 percent rates in the early 1980s and still higher rates in many emerging nations. (India's household sector savings rate was 25 percent in 2009 and China's urban household savings rate neared 30 percent).[1]

Meanwhile the economy has remained addicted to consumerism, with consumer spending as a share of GDP reaching as high as 70 percent after the recession. This compares to a rate spread of 58 to 65 percent in the advanced economies (U.K., Germany, France), and 35 and 57 percent respectively in the emerging economic powerhouses of China and India.[2] In fact, U.S. households, corporations, and government have become so dependent upon consumption and a credit-based economy that the very idea of rebalancing towards savings and investment strikes many as unrealistic. The truth is that Americans have become used to assuming that prosperity is a birthright.

It would be well if the financial crisis of late 2008 and the measures taken in the U.S. to recover from it are marking the end of this era. Because now, as the U.S. begins its recovery, the serious challenges posed by the structural changes now evolving in the global and domestic economies must be confronted.

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[1] *Bureau of Economic Analysis; IHS Global Insights; Haver Analytics.*

[2] *IHS Global Insights; Haver Analytics.*

# Structural changes in the global economy

Following the globalization of the developed world's capital markets in the aftermath of the breakdown of the Bretton Woods fixed-currency regime in the mid-1970s, the globalization and integration of the world's real economy began in earnest in the mid-1980s. It accelerated in the 1990s due to advances in digital technology and the liberalization of regulation (particularly of capital flows) by more and more nations. As a result, the economies of the U.S., Europe, and Japan became far more globally integrated and the process of integrating emerging market nations into the economy began. During this period, however, the overwhelming bulk of the global economy, as measured through financial exchanges rates, remained in the developed world. In 1990, for example, 66 percent of the entire world economy (at the exchange rates of the time) was in the U.S., Europe, or Japan, a concentration accounting for only about 21 percent of the world's population.[3]

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[3] *Ibid.*

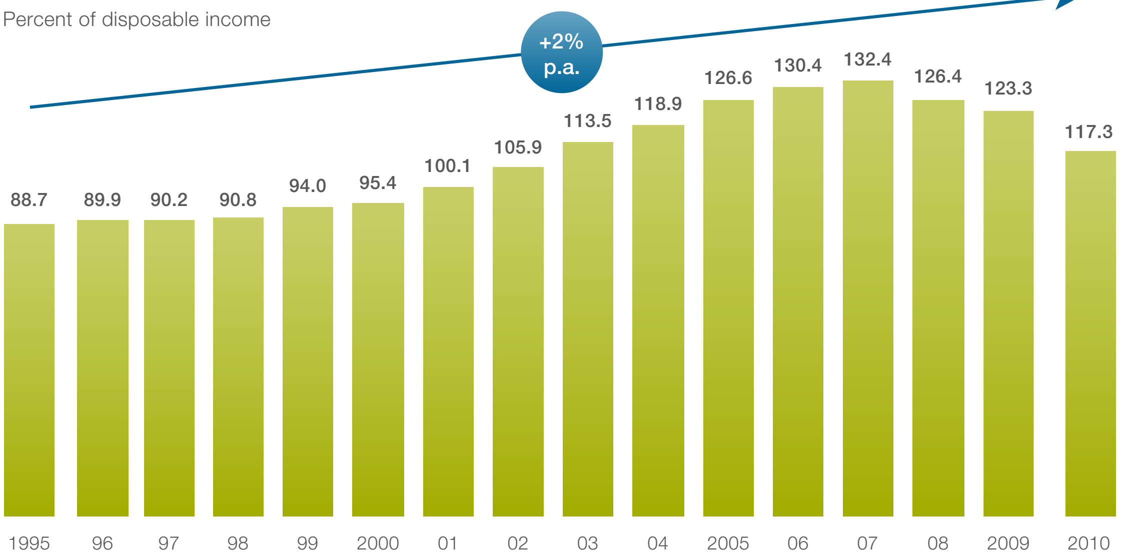
Structural changes in the global economy

# The consume and borrow era

Beginning in the mid-1990s, however, this began to change. In the aftermath of the 1997 emerging-markets financial crises, many of the large emerging-market nations (particularly China, India, and Brazil) embarked on programs to capture opportunities made possible through better integration of their national economies with the global economy. China built an economy by encouraging inward foreign direct investment, high internal savings rates, rapid urbanization and enormous investments in infrastructure as it became a major exporter, particularly to the United States. India built an economy based on rapid urbanization, insourcing of knowledge economy jobs, significant investment in infrastructure (but proportionately much less than China) and domestic market liberalization. This led to India's robust internal economic growth (though it was less robust than China's). Meanwhile the U.S., following the dot-com bust, went from having a reasonably balanced economy when measured according to levels of household debt and the balance between consumption and investment in the mid-1990s, to an economy in the 2000s based on consumption (particularly through imports), low savings and investment rates, and increased private sector debt, reinforced with fiscal stimulus and easy money. For example, the ratio of U.S. household debt to disposable income grew from 89 percent in 1995 to 132 percent in 2007.[4]

## U.S. household debt as share of disposable income

**Total household debt 1995-2010**
Percent of disposable income



*SOURCE: U.S. Federal Reserve; Bureau of Economic Analysis; McKinsey analysis*

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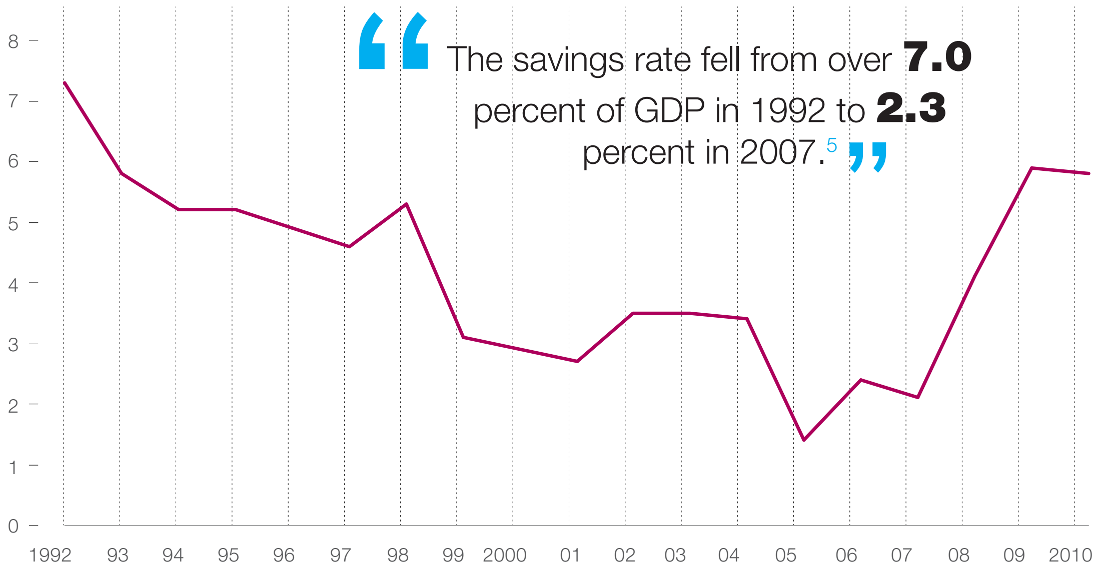
[4] *U.S. Federal Reserve; Haver Analytics; McKinsey analysis.*

Structural changes in the global economy

## Savings rate in the United States

**Personal savings as a percentage of disposable personal income 1992-2010**

Percent



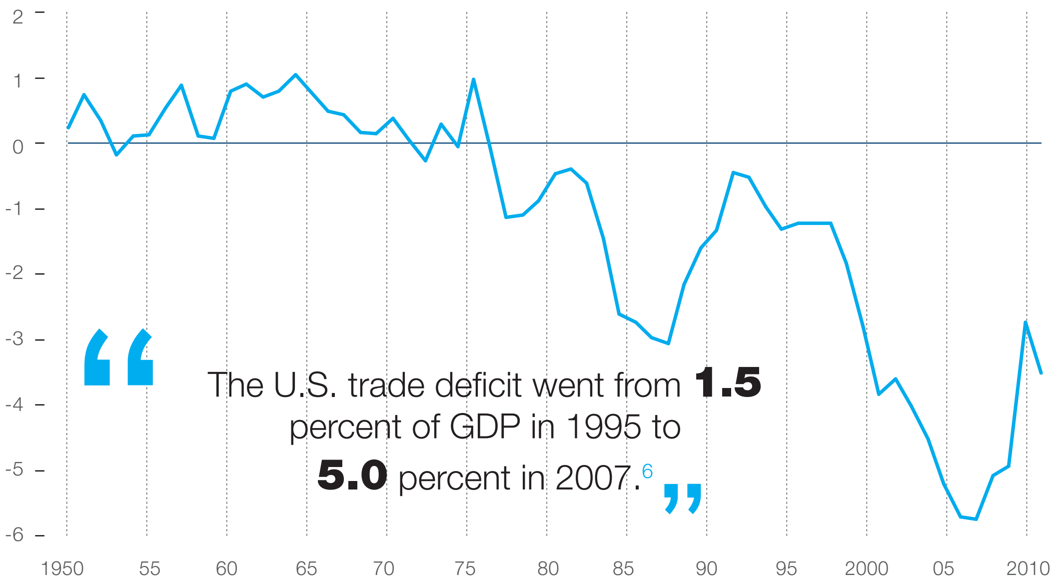
> “The savings rate fell from over **7.0** percent of GDP in 1992 to **2.3** percent in 2007.[5]”

*SOURCE: Bureau of Economic Analysis; Haver Analytics*

## Trade Balance as share of GDP

**Net exports of goods and services 1950-2010**

Percent of GDP



> “The U.S. trade deficit went from **1.5** percent of GDP in 1995 to **5.0** percent in 2007.[6]”

*SOURCE: Bureau of Economic analysis; McKinsey analysis*

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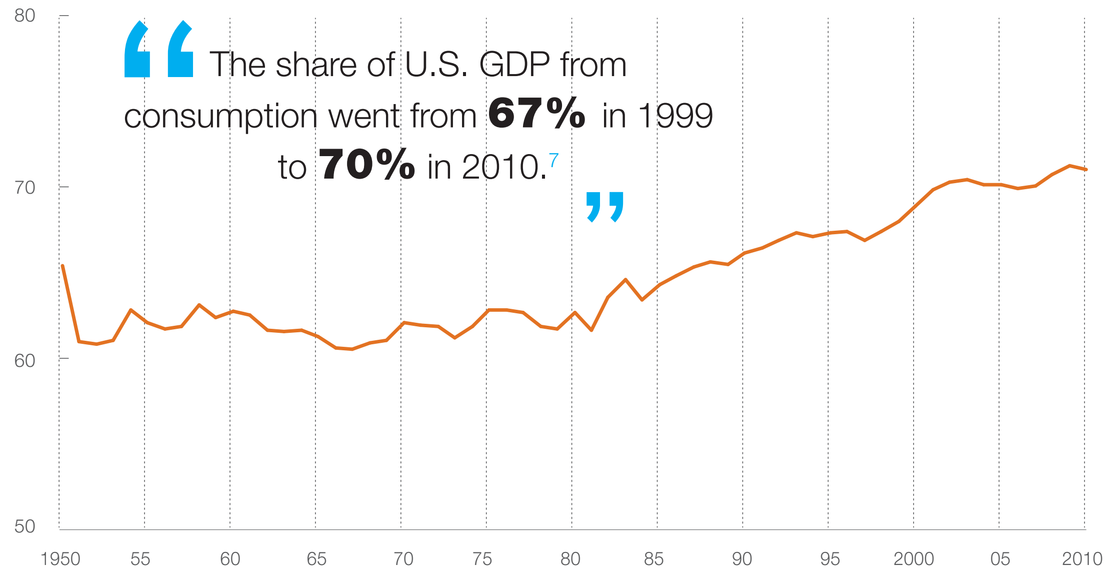
[5] *Bureau of Economic Analysis; Haver Analytics.*

[6] *U.S. Census Bureau; Bureau of Economic Analysis; Haver Analytics.*

## U.S. consumption as share of GDP

**Personal consumption as share of GDP 1950-2010**

Percent



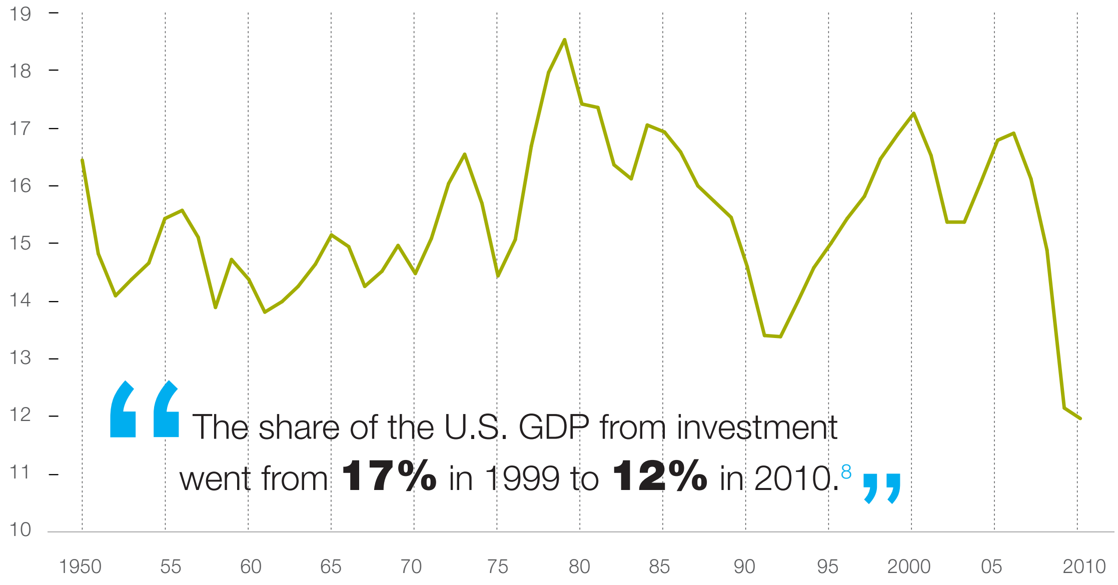
> “The share of U.S. GDP from consumption went from **67%** in 1999 to **70%** in 2010.[7]”

