



26-2 Prospects for Global Imbalances in 2026 and Beyond: Another China Shock?

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ABSTRACT

China's surging exports attracted a lot of attention in 2025. Contrary to most forecasters, we believe China's booming trade surplus has much further to rise and will increasingly take sales away from producers in the rest of the world, especially in the advanced economies of Europe and Asia. Already heightened trade tensions are likely to intensify even if global growth remains strong. A global slowdown, perhaps led by a collapse of the US AI boom and shrinking US imports, likely would plunge the world into trade conflict on a scale not seen since the 1930s, as countries pursue beggar-thy-neighbor policies to defend their own producers at the expense of others.

JEL Codes: F21, F32, F34, F51

Keywords: Current account; protectionism; tariff; trade tensions.

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INTRODUCTION

External imbalances are back in the news, because of both economics and politics. The second inauguration of President Donald Trump in January 2025 marked the start of a renewed trade war, with US tariffs rising against imports from all countries. President Trump justifies higher US tariffs as a response to perceived unfair trade and currency practices in the rest of the world that he claims have kept US trade in deficit for decades. Economists largely reject Trump's diagnosis of US trade and expect the tariffs to have little effect on the trade balance because they reduce exports as well as imports (Baldwin 2025).¹ Despite the higher tariffs they face in the United States, China's overall exports have been booming recently. In response, two of the authors of the original "China Shock" paper wrote in the *New York Times* that a second China export shock is coming that will be worse than the first.² Both the G7 and G20 have said that global imbalances will be a key topic at their 2026 Leaders' meetings.³ The risk of a generalized trade war is all too apparent.

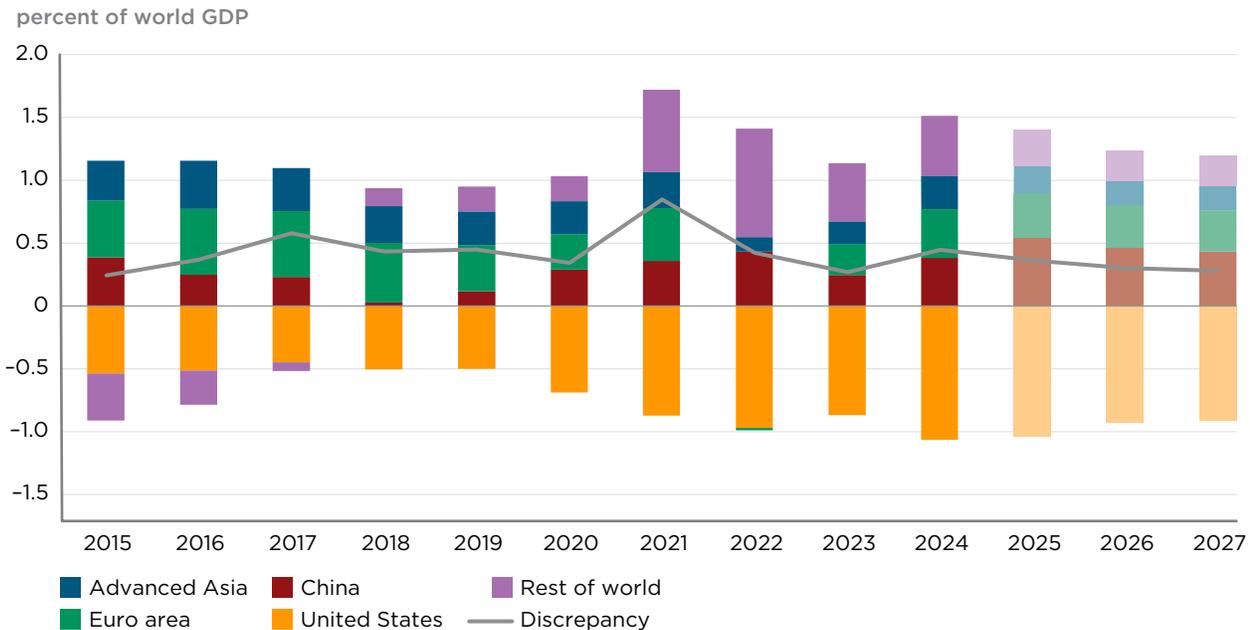
Figure 1 shows the evolution of global imbalances as a ratio to world GDP since 2015 including projections by the International Monetary Fund (IMF) for 2025–27. Five major regions are identified: the United States, which has run deficits throughout the period; China, the euro area, and advanced Asia (the sum of Japan and Korea)⁴ that have run surpluses; and the rest of the world, which after small deficits initially has also run surpluses.

The period from 2015 through 2019 was calm with steady growth, low inflation, and modestly narrowing imbalances in most economies. The COVID pandemic caused notable economic disruptions in 2020–22. After reaching a nadir before the pandemic, imbalances have been widening again, driven by growing deficits in the United States and surpluses in China. The proximate causes of these moves have been relatively looser fiscal policy in the United States and the collapse of a property bubble in China. Surpluses in the euro area and advanced Asia are down a bit from their mid-2010s highs. The net surplus in the rest of the world soared during the COVID pandemic and has lately returned close to its immediate pre-COVID level.⁵ Since 2018, the United States has been the sole large deficit counterpart to surpluses in many other regions.

The paler bars in figure 1 show that the IMF projects a narrowing of imbalances over the next two years, a view shared by most private forecasters

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- 1 Empirical studies find that tariffs cause a country's currency to appreciate with little impact on its trade balance (Furceri et al. 2019). Although foreign currency manipulation has contributed to past US deficits and the large US fiscal deficit is contributing to recent trade deficits, a larger and more persistent driver of deficits has been the attractiveness of US financial assets to global investors (Bayoumi and Gagnon 2025).
 - 2 David Autor and Gordon Hanson, "We Warned about the First China shock. The Next One Will Be Worse," *New York Times*, July 14, 2025.
 - 3 See Obstfeld (forthcoming) for a historical review of global imbalances and their economic and political impacts.
 - 4 Singapore and Taiwan have even larger surpluses in relation to their (much smaller) GDPs, but they are less exposed to direct competition from China.
 - 5 Some of the rest of world pattern may reflect measurement error, as indicated by the rising and falling global current account discrepancy.

Figure 1
Global current account imbalances, 2015–27



Note: Projections are shown in paler colors.

Source: IMF *World Economic Outlook*, October 2025.

at the time of the IMF forecast (*Consensus Forecasts*, November 2025).⁶ We disagree. Forces are in place to propel an even larger Chinese surplus this year and beyond. If US growth—currently supported by a boom in artificial intelligence (AI) investment—persists, the US deficit is likely to remain roughly as wide as in 2025. In contrast to the recent past, however, most of the widening in China’s surplus is likely to come from reduced surpluses in the other regions. Europe and advanced Asia are especially vulnerable to China’s move out of low-tech manufactures into medium- and high-tech goods such as automobiles, exacerbating existing trade tensions. The most contentious scenario would occur if the AI bubble bursts and the United States falls into recession. In that case, the US deficit would shrink, causing a global deflationary shock and a sharp rise in trade tensions.

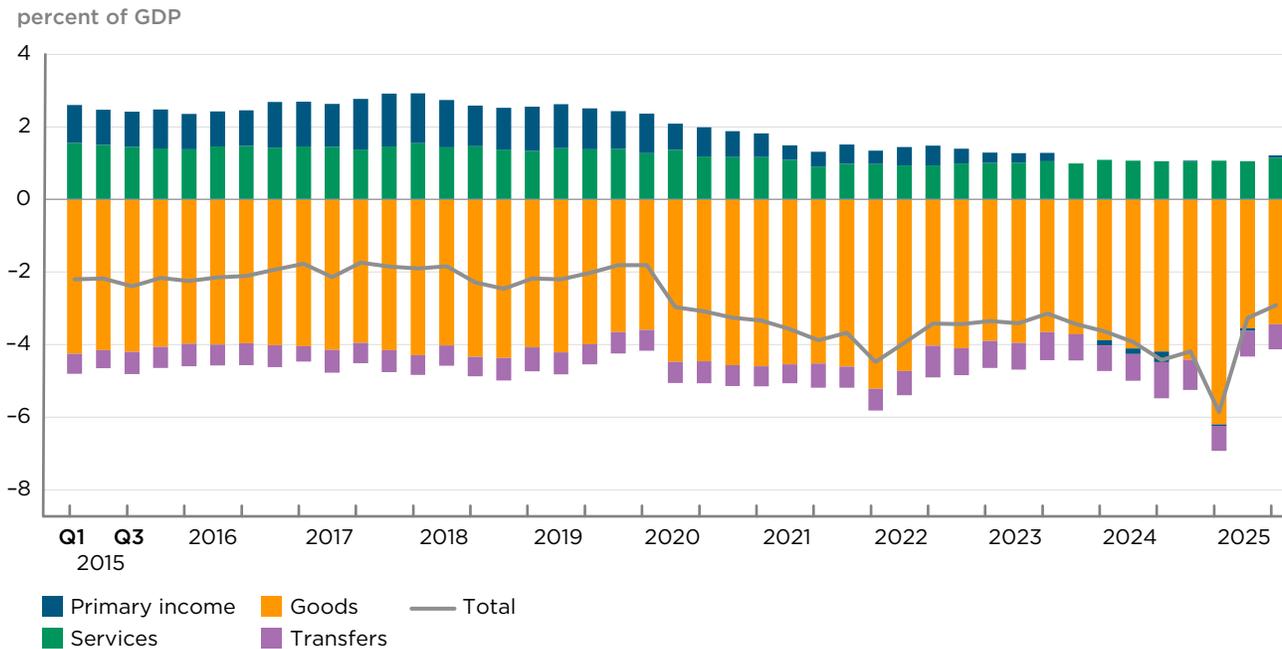
RECENT DEVELOPMENTS

Current Accounts

Since 2019, the US current account (CA) deficit has widened, first because of a surge of goods imports during the COVID pandemic, and then, after that subsided, because of rising interest rates on US debt held by foreigners that

6 To be specific, forecasters had expected China’s surplus and the US deficit to shrink, with roughly stable surpluses in the euro area and advanced Asia. As of January 2026, *Consensus Forecasts* still projects a narrowing of the US deficit but little change in any of the main surpluses and thus a growing global current account discrepancy.

Figure 2
US current account and components, 2015Q1-2025Q3



Source: US Bureau of Economic Analysis.

