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China's Domestic and External Imbalances Are Widening

Rebalancing Requires a Fundamental Transformation of the Economic Structure

Summary

China's domestic and external imbalances are widening, underscoring the need to rebalance the economy through a structural shift toward consumption-led growth.

China is currently estimated to be in the "current account surplus/deflation" quadrant to the left of the equilibrium point in the Swan diagram. A realistic first step would be to address the domestic imbalance by expanding domestic demand.

China has substantial potential for consumption-led growth. Expanding consumption will require maintaining fiscal expansion to ease deflationary pressures while lowering the household saving rate and raising the propensity to consume.

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1. China’s domestic and external imbalances are becoming a source of risk for the global economy, underscoring the need for rebalancing

China’s domestic and external imbalances are widening. Domestically, the economy faces deflationary pressures stemming from excess production and insufficient demand. Externally, the trade imbalance is becoming more pronounced as exports surge while imports remain sluggish. If the domestic imbalance is left unaddressed, China risks falling into a deflationary spiral. If the external imbalance persists, it could trigger renewed trade frictions. These developments also point to the limits of the investment- and export-led growth model that China has pursued for many years, underscoring the need to rebalance the economy through a structural shift toward consumption-led growth. Whether China can achieve such rebalancing will be important not only for the outlook for the Chinese economy but also for global economic stability.

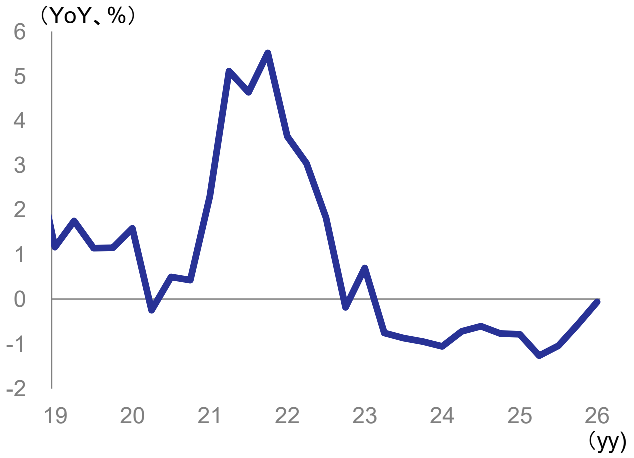
This report first examines China’s economic imbalances using available data and then considers policy options for rebalancing.

2. China is relatively close to domestic equilibrium but remains far from external equilibrium

China continues to face a persistent domestic imbalance between strong supply, reflecting excess production capacity, and weak demand, driven in part by negative wealth effects from falling property prices and households’ propensity to save. The Chinese government itself acknowledged at the Central Economic Work Conference in December 2025 that “the contradiction between strong domestic supply and weak demand has become prominent” (see Tsukioka, 2025a). Against this backdrop of excess production and insufficient demand, excessive competition among firms—widely referred to in China as involution-style competition—has intensified. Left unchecked, such competition could not only erode corporate profits but also fuel excessive price competition and exacerbate deflationary pressures. The government has therefore strengthened its “anti-involution” stance aimed at curbing excessive competition (see Tsukioka, 2025b).

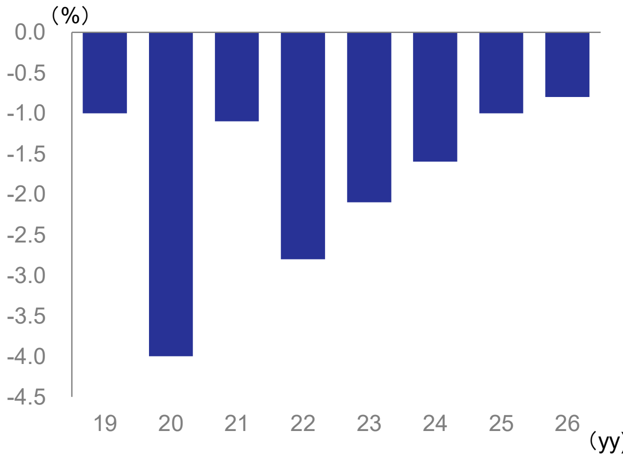
As Figure 1 shows, the GDP deflator, which captures broad price movements across domestically produced goods and services, has been negative for 12 consecutive quarters, highlighting the strength of the deflationary pressures facing the Chinese economy. The deflator is expected to turn positive in April–June 2026 because of cost-push inflation associated with recent developments in the Middle East. This, however, would merely be a temporary consequence of a supply shock and would not indicate that the underlying problem of insufficient demand has been resolved. Indeed, estimates by the International Monetary Fund (IMF) show that the output gap—the gap between actual real GDP and potential output—remains negative (Figure 2). A negative output gap indicates that demand is below the economy’s potential supply capacity. Weak demand also pushes up unemployment by reducing firms’ capacity to absorb labor. In China, young people have borne much of this burden, with the unemployment rate among those aged 16–24 remaining elevated at 15.6% in May 2026.

