THE NEW GLOBAL IMBALANCES: WHY CARE, WHY NOW AND WHAT SHOULD BE DONE?

Beatrice Weder di Mauro

and Jeromin Zettelmeyer

Global imbalances are back: since 2018, the sums of current account surpluses and deficits have each increased by about 30 percent, reaching their highest levels since 2012. History shows that imbalances trigger trade tensions and often end in financial crises. Drawing on the 2026 CEPR-Bruegel *Paris Report*, this essay analyses the causes of, and remedies for, external imbalances, and what countries should do if they do not decline.

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FOREWORD

As this essay points out, the topic of global imbalances is an old one. Even if the expression only appeared in the early 2000s, sustained current-account surpluses and deficits (or, to put it differently, net international saving flows) were a fixture of the first age of globalisation that preceded the First World War. The absence of such imbalances in the first decades of the post-1945 period was an incongruity: as noted by Feldstein and Horioka in a famous 1980 article*, external imbalances should be the norm in a world in which capital is sufficiently mobile and saving and investment rates differ across countries.

Global imbalances are however a threat if they cannot be sustained financially, because the recipients of savings flows accumulate excessive debt, or if they cannot be sustained geoeconomically, because the accumulation of trade deficits ends up triggering a protectionist backlash. Call it the Goldilocks approach to global imbalances.

Beatrice Weder di Mauro and Jeromin Zettelmeyer carefully document the reasons why imbalances are nowadays a cause for worry. For the United States, the financing of the external deficit by hedge funds and other non-bank financial

*Feldstein, M.S. and C.Y. Horioka (1980) 'Domestic saving and international capital flows', *Economic Journal* 90: 314-329.

institutions changes the terms of the equation. In particular, the return on US assets abroad is no longer sufficient to make it possible to combine an external deficit with a stable external debt ratio. Against this background, the policy scenarios which they outline may result in a precipitous and damaging external adjustment.

For China side, weak domestic consumption and a persistently high saving rate have resulted in a high external surplus, despite a comparatively elevated, but recently declining, investment rate. As residential investment weakened after the bursting of the housing bubble in 2021-2022, government policy aimed to promote manufacturing investment and exports, thereby attempting to substitute foreign demand for domestic demand. The result was a rise in the Chinese external surplus, which is increasingly unbearable for the rest of the world.

In the context of a heightened geopolitical rivalry between Washington and Beijing, the combination of US financial fragility and China's aggressive export push results in a major risk for the global economy. Moreover, as the essay points out, a weak EU could itself be tempted by protectionist responses, thereby aggravating, rather than lessening, international tensions.

The authors do not stop with the identification of risks. They also formulate recommendations for addressing them. Acknowledging that first-best outcomes are out of reach, they advocate second-best policies that seek to control threats and minimise damage: temporary rather than open-ended trade protection, openness to Chinese investment and World Trade Organization-consistent safeguards, to name only the main ones. Even if their recommendations may seem naive, they

are worth considering as they are intended to avoid the worst. Their implicit message is that even in a world dominated by the US and China, Europe still has agency. They are right.

Jean Pisani-Ferry
Senior Fellow and Founding Director of Bruegel
April 2026

1 INTRODUCTION

Global imbalances – trade and current account deficits and surpluses, leading to growing net claims and net liabilities between countries – have made a comeback. Since 2018, the sums of current accounts recorded in surplus and deficits countries have risen by about 25 percent and 35 percent, respectively, to their highest levels since 2012.

The increase remains modest relative to their previous large expansion, between the early and late 2000s, when deficits expanded by 50 percent, led by the United States, while surpluses rose by 145 percent, led by China[1]. That episode led to much acrimony in the 2000s. Was the US pulling in excess savings from the rest of the world, or was it being pushed into overconsumption by surplus economies? And it ended badly, with a global financial crisis and a debt crisis in Europe.

The new episode is generating similar acrimony between the US and China, and has become a focus of international attention. President Emmanuel Macron, for example, has made global imbalances the main priority of France's G7

1 Because of recording errors, deficits are not exactly matched by surpluses. The difference, called the 'global current account discrepancy' expanded in the 2000s (Figure 1).

presidency in 2026[2].

The lesson from history is that global imbalances often end in financial crises. That risk cannot be dismissed today. The stock of external liabilities of the central country in the global financial system is already high and projected to rise further. Meanwhile, asset managers hold increasingly concentrated exposures, equity valuations are stretched and signs of investor nervousness are emerging, with greater efforts to hedge risk. In such an environment, the potential for abrupt repricing and spillovers is significant.

Even when external imbalances do not trigger or magnify a financial crisis – or not yet – they are potentially worrying for a second reason: as a by-product of domestic problems and a potential cause of political ones. To the extent that imbalances reflect a large and/or rapidly rising trade imbalance, they can fuel protectionism and ultimately a fragmentation of the global trading system. Japan experienced a trade conflict with the United States in the 1980s. China came under intense pressure to revalue its currency prior to the Global Financial Crisis (GFC) and faced escalating tariffs during the first administration of US President Donald Trump. On Trump's 2 April 2025 'Liberation Day', when he said the US would impose high tariffs, the US administration signalled a shift toward a more unilateral and confrontational trade stance.

For both reasons, the cause of very large external imbalances needs to be understood, and steps should be taken to reduce them. How to do this is not self-evident. It depends on the size, trend and cause of imbalance. Furthermore, there is

2 Élysée 'The G7 priorities', 23 January 2026, https://www.elysee.fr/en/G7evian/2026/01/23/the-g7-priorities. See also IMF (2025).

the risk that reducing trade imbalances gives protectionists an excuse. Sometimes the imbalances need to be tackled by addressing their underlying causes. Sometimes, the need is just to tackle the protectionists.

This essay lays out the policy issues raised by the return of global imbalances. It has three main aims:

1. To explain why global imbalances have gained a new salience in international policy debates;
2. To summarise the main insights from recent economic research on the causes and remedies of the current imbalances, focusing on the three largest trading blocs: the US, the European Union and China;
3. To draw out policy conclusions on how the rest of the world should react to external imbalances in the US, Europe and China, should those imbalances persist.

To address the first two objectives, we draw heavily on the 2026 CEPR-Bruegel Paris Report on *The New Global Imbalances* (Rey *et al*, 2026). The discussion of the third is based largely on our own analysis.

We begin by reviewing the concepts and economic history underpinning today's discussion of global imbalances. The structure of the remainder of the essay reflects its three objectives, followed by a conclusion.

2 GLOBAL IMBALANCE BASICS

2.1 Back to basics

Despite their ominous label, global imbalances are not inherently detrimental. Their nature and implications are best understood by revisiting the fundamental concepts and accounting identities underpinning the balance of payments.

1. **Current account imbalances reflect domestic savings–investment gaps.** A current account balance is the mirror image of the difference between savings from domestic sources and investment in the domestic economy (from any source – public or private, domestic or foreign). Deficits arise when investment exceeds savings; surpluses when a country saves more than it invests. Imbalances are mostly a macroeconomic phenomenon.
2. **Such imbalances are not inherently bad.** For fast-growing or catching-up economies, investing more than domestic saving – by importing capital – allows growth to be accelerated and future income to be increased.
3. **A current account deficit means net capital inflows; a surplus means net capital outflows.** Countries with

deficits import foreign capital to finance direct or portfolio investment or consumption, while surplus countries export capital abroad.

4. **Risks rise when deficits become prolonged and large.** Persistent deficits can undermine confidence, leading to currency pressure, rising borrowing costs, sudden stops or debt crises. Surpluses can also distort global demand and financial flows, but financial instability risks tend to be more acute on the deficit side.
5. **What matters is the overall current account, not bilateral balances.** A country can run a bilateral deficit with one partner and a surplus with another; only the aggregate balance reflects its macroeconomic position.
6. **The current account includes more than trade in goods.** Services, income flows and transfers are equally important. Focusing only on the goods trade balance can give a misleading picture of external sustainability. Conversely, concerns about trade imbalances (eg related to import competition and the displacement of workers) might also be poorly proxied by the current account.
7. **Cumulated deficits imply increasing external liabilities** (external debt or equity claims), while sustained surpluses indicate accumulated foreign assets. Large foreign asset and liability positions are prone to valuation changes.

In sum, global current account imbalances reflect domestic saving–investment gaps. They can support growth when financed sustainably and directed toward productive uses, but they become risky if they are large, persistent and tied to rising leverage or asset bubbles. What matters for these risks is not bilateral trade balances, but the underlying

macroeconomic conditions. Durable adjustment therefore requires domestic policy changes, not trade measures alone.