*SOURCE: Bureau of Economic Analysis via Haver Analytics; McKinsey Global Institute*

## Investment as share of GDP

**Private fixed investment/GDP 1950-2010**

Percent of GDP



> “The share of the U.S. GDP from investment went from **17%** in 1999 to **12%** in 2010.[8]”

While Europe and Japan were on similar tracks in terms of debt levels and rising consumption, the emerging-market countries built their economies much more around high savings and investment rates. We can see this reflected in the relative shares of consumption in GDP for the major developed economies versus the BRIC countries: for the developed economies, the share averaged 62 percent in 2010, while for the BRIC countries it was 51 percent.[9]

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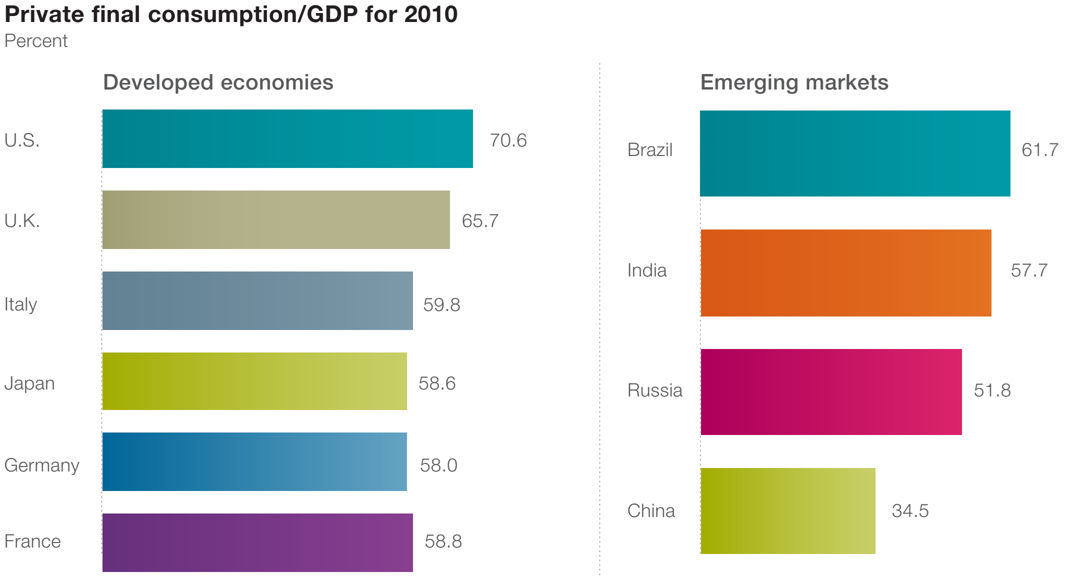
[7] *Bureau of Economic Analysis; Haver Analytics.*

[8] *Ibid.*

[9] *IHS Global Insight.*

## Cross country comparison of comsumption share in GDP

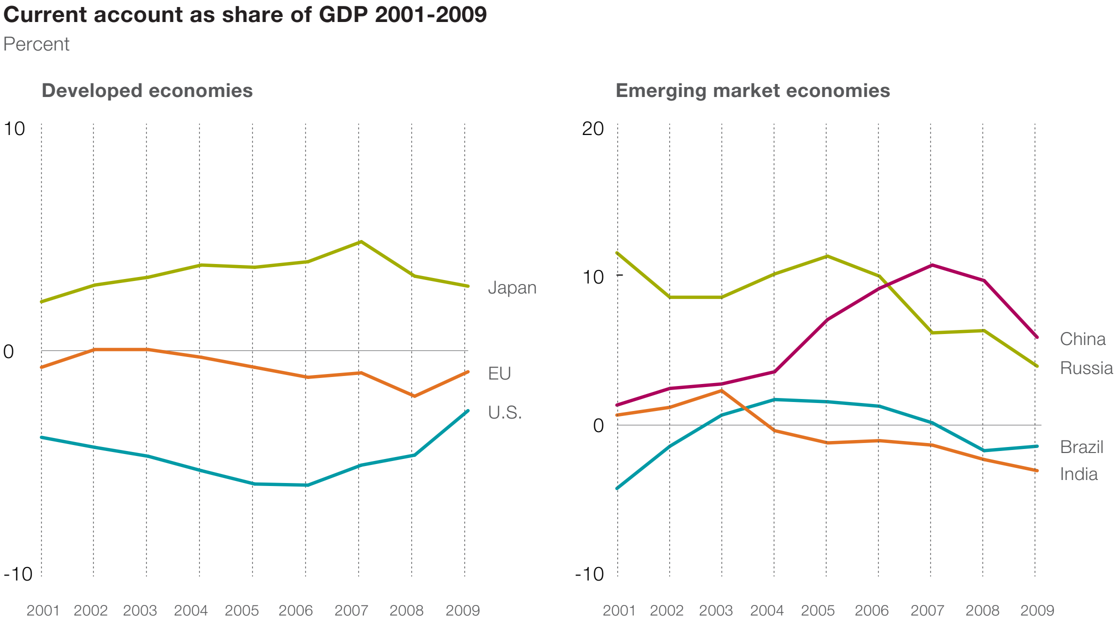


*SOURCE: : IHS Global Insight, World Bank, World Development Indicators*

## Structural changes in the global economy

What has made the U.S. a real outlier, versus all other nations, is the relative size of its current account deficit.

## Benchmarking the U.S. current account deficit: cross-country comparison



*SOURCE: Haver Analytics; National Statistical Agencies*

The easy money conditions in combination with lax regulation and unsound credit underwriting and securitization practices created a housing boom that in turn generated millions of domestic, high-paying jobs in construction, home furnishing, mortgage financing, and other related industries. The boom also drove up the values of existing homes and enabled many homeowners to borrow against the increased value to increase their consumption. Similarly, credit card usage grew explosively and to many of the nation's households their liquidity came in the form of unused credit card and home equity lines of credit.

U.S. consumption and borrowing was in turn being enabled by other nations (particularly China), which kept their currencies undervalued relative to the dollar. As these countries geared their economies towards exports and outsourcing, they held the accumulated trade surpluses in U.S. dollars. This combination of behaviors had the cumulative effect of making goods and services in the U.S. very cheap to U.S. households.

The financial crisis of late 2008 marked the end of this era. Now, some 2 years later, we can see that structural changes have taken place in the evolution of the global economy.

## Structural changes in the global economy

## The rise of global competitiveness among emerging-market nations

The most striking difference in the global scene today is the visible shift toward the emerging markets in the overall share of future economic growth. Underlying this growth are continuing increases in labor productivity in the emerging world, which will be sustained in the foreseeable future by urbanization and lowered dependency rates (i.e., a greater proportion of working-age people in the population). Increasingly, much of the labor demand is for medium- and high-skilled job categories. Two decades of sustained investment by developing countries have led to a vast improvement in their productive and competitive capacity.

In the next decade, not just in China, India, and Brazil, but also in Eastern Europe, the Philippines, and Mexico, and elsewhere, millions and millions of highly motivated, skilled and semi-skilled people are being mobilized into the workforce. Companies in the developed world are looking at these economies not just as sources for future growth but also as opportunities to gain access to new supplies of low cost, high quality labor. The scale of the labor arbitrage opportunity differs significantly depending on the industry and country under consideration and is heavily influenced by fluctuations in exchange rates. While arbitrage driven investments will force a narrowing of cross border labor cost savings over time, the window of opportunity for firms will not be closing any time soon.[10]

In this context, corporations worldwide have been more than willing to invest in the training, plant, and equipment needed to make this labor productive and to deliver high-quality output. Driven by their own competitive pressures, the corporations have become relentless in their search for opportunities to produce more output for less cost. Indeed, the competition to produce more for less has become intense between the emerging-market nations: if the cost of producing certain output in India or China becomes more expensive, or less reliable, companies are quick to search for alternatives in Malaysia, Indonesia, or Hungary.

At the same time income growth among the hundreds of millions of newly employed people in the emerging markets should be sufficient to drive economic growth in their own countries for decades to come. Furthermore, to the companies in the U.S. and other developed-world nations, these markets have already become important customers. They are important sources of demand and will become ever more important over the coming decades. However, as we will discuss below, signs are increasing that the labor cost

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[10] *Economist Intelligence Unit, Bureau of Labor Statistics, U.S. Department of Labor.*

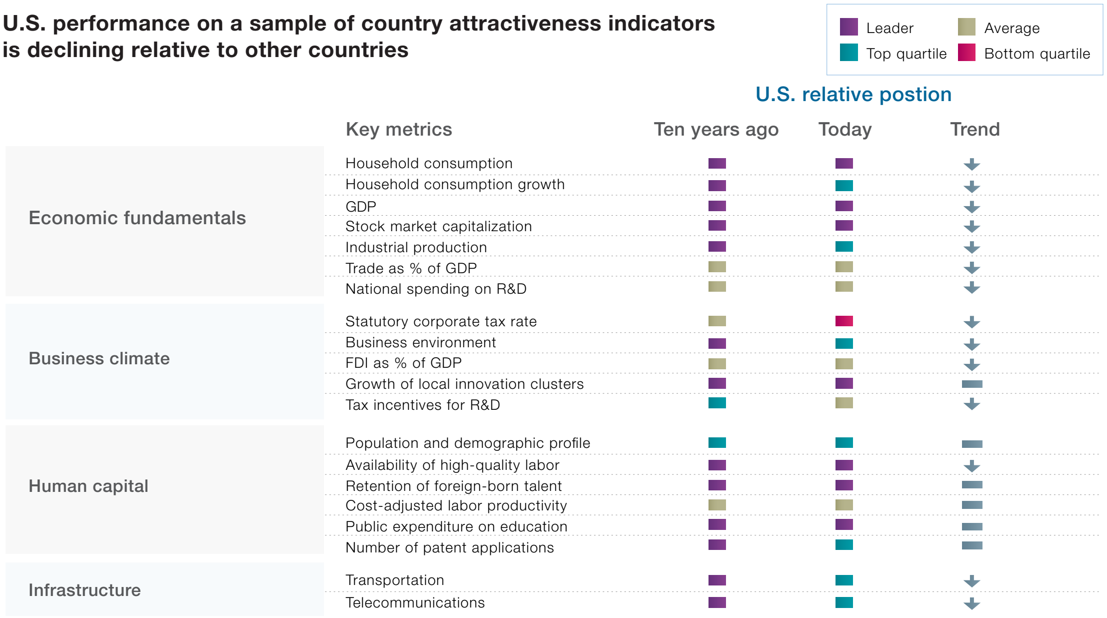
Structural changes in the global economy

advantages these nations enjoy are contributing to structural unemployment in almost all developed-world nations.

The U.S. remains the world's largest market with a highly productive workforce, yet, measures of U.S. ability to attract investment indicate movement in the wrong direction. Accordingly, the U.S. is falling behind in economic performance, business-climate quality, the ability to develop and retain talent aligned with the needs of its economy, and in the provision of competitive infrastructure.

## U.S. attractiveness indicators

**U.S. performance on a sample of country attractiveness indicators is declining relative to other countries**



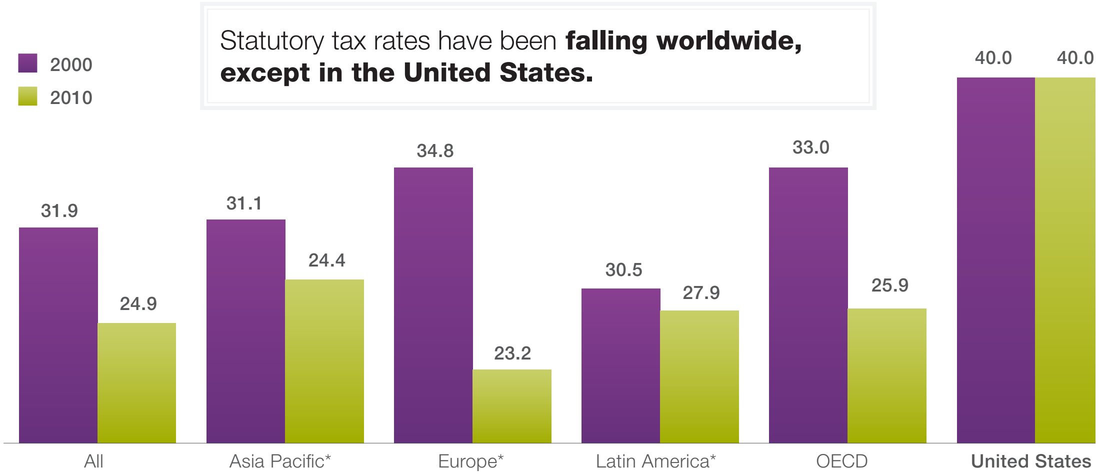
🟪 Leader
🟫 Average
🟦 Top quartile
🟥 Bottom quartile

| | | U.S. relative postion | | |
|---|---|---|---|---|
| | Key metrics | Ten years ago | Today | Trend |
| Economic fundamentals | Household consumption | 🟪 | 🟪 | ↓ |
| | Household consumption growth | 🟪 | 🟦 | ↓ |
| | GDP | 🟪 | 🟪 | ↓ |
| | Stock market capitalization | 🟪 | 🟪 | ↓ |
| | Industrial production | 🟪 | 🟦 | ↓ |
| | Trade as % of GDP | 🟫 | 🟫 | ↓ |
| | National spending on R&D | 🟫 | 🟫 | ↓ |
| Business climate | Statutory corporate tax rate | 🟫 | 🟥 | ↓ |
| | Business environment | 🟪 | 🟦 | ↓ |
| | FDI as % of GDP | 🟫 | 🟫 | ↓ |
| | Growth of local innovation clusters | 🟪 | 🟪 | ▬ |
| | Tax incentives for R&D | 🟦 | 🟫 | ↓ |
| Human capital | Population and demographic profile | 🟦 | 🟦 | ▬ |
| | Availability of high-quality labor | 🟪 | 🟪 | ↓ |
| | Retention of foreign-born talent | 🟪 | 🟪 | ▬ |
| | Cost-adjusted labor productivity | 🟫 | 🟫 | ▬ |
| | Public expenditure on education | 🟪 | 🟪 | ▬ |
| | Number of patent applications | 🟪 | 🟦 | ▬ |
| Infrastructure | Transportation | 🟪 | 🟦 | ↓ |
| | Telecommunications | 🟪 | 🟦 | ↓ |