[Figure 1: GDP Deflator]



Source: Made by Research Department, Mizuho Research Institute based upon National Bureau of Statistics of China, CEIC

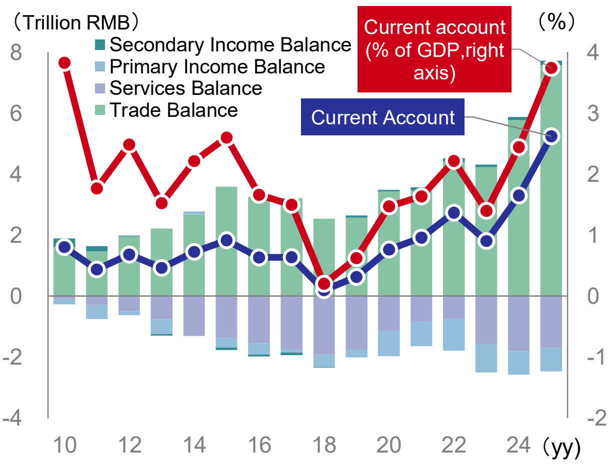
[Figure 2: Output Gap (IMF Estimates)]



Source: Made by Research Department, Mizuho Research Institute based upon IMF (2026)

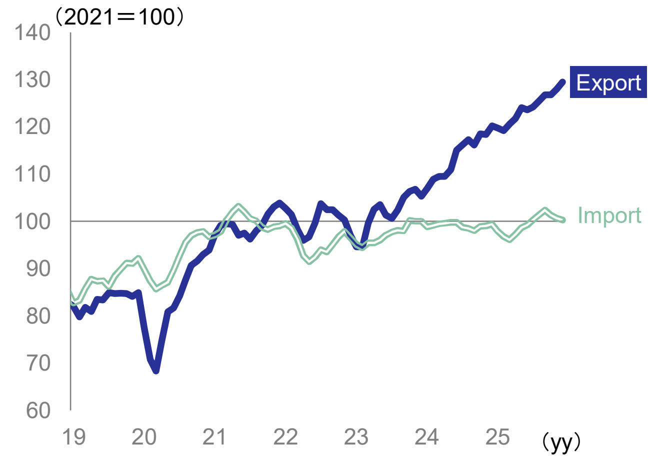
Turning to the external imbalance, China's current account surplus reached a record RMB 5.24 trillion (USD 735 billion) in 2025, rising to 3.74% of GDP (Figure 3). The principal driver was, of course, the widening trade surplus, which reached RMB 7.57 trillion (USD 1.06 trillion) on a balance-of-payments basis in 2025. The price competitiveness of Chinese manufacturing has strengthened in recent years amid industrial support and intense competition (see Tsukioka and Kamada, 2025). Exports have continued to rise, partly as firms have cut unit prices to expand export volumes. Imports, meanwhile, have remained sluggish as the government's push for "self-reliance and self-strengthening"—including import substitution and localization—has progressed (Figure 4). As a result, the trade imbalance has become increasingly pronounced.