Nevertheless, policies that economists would normally classify as microeconomic or sectoral – including industrial policies, trade policies and credit allocation – *can* influence current account imbalances under some conditions. First, import tariffs can lead the domestic currency to appreciate, raising the value of a country's external liabilities relative to its foreign assets, and consequently reducing the trade deficits a country can afford in the future (Itskhoki and Mukhin, 2026). Note that this effect is very different from what proponents of tariffs typically have in mind: they focus on import substitution and ignore the offsetting exchange rate movements.

Second, tariffs and subsidies can have an impact on the current account if accompanied by macroeconomic policies that lean against normal equilibrating forces. For example, industrial subsidies that expand production of tradables can increase the current account surplus if they are accompanied by policies that depress domestic spending, reducing domestic consumption (Obstfeld, 2026).

2.2 Some lessons from history: financial crisis risks

History provides repeated evidence of the dangers posed by large external imbalances. Eichengreen (2026) and Obstfeld (2026) reviewed major episodes over the past century; in most cases, these imbalances ended in economic and financial crises, in some instances laying the foundations for prolonged disruption and conflict.

One notable exception was the first Age of Globalisation (1870–1914). At the time, Britain and other European economies ran sustained current account surpluses, while

capital flowed to the United States and other 'new world' economies – Canada, Australia and Argentina. These capital inflows largely financed productivity-enhancing infrastructure, including railways and ports, which expanded export capacity and supported debt servicing. Capital and labour moved in the same direction, fiscal policy was generally disciplined and the gold standard provided a credible nominal anchor that facilitated balance-of-payments adjustment. Wage and price flexibility, together with cooperative central banking, reinforced systemic stability. Episodes of overextension and instability did occur, such as during the 1890s Baring crisis involving lending to Argentina, but they were resolved quickly. Few of these supporting conditions hold today.

By contrast, most other episodes involving large imbalances ended adversely. In the 1920s, the United States emerged as the dominant surplus country, channelling private capital flows to Europe and Latin America. Increasingly, these flows financed government spending rather than productive investment. Weak underwriting standards, fragile confidence in the gold standard and abrupt monetary tightening by the Federal Reserve in 1928 triggered destabilising reversals that contributed to systemic collapse.

Similarly, during the 1970s petrodollar recycling episode, large Organization of the Petroleum Exporting Countries (OPEC) surpluses were intermediated through US and European banks and lent to developing economies, particularly in Latin America. These flows financed substantial current account deficits and expansionary policies, many of which were unsustainable. The cycle reversed sharply when US interest rates rose under then Federal Reserve Chair Paul Volcker. Heavily indebted countries lost market access,

and Mexico's 1982 default marked the onset of a broader sovereign debt crisis, leading to abrupt adjustment, deep recessions and Latin America's 'lost decade.'

In the 1980s, the contentious issue was the trade imbalance between the US and Japan. Tight US monetary policy and large fiscal deficits led to high interest rates, a sharply appreciated dollar and a widening US current account deficit. Japan, by contrast, ran persistent surpluses driven by high savings and export-led catch-up growth. As Japanese exports gained market share, the imbalance became politically contentious in the United States, fuelling protectionist pressures. At a 1985 meeting in New York's Plaza Hotel, the G7 agreed to depreciate the dollar to fend off protectionist demands in the US – the Plaza Accord. As the Bank of Japan cut interest rates to offset the contractionary impact of yen appreciation, an asset price bubble was triggered in Japan (Obstfeld, 2026). After the bubble burst, the Japanese came to view the Plaza Accord as a cause of Japan's 'lost decades,' serving as a cautionary tale against yielding to US pressure for exchange rate appreciation (Hoshi, 2026).

The largest narrowing of global current account imbalances in recent memory was the 2009 Global Financial Crisis – so consequential that it acquired its own acronym (GFC). Once again, the United States was at the centre, running the largest current account deficit in absolute terms. In the runup to the crisis, surplus and deficit countries debated the underlying drivers of these imbalances. The dominant narrative in the United States attributed its deficits to the rest of the world: excess saving in emerging Asia and oil-exporting economies was alleged to have been 'pushed' into US financial markets, driving up the dollar and asset prices and widening the trade

deficit (Obstfeld, 2026). However, this account is difficult to reconcile with the evidence. The US dollar began a sustained depreciation in 2002, even as the current account deficit continued to expand. If foreign saving pressure had been the primary driver, one would have expected a persistently strong or appreciating dollar. Instead, the combination of a weakening currency and a widening deficit point to powerful domestic forces – most notably the housing boom, financial innovation, deregulation and highly accommodative monetary policy. These dynamics culminated in a real-estate and banking crisis that, although it originated in the United States, spread quickly across the globe.

The resulting financial and economic turmoil left deep economic and political scars. Importantly, however, it did not unfold in the way that had been expected: while the US current account partly reflected the domestic developments that led to the crisis, the crisis was not triggered by a reversal of capital flows to the United States. Instead, it triggered a flight out of risky assets in the United States and globally into US safe assets (Treasury bonds), with the net effect of *appreciating* the US dollar.

Taken together, these episodes show that large external imbalances can be dangerous – either by setting up an economy for a reversal in capital flows, or as a symptom of an underlying domestic problem that could at some point explode. They have often unwound in a disorderly manner, with sudden reversals of capital flows and financial crises. Debtor countries are typically most at risk. However, when the debtor is also at the centre of the global financial system and issues the main reserve currency, instability at the core is likely to spill over to the rest of the world.

3 WHY NOW?

3.1 A similar geography of imbalances, but with sharply increasing US net liabilities

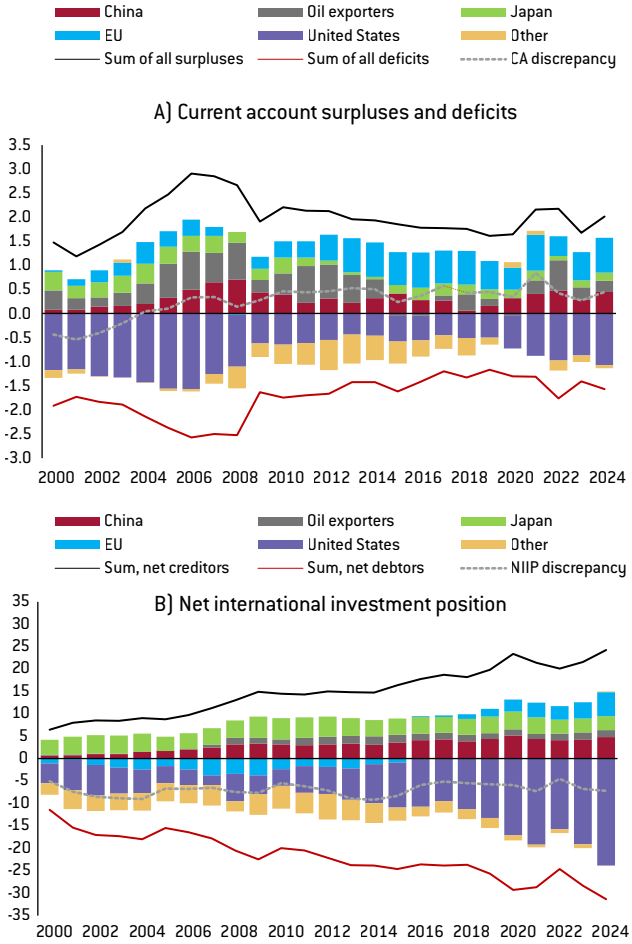
Why are global imbalances back on the agenda? What is different this time? At first glance, they do not even appear unusually large. At around 2 percent of global GDP, global imbalances (the sum of all current surpluses, which is equal to the sum of all deficits plus a 'global discrepancy') remain well below the peak of almost 3 percent of global GDP observed two decades ago, and are only about 0.4 percent of global GDP above the trough in 2019 (Figure 1, Panel A; see also Balakrishnan, 2026). The composition has also changed less than might be expected. The US continues to run the largest current account deficit, both relative to global GDP and in absolute terms. On the surplus side, the main counterparts are familiar: the major economies – particularly the EU, Japan and China – alongside oil exporters as a group.

On the debtor side, the persistent current account deficit of the US reflects the accumulation of external liabilities, although the relationship is not one-to-one owing to

valuation effects (Balakrishnan, 2026)[3]. As a result, the net international investment position (NIIP) of the US reached about 90 percent of US GDP, or 24 percent of world GDP, by end-2024 (Figure 1, Panel B). This development is attributable not only to sustained current account deficits but also to sizeable valuation effects associated with rising US equity prices and an appreciating dollar (through January 2025). At the same time, valuation dynamics have shifted and the 'exorbitant privilege' of the US – the ability to earn higher returns on external assets than it pays on liabilities – has largely eroded (Du *et al*, 2025). As a result, the US can no longer sustain large current account deficits without a meaningful further deterioration in its NIIP, reversing the pattern observed in the mid-2000s.