*SOURCE: McKinsey Global Institute synthesis of data from numerous sources; "Growth and Competitiveness in the United States: The Role of Its Multinational Companies," MGI, June 2010*

## Statutory tax rates

**Average statutory central, state, and local government taxes on corporations, 2000-2010**
Percent

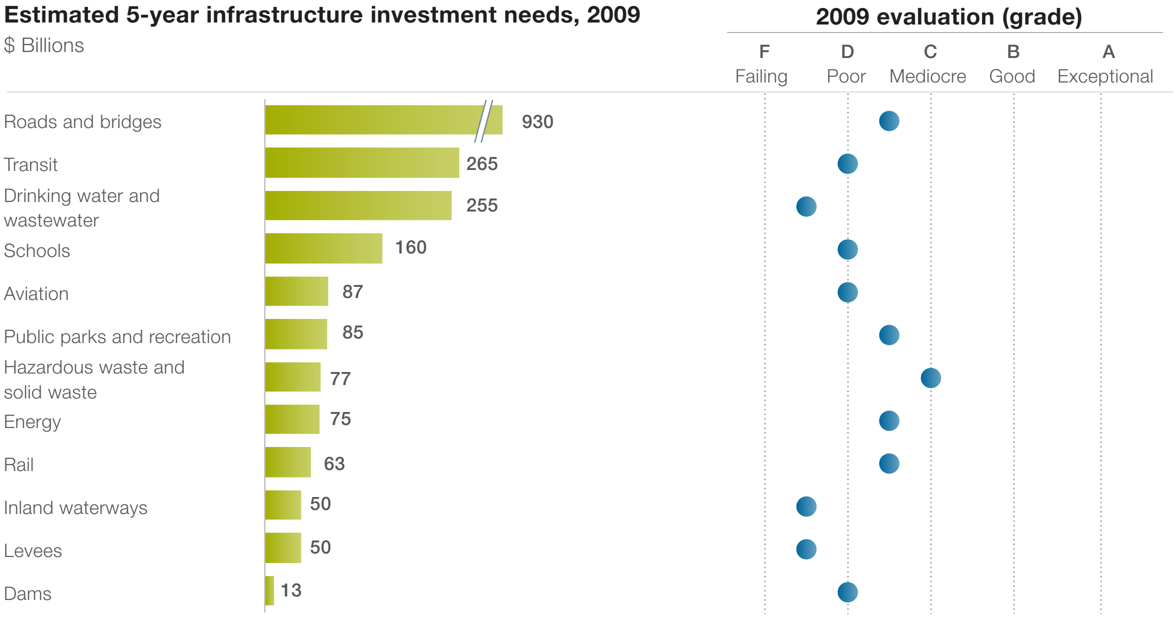


Statutory tax rates have been **falling worldwide, except in the United States.**

*SOURCE: KPMG Corporate and Indirect Tax Rate Survey, 2010*

U.S. hard and soft infrastructure is lagging behind the pace set by its competitors.

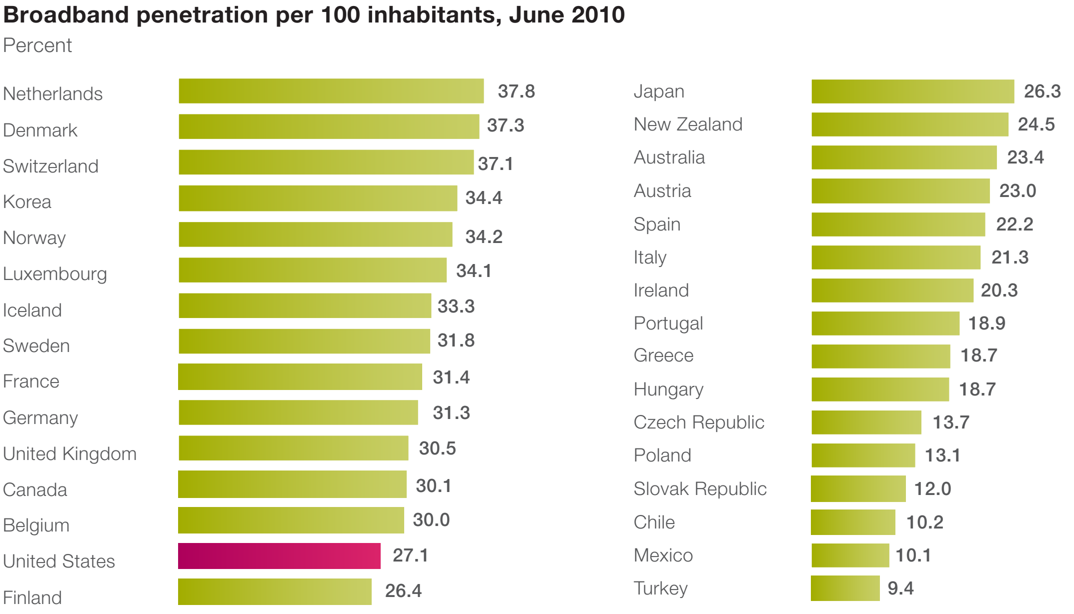
## U.S. infrastructure needs $2 trillion+ in investment



*SOURCE: American Society of Civil Engineers; http://www.infrastructurereportcard.org/report-cards*

The United States even faces a disadvantage in broadband penetration, ranking 14th among OECD countries.

## Broadband penetration



*SOURCE: OECD broadband statistics; http://www.oecd.org/sti/ict/broadband*

Structural changes in the global economy

A further challenge is that the emerging-market nations as a class now also enjoy significant competitive advantages in attracting globally competitive jobs. In addition to the natural cost advantages of employing highly motivated, educated, upwardly mobile new entrants to the labor force, companies employing workers in emerging-market countries currently also benefit from the differences that these countries enjoy from having undervalued currencies (relative to purchase power parity). The differences between all developed-world currencies and emerging-country currencies are large. For example, adjusted for the differences in purchasing power, the exchange-rate value of the Chinese yuan is only about 55 percent of the value of the dollar and the Indian rupee is only about 35 percent.[11] That is, a dollar converted into rupees has almost three times the spending power in India as in the U.S. Assuming the same output level per worker in the U.S. and India, a U.S. corporation can get three times the output for every dollar spent in India compared to that same dollar spent in the U.S. Or said differently, the purchasing power parity of a worker in India is nearly three times the purchasing power of a worker in the U.S. for an equivalent amount of pay as measured in dollars.

Arguments have been made that U.S. international taxation policy heightens the attractiveness of investing, earning, and realizing profits in other countries. In particular, the argument that companies cannot repatriate the earnings they create overseas to the U.S. for investment without paying prohibitive taxes is often pointed to as an impediment to domestic investment.

Unquestionably companies need to be able to hire overseas in order to gain access to new markets and remain globally competitive. In fact, many of the jobs these companies create by investing in overseas markets would not exist or would not remain competitive in their home market. Yet the evidence is increasing that certain factors such as exchange rate policies and taxation are driving companies to create globally competitive jobs in these nations which would have otherwise been created in the developed world.

## Structural challenges for the U.S. job market

Historically, the U.S. has had very significant competitive advantages in the creation of highly skilled work. The U.S. still enjoys “clustering” advantages, for example, in places like Silicon Valley and Wall Street; it also sustains cultural, political, and lifestyle advantages and has the world’s best educational and research institutions. It is furthermore the headquarters nation for more globally competitive multinational companies than any other country. These advantages make the U.S. the best country in the world for attracting and developing very highly skilled workers.

Moreover, not all jobs are globally competitive, particularly in fields that are location-specific, such as healthcare delivery, public service, and construction. Nor are most low-skill jobs, such as manual labor, housekeeping, and trash collecting, globally competitive.

Nonetheless a sizeable fraction of jobs are globally competitive and can be located anywhere. Indeed, given the labor savings available, companies everywhere are innovating to find opportunities to situate work in low-cost locations. In particular, medium-skill jobs seem vulnerable to global competition. Historically, many of the mid-skills jobs the U.S. has lost have been in the manufacturing sector, which has experienced a steady decline in employment. Nearly 45 percent of private sector employment was in the manufacturing sector in the mid-1940s; today that figure is 10 percent.[12]

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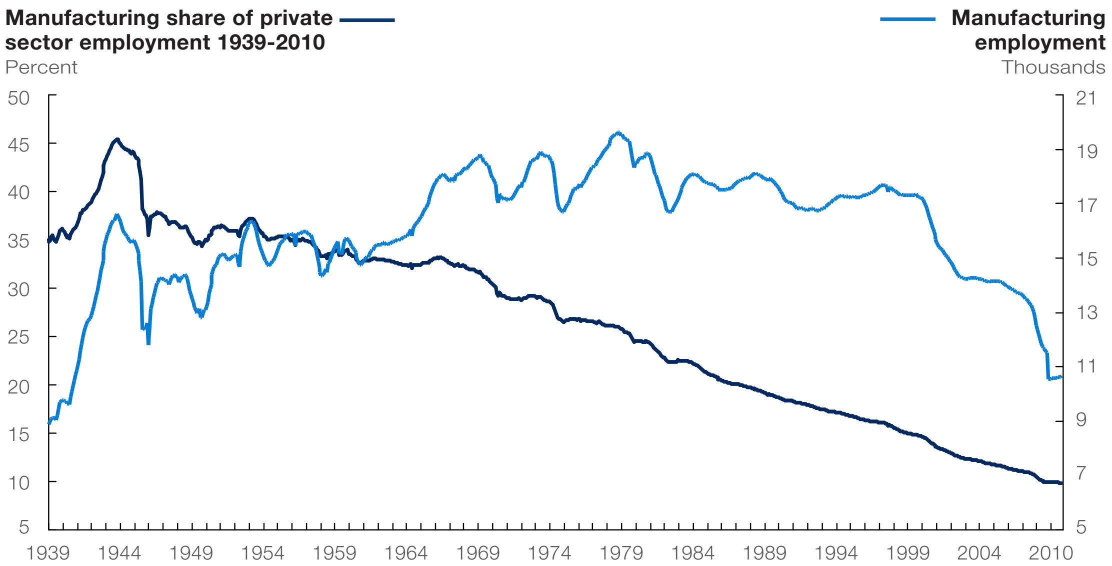
[11] *International Comparison Program (ICP), World Bank; IHS Global Insight.*

[12] *Bureau of Labor Statistics, National Bureau of Economic Research (NBER).*

## U.S. manufacturing employment



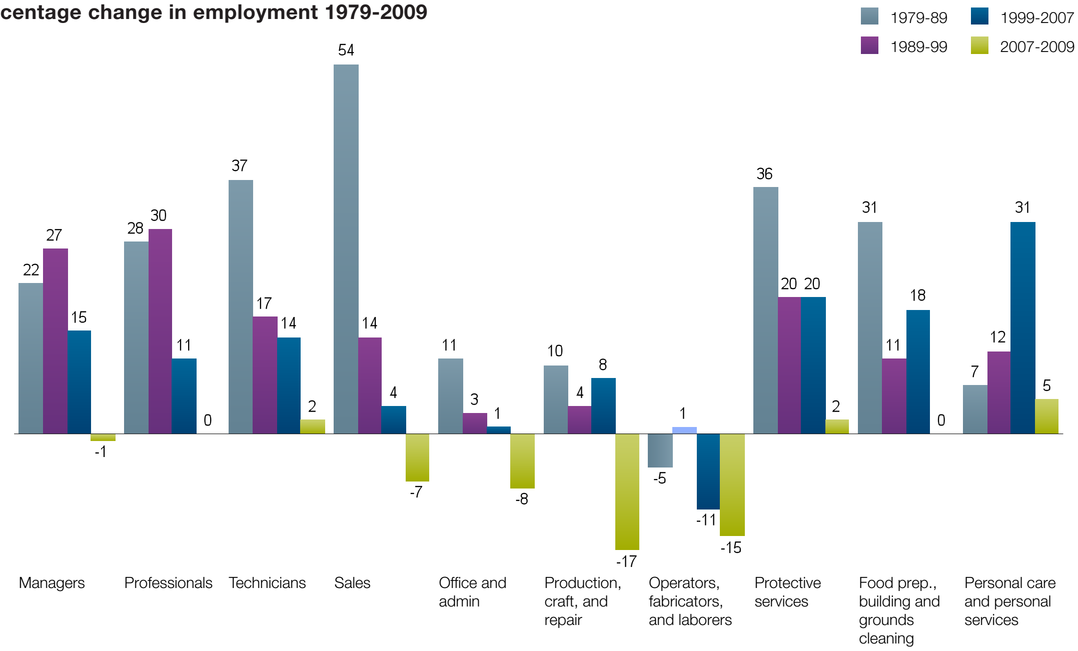
*SOURCE: Bureau of Labor Statistics; National Bureau of Economic Research*

**Structural changes in the global economy**

The U.S. jobs that have been lost over the course of the recession have been heavily concentrated in white- and blue-collar occupations of medium pay and educational requirements.[13]

## Change in employment by occupation

**Percentage change in employment 1979-2009**



*SOURCE: David Autor, "The Polarization of Job Opportunities in the U.S. Labor Market: Implications for Employment and Earnings," Center of American Progress and the Hamilton Project, April 2010*

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[13] *Bureau of Labor Statistics, Occupational Employment Statistics (OES).*

**Structural changes in the global economy**

The loss of medium-skill jobs is concerning in its own right, given the negative impact this has had on the middle-class backbone of the U.S. economy. Now, however, even high-skill work may be vulnerable to global competition in the future. This is because middle-skill jobs are often the stepping stones to higher-skilled jobs, as talented workers acquire the building blocks they need to advance.

