

What businesses need to know about the US **current-account deficit**

The US import balancing act could continue for some time, but the correction, when it comes, will have surprising consequences. Governments and businesses should prepare for them.

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At \$857 billion and growing, the US current-account deficit absorbs the vast majority of the world's capital outflows. To finance this chronic deficit, the United States has amassed trillions of dollars of foreign debt, leaving itself vulnerable to sudden changes in the sentiment of global investors. Many economists believe that the deficit is unsustainable and that a major correction involving a significant depreciation of the dollar looms¹ (see sidebar, "[Understanding the current account](#)").

New research from the McKinsey Global Institute (MGI), however, finds nothing inevitable about a correction in the US current-account deficit over the next five years. Instead, it could continue to grow, and the world would have enough capital to finance it. Any correction from shifts in exchange rates could occur very gradually, over a period of many years.

Yet while a large, sudden depreciation in the dollar is unlikely, the magnitude of today's imbalances and the pressure they place on the dollar remain significant. Business and government leaders would therefore be wise to plan for the changes in world demand and trade that could follow if a correction were to occur.

In general, US goods and services would be significantly more competitive in the global economy, and foreign companies would find the United States a more attractive location to build manufacturing and R&D facilities. Specifically, European demand for many types of financial and business services from the United States would increase. The US trade deficit with many Asian countries, including Japan, South Korea, and Taiwan, would become a trade surplus, as would its current trade deficit with Canada and Mexico. In contrast, China would retain both its manufacturing cost advantage and its trade surplus with the United States.

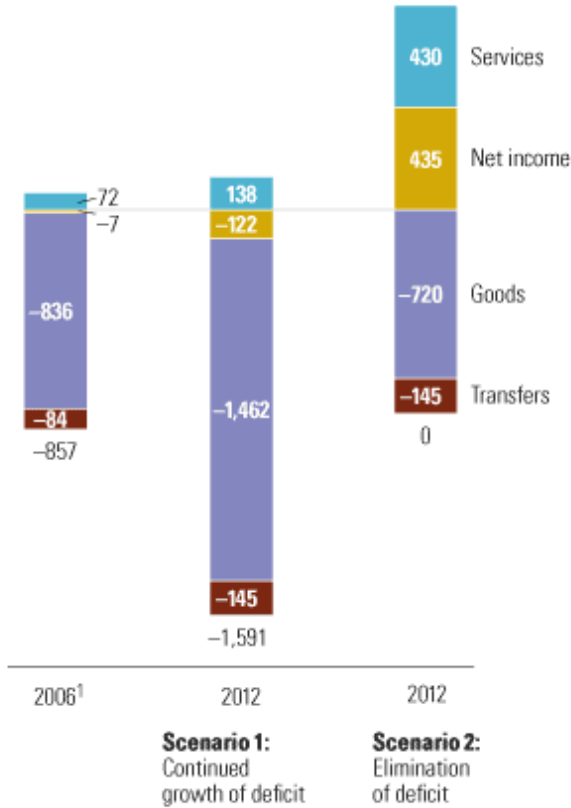
Two views of the future

MGI reached these conclusions by analyzing two very different five-year scenarios describing the evolution of the US current account. (For more detail, see the full report, *The US Imbalancing Act: Can the Current Account Deficit Continue?* available free of charge [online](#).) In the first, we assessed whether the US current-account deficit could continue to grow over the next five years if exchange rates remained the same and whether the rest of the world could finance an ever-larger US deficit. The second scenario posits a world where the dollar depreciates enough to eliminate the entire US current-account deficit—by some 30 percent from the dollar's level in January 2007—and the subsequent impact on trade patterns. MGI created the scenarios by using a microeconomic approach to analyze the effects of a depreciation of the dollar on demand for 30 different product categories in 100 countries, as well as on US foreign assets and liabilities. The two scenarios paint vastly different pictures of the US current account, trade balance, and net foreign income in 2012.² While reality is likely to lie somewhere between these two extremes, understanding them should help business leaders and policy makers better prepare for what lies ahead.