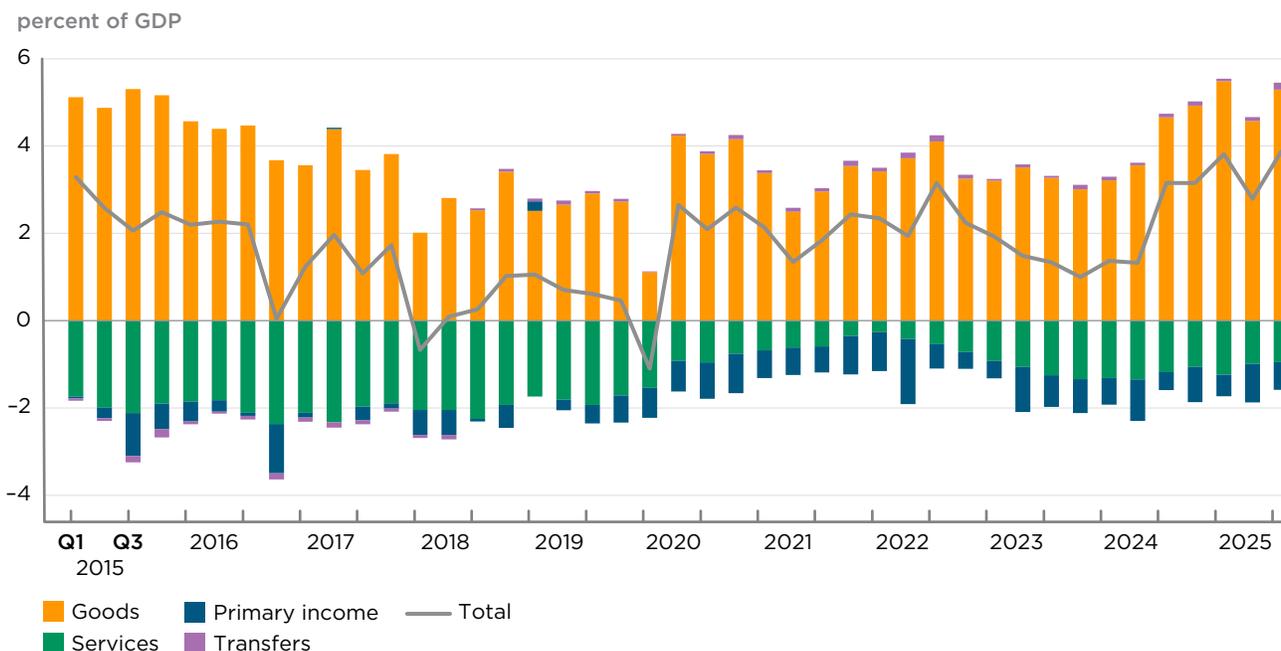
reduced the income balance (figure 2).⁷ The election of President Trump sparked a surge in goods imports in 2025Q1 to beat the anticipated higher tariffs. Goods imports then plummeted in Q2 and remained weak in Q3. It is not yet clear how much the narrowing of the goods deficit reflects temporary payback from the Q1 blowout versus a persistent drag from the tariffs, or even underreporting of imports to evade tariffs.⁸ The other components of the CA, services and transfers, have been remarkably stable.

The Chinese surplus increased during the COVID pandemic, reflecting China’s position as a key supplier of the consumer durables that boomed in those years (figure 3). After some retrenchment in 2023, China’s surplus began to grow again in 2024 and has surged to a new record (in US dollars) in 2025. One driver is the ongoing real estate slump that has reduced demand in China for traditional industries such as cement, steel, and home appliances, enabling a large shift into exports. Another is rising competitiveness in new industries (such as lithium batteries, electric vehicles, robots, and solar panels) driven by the “Made in China

7 For a deeper discussion of recent developments in the US current account balance, see Milesi-Ferretti (forthcoming).

8 Comparison of Chinese data on exports to the United States with US data on imports from China suggests that US importers began underreporting imports to evade tariffs soon after the initial increase of tariffs in 2018 (Clark and Wong 2021, Clark 2025). The gap between the two measures widened further after tariffs were raised again in 2025 according to data from the China General Administration of Customs and the US Census Bureau. Underreporting may be spreading to imports from other countries, as tariffs were raised against all countries in 2025.

Figure 3
Chinese current account and components, 2015Q1-2025Q3



Source: Macrobond.

2025” policy vision have boosted exports in these sectors. Yet another factor has been policy actions aimed at reducing China’s dependence on imported intermediate goods in its production processes.⁹

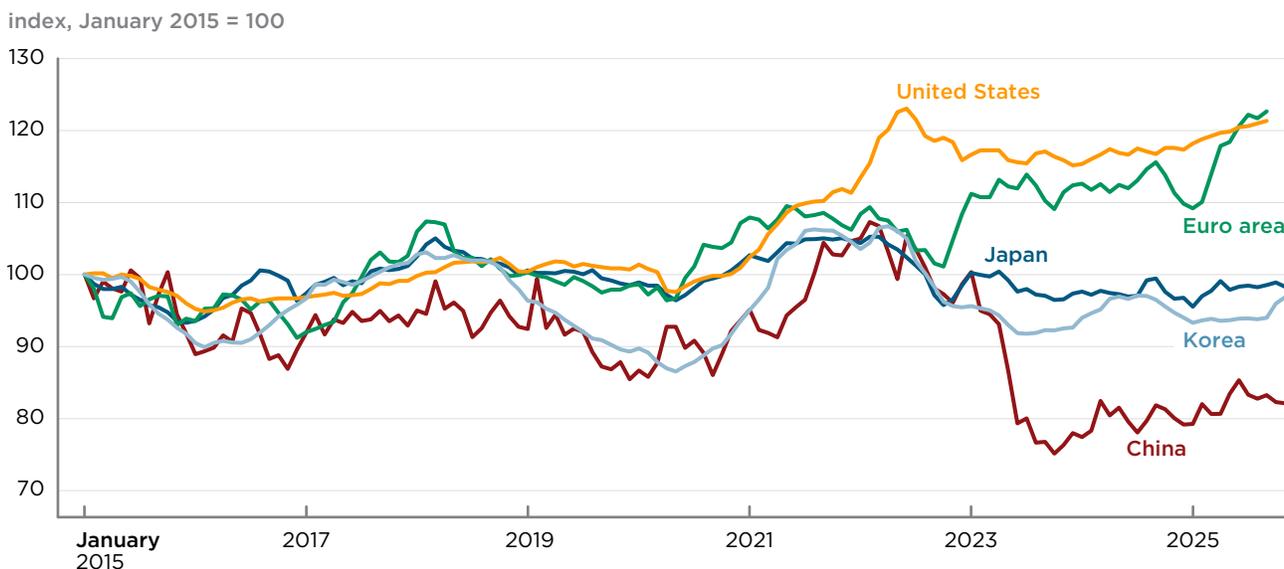
Excess capacity and slumping domestic demand have sparked a vicious internal price war in China, sometimes referred to by officials as “involution.” Falling domestic producer prices have fed through to falling export prices (figure 4). Between January 2015 and October 2025, Chinese manufactured export prices fell more than 30 percent relative to US and euro area manufactured export prices, and more than 15 percent relative to Japanese and Korean export prices. Moreover, as discussed below, export price indexes likely understate the true deflationary impact of China’s move into new product lines. Quality-adjusted prices for most Chinese goods are much lower than those produced elsewhere. This does not appear to reflect Chinese dumping of excess capacity into other markets at a lower price than that which prevails in China. Rather, prices in China are extremely low by global standards.¹⁰

Table 1 provides a glimpse of China’s incredible competitiveness in a key market, passenger cars. For each of the first four models shown, retail prices in China (excluding tax) are lower than in the other three markets, with the sole

9 For some color on China’s growing trade surplus, see Michael Hirson and Houze Song, “China’s Export Dominance: A Sign of Both Economic Strength and Weakness,” Econofact, January 15, 2026. Academics are only beginning to pay attention. See also Richard Baldwin, “China’s Globalisation Paradox,” Substack, November 26, 2025.

10 For more on the relatively low level of prices in China, including for tradable goods, see Chen, Yu, and Guo (2025).

Figure 4
Manufactured export price indexes in US dollars, 2015–25



Note: Euro area index is producer price index for nondomestic (extra-area) sales of total industry excluding construction and energy. Japan index is corporate sector export price. Korea index is export price excluding food and energy.
 Sources: National sources via Macrobond and authors' calculations.

Table 1
Retail automobile prices, 2025^a

Model	China	United States	Germany	Japan
<i>Battery electric vehicles</i>				
BYD Atto 3	15,940	29,990 ^b	34,832	24,438
Tesla Y LR AWD	44,342	48,990	52,654	37,983
<i>Plug-in hybrid vehicles</i>				
Volvo XC90	33,777 ^c	62,345	86,746	75,894
<i>Internal combustion vehicles</i>				
VW Tiguan	19,000	30,805	52,054	28,569
Chery Tiggo 5X	12,300	n.a.	n.a.	n.a.

n.a. = not applicable

a. All prices are advertised or manufacturers' list prices in US dollars for base models except the Tesla Y. Prices exclude taxes and destination fees. Websites were accessed on December 4 and 8, 2025. Some prices are based on news articles from earlier in 2025. Local prices are converted by December 4 exchange rates.

b. BYD does not sell in the United States. Price is for the comparably sized but lower featured Nissan Leaf.

c. Price is for the Lynk & Co 09 based on the Volvo XC90 platform and with similar features. Both Lynk & Co and Volvo are owned by Chinese automaker Geely.

Sources: Authors' calculations based on data from automaker websites plus insideevs.com, carnewschina.com, Edmunds.com, hzyungecar.en.made-in-china.com, autogermania.com, goo-net-exchange.com, and Alibaba.com.

exception of the Tesla in Japan.¹¹ In some cases, prices in China are less than half of those in other markets. The differences across markets are smallest for Tesla, which conveniently lists retail prices for all models in all major markets on its website. Doubtless, Tesla feels constrained about showing large differences in price across markets. But the upshot is that it is rapidly losing market share in China, with October 2025 sales down 36 percent from a year earlier despite a growing overall market.¹² Even Volkswagen, which is willing to discount heavily in China (but does not list Chinese prices on its website), saw a decline in its share of the Chinese car market from 14.5 percent in 2023 to 12.5 percent in 2024 (Volkswagen, *Annual Report 2024*). Foreign brands have seen their share of the Chinese auto market collapse from 62 percent in 2020 to 35 percent in 2024.¹³ Moreover, the pressure to cut prices is even stronger for smaller Chinese carmakers that have not established a global presence, as evidenced by the supercompetitive price of the Chery Tiggo 5X, which competes with the VW Tiguan but is not sold in advanced economies.

Figure 5 documents China's growing domination of the global motor vehicle industry. China's rise has come mainly at the expense of European production, but North America and advanced Asia have also lost share, and emerging markets (the bulk of the rest of the world) are starting to lose share as well. What the figure does not show is that China is rapidly moving into new product categories such as electric vehicles and sport utility vehicles including at the luxury end, with new technology features that Western models often lack.¹⁴ Chinese exporters have also been nimble, rapidly switching to hybrid models in response to European tariffs on fully electric vehicles.¹⁵

When firms introduce new products at a very low price, there is no direct impact on official measures of the price level. This is because such price indexes are built using changes in prices from the previous period. If a good was not sold previously, there is no change in its price and thus no effect on the price index. Cheap new products can lower measured price indexes only indirectly by inducing existing producers to lower their prices.¹⁶

Figure 6 provides a stylized example of the introduction of new car models to the Chinese car market and the implications for the price index of Chinese cars. The left panel shows that new cars are introduced in period 1 at a very low price for similar features and quality as existing cars. As the new cars grab market share, existing producers lower their prices but have only limited room to do so given their existing cost structure. New producers, which may make losses initially, gradually raise their prices. The right panel shows that the measured car price index changes little, as declines in the prices of existing cars are offset by increases in the prices of new cars. The measured ("chained") price

11 Japan's generally lower prices than in Germany or the United States almost surely reflects the current weakness of the yen and lower inflation in Japan, both of which pushed Japan's real effective exchange rate down 50 percent since 2011 (BIS narrow real index).

