



# The US Imbalancing Act: Can the Current Account Deficit Continue?

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# Preface

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This report is the product of a six-month research project by the McKinsey Global Institute (MGI). The research builds on MGI's previous research in global capital markets, and draws on the unique perspectives of our colleagues who work with financial institutions and companies in the United States and around the world.

Susan Lund, a senior fellow at MGI based in Washington, DC, worked closely with me to provide leadership for the project. The team also included Alexander Maasry and Sebastian Roemer, both MGI fellows. In addition, we would like to recognize the support given by Tim Beacom, a senior analyst at MGI, and Moira Sofronas, a senior analyst at the McKinsey Knowledge Center.

We have benefited enormously from the thoughtful contribution of our academic advisors. Martin N. Baily, an advisor to McKinsey and a senior fellow at the Peterson Institute for International Economics, provided valuable input throughout the project. Richard Cooper, professor of international economics at Harvard University, and Kenneth Rogoff, a professor of public policy and economics at Harvard University, offered insightful comments on the report. William Cline, a senior fellow at the Peterson Institute for International Economics, gave helpful feedback on our economic modeling.

We would also like to thank Janet Bush for her editorial efforts, Rebeca Robboy for leading external communications, and Deadra Henderson for managing report production. Sara Larsen, executive assistant, provided the team with support throughout the project.

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Our goal in this report is to provide business leaders and policy makers with a fact-base and insights into one of the most important issues in the world economy today—the growing US current account deficit. As with all MGI projects, this work is independent and has not been commissioned or sponsored by any business, government, or other institution.

Diana Farrell  
Director, McKinsey Global Institute  
June 2007  
San Francisco

# Executive summary

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Many economists believe that the United States' current account deficit is on an unsustainable path.<sup>1</sup> Economic alarm bells started ringing in the late 1990s, and yet the deficit has continued to grow unabated.<sup>2</sup> In modern times, no large economy has run a deficit of this size for such a prolonged period of time. This unprecedented situation is now commanding the attention of business leaders, investors, and policymakers around the world.

When the annual US current account deficit reached 3 percent of GDP in 1999, economists warned that the trend was worrisome. In 2006, the annual deficit reached 6.5 percent of GDP—a record \$857 billion—thus compounding economists' concerns (Exhibit 1). To fund its chronic deficit, the United States now absorbs a majority of net capital outflows from other regions of the world (Exhibit 2). The total US net foreign debt has swollen to \$2.7 trillion, leaving the United States vulnerable to changes in global investors' sentiment. If foreign investors were to lose their appetite for dollar-denominated assets, US interest rates would probably rise substantially, at least in the short run, thus restraining overall economic growth. Many economists and commentators believe a major correction—involving a significant depreciation of the dollar—is looming.

This prompted the McKinsey Global Institute (MGI) to consider the US current account deficit under two very different scenarios over the next five years: the deficit continuing to expand; and the current account coming into balance. On one hand, could the world fund an ever-growing US deficit? On the other, if the

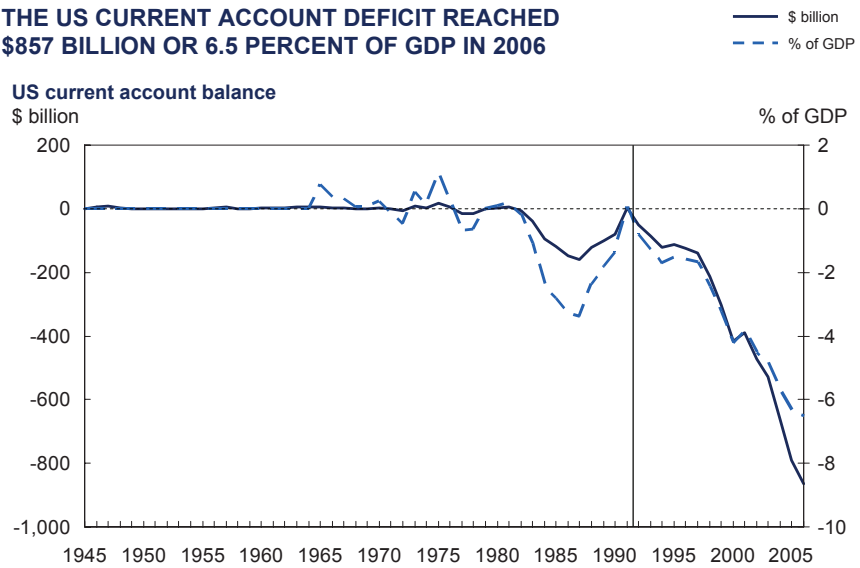
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1 For example, see Maurice Obstfeld and Kenneth Rogoff, "The unsustainable US current account position revisited," 2005; Martin Baily, *Dollar Adjustment to Reduce US Imbalance*, 2007; William Cline, *The United States as a Debtor Nation: Risks and Policy Reform*, 2005.

