SOTEU: State of the European Unbalance

China Shock 2 and the Reality of De-Risking in Turbulent Times

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"Let me be clear: we will use all the tools at our disposal to rebalance our relationship. Words are good. But deeds are better." In her recent State of the European Union speech, Commission President Ursula von der Leyen formulated clear expectations of substantial concessions from the ongoing talks with China to mitigate the **unbalanced trade relationship**. Following years of structural divergence, the EU is now registering a record-breaking **trade deficit with China of €1 billion per day**. "It leads to deindustrialisation in the industrial heartlands of Europe. This is unsustainable", von der Leyen emphasised in her speech. Trade Commissioner Šefčovič will travel to Beijing in early October to seek the required results. Shortly after, on 15 October, the European Council will consult on the next strategic steps.

Recent years have seen significant **pressure on manufacturing employment and industrial competitiveness** across Europe, particularly in Germany's automotive and engineering sectors. This disruption has led to a **strategic rethink towards China** and its aggressive economic statecraft. Although Chinese competitive pressure does not impact all industries and countries within the EU to the same degree, previously diverging views among policymakers and business leaders are increasingly converging around a more assertive approach towards China. The criticism targets, above all, industrial overcapacity, unfair subsidies, and an artificially undervalued currency.

To counter these practices, the EU has already implemented tailored **trade defence measures**. These include, among others, countervailing duties on electric vehicles as well as antidumping duties on major industrial inputs like steel, and the elimination of duty exemptions for low-value e-commerce shipments. By a vast margin, the majority of European anti-dumping and anti-subsidy measures against third countries target China. However, these interventions only offer isolated relief and fail to address the underlying **structural asymmetry** and persistent trade imbalance. "Some say the second China shock is looming. But it's already here", as von der Leyen put it in her speech.

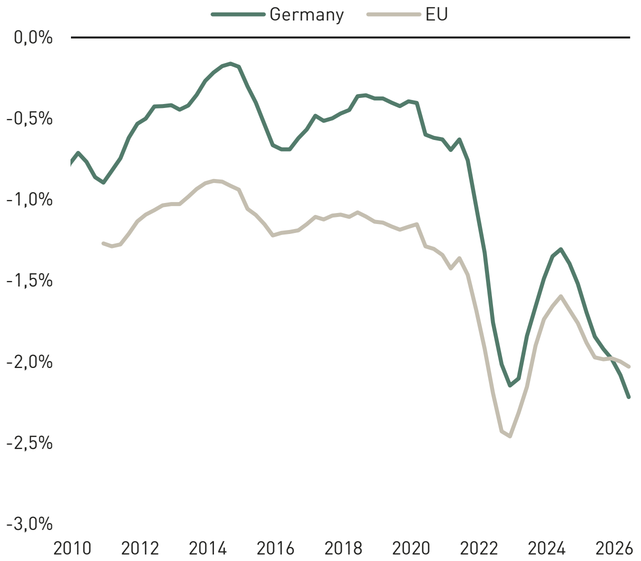
Given this **economically unsustainable status quo**, paired with shifting public opinion and the lack of tangible political results at previous summits, the Commission has intensified its efforts. On 26 June, the Commission and the Chinese government launched so-called **Trade and Investment Consultations** setting "an ambitious timeline to deliver tangible results by October" across four different work streams (trade and investment balancing, export controls, intellectual property rights, WTO reform). It remains uncertain whether Beijing is ready and willing to grant satisfactory concessions. Even if that were the case, China's other advantages like market scale, abundance of raw materials, fast political decision-making, and speed of innovation and commercialisation will still pose a significant obstacle to European (export-oriented) businesses.

The upcoming months will require walking a fine line between **engagement** and **escalation**, making sure to serve the European interest. The EU's approach of **de-risking** and reducing dependencies on China inherently means a higher degree of diversification. Against this background, the Commission wants to further equip its toolbox and will propose a " **diversification instrument** early next year. The concrete design of that initiative is not clear yet. What is clear, however, is that **like-minded middle powers** are beginning to cooperate more closely to better protect themselves against arbitrary measures by the two great powers, the US and China. The presence of Canadian Prime Minister Mark Carney at von der Leyen's speech, alongside discussions of **Canada** potentially becoming the EU's first associated member, reflects this growing alignment.

In the end, Europe's challenge in dealing with China is not simply to reduce its trade deficit or to diversify its supply chains, but to improve its own **structural competitiveness** without unduly undermining the economic interdependence on which European industry itself depends.