Given the high skill levels being developed in China in manufacturing and in India in knowledge work, and the cost advantages of locating such work in emerging market countries, growth of even high-skill work in the developed world is no longer guaranteed.

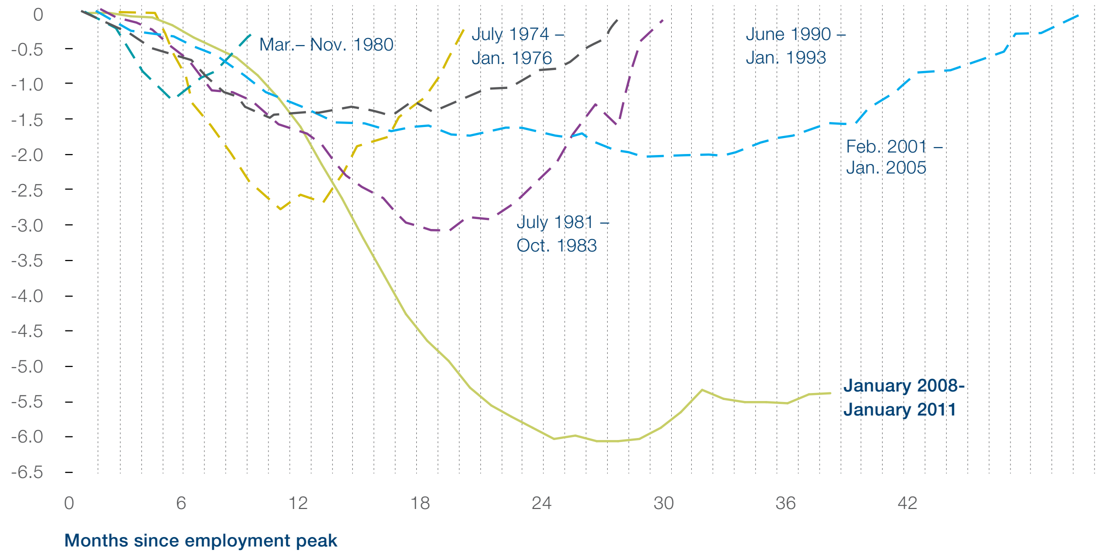
Two years have passed since the start of the financial crisis and job growth is still lacklustre in the U.S. despite massive fiscal and monetary stimulus. While many economists disagree, evidence is increasing that the U.S. job losses since the financial crisis are due more to structural than cyclical causes.

## Structural change in the U.S. employment outlook through crises past and present

Record decline in jobs from pre-crisis levels

**Decline from peak U.S. employment**[1]

Percent from peak month prior to recession



[1] *Total non-farm employment, seasonally adjusted*

*SOURCE: Bureau of Labor Statistics*

The job loss picture emerging from the present recession is unlike any experienced in the U.S. in the past 30 years. Indeed, it is hard to find much of a job recovery in the data. Some of the structural disadvantages causing this are self-inflicted. Many Americans, for example, bought houses they could little afford and cannot sell, so they are less mobile as workers than they have been historically. A more serious problem is a persistently over-valued currency, which we discuss in more detail below. To the extent that the lack of domestic jobs is structural, the output gap in U.S. GDP, which is nearly $900 billion per annum, or 6 percent of GDP, will remain large in the coming years.[14]

The resulting loss of income limits economic growth, reduces household consumption and the ability to service and pay down debt. It presents the federal government and state governments with a smaller income base from which to collect income taxes and social security taxes and reduces the amounts of health care costs paid for by employers. Depressed incomes also keep housing prices low, in turn limiting the ability of localities to collect property taxes. The large unemployed

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[14] *Congressional Budget Office, Budget and Economic Outlook, January 2011; U.S. Bureau of Economic Analysis; McKinsey analysis.*

population means that federal and state spending on unemployment insurance and social services grows. Without changes in taxation approaches, and lowered government spending, such high levels of structural unemployment and lost income therefore translates into huge, ongoing structural fiscal deficits.

If work cannot be found for the better part of the 25 million Americans who are either unemployed or underemployed, the U.S. economy will likely continue to stagnate.[15]

Structural changes in the global economy

## Structural challenges in the U.S. partly stem from the dollar's status as a reserve currency

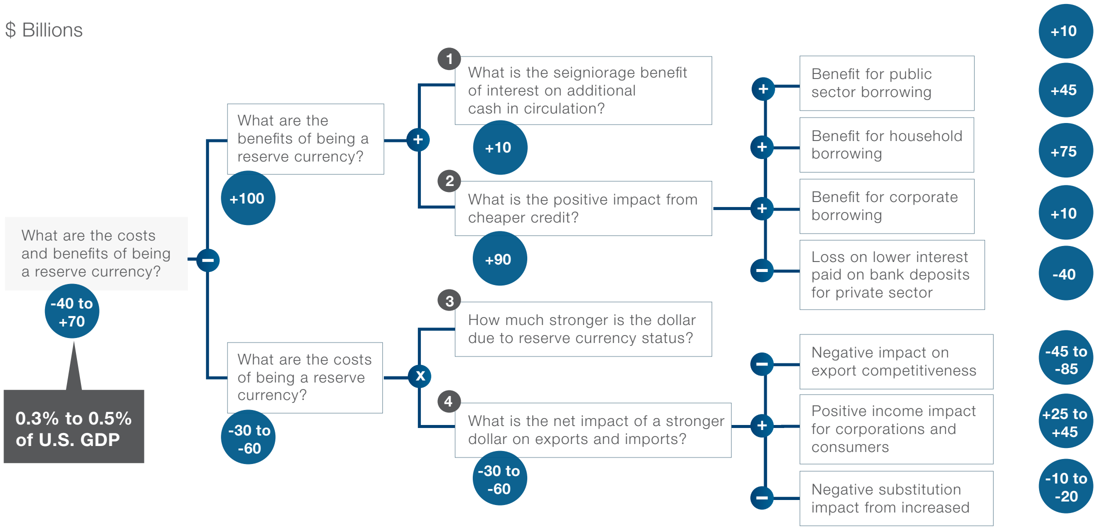
While Europe and Japan share many of the structural disadvantages for globally competitive jobs, the U.S. is unique in facing structural challenges in the global economy due to the status of the dollar as the primary reserve currency for the central banks of the world. Historically this status has created many advantages. One of these is the value of seniorage: the benefits of printing money that can be spent without associated interest costs. An even larger advantage is that the presence of reserves within the U.S. banking system has the effect of making credit cheaper for the public sector, households, and corporations (though this effect cuts both ways in that it also lowers interest paid on bank deposits to the private sector). For the U.S. government, one of the largest benefits is that as the reserve currency nation, it can issue debt in its own currency without any real limit – it has the ability to meet its obligations by printing money if it has to.

The disadvantages of being the issuer of a reserve currency largely stem from the tendency of such a currency to become overvalued. For the issuing country, this tendency leads to greater trade deficits, as exports diminish and imports increase.

Historically, the benefits have exceeded the costs. The McKinsey Global Institute estimates, for example, that in the last "normal" year, from June 2007 to June 2008, the reserve currency benefits to the U.S. economy were from $40 billion to $70 billion or about 0.3 to 0.5 percent of GDP.[16]

### Reserve currency benefit for U.S. in 2007-2008: a "normal year"

**The United States obtains a small net benefit from reserve currency status of 0.3%-0.5% percent in a normal year**



*Note: The impact is calculated relative to a scenario in which the dollar is not held as a reserve currency at all (i.e., a zero baseline). SOURCE: McKinsey Global Institute analysis*

In the crisis year of June 2008 to June 2009, the McKinsey Global Institute estimates the benefits were $110 billion and the costs $85 billion to $115 billion – that is, the pluses and minuses were roughly equal.

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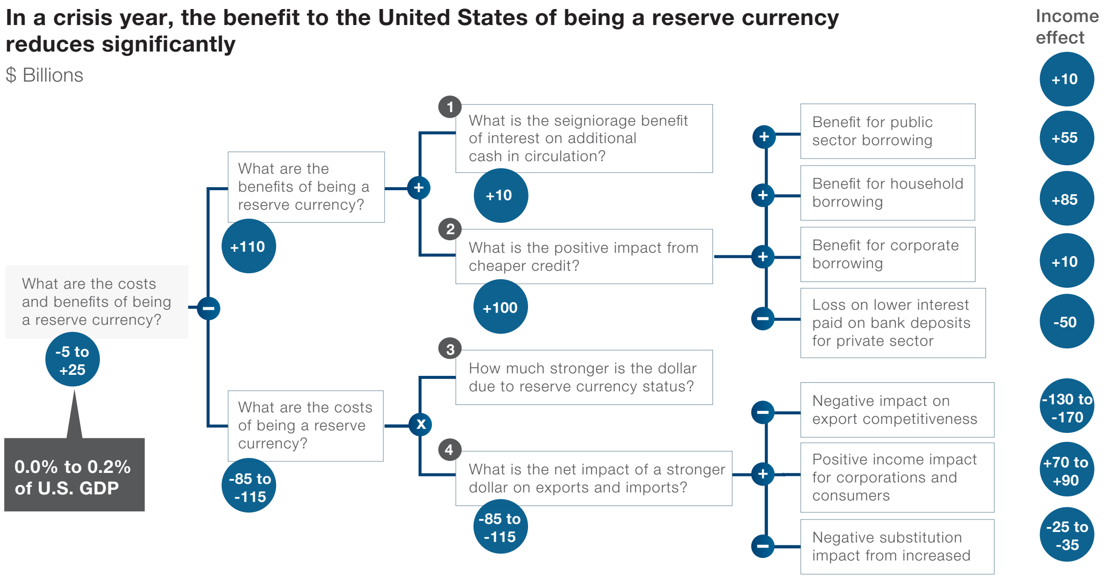
[15] *U.S. Department of Labor, Bureau of Labor Statistics.*

[16] *"An Exorbitant Privilege? Implications of Reserve Currency Status for Competitiveness," McKinsey Global Institute, December 2009.*

## Reserve currency benefits 2008-2009: a "crisis year"


**In a crisis year, the benefit to the United States of being a reserve currency reduces significantly**

$ Billions

*Note: The impact is calculated relative to a scenario in which the dollar is not held as a reserve currency at all (i.e., a zero baseline). SOURCE: McKinsey Global Institute analysis*

**Structural changes in the global economy**

The direction of such analyses, however, will probably change course in future years, because the costs of being the issuer of the reserve currency are almost certain to rise. As presently structured the analytic methodology includes the economic effect of lost exports, but excludes the economic effects of jobs lost to off-shoring from an overvalued dollar. If, as this paper maintains, much of the unemployment in the U.S. is now structural, then much of the output gap in U.S. GDP is due to an overvalued dollar. Should the PPP exchange rates for emerging market nations move closer to parity with current exchange rates, the U.S. job market would become fundamentally more competitive. Exports would rise, imports would fall, the off-shoring of jobs would slow, and the number of jobs at home would increase (not just from U.S. multinationals but from foreign multinationals as well). More importantly, a devaluation of the dollar against emerging market currencies would generally boost the global competitiveness of the U.S. workforce. This would ensure that the U.S. obtains its fair share of the job growth associated with a world economy being driven by the emerging markets.

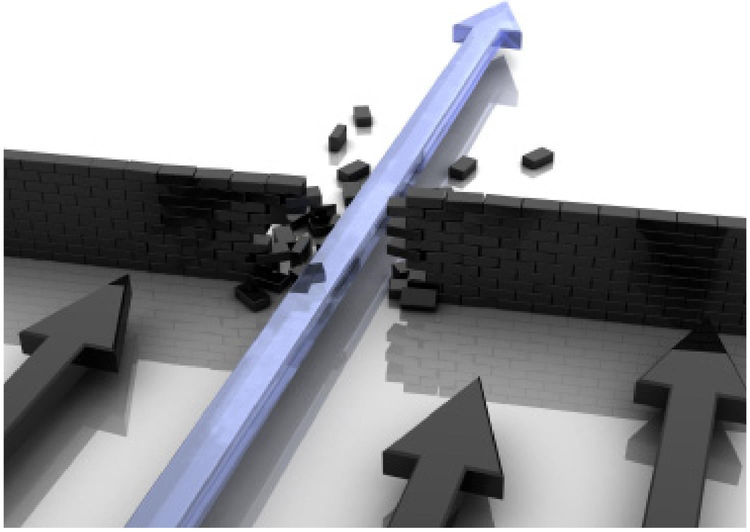
The U.S. does seem intent on reducing the value of the dollar, through pursuit of a monetary policy of quantitative easing. For the moment, however, the way forward on this path is blocked because some nations, China and India especially, show little inclination to allow their currencies to appreciate no matter how many dollars the Federal Reserve prints. Recommendations on how to get around the present impasse are beyond the scope of this paper, but the disadvantages engendered by the dollar's reserve currency status now merit greater attention than heretofore, when these were more than offset by the advantages.

## Structural changes in the global economy

# Breaking the vicious retrenchment cycle

Overall, the challenges associated with getting back on a sustained robust growth path are considerable. Consumers are going through an unprecedented period of deleveraging and have lost over $12 trillion of wealth through the decline in the value of their assets (particularly residential real estate). This is serving as a drag on consumption, which has been a significant economic driver of growth over the last decade. To adjust to these new realities, households have been increasing their savings rate. The McKinsey Global Institute has estimated that, absent income growth, every 1 percent increase in the savings rate leads to fall in consumption of $100 billion. [17] If we assume the "new normal" for households implies an increase in the savings rate of 3 percent, the implied drop in consumption becomes $300 billion. One way to close the gap in domestic consumption, would be through a large jump in exports. Exports of goods in 2010 were valued at $1.3 trillion, so the needed increase would be near 25 percent.[18]

The U.S. administration has, in fact, expressed a medium-term aspiration of doubling exports by 2014. Estimates of the increase in total world imports of goods (excluding the U.S.) between 2010 and 2014 fall in the $4 trillion range.[19] A doubling of exports would imply capturing a significant share of this global increase. Meeting this difficult challenge is made even more daunting now that the U.S. no longer has a dominant role in producing many of the products that will create this growth. A further complication is that the import intensity of U.S. exports has been increasing over time, a trend that would dampen the positive effect of an increase of exports on growth and jobs.