2 Among others, Catherine Mann in *Is the US Trade Deficit Sustainable?*, 1999.

## Exhibit 1

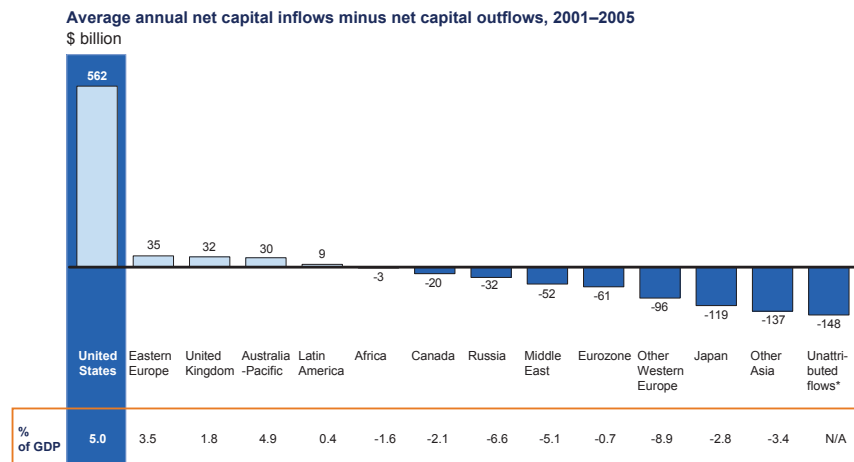
### THE US CURRENT ACCOUNT DEFICIT REACHED \$857 BILLION OR 6.5 PERCENT OF GDP IN 2006



Source: Bureau of Economic Analysis; International Monetary Fund; Global Insight; McKinsey Global Institute Global Capital Flows Database

## Exhibit 2

### THE UNITED STATES ABSORBS MOST OF THE WORLD'S NET CAPITAL FLOWS



\* Total net inflows exceed net outflows by \$148 billion due to statistical errors and omissions; some of this could reflect "gray market" money as well as the fact that some countries do not report inflows and outflows.

Source: International Monetary Fund; McKinsey Global Institute Global Capital Flows Database



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deficit were eliminated, what would be the impact on the value of the dollar and on US trade patterns? A number of surprising results emerge that challenge conventional wisdom.

We find there is nothing inevitable about a correction in the US current account deficit over the next five years. It could instead continue to grow, and the world would have enough capital to fund it. At current exchange rates, the United States could trim the deficit slightly by increasing service and manufacturing exports—but not enough to reverse its current trajectory. If a large dollar depreciation were to occur, we believe it would more likely be gradual than sudden. Nonetheless, our analysis illustrates how a very large and rapid dollar depreciation could bring the deficit back towards balance with significantly altered trade patterns. Irrespective of whether the adjustment process is gradual or rapid, however, business leaders and policy makers should start considering what a post-devaluation world would mean for them.

#### **THE US CURRENT ACCOUNT DEFICIT COULD CONTINUE TO GROW**

Our analysis shows that a correction in the US deficit is neither imminent nor inevitable. Under the current pattern of the US current account, world growth and exchange rates, the US current account deficit would reach \$1.6 trillion in 2012, or 9 percent of GDP. For this to happen, however, the current account surpluses of other countries would also have to grow sufficiently large to fund the deficit. We find that under reasonable assumptions, these surpluses would reach \$2.1 trillion, providing the capital required. US net foreign debt would reach 46 percent of GDP, but the United States would still be able to finance the deficit because the implied net foreign interest payments would remain at less than 1 percent of GDP.