Indicators to watch

Trade balance in goods with China
In % of GDP, rolling 4-quarter average

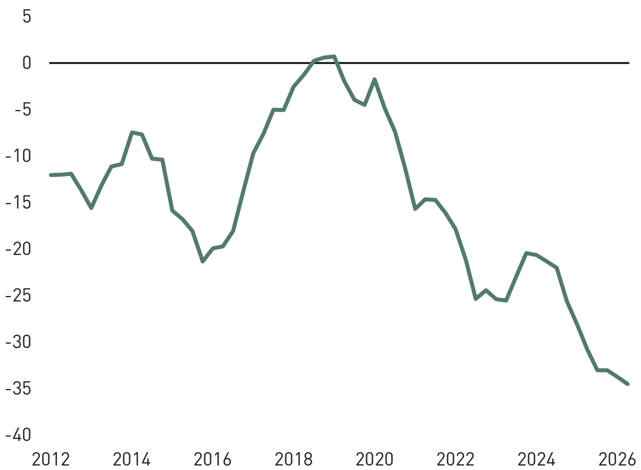


Source: Eurostat, Destatis.

Germany's trade deficit with China reached a new record

If the Commission and Chinese officials fail to reach a solution in their negotiations, the EU has promised to utilise and, if necessary, expand its trade defence toolset in order to reduce the ever-growing goods deficit with China. The deficit is almost back to the levels seen during the surge in imports caused by the supply chain issues following the pandemic and the European energy crisis of 2022. For Germany, the deficit has already reached a historic high of 2.2% of GDP. This matters since Germany is the country with the greatest influence over the EU's China policy and has made a remarkable shift in its own assessment. Having previously championed a conciliatory approach, it has now adopted a more hawkish stance. This pivot is also a result of changing industry views, shaped by growing concerns about global imbalances. While concerns about potential Chinese retaliation remain, the realisation that 'doing nothing has also become a risk' has started to change the calculation.

Chinese yuan relative to economic fundamentals
In %, negative means undervalued

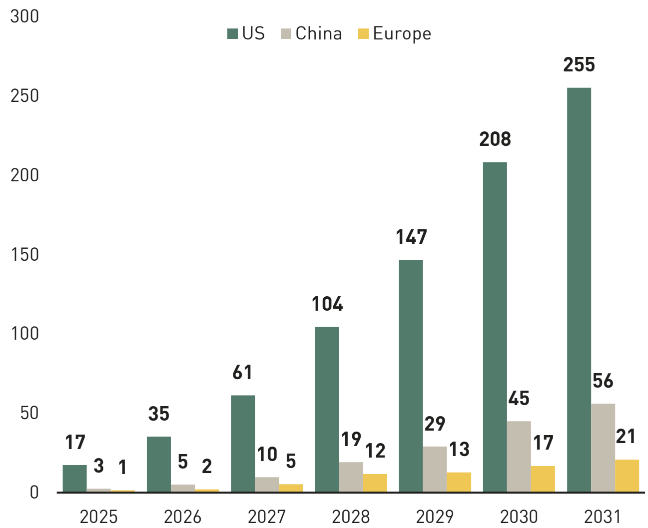


Source: Brad Setser/CFR, WSJ; based on adjusted current account data.

An undervalued yuan amplifies global imbalances

Despite repeated calls for rebalancing, Beijing's economic model continues to favour industrial expansion over household consumption. Subsidies, capital controls, high domestic savings and exchange-rate management reinforce one another, directing resources towards strategic sectors. An undervalued yuan amplifies these effects by making Chinese exports cheaper and foreign goods more expensive. This strengthens the case for coordinated international efforts to encourage yuan appreciation as part of a broader rebalancing strategy. Combined with domestic reforms to strengthen household incomes, appreciation could help shift China towards consumption-led growth. Stronger domestic demand would help offset a declining contribution from net exports, supporting growth while reducing global imbalances.