3 On the creditor side, the principal counterparts have been advanced European and Asian economies, for which net asset accumulation has been driven primarily by persistent current account surpluses. Valuation gains on US assets have accrued mainly to countries with substantial equity and foreign direct investment positions in the United States, and to countries with large sovereign wealth funds, notably Norway and in the Middle East (see Balakrishnan, 2026).

Figure 1: External imbalances 2000-2024 (% of world GDP)



Source: Bruegel based on IMF World Economic Outlook, and External Wealth of Nations Database. Note: The current account (CA) discrepancy is the sum of the current accounts of all countries. The NIIP discrepancy is the sum of the net international investment positions of all countries.

The US has long played the dominant role in supplying both global safe and risky assets. US Treasuries serve as the world's primary safe asset because of the scale of the US economy, its fiscal capacity to raise revenues, the depth and liquidity of its financial markets, Federal Reserve backstopping and its geopolitical strength – advantages that competitors such as the euro area, Japan or China have not fully replicated. At the same time, the US supplies the majority of global risky assets, with equity and corporate debt markets far exceeding Treasury supply, underpinned by strong institutions, robust property rights protections and a technology sector that attracted global investors. Safe and risky asset markets are interconnected: during periods of global stress, rising demand for Treasuries has led to dollar appreciation, increasing the value and attractiveness of all dollar-denominated assets and reinforcing a US *"safety premium"* (Itskhoki and Mukhin 2026). Yet this architecture, long taken as a structural feature of the international monetary and financial system, is increasingly under political and geopolitical strain – a point we return to in section 5.1.

Apart from the eroding 'exorbitant privilege' of the United States, a further feature distinguishing recent imbalances from those in the 2000s is that the US current account is no longer financed mainly by public savings (accumulation of reserves in China and other Asian countries) but instead by private capital flows. These are increasingly intermediated by non-bank financial institutions (NBFIs), often accompanied by rising leverage (Harr and Krogstrup, 2026). In advanced Europe and Asia, NBFIs have become the main conduit for savings into US assets, with assets under management rising sharply over the past two decades.

This has coincided with greater investment in riskier assets, including equities and corporate bonds, and with a marked increase in foreign holdings of US equities. Leveraged funds, particularly hedge funds, have also become more active in sovereign bond markets, using repo financing in strategies that may amplify volatility and trigger sudden spikes in yields. Price-insensitive investors are replaced by more elastic private actors; risk premia have become compressed – US equity valuations are historically high and credit spreads unusually tight – despite elevated geopolitical and trade uncertainty. The combination of leverage, low risk premia and greater reliance on market-based finance increases the potential for abrupt repricing and cross-border spillovers. The development of dollar-based stablecoins may add new complications (Moëc, 2026).

Are current imbalances excessive? According to the International Monetary Fund's 2025 *External Sector Report*, global imbalances in 2024 were not judged excessive overall. However, the rapid widening of imbalances in 2024 and 2025 has raised concerns. According to the IMF (2025), roughly two-thirds of the increase in global current account balances in 2024 reflected an increase in 'excess balances' (the gap between the actual current account and the current account that the IMF views as justified by fundamentals and desirable policies). This deterioration was driven mainly by China – the Chinese current account surplus rose from 1.4 percent in 2023 to 2.3 percent in 2024 and an estimated 3.3 percent in 2025 – and by the US, where the deficit widened from about 3.3 percent to about 4 percent. A smaller contribution came from the euro area.

In reaction, the IMF has switched its classification of Chi-

na's external position from *"moderately stronger"* to *"stronger than the level implied by medium-term fundamentals and desirable policies"* (IMF, 2026a). The IMF also expects the US current account deficit to decline modestly but remain high, at about 3.5 percent of GDP; and it has reiterated its concerns about the high US fiscal deficit and its rising debt-to-GDP ratio (IMF, 2026b).

In sum, while current account imbalances do not appear exceptional by historical standards, the persistent rise in the net external liabilities of the United States, its unsustainable fiscal trajectory, loss of 'exorbitant privilege' and dependence on private capital inflows intermediated by NBFIs all raise concerns. The US is vulnerable to a decline in foreign inflows, with risks for global financial stability. We return to these risks in section 5.1

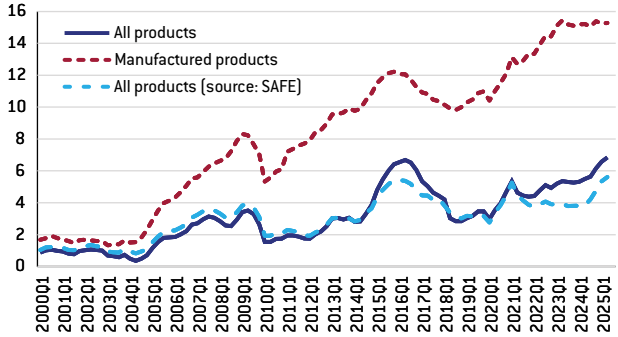
3.2 A different narrative: industrial policy and import competition from China

Today's imbalances narrative in the United States is drastically different from what it was in the pre-GFC period (Obstfeld, 2026). The focus is no longer on a global 'savings glut' originating in the rest of the world, but on perceived unfair competition primarily from China – and more recently also beyond. Persistent trade and current account deficits are portrayed as *prima-facie* evidence of discriminatory trade practices, currency policies and asymmetric burdens associated with providing open capital markets and the dollar as a global public good.

In this view, external deficits have contributed to deindustrialisation, manufacturing job losses and an erosion of US economic strength. Current concerns about global imbal-

ances are therefore more explicitly microeconomic in nature, centring on sectoral competitiveness, import competition from China, high-tech rivalry and the geographic concentration of manufacturing employment losses. An explosion in the Chinese trade surplus (Figure 2), particularly based on customs data[4], has added further fuel to this view, raising similar concerns in Europe and many other economies.

Figure 2: China's trade surplus (in % of rest of world imports, excluding intra-EU trade)



Source: Jean (2026). Note: based on customs data, except for 'All products (source: SAFE)'. SAFE stands for the Chinese State Administration of Foreign Exchange, which reports balance of payment data.

4 The widening gap between China's balance-of-payments data and customs trade statistics is not fully understood. Some explanations relate to recording of global production structures and corporate arrangements that have become more complex. Part of the gap may reflect offshore or 'factoryless' manufacturing arrangements, such as iPhone production in China, for which the timing of ownership transfer affects whether transactions are recorded as goods or services trade. Export over-reporting – linked to value-added tax rebate incentives – and import under-reporting – related to tariff evasion – could also contribute materially to the widening balance-of-payments–customs discrepancy (Ma and Wei, 2026). Pending greater clarity on the underlying causes, both sets of measures should be taken into account in assessing China's external position.

At the core of this debate are two questions. First, do current account deficits contribute to deindustrialisation in advanced countries? Second, has import competition from China accelerated this deindustrialisation?

The answer to the first question starts with the observation that all advanced economies, regardless of their external position, have experienced a shift in domestic value added from manufacturing to services. Hence, even persistent current account surpluses cannot prevent deindustrialisation in the long run. At the same time, it is true that many advanced countries that have run external surpluses in the past, including three of the G7 economies – Germany, Japan and Italy – have been able to maintain larger manufacturing sectors than countries that have typically run deficits, such as France, the United Kingdom and the United States (Figure 3, Panel A). But there are also counterexamples: Canada has run surpluses but has a relatively low share of manufacturing.

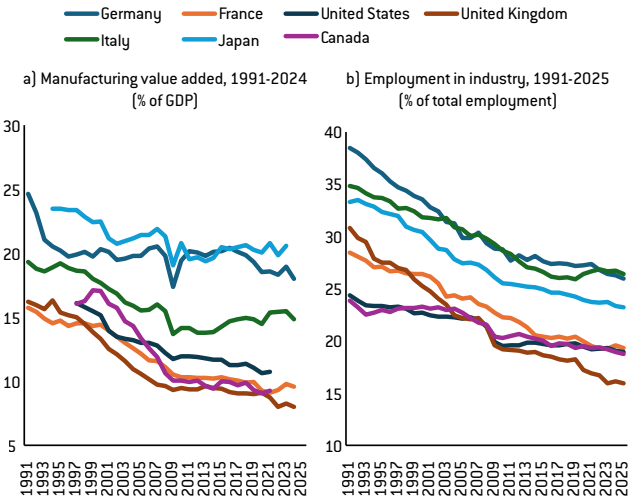
A simple conceptual framework going back to Corden (1960) helps clarify these correlations (see Obstfeld, 2026). Because people like to balance tradables and non-tradables consumption, there is a mechanical link between large tradables sectors and trade surpluses: excess tradables are exported. Tradables are typically industrial goods. But this is not always the case. In countries with high natural-resource endowments, such as Canada, the tradables sector might be dominated by commodities. In a country like Luxembourg, meanwhile, the tradables sector is dominated by financial services. Hence, Canada and Luxembourg have small manufacturing sectors, even though they are surplus countries. Furthermore, even where countries have large manufacturing sectors, these may not be the result of policies – and even

where they relate to policies, the objective of these policies may not have been to support manufacturing.