Continued growth of the US current-account deficit

Our analysis shows that a correction in the US deficit is not imminent or inevitable. If current trends in global savings and investment continued for an additional five years and there were no adjustments in exchange rates, the US current-account deficit would reach \$1.6 trillion by 2012, or 9 percent of GDP (Exhibit 1). However, under plausible assumptions, global capital outflows from other countries, reaching \$2.1 trillion in 2012, would also grow large enough to finance a deficit of that size.³ Under this scenario, the US deficit would simply resemble a more exaggerated version of the status quo, and the United States would increasingly borrow from abroad to pay for it (see sidebar, "[Who funds the US current-account deficit?](#)").

US current account, \$ billion (nominal)



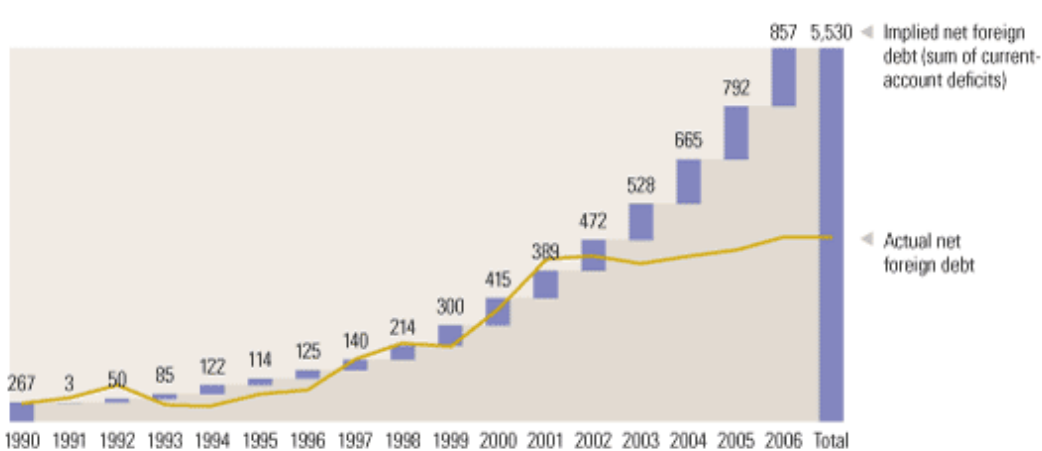
It's not implausible that the United States could pay for such a large imbalance. Running a current-account deficit of this size would triple today's net foreign debt, from \$2.7 trillion at the end of 2006 to \$8.1 trillion in 2012, or 46 percent of GDP. Yet a number of countries, including Australia, Ireland, and Mexico, currently carry a net external debt of a similar size relative to GDP. Furthermore, the United States is likely, at least over the next five years, to retain some unique advantages that help service a large foreign debt. Most obviously, it is denominated in the country's own currency, the dollar, eliminating the risk of ballooning payments resulting from currency swings.⁴

What's more, the United States has historically earned higher returns on its foreign assets than it has paid to overseas investors. One consequence is that the US net foreign debt today is significantly smaller than the sum of past current-account deficits (Exhibit 2). If this pattern continues, interest payments on the large external debt resulting from an even larger current-account deficit would be relatively low, less than 1 percent of GDP.

¹Figures do not sum to total, because of rounding.

Source: International Monetary Fund; McKinsey Global Institute global capital flows database

\$ billion (nominal)¹



Finally, foreign investors have continued to demand dollar assets, providing financing for the US deficit. Capital inflows into the United States have grown continually despite the September 11 terrorist attacks, the war in

¹Figures do not sum to total, because of rounding.

Source: International Monetary Fund; McKinsey Global Institute global capital flows database; McKinsey Global Institute analysis

Iraq, the ever-increasing deficit, and rising defaults in the subprime-mortgage market. Foreign investments in the United States reached a new record in 2006, at \$1.8 trillion, and foreign purchases of US equities and long-term debt have more than made up for the recent drop in purchases of US government debt. If these patterns continue, the United States will have no difficulty financing its current-account deficit, at least for the next several years.