AI compute projection by region 2025-2031
Total facility power in GW



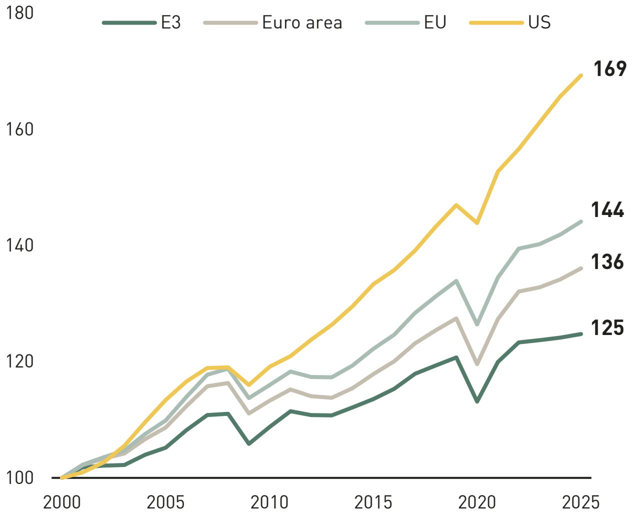
Source: Europe 2031; Europe includes non-EU countries.

Europe is on track to host only 6% of global compute by '31

Amid demographic decline and rising global protectionism, maintaining Europe's living standards will require stronger productivity growth. Faster AI adoption could add 0.3-0.4 pp to annual euro area total factor productivity growth. As Mario Draghi argues, Europe's rich public and industrial data offer a competitive advantage but exploiting it while preserving sovereignty requires more domestic computing capacity. Europe 2031 projects just 21 GW of European AI capacity by 2031, roughly 6% of the global total, compared with 255 GW in the US. Insufficient capacity could slow adoption by raising costs or preventing firms from keeping sensitive data in Europe. Fragmented demand is the main investment barrier: single companies rarely offer the commitments needed to finance large data centres. Pooling their demand could unlock new investment, lower computing costs and help Europe reap the gains from AI while retaining control over its data.

Real GDP in purchasing power parities (PPP)

Index: 2000=100, constant 2021 international USD



Source: World Bank; E3 = France, Germany and Italy.

The EU growth shortfall has become more pronounced

Since the global financial crisis, real GDP growth in the EU has consistently trailed behind that in the US, particularly in the EU's three largest economies. This gap widened further following Russia's invasion of Ukraine in 2022 and the subsequent surge in energy prices. Taken together, Germany, France and Italy have grown by only around 25% in real terms since 2000, compared with 69% in the US. The EU as a whole performed better, expanding by 44%. This was partly due to strong convergence growth recorded by newer member states. For example, Poland's and Romania's real GDP increased by 141% and 133%, respectively. While the difference in aggregate GDP growth is largely explained by faster population growth in the US, productivity growth has also diverged. The larger and more productive US tech sector explains about half of the measured productivity growth gap, while growth outside tech has been broadly similar.

Eurozone GDP per head relative to the US

In % of US level, in current prices at PPP

Source: OECD, Paul Krugman.

Eurozone GDP per head has risen relative to the US

While Europe's growth performance has lagged behind that of the US, its living standards remain among the highest in the world. Measured at current prices, living standards in the EU have not declined relative to the US. In fact, the US lead has shrunk over the last 25 years. One reason is that Europe has benefited from spillover effects from innovation developed by the larger and more productive US tech sector. While this rapid technological progress has boosted growth in the US, it has also resulted in better products for European consumers and producers. The key question is whether these spillovers will continue in the age of AI and weaponised interdependence. The US is already delaying access to its most advanced AI models, and China is actively considering export controls on its latest models, too.

TAKE: Two years after the Draghi Report, Europe faces an even more challenging global environment, marked by geopolitical rivalry, trade barriers, Chinese overcapacity and strategic dependencies. The single market is therefore becoming an ever more important source of growth and resilience. Unlocking its potential requires removing internal barriers, thereby enabling firms to scale and accelerate the adoption of productivity-enhancing technologies. It also means defending market-based competition against practices that try to exploit the EU's economic openness. Europe has the resources and scale to avoid the "slow agony" Draghi warned of. What it needs is the political resolve to act together. A key test will come when the October deadline for negotiations with China expires. If talks fail to deliver meaningful progress towards rebalancing the relationship, the EU may ultimately have little choice but to take action. In a world of strategic competition and weaponised interdependence, Europe's economic weight counts only if it is prepared to use it.

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Media Owner/Publisher:
Austrian Federal Economic Chamber
Economic Policy Department
Wiedner Hauptstrasse 63, 1045 Vienna, AUSTRIA
wp@wko.at, wko.at/wp, Phone: +43 5 90 900 | 4401

Head of Department:
Claudia Huber

Editor in Chief:
Thomas Eibl

Authors/Contact Persons:
Sebastian Köberl, EURep
sebastian.koeberl@eu.austria.be
Peter Obinger, EconPol
peter.obinger@wko.at

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