A good example is Germany, where fiscal surpluses and wage restraint have, since the mid-2000s, arguably contributed to keeping the manufacturing sector relatively large and to external surpluses, as these policies dampened consumption and supported competitiveness. However, the motivation for these policies was fiscal prudence and lowering unemployment, which was structurally high in Germany until the late 2000s, rather than the desire to resist deindustrialisation.

Reflecting their higher shares of industry in GDP, the shares of manufacturing employment in the G7 surplus countries have tended to be higher than in the deficit countries (Figure 3, Panel B). However, Figure 3, Panel B also shows that the *trend* of manufacturing employment has been the same – downward. This reflects a shift away from low-cost, labour-intensive production toward automation. Developing countries differ in this respect: as the rural population moves from agriculture to industry, the manufacturing share of employment might still be rising. For example, China's share of manufacturing employment rose by 9 percentage points of total employment between 2004 and 2024, even though its manufacturing value added *declined* by almost 7 points of GDP between 2004 and 2024 as a result of the growth in services.

Figure 3: Industrial employment and value-added shares in G7 countries since 1991



Source: Bruegel based on World Bank, World Development Indicators series SL.IND.EMPL.ZS and NV.IND.MANF.ZS.

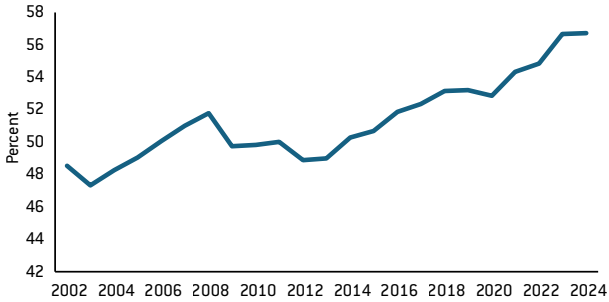
Turning to the second question – has import competition from China accelerated deindustrialisation in advanced countries? – there is strong evidence that Chinese import competition has accelerated manufacturing job losses in the US. Autor *et al* (2021) found that the 2000-2012 trade shock from China reduced US manufacturing employment as a share of the working-age population by about 1.6 percentage points over 2001-2019, almost 60 percent of the decline in the manufacturing share over that period. For Germany, Dauth *et al* (2014) similarly found that import competition from China and Eastern Europe (*"the East"*) caused substantial job losses

in import-competing industries, but these were more than offset by employment gains in export industries. The *net* effect of increased trade between Germany and *"the East"* in the period 1988-2008 was the *creation* of almost 500,000 new jobs.

However, China has stopped being a magnet for German imports. As Barkin and Williams (2026) have documented, growth in China and Chinese imports of German goods decoupled around 2021, while net car exports have plummeted since peaking in 2022. Balakrishnan (2026) showed that Chinese exports have become increasingly similar to those of the euro area (Figure 4). This suggests that much of the import competition in Europe is structural, ie Chinese goods have caught up with their competition. According to Grjebine *et al* (2026), one third of German exports and 68 percent of German manufacturing value added are now "*threatened"* by Chinese competitors.

An additional concern about China's trade surplus is that, in certain sectors, China has attained dominant market positions that may serve as political leverage. A prominent example is the refining of critical minerals, particularly rare earths and magnet production. China has repeatedly used export controls in this area, most recently introducing a global licensing system for rare earth exports (Szczepański, 2025).

Figure 4: Export similarity index between China and the euro area



Source: Balakrishnan (2026), based on UN Comtrade.

4 OPTIMAL ADJUSTMENT: ALL TOGETHER

The ideal adjustment would involve the main systemic economies – at least the United States, China and the EU – rebalancing simultaneously and in a coordinated manner. Such an approach would reduce the risk that adjustment in one economy simply shifts imbalances elsewhere or triggers destabilising spillovers.

In simple terms, the required policy mix is well known. The US would raise national saving, primarily through credible fiscal consolidation, thereby reducing its reliance on external financing. China would lower excess saving by rebalancing toward household consumption – strengthening social safety nets, boosting disposable income and shifting away from investment- and export-led growth. Europe would increase investment, particularly in infrastructure, defence and the green transition, thereby absorbing more domestic and global savings.

Such coordinated flow adjustment would help narrow current account imbalances and reduce trade tensions. However, risks to the financial system would not disappear automatically. Financial vulnerabilities depend not only on flow imbalances but also on the accumulated stock of

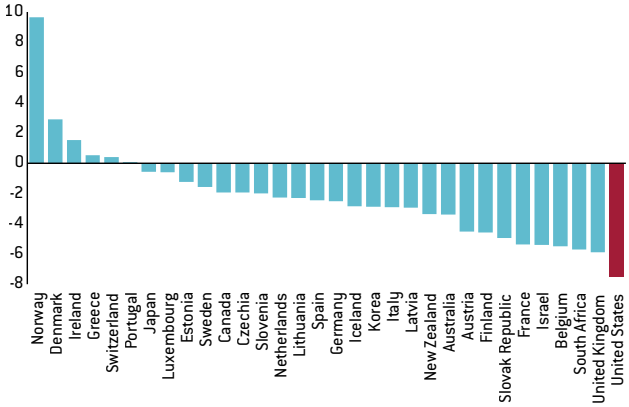
external assets and liabilities, leverage and asset valuations. Even if flows were to adjust, elevated debt levels, concentrated exposures and compressed risk premia would continue to pose stability risks. Nonetheless, shifting the flow dynamics would be an important first step towards a more sustainable global configuration.

4.1 Adjustment in the United States: it's mainly fiscal

The doubling of the US current account deficit since 2019 primarily reflects strong domestic demand in relation to relatively tepid external demand; it is reinforced by large budget deficits, buoyant asset prices and, most recently, an investment boom linked to AI (Obstfeld, 2026; Milesi-Ferretti, 2026). However, this boom comes at a fragile moment. The US net international investment position is significantly more negative than in past episodes (Bayoumi and Gagnon, 2025). Without significant consolidation, US public debt is on an unsustainable trajectory (Darvas *et al*, 2025; Dynan and Elmendorf, 2025; CBO, 2026). Despite solid growth and low unemployment, the US is running an exceptionally large fiscal deficit – the highest among all advanced economies, according to the OECD (Figure 5).

Fiscal policy should hence be the primary instrument for adjustment. Credible fiscal consolidation over the medium term would serve a dual purpose: placing public debt on a sustainable path and reducing reliance on foreign savings, thereby contributing to a more durable narrowing of the current account deficit.

Figure 5: Fiscal balance in advanced economies, 2025 (% of GDP)



Source: Bruegel based on OECD (2025).

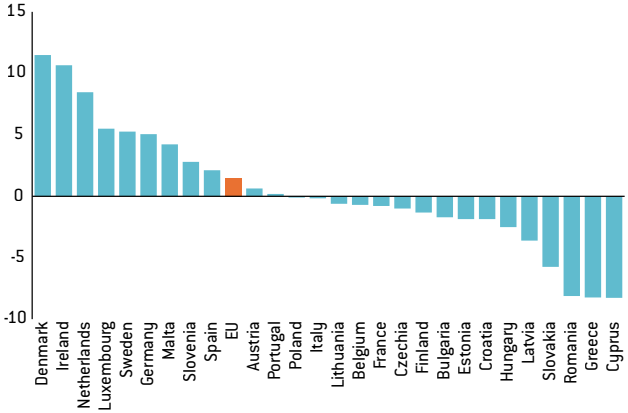
How exactly the US should adjust fiscally has been the subject of longstanding policy advice from institutions including the IMF and the OECD. IMF recommendations focus on increasing federal revenue and reforming long-term entitlement programmes (IMF, 2026b). Past recommendations have included raising indirect taxes (the US is the only major advanced country without a value-added tax), progressively raising income taxes and eliminating a range of tax expenditures (IMF, 2024).