The situation is not likely to be ameliorated by government stimulus, given concerns over deficits and ever increasing debt levels. In view of this, the solution would need to rest with business investment. The relatively healthy business sector has been constrained to ramp up investment, however, due in part to a lack of domestic demand combined with tax policies that make it expensive to repatriate capital. Thus a vicious retrenchment cycle is being reinforced across all actors in the economy.

In an optimistic scenario for the medium term, consumers regain control of their balance sheets, while shifting their behavior towards higher savings and commensurately more sustainable levels of spending. At the same time, we would see a confidence-induced upward shift in investment that compensates for the decline in consumption and drives up employment. The combined effect begins to manifest itself in an improved external sector with consumption-driven imports falling and investment induced exports rising. Ultimately, improvement in employment and business revenues help to bring down the budget deficit and the virtuous cycle is resumed.

Indeed, recent signs indicate that consumers are de-leveraging faster than expected, that businesses are beginning to feel more optimistic and are hiring, and some improvements are emerging in external trade. Unfortunately, how quickly you get to your destination depends on where you are starting from as well as the headwinds and obstacles you face en route.

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[17] *"The Economic Impact of Increased U.S. Savings,"* McKinsey on Finance *31 (Spring 2009), McKinsey Global Institute.*

[18] *Bureau of Economic Analysis, U.S. Department of Commerce; U.S. Census Bureau.*

[19] *Queri International; Haver Analytics.*

# Competing on the margin

Structural changes in the global economy

The globalization of the footprint of U.S. firms has been, and will continue to be, a critical enabler for enhancing American competitiveness and reach. At the same time, the nation needs to be doing all it can to improve its attractiveness as a top investment destination for both domestic and foreign firms. While the challenge may seem daunting the reality is that this aspiration is well within its grasp. Even marginal decisions can improve the ability of the nation's strongest assets – its labor force and its companies – to compete globally. Enhanced U.S. competitive ability will affect foreign and domestic companies in their decisions about where to invest, which products to buy, and whom to hire.

A recent study[20] examined the total U.S. landed cost of outsourcing a range of fabricated parts to a selection of low-cost countries. The results emphasize that the details can make a big difference. While all countries assessed had lower wages than in the U.S., when transportation costs, local inflation, raw materials costs, and changes in exchange rates are taken into account, the U.S. ranked favorably, for example, compared to Hungary, Brazil, the Czech Republic and Singapore, for a range of the products analyzed. Changes on the margin to any component of the cost structure can quickly swing one country out of favor for another. A 20 percent fully landed cost advantage to offshore production for a critical component can quickly swing back to the U.S. in a short period if there is a commensurate depreciation in the dollar. Continually chasing the next favorite location can ultimately also lead companies to register cumulatively high switching costs.

As companies decide where to make their next investments, they must take account of risk to supply chains. Just-in-time inventory practices combined with globally fragmented value chains have raised country and logistic risks, with disruptions at any point on the chain holding entire production lines hostage. While global value chains have increased the scope of cost-reduction opportunities for firms, one could also argue that they are reducing the intensity of information flows between buyers and suppliers in more localized regional clusters; just this kind of flow has been a historic source of rapid innovation. The U.S. innovation engine has been largely fueled by benefits captured from these information flows, which are translated into the design, development and dissemination of new processes, products and services.

As a nation, the United States has an opportunity to heighten its competitiveness by creating a new compact embracing all actors – government, companies and individuals – to ensure that decisions and related actions are collectively driving the nation in the same direction. Whether and how decisions made by U.S. actors align in terms of a national interest – where the U.S. invests as a nation, how individuals save, and how U.S. firms can best compete in the long run – will determine whether the United States wins or loses in the world economy. Despite the significant structural challenges already outlined in the paper (and additional medium-term challenges in focus in the next section), the evidence indicates that the U.S. can continue to compete to win and re-ignite its virtuous cycle of growth and prosperity. A necessary step in getting on this path is establishing an enabling environment that helps companies and the workforce compete on the margin.

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[20] *Alix Partners, U.S. Manufacturing Outsourcing Cost Index, Overview and Highlights, February 2010*

# Medium-term challenges

The structural disadvantages the U.S. carries into the global economy significantly compound many of the other challenges it faces in the next decade.

The structural challenges have been evident for years but are now becoming difficult to ignore. Unless they are addressed head on, U.S. prosperity and our very way of life may be threatened.

These challenges include: a rapidly aging population, rapidly accumulating fiscal deficits at both the federal and state levels, persistent trade deficits and the resulting continued accumulation of foreign claims on U.S. assets, and the increasing unemployability of U.S. workers.

Medium-term challenges

# Rapidly aging population

The U.S. population is rapidly aging, along a trajectory that is only somewhat less severe than those of the populations of Europe or Japan. The dynamic can only be understood by discussing the enormous demographic footprint of the so-called "baby boom" generation – those born in the U.S. between 1945 and 1964. By 2025, as the last of the baby-boomers begin to reach senior status, the U.S. will have about 64 million people over the age of 65, more than twice the number it had in that range in 2000.[21]

This population cohort has been both a product of and an instrument in achieving U.S. prosperity. Its very large size triggered a building demand in the 1950s and 1960s for houses and schools; in the last 25 years it drove the country's economic growth and consumption. From now on the demographic drivers of consumption will weaken. It is just as well, since in 2008 consumption as a percentage of GDP in the U.S. reached the unsustainable level of 70 percent (a rate not seen since 1940 at the end of the Great Depression). In comparison, in China, consumption was only 35 percent of GDP in 2009.[22]

The rapid aging of the population creates fiscal pressures, which will be described later. It also has the potential to adversely affect national income, labor productivity, and the quality of economic output. The baby-boom population is the most highly educated cohort in the nation's history and with 40 million of them working full-time, they represent about 40 percent of the full-time workforce and 46 percent of total wages.[23] If this cohort leaves the labor force at the same rate as people of the same age left the labor force in 2000, the proportion of the U.S. workforce with college degrees and high school diplomas will decline significantly over the next two decades.

Labor force participation declines with age. In 2000, for example, about 88 percent of people aged 50 to 54 participated in the labor force; the participation rates at age 65 fell to 67 percent and at 70 and older to 17 percent. In 2014, the youngest baby-boomer will be 50. If the baby-boomers leave the workforce at the rate of those who left it in 2000, only about 9 million of the 40 million baby-boomers working today will still be working in 2025.[24] This represents a decline of 31 million workers – a number about equal to the United Kingdom's entire workforce.[25] As the baby-boom generation retires, the potential to lose even more jobs more rapidly to offshoring will rise. On the margin, all else being equal, jobs will be exited by people with more experience and education than the present generations of U.S. workers. As these experienced workers leave the workforce, their jobs become susceptible of being filled by better educated and lower-cost offshore labor. It would be in the entire nation's interest if the baby-boomers left the labor force at a less rapid rate. Only one-third of the baby-boomers nearing retirement (born in 1945 to 1954) have savings enough to sustain retirement

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[21] *Bureau of Labor Statistics; Haver Analytics.*

[22] *Bureau of Economic Analysis; IHS Global Insight.*

[23] *Bureau of Labor Statistics, Current Population Survey.*

[24] *Ibid.; the figures given are for full-time workers.*

[25] *Haver Analytics.*

incomes of 80 percent of their working incomes. If these people would work for an average of 2 more years, the number without adequate savings could be halved.[26]

The longer this population works, the more it will earn, the more income taxes it will pay, the more it will save, the more it would spend in retirement, the less in entitlement benefits it would draw down, and the more time there will be to upskill their replacements.

Unfortunately, a betting person might wager that this cohort will retire sooner rather than later.

According to the U.S. Labor Bureau the average retirement age in the U.S. is only 62 and continues to decrease. The average life expectancy in the U.S., on the other hand, is increasing: it was 59 when the Social Security program was created in the 1930s and is about 78 years today.[27] Ultimately, it will be important to reverse this trend of retiring younger. While some recent evidence suggests that older workers have been holding on to their jobs longer since the recession began, boosting the average retirement age over the long term will require incentives created in a joint effort by policy authorities and business leaders.[28]

## Rapidly accumulating fiscal deficit

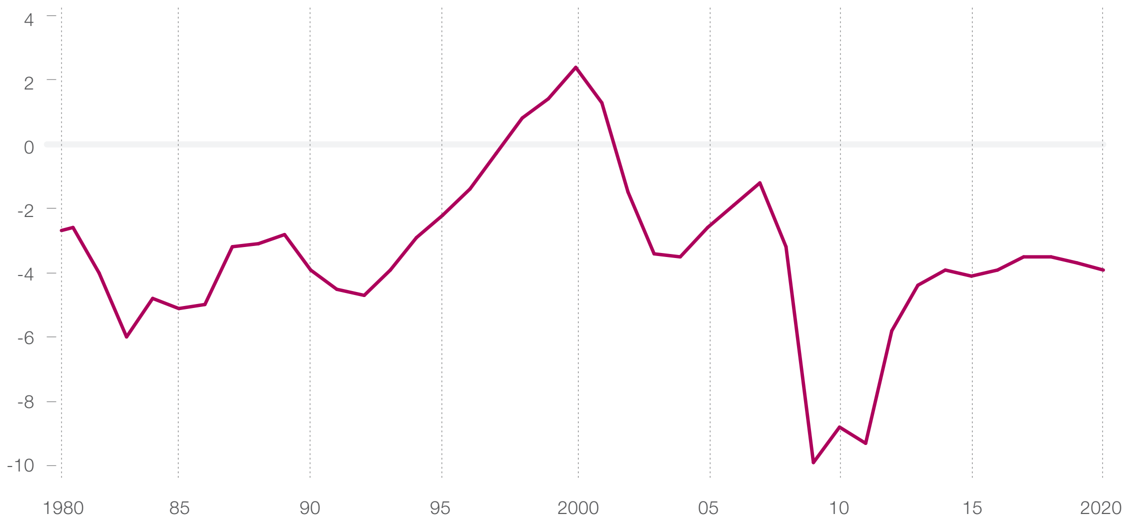
The aging of the population will likely add massive longer-term fiscal pressures to an already dismal picture of rapidly accumulating federal and state government deficits.

The turn towards running large deficits has been remarkably quick. In the 10 years from 2000 to 2010, the U.S. government went from running a modest fiscal surplus of 2 percent of GDP to a deficit of 10 percent in 2009 and 2010. The last time the budget deficit was over 10 percent of GDP was during World War II. Projections from the Congressional Budget Office show a deficit of near $1.5 trillion in 2011, again representing close to 10 percent GDP.[29]

### Projections for U.S. government deficits

**Federal surplus/deficit – percent of GDP**

Percent, fiscal year



*SOURCE: Congressional Budget Office*

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[26] *"Talkin' 'bout My Generation: The Economic Impact of Aging Baby-Boomers," McKinsey Global Institute, June 2008.*

[27] *National Center for Health Statistics,* National Vital Statistics Reports *54 (28 June 2006); World Bank World Development Indicators.*

[28] *Between 2007 and 2010 the percentage of jobs held by workers over 55 has gone up (Bureau of Labor Statistics).*

[29] *Congressional Budget Office, Budget and Economic Outlook, January 2011; Bureau of Economic Analysis; McKinsey analysis.*

## Medium-term challenges

As of today, total U.S. debt is about $14 trillion. Some $9.4 trillion of this is held by the public and some $4.6 trillion is held by intergovernmental agencies such as Social Security and the Federal Reserve.[30] By 2020, U.S. federal debt held by the public is projected by the CBO to be around 76 percent of GDP, assuming a GDP of about $23 trillion (the CBO assumes 3 percent real growth and 2 percent inflation in its GDP projection). Should the global economic structural factors described earlier limit annual GDP growth to 1 percent or so, GDP in 2020 would only be around $19 trillion, which would send the debt to GDP ratio over 90 percent.[31]

The bad news is that the really sharp projected increases in the U.S. fiscal deficit occur after 2020, when the baby-boomers move fully into their retirement years, causing entitlement spending to sky-rocket. The U.S. spends 10 percent of GDP on entitlements today. By 2035 the CBO projects that it will be spending 16 percent of GDP on entitlements.[32]

The ability of the U.S. government to service debt is not in question at the moment, since the debt is denominated in dollars and the U.S. can print as many dollars as it needs. However, the interest rates to service the debt would certainly rise over time if these deficits persist. The combination of a rising stock of outstanding debt and rising interest rates on that debt will mean a rise in the share of government spending that will go to debt service. For example, $15 trillion at a 2 percent rate is only $300 billion in interest payments but $20 trillion at 5 percent means $1 trillion in interest. Furthermore, if the trade deficit persists, more and more of this debt will be held by non-U.S. citizens. The interest on the debt that leaves the country will not provide income to tax nor spend in the U.S. Once this escalation takes place, debt service will consume more and more of the budget and more and more of the interest on it would leave the country.

Eventually, the debt burden would reach a tipping point at which the government would find it impossible to service its debt out of current or future income. The massive devaluation of the dollar (through the printing of money) or debt restructuring would become the only possible answers. Long before that tipping point is reached, however, non-U.S. holders of Treasury debt would begin selling their debt, causing interest rates to escalate rapidly. Some researchers, such as Kenneth Rogoff of Harvard, estimate that the tipping point would come at a public debt to GDP ratio of 90 percent.[33] (It should be noted that while Japan's debt to GDP ratio stands at 189 percent, only about 5 percent of the debt is held by non-Japanese investors.[34]) In any event, it seems imperative that the U.S. government address its fiscal deficit sooner rather later.