Elimination of the US current-account deficit

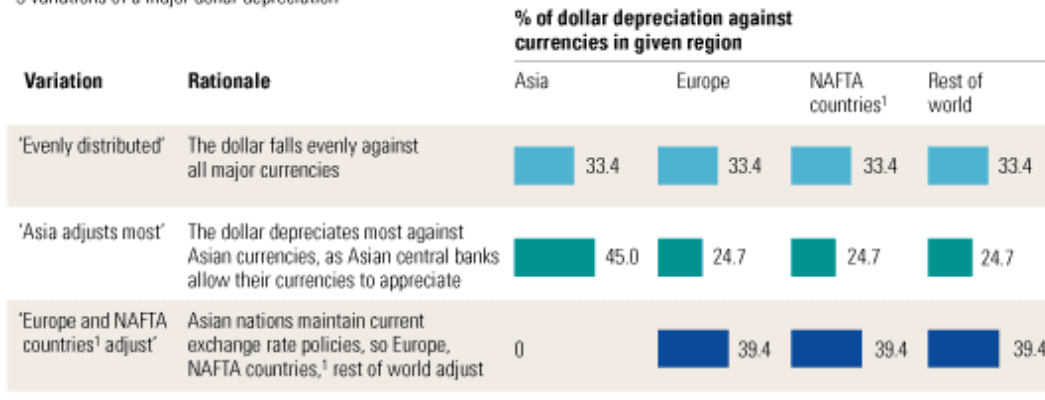
Even though the US deficit could continue to grow, a variety of economic shocks could spark changes in global trade, consumption, and savings patterns that might eliminate the US current-account deficit by 2012. US consumers may be forced to save more as the housing boom ends, for example. Asian countries might boost domestic consumption, perhaps through increased spending on education and health care, and save less in the form of US securities. Such changes would increase the supply of and lower demand for the US dollar, causing its value against other currencies to fall.

Our analysis suggests that a 30 percent depreciation of the dollar from its January 2007 levels would fully balance the US current account by 2012.⁵ A smaller decline—of 20 to 25 percent from January 2007 levels—would reduce the deficit to roughly 2 to 3 percent of GDP, which many economists feel is sustainable.

A 30 percent trade-weighted depreciation of the dollar could play out in multiple ways. Historically, currencies have rarely moved evenly against one another. Since 2003 the dollar has fallen in nominal terms by 19 percent against the euro, 22 percent against the pound, and 6 percent against the renminbi while gaining five percent against the yen.

We therefore considered three ways that the dollar might depreciate using 2005 data as our baseline (Exhibit 3). In the first, the dollar depreciates evenly by 33 percent against all other currencies.⁶ In the second, Asian countries abandon their de facto peg to the dollar and their currencies appreciate more than other global currencies. In the third, Asian countries maintain their de facto dollar pegs and the dollar depreciates only against the euro and other world currencies such as the Canadian dollar and Mexican peso.

3 variations of a major dollar depreciation



¹North American Free Trade Agreement: Canada, Mexico, and United States.

Source: McKinsey Global Institute analysis

In any of these cases, even with a balanced current account in 2012 the US trade deficit in goods would remain quite large—around \$720 billion, roughly today's level. However, the United

States would export more services and earn more income from overseas investments.⁷ Indeed, rather than being a large net debtor, owing about 46 percent of GDP, the country would be a significant net creditor, with claims equaling some 28 percent of GDP. The factors underlying this dramatic reversal are the same ones that limit the accumulation of net foreign debt today: the positive spread between the interest that the United States earns on its foreign assets and what it pays on its liabilities, as well as the appreciation of US assets abroad, in this case accelerated by a depreciation of the dollar.