4.2 Adjustment in Europe: invest and reform

Adjustment in the European Union is conceptually less straightforward than in the United States. This reflects the EU's heterogeneity: its current account surplus of about 3 percent aggregates 27 current accounts, ranging from a

surplus of almost 12 percent of GDP in Denmark to a deficit of close to 9 percent in Romania, Greece and Cyprus (Figure 6, referring to 2022-2024 averages). The heterogeneity is not surprising. The EU includes both advanced and 'emerging' economies (Bulgaria, Hungary, Poland, Romania). And while most of the former share the same currency, they differ wildly in their fiscal and structural fundamentals.

Figure 6: Current accounts of EU countries, 2022-2024 (average as a % of national GDP)



Source: Bruegel based on AMECO.

Attempting to control for these conditions, the IMF (2025) found that only about half of the euro-area surplus can be justified based on structural fundamentals and desirable policies. A related methodology used by the European Commission leads to the same result (Coutinho *et al*, 2022).

The implication is that the EU – or the euro area[5] – should be lowering its current account surplus by about 1.5 percent of GDP.

But exactly how should the EU adjust? Unlike the renminbi, the euro is a freely floating currency. And inside the EU, one might need to make policy recommendations to either raise investment or lower savings to up to 27 national authorities, plus the EU institutions.

Policy institutions including the IMF and the European Commission overcome this variability by making some implicit assumptions (see Darvas *et al*, 2026)[6]. First, the focus of policy prescriptions to reduce the current account is on the surplus countries; no-one ever advises countries in balance or deficit to make their deficits bigger for the sake of lowering the aggregate euro-area surplus. Second, almost all emphasis is on policies that are expected to raise growth, while arguably also contributing to a reduction in the surplus. This means that the emphasis is mostly on raising investment, not on reducing savings.

Although most of Europe's high-surplus countries are notable for their high savings rather than exceptionally high investment, this approach is likely justified, for two main reasons.

First, unlike in the 2010s – when German fiscal policy was too tight, in part because of legal constraints – there is no

5 It is debatable whether the EU or euro-area current account balance is more relevant when analysing global imbalances. The euro area shares a common currency, while the EU shares a common trade policy and a single market. In practice, the difference is not hugely important, as the EU and euro-area current accounts are almost the same, and more than 80 percent of EU GDP corresponds to the euro area.

6 See, for example, the IMF's 2025 euro-area assessment (IMF, 2025, Table 3.7).

straightforward fiscal policy lever to reduce savings. In the US, lowering the fiscal deficit would be good for both external and domestic reasons. In the EU, however, these policy objectives conflict. The European Commission considers the aggregate fiscal stance of the euro area to be appropriate (Cepparulo and Reitano, 2025). And with few exceptions – including Denmark and Sweden, which are small countries – EU countries do not have the fiscal space to raise the deficit. In 2025, Germany raised it, after shaking off its 'debt brake'[7], but will need to reduce it again at some point to stabilise its debt.

Second, bottom-up estimates (for example, quoted in the 2024 Draghi Report; Draghi, 2024) indicate continued large investment gaps in Europe in areas including digital infrastructure, renewable energy sources, electricity grids and military infrastructure. These estimates are a better indicator of the needed direction of travel than the relatively low investment rates of the United States.

The critical question is how to increase investment. The standard policy prescription consists of reforms that reduce single market barriers, promote capital markets and banking union, increase risk-taking and entry and exit in product markets, attract more FDI to Europe and reform European fiscal rules to make them investment friendlier. But the strength of the impact of these reforms on investment is unclear. Furthermore, most of the proposed reforms have long histories, floundering because of national red lines on further European integration or special interest opposition. And in some cases, such as greater openness to Chinese

7 Jeromin Zettelmeyer, 'What does German debt brake reform mean for Europe?' *The Why Axis*, 31 March 2005, Bruegel, https://www.bruegel.org/newsletter/what-does-german-debt-brake-reform-mean-europe.

foreign direct investment (FDI), they may involve trade-offs with economic security.

Most perniciously, the urgency triggered by increasing competition from China cuts both ways. While it reduces complacency and increases the resolve of politicians to do *something*, it also boosts the popularity of protectionist policies that are likely to reduce, rather than raise, investment and growth over the medium and long term. We return to this problem in the last section.

Still, Europe has to try again, and on many fronts at once.

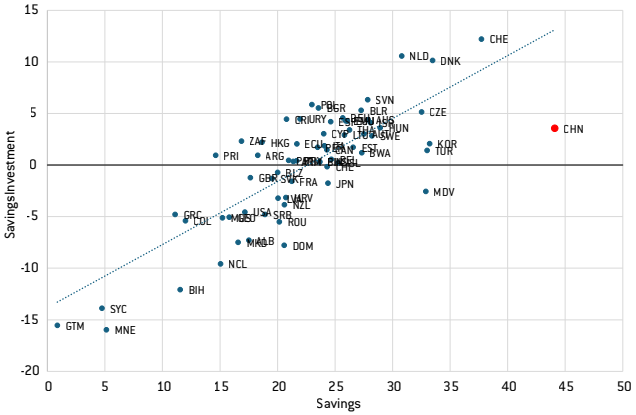
4.3 Adjustment in China: rebalance

According to the IMF, most of China's 2025 current account surplus – 2.3 percentage points out of a total of 3.3 percentage points of GDP – cannot be justified as reflecting medium-term fundamentals and desirable policy choices, and the real exchange rate is undervalued by 12 percent to 21 percent (IMF, 2026a). Hence, there is a *prima-facie* case for policy adjustment that would likely benefit China while lowering both its current account and trade surplus. The question is what policy steps this requires. Answering this question requires an understanding of the causes of China's external imbalances. Based on Huang (2026), IMF (2026a), Jean (2026) and Ma and Wei (2026), our reading is as follows.

To understand China's **structural** current account surplus, it helps to start with the gross savings rate. For a country that is neither a natural-resource exporter (such as Norway or the Gulf states), nor a small economy dominated by a financial centre or investment hub (such as Singapore, Ireland or Luxembourg), China's savings rate is extremely high (Figure 7). Figure 7 also shows a positive association between

the savings rate and the savings–investment balance, as approximated by the regression line. China's data point is well below this line, suggesting that given its savings rate, its current account surplus is abnormally low. For example, several European countries – the Netherlands, Denmark, Switzerland, Slovenia, Poland, Bulgaria and Czechia – have current account surpluses that are much higher as a share of GDP than China, even though their savings rates are much lower.

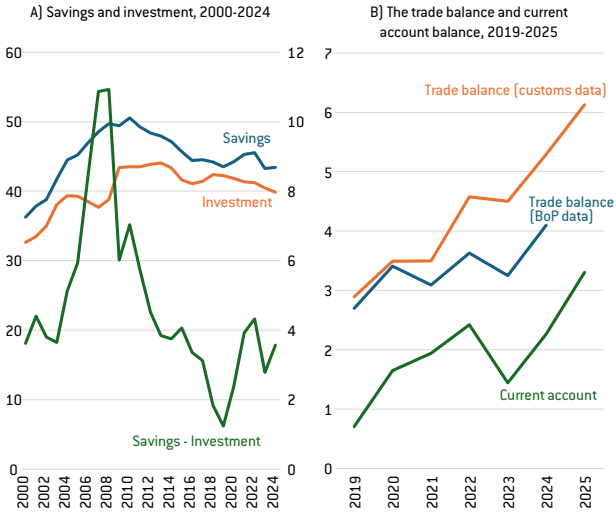
Figure 7: Savings rates and current account balances in advanced and emerging economies, 2022-24 average (% of country GDP)



Source: Bruegel based on World Bank (series NE.GDI.FTOT.ZS and NY.GDS.TOTL.ZS). Note: country sample includes all advanced and upper-middle-income economies except for natural resource exporters (Azerbaijan, Norway, Russian Federation, Gulf states, Mongolia, Turkmenistan), countries with large financial centres relative to country size (Bermuda, Macao, Hong Kong, Singapore, Ireland, Luxembourg, San Marino, Malta, Panama), heavily aid-dependent economies (Samoa, Kosovo, Greenland) and crisis countries with negative savings rates.

What makes China unusual is the combination of an exceptional savings rate with exceptionally high investment. Figure 8, Panel A shows that except in the second half of the 2000s, when the share of investment dropped and the current account surplus rose to about 10 percent of GDP, as well as a recent divergence, investment in China has been almost as high as savings.

Figure 8: The evolution of China's external imbalances (% of GDP)



Sources: Bruegel based on World Bank (series NE.GDI.FTOT.ZS and NY.GDS.TOTL.ZS), IMF World Economic Outlook, and Bruegel Dataset (2026) (for trade customs data).

To understand why the Chinese current account is structurally in surplus but normally *not* very high as a share of GDP, one has to understand why *both* savings and investment are abnormally high. The latter also helps to understand

why the goods trade surplus is much higher than the current account.