Another challenge facing the U.S. is its accumulating state deficits. Although many states are required by state law to run balanced budgets, many do not. In 2010, the U.S. states collectively were $192 billion in deficit.[35] The real issue facing states, however, is underfunded pension obligations. Estimates of the aggregate of these obligations range between $1 trillion and $3 trillion, depending on assumptions.[36] A recent study published by the National Bureau of Economic Research shows that state funds in aggregate will run out in 2024, assuming asset returns of 6 percent, or 2028, assuming (as states typically do) asset returns of 8 percent.[37] Such results would have catastrophic implications, so deliberate action is needed to stabilize and reinvigorate state pension systems.

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[30] *U.S. Department of the Treasury.*

[31] *Congressional Budget Office, Budget and Economic Outlook, January 2011; Bureau of Economic Analysis; McKinsey analysis.*

[32] *Congressional Budget Office, Long-Term Budget Outlook, June 2010.*

[33] *Carmen Reinhart and Kenneth Rogoff,* This Time It's Different: Eight Centuries of Financial Folly *(Princeton, 2009); the authors found that a 90 percent ratio of public debt to GDP is a tipping point in economic growth: developed economies that pass that point experience growth rates two percentage points lower, on average, than those that have not.*

[34] *Haver Analytics.*

[35] *Center on Budget and Policy Priorities; this figure represents about 1.4 percent of GDP. Preliminary estimates suggest that the U.S. states collectively are expecting a deficit of about $130 billion in fiscal year 2011.*

[36] *The estimates represent the difference between the dollars states have set aside to pay for employees' retirement benefits and the cost of those promised benefits; see "The Trillion- Dollar Gap: Underfunded State Retirement Systems and the Road to Reform," Pew Center on the States, and Robert Novy-Marx and Joshua Rauh, "The Crisis in Local Government Pensions in the United States," National Bureau of Economic Resarch, 2010.*

[37] *Robert Novy-Marx and Joshua Rauh, ibid.*

# The accumulated trade deficit and foreign claims in the U.S.

In general, the robust trade of goods and services is a social good and enables increases in the wealth of nations. In the short run, whether a nation runs a trade deficit or a surplus does not matter much to its economy.

Since 1997, however, the U.S. has run large, persistent trade deficits. As a result, non-U.S. investors now hold very large net claims on U.S. assets: the figure is now $3.6 trillion and growing. In just 10 years, from 2000 to 2009, the U.S. ran a cumulative trade deficit of over $5 trillion. In 2010, after shrinking dramatically in 2008 and 2009, the U.S. trade deficit rose again to an annual rate of nearly $500 billion.[38]

The goods and services deficit currently represents 3.4 percent of GDP, up from 2.7 percent of GDP in 2009. For goods, the deficit was $647 billion in 2010 while for services, the surplus was $149 billion. Based on World Bank data for 2009, the dollar size of the U.S. deficit in goods for 2010 is the equivalent in scale to the world's 18th largest economy, behind South Korea and the Netherlands and ahead of Turkey and Indonesia. Crude oil imports were valued at $252 billion in 2010 representing over 13 percent of total U.S. imports for goods in 2010 and the goods deficit with China alone hit $273 billion. Exports of goods to China represented $92 billion, while imports registered $365 billion.

Economists have pointed out that the economic importance of the bilateral trade balance with China is smaller than the data might superficially suggest. The reason for this is explained by the significant increase in trade in intermediate products. Much of what the U.S. imports from China, for example, includes high value components from other countries that have simply been assembled or reprocessed in China. It is estimated that the foreign share in China's manufactured exports averages about 50 percent. The number varies across sectors but ranges closer to 80 percent for more high-end products such as electronics.[39] While this development indicates mitigation of some of the U.S. deficit with China, it has little effect on end results for the U.S. This simply suggests that the economic importance of the bilateral trade with other partners such as Japan and South Korea are understated. Whatever its internal composition, that is, the U.S. annual trade deficit with the rest of the world is still $500 billion.

In 2010 the growth rates of U.S. imports largely matched those of exports. Given that the U.S. imports far more than it exports, a continuation of matching growth rates in future years would result in a trade deficit of near $1 trillion by 2016. Even with exports growing 25 percent faster than imports, it would still take up to 10 years to close the deficit. As noted earlier, a recent objective of the U.S. Administration has been to boost exports to the rest of the world. The Department of Commerce is actively engaged in providing information to companies interested in penetrating international markets. On the margin, informed decisions around what the U.S. imports could also make a big difference. For example, an information exchange could be created, to simply facilitate the matching of competitive domestic producers to U.S. firms who are currently importing. Our return to the virtuous cycle of growth and prosperity is being stalled by a lack of domestic demand yet the U.S. import bill is $1.9 trillion and growing.

To understand the challenges represented by the persistently large trade deficit, economists use a concept called the *trade identity.* It is a state of equilibrium, in which trade flows match capital flows. For the U.S. it means that every dollar of U.S. trade deficit must be financed by a matching dollar of capital claimed by a non-U.S. investor. Stated conversely, every dollar of net capital invested in the U.S. must result in a matching trade deficit.

As the reserve currency nation, the U.S. is subject to the desire of non-U.S. investors to hold dollar assets. This effect presents a challenge to the U.S. economy, because it can force the U.S. to incur trade deficits. This happens because the conditions of the trade identity can be met by adjustments in either the trade balance or capital flows. All else being equal, a persistent trade deficit by the U.S. could result in

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[38] *U.S. Department of Commerce, Bureau of Economic Analysis.*

[39] *Robert Koopman, Zhi Wang, and Shang-Jin Wei, "How Much of Chinese Exports Are Really Made In China? Assessing Domestic Value-Added When Processing Trade Is Pervasive," NBER Working Paper 14109 (2008).*

## Medium-term challenges

the U.S. dollar falling enough in value to make the price of its exports sufficiently competitive and the price of its imports sufficiently expensive to cause supply and demand to even out the balance of trade. However, all else is not equal, because non-U.S. investors want to hold U.S. dollars (particularly in uncertain times), and emerging-market nations, India and China most significantly, maintain restrictions on capital flows and currency rates, which keep the dollar overvalued. These factors cause the current imbalance to grow rather than shrink, because imports are cheap to domestic buyers and exports are expensive to overseas buyers.

A related issue is that the lion's share of those capital inflows are in the form of portfolio investments (primarily in obligations of the U.S. government or its agencies) rather than in foreign direct investment ( in plants, equipment, etc). Thus while these inflows lower dollar interest rates they do not contribute directly to U.S. job creation. As emerging markets grow and become wealthier, they desire to hold dollars to diversify their wealth beyond their local currency. This motivation may in turn force even larger trade deficits and/or cause the U.S. dollar to become even more overvalued.

This global desire for dollars continues despite the Federal Reserve's attempt, using a "zero" interest rate policy, to make the holding of U.S. dollars as unattractive as possible.

The challenge for the U.S. is that as long as it maintains no restrictions on capital flows and as long as emerging markets continue to restrict both capital flows and exchange rates, this dynamic will cause the U.S. dollar to be overvalued. The medium-term danger is that as the U.S. fiscal deficits accumulate and as the volumes of debt held by non-U.S. investors rises because of the trade deficit, a tipping point may be reached at which the non-U.S. investors would seek to diversify their holdings rapidly away from dollars. If this happens suddenly, rather than gradually, the value of the U.S. dollar could crash and U.S. dollar interest rates could sky-rocket.

Medium-term challenges

# U.S. workers are becoming less employable

Perhaps of the most disheartening features of the Great Recession has been the growth in the number of people in the ranks of the long-term unemployed (people without work for 6 months or more). Today, the long-term unemployment accounts for some 43 percent of total unemployment, compared to a rate of 15 percent or so in normal times. Only once since 1950 (in 1983) has it been as high as 25 percent.[40]

The unfortunate evidence is that these 6.5 million people are becoming unemployable in the modern global economy. Together with the 2.5 million who are so discouraged that they are no longer searching for work, there are now some 9 million people who would work if they could but will likely require an enhancement of their skill set, which may have deteriorated during the period of idleness.[41] One of the most damaging effects of job scarcity is the stagnation of skills: people need to be working in order to grow their skills. Many of the "discouraged workers" are young people seeking to start careers. Indeed, only 62.7 percent of men aged 16 to 24, and only 58.1 percent of women of the same age, were in the labor force in mid-2010, compared to an overall rate of 67.9 percent in 2007.

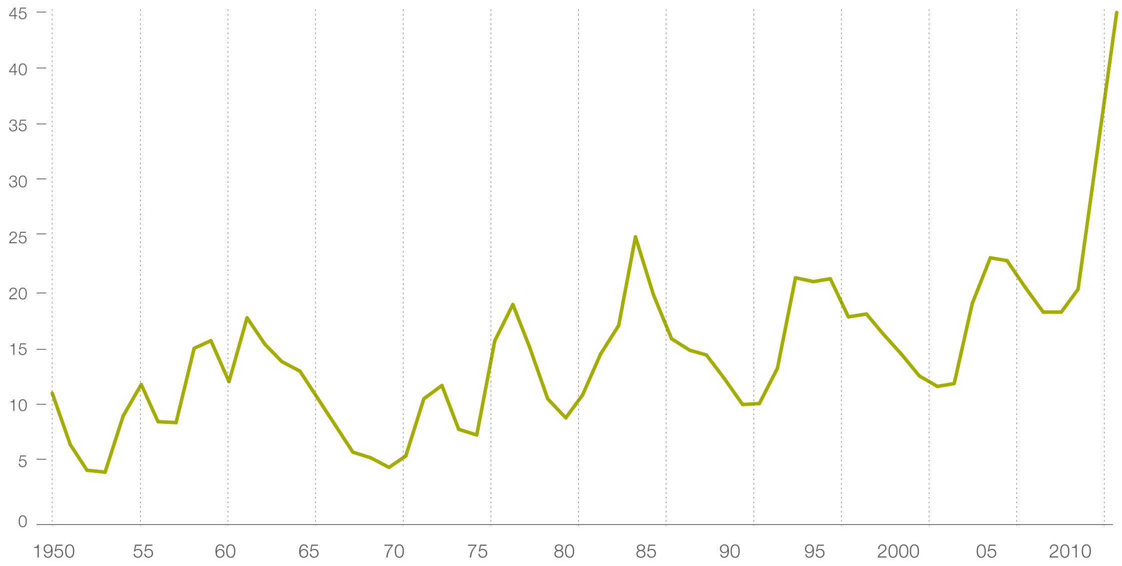
The reason why so many in this cohort are not looking for work is pretty clear. They can't find jobs. In late 2010, only 48.9 percent of this age cohort were employed compared to 58 percent in 2007.[42] The numbers for slightly older workers (ages 25 to 29) are almost as depressing.

Beyond the discouraged workers, and the long-term unemployed, an additional 8.9 million people are working part time but want more work; this group too are not able fully to develop their work skills. Finally, some 8 million people have been out of work for a shorter period of time (26 weeks or less). This makes a total of over 25 million people without jobs who want to work in an economy that at present has 139 million jobs.[43]

To put these numbers into perspective, in the relatively buoyant economic period of 2000 to 2008, the entire U.S. economy created a net of only 6 million new jobs. Of these jobs, 5.2 million were in knowledge work (work requiring problem solving and judgment), 1.7 million more were in transactional work (e.g., cashiers, package delivery), while jobs performing transformational work (e.g., agriculture, manufacturing) declined by 900,000.[44]

## Long-term unemployed as share of total employment

**Unemployed for 27 weeks and over – percent of civilians unemployed (SA)**
Percent



*SOURCE: Bureau of Labor Statistics; Havers Analytics*

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[40] *Bureau of Labor Statistics.*

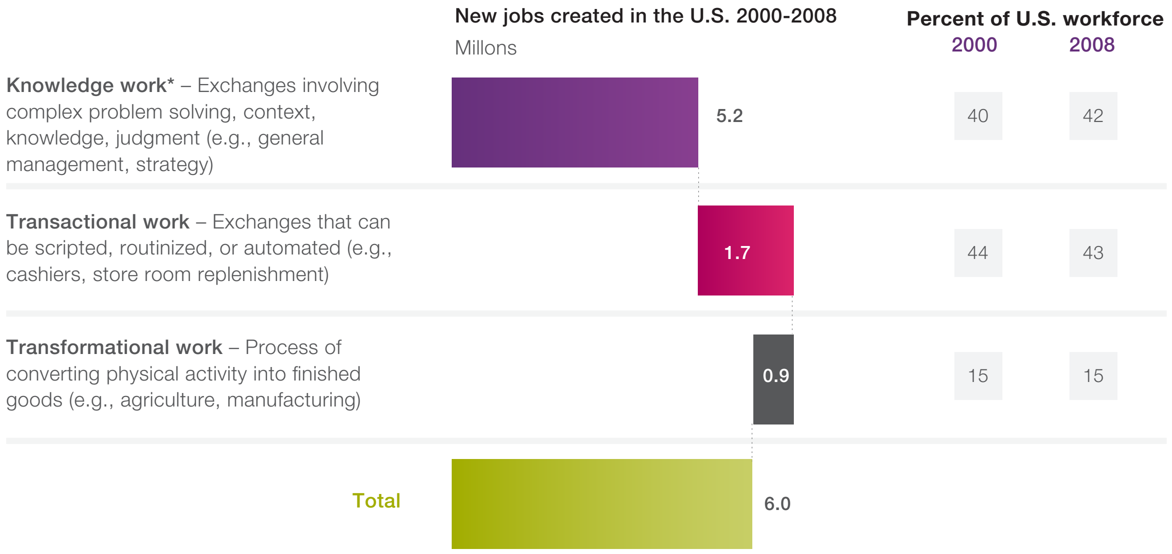
[41] *Bureau of Labor Statistics; Haver Analytics.*