[Figure 3: Balance of Payments]



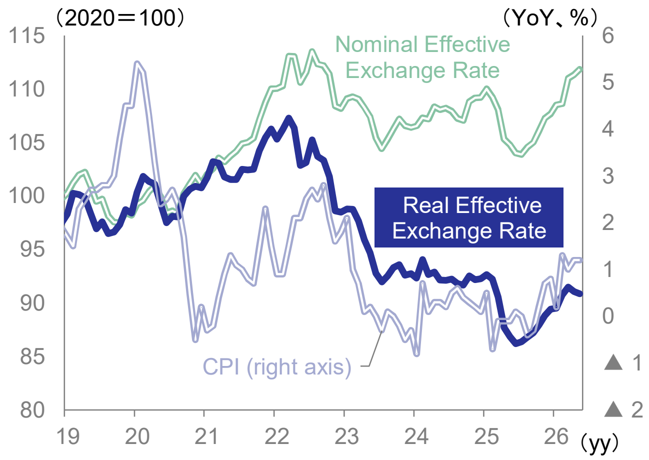
Source: Made by Research Department, Mizuho Research Institute based upon State Administration of Foreign Exchange (SAFE), CEIC

[Figure 4: Export and Import Volumes]



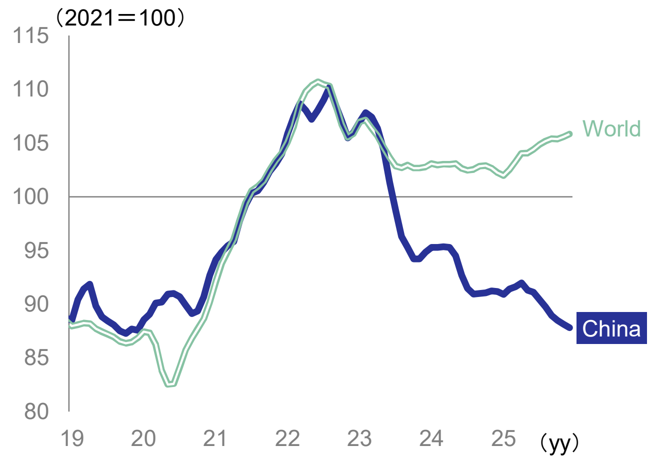
Note: 3-month moving average, Seasonally adjusted figures by the Netherlands Bureau for Economic Policy Analysis (CPB)
Source: Made by Research Department, Mizuho Research Institute based upon CPB, LSEG

[Figure 5: RMB Nominal and Real Effective Exchange Rates]



Source: Made by Research Department, Mizuho Research Institute based upon Bank for International Settlements (BIS), National Bureau of Statistics of China, CEIC

[Figure 6: Export Prices (China and World)]