12 Reuters, "Tesla's China Sales Fall to 3-Year Low amid Tepid Demand," November 10, 2025.

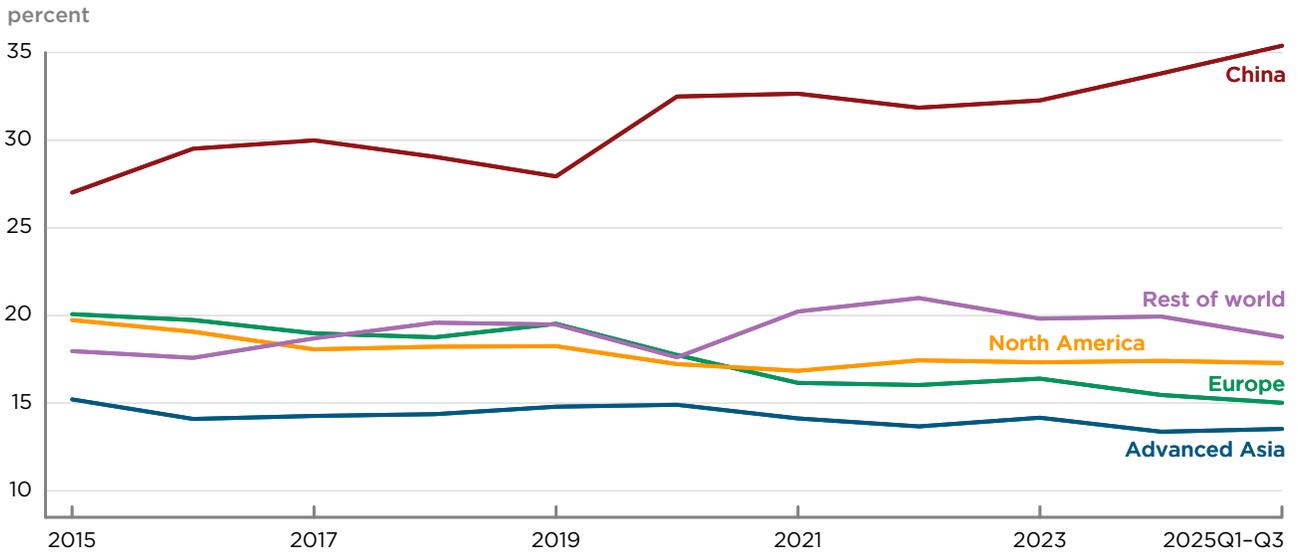
13 *Economist*, "Foreign Carmakers in China: Changing Lanes," December 6, 2025.

14 *Economist*, "Foreign Carmakers in China."

15 *Economist*, "How Chinese Cars Are Beating European Tariffs," December 18, 2025.

16 Feenstra (1994) describes how the introduction of new products causes measured US import prices to be overstated.

Figure 5
Shares of world motor vehicle production, 2015–2025Q3

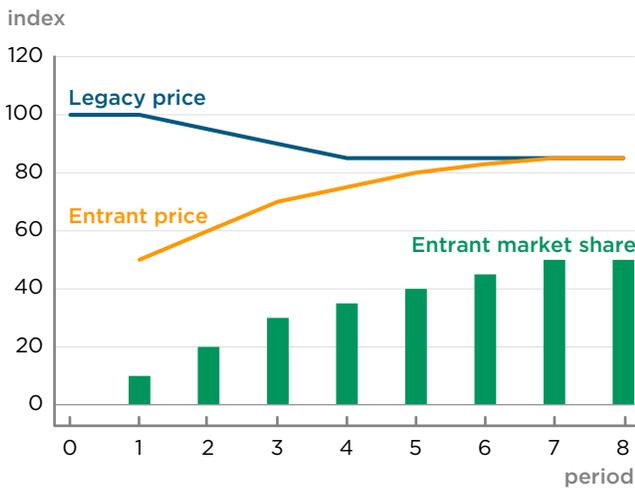


Note: North America is Canada, the United States, and Mexico. Europe is the European Union plus the United Kingdom. Advanced Asia is Japan plus Korea. Motor vehicles include passenger cars, trucks, and buses but exclude motorcycles and off-road vehicles.

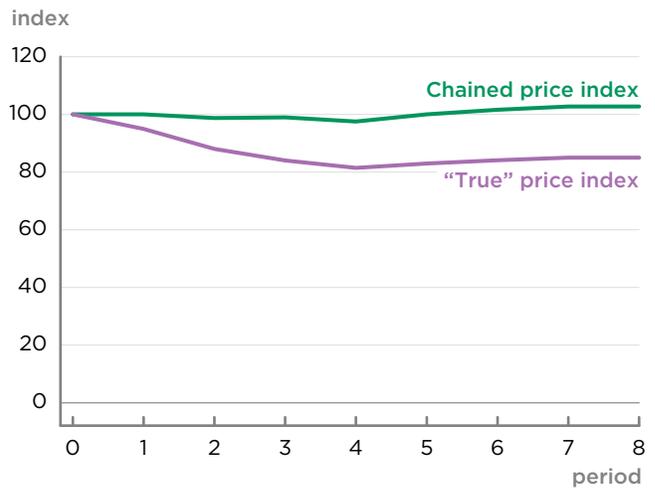
Source: International Organization of Motor Vehicle Manufacturers.

Figure 6
New products understate deflationary pressure

a. Stylized China car market



b. Alternative car price indexes



Source: Authors' illustration.

index completely misses the massive deflation in the true price of cars faced by consumers.¹⁷ Because China is exporting many new products in recent years, its measured export price index misses a potentially large part of the true fall in China's export prices.

Although Chinese balance of payments (BOP) data report record-breaking surges in the dollar trade and current account surpluses in 2025, some have argued that the true surplus is even higher (Setser 2025). Beginning with China's implementation of version 6 of the IMF's *Balance of Payments Manual* in 2015, and especially after the switch to a new survey of trading firms in 2022, the gap between Customs and BOP surpluses has widened and become much more volatile. Whether there is an understatement in the BOP data is difficult to ascertain, however, in part because increases in the Chinese VAT rebate on exports since 2017 may have led to a growing overstatement of Customs exports (Liu and Guo 2024, Ma and Wei 2025). A separate reason to believe that China's overall CA surplus is understated is the fact that China's income balance (figure 3) has remained stable and negative in recent years despite a growing positive net international investment position (NIIP) in an environment of rising interest rates. Box 1.1 of the IMF's 2025 *External Sector Report* draws attention to this puzzling anomaly and calls for improvements in Chinese data reporting in this area (see also Ma and Wei 2025).

Figures 7 and 8 show the composition of the current account as a percentage of GDP for two other major surplus regions, the euro area and advanced Asia. Both show major deteriorations in the current account and balance on goods near the end of the COVID pandemic and a subsequent recovery to around prepandemic levels.

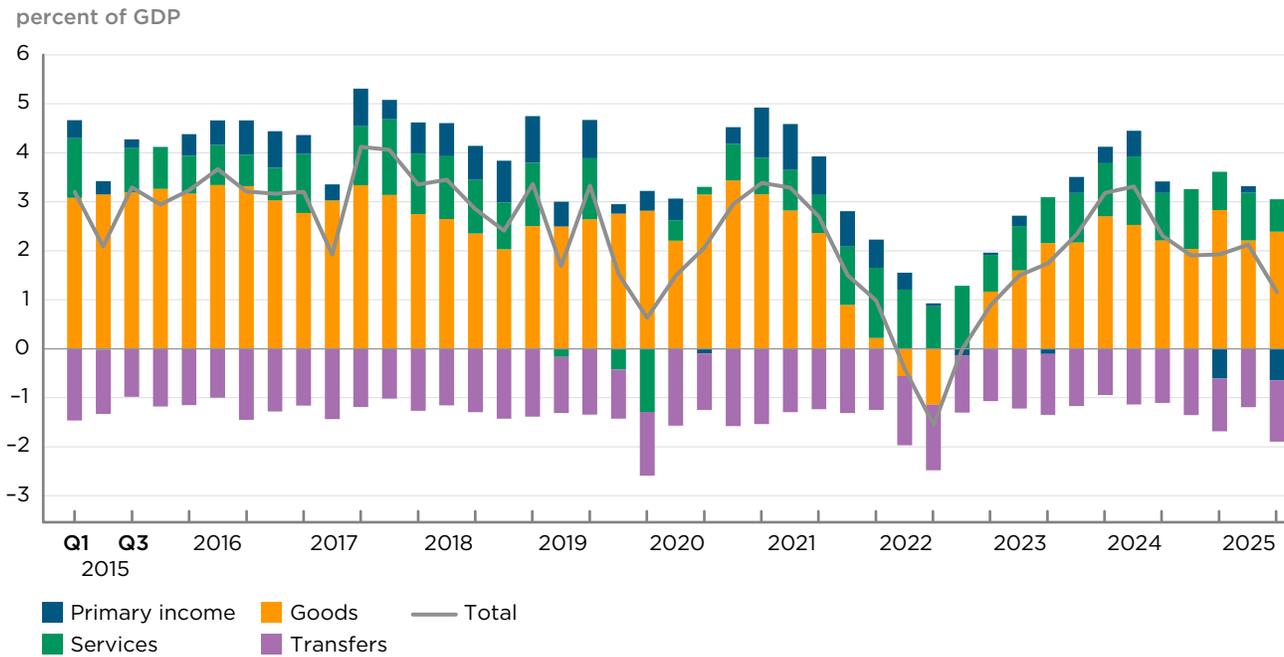
The global picture is shown in table 2, which reports the change in the current account and its main components between 2019 (the last year before the COVID pandemic) and 2024 as a percent of global GDP. Over this period the Chinese surplus on goods trade rose by $\frac{1}{4}$ percent of world GDP, offset by declines in all other regions (including the rest of the world, calculated residually).¹⁸ These declines largely follow relative GDP, being largest in the United States, followed by the euro area, the rest of the world, and then advanced Asia, consistent with the view that Chinese goods exports have a general competitive advantage versus other countries.

The pattern for global current accounts, however, is radically different. The decline in the US current account is many times larger than the change in the goods balance due to a major deterioration in net income from assets. Given the large negative US net international investment position and the rise of global interest rates over this period, a large decline in the US income balance is not surprising. What is surprising is that none of the massive deterioration is offset in the aggregate position of the euro area, China, and advanced Asia, even though

17 The "true" price index is a sales-weighted average of the price of existing and new cars, which is correct if both car groups have identical quality and features. The theory behind measured price indexes assumes that prices for products of identical quality are always equal in each period and thus cannot deal with periods of disequilibrium as consumers learn about new products.

