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China’s Trade Surplus, Part I

di Paul Krugman

Donald Trump’s erratic policies have dominated world economic news in 2025. But if U.S. policy weren’t being whipsawed by a wannabe authoritarian’s whims and obsessions, we would all be focused on a different problem: China’s massive trade surplus.

China’s surplus briefly made headlines a few months ago when it passed the trillion-dollar mark. While there is no special significance to that number, it helped bring attention to an important point: that China’s surplus has been surging for years — roughly since 2020.

One doesn’t have to be a crude, Trumpian-style trade protectionist to understand that it’s a major problem for the global economy when an economy the size of China’s – either #1 or #2 in the world, depending upon the measure used – runs persistent, extremely large trade surpluses. China’s trade surpluses are causing major economic disruptions around the world – particularly in the US and in Europe. Furthermore, China is an authoritarian regime. Its growing dominance of several strategic industries poses serious concerns, both in terms of national security and technology capture.

So today’s primer is the first of a two-part series devoted to China’s surplus: How big it is, what’s causing it, why it’s a problem, and what can be done about it.

Beyond the paywall I’ll address the following:

1. How to think about the scale of the Chinese surplus
2. China’s underconsumption problem and the role of Chinese government policies
3. China saves too much for its own good
4. How China’s government has effectively chosen to run trade surpluses
5. The Chinese trade surplus trap

Next week I'll discuss how China's surplus causes problems for the rest of the world, and how other nations — especially in Europe — should respond.

The scale of China's trade surplus is unprecedented

A nation runs a trade surplus when the value of the stuff it sells to other countries — its exports — exceeds the value of the stuff it buys from other countries — its imports. When I use the technical term "stuff", I'm not being sloppy. I am just acknowledging some inherent arbitrariness in the definition of a country's trade balance. Any measure of a country's trade balance requires choosing what to include and what not to include in both exports and imports.

Ordinarily, economists prefer to track trade imbalances using the "current account," a broad measure that includes almost everything a nation buys or sells. Unfortunately, we immediately encounter a problem when analyzing China's trade statistics: the Chinese government cooks the books to make its current account surplus appear smaller than it actually is.

Brad Setser of the Council of Foreign Relations, the go-to guy on these matters, has the receipts. For example, China reports implausibly low earnings on its overseas investments and improbably high spending by Chinese tourists abroad.

Why does China do this? As Setser explains, the International Monetary Fund focuses on the current account when determining whether a nation is running an excessive surplus. The U.S. Treasury also uses the current account when determining whether a country is engaging in currency manipulation. (However, under Trump the U.S. just imposes tariffs whenever the president feels like it.) So China plays statistical games to artificially lower its official current account surplus and thereby evade accountability from international organizations and the U.S. government.

While we can't trust China's official current account numbers, we can assign more credibility to China's reported "merchandise trade balance," the value of trade in physical goods. Why? Because China's official merchandise trade statistics can be cross-checked against numbers reported by other nations. After all, every Chinese export is another country's import, and every Chinese import is another country's export.

China's trade balance in manufactured goods is particularly important given the political and strategic importance of manufacturing, even though most workers are now employed in the service sector. And China's surplus in manufactured goods is enormous. As a share of world GDP, it's completely unprecedented. True, Japan and Germany ran big trade surpluses in the past. There were years in which those surpluses were bigger than China's when measured as a percentage of their own national GDP. But that comparison is misleading when you consider the impact of China's surpluses on the global economy. Because the Chinese economy is much bigger than either the Japanese or German economies, China's surpluses have a much greater impact.

To drive home that point, here's a chart from Setser, showing manufacturing trade balances as percentages of world GDP. China is the red line at the top:

Chart 1 Source

As you can see from the chart, China's trade surplus as a percentage of global GDP has exploded. Correspondingly, the US trade surplus as a percentage of global GDP has gone way down. Germany and Japan have trended down more slowly.

So China sells a lot more manufactured goods to the rest of the world than it buys. I'll do some number-crunching next week to quantify the effect. But it's clear that China's massive surpluses in manufacturing goods have a deindustrializing effect on the rest of the world. Manufacturing output in the rest of the world is currently around 9 percent smaller as a consequence of China's surplus than it would be without that surplus.