A longstanding structural reason for high savings, cited by both Huang (2026) and Ma and Wei (2026), is an underdeveloped social safety net. Together with exceptionally adverse demographics (resulting in part from China's one-child policy, which was abolished in 2016), this is one reason for exceptionally high household savings. The decline in the savings rate since around 2010 is accredited to improvements in the social safety net. Another reason, emphasised by Ma and Wei (2026), could be China's highly unbalanced male–female ratio (itself a result of the one-child policy), which leads parents of sons to save a lot to improve their son's standing in the marriage market (Wei and Zhang, 2011).

The causes of structurally high investment similarly relate to longstanding state policies and preferences, which are partly inherited from China's era of central planning. As pointed out by Huang (2026), a high investment share was a common feature of planned economies, such as the Soviet Union; it reflected the planner's preference for rapid industrialisation, to the detriment of consumption. This preference lives on in China, propagated by both traditional and less traditional planning instruments:

The arguably most powerful policy instrument keeping investment high is capital controls, which forces most savings to look for returns within China. In the absence of capital controls, domestic investment would fall, and its current account surplus would likely rise to a level of at least that of Denmark, the Netherlands or Switzerland.

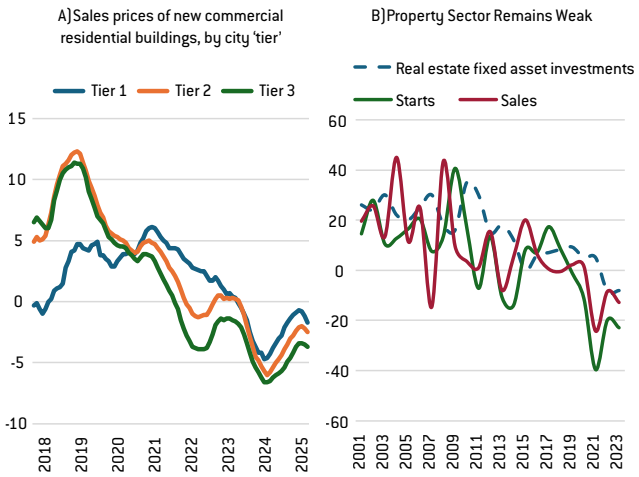
A further policy instrument is political competition at the local level. Local governments are incentivised to outperform

their peers in meeting growth target and industrial development targets in line with Five Year Plans (Huang, 2026). The response is to promote investment in favoured industries at the provincial level, using cheap land, cheap lending and other forms of subsidies.

This suggests that both China's structural current account surplus and its high investment rates are a result of its development model and political system, interacted with demographic conditions. There may be spillovers to the rest of the world, but perhaps these have to do with China's approach to keeping investment high, rather than just the current account.

This brings us to a second question, which is arguably more pressing: why have both China's current account and its trade balance been increasing as a share of GDP (Figure 8, Panel B) and – given China's relatively high growth – even more so as share of GDP and imports from the rest of the world (Figure 1, Panel A and Figure 2). On this, there is a fair amount of consensus around the interaction of weak demand and government policies that seek to keep growth on target (see also IMF, 2026a). China is, in 2026, in the third year of a housing downturn (Figure 9). Falling property values have weighed heavily on household wealth, consumption and local government revenues. Housing investment has collapsed, capacity utilisation in manufacturing has declined and China is experiencing deflation. With little flexibility in the nominal exchange rate, the real exchange rate has been depreciating relative to its trading partners, increasing China's external competitiveness. In effect, China has been pursuing a beggar-thy-neighbour policy, substituting foreign demand for domestic demand.

Figure 9: China's housing market: prices and volumes (%, year-on-year change)



Sources: Bruegel based on China National Bureau of Statistics, Bruegel Dataset (2023) and IMF (2026a). Note: Figure 9.a. shows year-on-year sales prices of newly built commercial residential buildings in 70 large and medium-sized cities. First-tier cities include Beijing, Shanghai, Guangzhou and Shenzhen. See IMF (2026a) for definitions of second and third-tied cities.

In China, this phenomenon is referred to as 'involution' – falling prices, cutthroat competition and low or negative profit margins (García-Herrero and Xu, 2026). Outside China, it is referred to as 'overcapacity' – a growing flood of cheap manufacturing exports. As shown by Jean (2026), this export growth has been particularly high in product categories that previously received state support.

What to do about all of this? As with the diagnosis of the problem, one can distinguish between structural measures and measures that deal with the consequences of the collapse of the housing boom and deflation.

- At the structural level, the priority measures would be to further improve the coverage and generosity of the social safety net (to lower savings), particularly in rural areas, and to remove incentives that lead local governments to favour investment in tradables over investment in human capital and services. Expanding high value-added services would support job creation, strengthen domestic demand and help reduce structural imbalances (see Huang, 2026).
- At the macroeconomic policy level, China should allow an appreciation of the currency. In addition, fiscal stimulus should focus on social spending and public infrastructure, such as the renovation of city centres and the expansion of the national power grids – an area in which China has underinvested (García-Herrero and Mu, 2025) – rather than investment in manufacturing. These could be financed by scaling back manufacturing subsidies.
- Finally, as argued by the IMF (2026a), there is scope to accelerate balance sheet consolidation and repair – facilitating the exit of unviable property developers, clearing of the housing inventory overhang and, if needed, local government debt restructuring.

5 CONTINGENT POLICY ADJUSTMENT

Coordinated adjustment along the lines proposed in section 4 is unlikely to happen. In the remainder of this essay, we examine the consequences of continued imbalances in the United States, the European Union and China, and make some policy recommendations for how the rest of the world should react to these imbalances.

5.1 What if the US does not adjust?

The policies of US President Donald Trump are clearly not, at time of writing, going in the direction recommended in section 3.1. Rather than raising domestic savings through fiscal consolidation, the administration seeks to boost economic growth through a mix of demand- and supply-side measures: low taxes, deregulation, promoting fossil fuels and pressuring the Federal Reserve to lower interest rates[8]. To the

8 On the first two, see The White House, 'Grow the economy', undated, https://www.whitehouse.gov/priorities/economy/, and The White House, 'Unleash American energy', undated https://www.whitehouse.gov/priorities/energy/. On the latter see Callum Jones, 'Trump steps up attacks on Fed's independence amid interest rates row', *The Guardian*, 1 August 2025, https://www.theguardian.com/business/2025/aug/01/trump-jerome-powell-tariffs-federal-reserve.

extent that these policies succeed in lifting growth in the short and medium term, they are likely to do so by raising private investment while maintaining a large – and growing – fiscal deficit (CBO, 2026). All else being equal, this implies a large and possibly growing current account deficit.

Importantly, however, all else need not be equal. In particular, there will be – and already have been – market reactions to the administration's unsustainable policies. What happens next will depend on these reactions.

In a benign scenario, equity prices would decline gradually and risk premia would widen. The economy would slow, leading markets to expect a prolonged period of easier monetary policy. In reaction, the dollar would depreciate further, continuing the trajectory on which it was in the 12 months to spring 2026 (according to the IMF's real exchange rate index, it has depreciated by about 6 percent to 7 percent since January of 2025). This would help rebalance both the current account and the net international investment position, as US net liabilities would decline due to valuation effects. US borrowing costs may not rise much, as wider risk premia and lower interest rates offset each other, and rising productivity growth resulting in artificial-intelligence take up may slow the expected rise of the debt ratio.

In a crisis scenario, markets would react more abruptly. This could be triggered by concerns about the United States's unsustainable fiscal trajectory, concerns about the institutional independence of the Federal Reserve, a sharp correction of stock market valuations inflated by the AI boom or a crisis linked to opaque and leveraged portions of the financial sector (such as private credit).

The question is what the rest of the world can do to protect

itself in such a crisis scenario. The answer depends on two factors.

The first is the reaction of capital flows and the US dollar exchange rate. Historically, international financial crises – even crises originating in the US, such as the 2008-2009 GFC – have triggered a 'safe haven' flight into US Treasury bills and bonds, causing appreciation of the dollar and hence providing an insurance effect to the rest of the world that is long on US assets (the counterpart of the US negative net international investment position). But a crisis of confidence in US fiscal or institutional fundamentals – as opposed to a specific US asset class, such as subprime mortgages in the run-up to the GFC – might have the opposite effect. If US assets, even Treasury bonds and bills, are no longer considered safe, there would be a flight *out* of the dollar. Borrowing from the literature on emerging-market crises (Calvo, 1998), we refer to this scenario as a 'sudden stop' on the United States.