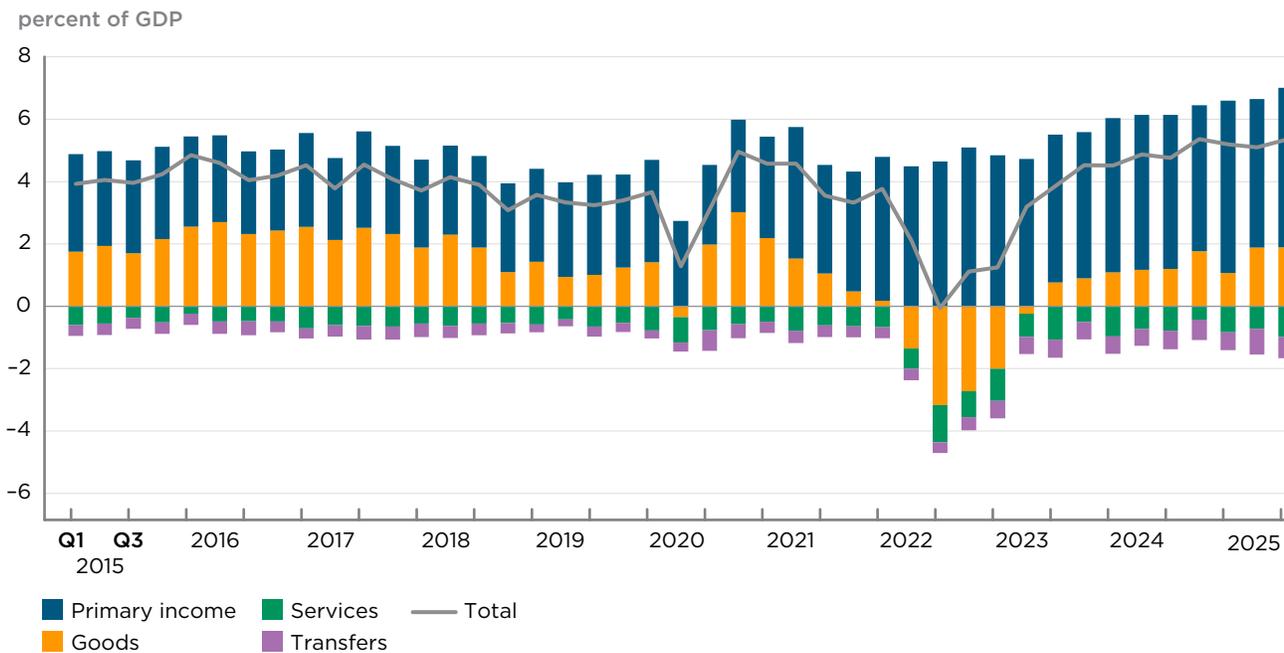
18 The residual is the negative of the sum of the values for the identified regions. Because of potential statistical errors in US, Chinese, euro area, and advanced Asian data, the residuals cannot be assumed to equal data for the rest of the world.

Figure 7
Euro area current account and components, 2015Q1-2025Q3



Source: Macrobond.

Figure 8
Advanced Asia current account and components, 2015Q1-2025Q3



Note: Advanced Asia comprises Japan and Korea.

Source: Macrobond.

Table 2
Change in the current account and components, 2019–24 (percent of world GDP)

Economy	Goods	Services	Income	Transfers	Current account
United States	-0.12	-0.06	-0.32	-0.07	-0.57
China	0.25	0.09	-0.07	0	0.27
Euro area	-0.05	0.10	-0.05	0.02	0.01
Advanced Asia	-0.02	0	0.02	-0.01	0
Rest of world + residual	-0.05	-0.13	0.42	0.06	0.29

Sources: Macrobond and IMF.

they have positive net investment positions. Rather, there is a large increase in the residual “rest of the world.” Because the rest of the world represents only 37 percent of 2024 world GDP and a much lower proportion of equity and bond markets, the residual almost surely is dominated by errors in the data of the main identified regions, often involving transactions with tax havens that are included in the rest of the world. These tax havens mainly recycle funds back into the United States, Europe, and advanced Asia, and are not a significant net borrower or lender of assets in their own right but have strong incentives to obscure the ultimate source of funds.

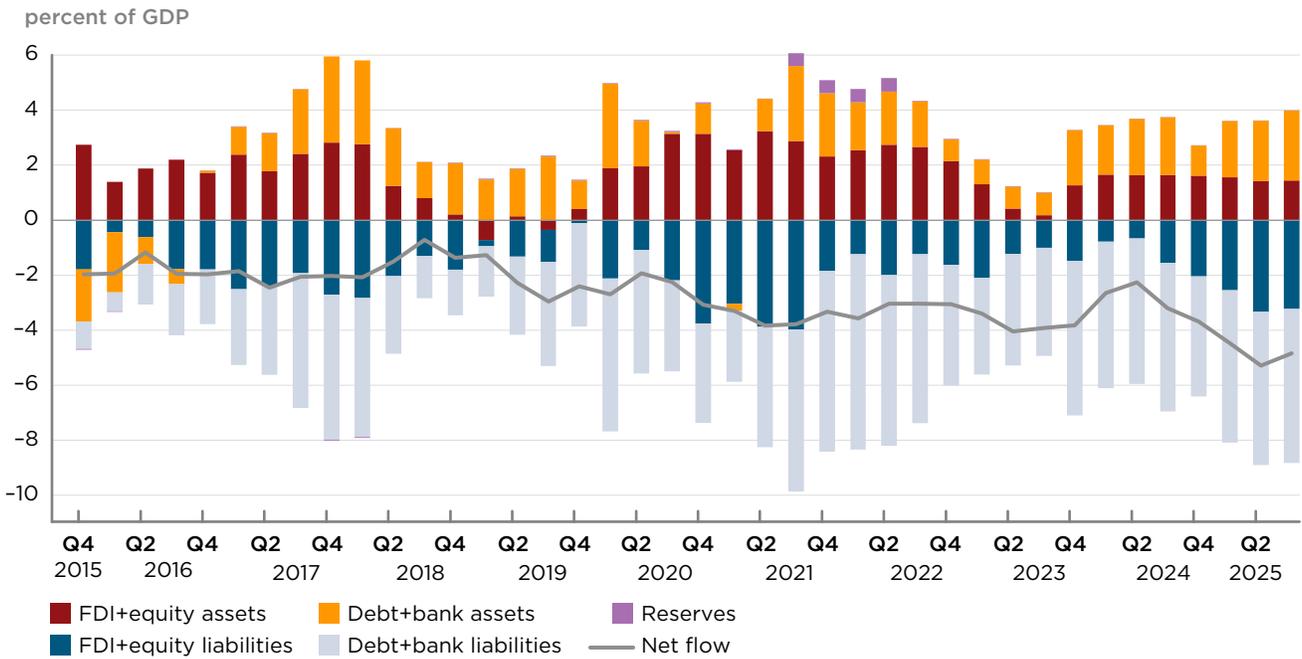
International Financial Flows

The counterpart to these current account surpluses and deficits are (net) financing flows. Figure 9 shows the US financial account since 2015 as well as its components, comprising flows of equity assets (the sum of foreign direct investment, FDI, and portfolio equity flows), debt assets (the sum of portfolio debt and other flows, which are basically bank transactions), the corresponding flows in liabilities, as well as changes in reserves. Since the data are more volatile than those in the current account, they are reported as four-quarter moving averages and are measured such that a negative value implies an increase in liabilities.

The US financial account has been in deficit throughout the period, with a surge since early 2024 that has been driven by growing flows of equity liabilities. This increase in equity liabilities coincides with the AI boom in values of US technology companies, plausibly suggesting that the rest of the world has been investing in these companies. Such inflows make sense, as no other country has as large a technology industry, making US markets a magnet for those wishing to participate in the AI sector. It also follows the typical pattern in which increases in the US current account deficit are largely financed by private inflows (Bayoumi and Gagnon 2025).

Figure 10 shows the equivalent data for China. The financial surplus has been rising since before the COVID pandemic. It reflects the ending of accumulation of Chinese assets (especially FDI assets) by other countries despite the boom in

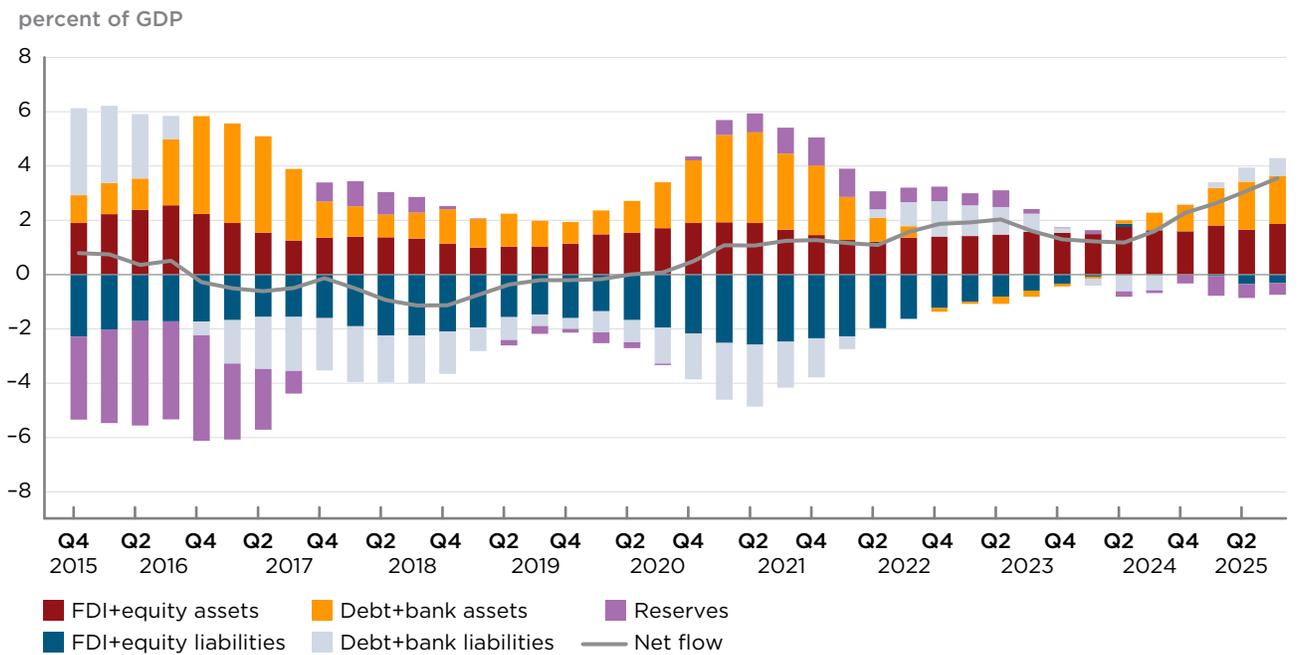
Figure 9
US external financing and components (4-quarter moving average), 2015Q4–2025Q3



FDI = foreign direct investment

Source: Macrobond.

