



By: Daniel Gros

Can European leaders recognize the EU's advantage in the new global economic order?



The world's three largest continent-sized economies are moving in different directions.

Each has its own strengths and weaknesses, though the balance appears to be more favorable in the United States and China than in Europe.

The US is strongest in software, some high-tech sectors, and hydrocarbons. US tech companies were dominating markets, particularly in the West, well before the emergence of AI, but the fast-developing technology—especially agentic AI—has bolstered their dominance.

Meanwhile, shale oil and gas have allowed for a **sharp increase** in domestic energy production, with the US now acting as a net exporter.

What the US does not have is savings. While its low savings rate—amounting to just **17.8% of GDP**—has not done much to hamper investment, particularly in data centers, it has meant that such investment directly contributes to America's large current-account deficit, which reflects deficits even in energy-intensive industries like **steel**.

The low rate of savings has also squeezed traditional manufacturing, because whatever capital is available is poured into the tech and energy sectors.

Successive US administrations have tried and failed to revive manufacturing, which now accounts for less than **10% of GDP**.

US President Donald Trump promised that tariffs would do the trick, but the data so far indicate otherwise.

Instead of compelling firms to move their manufacturing to the US, the tariffs have mostly amounted to a tax on US importers and consumers.

But, given how small the US manufacturing sector has become, this failure has not done much to erode headline economic-growth figures.

China's shift

China is in some ways a mirror image of the US: its **savings rate** of more than 40% of GDP continues to drive a large trade surplus. But the composition of this surplus is changing.

China's capital stock was very low when the country joined the World Trade Organization a quarter-century ago. Today, it is **more than twice** that of the US and rising fast.

The **skill level** of Chinese workers is also improving rapidly. For example, the number of **engineering graduates** per year has increased by a factor of eight since 2000.

This massive accumulation of human and physical capital is reshaping China's comparative advantage.

Rather than remaining a low-cost producer of low-tech goods, it is becoming increasingly competitive in the high-tech, capital-intensive sectors that advanced economies historically dominated.

The government is actively supporting this shift: the latest **Five-Year Plan** includes the promotion of advanced manufacturing, especially in strategically important sectors.

But it is likely that China's economy would move in this direction even without policy intervention.

The problem for China lies in domestic demand

The problem for China lies in domestic demand. By some **estimates**, real estate and infrastructure accounted for over 30% of total demand in 2021.

The subsequent **collapse of the real-estate sector** and construction downturn have since caused demand to plummet.

The additional investment that advanced manufacturing demands cannot offset these losses, meaning that the savings surplus is

likely to grow even larger.

This could reinforce protectionist sentiment in the US and Europe, where policymakers increasingly attribute China's trade surpluses to subsidies and other support that they deem unfair.

The EU is in the weakest position

The European Union seems to be in the weakest position. It has a small **savings surplus**, which translates into a small trade surplus. It lacks sufficient energy resources and leading AI firms.

And the mid- to high-tech industries that once drove its economy are among those facing the toughest competition from China.

Now, European policymakers are scrambling to save the old industries with protectionist measures and subsidies of their own.

In steel, for example, the EU recently halved **tariff quotas** and doubled tariff rates.

This response is as understandable as it is economically misguided. In fact, such measures have repeatedly proven ineffective.

Rather than try to salvage industries where it no longer has a relative advantage, Europe should focus on the specialized sectors where it increasingly does

The large anti-subsidy tariffs the EU imposed on imports of Chinese battery electric vehicles in 2024 had little impact.

Other efforts to subsidize sectors producing homogeneous products based on economies of scale—like batteries and, a decade ago, photovoltaic panels—also mostly failed.

Ultimately, trade is about relative, not absolute, advantage. Rather than try to salvage

industries where it no longer has a relative advantage, Europe should focus on the specialized sectors where it increasingly does. Chip-making machinery is a case in point.

Just one European firm, ASML of the Netherlands, holds a global monopoly on the extreme ultraviolet (EUV) lithography machines needed to produce the most advanced microchips.

New global division of labor

These are highly engineered and differentiated products, for which economies of scale are not especially important.

While chips are produced by the millions, or even billions, ASML ships only a few dozen of its EUV lithography machines per year.



While chips are produced by the millions, or even billions, ASML ships only a few dozen of its EUV lithography machines per year

Europe's surplus in such machinery can more than offset its deficit in chips themselves.

The EU also has a large trade **surplus in airplanes**—another specialized good that is not produced in massive quantities but does involve long-term customer relationships.

Europe's increasing bilateral deficit with China could be offset by higher exports of such specialized products to other markets.

Adapting to this new global "division of labor" will not be easy, but European policymakers

can and must facilitate the adjustment, especially by fostering greater flexibility in the economy and increased investment in research and development.

Crucially, any support governments provide to struggling industries should be tied to adjustment efforts. Attempting to prop up old structures is a losing proposition.

Daniel Gros is Director of the Institute for European Policymaking at Bocconi University.