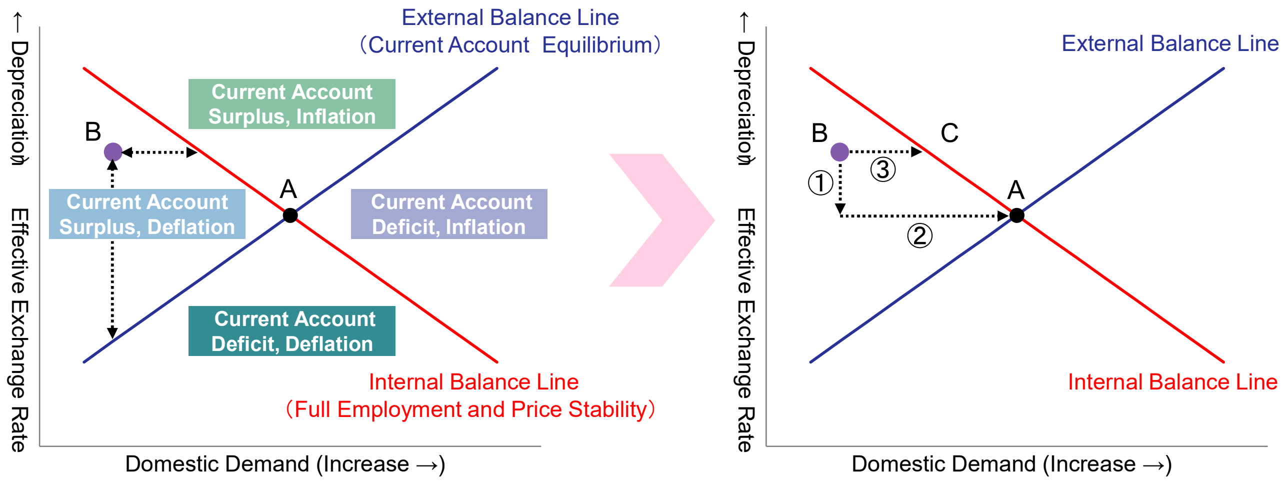


Note: 3-month moving average, Seasonally adjusted figures by the Netherlands Bureau for Economic Policy Analysis (CPB)
Source: Made by Research Department, Mizuho Research Institute based upon CPB, LSEG

Another factor contributing to the widening external imbalance is what might be described as a "hidden depreciation" of the renminbi. Figure 5 shows a substantial divergence between the renminbi's real effective exchange rate (REER) and nominal effective exchange rate (NEER). While advanced economies have struggled with inflation in recent years, China has faced deflationary pressures. As inflation in China slowed, the REER fell sharply from 2022 onward. The NEER, by contrast, did not decline, reflecting the People's Bank of China's emphasis on maintaining stability in the renminbi's nominal exchange rate against the US dollar under its managed floating exchange-rate regime. The resulting divergence between the REER and NEER represents a real depreciation of the renminbi that is not readily apparent from nominal exchange rates—in other words, a "hidden depreciation." As Figure 6 shows, this hidden depreciation, combined with China's export drive, has left Chinese export prices substantially lower than those for the world as a whole.

Figure 7 presents a Swan diagram, which illustrates an economy's domestic and external balances simultaneously. Domestic demand is plotted on the horizontal axis (x), while the effective exchange rate is plotted on the vertical axis (y). The domestic-balance schedule slopes downward because, if an increase in domestic demand causes the economy to overheat, the effective exchange rate must appreciate to restrain net exports and preserve domestic balance. The area to the left of the schedule corresponds to deflation, while the area to the right corresponds to inflation. The external-balance schedule, by contrast, slopes upward. An increase in domestic demand raises imports and worsens the current account balance, requiring depreciation of the effective exchange rate to increase net exports and restore external balance. The area to the left of the schedule corresponds to a current account surplus, while the area to the right corresponds to a current account deficit. The two schedules divide the diagram into four zones, sometimes referred to as the four zones of economic discomfort. Their intersection represents equilibrium point A. The Swan diagram can therefore be viewed as a map indicating how domestic demand and the exchange rate should be adjusted to achieve both domestic economic stability and current account stability.

[Figure 7: Internal and External Imbalances in China's Economy (Swan Diagram)]



Source: Made by Research Department, Mizuho Research Institute based upon Krugman et al. (2017), Capital Economics

The domestic and external imbalances described above suggest that China is currently located in the "current account surplus/deflation" quadrant to the left of equilibrium point A in the Swan diagram. Because the negative GDP deflator and output gap have both been narrowing, China does not appear to be far from the domestic-balance schedule. However, given the enormous current account surplus and the "hidden depreciation" of the renminbi, China appears to lie well above equilibrium point A on the y-axis—with the effective exchange rate weaker than its equilibrium level—and very far from the external-balance schedule. China's current position can therefore be represented by point B.

China's excessive imbalances are not sustainable. If the domestic imbalance is left unaddressed, deflationary pressures arising from excess production and insufficient demand will persist, creating a risk that China could fall into a deflationary spiral similar to that experienced by Japan in the past. If the external imbalance remains unresolved, other countries, concerned about excessive inflows of Chinese products and the erosion of their domestic industries, could impose additional tariffs or anti-dumping measures, while pressure for renminbi appreciation could intensify. China therefore needs to take steps to reduce these imbalances—in other words, to move closer to equilibrium point A. Reaching point A would require both (1) an appreciation of the currency and (2) a substantial expansion of domestic demand. The adjustment shock, however, would be extremely large given the distance the economy would have to move across the Swan diagram, making such rebalancing difficult. A more realistic approach, involving a smaller adjustment shock, would therefore be to begin with (3) an expansion of domestic demand, moving point B to the right toward point C, where it intersects the domestic-balance schedule.