[42] *Ibid.*

[43] *Ibid.*

[44] *Bureau of Labor Statistics, Occupational Employment Statistics.*

# Job creation over the last decade



** Includes all forms of tacit interaction work, both those requiring high skilled labor (e.g., managers) as well as complex interactions that can be trained on the job, such as high-end and complex sales transactions*

*SOURCE: Bureau of Labor Statistics, Occupational Employment Statistics; McKinsey Analysis*

## Medium-term challenges

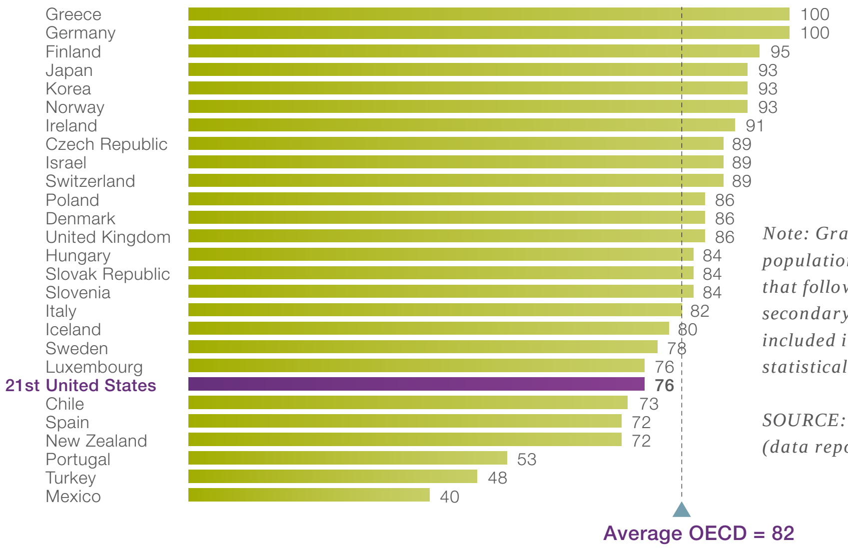
One of the challenges in creating work for the 25 million jobless and underemployed is that much of the work available requires at least a high school education. The United States, however, ranks poorly in educational attainment in comparison to other countries. According to an OECD study, the U.S. ranks 21st out of 28 OECD countries in educational attainment.

# U.S. ranks low in educational attainment

The United States has a lower overall attainment rate than many of its international peers

**Secondary school graduation rate**

Percent



*Note: Graduation rate covers "typical population of upper secondary school age that follows and successfully completes upper secondary programs"; not all OECD countries included in samples; differences may not be statistically significant.*

*SOURCE: OECD, Education at a Glance, 2009 (data reported for 2007)*

## Medium-term challenges

The decline in education equates to a decline in the number of home-grown people who can fill jobs that require advanced skills. Recent evidence suggests that this problem is getting worse and that the economic costs of the resulting gap are high. The U.S. ranked 52nd out of 139 countries in math and science in the World Economic Forum's competitiveness report.[45] In addition, a recent OECD report comparing 65 countries on educational achievement of 15 year-olds shows that the U.S. ranks 31st in math, 17th in reading and 23rd in science.[46]

When measured in economic terms, the costs of such gaps are staggering. A recent McKinsey analysis calculates that a persistent gap in academic achievement between children in the United States and their counterparts in other countries deprived the U.S. economy of as much as $2.3 trillion in economic output annually in 2008.[47] In other words, the education gap has imposed a higher recurring economic cost on the U.S. economy than the recent recession.

The end result is a skill gap that is likely to get worse with time. A recent study published by the Georgetown University Center on Education and the Workforce estimates that by 2018 nearly two-thirds (63 percent) of new and replacement jobs will require at least some post-secondary education. More than half of those jobs will require a bachelor's degree or higher.[48]

Indeed, there are some 3.1 million unfilled jobs in the U.S. right now including many in such fields as nursing, engineering, research, and professional business services.[49] But the potential for a rising mismatch of skills is only a small part of the larger structural issue which encompasses the job shortage and derives ultimately from the current trajectory of the global economy. The global economy is creating an abundance of new jobs. They just don't happen to be in the United States.

A single example illustrates the challenge. Apple is one of the most renowned U.S. companies. It employs some 47,000 people. Most of Apple's products are manufactured by a Taiwanese company called Foxconn, founded in 1974. Foxconn now employs 1 million people.[50]

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[45] *World Economic Forum, Global Competitiveness Report 2010-2011 (published in 2010).*

[46] *PISA 2009 Results: What Students Know and Can Do: Students Performance in Reading, Mathematics and Science, volume 1, OECD, 2009.*

[47] *Auguste, G. Byron, Bryan Hancock, and Martha Laboissier, "The Economic Cost of the US Education Gap,"* McKinsey Quarterly, *June 2009. If the U.S. had closed its gap with top performers such as Korea and Finland by 1998, U.S. GDP could have been between $1.3 trillion and $2.3 trillion higher in 2008.*

[48] *Anthony P. Carnevale, Nicole Smith, and Jeff Strohl, "Help Wanted: Projections of Jobs and Education Requirements through 2018," The Georgetown University Center on Education and the Workforce, June 2010.*

[49] *Bureau of Labor Statistics, Job Opening and Labor Turnover Survey, January 2011.*

[50] *Annual reports*

# Investing to meet the challenges

The medium-term challenges have not escaped the notice of the American people. Much of the debate engendered around these challenges and how to address them has, however, missed the central point: *the U.S. is losing competiveness in an increasingly integrated world economy*. Without becoming more globally competitive and without getting Americans back to work, the U.S. will not be able to recover sustained, private sector-driven, economic growth. The present recovery, such as it is, is largely dependent upon unsustainable levels of fiscal stimulus and on the Federal Reserve's ability to create money.

Almost everyone would acknowledge that the U.S. is reaching its public debt capacity limits. Much of the economic impact of U.S. deficit spending, furthermore, is indirectly transferred, creating jobs in India and China through offshoring and consuming exports. On the other hand, there is little room to ease monetary policy further. Money created, unless it flows through bank credit to households and companies that spend it, just keeps rates low. Although U.S. households are deleveraging at an unprecedented rate, they still have a very high household debt to GDP ratio of 91 percent today versus a 1998 ratio of 67 percent.[51]

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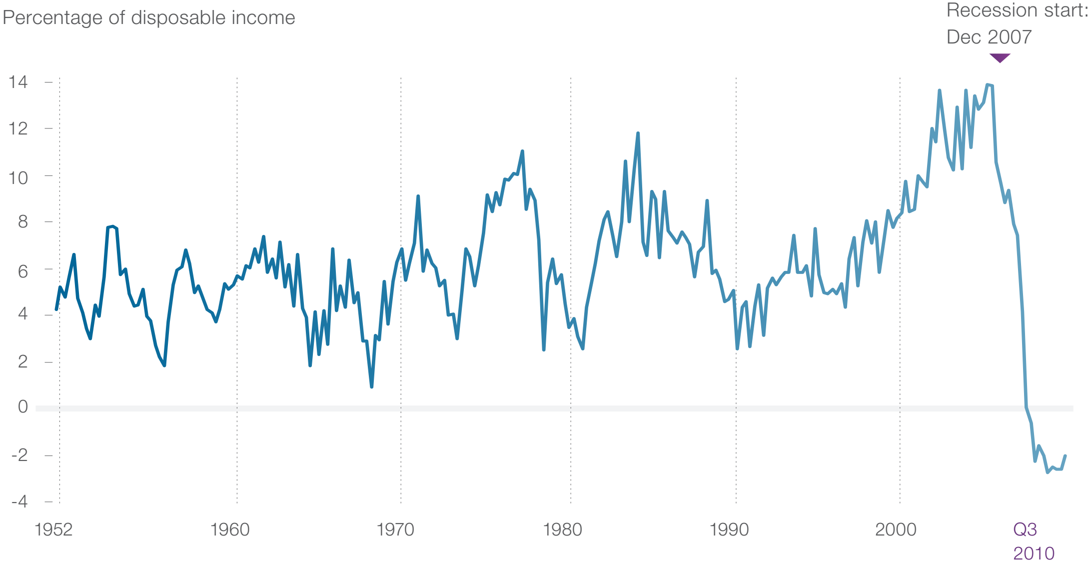
[51] *U.S. Federal Reserve; Haver Analytics.*

## Household deleveraging

U.S. households are experiencing an unprecedented deleveraging in the post-war era

**Net new borrowing of U.S. households**[1]
Percentage of disposable income



[1] *Includes households and non-profit organizations serving households.*
*SOURCE: Federal Reserve via Haver Analytics; McKinsey Global Institute analysis*

The deleveraging process seems likely to continue as long as the poor and those without jobs lack the assets or income to borrow for consumption. Meanwhile, given the low rates available on deposits and short-term Treasuries, the highest "safe" returns on savings available to affluent workers (particularly baby-boomers) is through repaying debt.

Moreover, the combination of staggering loan losses, higher capital requirements, bad assets remaining on their balance sheets, and increased regulatory oversight have made bankers far more conservative in extending credit. Perhaps this is not very surprising, since some $193 billion of the $487 billion total reduction of household debt since 2008 represents loan write-offs.[52] In other words, the prospects for creating economic growth by getting consumers to borrow for consumption purposes seem bleak.

Aggressive fiscal and monetary policies served us well in 2009 and 2010, propping up the U.S. economy in the financial crisis. The passage of the tax extension and stimulus package in December 2010 and the second round of quantitative easing by the Federal Reserve ensure that the U.S. will keep on this path for a while. But the efficacy of such policies is clearly reaching a limit. Fiscal and monetary stimulus cannot fix the fundamental structural issues facing the nation's workforce and the related loss of global competitiveness. Domestic jobs, income, and investment shortages will persist in the foreseeable future unless the structural global competitiveness issue is addressed head on. Otherwise real economic growth will not be restarted and sustained.

For the U.S. to keep its role in the world economy in some semblance of balance, its economy must grow more rapidly. Currently, in dollar terms, the U.S. economy is still about twice as large as India's and China's put together (approximately $14.5 trillion versus about $7.5 trillion). But the U.S. managed to grow at a real rate of only about 1.5 percent per year over the last 10 years, while India and China moved toward 10 percent per annual economic growth. Whether or not this picture changes depends in large part on the ability of the United States to generate real growth. If the pattern does not change, the world economic order will experience a dramatic shift in balance.

Should the economies of China and India continue their recent strong growth trajectory and the U.S.

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[52] *McKinsey Global Institute Analysis, January 2011.*

manages only 1.0 per cent real growth, and if the yuan and the rupee appreciate 40 percent relative to the dollar, then the change will be dramatic. In 2020 the combined real output of the Indian and Chinese economies would be valued at some $26 trillion, versus a real GDP of only $16 trillion by the U.S.

However, if the U.S. were to grow by 3 percent a year, and China and India by 6 percent a year, with their currencies appreciating 25 percent against the dollar, in 2020 the U.S. would still be producing more real output (valued at $20 trillion) than those two countries combined (valued at $16 trillion).

The great and ongoing rebalancing of the world's economy towards the emerging markets is unstoppable, but it is in the interest of the U.S., and the world as a whole, that the transition be smooth and gradual, not abrupt and rapid.

## What does the U.S. need to do?

The U.S. is ill-prepared to address these growing structural imbalances. At stake is not just the nation's prosperity, but also its ability to continue to protect both its own and the world's security. An economically weak America will benefit no one.

What is needed is a new debate, new ideas, and most of all, a new resolve on the part of the American people, corporations, and governments to address these structural issues with an intent on maintaining, and even growing, the nation's competitiveness in the global economy.

Much of the public debate over the last 2 years has missed the central point. The debate has been inwardly focused, on issues such as taxes, monetary policy, and spending on entitlements, as if the U.S. can continue to operate independently of global realities. These issues do matter, of course, but the truth is that we live in an ever more integrated global economy. If the U.S. does not correct its failing competitiveness, its role in the global economy will continue to diminish.

Without resolute action by 2020, America's prospects for financially sustaining the entitlements promised to its people or meeting obligations to pay the interest costs on its debts will have become bleak. The U.S. workforce will have become scarred by diminished labor participation and the polarization between the "haves" (i.e., those with jobs) and the "have nots" (those without them) will sharpen. The current level of military spending would certainly become unsustainable (if it has not already). Concerning income levels, the best that could be hoped for would be that they would remain flat for the foreseeable future. The optimism and confidence that have been the nation's mainstays since its formation will disappear. In the worst case, per capita income could actually start to fall, perhaps significantly, and social, political, and civil unrest could become extreme.

The U.S. needs to implement new ideas that do more than the "quick fixes" supplied through monetary and fiscal stimuli. Instead, incentives need to change, to encourage America's people and corporations to work together, to save more, invest more, work more productively, acquire better skills, and retire later. Fresh thinking is needed on how the national and state governments can remove obstacles that limit competitiveness and, on the margin, begin to tilt the odds towards U.S. workers and corporations – at least enough to offset what other nations are doing to advantage their own workers and corporations.

Most of all, the U.S. needs a new resolve. Over its history, America has rallied to meet its challenges – often in the aftermath of traumatic "wake-up calls" such as the Great Depression, Pearl Harbor, and Sputnik. When faced with such events, America's ability to rally around a common cause has always been impressive. The question is, absent such a crystallizing crisis, can the U.S. develop a sufficient common resolve to address its present structural challenges in time? Or, instead, will the U.S. allow

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itself to slip into a slow decline until some day, in a decade or two, Americans finally wake up to realize they live in a "has been" nation?

This paper will not offer specific policy recommendations to address these structural challenges. Such policies need to emerge from a renewed, better-focused, and urgent public debate. We would like to frame what we believe should be the focal points of this debate and to offer some starting thoughts on the kinds of policies that might be considered. Five areas are most important:

1. Fostering a mindset shift in both the U.S. public and its policy makers around the urgency of making the U.S. more competitive.
2. Revamping the tax system to enable the U.S. to invest in becoming more globally competitive, while still reducing the fiscal deficit over time.
3. Making the U.S. workforce far more competitive.
4. Creating a better partnership between the U.S. government and U.S. corporations.
5. Persuading the baby-boom generation to retire later.