That said, there are several scenarios that could limit growth in the global net capital outflows necessary to fund the US deficit. For instance, if China were to increase domestic consumption and reduce its savings significantly, net capital outflows from China—currently a significant source of funding for the US deficit—could fall dramatically. In our model, this would leave the US deficit equivalent to 90 percent of the remaining global net capital outflows, a figure that is implausibly high. However, we consider this scenario unlikely. MGI's research on China's consumer market shows that although domestic demand will account for a greater share of GDP, its expansion will come largely from growth in incomes and there will be only a slight fall in the national savings rate.<sup>3</sup> Other scenarios, in isolation, would not limit growth in the US deficit.

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<sup>3</sup> From "Made in China" to "Sold in China": The Rise of the Chinese Urban Consumer, McKinsey Global Institute, November 2006.

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Neither will the ability of the United States to fund its current account deficit depend on the price of oil. Oil imports are the largest single component of the US trade deficit. However, although a higher oil price increases the value of US imports, it also increases the current account surpluses in oil-exporting economies.<sup>4</sup> This capital is then “recycled” into global financial markets. It doesn’t matter whether these petrodollars are invested in Europe or Asia rather than being invested directly in the United States; by increasing the capital available in the global financial system, they still contribute to funding the US current account deficit.

### **ELIMINATING THE CURRENT ACCOUNT DEFICIT WOULD ENTAIL A LARGE DOLLAR DEPRECIATION**

Although our research shows that the US current account deficit could plausibly continue to grow over the next five years, the United States cannot continue to build up foreign liabilities forever. Eventually the deficit will need to stabilize, or even decline, relative to the size of the US economy. A major rebalancing of global demand and a dollar depreciation of historic proportions would be required for this to happen over the next five years.

To balance the US current account by 2012, we find that the dollar would need to depreciate by 30 percent from its January 2007 level. Reducing the deficit to 3 percent of GDP, a level that many economists believe to be sustainable,<sup>5</sup> would require a 23 percent depreciation. Only once over the last 35 years has the dollar depreciated by 30 percent within a five-year period—in 1985–88. However, in 1985 the dollar was at its highest level since 1970, whereas today the dollar is already below its average post-1970 value, and a further 30 percent fall would leave it at its lowest level since 1970.

In the absence of a depreciation in the dollar, we find it likely that the United States could do little more than slow the growth of the deficit. Based on a detailed micro-economic analysis of US exports, our findings suggest that at current exchange rates the United States could potentially increase its share of service and manufacturing exports to other countries by \$265 billion and \$240 billion respectively. However, this would require either much faster GDP growth in the rest of the world than is currently projected, or the United States to win share of imports from other

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4 Improving energy efficiency in the United States could reduce its oil imports and lower the trade deficit. We calculate that the United States could reduce oil imports by 10 percent by 2012 just by implementing technologies available today that improve energy productivity. See chapter 3 for more detail.

5 For instance, see Ahearn, Alan, William Cline, *et al.*, *Global Imbalances: Time for Action*, IIE Policy Brief, Peterson Institute for International Economics, Washington, DC, forthcoming in 2007

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countries. Even so, at best this increase would merely hold the US current account deficit to its current level relative to GDP, or 6.5 percent.

If the dollar were to depreciate, a 30 percent decline could play out in different ways, since currencies rarely move evenly against all others. We modeled three depreciation scenarios: first, an even depreciation against all currencies; second, a scenario under which Asian currencies adjust the most; and third, a scenario under which Asian currencies maintain their current value and the adjustment takes place in Europe, Canada and Mexico, and the rest of the world. While the effects of these scenarios differ, a number of changes in trade patterns appear under all three.

#### **AFTER DEPRECIATION, A LARGE US TRADE DEFICIT PERSISTS— PARTICULARLY WITH CHINA**

Surprisingly, even if the United States were to balance its current account, it would still continue to run a large trade deficit. Under all three depreciation scenarios, the US trade deficit in goods would stand at around \$720 billion in 2012—only slightly smaller than it is today. However, this deficit on merchandise trade would be offset by a \$430 billion surplus on trade in services and by positive net foreign-income payments. The latter is due to a turnaround in the US foreign debt position. If current trends were to continue, US net foreign debt would rise to \$8.1 trillion in 2012. However, if the dollar were to depreciate by 30 percent, the United States would become a net foreign *creditor* to the tune of \$4.8 trillion, generating \$435 billion a year in net interest payments to the United States.