Preparing for both scenarios

Which of these scenarios is likely to play out? Since the United States could continue running a large current-account deficit for the next five years, there's no reason to expect that the dollar will depreciate abruptly. For

many years, foreign investors have displayed a growing appetite for dollar assets. The United States has offered better returns on financial assets and business investments than have other mature economies, such as Europe and Japan—along with lower volatility and better institutional protection than can be found in emerging markets.

There's also no reason to expect that today's global trade, consumption, investment, and savings patterns will persist indefinitely. Redressing the imbalances will require the United States to save more and consume less, while other regions—especially Asia, Canada, Europe, and Mexico—would consume and import far more than they do today. As imports become more expensive for consumers in the United States, companies around the world will intensify their sales efforts elsewhere and lessen the global focus on the US economy.

The prudent course for business is to prepare for an adjustment of the US deficit, whether that happens gradually or abruptly. Despite the great uncertainty surrounding the deficit's fate, few companies have developed contingency plans for a significant depreciation of the dollar and the major shifts in trade and investment that would follow. Our analysis describes the implications of these changes.

Europe and the United States

The United States runs a trade surplus with Europe across many service subsectors, including business services (such as accounting, computer and information, consulting, and financial services), education, telecommunications, and travel. If the dollar declined and US services became cheaper for Europeans, these surpluses would more than triple in value.⁸

After a depreciation of the dollar, the US trade deficit in goods with Europe would shrink but not disappear. Two-thirds of the improvement would come from increased US exports to Europe—particularly of machines and other goods, such as farm and construction equipment. Also, US imports of manufactured products from Europe, such as scientific instruments and consumer goods, would decline.

European companies should prepare for the possibility that they will face new, more cost-competitive US entrants, perhaps by further differentiating their offerings. In general, they would also find the United States a more attractive place to build manufacturing and R&D facilities to serve both it and other markets.

Asia and the United States

The US trade deficit with China will persist for years, even in the unlikely event of a major short-term depreciation of the dollar against the renminbi.⁹ The reason is that China's exports to the United States today are five times as large as its imports; moreover, the cost difference in the goods the United States imports from China—such as toys, clothing, and consumer electronics—is too large for even a significant depreciation to erase. Further, China imports many components of the goods that it exports, and a stronger renminbi would reduce the cost of those inputs, helping to preserve China's manufacturing cost advantage. As a result, the preoccupation of business and government leaders with the depreciation of the renminbi seems misplaced.

In contrast, the US trade deficit in goods with Japan, South Korea, and Taiwan would become a trade surplus in the event of a significant depreciation; US imports of automobiles, computers, electrical appliances, and telecommunications equipment from them would decline. These three countries have major trading relationships with many other markets and would need to increase exports to them. And despite lower exports to the United States, Japanese, South Korean, and Taiwanese companies would enjoy lower costs for building and running plants there to serve its domestic market.

Still, policy makers in the three countries (and others that have traditionally depended on exports to drive economic growth) would find it prudent to foster domestic consumption by liberalizing their service sectors, improving their credit systems and products to facilitate consumer borrowing, and letting their currencies appreciate to improve consumer purchasing power. Although US consumption played an important role in revitalizing these economies after the 1997 financial crisis, it cannot continue to fuel global growth forever.

Canada, Mexico, and the United States

Canada and Mexico, whose trading relationships with the United States make up the majority of their total trading activity, would be significantly affected by a short- or long-term depreciation of the dollar. Because of the relatively low labor costs of these countries, they have enjoyed many production cost advantages over the United States since the creation of North American Free Trade Agreement (NAFTA), in 1993. After a major depreciation, however, those advantages would largely disappear. Instead of increasing investments in offshore-manufacturing facilities in Canada and Mexico, US companies would find it more cost effective to produce goods at home, where labor costs would be comparable and new factories could be built without the

complexity and expense of operating abroad.