The fact that China's trade surplus shrinks other countries' manufacturing output and employment doesn't necessarily mean that it hurts their economies as a whole. In fact, those countries can and do compensate for lower employment in manufacturing with higher employment in service industries. The reason for concern about China's surpluses is subtler than "they're taking away our jobs." But as I'll explain next week, it's a compelling concern nonetheless.

Today, however, I'll focus on the question of *why* China runs these huge trade surpluses. And that story begins with the persistent weakness of Chinese consumer spending.

China's underconsumption problem and the role of Chinese government policies

There's a popular misconception that a nation's trade balance is an indicator of its economic strength. In other words, many people assume that highly productive, competitive nations run surpluses, while lagging or failing economies run deficits. This is, in fact, all wrong. If anything, trade surpluses are often a sign of underlying economic weakness.

For an example of how persistent trade surpluses aren't synonymous with economic strength, compare the German economy to the American economy over the past decade.

Chart 2 compares economic growth in Germany (solid blue line) with growth in the United States (dashed green line) since 2015. America has hugely outperformed Germany, especially since the pandemic and especially in high technology. Yet if you look back at Chart 1, which shows trade balances in manufactured goods, you see that

Germany has run a persistent surplus (yellow line) while America has run a persistent deficit (blue line).

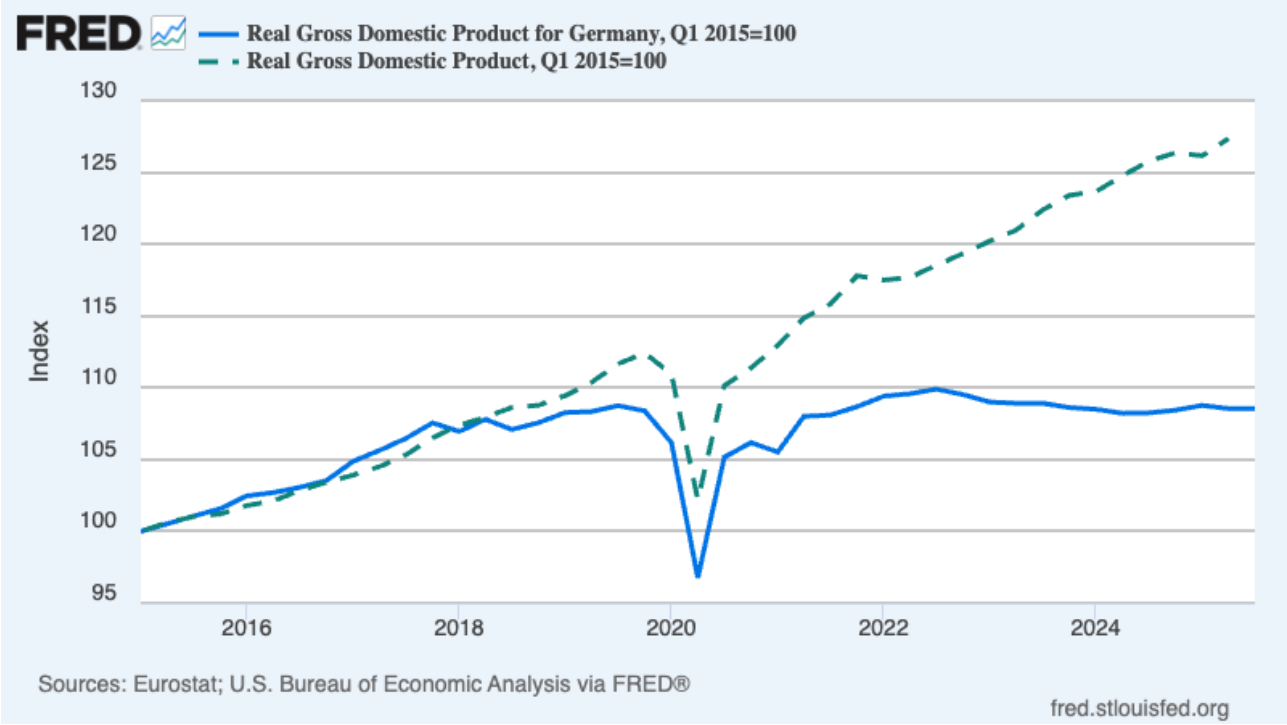

Chart 2

Granted, China's economy isn't stagnant like Germany's — it's still growing rapidly. But its growth rate has slowed. Moreover, China has a major structural problem: Consumer spending hasn't kept up with economic growth. Here's a chart from the New York Fed's Liberty Street Economics blog, comparing Chinese consumption spending and income with those of other nations (both axes are measured in natural logs):