Under all depreciation scenarios, the United States would continue to run a large bilateral trade deficit with China. The bilateral deficit was \$198 billion in 2005—more than one-quarter of the total US trade deficit. Even if the dollar were to depreciate by 45 percent against the yuan (as it does under our second depreciation scenario), however, the US trade deficit with China would still be \$87 billion.<sup>6</sup> The huge cost advantage that China enjoys in producing goods such as toys and clothing means that the yuan would need to appreciate by more than 50 percent to eliminate the US trade deficit with China.

In contrast, US trade with Canada and Mexico—countries often overlooked in the current debate—would improve dramatically. Our model shows that the US trade balance with NAFTA would swing from a deficit of \$109 billion to a surplus of

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6 Our model assumes that the dollar depreciates against all Asian currencies by the same amount. If the yuan appreciated more than other Asian currencies, some production of low-cost goods could shift, over time, from China to other countries, such as Vietnam or Cambodia. This could reduce the bilateral deficit with China.

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\$100 billion or more. This would hit the Canadian and Mexican economies hard, and the United States would have to work with them to ease the transition.

### **SERVICES AND HIGH-TECH EXPORTS SHOW BIGGEST OPPORTUNITY FOR IMPROVEMENT**

Although, with a balanced current account, the United States would still have a trade deficit, in the years following a large dollar depreciation US exports across a range of products would increase dramatically. US services exports could increase by 30 percent, or \$107 billion, from today's level. Current US trade surpluses in financial services, royalties and licenses, business services, travel, and education would grow dramatically—particularly to Europe, the United Kingdom, Japan, and Canada.

Also receiving a strong boost from depreciation would be US exports of high-tech machinery, such as computers and semiconductors, medical devices, electrical appliances and machinery, office and telecommunications equipment, and farm and construction equipment. Today's \$134 billion US trade deficit in this category would turn into a surplus of as much as \$51 billion. This growth potential highlights the importance of continued productivity improvements in a sector that not only generates exports directly but also enables the United States to produce other technologically sophisticated products, from surgical equipment to computerized farm machinery.

### **AN AGENDA FOR BUSINESS LEADERS AND POLICY MAKERS**

Although the US current account deficit could possibly be reversed over the next five years and spark a major decline in the value of the dollar, we believe that the adjustment is more likely to be gradual. The world could fund a larger deficit, and a reversal need not be immediate. Capital inflows into the United States have grown continuously despite the deficit, the war in Iraq, the 9/11 terrorist attacks and other adverse events. Fundamentally, the US economy is strong and offers an attractive risk-adjusted return for investors. Nonetheless, business leaders and policy makers should start planning for the possibility that a large dollar fall might unfold more rapidly.

Business leaders would do well to consider how a large decline in the dollar would affect their income statements and balance sheets and what actions they can take today to prepare for this possibility. Our research yields detailed insights into what a post-devaluation world would look like. China, for example, would retain its costs advantage as an export location, but Canada and Mexico

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could lose theirs. US companies would see growing foreign demand for many types of financial and business services but, to capture this opportunity, they would have to acquire the requisite language skills and develop products that meet foreign standards. US companies producing computers, semiconductors, medical devices, and construction equipment would benefit disproportionately.

Much of the public debate over the current account deficit, including concern over the bilateral trade deficit with China, is misplaced. There are other more realistic options for balancing the current account deficit, such as improving the US trade balance with NAFTA and with other Asian economies and expanding service and high-tech exports.

The primary policy focus should be on areas offering the United States opportunities to improve its trade balance significantly. Service exports clearly have significant growth potential, and trade negotiators should continue to reduce barriers to global trade in services. The United States must retain the competitive environment necessary for its high-tech sectors to drive innovation and R&D in order to develop the next generation of cutting-edge products. And policy makers should recognize that trade with Canada and Mexico is at least as important as that with Europe and Asia, and consequently they should step up efforts within NAFTA to enhance the area's competitive advantage.

The following chapters discuss these findings in more detail. Chapter 1 profiles the US current account deficit and explores who is funding it. Chapter 2 assesses how large the deficit would be by 2012 if current trends continued, and explores whether the world could plausibly fund an even larger US deficit. In chapter 3 a microeconomic approach is employed to examine the potential for the United States to increase exports of services and manufactured goods without a change in the value of the dollar. Chapter 4 explores scenarios for dollar depreciation to reduce the size of the deficit and their implications for trade patterns. Chapter 5 outlines the opportunities and challenges facing business leaders and policy makers.