Figure 10
Chinese external financing and components (4-quarter moving average), 2015Q4–2025Q3



Source: Macrobond.

local markets, as the Chinese economy changed from being seen as a strategic partner in the global economy to a geopolitical rival.¹⁹ Two further features of the Chinese data stand out. The first is that the financial account is in approximate balance from 2015 through 2020 even though the current account was in surplus, suggesting that the data are missing significant capital flight (the current and financial accounts are much more consistent recently).²⁰ The second is the dramatic run-up in debt assets and rundown in debt liabilities in 2015 and 2016 which was offset by major reserve asset sales. By contrast, in recent years the fall in inflows from rest of the world has not been offset by reserve asset sales, leading to significant net financial outflows that correspond to the rising CA surplus. Equivalent graphs for the euro area and advanced Asia (not included for the sake of brevity) show relatively stable financial flows despite some fluctuations over the COVID pandemic.

Table 3 shows the global picture for financing flows, comprising FDI, portfolio equity, portfolio debt (including reserves), and bank flows, again measured as a change in the percent of world GDP from 2019–24. The importance of net portfolio equity inflows in financing the deterioration in the US current account is apparent. Indeed, at almost ½ percentage point of world GDP, the increase in these inflows is larger than the deterioration in the overall US financial balance, with a significant offset from greater net outflows of FDI. Increased portfolio equity outflows from China, advanced Asia, and the euro area largely account for higher US inflows. The other main contributor to the deteriorating current account is portfolio debt flows (including reserves). None of the higher US inflows in this category are accounted for by the other main regions, which also show higher net inflows in the aggregate, leaving a large residual portion that likely reflects difficulties in identifying flows, particularly those going through tax havens.²¹ In contrast, the residual is small for changes in bank flows, plausibly reflecting better tracking including through “know your customer” regulations and reporting requirements.

Table 4 reports the equivalent data on change in the net international investment position for the same asset categories. There is a large deterioration in the US FDI position that has only small offsets in other major regions. In this case the issue lies with the US data. The US Bureau of Economic Analysis assumes that the value of FDI liabilities rises in line with the overall US equity market, but over the last few years the overperformance of US equities has come from a handful of technology firms, a sector that is notably lacking in foreign-owned operations (Bayoumi and Gagnon 2025). Consequently, the rapid increase

19 Although inflows remained moribund through 2025Q3, some Chinese market participants claim there is renewed interest lately by foreigners in Chinese equities, perhaps related to the strong performance of Chinese equity price over recent months. We expect any such inflows will be small relative to growing outflows.

20 A recent paper shows that Chinese portfolio equity liabilities held through offshore tax havens are understated by about \$1 trillion (Coppola et al. 2020). However, the discrepancy between the current account and the financial account suggests that there is an even larger understatement of Chinese overseas assets.

21 Barth et al. (2025) provide a detailed exploration of missing data on foreign holdings of US Treasury securities through the Cayman Islands.

Table 3
Change in net financial flows, 2019–24 (percent of world GDP)

Economy	Foreign direct investment	Portfolio equity	Portfolio debt and reserves	Bank flows	Financial balance
United States	0.25	-0.44	-0.15	-0.05	-0.39
China	0.20	0.15	0.05	0.02	0.42
Euro area	0.07	0.16	-0.08	0.01	0.16
Advanced Asia	-0.08	0.08	-0.07	0.07	0.01
Rest of world + residual	-0.44	0.05	0.25	-0.05	-0.19

Sources: Macrobond and IMF.

Table 4
Change in net investment position, 2019–24 (percent of world GDP)

Economy	Foreign direct investment	Portfolio equity	Portfolio debt and reserves	Bank claims	Net international investment position
United States	-1.93	-3.17	0.60	-0.60	-5.11
China	0.29	0.44	-0.41	0.07	0.40
Euro area	0.16	1.19	0.39	0.69	2.42
Advanced Asia	0.14	0.42	-0.95	0.07	-0.32
Rest of world + residual	1.34	1.11	0.37	-0.22	2.61

Sources: IMF and US Bureau of Economic Analysis.

in the reported value of US FDI liabilities and the associated increase in residual FDI assets are largely illusory.

The 3¼ percent of world GDP decline in US net portfolio equity, on the other hand, is not illusory, as US equity market prices have risen much faster than rivals. Over half of the fall is offset by increases elsewhere, largely in the euro area. This broadly corresponds to the bilateral holdings of US equities as reported by the IMF's Portfolio Investment Positions by Counterpart Economy dataset (PIP, formerly called the Coordinated Portfolio Investment Survey), which reports that in 2024 the euro area held around one-third of US equity liabilities, advanced Asia a further 10 percent, and China a meager 1.6 percent.²² The rapid increases in reported holdings in recent years is fully consistent with the regions participating

²² These data, which report bilateral positions for US liabilities based on counterparty data (e.g., the German position in the United States is measured using German data), amount to around four-fifths of portfolio equity liabilities as reported by the United States.

in the AI equity market boom, although the limited offset to the decline in the US net portfolio equity position coming from them again suggests an issue with assigning ultimate ownership of assets (around 15 percent of the PIP equity assets are assigned to the Cayman Islands alone).

The changes in the net asset positions with respect to portfolio debt (including reserves) and to bank claims are smaller, reflecting the more limited price changes of these assets compared to equity. For banks the movements across the major regions largely cancel out, repeating the pattern seen for flows and reinforcing the view that these assets are relatively well measured in the data.

MACROECONOMIC IMBALANCES

The macroeconomic environment is close to a full-employment equilibrium in the United States, the euro area, and advanced Asia. China is suffering from a deflationary loss of demand owing to the collapse of the property bubble.

In the United States, the unemployment rate is close to most estimates of sustainable full employment and the IMF estimates that output is at potential. Figure 11 shows that inflation, which had been gradually approaching the Federal Reserve's target of 2 percent from its COVID-era highs, stalled out near 3 percent in 2025 primarily because of the increase in import tariffs.²³ But US inflation is widely expected to resume drifting down in 2026 (*Consensus Forecasts*, January 2026).

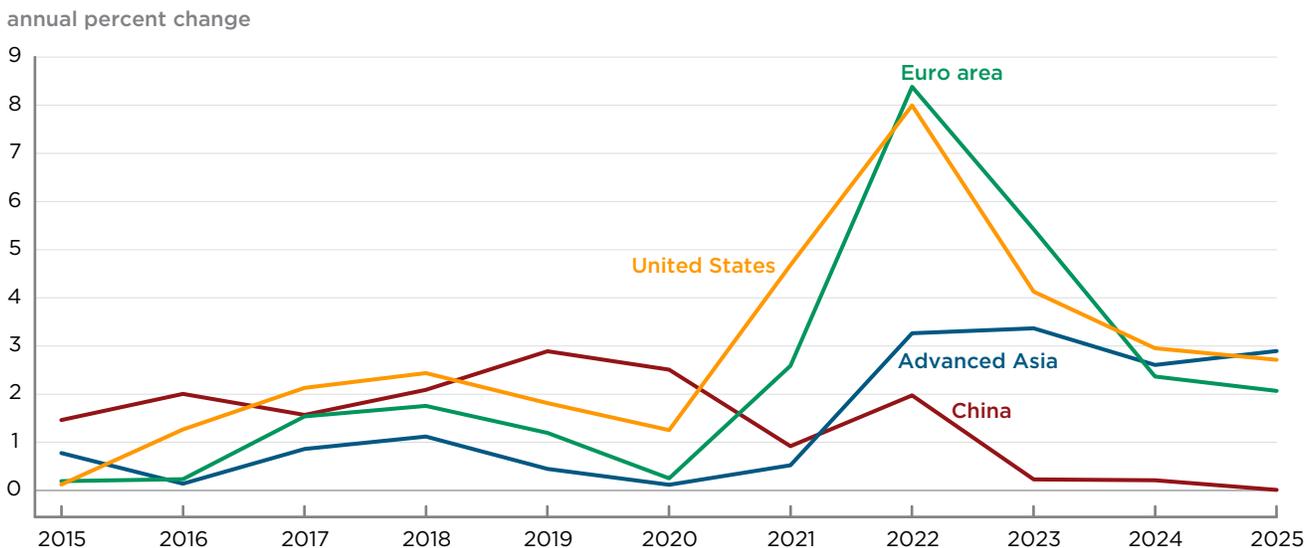
In terms of the US balance between saving and investment, which is the domestic counterpart to the external (CA) balance, falling investment in most sectors has been offset by the rise in AI-related investment. As shown in table 5, the fiscal deficit is notably larger than its pre-COVID level, whereas private saving is down only slightly. The net effect has been nearly unchanged gross investment and a decline in gross saving, consistent with the increased CA deficit.

In the euro area, there are notable divergences between member economies, with Spain performing strongly and Germany weakening noticeably. Overall, however, the unemployment rate is close to estimates of sustainable full employment and the IMF estimates that GDP is only 0.3 percent below potential. Inflation is now close to the European Central Bank's 2 percent target. Investment is down about a percentage point from its pre-COVID level (table 5). Saving is down by almost the same amount, as a much larger fiscal deficit is partially offset by higher private saving. The net effect is little change to the CA balance.

There are modest divergences within advanced Asia. The IMF estimates that Japanese output is 0.3 percent above potential, which, along with a very weak exchange rate, is keeping inflation moderately above its 2 percent target. But inflation is widely expected to decline sharply in 2026 (*Consensus Forecasts*, January 2026). Korean GDP, on the other hand, is estimated to be 1.1 percent below potential and inflation is at its 2 percent target. For the two economies together, output is close to potential and inflation expected to return to target. Gross investment and private saving have changed little since before COVID, but

23 Economists at Goldman Sachs estimate that tariffs contributed 0.5 percentage point to US inflation in 2025 (Walker 2026).

Figure 11
Consumer price inflation, 2015–25



Note: 2025 data are estimates.

Source: IMF *World Economic Outlook* database, October 2025.

the fiscal deficit is smaller, resulting in a modest increase in overall saving and the CA balance.²⁴

It is more difficult to gauge the macroeconomic environment in China. The unemployment rate does not fluctuate much, in part because urban workers from rural areas return to their hometowns during slumps, causing them to drop out of the statistics. The IMF does not publish an output gap for China. But real estate investment has fallen more than 50 percent from its pre-COVID level (table 5) and inflation fell far below its original 3 percent (now 2 percent) target (figure 11).²⁵ Experience shows that when a country's inflation rate falls to near zero for more than a few months, especially if inflation averaged around or above 2 percent for many years previously, it is a clear sign of weak aggregate demand and economic slack.²⁶

Gross investment in China is down nearly 4 percent of GDP (table 5), as a policy-directed surge in industrial investment only partly offset the slump in property investment (figure 12). Total profits in the manufacturing sector are back to their 2015 level despite a 75 percent increase in manufacturing

24 Despite the increase in the CA as a percent of advanced Asian GDP, the weakening of the yen and faster growth in the rest of the world imply that the CA has declined as a percent of world GDP, as shown in figure 1.