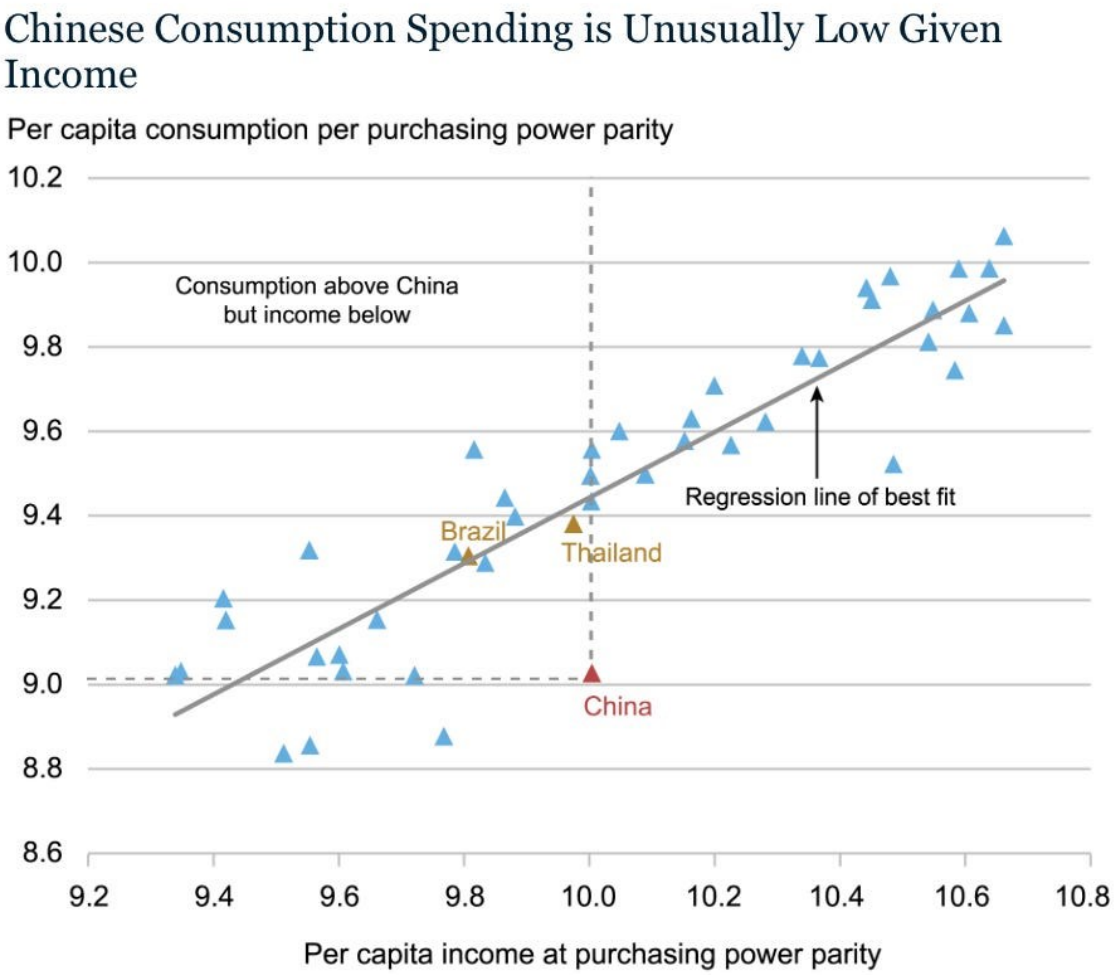

Chart 3 Source

As you can see from the graph, the great majority of countries follow a pattern in which rising income is closely tied to rising consumption. China, however, is an extreme outlier, with much lower consumption than predicted by the normal pattern.

Why is China's consumer spending so low? There's a huge research literature on that question, with less consensus than I'd like. But the general view is summarized by a 2018 International Monetary Fund paper, which declares that:

[China's] high savings mostly emanate from the household sector, resulting from demographic changes induced by the one-child policy and the transformation of the social safety net and job security that occurred during the transition from planned to

market economy. Housing reform and rising income inequality also contribute to higher savings.