The transition from point B to point C would nevertheless require a transformation of China's economic structure. As discussed above, insufficient domestic demand means that production capacity that cannot be absorbed at home is being directed toward exports, contributing to the expansion of the current account surplus. Part of this production capacity therefore needs to be redirected toward the domestic market. More specifically, labor and capital disproportionately concentrated in export-oriented and investment-related industries would need to shift toward consumption-related industries. If this reallocation of resources broadens the base of consumption-related industries and enables consumption-led growth, the output gap would narrow, deflationary pressures would ease, and reliance on exports would decline. Moving toward point C would therefore help not only to resolve the domestic imbalance but also to reduce the external imbalance, making it a critical step in the rebalancing process.

3. Considerable potential for consumption-led growth: Sustained fiscal expansion and a lower household saving rate are key

Rebalancing through stronger domestic demand will require a structural shift toward a consumption-led economy. Given the low share of private consumption in China's GDP—40.0% in 2025—there is considerable scope for consumption-led growth.[1] The IMF has likewise noted that "unlocking the potential of its large domestic market" would allow China to make growth more resilient by reducing its dependence on external demand.[2] In its Staff Report for the 2025 Article IV Consultation—the IMF's annual policy consultation with member countries—the Fund set out policy recommendations for reducing China's domestic and external imbalances and achieving consumption-led growth. The main reform measures are summarized in Table 1. Although implementing all of these reforms would clearly be desirable, the author considers two measures particularly important for rebalancing: in the short term, maintaining fiscal expansion to ease deflationary pressures; and over the medium to long term, reducing the household saving rate to raise the propensity to consume.

[Table 1: Key Reform Measures to Reduce Domestic and External Imbalances and Promote Consumption-Led Growth: IMF Policy Recommendations]

Area	Proposed measures	Objective	Chinese government's response
Maintain fiscal expansion	Widen the fiscal deficit through an easing of the cyclically adjusted primary balance (CAPB); expand social security; provide support for the property sector	Ease deflationary pressures and achieve a sustained expansion in consumption	Continue a "more proactive" fiscal policy in 2026
Reduce household saving	Substantially increase social spending in rural areas; use *hukou* reform to reduce disparities in access to social security; strengthen progressive income taxation and taxation of capital	Reduce precautionary saving and raise the propensity to consume	Recognizes the importance of promoting consumption; reforms to proceed gradually, taking local conditions into account
Facilitate adjustment in the property market	Allow nonviable developers to exit; provide central government support for presold housing projects; accelerate supply-demand adjustment through greater price flexibility	Improve market sentiment and support consumption	Assesses that financing support has helped bring the market close to a bottom; aims to achieve medium-term market equilibrium
Scale back industrial policy	Reduce subsidies except where market failures are clearly identified; strengthen central government policy coordination with due consideration for externalities	Improve resource allocation and reduce the fiscal burden	Industrial development remains important; subsidies will comply with WTO rules
Maintain external openness	Strengthen dialogue over concerns including subsidies; limit restrictions imposed on economic-security grounds	Ease trade frictions and reduce uncertainty	Reaffirms commitment to the multilateral trading system

Source: Made by Research Department, Mizuho Research Institute based upon IMF (2026)

On fiscal policy, the Chinese government has pursued a "more proactive" fiscal stance since 2025, widening the deficit under the general public budget—the general account—to 4.0% of GDP, beyond the 3.0% level that had previously been regarded as an implicit ceiling from the standpoint of fiscal discipline