25 The People's Bank of China lowered its inflation target to 2 percent in 2025 after undershooting the previous target for five years. See Bloomberg News, "China May Struggle to Hit Inflation Target Even After Cutting It," March 4, 2025.

26 In the presence of downward nominal wage and price rigidity and dispersion across individual wage and price changes, very high levels of unemployment are required to push overall inflation rates close to zero (Daly and Hobijn 2014, Gagnon and Sarsenbayev 2022).

Table 5
Saving and Investment, 2019 and 2025 (percent of GDP)

Country	Measure	2019	2025	Change, 2019–25
United States	Investment	21.7	21.4	-0.3
	<i>of which, dwellings</i>	3.8	3.9	0.1
	Saving	19.3	17.3	-2.1
	Fiscal balance	-5.8	-7.4	-1.6
	Saving ex. fiscal	25.1	24.6	-0.5
China	Investment	42.6	38.8	-3.8
	<i>of which, real estate</i>	13.1	5.9	-7.2
	Saving	43.3	42.1	-1.2
	Fiscal balance	-6.0	-8.6	-2.6
	Saving ex. fiscal	49.3	50.7	1.3
Euro area	Investment	22.4	21.5	-0.9
	<i>of which, dwellings</i>	5.5	5.6	0.1
	Saving	25.4	24.7	-0.7
	Fiscal balance	-0.5	-3.2	-2.6
	Saving ex. fiscal	26.0	27.9	1.9
Advanced Asia	Investment	27.2	27.4	0.3
	<i>of which, dwellings</i>	4.6	4.2	-0.4
	Saving	30.5	31.6	1.1
	Fiscal balance	-2.2	-1.3	0.8
	Saving ex. fiscal	32.7	32.9	0.2

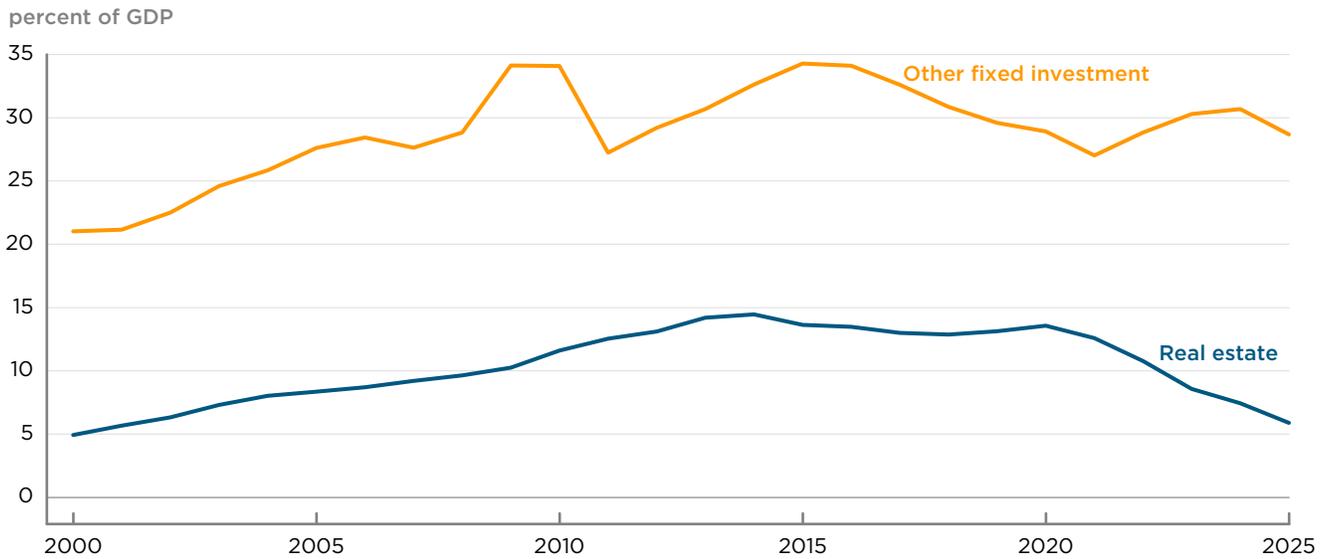
Note: Advanced Asia is Japan plus Korea.

Sources: Investment, saving, and fiscal balance are from IMF; 2025 data are IMF estimates. US, euro area, and Japan dwellings are from OECD via Macrobond; Korea dwellings are from national source via Macrobond. 2025 dwellings data for United States, euro area, and advanced Asia are for Q1–Q3. China real estate is from WIND and includes nonresidential.

value added over the past 10 years, implying a collapse in the rate of return on investment (figure 13). Further declines in manufacturing (and thus non-real estate) investment seem likely.

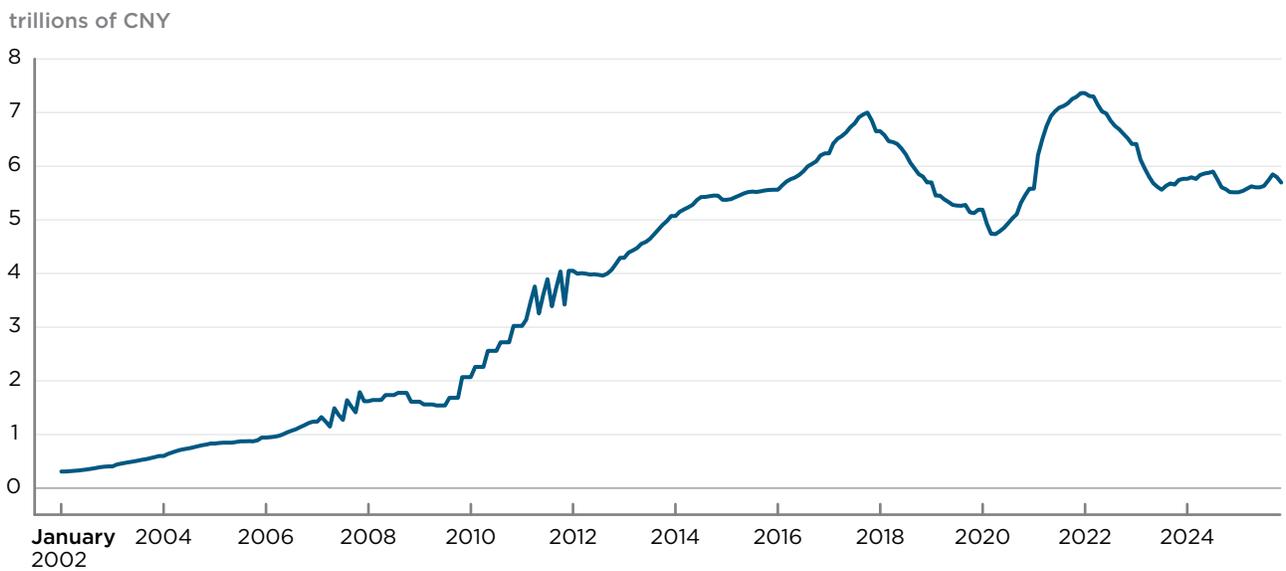
The fiscal deficit surged in recent years, reflecting a loss of revenues from the property sector and some subsidies for industrial investment. Private saving increased in response to falling property prices and plummeting consumer confidence (figure 14). The net effect has been a dramatic widening of China's external surplus.

Figure 12
Fixed investment in China, 2000-25



Sources: IMF, National Bureau of Statistics of China via WIND, and authors' calculations.

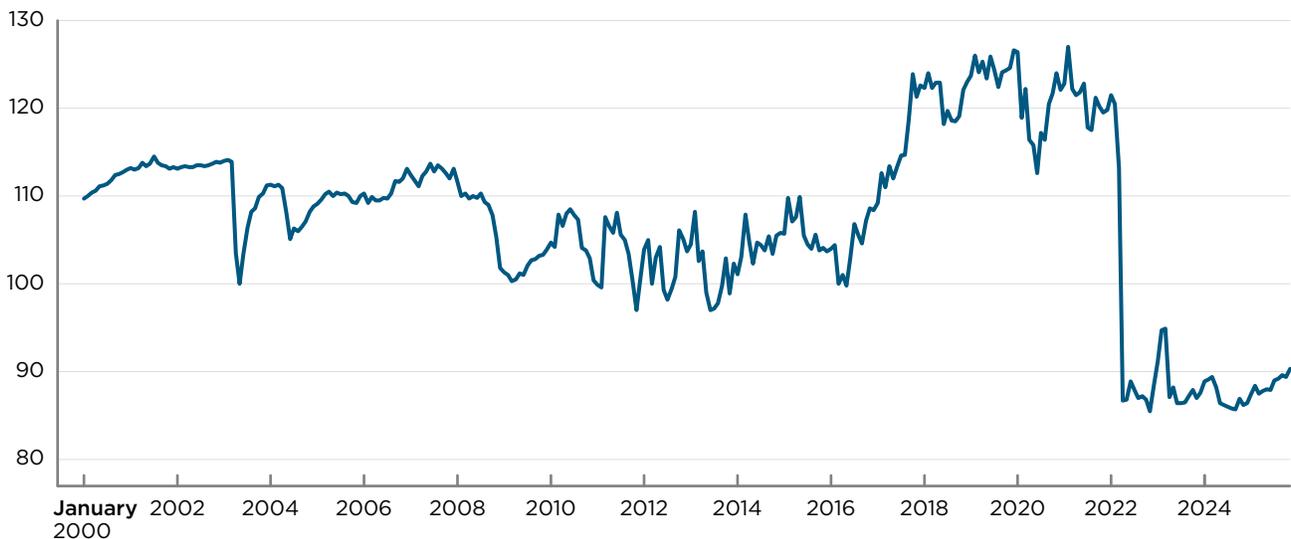
Figure 13
Manufacturing sector profits in China, 12-month totals, January 2002–November 2025



Note: Data are based on firms with at least CNY 20 million in revenue. Data for 2007-11 are quarterly values inserted into one month of each quarter.

Sources: National Bureau of Statistics of China via Macrobond and authors' calculations.

Figure 14

Consumer confidence in China (index), January 2000–November 2025

Source: National Bureau of Statistics of China via Macrobond.

ANALYSIS OF FUTURE PROSPECTS

What is the likely trajectory for global imbalances over the next few years? Prognostication is always difficult; in this case the erratic policies of the Trump administration and the unprecedented nature of the AI boom compound the normal uncertainties.