Or as I'd put it, market-oriented economic reforms set China on the path to rapid economic growth, but they also broke the "iron rice bowl" that had provided economic security under central planning, without providing effective guarantees of health care or income while unemployed. At the same time, the one-child policy meant that working-age Chinese could no longer rely on children to support them in old age. So Chinese families got into the habit of saving a large share of their income as a precaution against possible misfortune.

But why is a high savings rate a problem? Don't high savings make it possible to finance high investment, which leads to high economic growth?

The answer is yes, high savings are good — up to a point. But China is well past that point.

China saves too much for its own good

Imagine for a moment that China didn't have the option of running a trade surplus. In that case low consumer spending would keep the Chinese economy persistently depressed unless it was offset by high investment spending. Or to put it another way, China would need to persuade its domestic businesses to put its high national savings to work.

In fact, China has consistently maintained very high rates of investment. Here's gross capital formation — basically all spending on structures (including houses), equipment and software — as a percentage of GDP for China and the United States. As you can see, China invests far more of its GDP than we do.

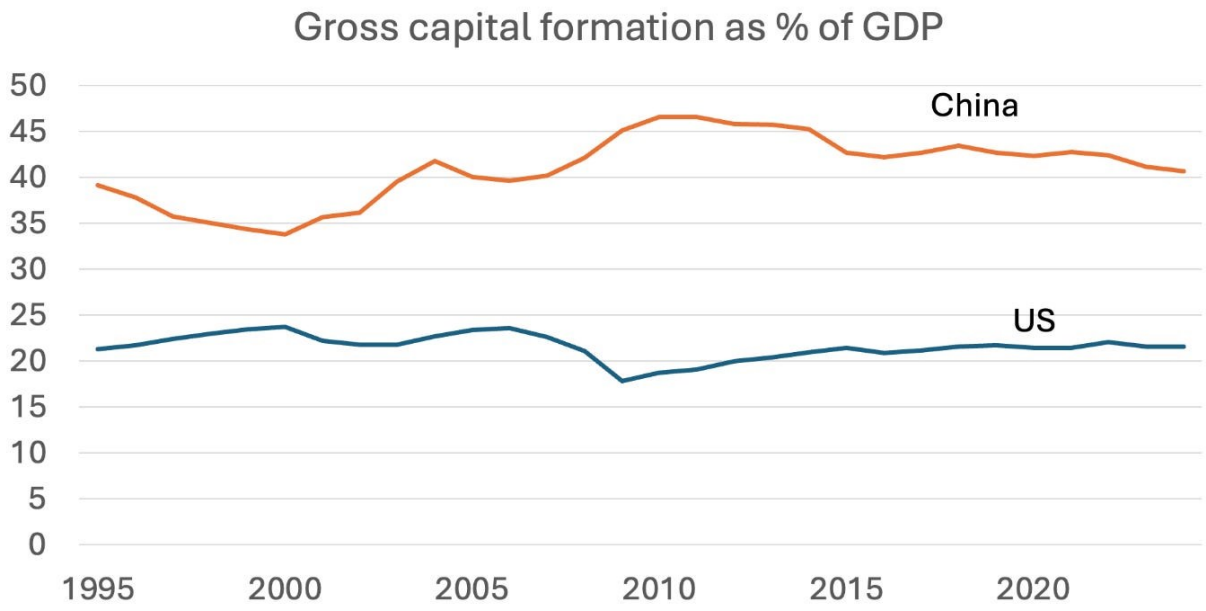

Chart 4 Source: IMF

This high rate of investment has contributed to China's rapid economic growth. But while China's investment rate has remained extremely high, its rate of economic growth, while still high, has declined substantially since the mid-2010s. Here's China's growth rate over the past three decades:

Chart 5 Source: IMF

Notice that I've labeled the growth rate shown in Chart 5 "reported." After all, given that China is cooking the books in reporting its trade surplus, why should we trust what it reports about its GDP? Setser calls Chinese GDP statistics "works of performance art."

Indeed, it's widely acknowledged that China's reported GDP growth is too smooth and steady to be true. For those familiar with business history, China's reported GDP is similar to GE's reported earnings during the Jack Welch era, which were manipulated to show unnaturally steady growth.

It's not clear, however, that China systematically either overstates or understates growth. And there's no question that the big decline in China's growth rate reported in official statistics is real. It's notable that the Chinese government hasn't tried to hide that decline.