Exports from Canada and Mexico to the United States could decline as much as their imports from it increased, creating a double shock. Both would export fewer manufactured goods there, especially furniture and clothing, and Canada would also export smaller quantities of mineral fuels. At the same time, both would consume more US goods, especially industrial and electrical machinery, medical devices, computers and other high-tech gear, and farm and construction equipment. Canada and Mexico might need to increase their trading with Central America and other parts of the world as a result. To do so, Mexico would have to move more quickly into higher-value-added types of production, since it could no longer rely on low wages to compete.¹⁰


Maintaining healthy economies throughout the NAFTA region benefits everyone, so the three members should work together to prepare for the possible effects of any depreciation of the dollar. Even if differences in their production costs were to narrow, the free-trade area would continue to benefit all member countries; the growth unleashed by the integration of European economies in recent years is a testament to this point. By reducing trade barriers, NAFTA has already allowed low-cost manufacturers, especially in Mexico, to increase their exports to the United States. Increases in other types of cross-border commerce are still possible. All three countries should continue to build the physical and telecommunications infrastructure necessary to facilitate such trade by harmonizing product standards and regulations and streamlining border procedures and red tape.

Lessons for the United States

For US companies and government leaders, economic pragmatism is surely the wisest course. Emphasizing those areas in which the United States has genuine potential to improve its trade and current-account position will have more impact than focusing on some of the red herrings—revaluing the renminbi, for example—in the current public debate. The highly productive and innovative US high-tech sector warrants special attention because of its direct exports and its role in facilitating innovation in other sectors; it produces not only computers and semiconductors but also components for a wide range of goods, such as surgical instruments and medical devices, office equipment, farm and construction machinery and vehicles, and air-conditioning and heating systems.

Fostering the high-tech sector will require the United States to provide an environment that facilitates innovation. Competition is vital, as is the free flow of ideas across companies and borders. Since the terrorist attacks of September 11, policy changes prompted by national-security concerns may have jeopardized this flow. The current long delays in approving visas for highly skilled foreign workers and graduate students are shortsighted. Policies that discourage investment by foreign companies in the United States also will do more harm than good.

Service businesses in the United States should prepare to increase their exports to Europe by tailoring their offerings to meet local regulatory requirements and consumer preferences. Other companies ought to consider what adjacent services they might provide. US trade negotiators should continue trying to reach global agreement on the removal of tariff and nontariff barriers to trade in services, and policy makers would be wise to initiate broader long-term efforts to break down the language and cultural differences that constrain the growth of service exports. Foreign-language study, for example, should receive more emphasis in US schools.

The US current-account deficit could continue to grow for at least the next five years. When the adjustment does take place, it is more likely to be gradual than abrupt. Still, a major depreciation of the US dollar and large shifts in global consumption and savings are possible. Governments, business leaders, and investors around the world should prepare for the potential effects. 

Understanding the current account

A country's current account keeps track of different types of purchases and transfers among countries. It consists of four components, each of which can be in surplus or deficit:

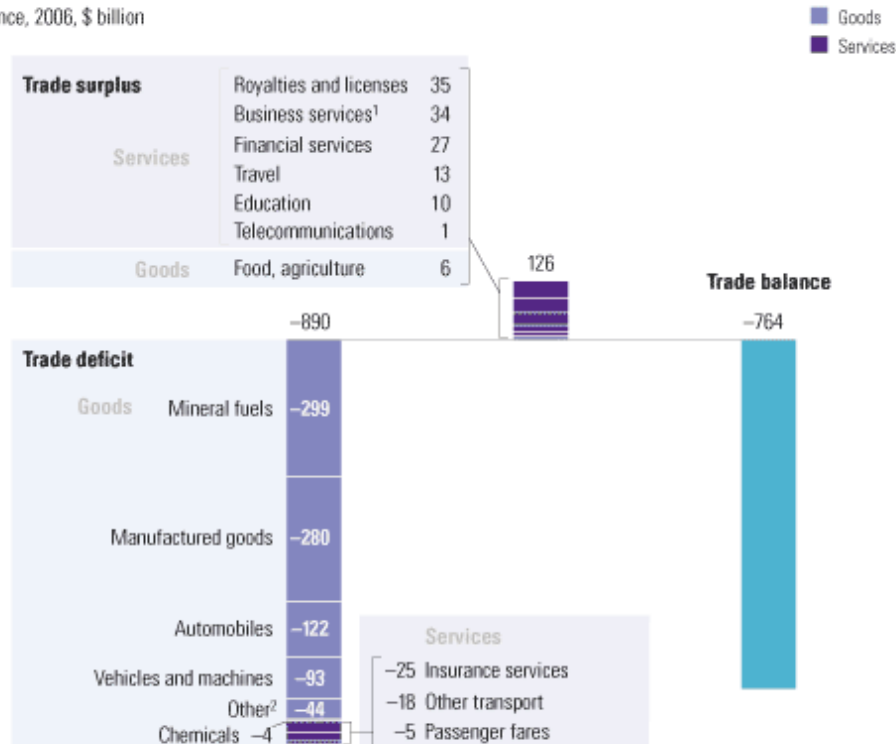
- Trade in goods, or funds paid for the delivery of goods
- Trade in services, or funds paid for the delivery of services
- Transfer payments, or funds that are exchanged for other reasons, such as remittances sent

abroad by immigrants and foreign-tax payments

- Net foreign income, which includes both foreign-income payments (such as interest payments on loans from other countries) and foreign-income receipts (such as profits from overseas subsidiaries)

The US current account is in deficit because the US imports more in these four categories than it exports. The trade deficit on goods is by far the largest component of the current account (Exhibit 1).

US trade balance, 2006, \$ billion



A current-account deficit implies that the US economy is spending more than it earns. To finance this spending, the United States must borrow from other countries. The

¹Includes computer and information services, film, management and consulting services, operational leasing, R&D, other.

²Includes low-value imports, nonmonetary gold and coin, trade not classified elsewhere.

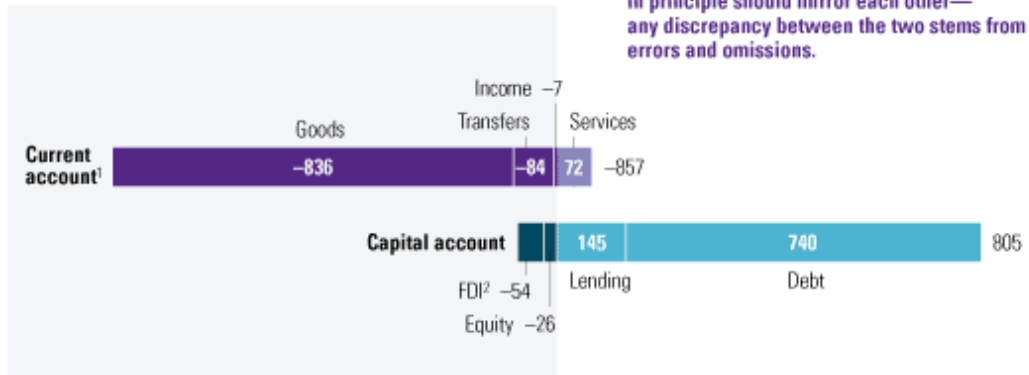
Source: US Bureau of Economic Analysis; US International Trade Commission; McKinsey Global Institute analysis

investments—made by foreigners into financial assets such as equities or bonds—are called capital inflows; conversely, capital outflows represent foreign investments made by US residents. A country's capital account balance is the difference between its capital inflows and outflows. The current account and capital account are accounting identities that in principle should mirror each other; when a country's current account is in deficit, its capital account is in surplus by the same amount (Exhibit 2). In practice, there is usually a discrepancy between the two resulting from errors and omissions.

In the global economy, current-account deficits are not always undesirable and in fact have both benefits and disadvantages. Running a current-account deficit allows the United States to consume more now than it otherwise would. But by shifting consumption from the future to the present, it also creates liabilities that will need to be paid later. Similarly, although the individuals, governments, and companies financing the US current-account deficit are earning returns on their investments, the deficit is absorbing investment capital from other regions, including emerging markets that may need those dollars more acutely.