The second factor is the reaction of the US authorities to the international dimension of the crisis. The 2008-2009 crisis was quickly contained through international cooperation (except for its knock-on effect on Europe during the euro crisis). This included coordinated fiscal stimulus and the extension of Federal Reserve US dollar swap lines to all other reserve currency central banks, as well as some central banks in the emerging world.

This type of cooperation could fail in the next crisis originating in the United States, for reasons ranging from unintentional to discriminatory. Coordinated fiscal stimulus might be off the table because of lack of fiscal space. The Federal Reserve may decide that it can no longer politically afford unlimited

swap lines with foreign central banks. And worse, the United States may use crisis-management instruments such as capital controls that discriminate against foreign residents.

The difficulty in mitigating the crisis will depend on the interaction of the crisis type and the US response (Table 1):

1. In the top-left scenario in Table 1, the crisis originates in a specific sector – private credit, for example, or crypto – but US Treasuries remain good collateral. To the extent that capital flows react, they would do so by fleeing into US Treasuries. This risks a dollar liquidity crunch in the rest of the world, but this could be averted by the Federal Reserve, which would extend dollar liquidity to its counterparts.
2. The top-right scenario is the same, except that the Federal Reserve suspends swap lines. US dollar liquidity would continue to exist but could not travel freely to where it is needed. The consequence would be a severe liquidity crunch for dollar-exposed entities without direct or indirect access to the Federal Reserve system, particularly in emerging markets and non-core financial systems, and also in Europe.
3. In the bottom-left scenario, investors flee the United States because of fears of default, high inflation or both. Both the dollar and treasury bond prices would collapse (a repeat of the pattern seen after President Trump's 2 April 2025 announcement of 'Liberation Day' tariffs, only more severe), but dollar liquidity would not be impaired. The Federal Reserve would most likely supply dollars to US institutions and this liquidity would become available internationally, through the money market, to whatever institution requires it. The crisis would strengthen the

balance sheet of foreign entities with net dollar liabilities but could eviscerate that of those with exposure to US Treasuries.

4. The bottom-right scenario is similar, except that capital controls and the suspension of swap lines could in addition create a dollar liquidity crisis abroad (at the same time, capital controls might also mitigate the dollar collapse).

Table 1: US crisis scenarios

		US response	
		Cooperative	Uncooperative
Crisis type	Standard (US retains 'safe haven' status)	*Scenario 1*: US maintains swap lines	*Scenario 2*: US suspends swap lines
	Sudden stop (flight out of the US)	*Scenario 3*: Capital flows unimpaired	*Scenario 4*: US suspends swap lines, imposes capital controls

While it is hard to rank the scenarios in terms of severity, scenario 1 would clearly be the most benign, but that does not mean it *is* benign. The internationally relatively inconsequential bursting of the dot-com bubble belongs in this category (while swap lines were not in place, neither was there a need for them at the time). So does the GFC. While the latter had some unique features that make a repeat of it unlikely, the increase in private exposure to the US since the early 2010s, often intermediated by non-bank financial institutions (Harr

and Krogstrup, 2026), implies that international contagion could be severe.

It is also clear that the uncooperative version of the 'standard' crisis – scenario 2 – might be far worse, as a liquidity crunch is added to the direct impact of the crisis. Finally, both scenarios 3 and 4 would take the world into uncharted territory. Given world exposure to US assets, the associated wealth destruction could be stratospheric – and its impact could be magnified by a liquidity crunch (Scenario 4).

In general terms, the world can prepare for these scenarios by both building dollar liquidity buffers (for scenarios 2 and 4), and by either reducing exposure to US Treasuries or building capital buffers (scenarios 3 and 4). But these measures are also costly, and their effectiveness is unclear. Furthermore, a sudden and coordinated reduction of Treasury bond exposure – which we do not recommend – could also precipitate a crisis.

The right response will therefore be institution-specific, but what is right will also depend on what others do. Financial supervisors in the rest of the world can help their supervisees prepare by quantifying scenarios of the type described in Table 1 and asking institutions to conduct stress tests based on these scenarios.

Given how disruptive some of these scenarios could be, there is also a strong case for intensified preparation and coordination among systemically important economies and international institutions. Central banks – working through the Bank for International Settlements – as well as the IMF and other international fora, should be continuously stress-testing adverse scenarios and preparing policy responses that do not require US participation. This should span the full range of cooperative instruments used in past

crises, including liquidity pooling arrangements, coordinated liquidity provision through the IMF, temporary moratoria and, where necessary, coordinated capital-flow management measures. It may require the upgrading of both the tools and governance of the IMF and other global cooperative institutions, as suggested by Papaconstantinou (2026). Proactive coordination might reduce the risk of disorderly adjustment and help preserve global financial stability under severe stress, while also creating awareness in the United States of the importance of prevention and cooperation.

5.2 What if the European Union fails to raise investment?

An ongoing theme in the European Union is been the push to raise investment and growth, currently through higher public spending on rearmament and reforms that reduce internal fragmentation and promote innovation and productivity. But what if the attempt fizzles out? A continued EU current account surplus in the order of 2.5 percent of EU GDP may not be large enough to create a 'savings glut' that would raise a financial stability risk for the rest of the world in the aggregate (Darvas *et al*, 2026). But it could fuel stability risks in specific countries that have high current account deficits for their own reasons. These include the US and many developing countries (Chari, 2026). A failure of the European Union to rebalance would hence strengthen the case for reforms that reduce large current account deficits (in particular, through fiscal adjustment) and/or make deficit countries less vulnerable to volatility in international capital flows.

Beyond its impact on capital flows, a failure of the EU to raise investment and growth could impact the rest of the world

through trade and political channels. A weak EU is more likely to become politically polarised, and demand for trade protection will rise. This is bad news for the rest of the world, both deficit and surplus countries. The EU reform agenda should thus be given strong international support. At the same time, the rest of the world should stand firmly against EU attempts to turn inward, such as through 'buy European' programmes, or attempts to undermine the most-favoured nation principle underpinning rules-based trade[9].

5.3 What if China does not rebalance?

Despite all obvious uncertainties about how the Chinese external surpluses will evolve, policymakers in the rest of the world can safely make three assumptions.

1. Over the medium term, the Chinese external surplus – particularly its trade surplus – is likely to decline. The reason for this is two-fold. First, the demand slump associated with the bursting of the property bubble will slowly unwind, as the property sector adjusts and bad credit is restructured or written off. Second, the 'involution'/ 'overcapacity' situation is unsustainable. Exit of unprofitable firms is inevitable. Consolidation or exit will likely be not only tolerated, but promoted by the Chinese authorities, at least in some sectors.
2. The reduction of the surplus/overcapacity will happen very slowly – and the surplus may rise before it declines. Demand recovery and elimination of excess capacity are

9 Andy Bounds and Peter Foster, 'EU seeks to reform WTP 'most favoured nation' trade rules', *Financial Times*, 21 January 2026, https://www.ft.com/content/2f5e1b1c-07f8-4316-ab40-fd4e1482df9f.

slow in the best of cases. Furthermore, China's current 'anti-involution' policies will likely prove insufficient (García-Herrero and Xu, 2026; IMF, 2026a). There are no signs yet that the authorities have understood the main lesson of section 4.3, which is that rebalancing the economy is not just about strengthening domestic demand, but that it requires changing the *composition* of domestic demand and supply – from investment to consumption, and from the tradables sector to the services sector. This change in economic strategy would run counter not just to decades of policy tradition in China, but also to the geopolitically fuelled urge to reduce dependence on virtually any import that is essential for the functioning of the economy.

3. At the end of the tunnel – that is, even if the Chinese economy successfully rebalances – the structure of the world economy will look fundamentally different from what it did 10 or 15 years ago, or indeed from what it does today. China will dominate world exports markets for manufactured goods, including the most sophisticated ones. And it will be a much larger economy than those of the traditional advanced-country industrial leaders. China will have caught up with advanced countries, rebalancing or no rebalancing.

The implications of these predictions for the rest of the world vary. For Germany and other former manufacturing export powerhouses, it is bad news. It means that their industrial models need to change, and gives their economies little time to adjust. For developing countries, the news is more ambiguous. An extended period of Chinese overcapacity makes export-led growth harder for economies such as India (Bery, 2026). At the same time, the availability of cheap capital goods

from China can help those economies to develop (much like competitive capital goods from Germany helped China develop in the 2000s). And in the long term, China will make room for the entry of lower-wage, technologically sophisticated economies, just like advanced countries have been forced to make room for China. Developing countries that manage to upskill their large pools of reserve labour and attract foreign investment will be the new winners.

The implication is that policies in the rest of the world should be geared towards three objectives.