Why has China's growth slowed? First, the country is running out of workers. The one-child policy reduced the birth rate, but fertility has remained low even with that policy no longer in effect. As a result, China's working-age population peaked in 2015 and has been declining ever since:

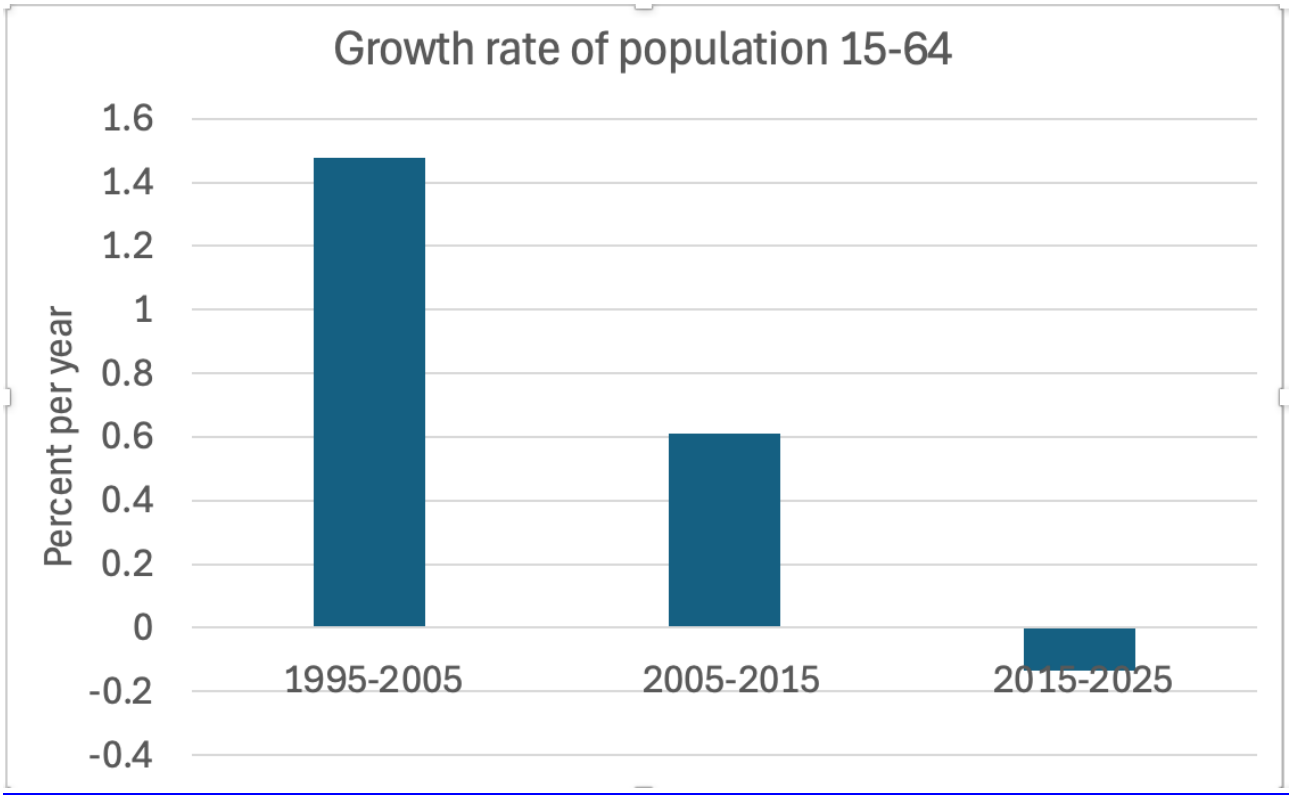

Chart 6 Source: World Bank

Second, as China's overall level of productivity has converged toward Western levels, productivity growth has slowed because it's harder to achieve rapid gains through technological borrowing – borrowing technological advances from other countries instead of innovating domestically. China continues to make impressive technological gains in some sectors, but there's no question that progress in the economy as a whole has slowed sharply (although there are many competing numerical estimates, with little consensus.)

When very high rates of investment collide with a shrinking work force and a productivity slowdown, the result is sharply diminishing returns on investment.

Basically, Chinese businesses can't profitably invest all the money Chinese consumers want to save. So the extremely-high-savings, extremely-high-investment model that has driven China's economic strategy for more than three decades is no longer sustainable.

The solution seems obvious: Reorient the economy toward consumption. At this point the rate of return on investment in China is so low that, as Matthew Higgins has argued, shifting resources away from investment toward consumption would raise Chinese living standards, not just in the short run, but for multiple decades.