### 1. Shifting U.S. mindsets

After 65 years of largely uninterrupted growth in income and wealth, the nation – its population, its politicians, and its media – have come to focus almost exclusively on who gets what share of an existing pie, rather than on how to expand the size of the pie. Presently, a mentality of "we're all in this together," and all the creativity that it implies, seems more elusive than ever.

This current rhetoric first of all needs to change. People must begin talking about what is economically "virtuous." Over the last 15 years or so, the U.S. built its economy on consumption and debt financed by easy money and the savings of other nations. During the last 2 years the mainstream media have both lamented the fall off in consumption in the U.S. and the deleveraging of the economy, regarding these developments at best as necessary evils. Little attention has been paid to what we believe is an urgent national need to save for retirement and to invest for future prosperity. Currently the rate of investment in the U.S. is about 15 percent of GDP – only a little larger, that is, than the rate of depreciation of U.S. capital stock.

Work by the McKinsey Global Institute estimates that an investment of about 2.5 percent of GDP above the rate of depreciation is needed to see a 1 percent growth in GDP. Given a depreciation rate of about 12 percent, an investment rate of close to the U.S. historical average of 20 percent is required for the economy to grow at its historical rate, of about 3 percent. Such a rise in investment (from 15 to 20 percent) would be enabled by a corresponding fall in the present U.S. consumption rate of 70 percent, to its historical average of 65 percent.

Similarly, the entire nation needs to focus on creating jobs, working more productively, and improving worker skills. Only success on these clear imperatives will generate the income workers need, create demand for goods and services that is not based upon debt, and raise the tax revenues required to pay for entitlements and government services without continuing to build up large deficits. Those who persist in thinking that all will be well if unemployment benefits are sustained until the economy improves, are burying their heads in the sand. Unless the structural disadvantages faced by younger and less educated workers in the global economy are addressed, no rosy scenario will come to pass.

At the same time older, highly skilled workers need to be energized to keep them from retiring too early. Later retirement among this cohort will reduce their need for entitlements, create income they can use when they do retire, and allow them as active workers to transfer skills to their younger colleagues. Existing corporate and government policies do the opposite, however: they motivate older workers to retire earlier than later.

Given the intensity of the political debate in the U.S. over narrow interests, it may seem almost a fool's errand to try to shift the focus to finding common ground on these issues. But not only must this shift be attempted, it must be accomplished. The alternative is for the U.S. to face a gradual, but inevitable, loss of prosperity, social cohesion, and even national security.

## 2. Revamping the tax system

The most important single policy action the U.S. can take to improve national competitiveness is to reform the U.S. tax system. After long deliberations, the Bipartisan National Commission on Fiscal Responsibility and Reform concluded last fall that "the current income tax system is fundamentally unfair, far too complex, and long overdue for sweeping reform." We agree with that assessment and also with the broad direction of the specific reforms the Commission recommended. Among these are a lowered corporate tax rate, an end to the taxing of foreign-source income, and the replacement of the current hodgepodge of industry- and company-specific deductions with a flatter, simpler system. The aim of any reform, as the commissioners have noted, should be to "lower tax rates, reduce the deficit, simplify the tax code, reduce the tax gap, and make America the best place to start a business and create jobs."

We believe, however, that these worthy aspirations miss one fundamental point: the U.S. also needs to generate additional money, beyond what it is currently spending, in order to invest in growing the economy, increasing the skills of workers, and making the U.S. a more attractive place for investment. Therefore, we believe that tax reform should be used not only to close the fiscal deficit but also to shift the rate of investment in the economy.

A big advantage in the tax policy lever beyond its ability to raise money is that it can alter marginal economic decisions (those decisions that could go one way or the other) by changing incentives. A classic example: If for the public good you want to discourage smoking, then you impose high taxes on cigarettes.

On balance, however, current U.S. tax policies actually motivate behaviors that exacerbate the medium-term competitiveness challenges. Examples: the U.S. taxes income but not consumption; tax breaks are given for borrowing (e.g., mortgage interest deductions) but not for savings (e.g., interest income); corporations are taxed for bringing funds back to the U.S. to invest, while the same funds remain untaxed if they are invested offshore.

In this paper, no specific tax changes are recommended, but we do want to underscore one critical point: aside from political considerations, there is no theoretical reason standing in the way of the U.S. reforming its tax code to encourage competition while not adding to the deficit. A consumption tax might be levied, for example, in such a way that use of the proceeds would be restricted to creating domestic jobs and encouraging domestic investment. This could be done through creating escrow accounts to subsidize new additions to private-sector payrolls, support job-specific education and on-the-job training programs, fund public investment in infrastructure, or help spur domestic investment by corporations. Following a similar pro-saving strategy, the U.S. might choose to eliminate the deductibility of interest over time and replace it with exemptions for the first $30,000 or so of interest or dividend income earned. Whatever the precise measures, the aim should be to lift investment as a share of GDP back to our historic norms.

The evaluation of all reforms, of course, needs to be based upon their impact on the fiscal deficit. But there is no doubt that these kinds of changes could either be self-financing or actually create more new tax income – by improving competitiveness and thus creating a larger economic pie to be divided up. Here's the math. If the U.S. economy grows at 3 percent per year on average as projected by the CBO (i.e., 3 percent growth real and 2 percent inflation), by 2020 annual GDP size will be $23 trillion. If it grows at only 1 percent annually, by 2020 GDP will reach only about $19 trillion. Assuming the economy is taxed at about 18 percent of GDP (versus our average over the last decade of 17.6 percent), the difference in growth rates would mean about $700 billion in tax revenue annually.

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Unfortunately, the CBO assumes real GDP growth of 3 percent already. If GDP grows at only 1 percent real, the fiscal deficit will be $700 billion larger than currently being projected by the CBO.

This means that, over time, as the U.S. population ages, increases in tax rates and cuts in entitlements are inevitable if a fiscal disaster is to be avoided. However, such increases in taxes and cuts in entitlements will be far less painful if they occur in an economy that is benefiting from investment-led growth.

## 3. Building a more competitive workforce

Keeping the American dream alive will require more than changing mindsets and tax policies. Perhaps the most difficult problem to address is the declining rate of educational attainment in the U.S. and the loss of relative advantage in workforce skills versus other nations. Economic policy actions alone will not be enough to reverse this loss. Many of the underlying issues behind this decline are cultural and societal. Certain of these social factors (e.g., weak local public school systems) are outside the scope of this paper. One core economic issue can be tackled, however: the U.S. needs to ensure that if someone is willing to work hard and improve themselves, then they will have that chance. This is where the U.S. is failing as a society today.

More and more Americans, particularly males, are unemployable. Currently, 20 percent of men aged 25 to 54 do not have jobs, as opposed to 13 percent in 2007 and 6 percent in 1948 (when this data were first collected). Obviously, for large cohorts of underskilled and undereducated people of workforce age, relying on conventional educational approaches to make themselves more employable is no longer possible. Instead programs focused on career-specific education and on-the-job training are needed to improve their work skills. As noted in point 2, the creation of a public escrow account funded by additional tax revenue could be used to provide assistance to people wanting to build their skills – and incentives for employers to hire them – all without expanding the deficit.

Beyond the reskilling and upskilling of American workers, bold new ideas are needed to revamp the way people who have left school early are educated. For example, many young people seem to find it easy and exciting to play electronic games. Couldn’t creative people and companies be encouraged and rewarded with national prizes, or other incentives, to develop electronic “games” that engage and excite young people to learn new marketable skills?

It is particularly important for the U.S. to address the skills gaps in high-skill job categories where there are unfilled positions. That these jobs are unfilled means that the U.S. work force is forgoing income and the U.S. economy is forgoing output. As noted earlier, the U.S. has some 3.1 million open jobs, many of which remain open because employers cannot find people with appropriate skills. A practical approach to closing this skill gap is to identify those jobs classes where there is a supply shortage, provide incentives for workers to acquire the skills needed to fill them, and incentives for employers to provide on-the-job training. The U.S. faces a shortage of nurses, for example, and recruits large numbers of these from nations such as the Philippines. To eliminate the nursing shortage, the government could subsidize schools for educating workers and hospitals and other employers for offering on-the-job training, while providing incentive payments to graduates of nursing schools for taking domestic jobs. In effect, these payments would enable workers and employers partially to recoup their investments in building the skills needed to fill economically valuable job categories. These subsidies would be repaid over time, furthermore, with a boost in incoming tax revenues from active skilled workers and a corresponding drop in outgoing entitlements.

And, for critically needed skills, the H1-B visa program can be expanded to enable high-talent non-Americans, particularly those educated in the U.S., to work in the U.S.. By allowing these talented people to work in the U.S., the U.S. government would not only be fostering the generation of income at home (which can be taxed), but also raising production of domestic output that would otherwise not exist or be created off shore. This activity, in turn, would create additional domestic jobs for American citizens.

## 4. Building a better partnership between government and corporations

Lately, both the current Administration and Congress have begun to realize the enormous economic potential available to the U.S. economy if corporations were motivated to create jobs and make investments domestically. This is a very encouraging sign. Perhaps the most valuable assets the U.S. has for addressing its competitive challenges are the number and quality of the corporations headquartered within its borders. U.S. multinationals remain the most prominent players in most global industries and the depth and breadth of the mid-sized and small business sectors in the U.S. is unmatched by any nation.

A far better partnership can be created between the American people, its government leaders, and corporations, to work together for their common interest. Like it or not, many countries are using the power of the state to give their companies and workers an edge in the global economy. By contrast, the primary way in which the U.S. government engages with its corporations is to tell them what they cannot do (through regulation) rather than helping them to compete.

The range of options is wide and especially open to bold and unconventional action. For example, those escrowed funds described earlier might be offered as hiring incentives to offset the overvalued U.S. dollar, to any company that adds new employees. In addition, a national investment program could be launched, aimed at sustaining the U.S. position as a world leader in technology, and thus ready to engage in such vital 21st century economic areas as clean energy, nano technology, water technology, and healthcare technology. The U.S. has already started down this path with some of the programs included in the Recovery Act, such as the creation of the Advanced Research Project Agency-Energy (ARPA-E). But there is a crying need in this area for something much larger in scope.

Borrowing a page from what many successful emerging countries have done, the U.S. might go further by creating a “sovereign wealth” fund with a mandate to look for opportunities to invest in the U.S. In opting for such an approach, the government could restrict its ownership of any company to no more than 20 percent. Whatever steps are actually taken, those that would keep the U.S. globally competitive will reflect a measure of boldness and big thinking – nothing less will do.

## 5. Persuading the baby-boomers to delay retirement

Finally, to ensure the nation’s competitiveness, especially given its demographics, the U.S. should seek ways to adapt its systems of taxation and entitlements to motivate workers to delay retirement and increase savings.

Consider, for example, what would happen if the 40 million baby-boomers currently in the workforce were, on average, to leave the workforce 3 years later than did similarly aged people in 2000. Given a per capita income of $45,000, they would generate about $5.5 trillion of cumulative extra income (roughly 40 percent of a full year of U.S. GDP). If they saved at a 15 percent rate appropriate to their ages, they would create about $800 billion in additional savings for their retirement. They would pay some $1 trillion in additional income and Social Security taxes and would receive some $2.4 trillion less in entitlements (at an assumed per capita annual rate of $20,000 per person or some $60,000 over the 3 years). Of course, this analysis assumes that the U.S. can create sufficient jobs through the other programs described earlier to keep the rest of the workforce employed as well (i.e., it assumes delayed retirement does not displace other workers from having jobs).

Some of the ways to get workers to delay retirement have already been discussed in the public debate, such as increasing the age before Social Security recipients are eligible for full retirement benefits. Changes could also be made to delay receipt of Medicare benefits for people who are still employed (i.e., with continued employer-paid for health coverage).

It also makes sense to consider some new incentives to encourage older people to work longer. Part of the additional $1 trillion in extra income and payroll taxes gained by extending the work career by 3 years could be shared with the worker to provide the incentive to work longer. For example, to encourage savings, the marginal tax rates for the first $250,000 of income for people over 65 could be halved, given that this income and the taxes it generated would not exist if these workers were retired. Or, workers over 65 (not their employers) could simply be exempted from paying payroll taxes to offset their delayed receipt of Medicare and Social Security benefits. To further encourage savings, 401(k) rules could be changed to permit anyone over age 55 to put up to 50 percent of their income up

to $250,000 into a retirement plan. They would thereby avoid taxation on investment income until they started withdrawing it at age 70. Such policies would also serve to increase the private sector savings rate and would make the aging population less reliant on Social Security.

## Investing to revitalize the American economy

As we have emphasized, this paper is not intended to advance specific policy recommendations. Our goals have been to lay out the sheer scale of the challenge and show a range of possible actions that could effectively address it. If the U.S. can generate the political will to adopt an investment and savings program as described here, then it will have demonstrated its potential to revitalize its economy. While the immediate boost to the U.S. economy that will come from employing millions more people is substantial, the real benefits would derive from capturing a greater share of the growth in the entire world economy.

The key to the potential success of this program is that it is based on growth, and so avoids many of the parsimonious trade-offs that are currently part of the public debate. Since the investment program would be self-financing, it would not add to the deficit beyond an initial lag period. Instead, over time investment will close the deficit through stimulating economic growth, increasing tax revenues and reducing entitlements. It would accelerate the deleveraging of the household sector by boosting household income through job growth, which in turn should help turn around housing prices.

If Americans fail to engage in this debate and fail to take deliberate, effective, and timely action, the American future will become bleak, for all the reasons we have outlined. It is in the power of the American nation to choose the path of growth. With the right collective mindset and virtuous policies the U.S. will be able to reemploy its workforce and improve its global competitiveness. The challenges can be surmounted. The U.S. can remain prosperous, retain its global leadership – and keep the American dream alive.

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