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US current account and capital account, 2006, \$ billion



Who finances the US current-account deficit?

In 2006

¹Figures do not sum to total, because of rounding.

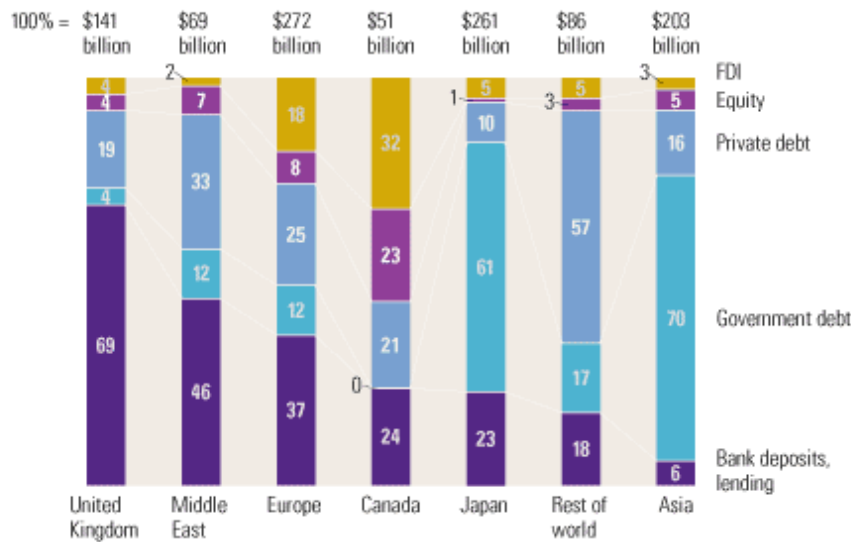
²Foreign direct investment.

Source: US Bureau of Economic Analysis; US International Trade Commission; McKinsey Global Institute analysis

governments, companies, and individual investors from around the world purchased \$1.8 trillion of US financial assets. Their investments included foreign direct investment (FDI) into US companies; purchases of equity, private debt, and government debt securities; loans to the United States; and deposits into US banks and financial institutions.¹

In recent years asset preferences of foreign investors have varied by region. From 2002 to 2005, for example, two-thirds of Asian investments consisted of US government debt products. Europeans invested more of their funds in US bank deposits and corporate debt and loans. Middle Eastern investors participated in US markets through corporate-debt securities, FDI, and deposits into banks and other financial institutions, such as private-equity funds (Exhibit 1).

Distribution of inflows of foreign capital to United States by region, 2002–05 average, %



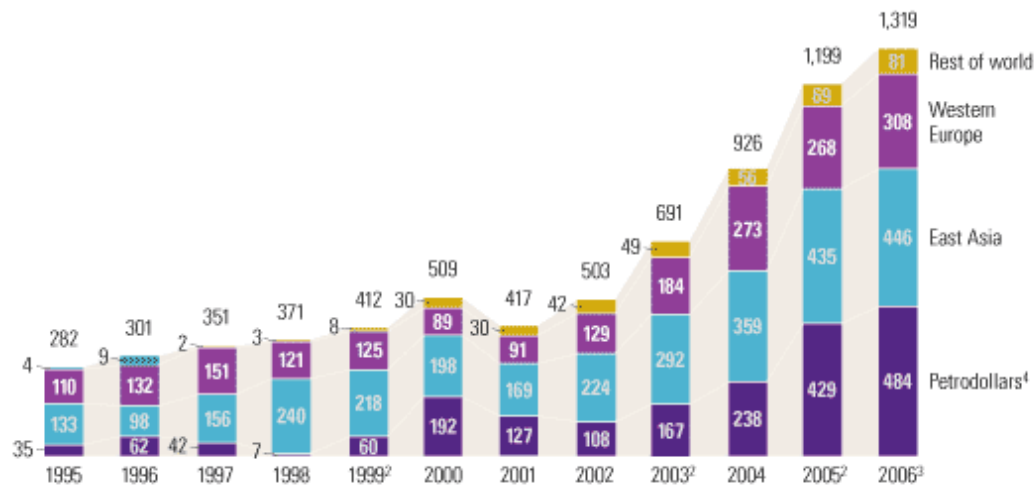
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Source: US Bureau of Economic Analysis; US Treasury Department; McKinsey Global Institute analysis