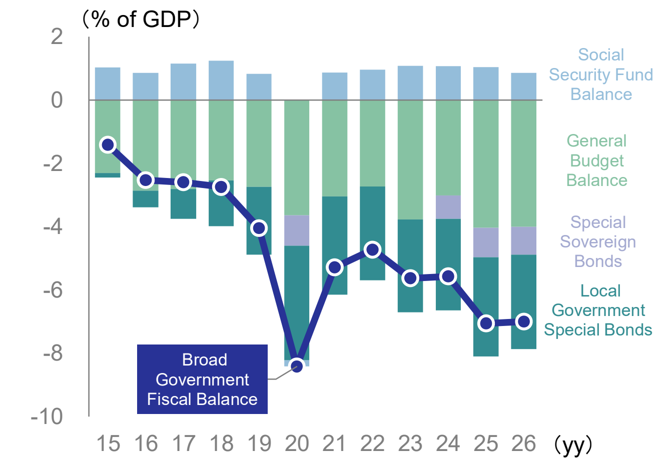
[1] In its 15th Five-Year Plan (2026–30), the Chinese government has set a target of "significantly increasing the share of household consumption in GDP." This indicates that the government itself recognizes the low share of private consumption as an issue. See Tsukioka (2026a).

[2] Sonali Jain-Chandra et al., "How China's Economy Can Pivot to Consumption-led Growth," IMF Country Focus, February 18, 2026.

(see Tsukioka, 2026b). This direction is broadly consistent with the IMF's recommendations, although some market participants have called for even more aggressive fiscal stimulus. Further fiscal expansion, however, would not be easy given concerns about fiscal sustainability. As Figure 8 shows, the broad government deficit, including the government-managed funds budget—the special account—and the social security balance, has remained elevated since the COVID-19 pandemic and has exceeded 7.0% of GDP in recent years. The IMF has therefore proposed redirecting fiscal resources freed up by reducing excessive local government investment and industrial subsidies toward social security and support for the property market.[3] Support for the property market in particular could accelerate market adjustment, bring the property downturn to an earlier end, alleviate negative wealth effects, and improve consumer sentiment.

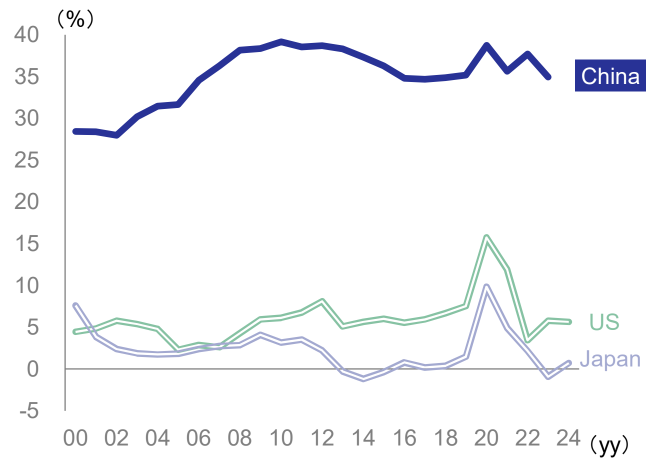
Meanwhile, China's household saving rate is extremely high compared with those of other major economies (Figure 9). One reason is that Chinese households have a strong tendency toward precautionary saving, reflecting a desire to protect themselves against future uncertainty as well as the heavy financial burden associated with housing, education, healthcare, and other expenses. The government therefore needs to shoulder more of these future risks and costs so that households can consume with greater confidence. The IMF has proposed expanding social spending in rural areas, reforming the hukou household-registration system to reduce disparities in social security coverage, and reforming the tax system to strengthen income redistribution and reduce income and wealth inequality.[4] These reforms will not be straightforward, however. Expanding social security and reforming the hukou system would entail a substantial fiscal burden, while tax reform could face opposition from vested interests. Moreover, it remains uncertain whether such reforms would be sufficient to change households' propensity to save. Ultimately, changing consumer behavior and lowering the household saving rate will require a long-term and unwavering commitment by the Chinese government to transforming the economy toward a consumption-led growth model.

[Figure 8: Broad Government Fiscal Deficit]



Note: Figures for 2026 are on a budget basis
Source: Made by Research Department, Mizuho Research Institute based upon Ministry of Finance of China, CEIC

[Figure 9: Household Net Savings Rate]



Source: Made by Research Department, Mizuho Research Institute based upon OECD

Reference

Refer to the original Japanese report by clicking the URL below for the reference material.
https://www.mizuhobank.co.jp/corporate/mhri/research/report/pdf/insight-as260702.pdf

[3] IMF (2026), pp. 20–22.
[4] IMF (2026), p. 30.