China's Export Boom

At the core of our analysis is the assumption that the Chinese export boom will continue.²⁷ China is highly competitive in the new products at the heart of the boom. It would take a massive, and highly unlikely, appreciation of the renminbi to put a significant dent in this competitive advantage. In addition, we assume that the economic consequences of China's real estate collapse will continue. There is no sign of a bottom to house prices, and even if prices do stabilize soon, firms and households would still need to repair the damage to their balance sheets, putting a damper on prospects for rising consumption or real estate investment.²⁸ Meanwhile, the sharp decline in the rate of return on manufacturing investment and lower support as the government combats involution by discouraging subsidies in industries with excess capacity suggest that the mini-surge in non-real-estate investment from 2021 through 2024 is over, with likely

27 The ongoing Chinese export boom has attracted widespread attention from economics commentators and the popular press. See, for example, various Substack posts in late 2025 and early 2026 by Richard Baldwin, Paul Krugman, and Robin Brooks. See also Greg Ip, "China's Growth Is Coming at the Rest of the World's Expense," *Wall Street Journal*, December 6, 2025, and Noah Smith, "Why Europe Should Resist the Second China Shock," *Noahpinion*, December 24, 2025.

28 For a somewhat more optimistic take on consumption and investment, see Schipke et al. (2026).

further declines over the next two years on the order of 1 or 2 percent of GDP per year.²⁹ The pattern of overinvestment leading to collapsing profit margins is a classic precursor to economic crashes in fast-growing economies as their rates of potential growth begin to slow.³⁰

The obvious policy response is to boost consumption, and China has long acknowledged the importance of raising consumption. But actions to date, as well as those specified in the latest five-year plan, are woefully inadequate.³¹ Moreover, officials are reluctant to further increase the large fiscal deficit, although they will surely do so if the economy takes a further downward lurch. With limited demand from the domestic side of the economy, the export sector becomes the major driver of growth and the Chinese external surplus will continue to rise rapidly, possibly supported by further explicit or implicit government support through subsidies or other preferences.

How can the additional net financial outflows that come with a rising current account surplus be financed? Fundamentally, China is a high saving economy due to many factors, such as rising longevity and a limited social safety net as well as a demographic imbalance between men and women that has increased the incentives for single men and their families to save to find a marital partner (Ma and Wei 2025). Consequently, capital controls are keeping money from flowing out (Bayoumi and Ohnsorge 2013). Some relaxation of such controls would therefore allow an increase in net outflows, a depreciation in the yuan, and an increase in the current account—particularly as the tensions that have resulted in a collapse in capital inflows seem likely to continue. In this context, it should be noted that the IMF (and the US Treasury) have been advocating that China relax capital controls and float the renminbi for more than a decade. They may soon regret the results of China finally taking their advice.

US AI Boom or Bust?

The most important question on the economic front is the future of the US AI boom. If it continues then it will hold up activity, wealth, and investment, while if it collapses the outlook is for a slump in output and wealth in addition to a major blow to AI firms' capital spending. Given these rather different paths, this paper outlines a scenario in which the AI boom continues and an alternative with an AI bust. These scenarios are intended to illustrate the issues and are not derived from any specific economic or statistical model.

29 It is possible that investment could increase outside of the manufacturing and real estate sectors, for example, if the government launches another deficit-led infrastructure boom. We believe that is likely only as a response to even weaker consumption or investment in other sectors than we assume.

30 Japanese profitability fell before the real estate crash of the early 1990s and growth slowed dramatically in its wake (Ramaswamy 2000, Bayoumi 2000). Similar, if less dramatic, patterns of a domestic boom followed by a slump and slowdown in potential growth were evident in Korea and Thailand.

31 Lardy (2025) and Xu et al. (2025) document the measures China has taken to boost consumption. Nevertheless, the share of consumption in Chinese GDP remains very low compared to that in other countries. The Central Economic Work Conference in December 2025 provided little reason to expect more policy action on consumption in 2026. See, for example, Ernan Cui, "Consumer Support Loses Its Punch," *Gavekal Dragonomics*, January 7, 2026.

Effects of US Tariffs and the Dollar

There are additional uncertainties on the policy side of the equation. A major issue is the impact of US tariffs. It is still unclear how large the hike in tariffs has been, which is compounded by the unpredictable nature of current US policymaking and hence uncertainty about eventual tariff levels.

The average increase in US tariff rates based on presidential announcements in 2025 is about 14 percentage points (CBO 2025, Budget Lab at Yale 2026).³² However, as of October US tariff revenues had increased only 10 percentage points as a share of goods imports from their 2024 levels.³³ The reasons for this shortfall remain unclear. It may be that US Customs has been slow to implement the new rates or that the administration is granting many exemptions beyond those publicly announced. Another possibility is that importers are lying about the origin or category of imports to obtain lower tariff rates. Anecdotal reports suggest that China is rerouting exports through third countries to obtain lower tariff rates, but the lower rates are still around 15 or 20 percentage points higher than before. Moreover, to obtain these “lower” tariff rates, many countries had to agree in principle to a minimum local content ratio of 50 percent.³⁴ That said, it is not clear to what extent US Customs has the ability or the desire to investigate the accuracy of reported local content ratios. Given the importance of affordability in the current US political debate, we doubt that average tariffs will rise by 14 percentage points and instead assume an average increase of 10 percentage points.

Most economists believe that tariffs have little or no effect on trade balances, but this outcome depends critically on the assumption that tariffs cause a country’s currency to appreciate. Although the dollar did appreciate about 5 percent from October 2024 through January 2025 (Bank for International Settlements broad real exchange rate) it has since given back those gains and is currently at its average value of the past three years.³⁵ In our AI boom scenario, we assume the dollar appreciates sufficiently to stabilize the US CA in 2026 at its 2025 level as a percent of GDP before widening modestly in 2027. In the AI bust scenario, the dollar stays near its current level in real terms or even declines a bit. Combined with the marked slowdown in US growth, the US CA narrows substantially.

32 These increases are weighted by past trade shares. Over time, as imports of goods with the highest tariffs drop sharply, weighted average tariffs will decline a bit. The Budget Lab at Yale University estimates that after a year or so, the average tariff increase will be 12 percentage points.

33 Sources: US Treasury Department, Monthly Treasury Statement; and US Bureau of Economic Analysis, International Trade in Goods and Services.

34 See, for example, *The Nation (Thailand)*, “Thailand Agrees to US Terms, Adopts 50% RVC to Curb Chinese Goods,” August 4, 2025.

35 If the dollar were to remain near its current level and GDP to grow near trend in the United States and abroad, a 10 percentage point average tariff increase would be expected to reduce the US trade and CA deficits about 1 percent of GDP after a year or two, based on a conventional import price elasticity of 1. One interpretation of the dollar’s behavior in 2025 is that the Trump administration’s policies and rhetoric have frightened foreign investors somewhat and caused them to reduce desired investment flows to the United States.

Policy Reactions Elsewhere

Another major policy uncertainty is the response of the euro area and advanced Asia to the growing role of China in key products such as automobiles. The success of these products will obviously create calls for higher tariffs to protect domestic producers. The policy response, however, is complicated by at least two factors. The first is that it would take a major tariff hike to significantly reduce the competitiveness of Chinese products in the domestic market and that, unlike the United States, the appetite for a large hike may be limited given their extensive trading relationship with China, especially in the case of advanced Asia. In addition, for the euro area the tariffs would have to be enacted across the entire European Union, which includes many additional countries that are not major producers of these new goods and some countries, such as Hungary, that have relatively close economic relations with China.³⁶ The second complication for both regions is that, even if such a hike were enacted, autos and similar products are major exports for the euro area and advanced Asia. China's export surge into third markets still dents output and prosperity in these advanced regions.³⁷ On balance, we take the view that a major hike in tariffs in the euro area or advanced Asia is unlikely and build our scenarios around that assumption.

AI Boom Scenario

The AI boom scenario is basically a continuation of recent trends, and we assume GDP in the major regions follows the IMF forecast. Unlike the IMF, which projects narrowing CA imbalances in China and the United States and stable imbalances in the euro area and the rest of the world, we project a sharp increase in China's surplus and a narrowing of surpluses elsewhere with a small increase in the US deficit (figure 15).³⁸

In 2025, the Chinese CA surplus increased nearly 1.5 percent of GDP, driven by rising exports of goods.³⁹ We assume it increases by 1 percent of GDP in both 2026 and 2027. This allows non-real-estate fixed investment to fall an equal amount each year while holding consumption, real estate investment, and the fiscal balance constant as shares of GDP. We believe that risks are tilted toward even larger declines in private domestic demand but these could be countered by larger fiscal deficits. A recession in China is a serious risk, but it is not part of this scenario.

This projection calls for a much smaller increase in China's CA surplus (as a percent of GDP) than occurred in 2003–07 despite a larger depreciation of China's real effective exchange rate (REER). Over the past 32 years, China's REER appreciated an average of 1.7 percent per year,⁴⁰ consistent with the trend

36 For a deeper discussion, see *Economist*, "Briefing: Europe's China Shock," November 22, 2025.

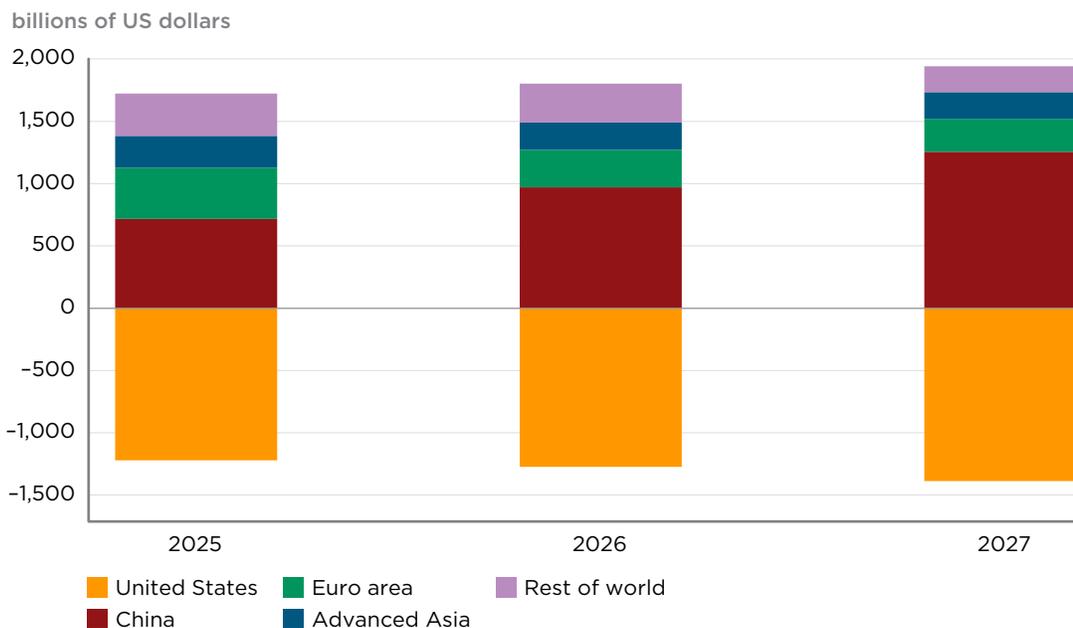
37 For a discussion, see Robin J. Brooks, "How US tariffs Are Hurting China," Substack, October 14, 2025.