But China's leadership refuses to do what seems obvious — and has in effect chosen to run massive trade surpluses rather than raising Chinese living standards.

The Chinese government chooses surpluses

The idea that China should reorient its economy away from investment toward consumption isn't radical. On the contrary, it has long been close to received wisdom among economists studying China and international organizations like the IMF and World Bank. The Chinese government itself keeps saying that the economy must pivot toward consumption.

But it keeps not happening.

The obvious way to boost consumption would be to strengthen China's weak social safety net, so that working-age Chinese citizens don't feel compelled to engage in such high levels of precautionary savings. As a useful article by Keith Bradsher put it two years ago, China's safety net remains "full of holes," offering grossly inadequate protection against medical costs, unemployment and old-age poverty. Yet as the article also says, rather than pivoting to consumption, China's economic strategy "has mostly doubled down on investments to generate growth."

The problem is that, given its growing scarcity of workers and its innovation lag, China's economy doesn't offer enough good investments to make productive use of its vast savings. So efforts to promote investment-led growth have led to a lot of bad investments. Notably, during the 2010s China had a vast housing boom — much bigger, relative to the size of the economy, than the U.S. bubble that led to the 2008 financial crisis — that created a huge excess supply of housing, most famously

illustrated by the emergence of huge largely abandoned developments called "ghost cities".

You might think that a policy pivot that aimed to make economic growth sustainable while making families more financially secure would be a no-brainer — it would be popular as well as sensible. So why won't China's leaders do it?

Much of the answer involves a combination of ideology and geopolitical ambition. Many people have quoted from a 2021 speech by Premier Xi Jinping, in which he declared

To promote common prosperity, we must not engage in "welfare". Some Latin American countries in the past have engaged in populism, and welfare in these countries has raised a group of "lazy people" with unearned incomes. As a result, the countries' financial systems were overwhelmed and fell into the "middle-income trap", that they were unable to extricate themselves from for a long time. Welfare benefits cannot decrease if they go up, and "Welfare-ism" that exceeds one's ability is unsustainable, and it will inevitably bring about serious economic and political problems!

My interpretation of these remarks is that Xi sees China on the verge of becoming the world's leading economy, but is deeply worried that it might fall short, that it might fall into the so-called middle income trap, in which countries that experience rapid economic growth seem to stall out with per capita GDP still well short of Western levels. So he's unwilling to take his foot off the gas pedal, despite the warning lights on the dashboard.

We should also note that after many years of following an economic strategy centered on investment and manufacturing exports, there are powerful players in China with a vested interest in continuing this strategy. Interest group politics in an authoritarian regime is less transparent than it is in a democratic system partially corrupted by money, which is what we have here. But the absence of open electoral competition doesn't make vested interests irrelevant. Far from it.

And by refusing to boost consumption, China's leaders are in effect also choosing to run massive trade surpluses.

The Chinese trade surplus trap

China remains an economy with low consumer spending and hence very high savings. Yet it's growing ever harder to find productive ways to invest those savings at home. And once again, an economy with low consumption that can't offset low consumption with high investment will be persistently depressed. That is, it will be persistently depressed *unless it runs a large trade surplus*.

For a large trade surplus helps to sustain sufficient demand for Chinese goods and services to maintain full employment in the face of low consumption and faltering investment. For example, Chinese auto companies can flourish despite weak overall Chinese consumer demand both by replacing imports from Germany and by selling cars to customers overseas.

What this means is that for an economy afflicted by underconsumption, as China's is, the trade surplus functions as a sort of safety valve, allowing China to escape the full consequences of its inadequate consumer demand.

This post is already long and intricate, so I'll wait until next week to describe the mechanics of the Chinese trade surplus — the policies that promote exports and reduce imports. Let me just leave a marker and say that the most important factor is a weak yuan, supplemented by the effects of government subsidies.

Chinese policies that promote exports and discourage imports are, however, downstream from the essential policy choice, which is the refusal to strengthen the social safety net and hence promote higher consumer spending. Given that choice and diminishing returns to investment at home, China essentially must run large trade surpluses to stabilize its economy.

The problem is that while China's trade surplus may help stabilize the Chinese economy, it has destabilizing effects on other nations' economies. So China's refusal to boost consumption creates a trade surplus trap and is setting up a global economic confrontation.