First, there may be a case for transitory protection, defined as policies to mitigate the impact of Chinese overcapacity on the manufacturing sectors of importing countries. China's export surge is analogous to (and accompanied by) a real appreciation of the importing country, which will eventually recede. This must not be allowed to lead to the loss of skills, technologies and capital that would remain competitive after the surge is over[10]. Importantly, this argument does not justify permanent protection. Furthermore, no amount of protection will shield domestic producers from Chinese competition in export markets.

Second, policies should support the transition to the 'new world' in which China has both caught up and rebalanced. In that new steady state, continued protection will be inefficient: sectors in which China has caught up and surpassed the old industrial powerhouses should have exited or transformed themselves. The question is what will take their place.

10 The argument for this is analogous to the case for exchange rate management made in Paul Krugman's classic 1987 paper, 'The Narrow Moving Band, the Dutch Disease, and the Competitive Consequences of Mrs. Thatcher' (Krugman, 1987). In the presence of a learning-by-doing externality, a large real appreciation can lead to permanent de-industrialisation.

Export-oriented advanced countries will need to discover new comparative strengths, preferably in industrial and services sectors that are associated with learning, innovation and agglomeration externalities, and hence high growth.

Third, whatever policies are adopted to mitigate overcapacity and guide the economy to new areas of comparative advantage should be consistent with the preservation of rules-based trade. In the new steady state, trade will remain an essential motor of growth. Emerging and developing countries will eventually catch up with China in manufacturing, while advanced countries look for niches at the technology frontier. Emerging and developing countries will need export markets. Advanced countries, and Europe in particularly, will need both export markets and competitively priced intermediate goods, particularly energy-intensive intermediate goods (McWilliams *et al*, 2025). Hence, none of these 'growth models' will work without trade.

The trouble is there are two types of tension between these objectives:

1. Trade protection and industrial policies meant to facilitate structural transformation could in fact hinder **it**, permanently damaging industrial competitiveness. This would be the case if: (i) protection and/or industrial policy meant to promote old sectors keeps firms and sectors alive that are not competitive in the new regime, rather than allowing their orderly exit; or (ii) protection reduces the incentives of firms to upgrade and innovate, accelerating their loss of market share in export markets. Such policies amount to 'negative industrial policy' for the sectors and firms that should be leading future growth.

2. The desire for protection may lead to policies that destroy rules-based trade. The US already did that in the first Trump administration, did not reverse course in the Biden administration and is, under the second Trump administration, in the middle of its most aggressive attack on the rules. China has been harming the industrial sectors of its trading partners through its subsidies-based investment promotion. If Europe and other advanced economies take the same approach, what remains of the multilateral trading system will fragment. Putting it back together could take decades.

To avoid these pitfalls, countries seeking to reconcile the three objectives described should prioritise a strategy that: (1) embraces policies that avoid by design the trade-offs described above; (2) focuses industrial policy on technology adoption and/or on innovation in areas of comparative strength; (3) makes structural change less costly; (4) encourages Chinese FDI in areas in which China is clearly ahead; (5) uses trade-defence instruments and industrial policies that stay within World Trade Organization rules, preferably in coordination with other countries that are hurt by Chinese overcapacity; and (6) avoids 'Made in Europe'-type policies and instead promotes new trade partnerships that reduce import dependence on China.

1. **Push no-regret policies**. Reforms that improve skills, expand markets, reduce regulatory burdens, improve infrastructure, reduce energy costs, improve access to finance and improve the incentives to experiment and innovate will help current industry to survive Chinese competition *while also* supporting new entrants and structural change in the direction of comparative advantage.

2. **Allocate subsidies competitively, based on technological and commercial promise and consistency with high-level strategic objectives.** High-level objectives could include the green transition or security. Deciding what is commercially promising requires judgement by skilled and accountable individuals, operating within a transparent institutional framework (such as a development bank or an agency akin to the US Defense Advanced Research Projects Agency).
3. **Make structural change less costly**. For societies to survive large trade-related shocks, individuals that lose their jobs must be able to move geographically and/or re-skill. The state can support both. When the 'Quartz crisis' hit the Swiss watchmaking industry in the 1970s, it destroyed about 2 percent of Swiss jobs and had massive local impacts (Twinam, 2022), but did not seriously set back aggregate employment, in part because of mobility.
4. **Invite Chinese FDI**. Subject to appropriate security screening[11], Chinese FDI should be encouraged, particularly in areas in which China is ahead. Chinese competition from *within* countries or trade blocs that use protection against China will put pressure on domestic companies to do better or exit, and will build skills that can be transferred to other companies and sectors.
5. **Use WTO-consistent safeguards rather than discriminatory tariffs.** 'Safeguards' are temporary trade defence instruments[12] – including tariffs, quotas or a combination

11 See, for example, European Commission press release of 24 January 2024, 'Commission proposes new initiatives to strengthen economic security', https://ec.europa.eu/commission/presscorner/detail/en/ip_24_363.

12 Article XIX of the General Agreement on Tariffs and Trade (GATT), as well as the (more specific) 1994 Agreement on Safeguards, annexed to the WTO Treaty.

of both – in response to a surge in imports that causes or threatens to cause serious injury to a specific industry. Under WTO law, safeguards can be imposed for four years and extended to a maximum of eight years. Unlike discriminatory tariffs, which are generally prohibited under WTO law, they apply to all suppliers; and unlike countervailing duties, they do not require lengthy investigations into foreign subsidies. At the same time, they can be designed in a way that mainly impacts the supplier whose imports have surged (by setting a quota based on pre-surge import levels, together with a tariff for imports above that quota).

6. **'Made with X' rather than 'Made in X'**. 'Made in X' policies (insert your domestic jurisdiction here) that condition government subsidies on sourcing within the local jurisdiction are counterproductive. They violate WTO rules, upset like-minded trading partners and make it harder for domestic companies to remain competitive. They should be replaced by 'Made *with* X' policies that promote new trade partnerships, including through government procurement[13]. 'Buy European' procurement policies do not make sense for similar reasons, though a policy to discourage procurement from countries that are not signatories to the WTO Agreement on Government Procurement, including China, could make sense[14].

13 Ignacio García Bercero, Ben McWilliams, Niclas Poitiers and Simone Tagliapietra, '"Made with Europe" not "Made in Europe" should guide EU industrial policy', *First Glance*, 10 February 2026, Bruegel, https://www.bruegel.org/first-glance/made-europe-not-made-europe-should-guide-eu-industrial-policy.

14 The EU Industrial Accelerator Act, proposed by the European Commission on 4 March 2026 effectively takes this approach (European Commission, 2026). Although the term 'Union origin requirement' is used in the draft act, this is defined to include content originating in countries with which the EU has a free trade agreement or a customs union, or that are parties to the Agreement on Government Procurement (Article 8).

6 CONCLUSION

Unlike in past periods, global imbalances today are unfolding against a backdrop of elevated public and private debt, large gross external positions and geopolitical fragmentation. Risks thus extend beyond ongoing trade tensions: financial stability vulnerabilities are material, and strains on the rules-based trading system threaten medium-term prosperity across both advanced and emerging economies.

The first-best response remains a coordinated rebalancing among the systemic economies. In the United States, credible medium-term fiscal consolidation would raise national savings, reduce reliance on foreign financing and place public debt on a more sustainable path. In China, a durable shift away from investment in tradables and export-led growth towards household consumption – supported by stronger social safety nets, reoriented local government incentives and balance-sheet repair – would reduce excess saving and moderate external surpluses. In Europe, higher and more productivity-enhancing investment, combined with deeper market integration and structural reform, would absorb savings and narrow the aggregate surplus.

Taken together, such adjustments would reduce current

account imbalances at their domestic source and lower the risk of destabilising spillovers. At the same time, flow adjustment alone would not eliminate financial vulnerabilities. Large external balance sheets, valuation risks, and concentrated exposures imply that even orderly rebalancing must be accompanied by stronger buffers and more robust financial oversight.

In the absence of coordination, countries will need to rely on contingent strategies: building resilience to adverse US-centred financial scenarios, preparing for both dollar liquidity shortages and disorderly exchange rate movements, mitigating the temporary effects of Chinese overcapacity without entrenching permanent protection, and reinforcing multilateral mechanisms for crisis management. Closer cooperation between central banks and international financial institutions would be critical in this context.

Finally, it is important to recognise that the global economy has already undergone an irreversible structural shift. The decline in manufacturing employment in advanced economies has been broad-based, reflecting deep forces of technological change and structural transformation. Rebalancing or not, China is likely to remain the dominant global exporter of manufactured goods – including sophisticated products – and to exceed traditional industrial leaders in economic size. Failure to acknowledge the structural nature of these changes and excessive emphasis on protection will undermine long-term growth for all.

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