38 In both figures 15 and 16, the global CA discrepancy is held fixed at its 2025 value in percent of world GDP. As a consequence, measured surpluses exceed measured deficits by more than \$500 billion each year.

39 Preliminary data released in mid-February 2026 show a Chinese CA surplus of 3.7 percent of GDP in 2025, 0.4 percentage point higher than the IMF projection in figure 1.

40 Source: Bank for International Settlements broad real exchange rate.

Figure 15
Current account balances in the AI boom scenario



Sources: IMF and authors' calculations.

increase in its productivity relative to that in the rest of the world. Since 1994, there have been only two substantial and sustained REER depreciations: (1) In 2005 the REER averaged 7 percent below its 2001-02 average; and (2) in 2025 the REER averaged 14 percent below its 2021-22 average. Over the 2003-07 period, China's CA rose by more than 7 percentage points of GDP.⁴¹ Our projection has the CA rising only 3.3 percentage points in 2023-27, which we regard as conservative, considering that an estimate of the seasonally adjusted current account in 2025Q4 of 4.5 percent of GDP⁴² is nearly as large as our projection of 4.7 percent for all of 2026.⁴³

Turning to the corresponding Chinese financial flows, FDI outflows continue to rise as Chinese companies expand particularly into developing economies while FDI inflows remain moribund. Portfolio outflows rise, mainly directed to advanced economies, as authorities relax capital outflow restrictions. The renminbi stays relatively stable in trade weighted terms or even appreciates

41 China's WTO accession in 2001 was associated with a surge in manufacturing investment that supported export growth including in new products and brands, a development now referred to as "the China shock."

42 See Yuting Yang, China: Q4 2025 BOP Data Show Stronger Current Account Surplus, Goldman Sachs Research, February 13, 2026.

43 In both the previous and projected episodes, the CA rises more than would be implied by the size of the depreciation, given a conventional trade price elasticity of 1. In part, this arises because the depreciation should be measured relative to the appreciating trend REER. But it also likely reflects that the ability to create new products and brands (associated with trend productivity growth) enables a country to increase its exports even in the absence of a depreciation (Helpman and Krugman 1985). Cross-country evidence strongly supports the Helpman-Krugman hypothesis (Gagnon 2008).

along with the dollar, with limited intervention as strong private outflows and a continued dearth of inflows provide financing for the higher trade surplus.

In the United States, continued international flows into the AI sector lead to a moderate appreciation of the dollar that offsets the incipient contraction in the CA deficit caused by the tariffs. The CA deficit remains constant as a share of GDP in 2026 and widens in 2027 by an amount proportional to the declining surpluses in the euro area and advanced Asia.

The euro area and advanced Asia suffer the brunt of China's export competition (de Soyres et al. 2025) and higher US tariffs in 2026, as their CA surpluses decline by nearly $\frac{3}{4}$ percent of GDP. They share the burden with the United States and the rest of the world in 2027, with CA balances in all four regions declining another $\frac{1}{4}$ percent of GDP. We assume fiscal and monetary policies loosen to keep GDP growing close to potential.⁴⁴ The euro depreciates modestly, which supports the embattled export sector while putting a damper on net financial outflows by raising the price of foreign assets. Given the recent weakness of the yen, advanced Asia may not need significant further depreciation.

In sum, the AI boom scenario is basically a continuation of existing trends, with booming Chinese exports leading to a fall in trade balances elsewhere, with some rotation away from the United States toward the euro area and advanced Asia. Given the modest size of the shock and room for fiscal and monetary easing, the path for output is relatively benign. The crucial difference between this path and that presented in figure 1 is that instead of narrowing moderately China's surplus widens a lot and the US deficit increases a small amount. Since China's surplus widens more than the US deficit, the surpluses of other regions are forced to contract, creating heightened international economic tension between China and the advanced (and some developing) economies.

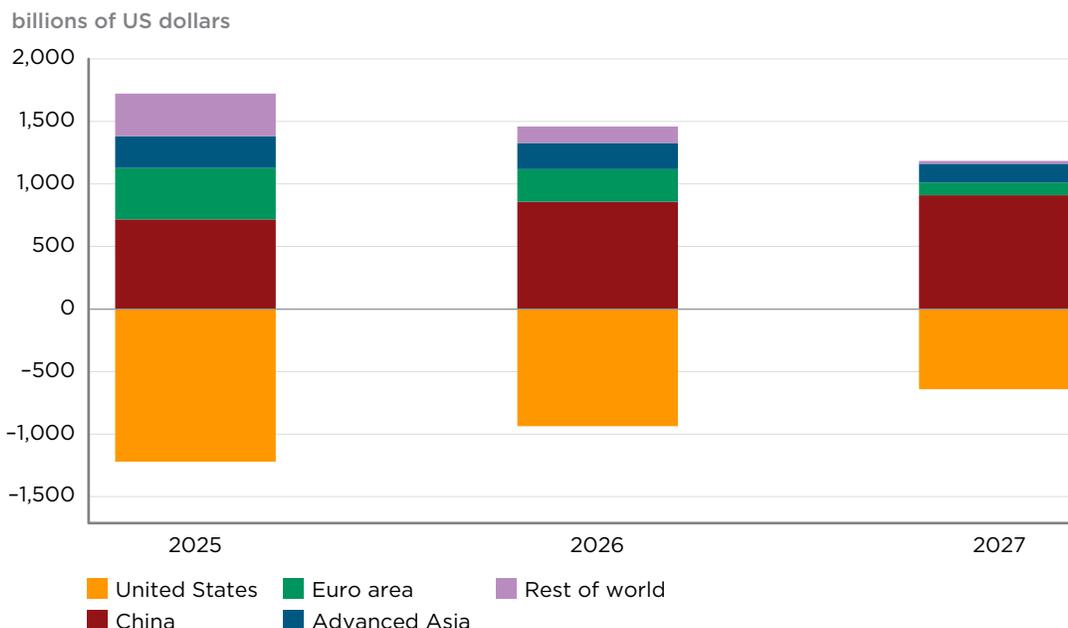
AI Bust Scenario

The AI bust scenario, by contrast, creates much more immediate economic conflict and policy dilemmas. In this scenario, a collapse of business investment and equity prices (and thus consumption) pushes US GDP 2 percent below the IMF forecast in 2026 and 3 percent below in 2027. Instead of appreciating, the dollar stays constant or even depreciates a bit as foreign inflows into US direct investment and portfolio equity dry up. The resulting trade and wealth shocks reduce GDP in the other regions by 1 percent in 2026 and 1.5 percent in 2027 relative to the IMF forecast. The advanced regions and some developing economies are pushed to the zero lower bound on policy interest rates. Fiscal policy is loosened more than in the boom scenario but not enough to maintain GDP at potential, in part because of financial or political limits on fiscal space.

With no appreciation to offset the tariffs, the US CA deficit narrows to 3 percent of GDP in 2026 and the recession narrows it further to 2 percent of GDP in 2027 (figure 16). Sharp reductions in the US CA deficit during recessions are the typical historical pattern. Given its strong competitiveness, China's CA surplus still expands but only by $\frac{1}{2}$ percent of GDP in 2026 and stabilizes

44 Leaders in both Europe and advanced Asia have been discussing large increases in defense spending.

Figure 16
Current account balances in the AI bust scenario



Sources: IMF and authors' calculations.

thereafter, far less than half the expansion in the boom scenario. The surpluses in the euro area and advanced Asia narrow by nearly 1 percent of GDP a year, while the surplus in the rest of the world essentially disappears.

The policy dilemmas in this scenario are much worse, as manufacturing regions outside of China and the United States wish to combat the blow to output coming from falling net exports to China and the United States, creating a temptation to resort to beggar-thy-neighbor policies like protectionism or currency manipulation. Commodity producers also suffer from reduced global growth, but their consumers benefit from cheap manufactured imports and they are less likely to adopt protectionist measures. The response of the United States is unpredictable, but we do not expect significant further protectionist measures given the major actions already taken and the rapid decline of the US trade deficit assumed in this scenario.

Perhaps the most important uncertainties are associated with China's policy response. Will it take this opportunity to finally expand consumption in a dramatic and sustainable way by addressing the structural forces behind high savings? Or will it continue down the road of export-led growth based on an undervalued exchange rate and implicit or explicit subsidies for new sectors? Will Chinese investors continue to send their money abroad into a stagnant world economy with rising anti-China feelings and policies? Will China return to currency manipulation to prevent a soaring renminbi? The record so far has been that Chinese policy makers are unwilling to abandon the export-led growth model despite the resulting domestic imbalances. Will a global recession and the associated rising trade and geopolitical tensions finally change this pattern?

Alternate AI Boom Scenario

The continuing weakness of the US dollar in early 2026 amid widespread talk in the financial press of a “sell America” trade raises the possibility of a third scenario, in which AI investment and global growth remain strong but the dollar does not rebound. This scenario retains the GDP assumptions of the AI boom scenario but assumes the dollar remains near its early 2026 level. In that case, the recent tariff increases shrink the US current account deficit about 1 percent of GDP gradually over the course of 2026 and 2027, with offsetting reductions in the surpluses of all the other regions of about $\frac{1}{3}$ percent of GDP. We assume this modest reallocation of global demand can be offset by moderately tighter US monetary policy and slightly easier monetary policies in the rest of the world, keeping GDP in each region on its projected path. Trade tensions would be somewhat greater than in the AI boom scenario but not as bad as in the AI bust scenario.

CONCLUSIONS

Global current account imbalances widened notably over the past two years, led by growing surpluses in China and deficits in the United States. The International Monetary Fund projects a shrinking of China’s surplus and the US deficit in 2026 and 2027, with stable surpluses in the other main regions. We disagree. Trade tensions are only going to increase in the near term, perhaps by a lot.

If the main economies continue to grow near recent rates, as is the broad consensus, then China’s surplus will expand dramatically and the US deficit will change only modestly, putting downward pressure on surpluses in most other economies. Such an outcome would surely increase trade tensions, but perhaps by a manageable amount.

China’s growing surplus is driven by ultracompetitive exporters in both traditional industries like electronics and home appliances, as well as new products like automobiles, robots, and solar panels. Moreover, it is facilitated by a large incipient financial imbalance, as Chinese savers looking for foreign investment opportunities are not matched by a similar foreign desire to invest in China. China’s leaders have paid lip service to the goal of consumption-led growth, but their policies have mainly enabled a massive investment surge into new export industries while keeping costs in China far below global levels. The outcome of these choices is now being unleashed on a world that is not prepared for a second China shock.

Tensions will be far more extreme in the event of a collapse of the AI investment boom, leading to a recession in the United States and slowdowns everywhere else. In that case, the US deficit may be cut in half and China’s surplus will grow only modestly. Surpluses in the other regions would be squeezed ferociously. Many economies would return to the zero lower bound on interest rates and fiscal policy is likely to be inadequate to the task. Conditions would be ripe for an all-out trade war, with more tariffs and trade barriers and renewed currency manipulation as policymakers strive to protect domestic producers against foreign competition.

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