understand who finances the US deficit, however, one must also look at the country level. After all, the ultimate sources of inflows are governments, companies, and individual investors from countries with current-account surpluses—the world’s net capital exporters, such as China, Indonesia, and the Netherlands. Even if investors in these countries do not invest directly in the United States, their surpluses add to global liquidity and allow capital to flow to countries running deficits.

The countries that supply the world with capital have shifted over time (Exhibit 2). In recent years higher oil prices have enabled oil-exporting nations to become a new and growing provider of global capital. In 2006 these countries became the largest source of net capital outflows, surpassing East Asia. Some Western European countries, including Germany and Switzerland, have also been large net exporters of capital over the past 15 years.

Net capital outflows from countries with current-account surpluses.¹ \$ billion



¹Includes only those countries in any given year with current-account surplus and capital account deficit.

²Figures do not sum to total, because of rounding.

³Estimated.

⁴Algeria, Indonesia, Iran, Kuwait, Libya, Nigeria, Norway, Russia, Saudi Arabia, Syria, United Arab Emirates, Venezuela, and Yemen.

Source: Global Insight; International Monetary Fund; McKinsey Global Institute global capital flows database

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Notes

¹ Most of the money we attribute to the “rest of the world” was channeled through Caribbean nations. Some of this money may, in fact, have originated in the Middle East, Europe, Asia, or even the United States itself.

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 Diana Farrell is

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Notes

¹ See Maurice Obstfeld and Kenneth Rogoff, “The unsustainable US current account position revisited,” NBER working paper, 10869, June 2005; Martin N. Baily, “How Large a Dollar Adjustment to Reduce the US Imbalance?” presented at joint Bruegel, Korea Institute for International Economic Policy, and Peterson Institute for International Economics Workshop on Adjusting Global Imbalances, Washington, DC, in February 8–9, 2007 and revised March 19, 2007; William R. Cline, *The United States as a Debtor Nation: Risks and Policy Reform*, Institute for International Economics, 2005.

² By contrast, another component of the current account—transfer payments, mostly remittances that workers send abroad and foreign-tax payments—would be the same in both scenarios, as they grow in line with US GDP and are not sensitive to exchange rate movements.

³ We modeled capital outflows separately for four regions: Asia, oil exporters, Europe, and rest of the world. Growth in each region is based on a forecast of GDP growth, current-account balances, and, for oil exporters, oil prices.

⁴ By contrast, the East Asian financial crisis of the 1990s was exacerbated by the fact that many countries held substantial dollar-denominated debt. When the value of their own currencies declined relative to the dollar, many could not repay it.

⁵ For modeling purposes, MGI assumed that all depreciation would occur at once and then played out the results over the five-year period.

⁶ Under all scenarios, we calculate the depreciation from December 2005 levels. The depreciation required against the euro would be slightly lower today, given that the dollar depreciated against the euro over the course of 2006.

⁷ The US trade surplus in services would reach \$430 billion, while net foreign income would grow to \$435 billion a year by 2012.

⁸ After a 30 percent dollar depreciation, the US trade balance in services with Europe would increase to \$84 billion, from \$22 billion.

⁹ We find that the United States would still have a bilateral trade deficit with China even if the dollar depreciated by 45 percent against the renminbi.

¹⁰ Diana Farrell, Antonio Puron, and Jaana K. Remes, "Beyond cheap labor: Lessons for developing economies," *The McKinsey Quarterly*, 2005 Number 1, pp. 98–109.

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